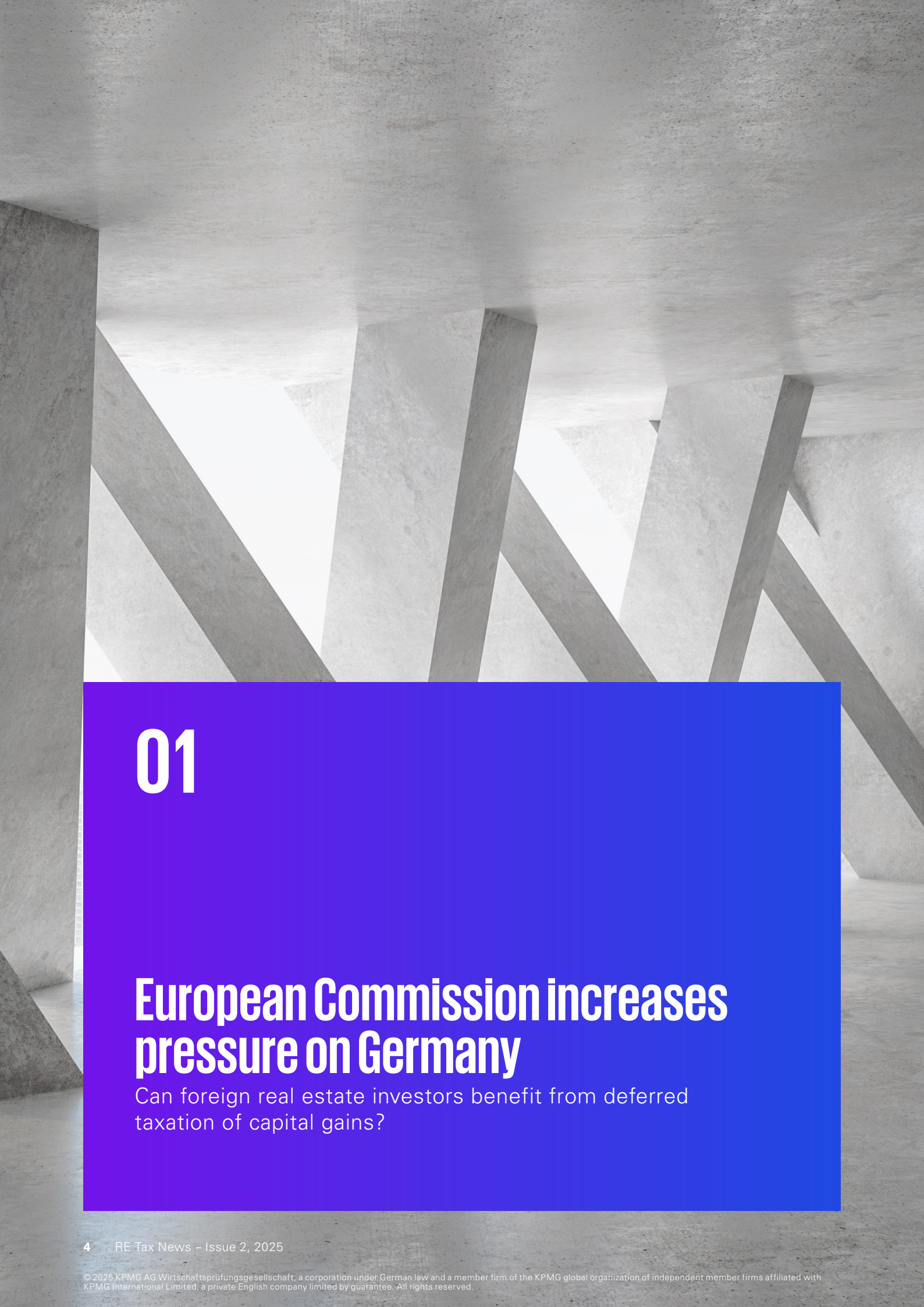

01

European Commission increases pressure on Germany

Can foreign real estate investors benefit from deferred taxation of capital gains?

The sale of a property can lead to a taxable gain. However, the legislator allows a deferral of taxation, which shifts taxation to the future. This option is currently denied to foreign real estate investors. For this reason, the European Commission recently decided to take Germany to the ECJ. The European Commission is thus continuing infringement proceedings that began in 2019.

A. Background

1. Investment structures affected

Investments in German real estate are often made through foreign investment structures. Investors make use of an indirect investment, which is regularly made through a Luxembourg S.à r.l. or Dutch B.V. as the property holding entity. This investment structure is popular, as the special purpose vehicles are subject to German corporate income tax (section 2 no. 1 KStG in conjunction with section 49 para. 1 no. 2 lit. f) EStG). However, the property holding entities are not subject to German trade tax. Trade tax is levied on business operations conducted in Germany (section 2 GewStG). If the special purpose vehicles do not establish a permanent establishment in Germany, there is no business operation for trade tax purposes.

In practice, these investment structures are referred to as the „no-PE model". Income from the lease of German properties and any capital gains of German properties are income from business operations. However, this is only a legal fiction for determining income. In the absence of an actual standing business operation in Germany, this income is subject exclusively to corporate income tax, but is calculated on the basis of a comparison of business assets.

2. Tax deferral pursuant to section 6b EStG

Legislation provides for deferred taxation of capital gains from real estate in accordance with section 6b EStG. Assets eligible for tax relief include land and buildings. It is therefore possible to transfer hidden reserves from the sale of land and buildings to newly acquired or constructed land or the building on it.

The transfer of hidden reserves from the year of disposal to the future is achieved by either reducing the acquisition costs of a reinvestment property in the year of disposal. On the other hand, the shift can be achieved by creating a tax-exempt reserve in the amount of the capital gain (so-called „section 6b EStG reserve"). Subsequently, the reserve can be transferred to a reinvestment property in which the acquisition costs are reduced by the amount of the reserve.

However, the transfer of hidden reserves through the "section 6b EStG reserve" must take place within four years. If a reinvestment is not made within this period, there is a risk that the reserve will be reversed. In addition, taxpayers would be charged interest on the reserve. The reversal through the profit and loss statement is linked to an interest charge of six percent per financial year.

The conditions for deferral of taxation are set out in section 6b para. 4 EStG. Specifically, the deferral of taxation can only be applied for if:

- the taxpayer determines the profit by comparing business assets,
- the assets sold have been part of the fixed assets of a domestic permanent establishment for at least six years without interruption at the time of the sale,
- the purchased or manufactured assets (i.e., the reinvestments) are part of the fixed assets of a domestic permanent establishment,
- the gain arising on the sale is not excluded from the calculation of the domestic taxable profit and
- the deduction or creation and reversal of a reserve can be tracked in the accounts.

B. Application of section 6b EStG for foreign special purpose vehicles

These requirements also show why foreign special purpose vehicles (i.e., Luxembourg S.à r.l. or Dutch B.V.) are not permitted to apply section 6b EStG. Application would always fail due to the requirement that both the disposal object and the reinvestment object must be allocated to a domestic permanent establishment. This is not possible for foreign special purpose vehicles if the investment is made under the no-PE model. The fixed assets cannot be allocated to a domestic permanent establishment if there is only one permanent establishment abroad (e.g., management office in the state of residence).

1. Potential violation of fundamental European freedoms

However, in this case, there are good reasons to argue that foreign taxpayers are being disadvantaged in a way that is not compatible with European fundamental freedoms. For this reason, the European Commission has also initiated the next step in the infringement proceedings against Germany.

The freedom of establishment (Art. 49 Treaty on the Functioning of the European Union, "TFEU") and the free movement of capital (Art. 63 TFEU) come into consideration. The distinction between these fundamental freedoms can be difficult. While the freedom of establishment extends to activities directly related to the (self-)establishment, the free movement of capital focuses on the taxpayer's capital investment or capital transfer decision. The distinction must be made on the basis of the subject matter of the regulation concerned. The abstract scope of application of the regulation is therefore decisive.

The application of section 6b EStG always fails in the no-PE model due to the requirement that the real estate and reinvestment properties sold must always be allocated to a domestic permanent establishment. In this respect, the lack of a permanent establishment in Germany triggers a disadvantage compared to domestic real estate companies as a comparative pair. The scope of application of the freedom of establishment therefore appears to be affected.

The legislator grants comparable (domestic) corporations a tax deferral even though their activities and overall situation are comparable. This disadvantage is likely to make establishment in other European countries less attractive.

The Munich tax court has already dealt with the case outlined here (Munich tax court, judgment of 30 April 2019, 6 K 1185/18). Although this judgment denies the violation of the freedom of establishment, the judgment is not convincing on several points. In particular, the Munich tax court chooses a comparison group without taking comparable activities into account. As a result, the Munich tax court weighs up the advantages of the no-PE model against the disadvantages of the trade tax burden on domestic corporations. This approach is not convincing, as comparable domestic corporations can make use of the extended trade tax reduction for the income resulting from German real estate pursuant to section 9 no. 1 sentence 2 GewStG and are therefore generally not subject to trade tax.

2. Recommended action for foreign property holding entities

In this respect, it is not surprising that the European Commission wishes to continue the infringement proceedings even after Germany has issued its opinion. It remains questionable whether foreign property companies could already benefit from the ongoing proceedings.

The ECJ's decision only has a direct effect on the member state concerned. Nevertheless, affected special purpose vehicles should review the application of section 6b EStG. If the application - apart from the allocation of permanent establishments - comes into consideration, it would be conceivable to lodge an appeal against the assessment. Pending a decision by the ECJ and potential new legislation, appeals and legal proceedings would have to be suspended (section 363 para. 1 AO, section 74 FGO).

In addition, taxpayers could also work towards ensuring that the tax authorities do not assess a tax deferral, but that the taxes are provisionally assessed on the basis of the ongoing proceedings (section 165 AO). The assessment with a provisional assessment notice would be expedient as, on the one hand, taxpayers would be relieved of the need to file their own appeals. On the other hand, the provisional assessment only allows the assessment period to be kept open at certain points.

If the ECJ ruling is in the taxpayers' favor, taxpayers may be entitled to extensive interest claims. These claims for interest include a claim arising directly from EU law and the national claim for interest due to the change in the tax assessment. If, on the other hand, a decision is made in favor of Germany, the taxpayers would not suffer any direct disadvantages as a result. This is because the tax assessment in these cases was already made without the transfer of hidden reserves. In this respect, no additional tax payment is possible.

Facts

The deferral of taxation in accordance with section 6b EStG is a sensible measure by the legislator to encourage economically reasonable reinvestment decisions. These decisions can be made by both foreign property holding entities and domestic property holding entities. Nevertheless, foreign real estate investors are currently at a disadvantage. In this respect, the ECJ's decision can be followed with interest. Although the wheels of justice grind slowly, foreign taxpayers could already take advantage of the proceedings.

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