Real Estate Tax Newsletter

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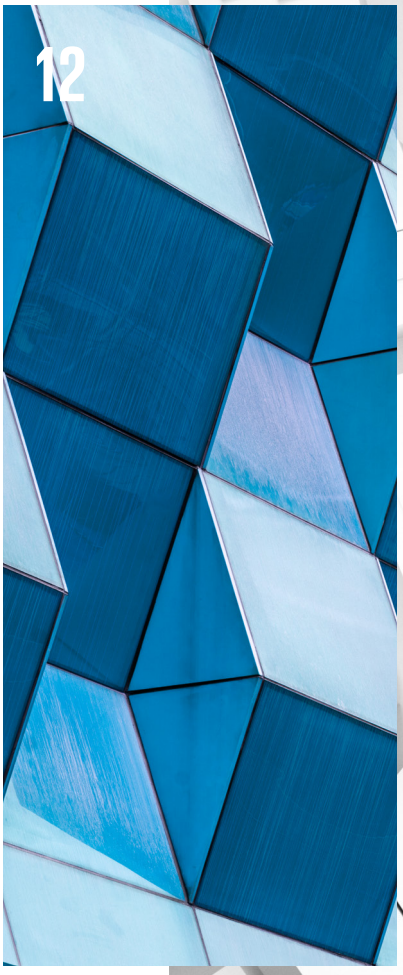
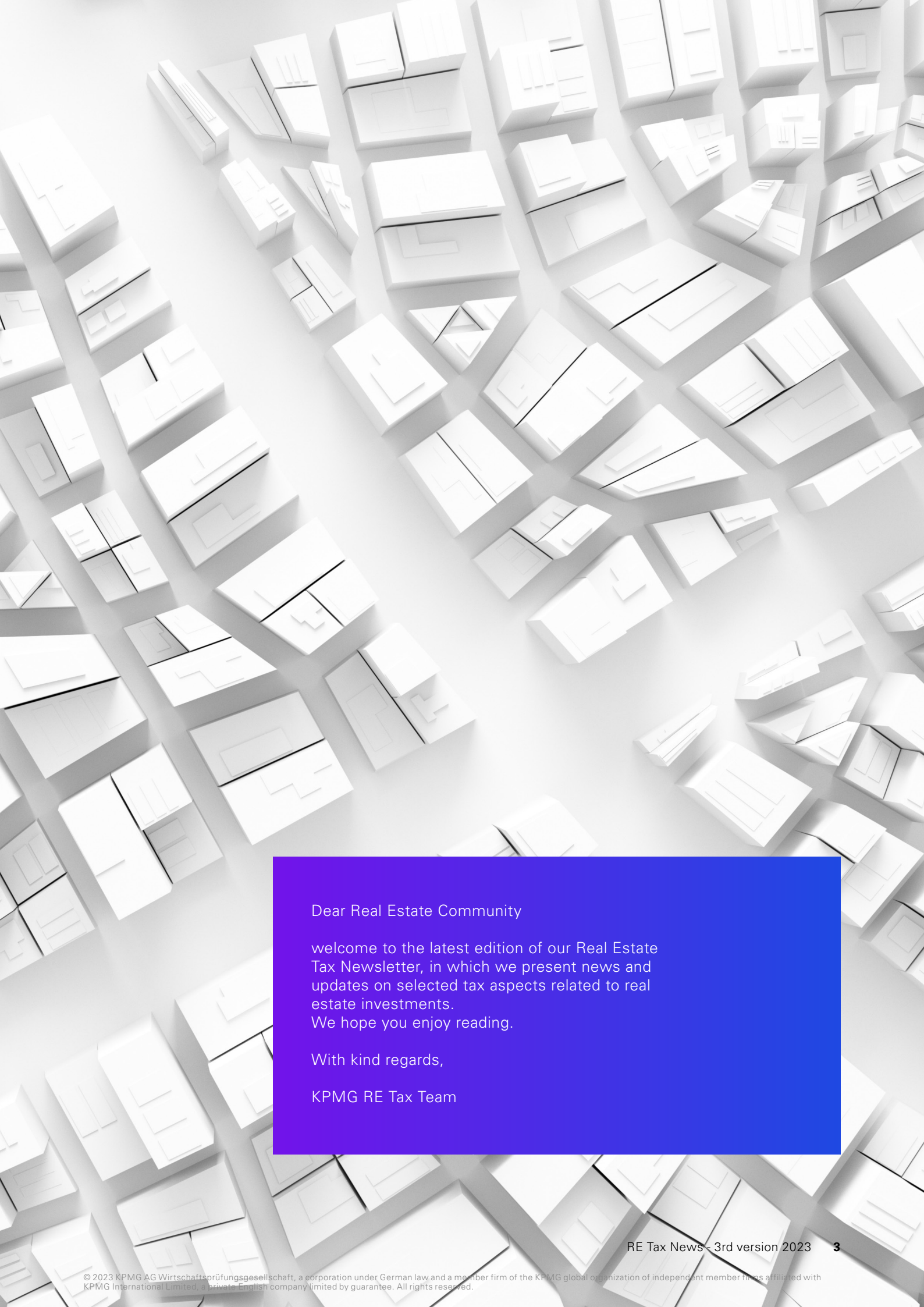
Content





Dear Real Estate Community

welcome to the latest edition of our Real Estate Tax Newsletter, in which we present news and updates on selected tax aspects related to real estate investments.
We hope you enjoy reading.

With kind regards,

KPMG RE Tax Team

01

Growth Opportunity Act

Overview of the essential planned contents

On 30 August 2023, the German Federal Ministry of Finance ("BMF") published the government draft for an „Act to Strengthen Growth Opportunities, Investment and Innovation as well as Tax Simplification and Tax Fairness" ("Growth Opportunities Act" - WtChancenG).

The aim of the law is to increase growth opportunities for the economy, enable investment and innovation in new technologies and strengthen Germany's competitiveness as a business location. To this end, the liquidity situation of companies is to be improved and impetus given to investment (e.g., better use of losses, investment premium for climate protection measures, extension of research allowance, improvement of depreciation options, reform of the retention allowance). In addition, numerous measures are planned to simplify the tax system and reduce bureaucracy, especially for small businesses, by raising thresholds and flat rates (e.g., simplification of the reporting procedure for cash register systems, simplification of payroll tax, raising the limits for compulsory bookkeeping and for actual taxation). In addition, undesirable tax arrangements are to be effectively prevented (e.g., reform of the interest barrier and introduction of an interest rate barrier, mandatory reporting of domestic tax arrangements, prevention of tax arrangements for investment funds).

The draft bill contains a large number of legislative amendments in various areas of tax law in a total of 46 articles.

1. Overview of the essential planned contents

Restrictions on the deduction of interest expenses

Reform of the German earnings stripping rules (Sec. 4h German Income Tax Act, or "GITA", and Sec. 8a German Corporate Tax Act, "GCTA")

- Introduction of an „anti-fragmentation rule": The exemption limit of EUR 3 million is no longer granted separately for each business within the meaning of the earnings stripping rules (e.g., for each subsidiary). Instead, similar businesses that are under uniform management are considered as one business for the purposes of the exemption amount. The exemption limit is to be divided among the associated businesses.

- Adjustments to the two exemption rules (stand-alone clause and equity escape, section 4h (2) sentence 1 letters b and c GITA) to comply with ATAD requirements:

- Accordingly, the stand-alone clause shall only apply if the taxpayer is not related to any person within the meaning of Sec. 1 (2) Foreign Tax Act ("FTA") and does not have a permanent establishment outside the state in which their residence, habitual abode, registered office or management is located.

- With regard to the equity scope, there is a change in the sense that such operations are no longer considered to be part of a group that could be consolidated with one or more other operations.

- As a result of the amendment to the stand-alone clause in section 4h GITA of the government draft provides for the deletion of section 8a (2) of the GCTA and an amendment to Section 8a (3) GCTA in response to the Federal Finance Court ("BFH") case law (ruling I R 57/13 of 11 November 2015). Accordingly, the BFH has ruled that, contrary to the administrative opinion (the Federal Ministry of Finance, or "BMF", letter of 4 July 2008, para. 82), remuneration for debt capital of the individual qualified shareholders is not to be added together when examining the 10% limit for harmful shareholder debt financing. The provision is now to be amended to this effect and the administrative opinion is thus to be legally standardized.

- Expansion of the definition of interest (e.g., also economically equivalent expenses and other expenses in connection with the procurement of debt capital).

- The amended earnings stripping rules is to be applied for the first time to fiscal years beginning after the date of the law's enactment and not ending before 1 January 2024.

Introduction of an interest rate cap (Sec. 4l GITA-E)

- It is agreed in the coalition agreement of the governing parties.

- It will prohibit deduction of operating expenses for interest expenses exceeding a legally defined maximum rate (Sec. 4l GITA-E).

- It applies only to interest expenses where a business relationship exists between related parties.

- The maximum deductible rate is to correspond to the Civil Code base interest rate increased by two percentage points. As of 1 January 2023, this would correspond to 3.62%.

- Ability to provide proof: that both the creditor and the ultimate parent company could only have obtained the capital at an interest rate above the maximum rate. If this can be proven, then the interest rate that could have been obtained in the most favorable case shall be deemed to be the maximum rate for the purposes of the interest rate cap. If the interest rate exceeds the maximum rate solely as a result of a change in the Civil Code base rate subsequent to the conclusion of the agreement, the interest rate cap shall not apply until one month after the date of the adjustment of the base rate. If the agreed interest rate is reduced within this month, there is no restriction on deductions (Sec. 4l (2) GITA-E).

- In addition, where there is the ability to prove to the contrary: the interest rate ceiling does not apply, provided the creditor carries out a substantial economic activity in its country of residence.

- The legislative changes are scheduled to take effect 1 January 2024.

2. Improvement of the tax loss deduction (Sec. 10d GITA-E)

Loss carry-back

- Extension to 3 years (for the first time for losses in FY 2024).

- Permanent increase to EUR 10 million (EUR 20 million in the case of joint assessment), i.e., beyond FY 2023.

Loss carried forward (minimum profit taxation)

- Increase in the percentage limit up to which losses in excess of EUR 1 million may be offset from the current 60% to 80% in the years 2024 to 2027 on a temporary basis.

- The amendments are to be applied accordingly to the utilization of trade tax deficits (Sec. 10a Trade Tax Act-E).

3. Introduction of a climate protection investment premium

It is agreed in a similar form in the coalition agreement of the governing parties.

Who: For all taxable companies regardless of legal form, size and activity.

Temporary funding period:

- Investments commenced and completed after 31 December 2023 or, at the earliest, the date of promulgation of the Act and before 1 January 2030 (approx. six years); investments completed after 31 December 2029 shall be eligible only to the extent that expenses were incurred prior thereto (partial construction costs or advance payments on acquisition costs).

Funding level: 15 %, in the funding period a total of max. EUR 30 million per beneficiary

- Assessment basis: sum of the proven Acquisition Costs/Production Costs; max. EUR 200 million per beneficiary for the entire funding period.

- Requirements under state aid law must be observed (EUR 30 million per investment project including further aid).

Eligible investments: new depreciable movable fixed assets and measures on existing movable fixed assets (subsequent acquisition/production costs).

- must contribute to a reduction of energy consumption in the company, be included in an energy or environmental management system or in an energy audit and be able to exceed applicable standards.

- At least EUR 5,000 AC/PC.

Subject to application: Date freely selectable, as long as a subsidy claim has arisen (independent of tax declaration) and assessment basis at least EUR 50,000; no later than 31 December 2031.

Maximum of 4 applications per eligible person in the entire grant period.

Separate determination in investment premium notice, payment within one month.

Recognized **directly in equity** as a contribution (in the case of corporates: to retained **earnings**).

Depreciation is calculated on the basis of the reduced capital employed / capital expenditure reduced by the investment premium.

4. Enhanced depreciation options and further investment incentives

Enhanced depreciation options

- **Temporary reintroduction of declining-balance depreciation** (Sec. 7 (2) Sentence 1 and (5a) GITA-E): up to 25%, up to a maximum of 2.5 times straight-line depreciation, for movable fixed assets acquired after 30 September 2023 and before 1 January 2025. The introduction of declining-balance depreciation is at a rate of 6% for residential buildings whose construction has begun after 30 September 2023 and before 1 October 2029 or whose acquisition falls within this period.

- **Immediate depreciation of low-value assets** (Sec. 6 (2) GITA-E): Increase of the limit of acquisition or production costs (from previously EUR 800) to EUR 1,000.

- **Collective items** (Sec. 6 (2a) GITA-E): Increase of the limit of acquisition or production costs (from previously EUR 1,000) to EUR 5,000; reduction of the reversal period (from previously 5 years) to 3 years.

- **Special depreciation** under Sec. 7g GITA-E: Increase of special depreciation under Sec. 7g (5) GITA-E (from currently up to 20%) to up to 50% of investment costs.

- First-time application for assets acquired, manufactured or transferred to business assets after 31 December 2023.

Expansion of research allowance (generally from 2024)

- Among other things, expansion of eligible expenses to include the depreciation of depreciable movable fixed assets used in the beneficiary research and development project that are necessary and essential for the implementation of the research and development project.

- Corresponding increase in the eligible cost share for contract research from 60% to 70%.

- Increase of the maximum assessment base from EUR 4 million to EUR 12 million.

Extended land relief

- Solar power generation on buildings and operation of charging stations: increase of the exemption limit by 10 percentage points from 10% to 20% for the first time for FY 2023 (Sec. 9 No. 1 Sentence 3 Letter b Trade Tax Act-E).

Investment fund

- Increase in the limit for the amount of non-detrimental income from active entrepreneurial management from 10% to 20% for special investment funds from 2024 (Section 26 No. 7a Sentence 2 German Investment Tax Act-E).

Housing cooperatives and associations

- Increase in the exemption limit for other income from the supply of electricity from tenant electricity systems from the current 20% to 30% from the 2023 tax year (Sec. 5 (1) No. 10 Sentence 3 GCTA-E).

5. Partnerships

Improvement of the retention allowance (Sec. 34a GITA-E)

- Higher retention volume: The profit eligible for preferential treatment is to be increased by the trade tax paid. In addition, withdrawals are to be disregarded for the payment of income tax on profits not withdrawn (Sec. 34a (2) GITA-E).

- First-time application for FY 2025.

Increasing the attractiveness of the corporate income tax option (Section 1a GCTA)

- Access for all partnerships (instead of previously only commercial partnerships or partnership companies).

- Also available for newly established companies as well as for corporations changing their form into a partnership.

- Facilitation for the tax-neutral exercise of the option.

- Improvements in the distribution of retained earnings.

- Entry into force on the day following the promulgation of the Act.

Adjustments to the Partnership Law Modernization Act ("PLMA")

- Continuation of the principle of joint ownership in income taxation (Sec. 39 (2) No. 2 Tax Code-E).

- Distinction between legally capable (in particular legally capable partnerships including OHG, KG) and non-legally capable associations of persons (Sec. 14a Tax Code-E).

- Procedural changes for associations of persons with legal capacity, including: Fulfillment of tax obligations by the legal representatives (Sec. 34 (1), Sec. 79 (1) No. 3 Tax Code-E); tax return obligation to be primarily incumbent on the association of persons (Sec. 181 (2) Sentence 2 No. 1 lit. a Tax Code-E), the association of persons is to be held liable for late payment penalties (Sec. 152 (4) Sentence 3 No. 1 Tax Code-E), notification of administrative acts to the association of persons (Sec. 183 Tax Code-E), right of objection/suit of the association of persons itself (Sec. 352 (1) No. 1 Tax Code-E, Sec. 48 Financial Court Rules-E).

- The entry into force of the PLMA is not intended to lead to a violation of retention periods; Sections 5 (3), 6 (3) and 7 (3) of the Real Estate Transfer Tax Act are to continue to apply to favored, already realized acquisition transactions until the expiry of the periods, subject to the proviso that the company assets as defined by the PLMA take the place of the joint ownership (Section 23 (25) Real Estate Transfer Tax Act-Draft).

6. Measures to prevent tax structuring

Obligation to notify domestic tax arrangements (Secs. 138l to 138n Tax Code-E)

- Already anchored in the coalition agreement.

- Close alignment with the already existing notification obligation for cross-border tax arrangements (Sec. 138d to Sec. 138k Tax Code).

- However, the number of relevant arrangements (indicators) is limited: Unlike in the case of cross-border arrangements, the main benefit or one of the main benefits of the arrangement must be the attainment of a tax advantage for each indicator (so-called main benefit test).

- No adoption of the indicators that have a cross-border arrangement, e.g., in connection with transfer pricing, cross-border payments or the erosion of notification obligations.

- However, introduction of new indicators: Arrangements in connection with the multiple allocation of a circumstance to several persons, coupling transactions and benefits in the area of capital gains tax deduction.

- The BMF is to have the authority to determine the start of the new notification obligation itself by means of an announcement; the date is to be determined at least one year in advance. Assuming that the WtChancenG enters into force in 2023, the latest date envisaged is 31 December 2027.

Tax arrangements for investment funds

- Prevention of tax arrangements in investment funds that have become known through notifications of cross-border tax arrangements (Sec. 138d ff. Tax Code).

- This concerns the

  Consideration of real estate in the real estate quota of real estate funds if the rental income is not subject to a preliminary tax burden (Sec. 2 (9a) German Investment Tax Act-E),

  The tax liability of capital gains from real estate corporations at fund level (Sec. 6 (5) Sentence 1 No. 1 German Investment Tax Act-E)

  And the DTA tax exemption at investor level for special investment funds (Section 43 German Investment Tax Act-E).

Outlook

After the government bill has been introduced into the parliamentary procedure, the Federal Council (Bundesrat) has the opportunity to comment on the bill. This is followed by the resolutions of the Parliament (Bundestag) and the Bundesrat. Significant changes can therefore still be made in the course of the legislative process.

The legislative process can be completed before the end of the current year. In principle, the law is to enter into force on the day after promulgation. The special regulations on the entry into force of the individual articles and on the timing of the application of the individual laws must be observed.

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Tax Services

02

Discussion Draft for the Amendment of the Real Estate Transfer Tax Act of the Federal Ministry of Finance ("BMF")

On July 5, 2023, the BMF submitted a draft amendment to the German Real Estate Transfer Tax Act for voting.

On 5th July 2023, the Federal Ministry of Finance submitted a "discussion" draft of a bill to amend the Real Estate Transfer Tax Act ("BMF Draft Bill") to the German federal states for a vote. The draft, which is for discussion purposes, is essentially a reform of the taxation of so-called "share deals" involving the transfer of shares in real estate-owning companies. With regard to the taxation of property acquisitions (so-called asset deals), the discussion draft only provides for a power for the German federal states to introduce a reduced tax rate for acquisitions for own residential purposes.

Background to the proposed reform

Transfers of real estate companies in which no real estate transfer tax ("RETT") is triggered by participations of minority shareholders (so-called RETT blockers) are still perceived as a problem by the public, although such share deals have decreased significantly after the last RETT reform came into force on 1st July 2021. Also, the transfer of shares in real estate special funds within the meaning of the German Investment Code („KAGB"), which are structured according to the so-called trust solution, and of shares in corresponding foreign vehicles (so-called unit deals), still do not incur RETT.

In addition, the Act on the Modernisation of Partnership Law („MoPeG") will come into force on 1st January 2024. This means that at least for partnerships with legal capacity, i.e. in particular general partnerships (OHG) and limited partnerships (KG), the so-called „Gesamthandsvermögen" (joint property) will cease to apply. However, the exemption provisions of §§ 5, 6 and 7 of the German Real Estate Transfer Tax Act ("RETTA") expressly require partnerships with joint property. They are therefore no longer applicable in full (sec. 5 and 6 RETTA) or in part (§ 7 RETTA) as of 1st January 2024.

Even worse: If tax exemptions for the transfer of real estate to a partnership were claimed in the past or will be claimed until 31st December 2023, this triggers a ten-year (until 30th June 2021: five-year) retention period. If the partner who transferred the real property to the partnership reduces his interest in the joint property of the partnership that acquired the real property within the ten-year (until 30th June 2021: five-year) retention period, the tax exemption shall cease to apply retroactively. Likewise, the tax exemption ceases to apply retroactively if, upon transfer of a property from one partnership to another partnership, the partner who held an interest in both partnerships reduces his interest in the joint properties of the partnership that acquired the property. In its BMF cornerstone paper published on 23rd June 2023, the tax authorities assume that the tax exemption as a whole will cease to apply retroactively with the discontinuation of the joint property on 1st January 2024, since due to the lack of joint property the respective partner can also no longer be involved. A statutory regulation therefore appears necessary.

The BMF Draft Bill, which was prepared by representatives of the tax authorities together with experts from science, consulting and jurisdiction, wants to solve these problems with share deals as follows:

New taxation provision for share deals

The previous taxation provisions of Sec. 1 para. 2a and 2b RETTA (taxation in the event of direct or indirect transfer of at least 90% of the shares in a company owning real estate to new shareholders within 10 years) as well as the „legal" and „economic" share unification (taxation in the case of direct or indirect unification of 90% or more of the shares in a company owning real property in one hand) shall be newly regulated in Sec. 1a of the BMF Draft Bill as follows:

- In the future, the direct or indirect unification of the „totality of shares" in a real estate-owning company in the hands of one person or a group of acquirers is to be taxed (Sec. 1a para. 1 BMF Draft Bill). In the case of indirect unification of shares, the totality of the shares shall be determined by means of a calculation through the individual shareholding levels, as in the current Sec. 1 para. 3a RETTA (Sec. 1a para. 5 and 6 BMF Draft Bill). .Partnerships and corporations are treated equally in this respect.

- The unification of the totality of shares by a group of acquirers is the coordinated direct or indirect

acquisition of all shares in a real estate company by two or more persons, irrespective of whether these persons are related to each other or are third parties in relation to each other. In particular, there shall be a coordination if the acquisitions of the members of the acquisition group are related in terms of fact or time (Sec. 1 para. 1a and 7 BMF Draft Bill).

- As was previously the case with the current section 1 para. 3 RETTA, the legal transaction under the law of obligations („signing") generally triggers RETT, section 1a para. 1 no. 1 BMF Draft Bill. Only if there is no signing of the transaction (e.g. in the case of a merger), the transfer of the shares („closing") is decisive, section 1a para. 1 no. 2 BMF Draft Bill.

- The transfer of the beneficial ownership in the totality of shares in real estate-owning companies is also to be decisive - in accordance with the current section 1 para. 2 RETTA in the case of asset deals (section 1a para. 1 No. 2 sentence 2 in conjunction with para. 5 sentence 2 of the BMF Draft Bill). This covers, among other things, trust cases.

- Only the company that has purchased the real estate or otherwise acquired it in a taxable manner (as in an asset deal) is considered to be the real estate-owning company. Companies that have only acquired the economic ownership in a property (e.g., in the case of a trust agreement) are also be deemed to be a real estate-owning company pursuant to section 1a para. 3 BMF Draft Bill.

- Investment funds, within the meaning of the German Capital Investment Code, and corresponding foreign vehicles can also be deemed real estate-owning companies where the asset management company („AMC") holds real estate for the investment fund (section 1b para.1 No. 1 in conjunction with para. 4 sentences 1 and 2 of the BMF Draft Bill). In addition, the AMC is also deemed a real estate-owning company for the same real estate (section 1b para. 4 sentence 1 of the BMF Draft Bill). The same applies for domestic and foreign sub-funds (parts of a special investment fund that are separate in terms of liability and assets), pursuant to section 1b para. 1 no. 2 and in accordance with para. 4 sentence 3 of the BMF Draft Bill. Share certificates ("Units") in corresponding special investment funds or entitlements to corresponding sub-funds are treated in the same way as shares in real estate-owning companies (section 1b para. 3 of the BMF Draft Bill).

- If a special investment fund or a sub-fund holds shares in a real estate-owning company, the percentage of the participation in the special investment fund or sub-fund are multiplied with the percentage of the participation in the real estate-owning company ("calculating through") in order to determine if all shares in the real estate company are unified in the hands of one acquirer or a group of acquirers (section 1b para. 2 in conjunction with section 1a para. 4 to 6 of the BMF Draft Bill).

- Treasury shares, i.e., shares which the real estate-owning company holds in itself, are to be disregarded when determining the totality of shares (section 1a para. 8 No. 1 of the BMF Draft Bill).

- Shares held or acquired by a person in the interest of the acquirer, or a member of the acquiring group shall also be disregarded when determining the totality of shares (section 1 para. 8 No. 2 of the BMF Draft Bill). Such a so-called serving interest of a person is deemed to exist, for example, where

  - the market value of the shares acquired or held by the person is lower than the real estate transfer tax that would be incurred if all shares were acquired,

  - the person's corporate rights are restricted (if necessary, subsequently),

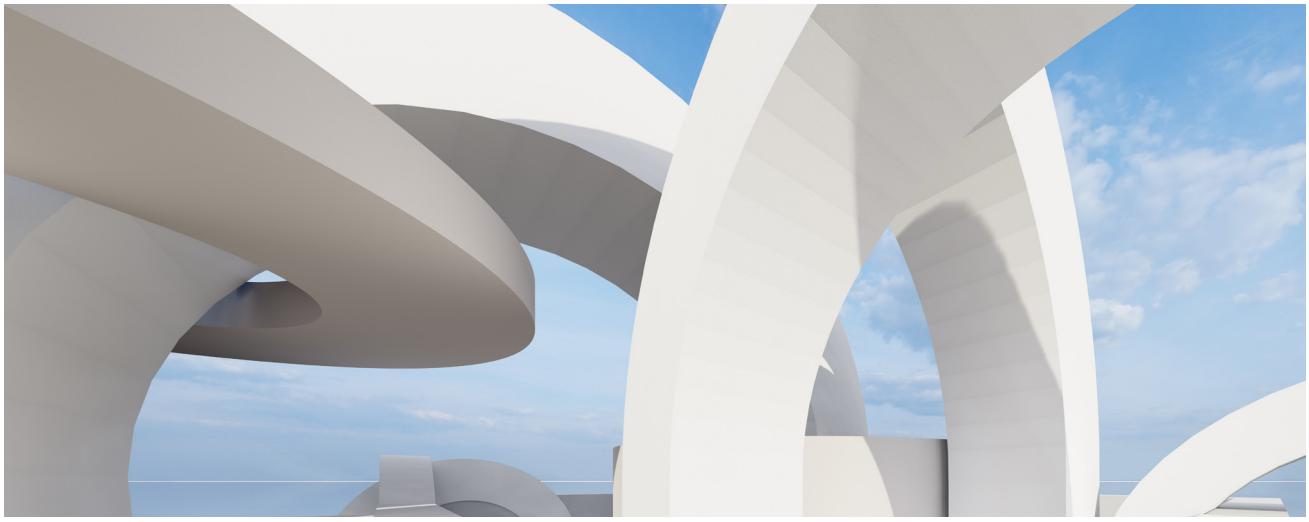
  - the person receives a fixed remuneration (also in the case of a subsequent agreement; exception: fixed remuneration in the case of a profit transfer agreement),

  - a co-determining influence can be exercised on the person (inhibition of the so-called foundation model or Dutch Stichting model).

Taxpayer

The taxpayer shall be the acquirer and (if available) the so-called participating intermediary company or the members of the acquiring group who would be jointly and severally liable (section 13 para. 5 of the BMF Draft Bill).

If, in the course of an acquisition transaction, one legal entity indirectly combines the totality of the shares and, at the same time, one or more intermediary companies directly or indirectly combine the totality of the shares in the same acquisition transaction, only the top legal entity, in which no other acquirer unify



the totality of the shares, is the acquirer (Sec. 1a para. 2 of the BMF Draft Bill) and thus the taxpayer.The company which acquires directly the shares in the real estate company is called the participating intermediary company and is jointly and severally liable with the acquirer, i.e., the legal entity that holds directly or indirectly the totality of the shares in the intermediary company.

For example, in a trinominal 100% chain of parent, subsidiary, and sub-subsidiary, where the sub-subsidiary acquires all of the shares in a real estate company, the parent as top legal entity would be the acquirer and the sub-subsidiary would be the participating intermediary company. The parent company and the sub-subsidiary would owe the RETT as joint and several debtors.

Tax exemptions

The complicated group clause of Section 6a RETTA is to be replaced by Section 5 para. 1 of the BMF Draft Bill, which stipulates the following: within groups of companies with the same sole shareholder, i.e., if the top legal entity directly or indirectly holds the totality of the shares of all subsidiaries, real estate and real estate-owning companies may be transferred free of RETT - without any pre- or post-retention periods.

Co-owners and sole owners of real estate can transfer it to a company (a corporation or partnership) free of RETT to the extent that the amount of the interest in the real estate and in the company coincide. The prerequisite is that the real estate has been held by the transferring shareholder or partner for at least five years prior to the transfer (section 5 para.2 of the BMF Draft Bill).

Conversely, companies (corporations or partnerships) may also transfer their real estate to their shareholders or partners free of RETT to the extent that the amount of the interest in the real estate and in the company held by the acquiring shareholder or partner coincide. The prerequisite is that the real estate is held by the acquiring shareholder or partner for at least five years after the acquisition (section 5 para. 3 of the BMF Draft Bill).

Transitional rules

The previous taxation rules on the change of shareholder (section 1 para. 2a and 2b RETTA) and on the merger of shares (section 1 para. 3 and 3a RETTA) cease to apply if the BMF Draft Bill comes into force on 1st January 2024. Insofar as RETT exemptions were claimed under the current law, which triggered retention periods pursuant to the current section 5 para. 3 RETTA, section 6 para. 3 sentence 2, section 7 para. 3 sentence 2 and section 6a sentence 4 RETTA, these shall continue to apply unchanged.

Impact of the draft Growth Opportunity Act on the BMF Draft Bill

As already mentioned above regarding the background of the reform efforts, due to the entry into force of the MoPeG on 1st January 2024, there is a risk that the aforementioned retention periods within the meaning of sections 5, 6 and 7 RETTA, which were triggered until 31st December 2023, will be violated. This would mean that, in cases where tax exemptions within the meaning of the current Sections 5, 6 and 7 RETTA have been granted and corresponding retention periods have been triggered, tax exemptions already granted would cease to apply retroactively without any action on the part of the taxpayer, and the RETT would have to be levied subsequently.

According to the draft of the Growth Opportunities Act of the German Federal Government dated 29th August 2023, the company assets within the meaning of the MoPeG are therefore to take the place of the joint property (Gesamthandsvermögen). This should prevent the feared retroactive loss of RETT exemptions.

This would eliminate the most pressing reason for a RETT reform. It therefore seems likely that the BMF Draft Bill will not be implemented until 1st January 2024. However, the other problems described above under "Background to the proposed reform" remain. As the discussion draft is already very mature and largely solves these problems, it can be expected that discussion draft will be implemented in the next few years.

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Conclusion/Key Facts

The BMF Draft Bill should further complicate arrangements to avoid RETT using a so-called RETT blocker and tax unit deals. The new group clause, which facilitates the transfer of real estate and real estate companies in 100% groups free of RETT, is to be welcomed. In addition, the BMF Draft Bill prevents the retention periods for tax exemptions granted in the past from lapsing when the MoPeG comes into force on 1st January 2024 and RETT has to be collected subsequently.

However, the latter is also prevented by the draft Growth Opportunities Act. It is therefore unlikely that the BMF Draft Bill will come into force on 1st January 2024. Nevertheless, since the Growth Opportunities Act only addresses the currently most pressing problem of the German RETT and does not address all the other objectives that policymakers have set themselves, it is to be expected that the BMF Draft Bill will be implemented at a later date.

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03

Transfer Pricing Aspects of Intra-group Real Estate Financing

Current Transfer Pricing Challenges and Implications of the Planned Growth Opportunities Act

Rising financing costs paired with partially falling real estate prices represent an increasing challenge for the real estate sector from a transfer pricing perspective. In particular, the proof of an arm's length debt capacity is often the main issue of dispute in current tax audits, whereby it is at present not clearly regulated how this capacity can be proven. Furthermore, the current government draft on the Growth Opportunities Act contains additional restrictions on interest deductions (for example, the introduction of an interest rate cap and the tightening of existing interest limitation rules), raising several questions.

Current developments on the real estate and financial markets pose new tax challenges, especially for the real estate (RE) sector. Since July 2022, the ECB's main refinancing rate has risen from 0.00 percent to 4.00 percent, marking a return to pre-2008 financial crisis levels.[1] At the same time, credit institutions are increasingly tightening their lending standards due to rising risk perception, which increases the risk of possible credit rationing.[2] In addition to the contractionary monetary policy, the development in the RE sector has been accompanied by a decline in real estate prices, which could continue until 2024.[3] In the first quarter of 2023, for example, German commercial real estate prices fell by 8.3 percent compared to the same quarter of the previous year. These trends are particularly important for the RE sector,[4] as no other sector has higher financing needs. The recently published government draft of the Growth Opportunities Act, which, among other things, provides for the introduction of an interest rate cap, also poses further challenges.

From a transfer pricing perspective, it is to be expected that there will be an even greater substitution of external funding with intra-group financing based on developments in the capital market. However, intra-group financing must take account of this development in respect of the arm's length principle, whereby a delineation has to be made in accordance with international and German transfer pricing standards on the merits (debt capacity analysis) as well as the interest rate.[5] Such a distinction between debt and equity in the form of a debt capacity analysis was first explicitly presented with the publication of Chapter X of the OECD Transfer Pricing Guidelines in February 2020.[6] Against the background of an appropriate delineation of transactions, it is analyzed whether the funds provided constitute debt or equity. In other words, the taxpayer must prove that the capital provided is, in fact, a loan, thus implying corresponding interest payments. From a German perspective, the requirements are regulated by the Administrative Transfer Pricing Principles of 6 June 2023 – by reference to the OECD Transfer Pricing Guidance – after an explicit anchoring in German tax law failed due to the draft bill of the ATAD Implementation Act.

Although explicit proof of debt capacity was officially anchored in the OECD transfer pricing guidelines in February 2020, this aspect is a regular topic of discussion in ongoing tax audits – primarily relating to the years 2018 to 2020 – and, in some cases already in prior assessment periods.

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1 *ECB, ECB interest rate on main refinancing operations / situation at the end of July 2023, https://www.bundesbank.de/dynamic/action/en/statistics/time-series-databases/time-series-databases/745582/745582?listId=www_sgeldmkt_mb01&tsId=BBK01.SU0202&dateSelect=2023*

2 *EZB: "The euro area bank lending survey - First quarter of 2023", Mai 2023, https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2023q1~22c176b442.en.html#toc5*

3 *Allianz Research: „Eurozone commercial real estate – selective matters!", 25. May 2023, https://www.allianz.com/content/dam/onemarketing/azcom/Allianz_com/economic-research/publications/specials/en/2023/may/commercial-real-estate/2023_05_25_EurozoneCRE_SelectivityMatters.pdf*

4 *Association of German Bond Banks: „Price correction on the real estate market continues", Q1 2023, https://www.pfandbrief.de/site/dam/jcr:904bdc7e-2ae5-46ff-b4f1-865dcc009d4c/vdp_Index_2023_Q1%20_%20DE_Broschuere_final.pdf*

5 *For a discussion with regard to an arm's length interest rate, cf. e.g., Ronny John (2023): „Transfer pricing aspects of intra-group real estate financing", RE Tax News, 1/2023.*

6 *OECD 2022 Section B.1.*

Whereby the proof of debt capacity in the real estate sector often has been provided based on the (expected) value of the financed property in the form of a loan-to-value ratio, this approach however, disregards the question of the borrowers interest-bearing capacity and possible follow-up financing. In this context, the tax audit regularly criticizes the fact that a loan can only be granted at arm's length if both the debtor's interest-bearing capacity in conjunction with regular repayment and the possibility of repaying the loan in full, either through the proceeds of the sale or follow-up financing, are given. Furthermore, the relevant transfer pricing literature analyzes to what extent additional hurdles for the proof of debt capacity should be anchored along the lines of lending standards of banks according to the European Banking Authority.[7] Notwithstanding this, merely proving that an arm's length loan-to-value ratio exists is regularly not accepted by the tax authorities as sufficient evidence of debt character.

Demonstrating debt capacity is also made more difficult by current market developments. For example, the rising interest rate environment is leading to a decline in interest rate sustainability for variable-rate or new loans, while the increasing lending standards of banks are making follow-up financing even more difficult. At the same time, the partial decline in the price level on the real estate markets reduces the value of the property, which makes it harder to prove that the loan-to-value ratio is at arm's length. Taking this development into account, the tax authorities are currently regularly negating the debtor's debt capacity on the grounds that the borrowing was either based on an overly optimistic forecast or that insufficient sensitivity analyses were carried out to accurately take account of market developments. Moreover, the lack of evidence of debt capacity is also addressed in connection with the level of the arm's length interest rate. Thus, tax authorities admit that, although the interest rate can be regarded as being at arm's length in isolation, it should only be applied to part of the intra-group loan, since the remainder is not accepted as debt.

As part of the Growth Opportunities Act (government draft officially adopted on 30 August 2023), the interest barrier is to be tightened onwards and an additional interest rate cap is to be introduced.

Contrary to what was indicated in the draft bill, the government bill does not provide for the conversion of the exemption limit of €3 million into an allowance. However, similar establishments under the uniform management or dominant influence of the same person or group of persons should be considered as one establishment for the purposes of interest deduction. This can have both a significant impact and a major deterioration in the interest deductibility option, especially for real estate portfolios with a large number of real estate entities under a common holding structure. This is exacerbated by the fact that the other escape clauses („stand alone" clause and equity comparison) are to be abolished.

In addition, the Growth Opportunities Act provides for an extension of section 4 of the Income Tax Act to include section 4l, according to which intra-group interest expenses based on an interest rate above a certain maximum interest cap are not tax-deductible. The maximum interest rate consists of the base interest rate according to section 247 of the German Civil Code and a surcharge of two percentage points. The former is published by the Bundesbank on 1 January and 1 July of each year and currently stands at 3.12 percent. Thus, the current maximum interest rate is 5.12 percent. A higher interest rate would only be tax-deductible if it could be proven that both the creditor and the ultimate parent company would be able to borrow funds externally at a higher interest rate. Alternatively, the creditor would have to be engaged in a substantial economic activity in line with the meaning of section 8(2), sentences 2, 3 and 5 of the Foreign Tax Act. However, this proof requires both personnel and material resources on the part of the lender. In addition, it must be proven that adequately qualified personnel can carry out this activity independently and on their own responsibility. Experience has shown that this hurdle is quite high.

In addition to the interest barrier, the addition of trade tax and compliance with the arm's length principle, the concept of the interest rate cap thus represents the next additional interest deduction restriction and aims to severely limit intra-group loan transactions of insubstantial foreign financing companies.

7 *See for example, Eymann, Stefan; Grams, Alexander and Gugeler, Dominik (2023): "Der Schuldentragfähigkeitstest bei der Konzernfinanzierung oder: Der Krug geht so lange zum Brunnen, bis er bricht.", Ubg 2023, 312-322.*

At the same time, the burden of proof in accordance with the above-mentioned escape clauses is to be transferred to the taxpayer. In its current version, however, a large number of questions remain unanswered. So far, there is no distinction between loans with different maturities, while currency differences are completely ignored. It also remains unclear how proof of higher external financing conditions can be achieved in practice, given that (according to the OECD and the German tax authorities) non-binding bank offers are usually not accepted, which should also be the case in this context.[8]

Current developments have made clear that the preparation of a debt-capacity analysis within the framework of transfer pricing documentation or a planning study is essential in order to be able to defend the interest deduction – at the latest within the framework of the external tax audit, while taking into account further interest deduction restrictions. In addition, the Growth Opportunities Act provides for additional challenges for the RE sector with a tightening of the interest barrier and the introduction of an interest rate cap.

Conclusion/Key Facts

The current development on the financial and real estate markets poses tax challenges for the RE sector, in particular from a transfer pricing perspective. Rising interest rates coupled with partially falling real estate prices make it particularly difficult to prove the debt capacity of the intra-group debtor. This topic is already an increasingly frequent topic of dispute between tax authorities and taxpayers in current tax audits and will continue to increase in the future. The planned introduction of an interest rate threshold and the tightening of the interest barrier for 2024 also pose an additional challenge.

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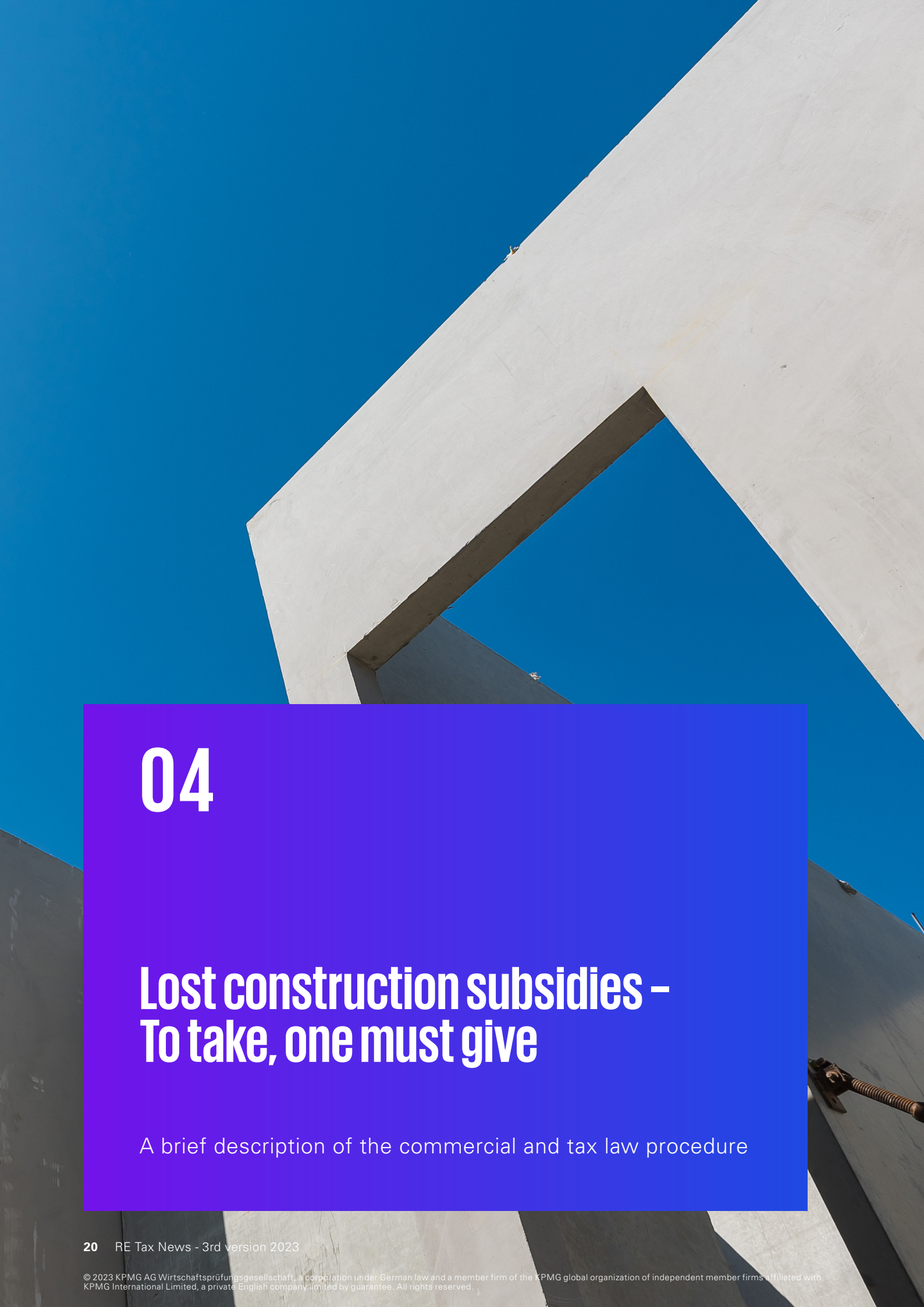
8 *OECD 2022, para. 10.108.*



04

Lost construction subsidies – To take, one must give

A brief description of the commercial and tax law procedure

The Chinese philosopher Laozi is said to have coined the phrase ‚To take, one must give'. And so, purely economically and quite unphilosophically, the goal of construction cost subsidies is often to create rental incentives for attractive tenants and to achieve the highest possible fit-out standards in the rental spaces. It is often overlooked that construction cost subsidies can also achieve tax benefits - from the gradual reduction of profits through periodic expenses, to the claiming of negative value-added tax, as well as to the actual input tax.

1. Background to agreements on the granting of construction subsidies

Based on the previous civil law classification, a distinction must be made between „usable" and „lost" construction cost subsidies:

- **Usable construction cost** subsidies are often subsidies that are contractually regulated, represent financing contributions and other asset expenditures on the part of the tenant, and are credited towards the owed rent.[1]

- On the other hand, **lost construction cost** subsidies are financing contributions and other asset expenditures that are characterized by the absence of a contractual obligation to refund or repay the contribution (with the exception of rental agreements for residential space). Similarly, in the case of lost construction cost subsidies, the tenant is not obliged to leave any installations in the rental property upon termination of the lease. In real estate practice, landlords are regularly confronted with lost construction cost subsidies paid to commercial tenants. Therefore, this article deals with the commercial and tax treatment of such lost construction cost subsidies from the landlord's perspective.

In real estate practice, one is regularly confronted with lost construction cost subsidies paid by the landlord to commercial tenants. Accordingly, this article is dedicated to the commercial and tax law treatment of such lost construction cost subsidies from the landlord's point of view.

2. Treatment under commercial law

Capitalization as an asset

The capitalization of lost construction subsidies as an asset is ruled out for various reasons. At first glance, if a lost construction cost subsidy is given, a pecuniary advantage with regard to the subsidy is no longer recognizable, since there is no obligation to repay. The landlord simply loses the financial advantage through the payout.

The existence of a pecuniary advantage must therefore inevitably be sought beyond the subsidy, in the incentives of a desired tenant or tenancy. A broad understanding of the term can be derived from the case law of the Federal Fiscal Court, which also includes concrete possibilities and actual conditions – in other words, all advantages that the merchant can afford to obtain.[2] It is obvious that the granting of the subsidy is included in the disposition of the tenant during the contract negotiation. As a result of the subsidy, potential, attractive tenants may be inclined to actually conclude the lease and also accept a higher basic rent.[3] Accordingly, there would be a financial advantage in the form of concrete possibilities or opportunities.

This pecuniary advantage must be significant as an individual and must not evaporate as part of goodwill.[4] However, in these cases, the financial advantage is to be seen in the tenancy or in the tenant himself. In terms of balance sheet tangibility, capitalization would be equivalent to the capitalization of attractive customer bases that are subject to a prohibition on capitalization. Therefore, the only thing left to do is to record it as an operating expense.

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1 *Weidenkaff in Grüneberg German Civil Code-Commentary, Einf v § 535, Rn. 111.*
2 *inter alia Federal Fiscal Court judgment of 14.12.2011, I R 108/10, BStBl. II 2012, 238, para. 12; Federal Fiscal Court judgment of 29.11.2012, IV R 47/09; BStBl. II 2013, 324, para. 33.*
3 *FG Saarland decision of 26.07.2001, I V 154/01, BeckRS 2001, 21010337.*
4 *Federal Fiscal Court judgment of 29.11.2012, IV R 47/09; BStBl. II 2013, 324, para. 33; RFH v. 21.10.1931, VI A 2002/29, RStBl 1932, 305; Thiele/Turowski in Baetge/Kirsch/Thiele, Bilanzrecht, 111th ed., § 246 HGB, marginal no. 50; Kirsch in Kirsch, ReLe Kommentar, 119th ed., § 246 HGB, marginal no. 60.*

Qualification and delimitation as an operating expense

In addition to recognition as an expense, the granting of the subsidy requires landlords to capitalize as an accrued income and deferred income (Section 250 (1) of the German Commercial Code ("HGB")). In doing so, the understanding of the term „expenses" under commercial and tax law must be taken into account.

In this respect, it is not only a question of the cash-effective outflow of the subsidy. The issue may also consist of the receipt of a liability. Since the contractual agreements on construction cost subsidies, especially on payment conditions, can be very heterogeneous, a blanket assessment is not possible.[5]

Depending on the content of the agreement, it may also be necessary to record it as an accrued income and deferred income before the subsidy is paid out if the construction cost subsidy is already certain as a liability in terms of reason and amount. The term will depend on the length of the lease. This means that the landlord may achieve a partial reduction in profits even before payout, which brings tax advantages.

3. Income tax treatment

Determination of income according to a comparison of business assets

In the case of taxpayers, the construction cost subsidies recognized as operating expenses and capitalized as deferred income are taken over for tax purposes by the principle of relevance (Section 5 (1) sentence 1 German Income Tax Act). If the landlord is a taxpayer whose income is determined according to the general comparison of business assets (Section 4 para. 1 German Income Tax Act "EStG")[6] , the construction cost subsidies lead to the same result. This is because the recognition and valuation reservations of Section 5 (5) of the German Income Tax Act would also have to be taken into account in the general comparison of business assets.[7]

Determination of income by means of surplus accounting

The income determination provisions of Sections 4 (1) and (5) of the German Income Tax Act are mutually exclusive to Section 4 (3) of the Income Tax Act in their personal scope of application. Consequently, the delimitation of lost construction cost subsidies does not take place in the case of taxpayers who determine their income in accordance with Section 4 (3) of the German Income Tax Act or do not generate income from business operations, but income from renting and leasing.[8]

Moreover, there is no doubt that the lost construction subsidies should be allocated to income from renting and leasing on the basis of their direct economic link.[9] Taxpayers who determine their income on the basis of the surplus account will therefore not benefit from the early reduction in profits.

4. VAT treatment

Classification as a taxable supply

From a VAT point of view, it must first be assessed whether a construction cost subsidy qualifies as a service subject to VAT. It is obvious that another service within the meaning of Section 3 Para. 9 of the German VAT Act can be considered for the granting of a construction cost subsidy. However, it is more difficult to determine the content of the other service. This is because it could be part of the rental service or an independent financing service to the tenant – which entails other VAT consequences.

An interpretation in conformity with EU law requires that all the circumstances of the individual case and, above all, the facts actually occurred be taken into account in accordance with previous ECJ case law. According to the objective content of the subsidy agreement in connection with the tenancy, it is usually not the financing of individual conversions that will be decisive for the tenant, but the rental of the leased property itself. There are good arguments to ascribe relevance to the construction cost subsidy as an additional co-condition for the tenancy itself[10] – true to the wisdom of life „to take, one must give". If a lost construction cost subsidy is granted to the tenant, this is also part of the rental service to the tenant.

Admittedly, the question arises as to whether, against the background of the different treatment of financing and leasing services, an examination must be carried out for the existence of mixed services. However, the existence of a mixed benefit should be denied, since,

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5 *ADS, 6th ed., § 250 HGB para. 25; Kirsch in Kirsch, ReLe Kommentar, 121st ed., § 250 HGB, marginal no. 56; Schubert/Waubke in Beck Bil-Komm., 13th ed., § 250 HGB, marginal no. 20.*

6 *For example, a Luxembourg S.à r.l. with limited tax liability.or Dutch B.V. with domestic real estate.*

7 *Federal Fiscal Court judgment of 08.11.1979, IV R 145/77, BStBl. II 1980, 146; Federal Fiscal Court judgment of 15.02.2017, VI R 96/13, BStBl. II 2017, 884.*

8 *Krumm in Brandis/Heuermann, ErtragStR, 166th ed., § 5 EStG, marginal no. 64.*

9 *Federal Fiscal Court judgment of 28.10.1980, VIII R 34/76, BStBl. II 1981, 161; Federal Fiscal Court judgment 11.10.1983, VIII R 61/81, BStBl. II 1984, 267.*

10 *ECJ judgment of 16.12.2010, MacDonald Resorts Ltd, C-270/09, para. 24.*

according to the general perception of the public, on the one hand, there is an ability to make optimal use of the subsidy and, on the other hand, no tenant would merely request the subsidy without an associated property.[11] [12] [13]

Accordingly, the previous case law of the Federal Fiscal Court also recognized a service linked to the rental service. The lost construction cost subsidy is therefore a non-separable part of the VAT-taxable rental service (Section 1 Para. 1 no. 1 of the German VAT Act), the tax exemption/obligation of which is based on the underlying tenancy (Section 4 no. 12 lit. a) in conjunction with Section 9 Para. 1 of the German VAT Act).[14]

Assessment of remuneration and incurrence of tax

There is no discernible reason to deviate from that assessment as regards the assessment of remuneration. The lost construction cost subsidy correspondingly represents an anticipated reduction in the rental fee. As a result, lost construction cost subsidies lead to negative tax-exempt or taxable sales – depending on the structure of the underlying tenancy.[15]

However, it is questionable whether the tax on the anticipated rent reduction already arises at the time of the agreement or only when the construction cost subsidy is paid out. When calculating the tax according to the fees received, it is appropriate (Section 13 para. 1 lit. b) of the German VAT Act) to also declare the negative sales due to the construction cost subsidy at the time of payment.

In contrast, when calculated according to agreed remuneration, the tax arises in the (pre-registration) period in which the service was performed. This also applies to partial services (Section 13 para. 1 lit. a) p. 2 and 3 of the German VAT Act). Long-term tenancies are characterized by partial services, as they are continuous services, and these multi-year contracts are regularly subdivided by monthly or annual payment and service periods. Thus, the pro-rata assertion of negative sales[16] tax due to lost construction cost subsidies is justified from the beginning of the lease (see Section 2.2). In addition, there is a synchronization for income tax and VAT purposes, where the expenses of the construction cost subsidy are booked at the beginning and then accrued over the duration of the tenancy.

Conclusion/Key Facts

From a business point of view, construction subsidies are a popular means of creating incentives for attractive tenants. In addition, the development of the site can be controlled. From a tax point of view, construction subsidies are an ideal means of generating periodized expenses and spreading profits over several periods.

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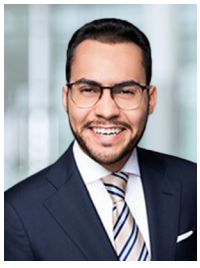

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11 *English in Tipke/Lang, Tax Law, § 17 marginal no. 17.110.*
12 *ECJ judgment of 29.03.2007, Aktiebolaget, C-111/05, para. 23.*
13 *ECJ judgment of 27.10.2005, Levob, C-41/04, para. 22.*
14 *Federal Fiscal Court judgment of 19.05.1988, V R 102/83, BStBl. II 1988, 848.*
15 *Federal Fiscal Court judgment of 21.10.1965, V 11/63, HFR 1966, 90; Federal Fiscal Court judgment of 19.05.1988, V R 102/83, BStBl. II 1988, 848.*
16 *Federal Fiscal Court judgment of 01.02.2022, V R 37/21, BStBl. II, 860.*

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