CJEU decision on the German tax rules applicable for non-resident closed-end real estate funds

Taxation of real estate property – Corporate income tax – Investment funds – Free movement of capital – L Fund

On April 27, 2023, the Court of Justice of the European Union (CJEU or the Court) gave its decision in the case C-537/20 (L Fund). The case concerns the compatibility with EU law of the German corporate income tax applicable to non-resident closed-end real estate funds.

The Court held that the German tax treatment of revenues derived by non-resident closed-end real estate funds, with exclusively foreign investors, from immovable property located in Germany was contrary to the free movement of capital.

Background

The plaintiff was a Luxembourg closed-end fund, with no legal personality, that received income from renting and selling real estate properties in Germany. The fund had only two institutional investors, none of which had a registered office or central administration in Germany.

Under German tax law, domestic closed-end real estate funds are treated as corporate taxpayers but are exempt from corporate income tax. Tax is nevertheless due at the level of the investor. In the case of domestic funds with exclusively non-resident investors, the immovable property income is attributed directly to the latter, and the relevant tax is withheld by the fund. On the other hand, non-resident closed-end real estate funds do not benefit from the corporate tax exemption in respect to the immovable property income derived. Instead, such revenue is taxable at fund level. As a result, in both cases, the German income received by non-resident investors is taxed only once in Germany, but at different levels.

The plaintiff challenged the corporate income tax treatment described above and, following several appeals, the case was brought to the German Federal Fiscal Court. On October 21, 2020, the court made a reference for a preliminary ruling, requesting clarifications regarding the compatibility with the free movement of capital of such rules. Following the CJEU's decision in case C-545/19 - concerning the compatibility with EU law of the Portuguese withholding tax levied on dividends paid by Portuguese companies to foreign undertakings for collective investment in transferable securities ('UCITS'), the referring court informed the CJEU that it wished to maintain its request for a preliminary ruling.

The CJEU decision

The CJEU first recalled its settled case-law based on which measures that are likely to dissuade non-residents from making investments in a Member State or to dissuade residents from making investments in other States, restrict the free movement of capital. The Court then noted that this is also the case of the legislation under dispute.

Comparability analysis

Turning to the question whether the difference in treatment relates to situations that are objectively comparable[1], the Court recalled that such analysis should be based on an overall assessment having regard to the aim, purpose and content of the German legislation. The reported aim of the measures under dispute was to implement the transparency principle, under which income is taxed only once, as well as to ensure equal treatment between direct investments and investments made through an investment fund. The Court also recalled that only the relevant distinguishing criteria in the German legislation must be taken into account to assess whether situations are in fact comparable. In the case at hand, the CJEU noted that, in their view, the only criterion of distinction in the German law was the tax residence of the fund – since both the corporate income tax exemption and the requirement to withhold tax on behalf of non-resident investors applied solely in the case of domestic funds. In this context, the Court noted that resident and foreign closed-end real estate funds were in a comparable situation.

Justification

Finally, the Court successively considered and rejected the justifications brought forward by the German government, i.e. the need to safeguard the coherence of the German tax system and the need to ensure a balanced allocation of taxing rights.

First, the Court noted that justifying a tax advantage based on the coherence of the tax system required a direct link between such advantage and offsetting it with a tax levy. The CJEU noted that the referring court and the German government considered that such a link existed, since the corporate income tax exemption applicable to resident closed-end real estate funds was offset by taxing the property income at the level of the investors. The referring court, which has sole jurisdiction to interpret national law, would be responsible to determine whether the advantage is indeed offset. However, even if such direct link existed, the Court noted that, in their view, the rules under dispute were not proportionate. A less restrictive measure would be to exempt foreign closed-end real estate funds, provided the investors pay a tax equivalent to that of investors in a German closed-end real estate fund. Moreover, the rules at hand might not attain the objective of the legislation, as German investors in foreign closed-end real estate fund could suffer double taxation – first the property income would be taxed at the level of the fund, and subsequently at the level of the investor.

With regard to the need to ensure a balanced allocation of taxing rights, the Court referred to its previous case-law based on which this justification cannot be invoked in cases where a Member State chose not to tax domestic funds on the immovable property income received.

In light of the above, the Court found that the German corporate income tax treatment of non-resident closed-end real estate funds, with exclusively foreign investors, constituted an unjustified breach of EU law.

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[1] Under CJEU case-law, a difference in treatment would not constitute discrimination or a restriction on the free movement of capital provided the treatment concerns situations not objectively comparable or is justified by an overriding reason in the public interest.

ETC Comment

The CJEU decision is broadly in line with its previous case-law on the taxation of non-resident funds. Although a number of Member States have changed their legislation in the past few years, there continues to be a number of jurisdictions that are still defending their regimes for investment funds. The Court reiterates that different treatment based solely on the place of residence of the funds may introduce unjustified restrictions on the free movement of capital.

It is interesting that the CJEU disregarded the referring court's views that the relevant distinguishing criteria for the comparability analysis was the place of residence of the investor. The German court had previously noted that domestic closed-end real estate funds with non-resident institutional investors were not subject to corporate income tax because of the direct allocation of income from property to non-resident investors. In the referring court's view, this inferred that the national legislator used the tax status of the investors as a distinguishing criterion for determining the applicable tax treatment. The CJEU nevertheless noted that the direct allocation of income is only available to domestic funds and concluded that the differentiator factor was the residence of the fund.

The case also provides some interesting insights in the proportionality analysis. Whilst in the Fidelity Funds case (C-480/16) – see Euro Tax Flash Issue 373, the CJEU suggested less restrictive measures by looking at the tax equivalent paid at the fund level, the case at hand considered the situation of the investors.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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