Real Estate Tax Newsletter

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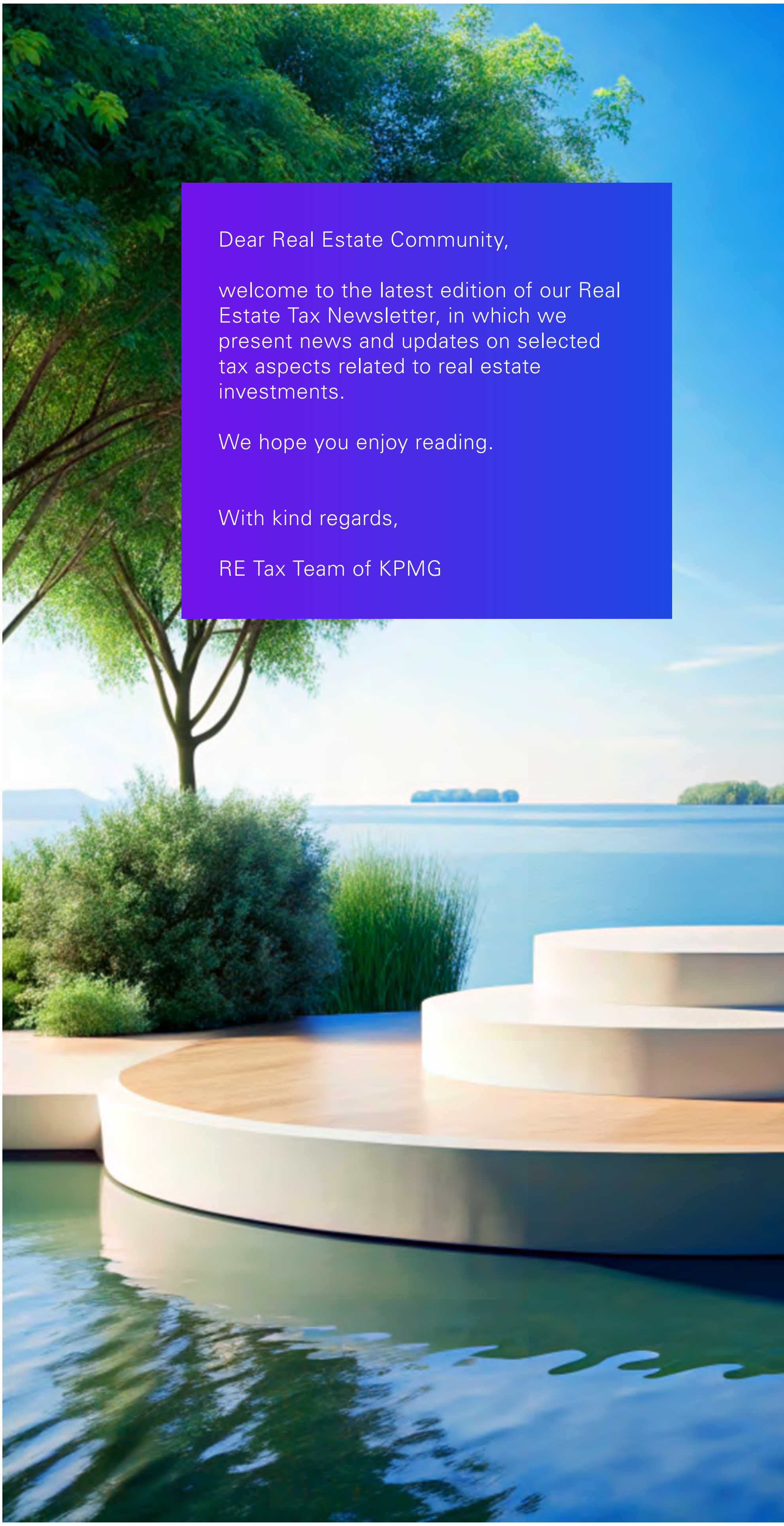
Content



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,

RE Tax Team of KPMG

01

German CFC Rules

Current developments with regard to funds and other companies in the real estate sector

The German CFC Rules (Sections 7 et seq. German Foreign Tax Act [AStG]) have awoken from their slumber in recent years. With the ATAD Implementation Act of June 25, 2021[1], Sections 7 et seq. AStG were largely amended. The amended version is to be applied for the first time from January 1, 2022 (Section 21 (4) AStG). In a letter dated December 22, 2023, the Federal Ministry of Finance (BMF) commented on the amended version.[2] Furthermore, the submission deadline for the "AStG returns 2022" (Section 18 AStG) for advised and non-advised cases was extended to July 31, 2024 (BMF letters dated June 23, 2022 and September 11, 2023). Finally, the low tax threshold for German CFC taxation has been reduced from 25 % to 15 % with effect from 2024 by the Minimum Taxation Directive Implementation Act of December 27, 2023[3].

The following article first presents the wording and legal consequences of the German CFC Rules and then the main contents of the BMF letter dated December 22, 2023, particularly with regard to funds and companies in the real estate sector.

Wording and legal consequences

The basic facts of the German CFC Rules (Sections 7 et seq. AStG) apply if a low-taxed company domiciled abroad generates passive income and is controlled by a person with unlimited tax liability in Germany (so-called intermediate company). Section 8 (1) AStG does not list any passive income. Instead, Section 8 (1) nos. 1 to 9 AStG contains an exhaustive list of active income. All income that is not active in this sense is passive and therefore harmful for the purposes of the German CFC Rules. In EU/EEA cases, CFC taxation can be avoided if proof is provided that the foreign company is engaged in a substantial economic activity (so-called motive test, Section 8 (2) to (4) AStG). In the case of participations in so-called investment companies within the meaning of Section 13 AStG, the motive test can also be applied to participations in third countries (Section 13 (4) AStG). The motive test is intended to ensure that the German CFC Rules comply with European law.

The legal consequence of the German CFC taxation is that the interim income is to be recognized as an add-back amount for the resident in accordance with his participation in the nominal capital and is fully taxable (Section 7 (1) 1, Section 10 AStG). The purpose of the German CFC taxation is to prevent the shifting of income to low-taxed foreign countries.

BMF letter dated December 22, 2023 – Key content

1. Control via a partnership

An intermediate company is controlled by a taxpayer with unlimited tax liability in Germany if the taxpayer alone or together with related parties within the meaning of Section 1 (2) AStG holds more than half of the shares directly or indirectly (Section 7 (2) AStG). A partnership is itself a related party if it fulfills the requirements of Section 1 (2) AStG (Section 7 (3) 2 AStG). The partnership itself is not subject to German CFC taxation. The CFC taxation and declaration obligations apply to its domestic partners (BMF letter dated December 22, 2023, margin no. 955).

1 BGBl. I 2021, 2035.
2 IV B 5 – S 1340/23/10001 :001, BStBl. I 2023 Sondernummer 1/2023, 2.
3 BGBl. I 2023 Nr. 397.

Example:

X, who is subject to unlimited tax liability, holds a 25 % stake in Y-KG (German partnership), to which 100 % of the shares in the nominal capital of the foreign intermediate company (ZG) are attributable. Apart from X, only third parties hold shares in Y-KG.

Viewed in isolation, X would not (indirectly) control the ZG (> 50 % control criterion is not fulfilled). However, the participation of Y-KG, which is closely related to him, in ZG is attributable to him pursuant to Section 7 (3) 2 in conjunction with Section 1 (1) 2 clause 2 in conjunction with (2) 1 no. 1 letter a) AStG (so-called 25 % limit), so that control of the ZG by X is to be affirmed.

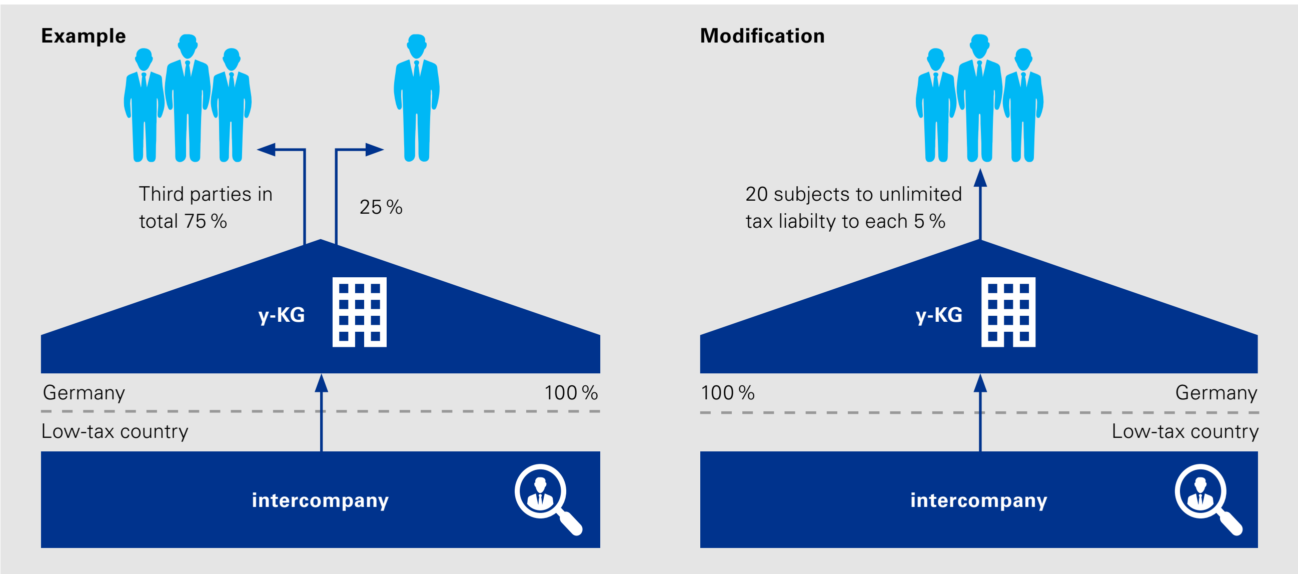
Variation:

20 unlimited taxpayers each hold 5 % of the shares in Y-KG, to which 100 % of the shares in the nominal capital of the foreign intermediate company (ZG) are attributable.

Section 7 (3) 2 AStG does not apply here as the 25 % threshold is not met; instead, Section 7 (4) 1 and 2 AStG must be observed: Accordingly, persons are deemed to be related to the taxpayer – irrespective of Section (1) 2 AStG – even if they cooperate with the taxpayer in relation to the intermediate company through concerted behavior. In the case of the direct or indirect shareholders of a partnership that holds an interest in an intermediate company, it is rebuttably presumed that there is cooperation through concerted behavior.

It is questionable how the assumed cooperation between X and the other partners can be refuted. It is to be welcomed that, according to margin no. 301 of the BMF letter dated December 22, 2023, cooperation by concerted behavior is to be regularly refuted if a shareholding of 5 % in the partnership is not exceeded and no special circumstances apply. In the modification described above, it should therefore be possible to refute this. In all other cases, it would be welcome if the tax authorities were to agree to a well-presented and understandable counterstatement in a practical and timely manner.

Figure 1:
German CFC taxation



Quelle: KPMG, Deutschland, 2024

2. Differentiation from the German Investment Tax Law (InvStG)

The German CFC taxation does not apply if the provisions of the InvStG are applicable to the income for which the foreign company is an intermediate company (Section 7 (5) 1 AStG). This priority of investment taxation is intended to avoid double taxation that could arise in the event of parallel application of investment and CFC taxation at the level of the German investor of a foreign investment fund or foreign special investment fund that qualifies as a foreign company within the meaning of Section 7 (1) 1 AStG. However, Section 7 (5) 2 AStG contains an exception: CFC taxation applies in addition to investment taxation if more than one third of the transactions underlying the income are carried out with the German investor or related parties (so-called one-third limit). The BMF letter dated December 22, 2023, states in margin no. 313 that the calculation of the one-third limit is to be based exclusively on the passive income for which the foreign company is the intermediate company. Accordingly, the one-third limit is exceeded if the sum of the interim income from transactions with the German taxpayer and related parties amounts to more than one third of the total interim income of the foreign (special) investment fund.

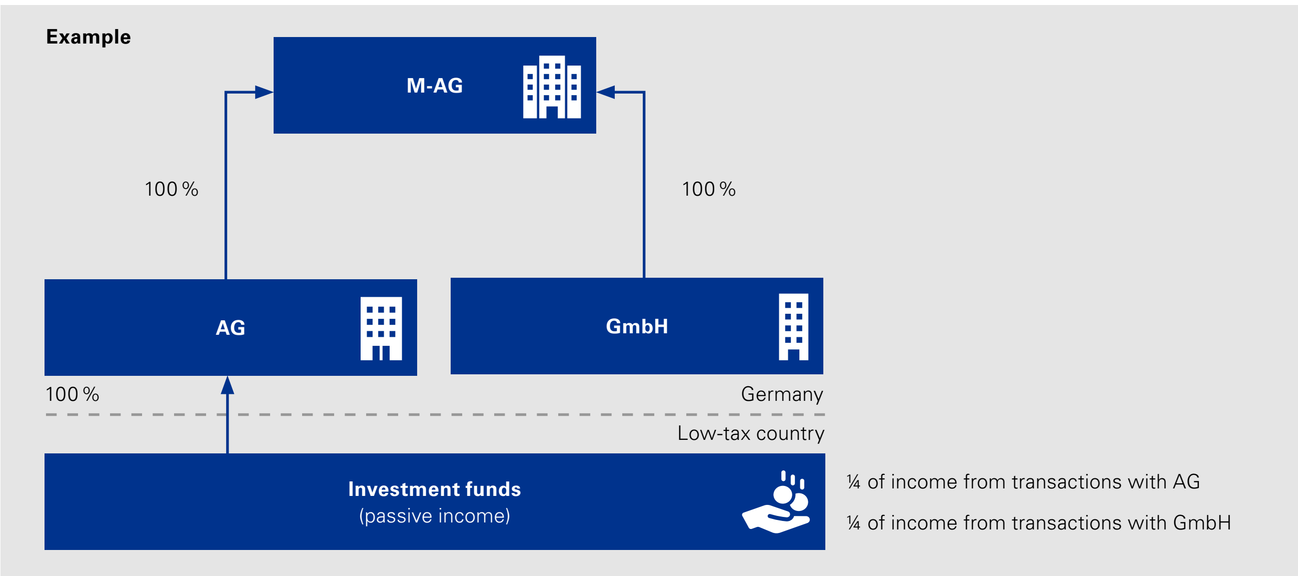
Example (BMF letter dated December 22, 2023, margin no. 315):

A German corporation (AG) with unlimited corporation tax liability holds a 100 % stake in an investment fund with management and registered office abroad. According to the legal type comparison, the investment fund corresponds to a foreign company within the meaning of Section 7 (1) 1 AStG and only generates passive low-taxed income. A quarter of this income comes from transactions with the AG; another quarter comes from transactions with a related party of the AG.

As half, and therefore more than one third, of the transactions underlying the interim income of the investment fund are conducted with the AG and a related party, the priority rule of Section 7 (5) (1) AStG does not apply (Section 7 (5) 2 AStG). Therefore, the general CFC taxation pursuant to Section 7 (1) to (4) AStG is applicable. Section 10 (6) AStG (reduction of the CFC amount if the income or sources of income on which the CFC amount is based lead to income of the taxpayer within the meaning of the InvStG) must be observed.

However, if the foreign investment fund / special investment fund is an investment company, Section 13 (5) 1 AStG must be observed: This states that German CFC taxation does not apply if the provisions of the InvStG apply to the income of an investment nature for which the foreign company is an intermediate company. The one-third limit does not apply here.

Figure 2:
German CFC taxation



Quelle: KPMG, Deutschland, 2024

3. Motive test – outsourcing

In practice, the question often arises as to whether the foreign corporation must always carry out the substantial economic activity itself within the scope of the motive test or whether outsourcing to third parties (in particular other group companies in the same country) is possible (so-called outsourcing). In its judgement of September 22, 2022, the Lower Tax Court of Cologne[4] made a legally binding decision on Section 8 (2) AStG (old version) that outsourcing does not generally prevent the application of the motive test.

The new version of Section 8 (2) AStG nevertheless contains the statement in sentence 5 that the motive test cannot be applied if the company has its main economic activity predominantly carried out by third parties. In the opinion of the tax authorities, substantial economic activity is predominantly carried out by third parties if third parties carry out the activity using their own material and personnel resources in such a way that they shape it in terms of quality and quantity . In particular, this is not precluded if the foreign company carries out subordinate activities (such as auxiliary and ancillary activities) in connection with the activity itself.[5] However, outsourcing to related parties in the same country is harmless.[6] The tax authorities are thus adopting the group substance concept in line with the decision of the Lower Tax Court of Cologne, insofar as this substance is located within the same state, which can probably be seen as a reduction of the current Section 8 (2) AStG in order to preserve its validity. Interestingly, the structure of CFC taxation is thus moving even more in the direction of a global minimum taxation characterized by a country-by-country aggregation of the activities of a corporate group, which in our view is to be welcomed. De lege ferenda, the question therefore arises as to whether this country-by-country group substance approach and aggregation of activities should not be accentuated even more in CFC taxation. The current approach to CFC taxation, which focuses heavily on individual companies, appears to be an outdated approach – particularly in view of the global minimum taxation.

Conclusion and Key Facts

The deadline for submitting the 2022 AStG declarations (Section 18 AStG) is the end of July this year. As 2022 is the first year of the new version, taxpayers with foreign shareholdings should familiarize themselves now at the latest with the version of the German CFC taxation applicable from 2022 and the associated AStG letter. However, there are still no tax forms for preparing the 2022 AStG declarations. In our opinion, it cannot be ruled out that the submission deadline will therefore be extended again. The reduction of the low tax threshold from 25 % to 15 %, on the other hand, can only provide relief for years from 2024 onwards.

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4 6 K 2661/18, EFG 2023, 89.
5 BMF letter, December 22, 2023, margin no. 457.
6 BMF letter, December 22, 2023, margin no. 458.

02

Legislative updates

Selected tax changes as a result of the Growth Opportunities Act and the draft Annual Tax Act 2024

At times, tax law can almost feel like a visit to a restaurant: While the Growth Opportunities Act (GOA) is still warm on the plate, the Annual Tax Act 2024 (ATA 2024) is already being prepared in the kitchen. In order to maintain an overview of this culinary overload, the following article presents the changes to the GOA and the ATA 2024 that are relevant to the real estate sector in bite-sized chunks.

Growth Opportunities Act

Introduction

On March 22, 2024, the Bundesrat approved the GOA as amended by the Finance Committee (taking into account the recommendation of the Mediation Committee). The Act was promulgated in the Federal Law Gazette[1] on March 27, 2024, and came into force on the day after its promulgation.[2]

Temporary introduction of a declining depreciation for residential buildings

In order to promote residential construction and support the construction industry, the GOA introduced a temporary declining balance depreciation of buildings in decreasing annual amounts (Section 7 (5a) EStG).

The option to use the declining balance method of building depreciation is only available for residential buildings whose construction began or will begin after September 30, 2023, and before October 1, 2029.

For buildings that are not self-constructed, the declining balance method of depreciation can be used if (i) the signing takes place after September 30, 2023, and before October 1, 2029, and (ii) the closing actually takes place in the year in which the building is completed.

The depreciation rate is 5 % of the respective book value or residual value of the building. Special depreciation for extraordinary wear and tear is not possible during the period in which declining balance depreciation is used. However, it is possible to switch to straight-line depreciation at any time.

The regulation comes into force with effect from January 1, 2023, and is therefore already applicable retroactively for 2023.

Loss utilization

In order to strengthen the liquidity of SMEs, the percentage limit for minimum taxation was raised for a limited period. The following table shows which percentage limit applies to the loss carryforward in which assessment period.

Figure 1:
Assessment period and percentage of tax losses that can be used

Assessment period	Negative income that exceeds the total amount of income of EUR 1 million / EUR 2 million is deductible to a limited extent in the amount of...
2023	60 %
2024	70 %
2025	70 %
2026	70 %
2027	70 %
2028	60 %

Quelle: KPMG, Deutschland, 2024

1 *Federal Law Gazette 2024 I No. 108.*
2 *Insofar as the regulations discussed below have retroactive effect*

Extended reduction for real estate companies

In order to further promote the expansion of solar power generation on buildings and the operation of charging stations and to strengthen the necessary incentive effect, the harmlessness limit in Section 9 no. 1 sentence 3 letter b GewStG was increased from 10 % to 20 %. Real estate companies can expand their involvement in the supply of electricity in connection with the operation of plants for the generation of electricity from renewable energies or from the operation of charging stations for electric vehicles or electric bicycles and still benefit from the extended reduction. The prerequisite is now that this income from the supply of electricity in the financial year does not exceed 20 % of the income from the transfer of use of the property.

The increase in the 10 % limit to 20 % is to be applied for the first time for the 2023 tax period.

InvStG

The GOA also contains amendments to the InvStG. This was largely prompted by the disclosure of corresponding structures in the course of DAC 6 notifications:

A new Section 2 (9a) InvStG was introduced. This aims to exclude a real estate or foreign real estate partial exemption if there is no or only a low tax burden due to tax exemption regulations.

The amendment to Section 6 (5) sentence 1 no. 1 InvStG is intended to prevent the avoidance of a tax liability through the interposition of a corporation.

Furthermore, an amendment to Section 26 no. 7a sentence 2 InvStG increased the limit by ten percentage points, from 10 % to 20 %. This allows special investment funds to significantly expand their involvement in the operation of facilities for generating electricity from renewable energy or from the operation of charging stations for electric vehicles or electric bicycles. In addition, a synchronization with the regulations on the extended reduction in the Trade Tax Act is established.

The amendments to the InvStG came into force on the day after the law was promulgated. The specific application of the individual provisions can be found in the newly inserted Section 57 (8) InvStG.

Annual Tax Act 2024

Introduction

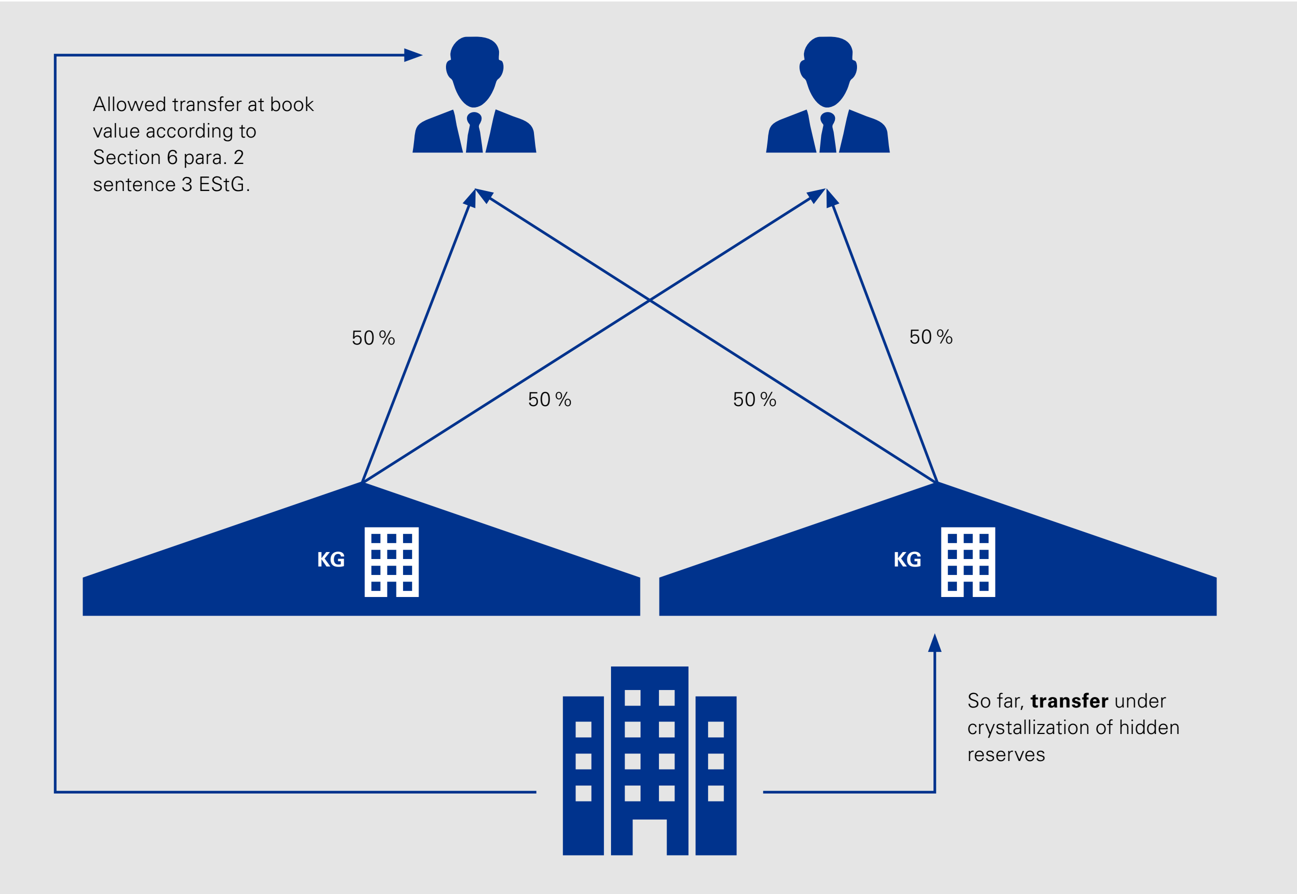
On May 8, 2024, the Federal Ministry of Finance published an unofficial draft bill for an Annual Tax Act 2024 („ATA 2024"). The problem definition and objective of the draft already make it clear that tastes in tax law are changing and that the first courses have been spurned. In its draft, the Federal Ministry of Finance writes of "necessary adjustments to EU law and ECJ case law", "reactions to case law of the Federal Constitutional Court" and "error corrections".

Transfer between partnerships with identical shareholdings

The draft contains a large number of legal amendments that have little or no thematic connection. One of the most important changes relates to transfer procedures and is a reaction to the case law of the Federal Constitutional Court.

German tax law privileges gratuitous transfers between partners and their partnership (Section 6 (3) and (5) EStG). However, the tax authorities had treated gratuitous transfers as tax-effective if they took place between partnerships (with identical shareholdings).[3] In this constellation, there could be a "proper" change of legal entity. Assets and the hidden reserves attached to them would be transferred to another legal entity. This would not be a transfer between the partnership and the shareholder, but rather a transfer to another co-entrepreneurship.

Figure 2:
Comparison of transfers and carryovers



Quelle: KPMG, Deutschland, 2024

3 *Federal Ministry of Finance of December 8, 2011, IV C6 – S 2241/10/10002, BStBl. I 2011, 1279, para. 18 f.*

The Federal Constitutional Court[4] recently ruled that Section 6 (5) EStG violates the ability-to-pay principle, as the transfer of partnerships with identical sharehol-dings is not favored, but instead leads to the taxation of hidden reserves. As a result, the legislator is obliged to retroactively create a new regulation that conforms to the constitution. This new regulation must favor corresponding transfer transactions after December 31, 2000. The ATA 2024 is intended to take up the legislator's obligation and provides for the following changes:

- Section 6 (5) sentence 3 no. 4 EStG-E expands the list of preferential transactions. The catalog also includes transfers in partnerships with identical participations.
- It will be applied retroactively in all open cases. The new regulation is flanked by special procedural provisions which are intended to enable the amend-ment of tax assessments at the level of the acqui-ring partnership (Section 52 (12) EStG-E).
- To protect legitimate expectations, it should be possible to apply to waive the continuation of the book value at the time of the transfer (Section 52 (12) EStG-E). This application should be possible for transfers before January 12, 2024.

Value added tax

A legal change in the area of VAT is similarly inherent in the system. This is because mixed-use buildings allow a partial deduction of input tax. For this purpose, the input tax must be divided into a deductible part and a non-deductible part.

As a rule, this allocation is to be determined by means of an appropriate estimate. In the case of building rentals, an area key is generally assumed. The taxable or tax-free rented areas are therefore compared to the total area in order to determine the deductible or non-deductible part of the input tax. The draft contains new formulations that are to be understood as clarifications:

- The provision on appropriate estimation is based more closely on the wording of the overriding VAT Directive.
- The draft specifies that an estimate based on the total turnover key is only possible if this is the only possible allocation method. It is therefore subordina-te to other, more precise allocation methods.

However, no substantive changes are intended. Rather, the legal situation set out in the draft has already been established by case law at national and European level. In particular, other turnover-based keys (property or department-based turnover keys) remain applicable and can also lead to more appropriate allocations.

4 *Federal Constitutional Court, decision of November 28, 2023, 2 BvL 8/13, NJW 2024, 117.*

InvStG

Not only the GOA contains amendments to the InvStG, but also the draft. Specifically, it is proposed to expand the catalog of taxable income from real estate funds.

In the case of mutual funds, gains from the sale of rent and lease receivables will also qualify as taxable domestic real estate income in future (Section 6 (4) no. 3 InvStG-E). The expansion of the catalog of taxable income for special investment funds, on the other hand, is more extensive. For real estate funds in the form of a special investment fund, it is primarily relevant that all income from letting and leasing is subject to taxation as income equivalent to distributions (Section 36 (1) no. 2 sentence 2 InvStG-E). According to the previous wording, gains from the sale of rent and lease receivables were neither distribution-equivalent income nor tax-free capital gains that could be reinvested. As a result of the amendment, all rental and lease income within the meaning of Section 21 EStG will be subject to annual taxation.

The draft also contains further amendments in the area of partial exemption, which relate in particular to regulations on the limitation of structures. These amendments lead to further proof requirements for investors (Section 20 (4), (4a) InvStG-E).

Conclusion and Key Facts

Haute cuisine is characterized in particular by a creative approach, attention to detail and a perfect arrangement. From this perspective, the German tax legislator is unlikely to feature in the Michelin Guide any time soon.

Nevertheless, from the perspective of the real estate industry, it is very pleasing that, in addition to heavy fare such as the amendment to the German Investment Tax Act (InvStG), easily digestible morsels such as relief from the extended property deduction and improved loss utilization are also being served up.

It remains exciting to see which proposals in the ATA will make it onto the final menu.

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03

Tightening of intragroup financing regulations

Impact of the Growth Opportunities Act on intragroup financing transactions in the real estate sector

With effect from January 1, 2024, the German legislator has introduced binding regulations for inbound intragroup financing transactions with Section 1 para. 3d and para. 3e Foreign Tax Act ("FTA"). These new regulations represent a further restriction on interest deductibility (in addition to the earnings stripping rules and the addback of trade tax), which will in particular affect foreign financing of real estate, infrastructure, and renewable energy projects. The interest expense resulting from internal financing can only be claimed for tax purposes after various analyses have been successfully carried out and sufficient evidence has been provided. However, parts of the wording of the law are open to interpretation, creating the potential for future conflict with the German tax authorities.

With the extension of the FTA, the legislator has incorporated the OECD Transfer Pricing Guidelines 2022, Chapter X, into national law. The regulations apply to multinational groups of companies that, in accordance with Section 90 para. 3 sentence 4 General Tax Code, consist of at least two companies that are based in two different countries and are related within the meaning of Section 1 para. 2 FTA or consist of at least one company with at least one permanent establishment in another country. Both unlimited and limited taxpayers are affected by the new regulations. The amendment will enter into force on January 1, 2024. In addition to new intragroup financing transactions, transactions and the resulting interest expense that were entered into prior to the amendment and that are still active at the time it comes into effect, i.e. that generate interest expenses after January 1, 2024, will also be affected.

Financing relationships

Pursuant to Section 1 para. 3d FTA, expenses from cross-border financing relationships within a multinational group of companies are only tax deductible if:

1. The domestic taxpayer demonstrates that he could have provided the debt service over the entire loan term from the outset ("debt capacity analysis"); and

2. The financing is commercially necessary and used for the purpose of the business ("business purpose test"); and

3. The applied interest rate is equal or below the rate that would be granted by an external third party using the group credit rating ("maximum interest rate"). If, on an individual basis, it can be demonstrated that a rating derived from the group credit rating corresponds to the arm's length principle, this must be taken into account when calculating the interest rate.

One of the reasons given by the legislator for introducing the above-mentioned restrictions on interest deductibility is that intragroup cross-border financing relationships generally offer a great potential for minimizing tax payments, particularly in the case of high-interest (hybrid) financing or the provision of debt and equity capital to real estate companies.

Two issues are particularly critical for the real estate sector when it comes to introducing debt capacity as a legal requirement. On the one hand, the taxpayer must prove that he would have been able to provide the periodic debt service from the outset, which seems unrealistic, especially for development or renovation projects, as these usually do not generate rental income in the (initial) financing phase. Secondly, the debt service includes both interest and principal payments. Therefore, even in the case of a bullet loan, an amortization loan must be notionally assumed, which is atypical for the real estate sector.

The intended use of the group rating must also be questioned in the real estate sector. For example, the use of property companies as special purpose vehicles is explicitly designed to limit the liability for the group, which is usually also recognized by banks in the course of external financing. Furthermore, a group rating is not available in all cases (e.g. in the case of investment funds). The proposed escape clause, according to which an individual rating derived from the group rating can be used in individual cases, does not circumvent the challenges outlined above and shifts the burden of proof to the taxpayer. In addition, the wording "a rating derived from the group credit rating" is highly open to interpretation.

Routine financial services

Section 1 para. 3e FTA also introduces a classification of low-function and low-risk services for financing relationships. Accordingly, pure brokerage services, the forwarding of financing transactions and typical treasury functions (e.g. liquidity management, financial risk management and currency risk management) or activities of financing companies are to be classified as low-function and low-risk services which are to be rewarded with a routine compensation. Non-routine remuneration is only possible if the taxpayer demonstrates a more complex profile for the financial services company on the basis of a comprehensive functional and risk analysis. The burden of proof for proving non-routine services lies once again with the taxpayer. With this regulation, the legislator is trying to sanction so-called FinCos, which are often based in low-tax jurisdictions abroad.

Implications for taxpayers

In view of the addition of para. 3d and 3e to Section 1 FTA, it is advisable to take certain measures to ensure compliance with the new transfer pricing rules. To this end, existing transfer pricing guidelines and templates for intragroup financing agreements should be reviewed. In addition, the new rules (including a debt capacity analysis, business purpose test, and detailed justification of the interest rate applied using a specific rating) should be taken into account in all future transfer pricing benchmarks. A review of the substance of existing intra-group financing/brokerage structures is also recommended. For financing arrangements entered into prior to January 1, 2024, it is recommended to conduct a health check and review whether the existing documentation can still be considered sufficient under the new regulations. In addition, the existing transfer pricing documentation should be adjusted if, for example, no debt capacity analysis has been carried out so far or the rating was determined without taking into account the group credit rating.

Conclusion and Key Facts

With the addition of para. 3d and 3e to Section 1 FTA, the legislator has for the first time established specific regulations for cross-border intragroup financing relationships. As a result, taxpayers within the real estate sector in particular are confronted with new regulatory challenges which, due to sector-specific characteristics, may lead to a high potential for conflict with the tax authorities. Against this background, taxpayers should in particular review their existing transfer pricing concept, their documentation approach and current cross-border intragroup internal financing arrangements.

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04

Retroactive obligation to capitalize fund establishment costs is ruled to be constitutional by a local court

Project companies, in particular funds qualifying as partnerships, must capitalize the so-called fund establishment costs as acquisition costs. This is still a controversial issue with regard to the specific handling and retroactive application!

The obligation introduced by law in 2019 to capitalize fund establishment costs, which also includes management fees, is still controversial. This applies, on the one hand, to the practical implementation of the standard and, on the other hand, to the retroactive effect prescribed by law.

The Münster Fiscal Court (12 K 357/18 F , hereinafter: Münster Fiscal Court ruling) has now commented on the requirements of Section 6e of the German Income Tax Act (EStG), which qualifies fund establishment costs as acquisition costs, and has ruled that its application to completed assessment periods constitutes a constitutionally permissible retroactive effect. Nevertheless, the standard and its application remain controversial in literature and practice. The BFH will now probably have to decide on its application. The case is pending there under case number IV R 6/24. This is all the more reason to take another closer look at the standard and think "clearly".

What does 6e EStG regulate?

Section 6e (1) EStG stipulates as a legal consequence that so-called fund establishment costs are included in the acquisition costs of assets that taxpayers acquire jointly with other investors in accordance with a contract pre-formulated by a project provider (e.g. ships, investments in corporations, real estate). The prerequisite for application is that the investors do not have any significant opportunities to influence the contract in their corporate relationship, cf. Section 6e para. 1 sentence 2 EStG. In this case, the assets are deemed to have been acquired within the meaning of Section 6e (1) sentence 1 EStG.

As a result, such fund establishment costs cannot be deducted immediately as profit-reducing operating expenses or income-related expenses and cannot increase the loss in accordance with Section 15b EStG.

Who is affected?

In the context of closed-end funds, the lack of possibility to influence the contractual structure, as required by the wording of the law, is typical. The provision therefore applies in principle to partnerships, but is of practical significance for alternative funds, particularly in the area of private equity funds, ship funds and real estate funds.

In addition, according to Section 6e (3) EStG, the legislator also considers comparable cases to be covered by the scope of application. According to the explanatory memorandum, such a case could be the acquisition of a condominium in an old building renovated by a property developer if, in addition to the sale, the developer also takes on the financing and subsequent letting (such concepts could also be found in the area of vacation apartments), but other cases are also conceivable. In practice, however, the standard with its many opening clauses is little known outside the tax sphere of closed partnership funds.

What are fund establishment costs?

In accordance with Section 6e (2) EStG, these fund establishment costs include, in addition to the traditional acquisition costs within the meaning of Section 255 HGB, all expenses paid to the provider on the basis of the pre-formulated contract value that are aimed at the acquisition of assets by the fund. Accordingly, this also includes all expenses paid to the project provider or to third parties that are economically related to the handling of the project in the investment phase and the liability and management fees for general partners, management fees for the exchange of services under the law of obligations and fees for limited partners in trust, insofar as they are attributable to the investment phase (regularly referred to as "management fees" in the closed-end fund sector).

The definition is vague and is closely based on the so-called "Bauherren- und Fondserlass" of October 20, 2003 (BStBl I 2003, 546). The purpose of the application is to be taken into account, insofar as it is not aimed at the acquisition (purchase) of the assets, such as expenses for the use and management of the acquired asset. The latter can be recognized as an expense immediately.

Typical examples of fund establishment costs are

- Equity brokerage commissions,
- Debt placement fees,
- Costs of fund conception (incl. advisor fees),
- Fee for placement guarantee,
- Fees for analyses of potential investment opportunities,
- Prospectus report.

According to the narrow wording of Section 6 (2) EStG, the costs are "expenses of the investors" and therefore it could have been interpreted that the application of Section 6e EStG requires the investors to bear the costs directly. However, the new Münster tax court ruling clarifies that costs borne by the fund itself, e.g. for shareholders joining at a later date or in connection with secondary market funds as a whole, are also subject to the capitalization requirement.

Definitional ambiguities remain even after the Münster tax court ruling

Section 6e EStG is characterized by unfortunate wording and numerous undefined terms. The recent Münster tax court ruling now attempts to outline some of these terms, at least approximately :

- "Jointly" – The court sees the joint decision in the shareholders' meeting, which must decide on the pre-formulated contract, as being of primary importance.

- "Pre-formulated contract" – The court considers a contract to be "pre-formulated" within the meaning of Section 6e para. 1 sentence 1 EStG if "the investor only has the choice of either accepting the entire bundle of contracts or not participating (BFH ruling of 14.11.1989 IX R 197/84, BStBl II 1990, 299). It is based on the unilateral 'specification' of the contractual framework by the initiator of the fund and the associated model-related passivity of the investors. In this case, the investors have no (entre-preneurial) influence on the economic concept of the fund (see also BFH ruling of April 14, 2011 IV R 15/09, BStBl II 2011, 706,[...]" , even if, for example, they give their approval or rejection of the

implementation of a project at a shareholders' meeting. Insofar as a few investors from a pool of many investors (e.g. a general partner) have exerted influence on the contract, this is not detrimental to the fulfillment of the criterion in the case decided by the tax court. In the present case, a board of directors had drawn up the "project". The administrative board consisted of only three persons in total, one of whom was a member of the plaintiff's management and only two of whom belonged to the group of over 900 investor limited partners. In the opinion of the Senate, these two persons cannot adequately represent the large number of investors and bring about a decision with a significant possibility of exerting influence under company law.

- Acquirer fund or a manufacturer fund – Furthermore, the court clarifies that the provision of Section 6e (2) sentence 2 EStG applies irrespective of whether the fund is an acquirer fund or a manufacturer fund without the application of Section 6e EStG. This circumstance was increasingly discussed in literature when Section 6e EStG was introduced.

- "Project term" – The court also addresses the term "project" within the meaning of Section 6e (2) sentence 2 EStG. Accordingly, the system within Section 6e EStG suggests that the term "project" does not correspond to the term "asset". Rather, it can go beyond this and – even according to general usage – is characterized less by an object than by a specific conceptual objective.
  In this sense, however, it is still unclear whether so-called "fund-of-funds" (i.e. two-tier partnerships in which the lower partnership is invested in a number of investments, including other partnerships) fall within the scope of the standard at all, as a partnership share is explicitly not an asset. It therefore remains questionable whether the "project concept" also includes investments in other partnerships, which did not have to be decided in the present proceedings.

- "Investment phase" – The court roughly defines the investment phase for the first time. This "regularly begins with the concrete planning and preparatory actions (by the project provider) with regard to the subsequent acquisition process and ends with the acquisition of the property [...]". According to the wording of the law, the investment phase is expressly not to be understood in terms of economic goods, but in terms of projects. Measures in the investment phase include, among other things, the procurement of the necessary capital, in particular the raising of loans and the acquisition of investor capital (see BFH ruling of April 13, 2017 IV R 14/14, BStBl II 2022, 716).

A question of constitutionally dubious "genuine" retroactivity for circumstances prior to the entry into force of Section 6e EStG

Section 6e EStG came into force in 2019 and applies to all outstanding assessment periods. This raises the controversial question in literature and practice as to whether the resulting retroactive effect is constitutional. According to the current prevailing opinion in literature, this should be denied, but the Münster tax court ruling takes a different view, at least in part, with regard to this specific case.

A genuine retroactive effect, as in the present case, is only constitutional if the affected parties have no interest worthy of protection (protection of legitimate expectations). This is usually the case if the legislator reacts immediately to a supreme court decision that abandons established case law and restores the legal situation that corresponds to the abandoned established case law.

A distinction is made between the following two periods:

- Old facts until July 11, 2018: During this time, there was consensus in case law and administrative practice (cf. Bauherren- und Fonds-Erlass, BMF letter dated October 20, 2003, BStBl I 2003, 546, supplemented by several OFD rulings, including Oberfinanzdirektion Rheinland in its ruling dated January 8, 2007 – S 2241 – 1002 – St 222) that fund establishment costs should be capitalized for project companies. Until the introduction of Section 15b EStG, the immediate deduction as operating expenses was therefore already prohibited for various fund establishment costs in the case of model structures under the application of Section 42 AO. In the case at issue, the Münster tax court did not see any unconstitutional retroactive effect for this period. Whether the administrative practice at the time also defined management fees as fund establishment costs on a nationwide basis and was also applicable to traditional private equity funds, for example, is doubtful and has not been conclusively clarified. The new Münster tax court ruling cannot provide any clear information on this, as it relates to a case involving ship fund investments.

- Facts from July 11, 2018, to August 9, 2019: However, the legal situation changed with the amendment in established supreme court case law as a result of the BFH ruling of April 26, 2018 IV R 33/15, which was published on July 11, 2018. The BFH ruling stated that the fund establishment costs should not be capitalized on the basis of the previous case law on the building owner decree (assuming these were an abusive arrangement within the meaning of Section 42 AO), as Section 15b EStG is a special anti-abuse provision that takes precedence over Section 42 AO. As a result, the BFH has allowed the deduction of fund establishment costs as immediately deductible operating expenses from this point in time. In the case at issue, the Münster tax court did not have to make a statement on this period and the question of the constitutionality of a genuine retroactive effect for this period remains unresolved and may not have to be clarified by the BFH, as the underlying initial facts are not affected here. However, with the submission of the draft bill on Section 6e EStG to the Bundesrat on August 9, 2019, there should no longer be any protection of taxpayers' legitimate expectations.

Conclusion and Key Facts

Adjustments to previous practice for the implementation of Section 6e EStG with continued uncertainty and the need for a provisional tax assessment

The unfortunate wording, peppered with numerous undefined legal terms, as well as the unsystematic treatment of costs, which deviates from the principles of commercial law, have presented legal practitioners with major challenges for years. Legal practitioners do not only refer to the "project" companies and the indirectly affected investors, but also the asset managers and tax advisors of these companies as well as the tax authorities themselves, who are still faced with practical implementation issues in the context of tax audits. Questions that have not yet been conclusively clarified, e.g. by an OFD ruling or even a BMF letter, are not conclusive:

- Which costs exactly are to be capitalized and how do you deal with overhead costs, including those covered or included by the management fee?
- How long is the investment phase and does it also apply to secondary funds?
- What practical simplifications and assumptions can be made when determining the investment phase, especially for project companies with a large number of individual assets within several "projects", such as fund-of-fund structures?
- What exactly is a pre-formulated contract and are, for example, so-called "co-investments", which often occur in practice and where a contract is regularly discussed individually with the contracting parties, already covered by the scope of application?
- When do investors have a possibility to exert influence and how is this defined and how should this be documented vis-à-vis the tax authorities? Is a specific investment amount sufficient?
- How exactly should costs be capitalized in practice, e.g. via collective items or similar? Various models are already established on the market.
- How should special cases such as a fund-of-fund private equity structure (two-tier personnel companies) be handled?
- For example, in the case of a collective item model, are there also requirements for the reversal of this item?

It therefore remains questionable how this standard should be applied in practice. Taxpayers should keep proceedings open until a supreme court ruling at the BFH. Negotiations and discussions with the tax authorities are likely, which is why good documentation and clear, uniform internal guidelines for the treatment of the capitalization of costs should be a must for fund providers.

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05

News from the real estate transfer tax

The identical guidelines issued by the supreme tax authorities of the federal states on March 5, 2024, the draft bill for the Annual Tax Act 2024 and a BFH procedure on real estate transfer tax ("RETT") in the case of restructuring groups of companies

On March 5, 2024, three new identical guidelines of the supreme tax authorities of the federal states were published for the application:

- **of Section 1 para. 3 of the German Real Estate Transfer Tax Act ("RETTA"), so-called "legal" unification of shares[1]**
- **of Section 1 para. 3 in conjunction with para. 4 RETTA to RETT group cases[2]**
- **of Section 5 and 6 RETTA (regarding tax exemptions for land-owning partnerships)[3]**

Compared to the previous versions of these guidelines dated November 11, 2018, and September 19, 2018, the guidelines on RETT group cases and on tax exemptions for land-owning partnerships do not contain any significant changes, but essentially only adjustments to the new participation limits (90 % instead of 95 %) and deadlines (10 or 15 years instead of 5 years) due to the so-called share deal reform, which became legally valid on July 1, 2021. Therefore, these two guidelines are not discussed further below.

The guidelines on the "legal" unification of shares summarizes various earlier guidelines on this issue, adapts them to the new limits of the share deal reform, but also contains some positive clarifications, which we present below. Due to the identical guidelines issued by the supreme tax authorities of the federal states on October 16, 2023, on the attribution of real estate for the rules on share deals in Section 1 para. 2a to para. 3a RETTA[4] ("**Attribution Guidelines as of October 16, 2023**"), apprehensions had arisen that the application of Section 1 para. 3 RETTA could become more stringent, particularly in multi-level corporate structures in which companies are at least 90 % affiliated with each other. The new guidelines on the unifications of shares dated March 5, 2024, clarifies in favor of the taxpayer that this is not the case.

According to the Attribution Guidelines as of October 16, 2023, RETT, pursuant to Section 1 para. 2a to para. 3a RETTA, can in certain cases be triggered twice at various levels if shares are acquired in a company that directly or indirectly owns a real estate company . This problem and other issues relating to the attribution of real estate shall be resolved by the Annual Tax Act 2024, as outlined below. A draft bill dated May 8, 2024, is available.

In proceedings II R 8/23, the question is pending before the Federal Fiscal Court as to whether it is contrary to the Council Directive 2008/7/EC of February 12, 2008, concerning indirect taxes on the raising of capital ("**Council Directive 2008/7/EC of February 12, 2008**") that restructurings of groups of companies with real estate holdings are in general not exempted from RETT.

1. Guidelines on the application of Section 1 para. 3 RETTA

According to the new guidelines, if a group of companies acquires shares in a company owning German real estate, a taxable unification in the meaning of Section 1 para. 3 RETTA comes into consideration for every company in the group that directly or indirectly unifies at least 90 % of the real estate company after the acquisition. However, the RETT is only realized for the company that is directly involved in the corresponding acquisition transaction. Only if this company directly involved in the relevant acquisition transaction does not itself meet the requirements for a taxable unification (e.g. because it does not meet the threshold of 90 %) the RETT will be assessed on the company closest to this company that directly acquires the real estate company and meet the requirements for a taxable unification. As a result, the RETT in the corresponding shareholding chains/multi-level structures will, as before, always be assessed at the lowest legal entity that meets the requirements for a taxable unification.

1 *Federal Tax Gazette ("BStBl.") 2024 I, p. 383*
2 *BStBl. 2024 I, p. 393*
3 *BStBl. 2024 I, p. 410*
4 *BStBl. 2023 I, p. 1872*

In addition, the guidelines stipulate that – as previously – no RETT within the meaning of Section 1 para. 3 RETTA is triggered in the case of amplification of shareholdings. Amplification of shareholdings is given, for example, if the minimum 90 % shareholding chains described above are shortened or shareholdings are increased (e.g. to 100 %). However, RETT can be triggered in accordance with Section 1 para. 2a or para. 2b RETTA if an indirect shareholder becomes a direct shareholder in the company owning the real estate because of the shortening of the chain.

The acquisition of a land-owning company may initially constitute a taxable unification of shares within the meaning of Section 1 para. 3 no. 1 or 3 RETTA at the time of the conclusion of the contractual obligation transaction (signing) and a taxable change of shareholder within the meaning of Section 1 para. 2a or para. 2b RETTA at the time of the subsequent transfer of the shareholding in rem (closing). In these cases, the guidelines stipulate that RETT should only be assessed at closing if there is likely to be not more than one year between signing and closing, provided that the property portfolio of the transferred company is identical at the time of signing and closing and both transactions were reported in full and on time. A similar regulation already existed in the identical guidlines issued by the supreme tax authorities of the federal states on May 5, 2022, on the application of Section 1 para. 2a RETTA[5] and Section 1 para. 2b RETTA[6] . In the meantime, it was unclear whether this equity regulation would continue to apply, due to changes in the law.

2. Draft bill for the Annual Tax Act 2024

If a company acquires at least 90 % of a land-owning company, the property is attributed to both the land-owning company and the acquiring company for RETT purposes in accordance with the Attribution Guidelines as of October 16, 2023. If the shares in the acquiring company are transferred directly or indirectly, this transaction can trigger RETT at the level of both the acquiring company and the company owning the land.

The draft bill stipulates that in future the property should only be attributed to the company owning the land, thus avoiding the possible double burden for the cases described.

However, the draft bill also stipulates that the property should not only be attributed to the company owning the property (i.e., the company that purchased the property, for example), but also to the company that acquired economic ownership of the property in accordance with Section 1 para 2 RETTA. In particular, trustors have economic ownership. If, for example, a company as trustee purchases a property for another company as trustor, the property is attributable to both the purchasing company and the trustor company for RETT purposes. This means that both the transfer of shares in the purchasing company and the transfer of shares in the trustor company can trigger RETT.

According to the draft bill, the following abusive arrangement is also to be prevented: A company sells a property before its change of shareholder. At the time of the change, the company is therefore without real estate, which means that no RETT is triggered. The company then reacquires the property. The tax assessment for both the sale and the repurchase of the property is not made or can be revoked in accordance with Section 16 RETTA. As a result, no RETT is payable.

The draft bill now stipulates that in these cases a retroactive event within the meaning of Section 175 para. 1 sentence 1 no. 2 AO is given, with the result that the company is retroactively deemed to own real estate and thus the transfer of its shares can trigger RETT pursuant to Section 1 para. 2a to 3a RETTA.

3. Federal Fiscal Court proceedings on RETT for the restructuring of groups of companies

The so-called group clause of Section 6a RETTA only provides for exemption from RETT in specific cases for restructurings of groups of companies in which directly or indirectly land-owning companies are affected.

In proceedings II R 8/23, the Federal Fiscal Court must now decide whether the general taxation of corresponding restructurings violates Art. 5 para. 1 in conjunction with Art. 4 of the Council Directive 2008/7/EC of February 12, 2008.

5 BStBl 2022 I, p. 801
6 BStBl 2022 I, p. 821

Conclusion and Key Facts

1. Guidelines on the application of Section 1 para. 3 RETTA

The shortening of shareholding chains in which each company holds at least 90 % of the shares in the subsequent company will not constitute a taxable unification of shares within the meaning of Section 1 para. 3 RETTA in the future either. However, if the shortening of the shareholding chain leads to a change of shareholder at direct level, a taxable change of shareholder pursuant to Section 1 para. 2a or 2b RETTA may be considered.

If a legal transaction under the law of obligations (signing) leads to a taxable unification of shares within the meaning of Section 1 para. 3 RETTA and the subsequent transfer of the shares (closing) leads to a taxable change of shareholder within the meaning of Section 1 para. 2a or 2b RETTA, the RETT for the signing is not assessed if

b. the period between signing and closing is expected to be a maximum of one year and

c. signing and closing were reported in full and on time and

d. the property portfolio of the transferred company is identical at the time of signing and closing.

2. Draft bill for the Annual Tax Act 2024

In future, properties are only to be allocated for RETT purposes to the company that has acquired the property itself and/or the economic ownership of the property.

3. Federal Fiscal Court proceedings on RETT for the restructuring of groups of companies

If RETT is assessed during a restructuring (e.g. because Section 6a RETTA is not applicable) or a tax exemption granted is fully or partially retroactively waived (e.g. because the subsequent retention period under Section 6a RETTA was not complied with), it should be checked whether the tax assessment should be kept open by means of an objection with reference to the pending proceedings at the Federal Tax Court II R 8/23.

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