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By PwC Deutschland | 02. Februar 2024

Update: ECJ - Different tax treatment of resident and non-resident funds hinders free movement of capital

Based on the German tax provisions existing in the years in dispute 2008 through 2010, resident and non-resident special real estate funds are treated differently, which is disadvantageous for non-resident special real estate funds. In its decision the ECJ sees a restriction on the free movement of capital which cannot be justified by overriding reasons of public interest.

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Background

The applicant in the main proceedings, L Fund, is a property fund set up as a specialized investment fund under Luxembourg law, with neither its registered office nor its central administration in Germany. L Fund is a closed-end fund with only two institutional investors and no head office or central administration in Germany. During the years 2008 through 2010 it received income from the rental of its properties in Germany and from the sale of some of the properties. The local tax office held the fund partially liable to corporate profit tax and issued corresponding tax notices for the years in dispute.

The case went before the Supreme Tax Court who observed that, under Sec. 2(1) Corporate Tax Act, L Fund, which has neither its registered office nor its central administration in Germany, is partially liable to corporation profit tax on the entire income which it received in Germany. In contrast to domestic open-end investment funds, L Fund could not benefit from the exemption from corporate profit tax as provided for in the second sentence of Sec. 11(1) of the Investment Tax Act in its (older) version in force during the tax years in dispute, since L Fund is a foreign fund. The Supreme Tax Court questions whether the exclusion of a foreign fund from the exemption granted to domestic funds is compatible with EU law. In both cases, income received in Germany by non-resident investors is taxed only once, but at different levels.

Considering this, the referring Supreme Tax Court asked the ECJ whether the exemption provided for in the second sentence of Paragraph 11(1) Investment Tax Act hinders the free movement of capital within the meaning of Article 63(1) TFEU.

ECJ decision

The ECJ notes, first, that the German legislation regarding the different treatment of the two types of investment funds constitutes a restriction on the free movement of capital which is prohibited under the regime of Article 63 TFEU. Such a difference in tax treatment, however, is not in violation of Article 63 TFEU if it concerns situations that are *not* objectively comparable with each other or if it is justified by an overriding reason in the general interest. For the ECJ, however, such reasons for justifications did not exist here.

Comparability of the situations

First the ECJ notes that resident and non-resident funds are in a comparable situation regarding the objective pursued by the transparency principle, namely, to ensure equal treatment between direct investments and investments made through an investment fund. The income from property of resident funds is only taxed at the level of their investors for the purpose of achieving that objective.

The objective of shifting the level of taxation from the fund to the investor can also be achieved in the case of non-resident funds by making the exemption from corporate profit tax provided for in the second sentence of Paragraph 11(1) of the Investment Tax Act 2004 conditional on the taxation of the investors of such funds. While it is true that Germany cannot tax non-resident investors, it must be observed that this is solely owed to the fact that taxation is shifted from the fund to the investor.

Thus, reserving the possibility of obtaining an exemption from withholding tax solely to resident specialized

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property funds is not justified by an objective difference in situation between those funds and those resident in another Member State. Therefore, resident funds and non-resident funds are in a comparable situation.

No overriding reason relating to the public interest

-- *On the need to preserve the coherence of the national tax system*

In that regard, the ECJ notes that in the case of resident investors in a non-resident specialized property fund, the taxation of that fund leads to double taxation of that income, since it is taxed, first, in the hands of the fund and, secondly, in the hands of the resident investor. The elimination of that double taxation cannot always be achieved, which is precisely the opposite of the objective pursued by the national legislation at issue in the main proceedings.

Moreover, the internal consistency of the tax system at issue could be maintained if non-resident specialized property funds could benefit from the exemption from corporate profit tax, provided that the German tax authorities ensure, with the full cooperation of those funds, that the investors in those funds pay a tax equivalent to that to which investors in a resident specialized property fund are liable. Allowing such non-resident specialized property funds to benefit from that exemption, under those conditions, would constitute a less restrictive measure than the current.

-- *On the need to preserve a balanced distribution of taxing power between Member States*

The justification based on the preservation of the balanced allocation of the power to tax between the Member States may be accepted where the scheme at issue is intended to prevent conduct likely to jeopardize the right of a Member State to exercise its taxing powers in relation to activities carried out within its territory. However, since Germany has chosen not to tax resident funds on their domestic income, it cannot rely on the need to ensure a balanced allocation of the power of taxation to justify the taxation of non-resident funds which receive such income.

Update (2 February 2024)

In its final judgment of 11 October 2023 (published on 1 February 2024) the Supreme Tax Court held that - from a purely German tax perspective and based on the provisions existing in the years in dispute 2008 through 2010 - a fund for collective investments (*fonds commun de placement*) set up under Luxembourg law in the nature of a specialized investment fund (*fonds d'investissement spécialisé*) may qualify “as other private law estate” (i. e. special assets of the fund) within the meaning of Section 1 (1) no. 5 of the German Corporation Tax Act and be subject to limited corporation tax liability on its domestic income.

However, the exclusion of a Luxembourg special real estate fund from the personal tax exemption of Section 11 (1) sentence 2 of the Investment Tax Act in the version applicable for the years in dispute violates the free movement of capital. The plaintiff must therefore be granted the tax exemption for reasons of EU law (thereby following the judgment of the ECJ of 27 April 2023 in the case C-537/20, *L Fund*).

Update (9 May 2023)

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Takeaway: This judgment is of great importance to foreign specialized property funds and other similar non-resident investment vehicles. Those foreign specialized funds should consider lodging an appeal against their German tax assessment notices after analyzing the individual case.

More information to be found in our **EUDTG Newsalert of 1 May 2023**.

Source

ECJ judgment of 27 April 2023, case: **C?537/20** *L Fund*

Schlagwörter

investment funds