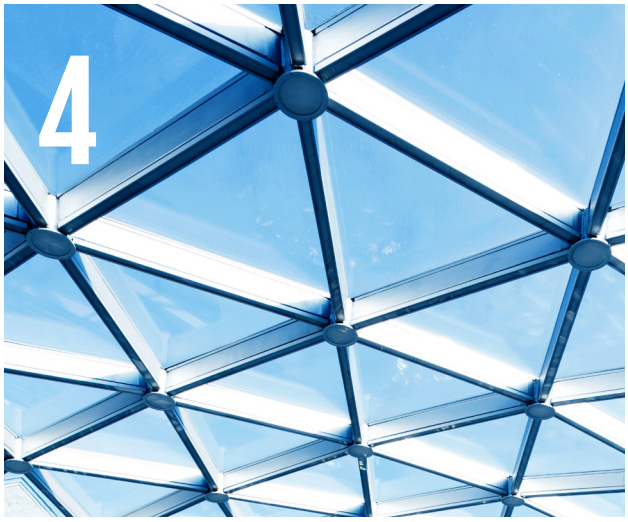
KPMG

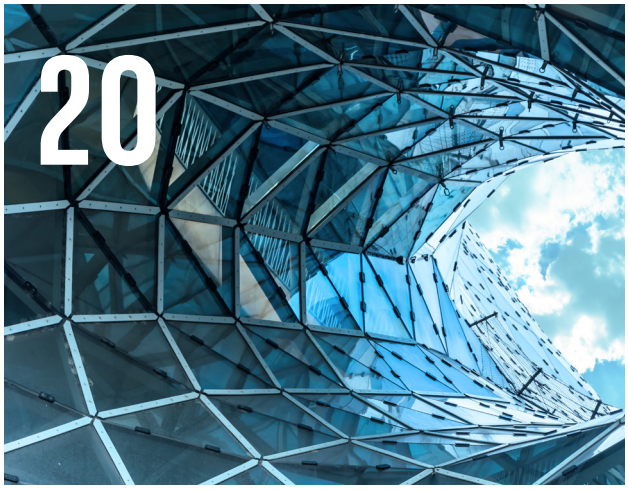
# Real Estate Tax Newsletter

Issue 01/2023

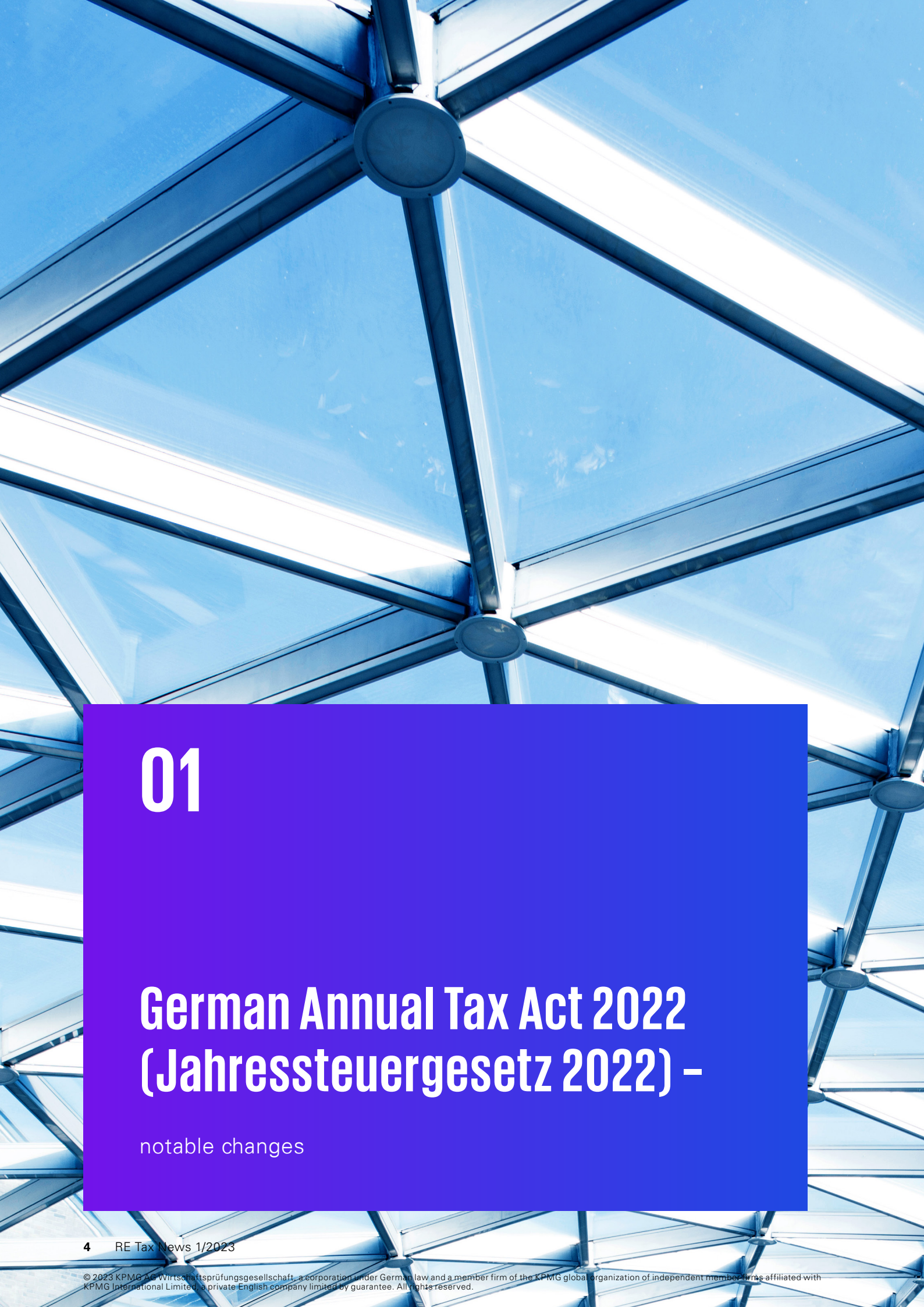









# Inhalt



# 01

# German Annual Tax Act 2022 (Jahressteuergesetz 2022) –

notable changes

The German Annual Tax Act 2022[1] (Jahressteuergesetz 2022, hereinafter "the Act") contains changes to the law that are especially relevant for the real estate sector. The Act has particular regard to the topic of renewable energy. The following post is a short description of particular changes brought in by the German Annual Tax Act 2022 and their consequences in practice.

### Tax exemption for small photovoltaic assets

Pursuant to the German Annual Tax Act 2022 (Jahressteuergesetz 2022, hereinafter "the Act"), income relating to the operation of a photovoltaic asset for s, single family homes (including outbuildings of such single family homes) or for non-residential buildings, where the photovoltaic asset is installed with a maximum output capacity of 30kW , remain tax- exempt. Similarly, where a photovoltaic asset is installed for other buildings, such as residential or commercial units, and where the photovoltaic asset installed has a maximum output capacity of 15kW per residential or commercial unit, income relating to the operation of said photovoltaic system remains tax exempt.

The tax exemption is limited to a maximum of 100kW per taxpayer or commercial partnership.

For asset administrating partnerships, the rules for commercial infection shall be wholly unapplicable as long as the aforementioned output limits are not exceeded.

For institutional investors such as pension funds who hold real estate via asset- administrating partnerships, the new regulations should not have a big effect due to the output limits foreseen. In this case, the risk that the partnership's whole activities are being commercially infected remains, with the consequence that in order to minimize the trade tax burden, the taxpayer would have to rely on the application of the extended trade tax deduction.

The Fund Location Act 2021 has fortunately eased the requirements to apply the extended trade tax deduction in the event that, in addition to rental income, income is also generated from the supply of electricity from renewable energies and charging stations for electric cars or electric bicycles as well as from other activities from direct contractual relationships with the tenants, so that not every secondary activity automatically leads to the complete denial of the extended trade tax deduction. However, due to the applied value limits for such ancillary services and also with regard to potential full trade tax burden upon sale of the property or the partnership interest, alternative structuring options such as outsourcing to n operating company ("OpCo") should still carefully be considered.

### Increase of depreciation rates on residential buildings to 3% and the remainance the possibility to demonstrate a shorter remaining useful life

The depreciation rate or residential buildings with completion of construction works after 31 December 2022was raised to 3% for the year. For already existing real estate there is no change to the applied depreciation rates.

The government's proposal to abolish the ability for the taxpayer to demonstrate a shorter remaining useful life has been abandoned in the course of the legislative process. As before, the possibility to demonstrate a shorter useful life and as a consequence increase the annual depreciation applied remains open to taxpayers.

### Increase of the value limits for "active entrepreneurial management" for certain activities (auB)

In order to qualify as a "Special Investment Fund", within the German Investment Tax Act (InvStG) the Fund may not actively and entrepreneurially manage its assets to a significant extent. If these requirements are violated, there is a risk that the Fund would lose its status as a Special Investment Fund which would lead to an automatic crystallization of all existing unrealized gains at fund level.

1 *JStG 2022 of 16 December 2022, promulgated in the Federal Law Gazette on 20 December 2022 (BGBl. I 2022, p. 2294).*

Up to this point, no active entrepreneurial management of the assets was assumed, in so far as the income from such activity amounted to less than 5% of the income of the investment fund.

In the Annual Tax Act the value limit has been raised to 10% in respect of income derived from the operation of electricity-producing installations which qualify as renewable energy under Section 3, Number 21 of the Renewable Energy Act (EEG), as well as for income from the operation of charging stations for electric vehicles or electric bicycles. As a consequence of the link to the catalogue EEG, income derived from the production of heat or energy from a combined heat and power ("CHP") system is not covered by the new rules and still falls under the 5% limit. The efforts of lawmakers to raise the relevant value limits are generally to be welcomed. Against the background of the substantial negative consequences that the loss of status entails due to the mandatory exit-taxationwith funds are likely to continue to act cautiously in the future.

Here it would be desirable for lawmakers to rethink the approach to be taken, in particular with regard to the growing importance of ESG for investors and fund managers andin order to prevent tax factors from becoming an obstacle for funds to actively participate in the transition to renewable energies, due to their significant side effects.

### Zero rate of tax for deliveries of photovoltaic assets

For the delivery of specified photovoltaic assets and related components the tax rate for VAT purposes will be reduced to 0%. In order to apply the zero rate of tax, the photovoltaic assets need to installed and located in or near apartments as well as public and other buildings, which are used for a used for an activity serving the common good.

For simplicity, the preconditions should be considered to be met if the gross maximum output of the photovoltaic system is no more than 30kW.

## Conclusion/Key Facts

The efforts of the legislator tto bring the topic of energy transition more into focus also in a tax context is a step in the right direction; however, the efforts do not go far enough when it comes to institutional investments. The discussions in the market environment have shown that the industry is open to making a larger contribution to the energy transition. The legislator is therefore required to create the right regulatory and tax framework for that.

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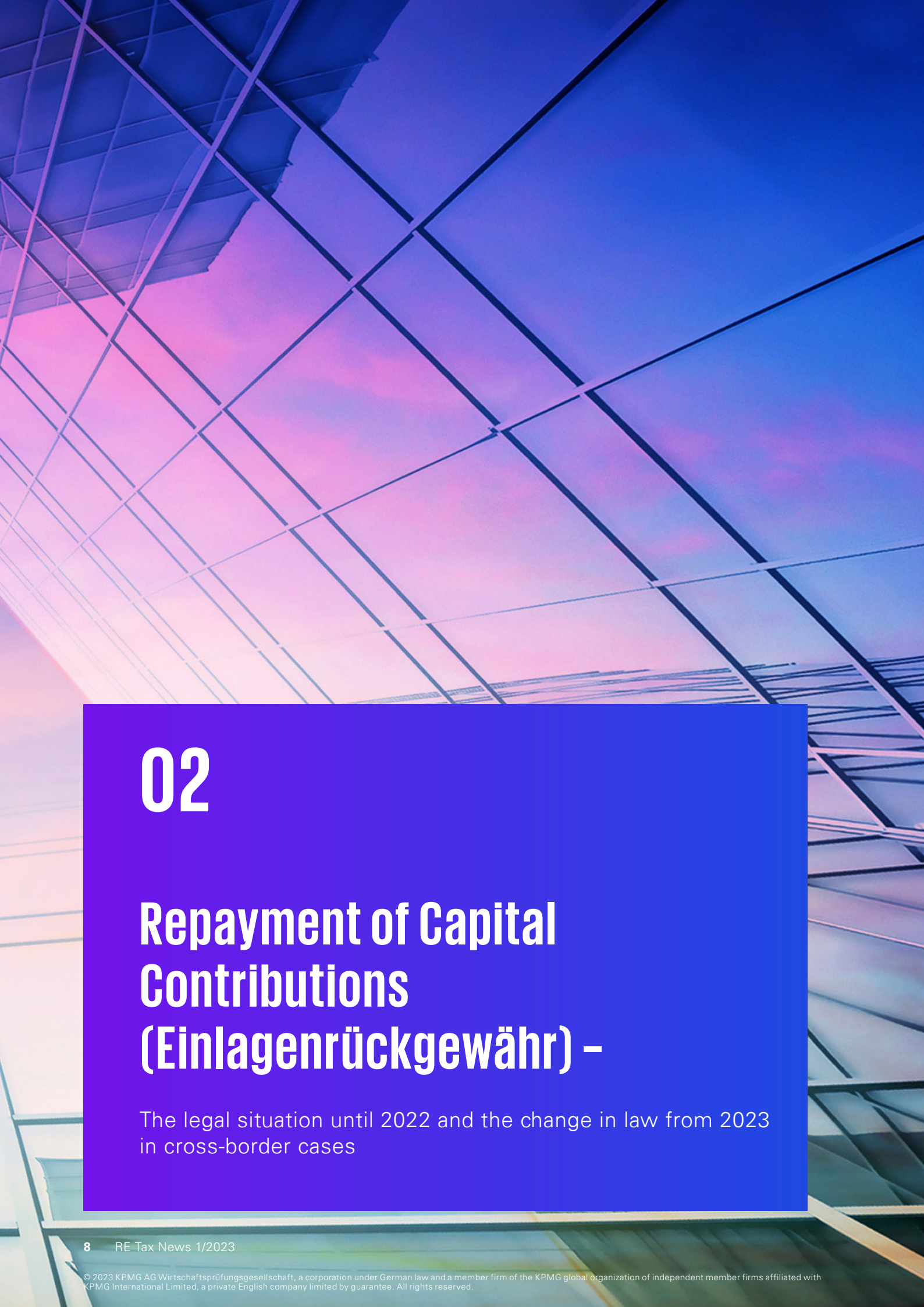

# 02

# Repayment of Capital Contributions (Einlagenrückgewähr) –

The legal situation until 2022 and the change in law from 2023 in cross-border cases

## The legal situation until 2022 and the change in law from 2023 in cross-border cases

The outflow of money from a corporation may be treated as a dividend distribution or the repayment of capital.

Due to the differing tax treatment, the distinction at the level of the shareholder is, in practice, especially relevant.

While dividends (depending on the legal form of the shareholder) are at least partially subject to tax; under certain preconditions, capital may be repaid completely tax-free.[1]

In respect of cash outflows from a foreign corporation, however, the preconditions have so far been insufficiently regulated by law and depend on whether the corporation is resident in the EU, EEA or a third country. This leads to numerous questions of doubt and to a practice shaped by Guidance provided by the Federal Ministry of Finance (BMF) and case law.

Through the Annual Tax Act 2022 (JStG 2022)[2] the preconditions for a tax-free repayment of capital from a foreign corporation will be uniformly provided for in law from 2023 onwards.

### Status quo

Solely for issuing corporations, which are themselves resident in another EU member state, Section 27, Paragraph 8 of the Corporate Income Tax Act (KStG) contains the following three preconditions for a tax-free repayment of capital:

- The issuing entity must be subject to an unlimited tax liability in another EU member state and be able to distribute its profits.
- An application was made by the foreign entity (invariably to the Federal Central Tax Office, BZSt) for special determination on the repayment of capital. This determination should be sought in the subsequent calendar year, to when the outflow took place (i.e., the outflow takes place in the prior calendar year to the special determination application).
- Observance of the so-called "order of application" within the meaning of Section 27 (1) Sentence 3 of the Corporate Income Tax Act (KStG) and presentation of the facts necessary for calculating the repayment of capital: that means a tax-free repayment of capital can then only exist insofar as it exceeds the distributable profit determined at the end of the previous financial year (the so-called subordination of the capital repayment to a dividend for tax purposes).

Where one of the conditions is not met, the outflow is treated as a taxable dividend.

The first condition can be contentious, especially where a capital repayment is made from a hybrid EU Fund. For example, the Lower Tax Court of Cologne[3] decided that a French investment fund was not eligible to apply.

Because in the case at hand, the fund was a transparent vehicle under French law (assets from a German perspective), so that there was no certificate from the French tax authorities on unlimited tax liability.

But, according to the Lower Tax Court of Cologne, it is possible and necessary, at the level of the individual investors, to enforcement a capital repayment within the framework of its own taxation procedure, because otherwise, this would violate the free movement of capital.

With regard to the second requirement, it should be noted that, in practice, this is a non-extendable cut-off period and that the application requirement also applies to nominal capital repayments.[4]

The third requirement (proof that the capital repayment exceeds the distributable profit) leads, in practice, to problems in its application:

Since foreign corporations, unlike domestic German ones, do not usually keep a tax-specific capital contribution account , a complex „shadow calculation" for several years is necessary in individual cases, in order to prove that the "order of application" has been observed.

The recognition of such evidence is often found to be controversial by Federal Central Tax Office (BZSt).

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1 *See § 27 KStG.*
2 *Promulgated in the Federal Law Gazette on 20.12.2022 (BGBl. I 2022, p. 2294).*
3 *Judgement of 22.06.2022, 2 K 2607/19, appeal to the BFH was admitted.*
4 *See BMF Guidance of 04.04.2016.*

## Federal Ministry of Finance Guidance from 21.04.2022

In contrast to those situated in the EU, for issuing entities in the EEA and third countries, there is currently no legal regulation governing their treatment.

The tax authorities therefore assumed for a long time that in such cases there were always taxable dividends. However, the Federal Tax Court[1] (BFH) has decided that a tax-free repayment of capital contributions can also be made by a company domiciled in a third country. The "order of application" should also be observed, and the amount of the distributable profits determined according to the respective foreign commercial and company law.

Since the Corporate Income Tax Act (KStG) does not provide for a separate determination procedure for the repayment of capital from third-country companies, the related questions can only be clarified within the framework of the respective taxation procedure at level of the shareholders.

In its official statement of 21 April 2022, the Federal Ministry of Finance (BMF) recognized the Federal Tax Court's (BFH) guidelines in third-country cases and established further principles. The Federal Ministry of Finance's (BMF) official statement contains the following core points:

1. Third country corporations

- Repayments of nominal capital: tax-neutral possible
  - Evidence of appropriate documents, in particular relating to the decision on the nominal capital reduction and repayment
  - Section 7 Para. 2 of the Tax Capital Increase Act (KapErhStG) is to be observed: where capital reduction within 5 years after the issue of new share rights and repayment occurs → dividend
- Where the repayment of contributions is not made from the nominal capital, a tax neutral position is possible, taking into account the "order of application":
  - By deriving the partial amounts from the foreign commercial balance sheet of the previous year: i.e., distributable profit, subscribed capital and contributions not made to the nominal capital (e.g., capital reserve)
  - Documents for determining the return of capital (to be submitted by the shareholder in German), i.e.
    - Proof of the unlimited tax liability of the distributing corporation in a third country for the requested period;
    - Amount of the domestic shareholder's participation;
    - The resolutions and evidence of the distribution made;
    - The foreign balance sheet.
- „Notification" of the return of contributions at the level of the shareholder in their tax assessment and within the framework of the deadlines to be observed for their tax assessment.

2. An EEA corporation (Norway, Iceland, Liechtenstein)

- Principle: Application of regulations for EU corporations (Section 27, Para. 8 Corporation Tax Act ,KStG), including application requirements and application deadline: by the end of the following calendar year;
- However: application of the third-country regulations if the application was not submitted by the deadline (by the end of the calendar year following the calendar year in which the benefit was provided).

Since the BMF Guidance is to be applied in all open cases, affected companies should examine legal remedies where the tax authorities have treated the services as taxable in the past.

## Legal changes through the Annual Tax Act 2022

The Annual Tax Act 2022 contains an extension of Section 27 (8) Corporation Tax Act (KStG) to EEA and third-country companies. The new version of Section 27 (8) (KStG) is to apply for the first time to benefits and nominal capital repayments after 31 December 2022. From 2023, uniform conditions will be created for a tax-free return of contributions from foreign companies, regardless of where they are resident. A timely application by the foreign company will therefore always be a prerequisite for a tax-free return of capital contributions.

Section 27 (8) Corporation Tax Act (KStG) was also amended in detail by the Annual Tax Act 2022 as follows:

1 *See BFH, judgement of 13.07.2016, VIII R 47/13, BStBl. II 2022, p. 263; of 10.04.2019, I R 15/16, BStBl. II 2022, p. 266.*

- Payments: explicit recording of nominal capital repayments,
- Assessment period: „For the financial year“ instead of „for the assessment period“,
- Application period: “By the end of the 12th month following the end of the financial year in which the service was provided” instead of “by the end of the calendar year following the end of the calendar year in which the service was provided” ,
- Certificate to be provided to the shareholders: “By the foreign company” instead of “by theFederal Central Tax Office (BZSt)”.

## Conclusion/Key Facts

The requirements for a tax-free receipt of a return of contributions from foreign corporations will be uniformly regulated from 2023. Until then, depending on the country of residence of the issuing foreign corporation (EU/EEA or third country), some different requirements for tax-free collection remain.

Affected domestic shareholders should therefore check:

- whether the issuing corporation is domiciled in an EU/EEA or third country,
- the type of return of capital contributions (nominal capital repayment or return of capital reserves),
- in which year the capital contributions were returned (uniform requirements will only apply from 2023),
- and whether the conditions for receipt of the funds are met in each case in order to receive them tax-free.

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# 03

# Annual Tax Act 2022 –

Threat of double taxation with real estate transfer tax in case of omitted or delayed notification of share deals

According to the Annual Tax Act 2022[1], a double liability to real estate transfer tax ("RETT") threatens e.g. in a standard everyday case where 100% of the shares in a real estate-owning company are sold and transferred to a purchaser, but timely and complete RETT notifications for the signing and closing were not made.

In order to describe the problem as simply and briefly as possible, only the standard case (selling and transferring 100% of a company owning German real estate) will be discussed below, even though double assessment may occur in more complex cases.

### Previous view

In the case of a direct or indirect transfer of shares in real estate-owning companies, two taxation situations come into consideration at least since 1st July 2021, which are presented in a highly simplified manner below:

Firstly, the so-called "Share-Unification" pursuant to section 1 para. 3 or 3a Grunderwerbsteuergesetz (German RETT Act, "RETTA"). These provisions tax the direct or indirect unification of 90% or more of the shares or interest in a company owning German real estate in the hands of the purchaser. As a rule, RETT arises with the so-called signing (i.e. the signing of the contract under the law of obligations) and is assessed against the acquirer of the shares.

Furthermore, the so-called "Change-of-Shareholder" triggers RETT pursuant to section 1 para. 2a RETTA (for partnerships) or pursuant to Section 1 para. 2b RETTA (for corporations). In the case of the Change-of-Shareholder, the direct or indirect transfer of 90% or more of the shares or interest in a company owning German real estate to one or more new shareholders within 10 years is taxed. RETT is triggered with the so-called closing (i.e. the transfer of shares or interest) and is assessed against the company owning the land.

Accordingly, in the event of the sale and transfer of, for example, 100% of the shares in a company owning German real estate to a purchaser, the question arises as to whether RETT is triggered according to the Share-Unification or to the Change-of-Shareholder or whether the transaction is taxed under both provisions and thus, twice.

Until approximately November 2021, the general opinion was that a taxation as Share-Unification pursuant to section 1 para. 3 or 3a RETTA is not applicable as long as a Change-of-Shareholders pursuant to section 1 para. 2a or 2b RETTA is still possible, i.e., as long as a share or interest transfer is possible.

In other words, it was undisputed that RETT could only be assessed against the purchaser for the signing by way of Share-Unification, as an exception, if the closing had finally failed. This is the case, for example, if an approval requirement or a condition precedent was agreed in the share purchase agreement for the transfer of the shares and the approval is finally refused or the condition precedent can no longer be fulfilled.

As a result, the sale and transfer of, for example, 100% of the shares was taxed only once, usually as a Change-of-Shareholder. As a rule, the tax debtor was the company owning the land.

### Changed view of the tax authorities

At the latest with the publication of the RETT guidelines as of 10th May 2022, regarding the application of section 1 para. 2a and section 1 para. 2b RETTA the tax authorities are of the opinion that the unification of 90%, or more, of the shares in a company owning real estate in the hands of a new shareholder can be taxed at the signing as Share-Unification (section 1 para. 3 or 3a RETTA) and again at the closing as Change-of-Shareholder (section 1 para. 2a or 2b RETTA).

However, the tax guidelines stipulated that the entire transaction (sale and transfer of e.g., 100% of the shares) should be taxed as before only at closing, on the level of the company owning the real estate, provided closing was to be expected within one year after the tax authorities became aware of the signing.

1 *JStG 2022 of 16 December 2022, promulgated in the Federal Law Gazette on 20 December 2022 (BGBl. I 2022, p. 2294).*

If closing was not expected within one year after the tax authorities became aware of the signing, RETT should be assessed against the purchaser as Share-Unification. At closing, RETT should then again be assessed against the company owning the real estate as Change-of-Shareholder. However, the tax assessment against the purchaser could, according to the controversial opinion of the tax authorities, only be revoked if the tax had been assessed subject to review (Section 164 General Tax Code, AO), or, where an objection had been raised against the tax assessment of the purchaser. Otherwise, in the opinion of the tax authorities, double taxation occurred.

There are serious reservations about this view. From our point of view, appeals and lawsuits against a possible double RETT assessment were promising, due to this legal situation.

### New legal situation through the entry into force of Section 16 para. 4a and 5 RETTA in the Annual Tax Act 2022

This situation, which was also unsatisfactory from the perspective of the tax authorities, is to be remedied by section 16 para. 4a and 5 RETTA in the Annual Tax Act 2022. Pursuant to section 16 para. 4a RETTA, the RETT assessment against the acquirer due to the Share-Unification is to be amended or cancelled upon application, where a Change-of-Shareholders is later realized at the level of the company owning the real estate as a result of the closing. However, this shall only apply if both the signing and the closing have been notified in due time and in full (section 16 para. 5 RETTA). The deadline is 14 days after the event in the case of a domestic acquirer or a domestic land-owning company.

The one-year deadline from the above-mentioned tax guidelines as of 10th May 2022 is missing in the new law. From this, it can be concluded that in future, in the case of sale and transfer of, for example, 100% of the shares, a RETT assessment should always be made for the signing and one for the closing. However, the RETT for the signing can only be waived upon application, when the signing and closing are reported in full and in due time. If one of the two notifications has not been made, or has been made late or incompletely, it is to be feared that, from the point of view of the tax authorities, the double RETT assessment will remain.

The Annual Tax Act lacks an application regulation with regard to section 16 para. 4a and 5 RETTA, meaning that it could also apply to circumstances prior to its entry into force (i.e., on 21 December 2022). If, due to missing or untimely notifications for signing or closing, transactions completed before 21 December 2022 were taxed double, there should be a genuine unconstitutional retroactive effect, so that legal action has good prospects of success in this respect.

## Conclusion/Key Facts

**Recommendation for action**

Where, for example, all shares in a company owning real estate are sold and transferred to a purchaser, it is imperative that signing and closing be reported in full and in due time. Should this not be done, there is a risk of fines, penalties and late payment surcharges, as well as double RETT, once for the purchaser of the shares, and once for the company owning the land. Appeals against the double assessment of RETT should have only moderate prospects of success for transactions after 21 December 2022. The same should apply to applications for equitable relief.

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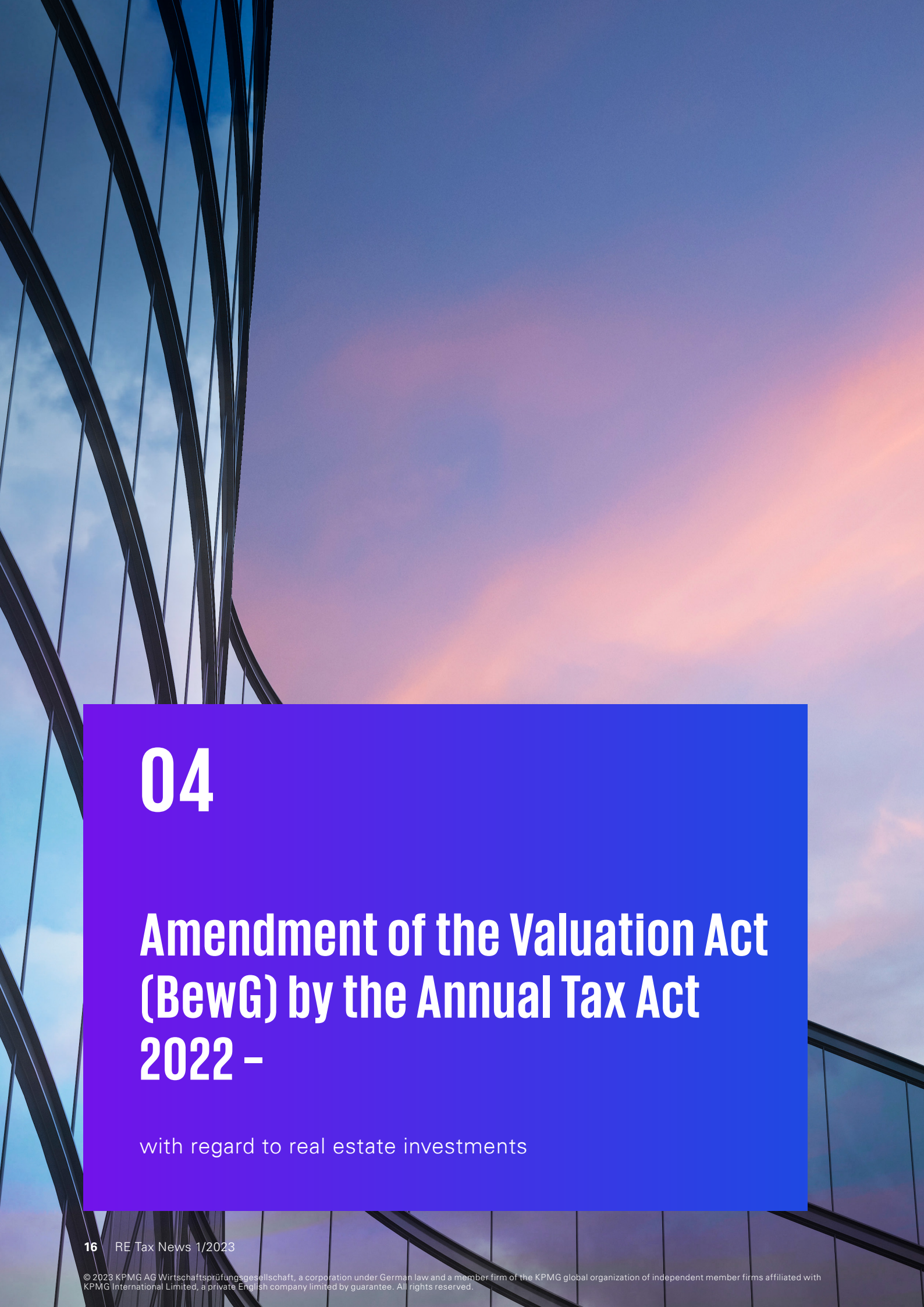

# 04

# Amendment of the Valuation Act (BewG) by the Annual Tax Act 2022 –

with regard to real estate investments

The Annual Tax Act 2022 passed on 16 December 2022[1] amended the Valuation Act (BewG), in particular in the area of real estate valuation (needs-based valuation). The real estate valuation is applied in the case of gratuitous real estate transfers in the context of inheritances or gifts and in the case of significant changes in the shareholder structure of a partnership or corporation in the context of real estate transfer tax. However, these changes have no effect on the property tax values after the property tax reform, which are also regulated in the Valuation Act (BewG).

The valuation of real property was most recently fundamentally reformed by the Inheritance Tax Reform Act 2008, taking into account the decision of the Federal Constitutional Court of 7 November 2006, in close accordance with the recognised regulations for determining market value on the basis of the Building Code (BauGB). In the process, the market value was established as the guiding valuation standard for inheritance tax law. Section 194 of the Building Code (BauGB) contains a definition of the market value, the determination of which is specified by Section 199 (1) of the Building Code (BauGB) in conjunction with the Real Estate Valuation Ordinance (ImmoWertV).

The property valuation is based on the Real Estate Valuation Ordinance (ImmoWertV) in terms of content, however, in order to achieve practicable bulk management, it provides for standardised lump-sum valuation regulations, which, however, can always be refuted by a lower market value appraisal. This is often indicated if there are special property-specific characteristics. The Valuation Act (BewG) provides for three standardised valuation procedures based on the Real Estate Valuation Ordinance (ImmoWertV), namely the comparative, the income and the asset-valuation method.

The Real Estate Valuation Ordinance (ImmoWertV) was substantially revised in 2021 and the regulations on the determination of market value were adapted to developments in this area. The new Real Estate Valuation Ordinance (ImmoWertV) is intended to ensure the application of uniform principles in determining the data required for the valuation, in particular, in the interest of the usability of the data, determined by the valuation committees and to be communicated to the tax offices pursuant to Section 193 (5) Building Code (BauGB) for tax valuation.

With the amendments to the Valuation Act (BewG), which are now in the Annual Tax Act 2022, in particular the income and asset-valuation method for the valuation of developed land as well as the procedures for valuation in cases of heritable building rights and cases with buildings on third-party land are adapted to the amended Real Estate Valuation Ordinance (ImmoWertV).

The comparative value procedure for single-family and two-family houses as well as condominiums is not changed by this. However, there are changes in the area of rented residential and commercial properties, as well as mixed-use properties and those where no comparative values are available, for which the income or asset-valuation method is applied.

In particular, these amendments are intended to ensure that the other data required for the valuation determined by the expert committees for land values on the basis of the Real Estate Valuation Ordinance (ImmoWertV) can continue to be used appropriately in land valuation for the purposes of inheritance and gift tax as well as land transfer tax, taking into account the principle of model conformity.

In the process, definitions such as for apartments were standardised, the law was adapted to case law and regulations such as the mathematical determination of the age of a building were included. In addition, the valuation of leasehold cases and buildings on third-party land was adapted to the valuation arithmetic of the Real Estate Valuation Ordinance (ImmoWertV). Furthermore, all declarations of valuation may now only be submitted electronically and paper form is only permitted in exceptional cases. The new regulations apply to valuations after 31 December 2022.

1 *Promulgated in the Federal Law Gazette on 20 December 2022 (BGBl. I 2022, p. 2294).*

### Significant changes in the capitalised earnings method

The capitalised earnings method is generally applied to residential rental properties, such as apartment buildings, and commercial properties for which a typical rent can be determined. The starting point of this method is the rental income, which, taking into account the operating costs and a deductible land value interest rate depending on a property interest rate and a capitalisation factor, results in a building income value, to which the land value is added. This system does not change in principle.

In the area of the capitalised earnings value method, the operating costs are now determined as a lump sum in accordance with the Real Estate Valuation Ordinance (ImmoWertV). This means that only the management costs (administration, maintenance and loss of rent costs) from the statutory system can be used instead of the empirical rates determined by the appraisal committees. The preconditions, when the property interest rates are determined by the expert committees, can be applied were specified. If the conditions for application are not met, the interest rates determined in the law are to be applied as a substitute. The interest rates were adjusted to the current market level from the legislator's point of view. In the process, the interest rate for residential rental properties was reduced from 5% to 3.5%, which, viewed in isolation, leads to considerable increases in value depending on the remaining useful life. In addition, the total useful life for building types with predominantly residential use was increased from 70 to 80 years in accordance with the regulation of the Real Estate Valuation Ordinance (ImmoWertV), which in turn leads to increases in value compared to the old regulation.

In the case of a 30-year-old apartment building with 4 flats, each with 100 sqm of rental space and a rent of €10/sqm, even just the reduction of the statutory property interest rate, all other things being equal, leads to an increase in value of more than 25% compared to the regulations which are applicable until 31 December 2022. Not as high, but still serious, are the effects of the reduction of the property interest for mixed-use properties and commercial properties with interest rate reductions of 1% and 0.5%. Although this is intended to bring the property interest rates in line with the general market level, this is most likely already outdated again due to the rapid increase in financing interest rates in the last 12 months. The extension of the total useful life of residential properties leads to a not inconsiderable increase in the value of the real estate compared to the old regulation. In the example case, the value increases again by approx. 10%, so that overall, the new valuation procedure leads to an increase in value of approx. 35% for the above-mentioned apartment building. This is not uncommon in the area of the income capitalisation approach.

### Significant changes to the asset-valuation method

The asset-valuation method, as a standard procedure, is used for owner-occupied apartments as well as for detached and semi-detached houses, where no comparable values are available, as well as for business properties and mixed-use properties for which no customary rent can be determined. Based on the standard production costs and taking into account wear and tear, an actual building value is determined which, together with the land value, represents the real value of the property using a value figure.

In respect of the tangible asset-valuation method - again with regard to the Real Estate Valuation Ordinance (ImmoWertV) - a regional factor and an age value reduction factor are added when determining the building's tangible asset value and the value figures are adjusted to the general market level in the absence of appraiser information.

Here, too, the useful life of buildings with predominantly residential use is extended from 70 to 80 years. The new regional factor introduced into the Valuation Act (BewG) takes into account the fact that the production costs of a building are also based on market conditions and are regularly higher in conurbations than in rural regions. This factor is determined by the expert committees. If this is not available, the regional factor is uniformly 1.0.

In terms of content, the factor of wear and tear corresponds to the previous value taken for a wear and tear reduction, i.e., the determination of a reduction in the value of the building, so that no changes result from this.

However, the adjustments to the flat-rate value figures have a greater impact, where the appraisal committees do not provide suitable tangible assets. The value figure is determined as a function of the standard land value and the provisional material value. If, for example, this amounts to more than €500,000 for a building, a standard land value of €500/sqm resulted in a value figure of 0.9 to the end of 2022. This now amounts to 1.3. This alone results in an increase in value of approx. 45%. All in all, the values are consistently higher than the previous values.

## Conclusion/Key Facts

In many cases, the previous valuation rules led to a considerably lower tax valuation than the actual market values due to lump sums or standardisation, and parameters that were not in line with the market. By adapting the Valuation Act (BewG) to the new regulation of the Real Estate Valuation Ordinance (Immo-WertV), this supposed advantage will no longer exist in the future, which is also appropriate against the background of uniform taxation.

The adjustments relate exclusively to the income-valuation approach and the asset-valuation approach. This means that the transfer of the single-family house or the condominium is not affected by this, as the comparative value method is regularly applied for these. Only if no comparative value factors are available from the appraisal committees, as is sometimes the case in rural regions, does the asset-valuation method apply here as well.

The Valuation Act (BewG) is now geared even more than before towards the provisions of the Real Estate Valuation Ordinance (ImmoWertV). This is a trend that has already found its way into the case law of the Federal Fiscal Court (BFH). Recent rulings on the determination of the remaining useful life of buildings (ruling of 28 July 2021, IX R 25/19) and the allocation of the acquisition costs of a property to the assets, buildings, and land (ruling of 20 September 2022, IX R 12/21) are worth mentioning. In both cases, the Federal Fiscal Court (BFH) followed the calculations of the Real Estate Valuation Ordinance (ImmoWertV), and the model approaches applied there.

Furthermore, the Valuation Act (BewG) does not provide for consideration of special property-specific property features such as special income ratios, construction defects and structural damage, soil contamination, property-related encumbrances or specific location features. In all these cases the way remains via the opening clause of § 198 BewG, which allows the proof of a lower market value on the basis of a market value expert opinion. Based on this, it can be assumed that the number of cases in which a market value appraisal leads to a lower value will increase in the future. Design elements such as the granting of a usufruct will be used more than before, especially in the case of anticipated successions.

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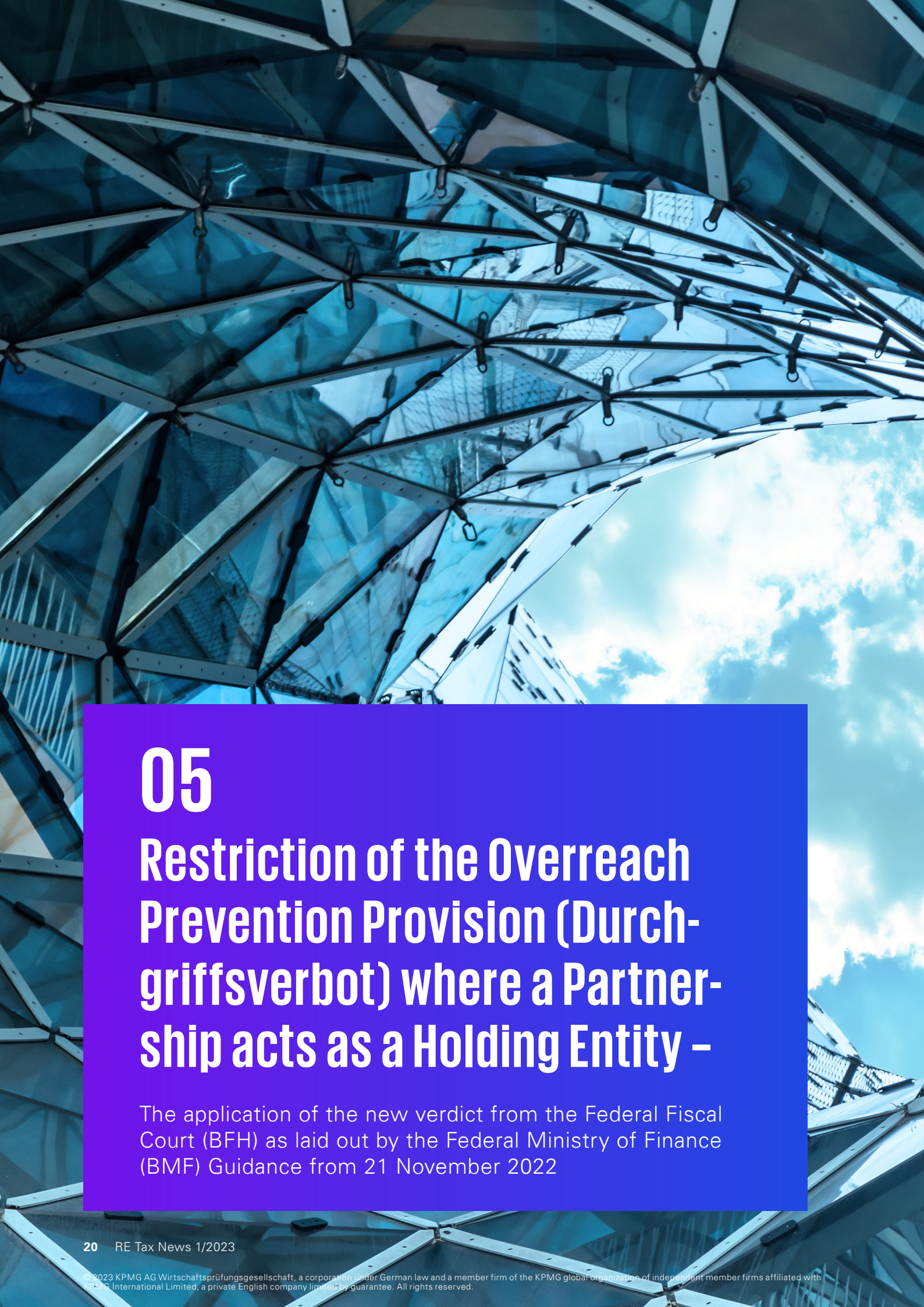

# 05

# Restriction of the Overreach Prevention Provision (Durchgriffsverbot) where a Partnership acts as a Holding Entity –

The application of the new verdict from the Federal Fiscal Court (BFH) as laid out by the Federal Ministry of Finance (BMF) Guidance from 21 November 2022

In practice, real estate used for business purposes is often held through property holding companies (PropCo) and leased to operating companies (OpCo). PropCo then uses the extended trade tax deduction and thus, reduces the overall tax burden.
Contrary to the previous view, the German Federal Fiscal Court (BFH) recently decided that the extended deduction should be denied if the same group of shareholders have an interest in the OpCo where those same shareholders also indirectly control a PropCo in the legal form of a partnership via a corporation. A new ministerial guidance outlines that this updated verdict is only to be applied from the 2024 assessment period.

### The Previous Situation: Renting between PropCo and OpCo

In order to optimize the tax burden with regard to commercially used real estate, in many cases, in practice, the real estate is held in a separate holding company (PropCo), which then leases the real estate to the operating company (OpCo). PropCo should, thus, be able to deduct the rental income from its trade tax base (extended trade tax deduction under Section 9, Number 1, Sentence 2 ff. of the Trade Tax Act [GewStG]) effectively reducing its trade tax burden to nil. As an operating expense, the rent reduces the tax base of the OpCo and is received by the PropCo free of trade tax, should the conditions for deduction be met.

The extended deduction among other things is denied, where the real estate is available for use by an associate of the business (Section 9, Number 1, Sentence 5, Number 1 GewStG) or where a business has been split into a holding company and an operations company in a specific manner (Betriebsaufspaltung).

Since, in these cases, the property is held and used within a group of companies, the question arises as to whether the intragroup lease inhibits availing of the extended trade tax deduction. A splitting-up of a business which is harmful for the application of the extended trade tax deduction presupposes that the PropCo lets a business asset to the operating company (and have "objective interdependence") and that the individuals behind the two companies can come together to achieve a united willingness to act (thus have "personal interdependence").

### Previous case law: No looking through the corporate veil

In respect of the OpCo, according to previous case law, the use of a corporation did not protect it against the assumption of "personal interdependence" and as such, a splitting-up of the business would be harmful to the extended trade tax reduction.

In contrast, jurisprudence was more favorable for the PropCo: i.e., where a corporation was admitted as a member of the partnership which acts as the PropCo, "personal interdependence" was prevented. Resultantly, the extended tax reduction was granted in such cases.

The reason for this lay with the respect of the corporate veil (Durchgriffsverbot): i.e., the corporation was viewed as a separate, independent company that made its own decisions, following the principle of separation. According to this view, "personal interdependence" could not be present. This would have required an explicit provision of the law, which was and is still not provided for in law.

### The new verdict of the Federal Fiscal Court (BFH)

With the judgment of September 2021[1], the Federal Fiscal Court (BFH) changed its verdict. In simple terms, the judgment was based on the following facts (see Figure 1).

The plaintiff was a "GmbH & Co KG" (i.e., a limited partnership where a limited liability company is a member and typically acts as the general partner) that rented a company property to M KG (i.e., a limited partnership).

The limited partners of the Gmbh & Co KG, who had no management authority, were a group of shareholders who also held the shares in the BV GmbH. This BV GmbH had been appointed to act as the general partner of the GmbH & Co KG. In addition, the members were 100% limited partners of M KG via H GmbH and also held 100% of the shares in its general partner, V GmbH.

The essential and new message of the decision is that a "personal interdependence" can exist, and as such, a harmful curtailment of the business-split can occur, even where indirect control of the holding company is exercised through a corporation.[2] The indirect control of the plaintiff by the group of shareholders in BV GmbH would then be enough to assume a "personal interdependence" between the plaintiff and M KG.

The Federal Fiscal Court explicitly asserts that it sticks to the assumption that the property is available for use by a shareholder when the property is owned by a PropCo which itself is indirectly held by a corporation.[3]The screening effect of the corporate veil inhibits the look-through to the indirect shareholders. In the case of the decision, however, the case was different, because the shareholder group held a direct stake in the plaintiff and held indirect control of BV GmbH, as general partner; and, according to the changed verdict, this led to a "personal interdependence".

### The Rules of Application vis-á-vis Guidance from the Federal Ministry of Finance (BMF)

In order to protect confidence, the letter from the Federal Ministry of Finance of 21 November 2022 outlines that indirect participation in HoldCos in the form of partnerships via corporations are only to be taken into account from the 2024 assessment period.

Thus, those effected have a year to review their corporate structuring and where necessary, make adjustments. In addition, the Federal Ministry of Finance (BMF) explicitly asserts that the case law regarding the lack of "personal interdependence" between associated companies still applies.

## Conclusion/Key Facts

The Federal Fiscal Court (BFH) decided that the extended tax reduction is denied where the same group of shareholders, who participate in the OpCo, control a PropCo in the legal form of a partnership indirectly through a corporation.

According to the Guidance from the Federal Ministry of Finance[4], the verdict is applicable only from 2024 onwards. Those affected should therefore, use the time to review their corporate structures and where necessary, make adjustments.

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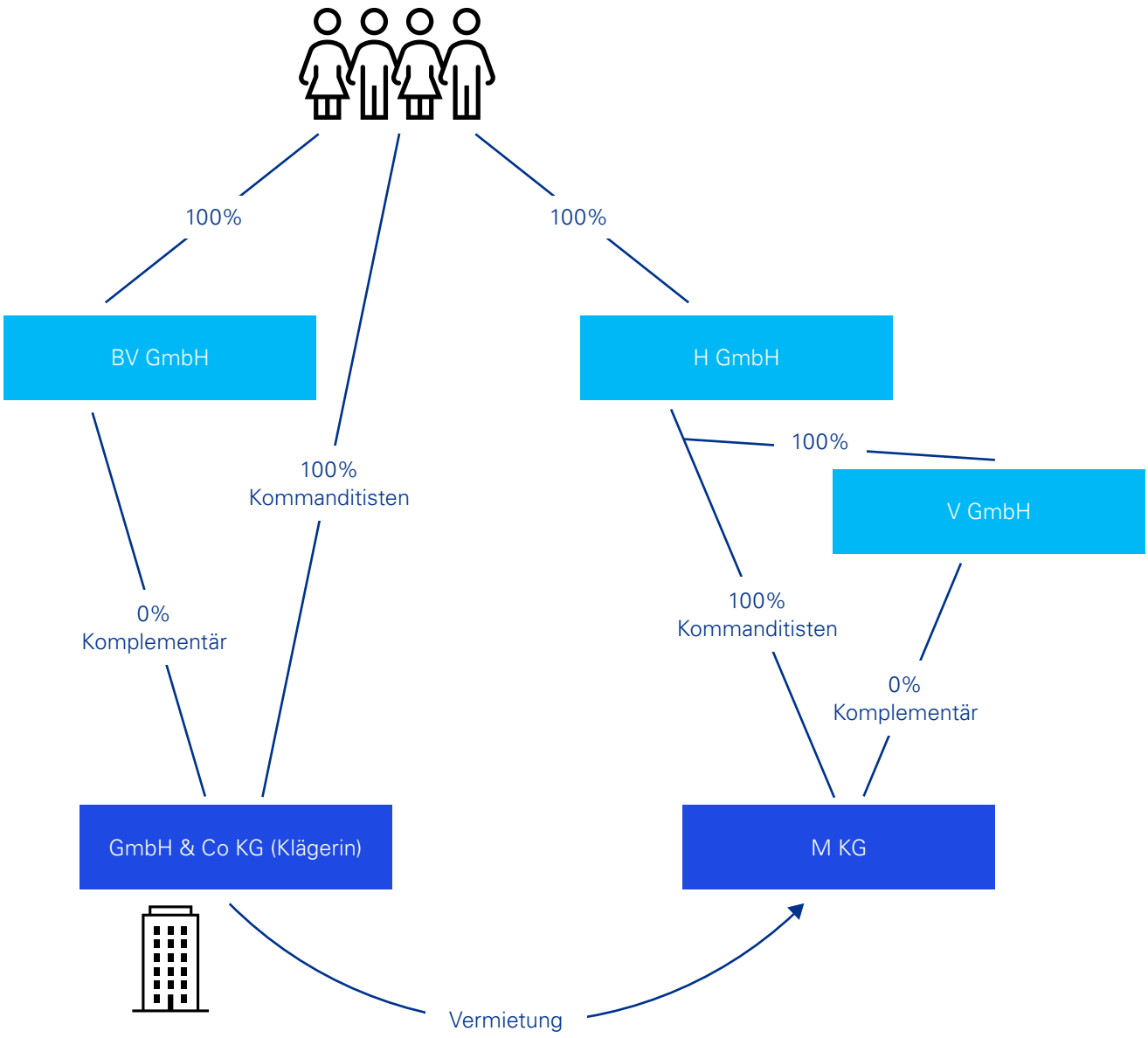
1 *BFH, judgement of 16 September 2021, IV R 7/18, BFH/NV 2022, p. 377.*
2 *BFH loc.cit. Note 1*
3 *BFH loc.cit. Note 1*
4 *IV C 6 – S 2240/20/10006 :002.*

Figure 01:
**shareholding structure**




*Source: Simplified representation of the Federal Financial Court ruling*

# 06

# Transfer pricing aspects for intra-group real estate financial transactions –

Current challenges against the background of the current economic development and the enforcement of transfer pricing regulations

Intra-group cross-border real estate transactions will continue to develop dynamically in 2023 - despite the expected challenging economic environment (especially with increasing financing costs and inflation). The core material issue from a transfer pricing perspective continues to be the tax deductibility of intra-group interest expenses, both on the merits and regarding the amount, against the background of the most recently substantiated German transfer pricing regulations and respective case law.

After a long-lasting period of low interest rates, the interest rate for EUR mortgage loans with ten-year fixed interest rates almost quadrupled from one to almost four percent within nine months in 2022. A comparable increase can also be observed for unsecured and subordinated loans. From a tax point of view, this increase plays a role in particular when so-called shareholder loans or generally intra-group loans are used to finance cross-border investments between related parties. The resulting increase in financing costs will attract the already increased attention of the tax authorities and will thus, be the focus of future tax audits. Therefore, the determination of the interest rate should be in line with the current transfer pricing regulations and case law.

Until the publication of the Administrative Principles governing Transfer Pricing by the German tax authority dated 14 July 2021 (Administrative Principles 2021), there were no specific tax regulations in Germany on the implementation of arm's length pricing for intra-group financial transactions. Partly due to this circumstance, the transfer pricing method applied (predominantly the comparable uncontrolled price (CUP) method) or the interest rate was therefore, regularly the subject of controversial discussions tax audits of cross-border real estate financing. The Administrative Principles of 14 July 2021 now refer to the OECD Transfer Pricing Guidelines, in particular Chapter X „ Transfer pricing aspects of financial transactions „, and also specify them in more detail. As a result, it should be noted that, in principle, the (external) CUP method is to be preferred, as sufficient comparable data is available, especially for financial transactions. At the same time, however, the internal CUP should not be disregarded. Only where no comparable external transactions are available, the transfer price for intragroup loans can - under certain circumstances - also be determined according to the „cost of funds" approach, which has been the preferred approach of the German tax authority for inbound loans in the past. This approach is based on the lender's cost of funds and has been rejected by the highest German tax court (BFH). Thus, in its ruling of 18 May 2021, the BFH criticises the application of the cost-plus method (or „cost of funds" approach) and states that the arm's length nature of the agreed interest rate for an intra-group loan must first be determined in such a way that the agreed interest rate is compared with the interest rate agreed in comparable transactions between third parties. Such as, those transactions that take place between independent third parties or between one of the group companies and an independent third party (i.e., CUP method). Only where the CUP method cannot be applied reliably, the so-called cost-plus method can be applied, in which the lender's cost price is determined and increased by an appropriate profit mark-up.

Especially relevant for intra-group cross-border real estate financing is also the decision of the Schleswig-Holstein Regional Court of 4 July 2017 (lower German tax court), in which the court took the view that a risk premium must be included in the arm's length comparison in the case of unsecured (junior) shareholder loans. In practice, this means that the

1 *RE Market 2023: These seven Real Estate trens you should know about (handelsblatt.com)*
2 *Federal Ministry of Finance of 14 July 2021, fig. 2.1f*
3 *Federal Ministry of Finance of 14 July 2021, fig. 3.88f*
4 *OECD 2022, fig. 10.90*
5 *OEDC 2022, fig. 10.94*
6 *OEDC 2022, fig. 10.97*
7 *BFH, judgement of 21 October 2021, 038/21, judgement of 18 May 2021, IR 4/17, it is still open how the Tax Authorities will react to the ruling - a publication in the Federal Law Gazette or an amendment to the BMF letter of 14 July 2021 seem to be possible.*

interest rate of secured (senior) bank loans can regularly differ, compared to the interest rate applied on subordinated unsecured shareholder loans of a real estate entities and should be accepted from a tax transfer pricing perspective.

In addition to the clarification on the preferred transfer pricing method (usually the CUP method), the OECD Transfer Pricing Guidelines 2022 and the Administrative Principles 2021 now require, among other things, an additional evaluation upfront on the basis of a function and risk analysis as to whether the shareholder loan represent debt or equity (so-called debt capacity analysis).

As part of the implementation of the DAC 7 Directive into German tax law, the transfer pricing documentation obligations will be enforced (Section 90, Para. 4 of the General Tax Code, AO). This also includes the documentation of the arm's length nature of intra-group interest rates. Currently, records on cross border transactions with related parties must be submitted only upon request of the tax authorities during a tax audit. The deadline is basically 60 days (or 30 days for extraordinary business transactions). The new regulation is that, in the case of a tax audit, the transfer pricing documentation must always be submitted and this without a separate request by the tax authority. In addition, the deadline will be shortened. In future, it will be 30 days from the date of the announcement of the tax audit order. Accordingly, the legislative initiative to accelerate the procedure of tax audits is also transferred to the taxpayer (in the sense of the inventory documentation). In principle, the new regulation is to be applied for the first time to taxes arising after 31 December 2024; by way of derogation, the new regulation is also to be applied to taxes arising before 1 January 2025, should an audit order in this regard be announced after 31 December 2024.

*8 Schleswig-Holstein Fiscal Court, 4 July 2017 - 1 K 31/16, appeal is not allowed, which means that the judgment is legally binding.*
*9 OECD 2022, fig. 10.4f*
*10 Law implementing Council Directive (EU) 2021/514 of 22 March 2021, amending Directive 2011/16/EU on administrative cooperation in the area of taxation and modernizing tax procedural law, promulgated on 28 December 2022 in the Federal Law Gazette, p. 2730.*

## Conclusion/Key Facts

Interest rates on the capital markets have risen sharply since mid-2022. This trend is expected to continue in 2023 and thus, also affect cross-border real estate investments by means of intra-group loans in the form of significantly higher interest expenses. These will most likely be the main subject of a tax audit. In combination with the enforcement of the transfer pricing rules, in particular, the requirement to prepare a debt-capacity-analysis to justify that the capital provided is debt, needs to be considered as well as stricter documentation obligations. Therefore, taxpayers should continue to pay close attention to the timely and complete documentation of their cross border intra-group transactions (loans) to reduce the risk of surcharges, or even, to risk the shift of the burden of proof to the tax authority.

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