03

New published guidance on hybrid mismatches

More clarity for international real estate investment funds?

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Section 4k of the German Income Tax Act (Einkommensteuergesetz – "EStG") was introduced in Germany to implement the requirements of the ATAD Directive and is applicable to expenses incurred after December 31, 2019. Under certain conditions, it limits the deduction of business expenses or prevents tax exemptions. Interest from shareholder loans in international real estate investment structures may also be affected. Almost five years after the first applicability of Section 4k EStG, the German Federal Ministry of Finance has now finalized its guidance on the deduction of business expenses in the event of tax mismatches (Section 4k EStG) and published it on December 5, 2024. Compared to the draft guidance dated July 13, 2023, there have only been a few changes, but these are all the more relevant for the real estate fund industry. In the following article, we would like to present possible cases of application of Section 4k EStG to international investment structures of real estate (special) investment funds and also discuss the findings of the final BMF guidance.

Background

One of the aims of the ATAD Directive was to better record and manage the tax effects of so-called „hybrid mismatches" – in German Section 4k EStG „tax mismatches". Hybrid mismatches or tax mismatches refer to different tax qualifications of the same situation from different national perspectives. The fundamental prerequisite is therefore always a cross-border connection, meaning that a situation must be assessed for tax purposes from several jurisdictions.

Various forms of taxation mismatches

Financial instruments can, for example, qualify as debt for tax purposes from the perspective of one jurisdiction and as equity for tax purposes from the perspective of another jurisdiction. In this case, one speaks of „hybrid financial instrument mismatches". This can affect, for example, convertible bonds, profit-participating loans or other financial instruments that have both equity and debt characteristics.

Legal entities may qualify as tax transparent from the perspective of one jurisdiction and as non-transparent from the perspective of another jurisdiction. In this case, one speaks of „hybrid entity mismatches". A hybrid entity can exist, for example, in connection with options such as the US „check-the-box" procedure.

These qualification conflicts can result, for example, in a tax deduction in both countries (so-called „double deduction" – DD) or a deduction in one country with simultaneous non-taxation in the other country (so-called „deduction/non-inclusion" – D/NI).

Section 4k EStG contains successive restrictions on the deduction of business expenses for the various types of possible tax mismatches in (1)-(5). For the prohibition on the deduction of business expenses to apply, the qualification conflict must also be causal for the non-taxation or low taxation. A personal tax exemption, e.g. in the case of pension funds, does not lead to a restriction on the deduction of business expenses within the meaning of Section 4k EStG.

Section 4k (1) EStG concerns hybrid financial instruments, (2) hybrid legal entities. (3) concerns deviating allocations or attributions of income, (4) the double recognition of expenses and (5) concerns so-called imported tax mismatches.

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1 Richtlinie (EU) 2016/1164 des Rates vom 12. Juli 2016.
2 BMF-Schreiben v. 5.12.2024, GZ IV C 2 – S 2144-i/21/10010 :014 (im Folgenden „das BMF-Schreiben")

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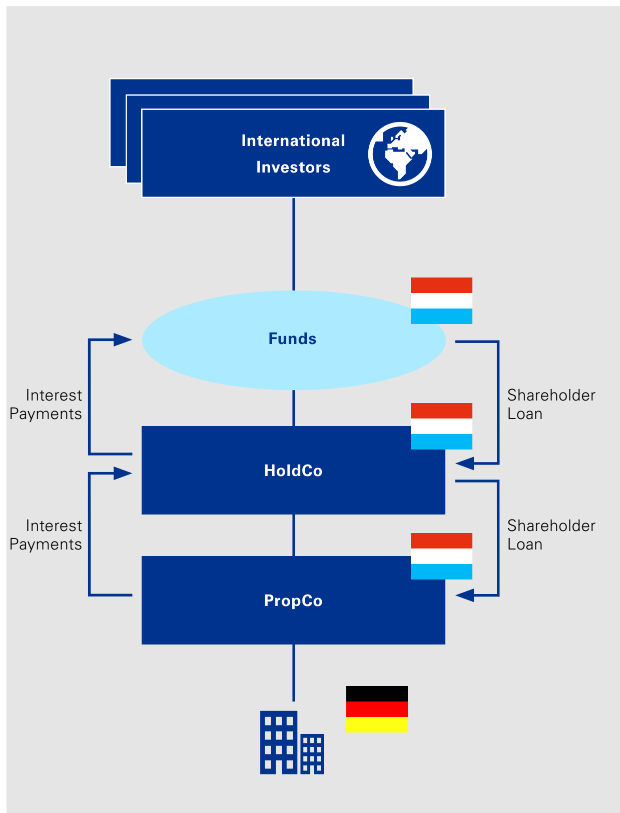
Example case



Source: KPMG Germany, 2025

The following simplified and abstracted practical example is intended to explain the relevance for internationally active real estate (special) investment funds:

A Luxembourg real estate investment fund in the form of a fonds commun de placement (FCP) (**„Fund“**) holds shares in a Luxembourg corporation (**„Lux HoldCo“**), which holds shares in another Luxembourg corporation, which in turn holds a German property (**„Lux PropCo“**). A large number of international investors are invested in the Fund.

To finance the acquisition of the property, the Fund grants a shareholder loan to Lux HoldCo, which passes this on to Lux PropCo. Lux PropCo pays interest to Lux HoldCo and Lux HoldCo pays interest to the Fund.

Lux PropCo is subject to non-resident taxation in Germany due to the property being located in Germany.

The interest paid by Lux PropCo is generally deductible as a business expense in Germany. At the level of Lux HoldCo, this is generally taxable. However, Lux HoldCo also has interest expenses from the interest payments to be made to the Fund, which offset its income. The Fund is treated as transparent from a Luxembourg tax perspective, meaning that the interest income is not included in the tax base in Luxembourg.

In the interaction between Luxembourg and Germany, there should be **no hybrid financial instrument** (Section 4k (1) EStG) and **no hybrid legal entity** (Section 4k (2) EStG) with regard to Lux PropCo, Lux HoldCo and the usual shareholder loans, and there should also be no tax mismatch within the meaning of Section 4k (3) and (4) EStG.

However, there could be an imported tax mismatch within the meaning of Section 4k (5) EStG if investors in the Fund do not treat it as transparent like Luxembourg, but as non-transparent and/or do not treat the income as taxable interest. This is because, in accordance with Section 4k (5) EStG, operating expenses are also not deductible if the income resulting directly or indirectly from these expenses is offset by expenses the deduction of which would be denied if Section 4k EStG were applied accordingly.

In the example case, the interest expenses that are generally deductible in Germany at the level of Lux PropCo result in interest income at the level of Lux HoldCo. At the level of Lux HoldCo, this would generally be taxable, but this is offset by interest expenses

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from the loan from the Fund to Lux HoldCo, which neutralize the interest income at the level of Lux HoldCo for tax purposes. In order to determine whether the deduction of these interest expenses at the level of Lux HoldCo could be restricted by a corresponding application of Section 4k EStG, the perspective of the Fund's international investors would also have to be taken into account.

Thus, the deduction of operating expenses at the level of Lux PropCo could be limited depending on the tax treatment of the Fund and the income at the level of the international investors.

In practice, this risk usually poses major challenges for funds with a large number of international investors, as information on the tax treatment at the level of the international investors may not be available or not fully available.

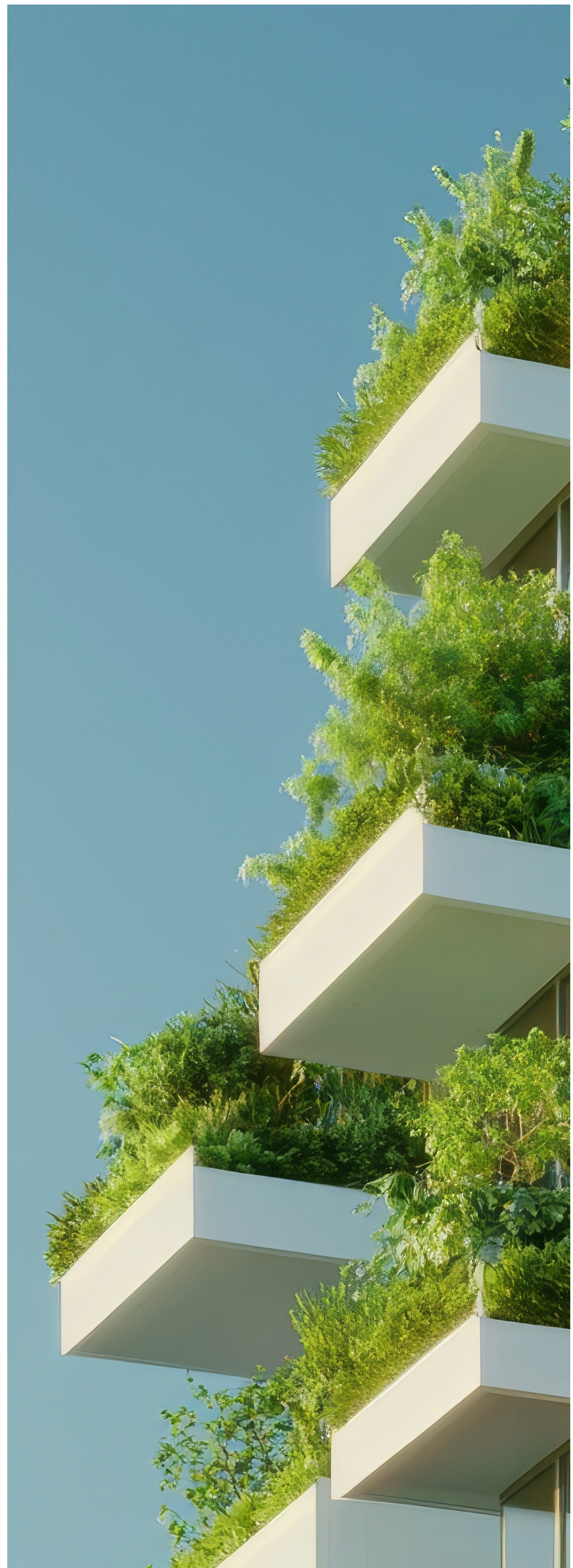
Helpful addition in the BMF circular

The final BMF guidance dated December 5, 2024, now contains a welcome and helpful clarification for the constellations described above and similar situations.

This is because a prerequisite for the application of Section 4k (1)-(5) EStG is, in accordance with Section 4k (6) sentence 1 EStG, that the facts are realized between related parties within the meaning of Section 1 (2) of the German Foreign Tax Act (Außensteuergesetz – **„AStG"**) or that a structured arrangement is to be assumed. For a structured arrangement to exist, the tax advantage from the tax mismatch would already have to have been included in the contractual relationships between the parties involved. This is not to be assumed in the present case.

It therefore depends on the parties involved qualifying as related parties and their acting together. According to Section 1 (2) AStG, a threshold value of at least one quarter is decisive with regard to the participation in the subscribed capital, voting rights or a claim to the profit or liquidation proceeds. An indirect or direct controlling influence or a joint parent company that holds a significant stake (at least one quarter) in both the person and the taxpayer can also constitute a close relationship.

The Fund regularly holds 100 % of the nominal capital of Lux HoldCo and the latter holds 100 % of the nominal capital of Lux PropCo, so there is no dispute that these are related parties.



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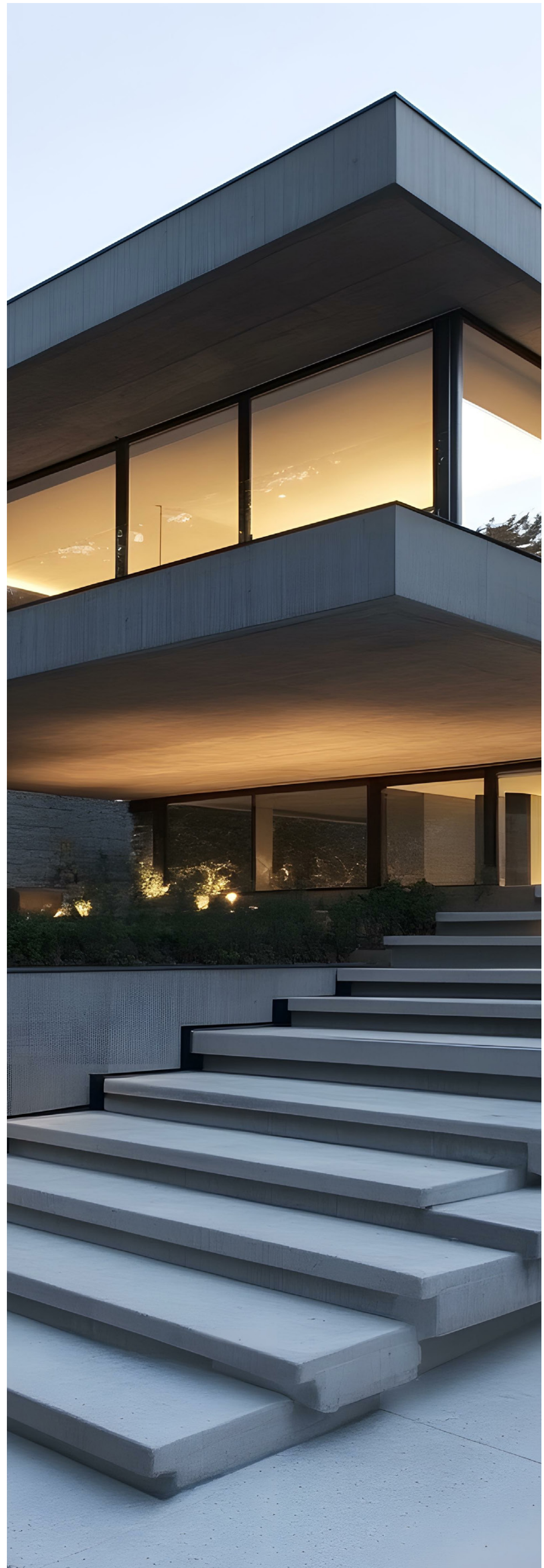
In addition, pursuant to Section 4k (6) sentence 2 EStG, the participation, voting rights and profit participation rights of a person who „acts together" with another person are attributed to the other person. Section 4k (6) sentence 1 EStG refers to Section 1 (2) AStG, and Section 4k (6) sentence 2 EStG uses the same terminology as in the context of the German controlled foreign company ("CFC") rules (Section 7 (4) AStG) with the reference to „acting together". Against this background, there was previously cause for concern that the – albeit rebuttable – presumption from the German CFC rules in Section 7 (4) sentence 2 AStG would also apply for the purposes of Section 4k EStG. As a result, in the case of direct or indirect shareholders of a partnership, acting together would be generally assumed. In the absence of explicit clarification in this regard, there was a further risk that the tax authorities could also apply this presumption to participations in (special) investment funds within the meaning of the InvStG.

However, the BMF guidance dated December 5, 2024, has now clarified that the rebuttable presumption from the German CFC rules is irrelevant for the purposes of Section 4k EStG. Rather, cooperation through concerted behavior requires specific coordination with regard to a tax mismatch within the meaning of Section 4k (1)-(5) EStG.

In relation to the example case described above, investors who hold <25 % of the Fund should therefore generally not be considered related parties for the purposes of Section 4k EStG and should not be considered as interacting without special circumstances. The tax treatment of the Fund and the income should therefore be irrelevant for the purposes of Section 4 (5) EStG, so that the risk of an imported tax mismatch is mitigated accordingly.

This should simplify the examination of Section 4k EStG for funds in practice.



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Conclusion

The application of Section 4k EStG requires a comprehensive understanding of tax implications at different levels of cross-border investment structures and taking into account different national tax perspectives. Particularly in the case of participations by international investors in real estate (special) investment funds, the final assessment is made more difficult by relevant tax status information that is sometimes difficult to access.

The final BMF guidance dated December 5, 2024, contains, among other things, a welcome clarification that – unlike for the purposes of German CFC rules – coordinated behavior is not already assumed on the basis of the legal form of the investment vehicle in the form of a partnership. This should simplify the examination of Section 4k EStG for funds in practice.

However, not least due to the dynamic developments in international tax law and changes in individual national interpretations, Section 4k EStG still requires very close ongoing monitoring of the tax regulations in all jurisdictions affected by an investment structure as well as increased requirements for transparency and documentation of the tax status of the parties involved in order to be able to make an appropriate assessment.

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