KPMG

Real Estate Tax Newsletter

1st Version 2025

Contents

Dear Readers,

I am delighted to welcome you to the first edition of the RE Tax Newsletter of 2025.

This year, we will continue to keep you informed with relevant tax law information, current developments and practical specialist articles - compact, informative and to the point.

I hope you enjoy reading this edition and look forward to engaging with you. Let's tackle the tax challenges and opportunities in the real estate sector together!

Best regards,

Stefan Kunze
Head of Real Estate Tax

01

New tax regulations 2025

focus on land-owning companies and (real estate) (special) investment funds

The following article provides an overview of selected new tax provisions at the turn of the year 2024/2025 with a focus on the area of land-owning companies and (real estate) (special) investment funds.

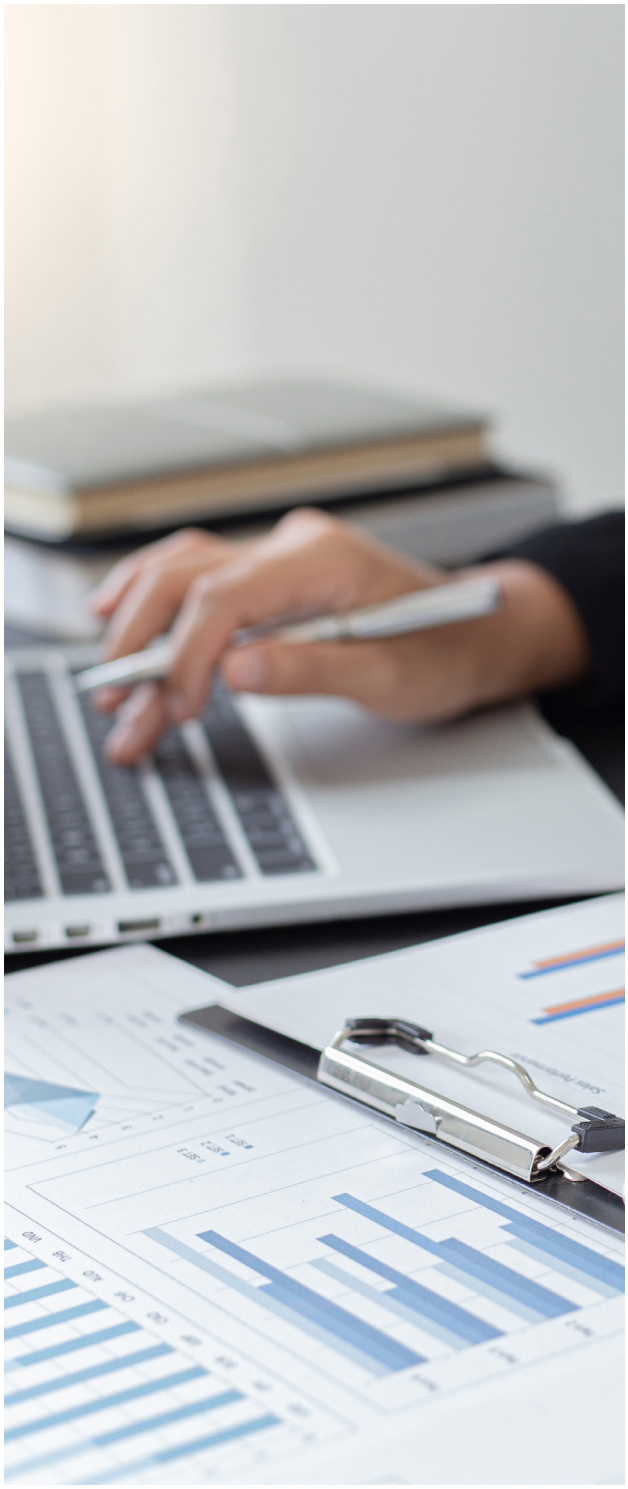
A. New income tax regulations

1. **Tax exemption for photovoltaic systems:**
   Increase in the permissible gross output from 15 kW to 30 kW (peak) per residential or commercial unit; applicable for the first time for photovoltaic systems that are acquired, commissioned or expanded after December 31, 2024.

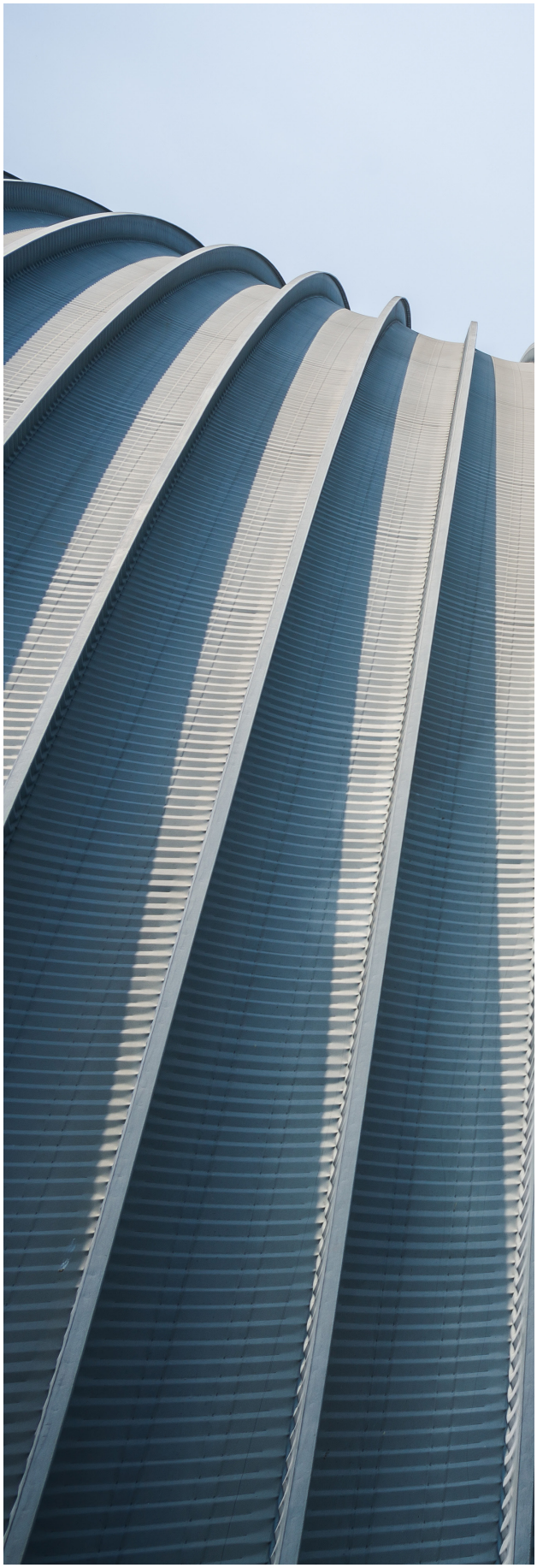
2. **Trade tax apportionment:**
   For businesses that exclusively operate energy storage systems, a new apportionment standard – labor wages at 10 % and installed output at 90 % – will be introduced from tax assessment period 2025.

3. **Trade tax property reduction:**
   From the tax assessment period onwards, the reduction for business property will be based on the property tax recognized as a business expense.

4. **Conversions:**
   Numerous changes were made to the German Conversion Tax Act (UmwStG), including the introduction of a submission deadline for the final tax balance sheet (in connection with the merger of corporations) for the first time for commercial register filings after December 5, 2024, the introduction of an application deadline for the shareholder's valuation option (Section 13 UmwStG) for the first time for a tax transfer date after December 5, 2024, an extension of the trade tax liability for capital gains or gains on the disposal of partnerships (Section 18 UmwStG) with retroactive effect for a tax transfer date after May 17, 2024, and a new regulation on the consideration of withdrawals in the tax retroactive period for contribution cases with retroactive effect in the event of a conversion resolution or contribution agreement after December 31, 2023.



1 *Jahressteuergesetz 2024, verkündet am 5.12.2024, BGBl 2024 I Nr. 387, nachfolgend: JStG 2024.*



5. **Book value transfers:**
   The transfer of assets at book value is also made possible retroactively in all open cases for a transfer free of charge between the joint assets of different partnerships of the same, identically participating partners (sister partnerships). At the joint request of the partners, the new regulation does not apply to transfers before January 12, 2024, i.e. no book value is recognized.

   The so-called capital corporation clause, according to which the hidden reserves must be disclosed in the event of a transfer transaction (possibly retroactively), will be tightened for transfers of assets that take place after October 18, 2024. The tightening regulates a so-called subject-related change of status.

B. New real estate transfer tax regulations

1. **Attribution of real estate:**
   The realization of the supplementary facts pursuant to Section 1 (2a) to (3a) of the German Real Estate Transfer Tax (GrEStG) presupposes that a company "owns" real estate. The new provision of Section 1 (4a) GrEStG stipulates that real estate is generally part of the assets of the company that last realized a basic fact in accordance with Section 1 (1) GrEStG. The new regulation applies to acquisition transactions that are realized after December 5, 2024.

2. **Continued validity of tax benefits in connection with a German "Gesamthand":**
   Following the entry into force of the Act on the Modernization of Partnership Law (MoPeG) on January 1, 2024, the continued treatment of partnerships with legal capacity in the GrEStG as "Gesamthand" or "Gesamthandsvermögen" is currently limited until the end of 2026. With regard to the subsequent retention periods of Sections 5 and 6 GrEStG, it is now regulated that the mere expiry of the continued validity regulation on December 31, 2026, does not lead to a violation of the current subsequent retention periods that were or will be triggered by property transfers realized by December 31, 2026.

C. New investment tax regulations

1. **Taxable domestic real estate income**
   The definition of taxable domestic real estate income is supplemented by „other income from letting and leasing pursuant to Section 49 (1) no. 6

EStG", so that, in particular, gains from the sale of rent and lease receivables are also included (Section 6 (4) no. 3 InvStG).
Application to income accruing to an investment fund in a financial year beginning after December 31, 2024

2. Deemed distributions
Instead of income exclusively from the letting and leasing of real estate and real estate equivalent rights, all income from letting and leasing is recognized as deemed distributions within the meaning of Section 36 (1) sentence 1 no. 2 InvStG.
Application to income accruing to a special investment fund in a financial year beginning after December 31, 2024

Income from private sales transactions is uniformly allocated to other income irrespective of the one-year (or ten-year) holding period (Section 36 (3) sentence 2 InvStG).

Application to sales transactions in which the assets are acquired in the financial years of the special investment fund beginning after December 31, 2024, on the basis of a legally binding contract or equivalent legal act concluded after this date

3. Tax free accumulated income
Currency futures transactions are introduced as a new category of other income that can be accumulated tax-free in Section 36 (3) sentence 3 InvStG.
Application to gains from the sale of currencies with deferred settlement where the obligatory contract is concluded with legal effect in the financial years of the special investment fund beginning after December 31, 2024

4. Tax exemptions for tax-privileged investors
Tax exemptions under both Section 8 and 10 InvStG are excluded in cases where a tax-privileged investor transfers his investment income to another (taxable) person through usufruct or a similar arrangement without transferring beneficial ownership of the investment units (Section 8 (4) sentence 2, Section 10 (6) InvStG).
Application from January 1, 2025

5. Extension of the liquidation period
The liquidation period recognized for tax purposes and the associated possibility of tax-neutral capital repayments is extended from five to ten calendar years.
Application from the day after promulgation

6. Partial exemptions
In particular, regulations are introduced to limit tax structuring options that will be applied from January 1, 2025.
For example, the requirements for the application of partial exemptions must now be met throughout the calendar year instead of during the financial year (Section 20 (4) sentence 1 InvStG).

If an investor has once provided proof of the application of a partial exemption, and losses of more than EUR 500 or partial write-downs are subsequently claimed, proof of compliance with the investment thresholds must be provided for the entire holding period (Section 20 (4) sentence 2 InvStG).

Investors are also obliged to enclose a tax or loss certificate from the custodian bank with their tax return (Section 20 (4) sentence 3 InvStG).

Finally, in the case of losses, the tax office is granted its own right to provide evidence of the actual continuous fulfillment of the requirements for partial exemption in a new Section 20 (4a) InvStG.

D. New regulations in international tax law and transfer pricing

1. **Cross-border financing relationships:**
   The provision of Section 1 (3d) of the Foreign German Tax Act (AStG) on the arm's length principle for cross-border financing relationships between related parties was introduced retrospectively from January 1, 2024. The Annual Tax Act 2024 subsequently introduces a transitional provision (Section 21 (1a) sentence 2, 3 AStG). Accordingly, Section 1 (3d) AStG does not apply to expenses incurred up to December 31, 2024, from financing relationships that were agreed under civil law before January 1, 2024, and the implementation of which began before January 1, 2024. If such financing relationships are significantly changed in 2024, the regulation only applies to expenses incurred after the significant change.

2. **Transfer pricing documentation:**
   The so-called transaction matrix is included as a new component of the transfer pricing documentation. In the event of a tax audit, fewer documents must be submitted without being requested – namely the transaction matrix, the master documentation and the records of extraordinary business transactions – and a shortened submission deadline of 30 days after notification of the audit order applies. The changes will apply from 2025.

3. **Multilateral instrument regarding double tax treaties (DTT):**
   According to the notification submitted by Germany to the OECD on the completion of the domestic implementation of the Multilateral Instrument (MLI), the MLI is applicable to the seven countries Croatia, France, Greece, Hungary, Malta, Slovakia and Spain

for withholding and assessment taxes as of January 1, 2025, by agreeing on a shortened transition period. Germany has not yet notified the OECD of the DTTs with Japan and the Czech Republic, which are also covered by the MLI Application Act.

4. Tax haven defense law (StAbwG)

- Prohibition of deduction of business expenses: From January 1, 2025, exceptions to the prohibition on the deduction of business expenses will apply to expenses relating to globally deposited bearer bonds and similar debt instruments if they are tradable on a recognized stock exchange, and to insurance or reinsurance benefits, with the exception of insurance or reinsurance premiums.
- Defense measures applicable from 2025 and retroactive deletions as of January 1, 2024: The prohibition on the deduction of business expenses (Section 8 StAbwG) is applicable for the first time for American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tabago, the US Virgin Islands and Vanuatu (newly listed in 2021). For Anguilla (newly listed in 2022), the measures for profit distributions and sales of shares (Section 11 StAbwG) are applicable for the first time. The states of Antigua and Barbuda, the Bahamas, Belize, the Seychelles and the Turks and Caicos Islands were removed from the list of non-cooperative countries and territories with retroactive effect from January 1, 2024. There were no new additions in 2024.

Alexander Hahn
Senior Manager, Steuerberater
Tax Services

Christian Herzberg
Senior Manager, Steuerberater
FS Tax Real Estate

2 *Viertes Gesetz zur Entlastung der Bürgerinnen und Bürger, der Wirtschaft sowie der Verwaltung von Bürokratie, BGBl 2024 I Nr. 323.*
3 *Gesetz zur Anwendung des Mehrseitigen Übereinkommens v. 24.11.2016 zur Umsetzung steuerabkommensbezogener Maßnahmen zur Verhinderung der Gewinnverkürzung und Gewinnverlagerung, BGBl 2024 I Nr. 205.*
4 *Eine Darstellung der sich ergebenden Ergänzungen des jeweiligen DBA durch das MLI bietet die MLI Matching Database auf der Homepage der OECD.*

02

German CFC and PFIC law in fund structures

Expert's report

The regulations on the German Controlled Foreign Company (CFC) and Passive Foreign Investment Company (PFIC) rules were fundamentally reformed by the ATAD Implementation Act, which was announced on June 30, 2021. This included changes to the control concept (introduction of a shareholder-based approach), the elimination of the concept of lower tier intermediate companies, the revision of the catalog of active income, amendments to the interaction between the German Investment Tax Act (GINVTA) and the German CFC/PFIC rules and the revision of the motive test.

The new regulations are to be applied for the first time for financial years of an intermediate company that begins after December 31, 2021 (Sec. 21 (4) sentence 1 of the Foreign Tax Act [FTA]).

In particular, the interaction between the provisions of the FTA and the GINVTA poses particular challenges for investors, fund managers and advisors.

The following comments provide a brief overview of the practical challenges textin the context of investments through funds.

A. Control together with a related party

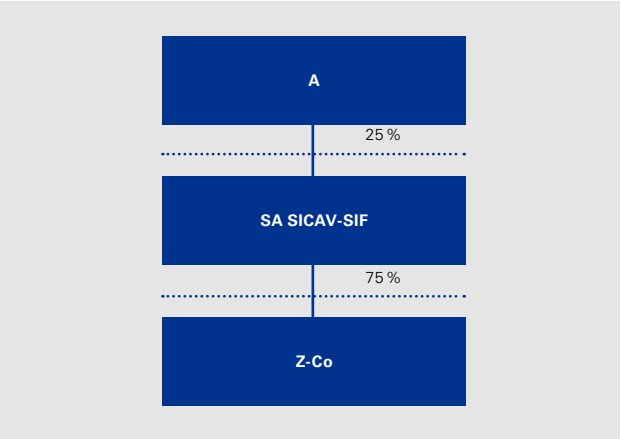
A foreign intermediate company is deemed to be controlled if a taxpayer alone or together with related parties holds more than 50 % of the voting rights, shares, profit rights or rights to participate in liquidation proceeds at the end of the financial year of the foreign company (so-called shareholder-related approach, Sec. 7 (2) FTA). The term „related party" is generally determined in accordance with the provisions of Section 1 (2) FTA.

In the opinion of the tax authorities, shareholdings of related parties are fully attributed to the German taxpayer for purposes of determining control over a foreign entity. Related parties , in particular also include limited partnerships (Sec. 7 (3) sentence 2FTA) as well as domestic and foreign investment funds.

It should be noted here that (special) investment funds that are separate in terms of liabilities and assets from each other are to be treated as independent in accordance with the treatment in the GINVTA.[1]

This means that a non-controlled Investment Fund may lead to control over an intermediate company in case it would be regarded as a related party and the statutory priority of application of the GINVTA for PFICs would not apply in this case (Sec. 13 (5) FTA).

Example:



Source: KPMG Germany, 2025

Unlimited domestic taxpayer A holds 25 % of the units in a Luxembourg investment fund in the legal form of an S.A. SICAV-SIF. The provisions of theGINVTA apply to the Luxembourg investment fund. The Luxembourg investment fund holds a 75 % interest in the foreign intermediate company Z.

Solution:

Due to the investment of A in Luxembourg S.A. SICAV-SIF, the latter is a related party of A.

1 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 282.*

The domestic taxpayer A therefore controls the intermediate company Z together with a related party. The control ratio of A is 75 %. The add-back ratio of A is 18.75 % (25 % of 75 %).

The amended concept of the control rule means that, in theory, a calculated shareholding of only 12.501 % in an intermediate company can already lead to control and thus to the application of the German CFC taxation (Sec. 7 (1) FTA).

B. Related parties due to concerted behavior (Sec. 7 (4) FTA)

Special challenges arise for investors in fund vehicles in the legal form of a partnership such as an investment limited partnership or a comparable foreign legal form such as a société en commandite simple (SCS) or a limited partnership. Persons are also deemed to be related parties if they act in concert with the taxpayer in relation to the intermediate company (Sec. 7 (4) sentence 1 ITA). In the case of direct or indirect partners in a partnership or co-entrepreneurship who have an (in)direct interest in a foreign intermediate company, acting in concert is rebuttably presumed (Sec. 7 (4) sentence 2 ITA). The provisions therefore extend the concept of a related party irrespective of the existence of a specific shareholding.

The consequence of this legal fiction is that, due to the assumed acting in concert, an attribution of the shareholding of other partners in a partnership could lead to control even if an investor with unlimited tax liability only holds a smaller shareholding.

Foreign fund vehicles are often established in the legal form of a partnership that holds shares in foreign companies. The ability to apply the rebuttal is therefore of particular importance

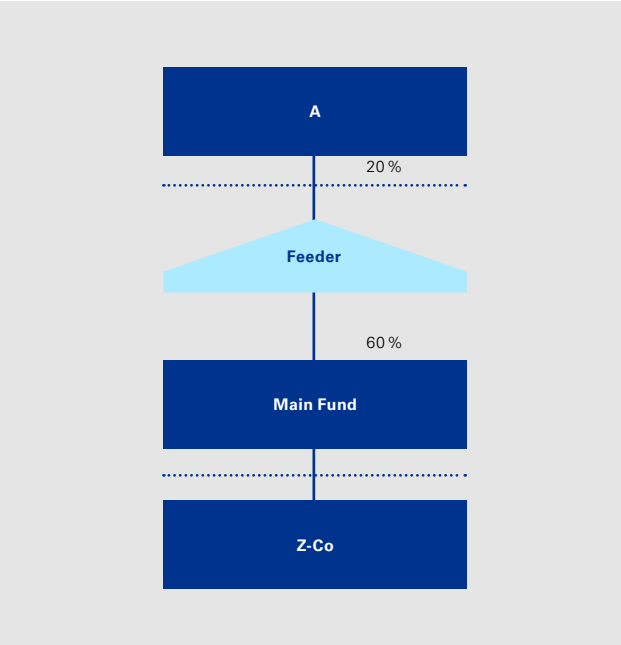
Within the framework of the application decree issued by the tax authorities on December 22, 2023, the tax authorities assume that a rebuttal is generally to be assumed for an investment of a maximum of 5 % in a partnership due to the small investment.[2] For all shareholdings that exceed this de minimis limit, an active refutation is required. The burden of proof lies with the taxpayer.[3]

According to the tax authorities, a rebuttal should be possible if the common purpose of the investors is the investment of assets and the investors do not know each other or the investors are only entitled to information rights.[4]

In the case of investments in fund vehicles in the legal form of partnerships, it is therefore advisable to make appropriate arrangements in the fund documentation or agreements between the fund and the investors (so-called side letters) in order to simplify the refutation of acting in concert.

Interesting questions arise when investing via a partnership, particularly for structures where there are participations in domestic and foreign investment funds in the investment chain, as the application of the rebuttal also affects the potential priority of application of the GINVTA.

Example:



Source: KPMG Germany, 2025

Domestic investor A holds a 20 % interest in a fund partnership in the legal form of an SCS SICAV-RAIF („Feeder"). The Feeder SCS holds an interest in a Luxembourg investment fund in the legal form of an S.C.A. SICAV-RAIF („Main Fund"). For German tax purposes, the Main Fund qualifies as an investment fund („Chapter 2 Fund"). The Main Fund holds investments in foreign subsidiaries that qualify as intermediate companies.

Solution:

A, who is subject to unlimited tax liability, does not control the intermediate companies either alone or together with related parties in accordance with Section 7 (3) FTA, meaning that a general priority of application of the GINVTA would apply (Sec.13 (5) FTA). However, through the participation in Feeder

2 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 301.*
3 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 217.*
4 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 300.*

SCS, an acting in concert with the other investors is rebuttably assumed, with the result that control over the Main Fund and the Z companies is deemed to be given. If no rebuttal is possible, no priority of application of the GINVTA would apply at the level of the Z companies.

C. Uncertainties in connection with investments via special investment funds

The amended regulations also give rise to questions of doubt for German special investment funds, which are relevant when determining the basis of taxation and preparing declarations of assessment in accordance with Section 51 GINVTA.

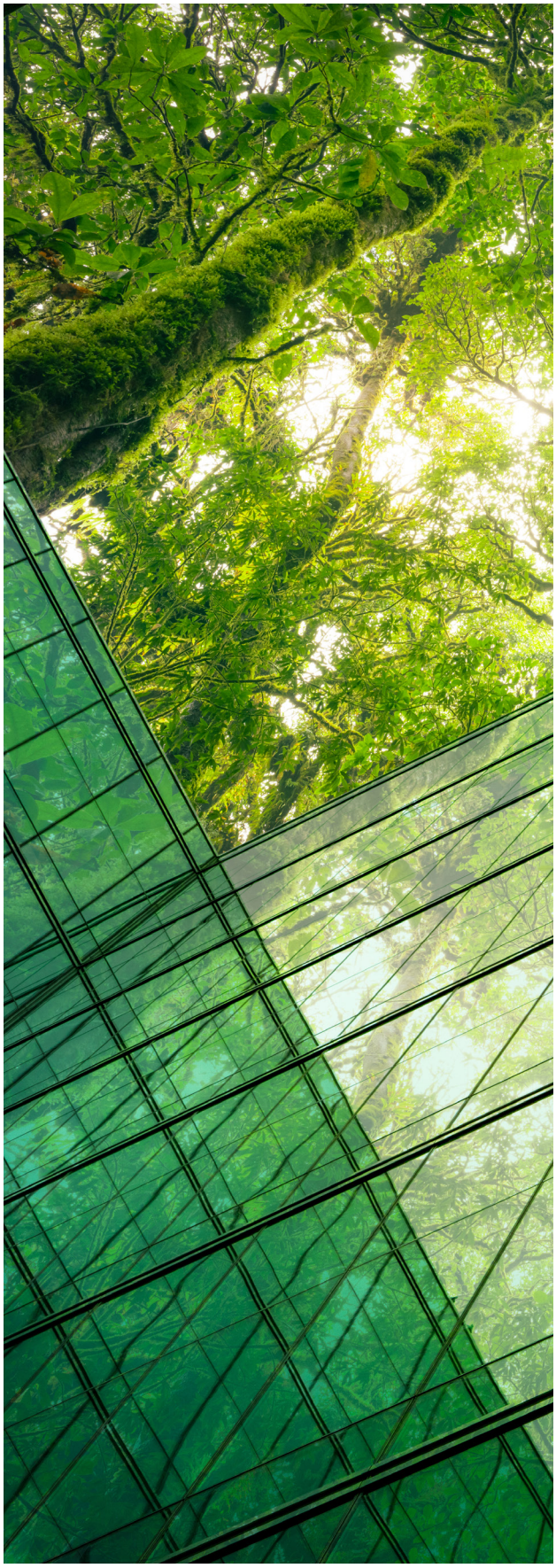
For the purposes of German CFC taxation, domestic special investment funds are deemed to have unlimited tax liability and therefore generally fall within the scope of the German CFC rules. When determining the income of special investment funds, CFC income qualifies as deemed distributed income ("ausschüttungsgleiche Erträge") within the meaning of Section 36 (1) no. 1 GINVTA.[5]

If CFC income is already included in the deemed distributed income at the level of the special investment fund, the CFC income allocable tothe investor is to be reduced by the amount of the deemed distributed income allocable to the respective investor (Sec. 10 (6) FTA). However, the provision only benefits those taxpayers who fall within the scope of the German CFC rules due to the size of their investment and no shielding affect applies. For investors who do not fall within the scope of the German CFC rules due to their level of participation and lack of control, the reduction provision of Section 10 (6) FTA would be ineffective.

The regulations in the GINVTA are therefore excessive and may lead to a disadvantage for investors who themselves do not fulfill the control criterion.

Depending on the investor structure, the view of the tax authorities expressed in the GINVTA application decree could lead to a suspension of the priority of application of the GINVTA provided for in the FTA, as in this case CFC income would have to be taken into account as deemed distributed income for the investor irrespective of control.

In this context, the fundamental question arises as to how such deemed distributed income in the form of CFC imcome can arise at all at the level of the special investment fund.



5 *BMF Decree of May 21, 2029 IV C 1 – S 1980-1/16/10010 :001 Rz. 36.6*

Investment funds or special investment funds are generally exempt from submitting a declaration of assessment for the purposes of CFC taxation, insofar as CFC income is not taxable at the level of the (special) investment fund. A tax return should only be submitted upon request by the German tax authorities.[6] At the level of the special investment fund, a tax liability on CFC income would generally only possible if such an amount were to be generated via a domestic permanent establishment (Sec. 6 (5) sentence 1 no. 1 GINVTA in conjunction with Sec. 49 para. no. 2(a) German Income Tax Act). In practice, this should be an exception. Under procedural law, an add-back amount can only be taken into account if it is determined at all (Sec. 18 (1) FTA), which means that there should hardly be any scope for taking it into account in the context of add-back taxation at the level of the special investment fund. In this respect, the respective investor would need to ensure that all relevant information on any add-back amounts is recorded directly as part of their personal tax return.

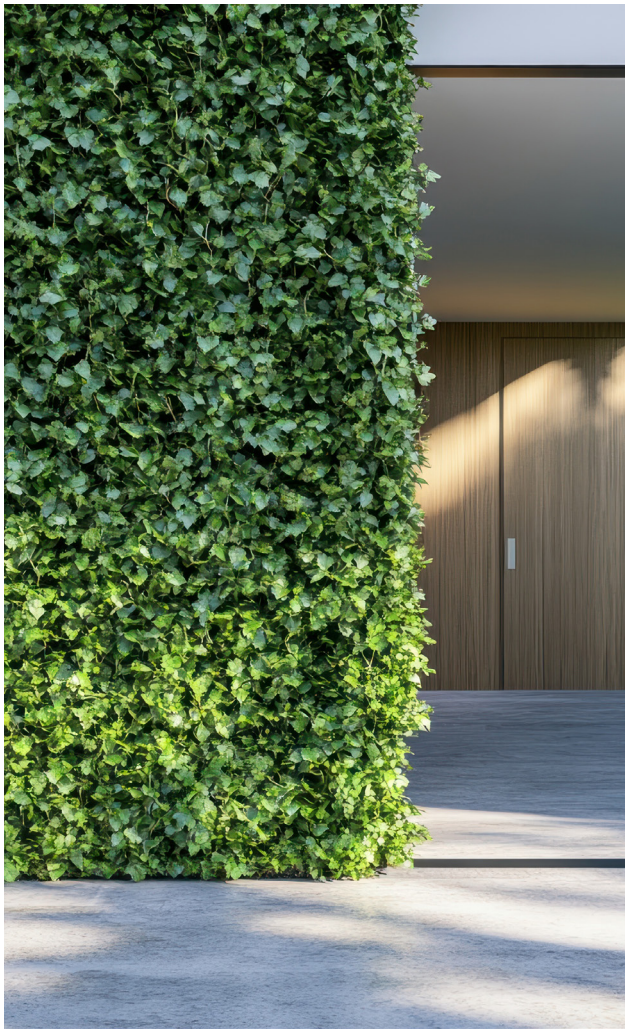
The Federal Ministry of Finance has apparently recognized the aforementioned ambiguities in relation to special investment funds. The discussion draft of the Minimum Tax Adjustment Act provides that add-back amounts at the level of the special investment fund are not to be taken into account when determining income (Sec. 37 (1) GINVTA draft).[7] This is intended to avoid the double recognition of add-back amounts for special investment funds and their investors.

D. Challenges in the context of tax return filings

The amended regulations on German CFC taxation have led to a significant expansion of the scope of application in the fund context. The current lack of an electronic submission option for declarations of assessment poses a particular challenge in practice. The option of electronic submission is still in development and is scheduled to be introduced from the 2025 assessment period (Sec. 21 (7) FTA).

The declaration of assessment must be signed by each taxpayer (Sec. 18 (3) FTA) in person, which leads to an almost unmanageable administrative burden, particularly for funds with a large number of investors, as only those with unlimited tax liability are involved in the assessment. In the case of investments via partnerships, the partnerships are not taken into account when determining the CFC income amounts.[8]

The tax authorities also seem to have recognized the associated complexity, with the result that, in addition to the technical simplifications promised, tax offices are also granting further extensions beyond the statutory submission deadline.



6 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 956.*
7 *Discussion Draft of a Minimum Tax Adjustment Act of December 2, 2024*
8 *BMF Decree of December 22, 2023, IV B 5 – S 1340/23/10001 :001 Rz. 233,259, 706, 934.*

E. Possible changes due to the second discussion draft of the Minimum Tax Adjustment Act

On December 2, 2024, the Federal Ministry of Finance published the second discussion draft of the Minimum Tax Adjustment Act.

In addition to the aforementioned elimination of the consideration of CFC income in the context of determining the income of special investment funds, a retroactive elimination of the regulations for PFICS Gein accordance with Section 13 FTA is also planned.[9] This would reduce the scope to scenarios where a control is given only. As this is only a discussion draft, it currently has no effect on a possible obligation to submit an FTA assessment declaration.

In cases of control, the exemption limit for mixed income is to be increased.

An implementation of the proposed amended regulations would only occur within the next legislative period.

Facts

The amended control concept has led to a significant expansion of possible cases of application of German CFC taxation, which means that investors who hold shares in foreign intermediate companies via (special) investment funds may also fall within the scope of the German CFC rules.

However, at the level of the special investment fund, based on our view, the scope of application of CFC rules should be limited.

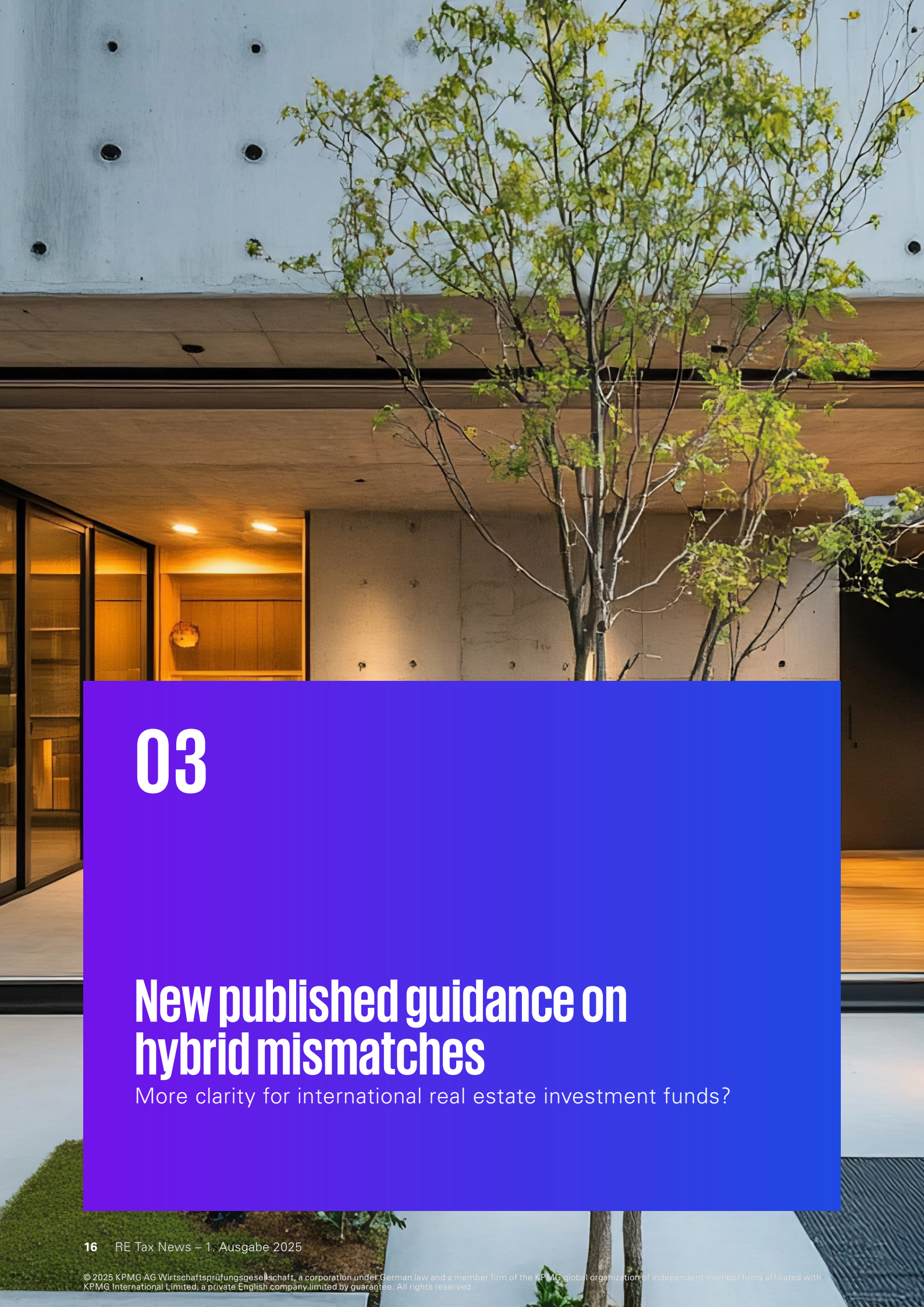
If the stricter rules for PFICs were to be abolished, the rebuttal would be of particular importance for investments via partnerships in order to exclude the application of German CFC rules. To this end, it is advisable to conclude appropriate agreements when acquiring fund units, which should rule out any interaction.

The lowering of the low tax threshold for financial years of an intermediate company beginning after December 31, 2023 to 15 %, should restrict the scope of application of CFC rules.

Katrin Bernshausen
Partnerin,
Financial Services Tax – Real Estate

Markus Helldörfer
Senior Manager,
Financial Financial Services Tax – Real Estate

9 *The retroactive abolishment would apply to all financial years of the intermediate companies that begin after December 31, 2021.*



03

New published guidance on hybrid mismatches

More clarity for international real estate investment funds?

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.

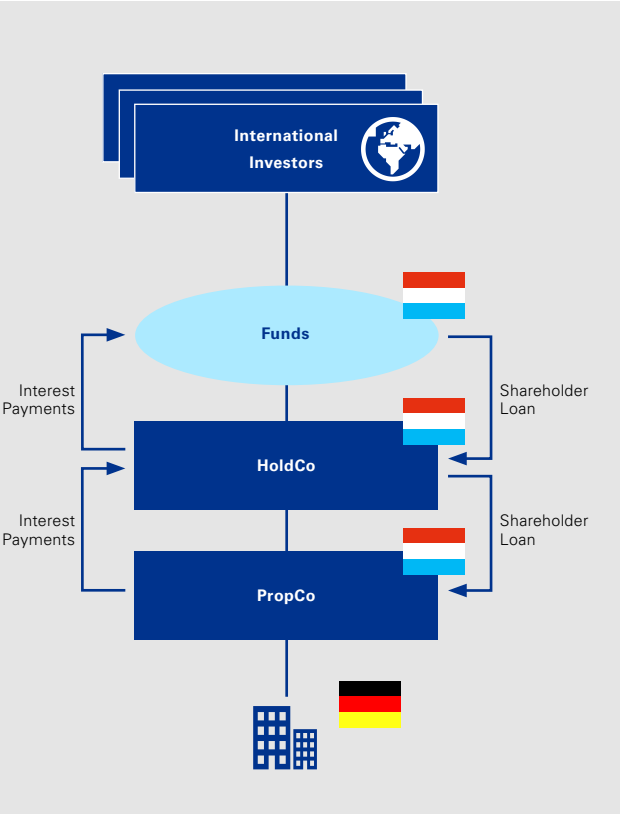
These qualification conflicts can result, for example, in a tax deduction in both countries (so-called „double deduction" – DD) or a deduction in one country with simultaneous non-taxation in the other country (so-called „deduction/non-inclusion" – D/NI).

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.

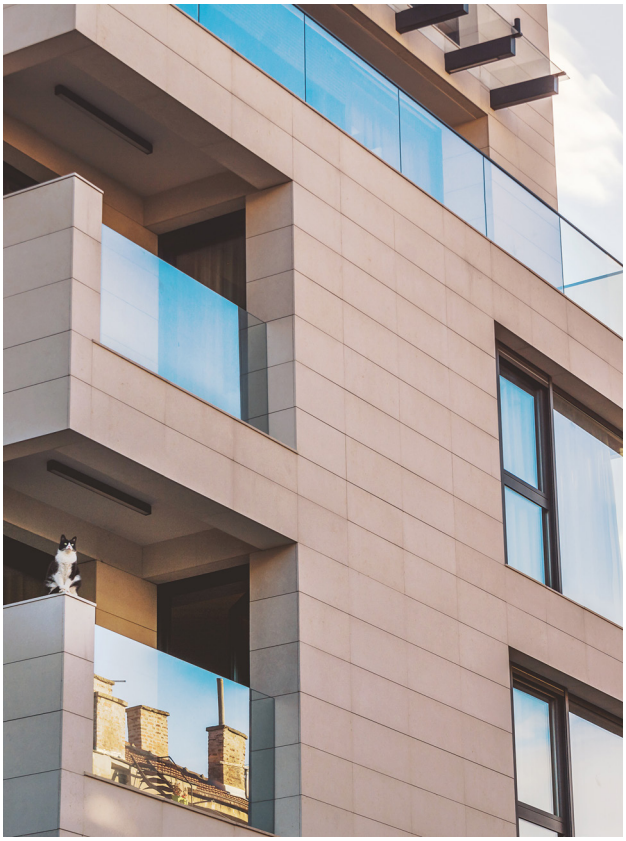
Section 4k (1) EStG concerns hybrid financial instruments, (2) hybrid legal entities. (3) concerns deviating allocations or attributions of income, (4) the double recognition of expenses and (5) concerns so-called imported tax mismatches.

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")*

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

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.

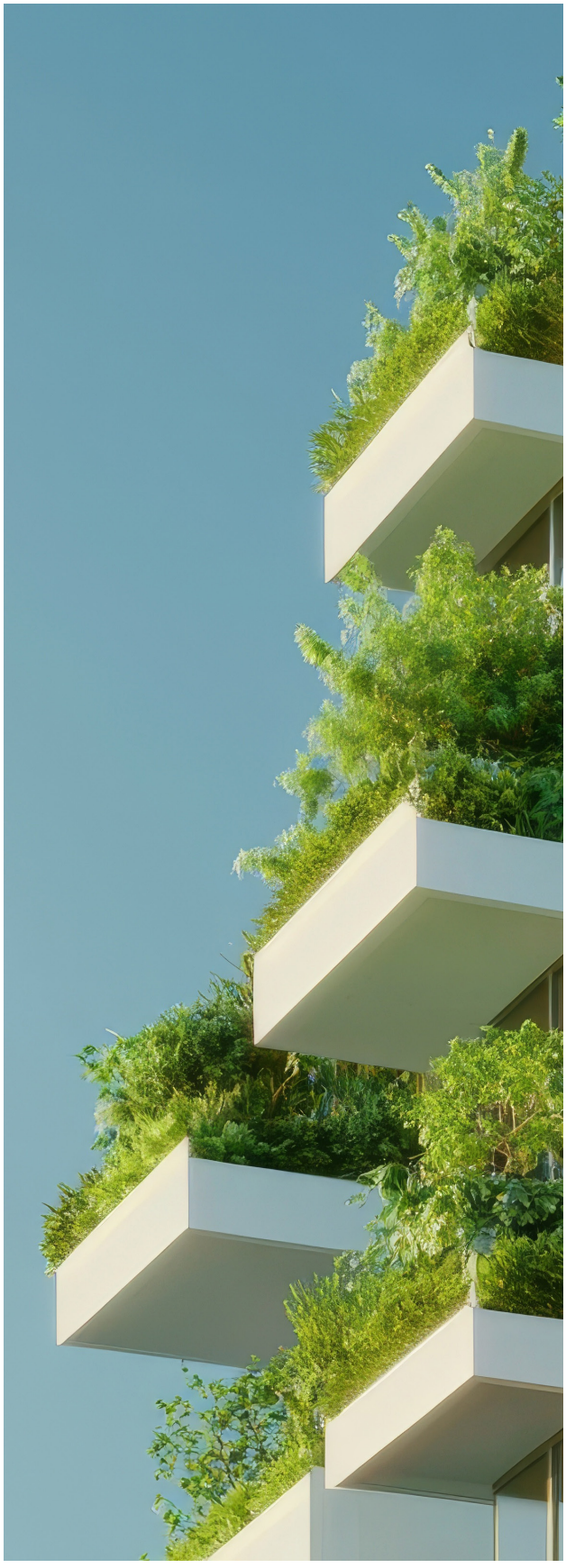
Helpful addition in the BMF circular

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.

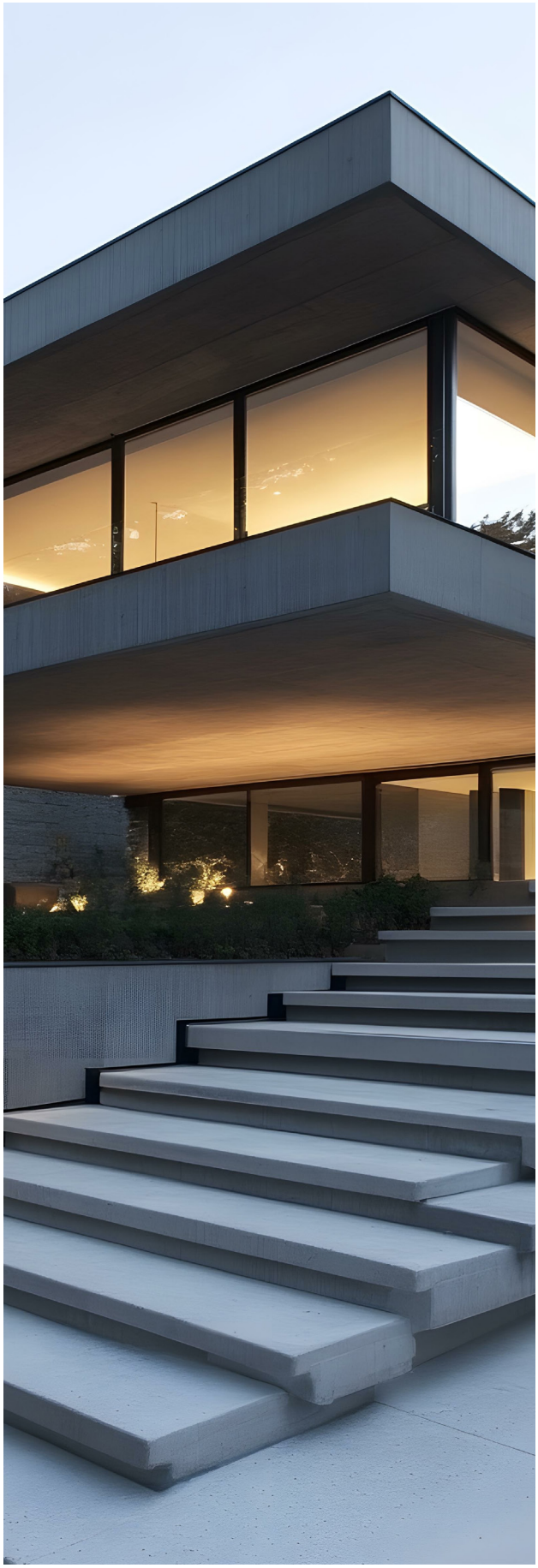


In addition, pursuant to Section 4k (6) sentence 2 EStG, the participation, voting rights and profit participation rights of a person who „acts together" with another person are attributed to the other person. Section 4k (6) sentence 1 EStG refers to Section 1 (2) AStG, and Section 4k (6) sentence 2 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.



Stefan Kunze
Partner
FS Tax Real Estate

Christian Herzberg
Senior Manager
FS Tax Real Estate

Roman Schander
Assistant Manager
FS Tax Real Estate

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.

04

New German transfer pricing regulations from 2025

Implications of the new administrative principles on Transfer Pricing 2024 and stricter documentation obligations

On December 12, 2024, the Federal Ministry of Finance (BMF) published the finalized version of the „Administrative Principles on Transfer Pricing – Principles for the Correction of Income pursuant to Section 1 FTA“ (VWG VP 2024) based on the draft from August 2024. Therein, the BMF extends the version of the administrative principles from 2023 (VWG VP 2023) with its interpretation of Section 1 (3d) and (3e) of the Foreign Tax Act (FTA), which were introduced as part of the Growth Opportunities Act in March 2024. In addition to the new VWG VP 2024, stricter documentation obligations apply to taxpayers in Germany since the beginning of 2025.

A. Administrative principles on transfer pricing 2024

The main changes to the new administrative principles compared to the previous version from 2023 are the additions relating to financing relationships (chapter J.), which set out the interpretation of the German tax authorities (BMF) on the application of Section 1 (3d) and (3e) FTA. Compared to the draft version of the VWG VP dated August 14, 2024, the final version contains only a few, but nevertheless relevant, changes.[1]

According to the BMF, intercompany financing is now also economically justifiable if it is necessary for the operation or maintenance of business activities, whereby it is still assumed that a prudent and conscientious businessman would not take on debt if there were not a reasonable prospect of a return that at least covers the financing costs (Sec. 3.126). With regard to the use of debt, it is still assumed that it must be in line with the overall purpose of the company, with investments in overnight money accounts or intragroup cash pools with no expectations of a higher return regularly failing to meet this criterion (Sec. 3.127). In this context, however, the tax authorities do not fundamentally rule out the raising of debt to hold liquidity reserves at arm's length or to hold capital buffers. Further explanations on borrowing for the purpose of profit distribution are provided by the tax authorities on the grounds that this must be in line with the company's usual distribution policy. Regarding the permissible use of debt, the canon is supplemented by the fulfilment of regulatory requirements, provided that this is covered by the functional and risk profile (Sec. 3.128). The debt capacity analysis and the reliance on the group rating or the consideration of group support remain an integral part of the VWG VP 2024 and should therefore be taken into account by the taxpayer, whereby the BMF provides for simplifications. For example, in the case of short-term capital transfers, particularly in connection with intragroup cash pools, it can now regularly be assumed that it is possible to provide the debt service although, in line with the previous explanations, the taxpayer's purpose for the provision of capital must still be demonstrated (Sec. 3.129).

If the underlying rating used to determine the interest rate of an intragroup loan is based on an investment grade rating (i.e. at least BBB- at S&P and Fitch, or Baa3 at Moody's), a debt capacity analysis is generally no longer required. However, there is a significant tightening of the rules when debt capital is reclassified as equity, as the associated related secondary costs (in particular commitment fees and prepayment penalties) are no longer deductible (Sec. 3.130). With regard to the rating to be used in determining an arm's length interest rate, the tax authorities have added credit ratings prepared by the Deutsche Bundesbank to the previous test scheme in cases where the group or the ultimate group company does not have a rating (Sec. 3.136).

Last but not least, the application rules for the amendments to Section 1 FTA dated March 28, 2024 (i.e. the implementation of (3d) and (3e) and the amendment of (6)) are aligned with Section 21 (1a) sentence 2 FTA. Accordingly, in the case of cash pools, the date on which the funds were drawn down is to be used as the basis, and not the date on which the cash pool was implemented. For intragroup loans that were granted before 2024 and that continue beyond December 31, 2024, there is no objection to the use of December 31, 2024, as the date for establishing credibility with regard to compliance with Section 1 (3d) FTA.

1 *For an overview of the draft, see John, Ronny & Mölleken, Christoph: „Konzerninterne Finanzierungsbeziehungen“, RE Tax News – 2nd issue 2024.*

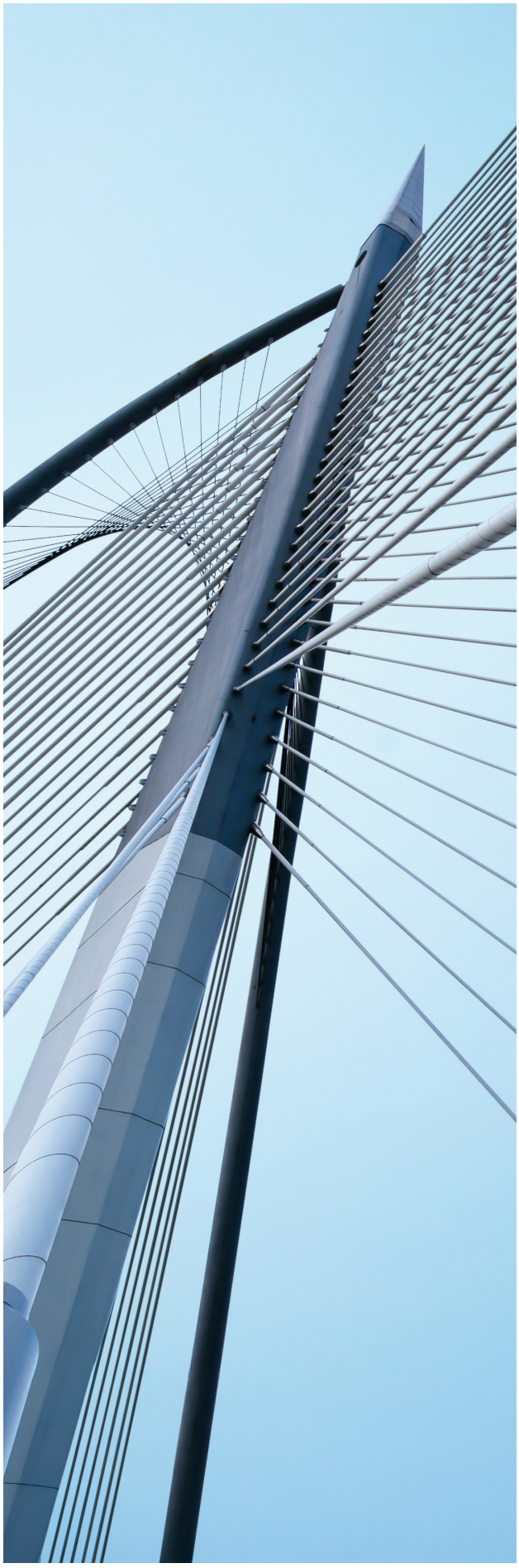
In practice, the new VWG VP 2024 makes it clear that taxpayers should document their intragroup financial transactions (loans and cash pool transactions) much more extensively and precisely than before, especially if the pricing methodology used differs from the outlined view of the German tax authorities. This is particularly important for the real estate sector, where the assessment of the creditworthiness used for subordinated intragroup financing is rarely in the investment grade range and, at the same time, the group rating can usually not be used to derive an arm's length interest rate. In addition, many investment projects have no positive cash flow in the initial financing period, which makes it more difficult to prove debt capacity. Nevertheless, the simplification rules for the proof of debt capacity via an investment grade rating as well as the specification of individual explanations by the BMF (e.g. proof of the business purpose of debt financing) are to be welcomed from the taxpayer's perspective.

B. Stricter documentation obligations

In addition to the publication of the VWG VP 2024 at the end of the year, stricter documentation obligations apply from January 1, 2025, onwards. The documentation on the nature and content of the business relationships within the meaning of Section 1 (4) FTA must be submitted within 30 days of the application or notification of the audit request. It should be noted that, in addition to the assessment period from 2025, this also applies to tax audit requests from this year onwards that relate to a period prior to 2025. Furthermore, in accordance with Section 90 (3) sentence 2 no. 1 of the German Fiscal Code („AO") the transaction matrix must also be submitted from January 1, 2025, in addition to the documentation of the factual background and the economic and legal basis for the application of the arm's length principle. The transaction matrix must include the following points:

- the nature of the business relationship;
- the service recipient(s) and provider(s) involved;
- the volume and remuneration;
- the contractual basis;
- the transfer pricing method applied;
- the affected tax jurisdictions; and
- whether transactions are not subject to standard taxation in the relevant tax jurisdiction.

According to the 4th Bureaucracy Reduction Act, as part of an efficient and risk-oriented audit approach,



not all transfer pricing records are to be submitted without a separate request, but initially only the transaction matrix, the master file and any records of extraordinary business transactions within a period of 30 days. However, the tax authority still has the right to request the submission of further records in accordance with (3) at any time during the external audit in accordance with the deadline in sentence 2 (4) of Section 90 AO. In justified individual cases, the deadline for submission may be extended.

Conclusion / Key facts

Intragroup financial transactions have been a major focus during German tax audits of real estate companies for many years. With the publication of the VWG VP 2024 and the stricter documentation obligations, taxpayers now receive the German tax authorities' interpretation of Section 1 (3d) and (3e) FTA and are thus required to document their intragroup financial transactions promptly and more comprehensively. The new VWG VP 2024 indeed brings more clarity to the interpretation of the issues of accepting the financing relationship on the merits and the determination of arm's length interest rates. However, it remains to be seen how the potential for disputes will develop in the context of tax audits on the subject of financing relationships. Experience has shown that a complete, meaningful and promptly provided transfer pricing documentation is a good starting point for tax audits.

Ronny John
Partner, Certified Tax Advisor,
Financial Services Tax

Dr. Christoph Mölleken
Manager,
Financial Services Tax

05

Reduced VAT rate for hotel breakfasts and input tax deduction for tenant electricity PV systems

ECJ submissions on the apportionment requirement and consolidation of the BFH case law

The BFH (Federal Fiscal Court) has now referred three cases to the ECJ (European Court of Justice) to examine the 19 % VAT rate on ancillary services for hotel accommodation, while at the same time it has decided regarding photovoltaic (PV) systems that input VAT deduction should generally be possible because the tenant's electricity is not supplied VAT-free.

Initial situation: Apportionment requirement despite uniformity of supply

German VAT law differentiates between accommodation services (7 %) and „services that do not directly serve the accommodation" (19 %) for the purposes of applying the reduced VAT rate in Section 12 (2) no. 11 sentence 2 of the German VAT Act [UStG]. The latter typically refers to catering services, but also includes use of communication networks (e.g. hotel Wi-Fi), the use of the minibar in the hotel room and the use of the hotel parking lot.

This „apportionment requirement" applies exclusively to those services that are to be regarded as ancillary services to accommodation services. If this rule did not exist, breakfast or the use of parking spaces, for example, would share the same fate as accommodation services, with the result that the reduced VAT rate would also apply to them (Section 3.10 (5) sentence 1 of the German VAT Application Decree [UStAE]). Conversely, a special regulation becomes irrelevant if it is established that breakfast etc. are independent services.

Dispute over the unlawfulness of the apportionment requirement for accommodation services under EU law

The apportionment requirement therefore represents a national exception to the VAT principle of uniformity of supply. Whether this is permissible under European law requirements has been a matter of debate particularly since the ECJ ruling in the „Stadion Amsterdam" case from 18.1.2018 (C-463/16).

Regarding the rental of operating facilities, which – in contrast to property rentals – is expressly to be treated as taxable in accordance with Section 4 (12) sentence 2 UStG, the ECJ has spoken out against dividing such services into tax-exempt rental of properties and taxable rental of operating facilities if the rental of operating facilities can be regarded as an ancillary service (see ECJ of 4.5.2023, C-516/21, FA X). The BFH agreed with this in its subsequent decision (BFH of 17.8.2023, V R 7/23). Nevertheless, the tax authorities have not yet implemented this in practice, which gives companies the opportunity to invoke the case law in individual circumstances.

Although it is clear from this mixed situation that uniform services must not be treated differently by national regulations, there is the question of what leeway the (national) legislator has, at least regarding tax rates.

BFH upholds the apportionment requirement for accommodation services

The BFH must currently decide in three proceedings (all dated 10.1.2024) whether certain additional services to accommodation services are subject to the reduced tax rate. Specifically, the proceedings concern breakfast services (XI R 13/23) as well as parking spaces, fitness and wellness facilities and hotel Wi-Fi (XI R 13/23 and 14/23). Due to recent developments at EU level, the BFH has referred all three proceedings to the ECJ.

In the orders for reference, the BFH upholds the principle of apportionment regarding the reduced tax rate. This is because, in contrast to the tax exemption regulations, the national legislator has been granted leeway by the Union legislator about the tax rates, allowing the reduced tax rate to be applied just to certain parts of a uniform supply to which a reduced tax rate may be applied. The only condition is that the Member States observe the principle of fiscal neutrality.

In its orders for reference, the BFH also clarifies the cases in which the apportionment requirement does not apply, namely when the additional services can be independently deselected by the hotel guest. In these cases, it is clear that the additional services have an independent character and are therefore to be regarded as independent services. These are subject to the standard VAT rate, meaning that Section 12 (2) no. 11 sentence 2 UStG becomes irrelevant. As the BFH deemed this indisputable, it saw no reason to refer the issue to the ECJ for clarification.

Input tax deduction for PV systems

A few months later, the BFH confirmed this legal opinion in a case concerning the supply of electricity by a landlord to a tenant. The background was a dispute about input tax deduction for PV systems that had been purchased for tenant electricity supplies. The BFH ruled that the supply of electricity was not an ancillary service to the (tax-free) rental service because, by law, the tenant is free to choose their electricity provider and the supply of electricity is billed separately and according to individual consumption (see BFH of 17.7.2024, XI R 8/21). In the specific case, the fact that the tenant had to bear conversion costs when switching to other electricity providers was irrelevant.

Implications for practice

Should the ECJ declare the German apportionment requirement for accommodation services to be contrary to EU law, this would particularly benefit hotel operators. Although the tax authorities are not expected to implement the new principles directly, hotel operators should have a good chance of successfully invoking the reduced tax rate, and this would lead to a genuine VAT advantage.

Regarding electricity supplies with PV systems for tax-free long-term rentals, current case law strongly supports the landlord's right to deduct input tax for the PV systems. Landlords should refer to this if there are any objections from the tax office; moreover, future investments can now be calculated with greater legal certainty.

Conclusion / key facts:

The apportionment requirement for accommodation services is entering the next round with the latest ECJ referrals from the Federal Fiscal Court, and the ECJ's decisions in this matter are eagerly awaited. The hotel industry in particular may benefit from VAT advantages in the future. In the case of investments in systems that are used for electricity supplies for tax-free rented properties, the possibility of claiming input tax deduction is at risk and a case-by-case assessment is urgently recommended.

Dr. Bastian Liegmann
Partner
Indirect Tax Services

Dr. Francesco Farruggia-Weber
Assistant Manager
Indirect Tax Services

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KPMG AG
Wirtschaftsprüfungsgesellschaft

Stefan Kunze
Head of Real Estate Tax
Partner, Steuerberater
T +49 89 9282-6894
skunze@kpmg.com

Katrin Bernshausen
Financial Services Tax – Real Estate
Partnerin
T +49 69 9587-3172
kbernshausen@kpmg.com

Impressum

KPMG AG
Wirtschaftsprüfungsgesellschaft
Ganghoferstraße 29
80339 München

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