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German Fiscal Court on funds and equal treatment under the EU freedoms

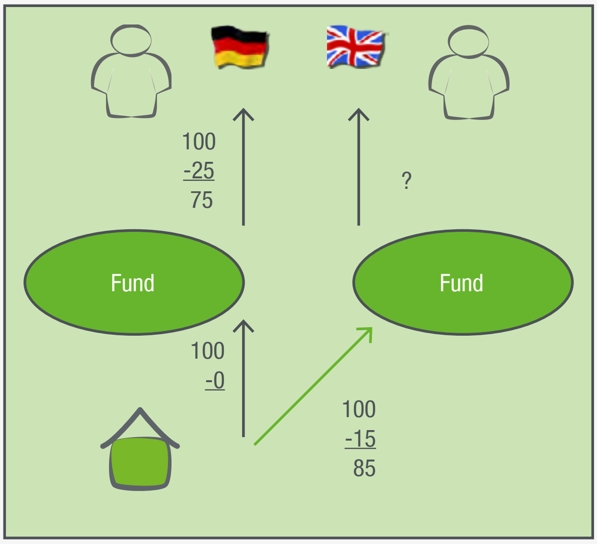
http://docs.bepartners.pro/2017-04-20_FG-Muenster_10-K-3059-14.pdf

Under the current tax regime Germany grants a tax exemption only for domestic funds but not for foreign funds. The Fiscal Court Münster (20/04/2017,10 K 3059/14 K) ruled that this is in line with the EU freedoms because the situation of German funds is not comparable to that of foreign funds.

In the case at hand a foreign real estate fund (a Luxembourg fonds commune de placement or FCP) holds German real estate directly. The foreign fund claimed that it should be exempt from German tax on the rental income. It argued that because of the tax exemption granted to a German domestic fund, a Luxembourg fund should be granted the same treatment and thus receive the same tax exemption privilege.

The dilemma of equal treatment for residents and non-residents

Funds need to be as tax-efficient as direct investments (tax neutrality). Countries have chosen different approaches under their tax laws to neutralize the effects of the interposition of a fund between the investment and the investor. The German approach is to have the fund treated as a taxable person but exempt it from paying tax. Under this approach the fund does not pay taxes on real estate income and capital gains and can receive dividends free of withholding tax but is often subject to a levy of withholding tax on distributions. However, the German tax system is currently based on tax laws that provide for different tax treatment of residents and non-residents. Thus, whereas tax neutrality for resident funds is established by granting a tax exemption, such tax exemption is not granted to non-resident funds as well.



According to the provisions on the freedom of establishment and the free movement of capital in the Treaty on the Functioning of the European Union ("TFEU"), persons, i.e. residents and non-residents, who are otherwise objectively comparable to each other, are entitled to equal tax treatment. Therefore, a Member State cannot treat a resident fund more favorably than a non-resident fund. According to Art. 65 TFEU, a different tax treatment may be justified only if (i) the distinction is made between situations that are objectively not comparable to each other or (ii) the distinction is justified by an overriding reason of public interest. This equal treatment requirement causes a problem in many Member States.

The comparability test

In a number of rulings by the European Court of Justice (Aberdeen ECJ C-303/07; Santander ECJ-C-338/11; Emerging Markets ECJ-C-190/12) it has been common ground that the comparability test is to be applied only at the level of the recipient of income without taking into account the fact how this recipient itself is taxed. So far, the cases decided by the European Court of Justice were cases on withholding tax for dividends. Now the case decided by the Fiscal Court Münster deals with rental income. However, neither the cases decided by the ECJ nor the case decided by the Fiscal Court Münster based their argument on the differences between taxation of dividends (in the form of withholding taxes) and rental income in so far as the comparability test is concerned. The argument of the Fiscal Court Münster in denying comparability is simply that whereas in a domestic case the fiscal administration has the right to tax the distributions of the fund (taxation at the level of the investors in the fund), it has no such right to tax a foreign fund. The Fiscal Court clearly sees that this argument contravenes the ECJ decisions. In particular, the ECJ stated clearly in the Emerging Markets decision that for the purpose of the comparability test, only the taxation at fund level itself is relevant and not the taxation at investor level. The Fiscal Court Münster explains that this cannot be upheld for the German system of taxation of investment funds. This is because the only reason for tax exemption at fund level is that a tax at investor level is maintained. We doubt very much that this argument can be upheld when this case will be reviewed on appeal. It is the dilemma of the European Union that is does not ask for harmonization of direct tax laws in the EU Member States, but that the ECJ nevertheless is very strict on the interpretation of domestic tax laws against the EU freedoms.

The to-does for EU Member States

The to-do for each of the EU Member States is to maintain tax neutrality of investment funds without differentiating between resident and non-resident funds. This can be achieved in two ways: either by ring-fencing domestic tax collection in that domestic funds will lose the tax exemption privilege or by granting tax exemption to all funds without differentiating between domestic and foreign funds. Germany, unfortunately, decided to go for the first option. As of 2018, German investment funds will no longer be tax exempt on German source income (such as dividends and rental income).

The to-does for foreign real estate funds

As it is already the case for refund claims of German dividend withholding tax, foreign funds should insist on a refund of German taxes paid on German rental income. Unlike German shares, however, German real estate usually is not held directly by a foreign fund. Instead, real estate investments are usually routed via foreign real estate holding companies. In such a case, no consequences should be drawn as such holding companies would be subject to tax in a purely domestic environment as well. Where a foreign fund holds German real estate directly, it should keep its tax files open and refer to the open case as the appeal now has to be decided by the Federal German Tax Court (BFH: I R 33/17).

be in touch: Any questions? Please do not hesitate to contact us!

Dr. Carsten Bödecker
Partner . Steuerberater . Rechtsanwalt
Tel. +49 211 946847-51
Fax +49 211 946847-01
carsten.boedecker@bepartners.pro

Carsten Ernst
Partner . Steuerberater
Tel. +49 211 946847-52
Fax +49 211 946847-01
carsten.ernst@bepartners.pro

Nathalie Grenewitz
US-Attorney at Law
Tel. +49 211 946847-57
Fax +49 211 946847-01
nathalie.grenewitz@bepartners.pro

Alexander Skowronek
Partner . Steuerberater . Rechtsanwalt
Tel. +49 211 946847-62
Fax +49 211 946847-01
alexander.skowronek@bepartners.pro