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Tax treatment of non-German resident real estate investment funds found to be incompatible with the free movement of capital under EU law - ECJ Decision in Case C-537/20

On 27 April 2023, the ECJ (Case C-537/20) ruled that Article 63 of the *Treaty on the Functioning of the European Union* (the “TFEU”) must be interpreted as “precluding legislation of a Member State which makes non-resident specialised property funds partially liable to corporate income tax in respect of the income from property which they receive in the territory of that Member State, whereas resident specialised property funds are exempted from that tax”.

The decision follows a request for preliminary ruling regarding the compatibility of German tax law (in force as of the date when the assessment was first made) with Article 63 of the TFEU (concerning the free movement of capital).

1. The Case (C-537/20)

The question referred to the ECJ regarded a Luxembourg specialized investment fund, with neither its registered office nor its central administration in Germany, that was held liable to corporate income tax in Germany on income deriving from the rental and sale of its German properties.

While the Luxembourg specialized investment fund, as a foreign investment fund (here, the “**Foreign Fund**”), was considered subject to corporate tax on its income from property located in Germany, a comparable domestic specialized property fund (here, the “**German Fund**”) would have not been subject to corporate income tax in Germany on the same type of income.

The German tax authorities and the referring court held that the exemption from corporate income tax of German Funds was due to avoid double taxation and implementing the transparency principle, under which income is taxed only once at the level of the investors. While for German Funds taxation occurred at the level of the investors, who were subject to withholding tax on income upon distribution of the proceeds, investors of Foreign Funds would not have been taxed under German law. This (in the German tax authorities view) led to a – justified – difference in the tax treatment.

In that context, the referring court questioned whether (i) the exclusion of a Foreign Fund from the benefit of that exemption is compatible with EU law (namely, with Article 63 of TFEU), and (ii) the distinction between German Funds and Foreign Funds could have been acceptable considering other German law provisions.

2. The ECJ decision

The ECJ held that the different tax treatment of German Funds and Foreign Funds was a restriction to the free movement of capital under Article 63 TFEU, since it was “likely to dissuade, first, non-resident specialised property funds from making investments in property situated in Germany and, secondly, investors resident in Germany from using non-resident specialised property funds for such investments”.

The ECJ then considered whether the mentioned restrictions could be legitimate under Article 65(1)(a) TFEU (i.e., if they were based on situations which were not objectively comparable, or if they were justified on an overriding public interest).

In this regard, the ECJ noted that neither the situation of the German Fund and that of the Foreign Fund was not objectively comparable, nor the different tax regime was reasonable considering overriding public interest.

The ECJ also specified that the different treatment could not be considered legitimate based on the circumstance that profits distributed to investors of German Funds were taxed in the hands of their investors, since the exemption of German Funds was not conditional upon full taxation of income at the investors' level.

Instead, the only criterion of distinction established appeared to be based on the place of residence of the investment funds.

In light of the above, the ECJ answered to the questions referred to it stating that *“Article 63 TFEU must be interpreted as precluding legislation of a Member State which makes non-resident specialised property funds partially liable to corporate income tax in respect of the income from property which they receive in the territory of that Member State, whereas resident specialised property funds are exempt from that tax”*.

3. Further considerations

Italian real estate investment funds are subject to Italian corporate tax, though being exempt on the most part of their income (including income from the lease and sale of their properties).

Although no official positions of the Italian tax authorities on the taxation of foreign funds are available, in principle they are subject to tax on income they derive from properties located in Italy. Foreign funds holding directly Italian real estate properties would then be bound to file yearly income tax returns in Italy, reporting taxable income and pay the relevant taxes.

Given the above, the depicted ECJ decision may be of interest to the industry as the Italian tax regulations might be considered similar to the German ones.

4. How can we help?

GOP has extensive knowledge of the investment funds industry and regularly advice management companies in structuring investments worldwide. Our multidisciplinary team is available to provide further analysis and support any actions.

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