

# Tax Real Estate: Client Information

## Report

Most structures used to invest in German real property are designed to avoid trade tax being imposed on the income generated by the property. In a cross-border context, their success depends on the assumption that as long as the activities of the investor are limited to the typical activities of a landlord, e.g. long-term passive leasing, in general no permanent establishment (PE) is created, the existence of a PE being a precondition for the imposition of the trade tax. It is, therefore, crucial to avoid creating a PE in Germany, in particular a PE arising as a result of the carrying on of management activities (i.e. a management PE) in Germany. A management PE is usually located at the place of business, i.e. the place where the day-to-day business decisions are made.

This issue was recently discussed in a news magazine article ("Manager-Magazin 10/2009") in relation to a well-known hedge fund that may have been accused of tax fraud. According to the article, German residents were appointed as managing directors of the property companies concerned and a group-owned management company located in Germany was involved in the business. Also, purchase agreements may have been signed in Germany. The article raises the question of whether the rules in this area lack certainty and clarity.

The article takes the typical approach of blaming the industry. The fact however, that this issue is discussed in news magazines suggests that the question of whether activities in relation to real estate investments in Germany give rise to a management PE may be taking on a political dimension. It therefore seems likely that in future tax officers will be taking a hard look at where management decisions are actually made. It is therefore recommended that investors review their decision-making processes, especially where German group companies are involved in the management of German assets.

## Federal Tax Court rules on evidence of active trade/business

Generally, in Germany, it is presumed that an active trade/business is being carried on where more than three properties are sold within a five-year period; properties that

have been held for at least 10 years, however, are not taken into account. If an implicit intention to sell the property is present from the time the property is acquired, even the sale of one property can be damaging. The sale of property during or immediately after its construction is generally assumed to constitute evidence of an active trade. In a decision dated 19 February 2009, the German Federal Tax Court held that not only the construction of the property by the seller itself is damaging, but also that the activities of a general contractor should be assigned to the builder for purposes of this rule. There is some debate in the technical literature as to whether this decision is applicable only to the particular case of the general contractor and the builder being sister partnerships or whether the decision has general application.



If an active trade is deemed to be carried on, the assets (i.e. the property) would be treated as current assets and therefore no regular depreciation would be allowable. Furthermore, reliance cannot be placed on the extended trade tax deduction, according to which the lease income is exempt from trade tax, as this deduction is no longer available.

#### **Tax authorities accept that delivery of electricity is part of (VAT-exempt) long-term lease**

The Federal Tax Court held on 15 January 2009 that the delivery of electricity by a landlord is part of a (VAT-exempt) long-term lease. While, in the case concerned, the Court had to decide on the appropriate tax treatment of the delivery of electricity by a campground operator to the permanent campers, the rule should apply in general to VAT-exempt leases, e.g. residential leases where the landlord provides the electricity. The tax authorities have abandoned their earlier position on this matter and adopted the new principles on 21 July 2009. As a consequence, input VAT paid in connection with the purchase/production of the electricity is no longer creditable.

#### **Federal Tax Court confirms that transfer of leased building results in transfer of going concern, even if only part of building leased at time of transfer**

If there is a change in the use of property such that turnover ceases to be VAT-able and becomes VAT-exempt within a period of 10 years after the acquisition/renovation of the property, input VAT deducted must be repaid proportionally. This is also the case where property is sold within the 10-year period, as the sale of property is usually VAT-exempt, where no option to charge VAT has been exercised. However, no repayment is required if the sale is regarded as the transfer of a going concern. In this case, the purchaser steps into the seller's shoes and takes over the VAT repayment obligation until the end of the 10-year period. The acquisition of a leased property, including the lease agreements, has hitherto been regarded as the transfer of a going concern. In its decision dated 30 April 2009, the Federal Tax Court confirmed that this is the correct treatment, even if parts of the property are not actually leased at the time of the transfer provided there was an intention to lease the vacant parts. In addition, the lower court of Düsseldorf expressed the view, in a decision dated 29 April 2009 that the same principles apply where part of a building is not used because of renovation/construction.

#### **Tax fraud where declaration for real estate transfer tax not provided**

German law requires that any taxable event for Real Estate Transfer Tax (RETT) purposes be notified to the competent tax authority by the taxpayer. In the case of the "unification of shares" in a real estate-owning company in the hands of a single owner or a group of companies, the taxpayer is the single owner or the group of companies; such a unification constitutes a taxable and, therefore, notifiable event for RETT purposes. In the case of a real estate-owning partnership, a 95% or more direct or indirect change in the ownership of the partnership within five years is also a taxable event. In this case, the partnership itself is the taxpayer for these purposes.

The Federal Tax Court recently held that failure to submit the RETT notice might give rise to tax fraud ("negligent tax evasion"). In the case concerned, a GmbH contributed real estate and shares in a real estate owning subsidiary to a GmbH & Co.KG in exchange for a partnership interest. The transfer contract was notarized by a Swiss notary. A RETT provision was set up in the tax balance sheet submitted to the tax authorities responsible for corporate income tax, but the taxable events for RETT purposes were not notified to the competent tax office. The Court held that the representatives of the GmbH & Co.KG should have been in a position to recognize the obligation to submit the RETT notification. Where tax fraud exists, penalties may be assessed. Additionally, the taxpayer will be charged with monthly interest of 0.5% of the RETT liability.

#### **Fair value depreciation in case of intended sale of real estate**

Generally, a write-down to fair value in the case of a building is only allowed if the decrease in value will last for at least half of the remaining useful life of the building. For normal (linear) depreciation purposes, the typical useful life of a building is defined by law as being 50 years (in the case of residential property) and 33.33 years (in the case of commercial property). In the case concerned, the Federal Tax Court had to decide whether the remaining useful life for purposes of fair value depreciation should be based on the useful life in the context of the individual business or on the typical useful life. The taxpayer in the case intended to sell the property concerned within the next two years. Unfortunately, the Court decided in favor of the typical useful life. According to the decision, even the risk of a loss resulting from the sale of property in the near future does not justify writing down the value of the property to its expected sales price if the fair value falls below the book value by not more than half for the rest of the typical useful life. The decision makes it much more difficult to justify fair value depreciation.

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