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Real Estate Tax Compliance – Current Focal Points from Recent Tax Audits

The management of single real estate properties through to extensive real estate portfolios is certainly a challenging task, and one which becomes more complex when taxation guidelines are to be taken into consideration. In addition to other factors, the recent administrative decree of the German Federal Ministry of Finance (BMF) concerning the differentiation between mere amendments of incorrect tax returns and a voluntary self-disclosure to the tax authorities of false or incomplete tax declarations in case of tax fraud, has seen tax compliance once again become the focus of all participants. Tax practice has shown that pitfalls are to be found in several places, and that the best tax-structure memo cannot provide any guarantee for a life without tax worries if circumstances change later or new circumstances arise, or the original legal or tax guidelines are not carried out properly.

The following report aims to highlight key focal points from tax audits with which we have been entrusted, and therefore offer proposals for possible solutions at the same time; in this respect, we assume an inbound scenario in which real estate located in Germany is held by domestic or foreign property companies.

Shareholder loans and appropriate interest rates – all clear in the case of general group recourse

In general, the financing of real estate funds is structured so that part of the investment sum is financed by bank loans. Since banks commonly only provide finance up to a certain lending limit, however, and demand comprehensive severance indemnity clauses (covenants), the remaining part is generally financed via the equity capital of the shareholders and shareholder loans. In this respect,

in the scope of so-called financing freedom, shareholders are generally free regarding the level of loan capital to be provided, at least if certain equity elements, which are frequently based on minimum capital regulations under company law, are fulfilled. In the case of German real estate, the restrictions of what is known as the interest cap must also be considered, although this is not discussed in any further detail in this report.

Therefore, in practice, shareholder loans are frequently encountered which have been issued by finance companies (Finco) affiliated with the investment company. These are frequently corporate entities domiciled in foreign countries; in Germany, the appropriate interest expenses can be deducted for tax purposes by the property company (Propco). It is naturally the case that in contrast to bank loans, which are fully collateralised on the basis of mortgages, the assignment of shares and the assignment of rental accounts etc., shareholder loans of this kind – including in terms of the de-facto absence of further loan collateral – are mostly issued as unsecured shareholder loans. The absence of collateral is reflected by an appropriate risk surcharge on the interest rate on the loan to be agreed with the bank – an approach which is generally in agreement with the relevant administrative decree of the BMF dating from 2011. As a result, this means shareholder loans of this kind are frequently concluded with interest rates which are to all intents and purposes significantly higher than those for the fully collateralised bank loan.

For some time, the fiscal authorities have generally taken this basic scenario as a reason to object against the interest expenses asserted by the Propco in the scope of income tax returns for real estate located in Germany, assuming a breach with the so-called arm's length requirement. In this respect, it is often the case that this in no way only relates to the level of the appropriate interest rate itself. On the contrary, in reference to a ruling by the German Federal Fiscal Court (BFH) dating from 1994, the German fiscal authorities argue that the maximum interest rate for the unsecured shareholder loan is the interest rate for the fully collateralised bank loan. This extremely restrictive approach on the part of the fiscal authorities, which is incomprehensible from an economic perspective and has been criticised strongly in the tax publications, is based on a particular interpretation of the aforementioned ruling of the BFH dating from

1994. At that time, the BFH noted that the collateralisation of shareholder loans was unusual incorporate group structures, as on the basis of their shareholding, the parent company may be able to draw on all the assets of the affiliated subsidiary companies. This general remark on the part of the BFH was subsequently interpreted by the fiscal authorities, in an extremely restrictive way, as being a prohibition on the charging of risk-appropriate (higher) rates of interest for shareholder loans due to the lack of loan collateral.

In a recent ruling by the fiscal court of Schleswig-Holstein, in a case that we conducted, the fiscal court confirmed that on the basis of the jurisdiction of the BFH to date (including I R 65/94 dating from 21.12.1994 and I R 24/97 dating from 29.10.1997 as well as I R 29/14 dating from 24.06.2015), a general prohibition of risk surcharges on shareholder loans cannot be interpreted under any circumstances. On the contrary, in the case of special purpose vehicles within the structure of closed-end real estate funds, it is necessary to consider the fact that structures of this kind are initially configured to limit the risks resulting from investment properties and to protect the overall group from risks of this kind as far as possible. In addition, the operational relevance of a real estate property company to the overall group is naturally lower, for example, than that of individual manufacturing businesses in a manufacturing group, respectively an operational integration of a real estate company may not have occurred. In view of these circumstances, a third party would not have renounced a risk surcharge when assessing the interest rate of the loan due to the group affiliation of the plaintiff. The ruling of the fiscal court is legally binding; the application for an appeal with the Federal Fiscal Court was dismissed.

At the practical level this ruling – which has not yet been published – provided long sought-after clarification, which – including in our firm – resolves a significant number of current and future appeal procedures. The general prohibition (of appropriate) risk surcharges is therefore off the table, the only thing remaining is the question regarding and the proof of the appropriate interest rate that a third party would have applied in comparable arrangements. Our recommendation: ideally, obtain the terms and conditions from a variety of different banks, including for subordinated loans, at the start. If this does not occur or was neglected in the past, the only remaining approach is via what is

known as a transfer price survey (database study). In this context it should be noted that there is currently a tax court case pending with the German Federal Tax Court (I R 4/17) challenging the application of the comparable uncontrolled price method, the mostly applied transfer pricing methology in such cases.

Active trade or business in case of the provision of advertising and sales promotion measures within the scope of active asset management

The leasing of large-scale properties, particularly office real estate, retail real estate and even entire shopping centres, requires the continuous and active management of both the individual real estate units and the entire real estate portfolio. In particular, this must be ensured on the basis of active measures that ensure that the real estate is considered attractive and has a high profile among both potential tenants as well as the potential employees of tenant companies, and in the case of shop tenants, the potential customers of the shop tenant – who themselves may be tenants in the property.

Unfortunately, the area of tax law is yet to have latched onto this trend and frequently still acts according to the model of a private apartment rental, i.e. expressed in the rather exaggerated motto of "sign the rental agreement and enjoy a quiet life for a few years."

In this respect, the administrative practices and jurisprudence surrounding the distinction between pure asset management-based leasing and additional commercial services are frequently antiquated and/or no longer satisfy today's requirements regarding contemporary asset management. Therefore, lessors frequently have little understanding of why the co-leasing of air conditioning systems in server rooms in office buildings, the co-leasing of kitchen facilities for canteens, or the operation of photovoltaic systems for the generation of electricity according to the German Renewable Energy Act including feeding electric power into the public grid frequently leads to full trade tax liability for the partnership or corporation which was so far qualified for mere leasing and/or asset management activity. Furthermore, the German Law to Support Electricity Generated by Tenants (MietStrFG) which was passed in June 2017 is

well intentioned, but is also associated with the familiar problems surrounding trade tax. The only way to avoid risks posed by trade tax is if the property company is located in a foreign country. This is of no help, however, if activities occur in the domestic real estate which lead to the assumption of a commercial permanent establishment.

Some stand-out examples from our consulting work include the operation of short-stay car parks (multi storey car parks with parking ticket dispensers), the hourly or daily provision of space for conferences by tenants or third parties with the accompanying provision of technical equipment and catering, or the active centre management of a shopping centre with active participation, particularly the coordination of the advertising association by the domestic or foreign property company (Propco). With their ruling IV R 34/13 dating from 14.07.2016, the BFH provided clarity to the lessors of shopping centres to the extent that the provision of centre management and the coordination of marketing work– not for individual tenants, but with the goal of raising the profile and the attractiveness of the overall property – does not in the vast majority of cases lead to the assumption of commercial active trade or business for the overall property thus triggering trade tax – in practice, on the entire letting result.

The BFH has rightly determined that the shopping centre can itself promote the entire offer and hold events in the interests of drawing reference to the overall special offer and therefore ensure the attractiveness of the location, retain existing tenants and gain new tenants, and that activities of this kind are generally in the interests of the lessor, also in terms of turnover-linked rentals with shop tenants. Pleasingly, this also includes the apportionment of the costs of the centre management to the (shop) tenants.

This very positive ruling does not hitherto amount to a free hand in terms of all arrangements which pose problems in terms of trade tax, however. In this context, no relieving jurisprudence is yet to be seen for the "concierge" who is frequently to be found in office buildings, particularly if his services extend beyond the scope of a straightforward security service and additional services are offered to tenants, such as a shopping service, clothes care or travel reservations. Care is also required in terms of the provision of air conditioning systems

in server rooms or canteen and kitchen facilities by domestic commercial partnerships or corporations, which are dependent upon the so-called "extended trade tax reduction". If configured appropriately, however a "Coca-Cola truck" during the Christmas period or an event which includes a well-known car manufacturer are possible. The "don'ts" include the operation of short-stay car parks or the hourly/daily letting of conference space with the associated on-site organisation, the provision of technological equipment and catering services, as well as the completion of all kinds of events for which the participant must pay, such as so-called public viewings for sports events. In all the aforementioned cases, careful analysis and structuring is necessary.

All examples show that the devil continues to be in the detail. Following from the ruling on shopping centres, many things are now possible which were previously considered impossible. Careful analysis and structuring is necessary in individual cases, however.

Special factors pertaining to fire safety, tenant improvements and building cost subsidies for tenant installations

If construction work is carried out in the buildings, then – with regards to accounting and tax concerns – the question is raised as to whether the associated expenses must be capitalised or can be treated as immediately deductible expenses for tax purposes. The latter case offers the advantage of an immediate reduction in profits in the same year, including a liquidity advantage due to the income tax saving. The issue includes comprehensive pronouncements on the part of the fiscal authorities (BMF administrative decree dating from 18.07.2003) as well as the statement of the German Institute of auditors IDW RS IFA 1, which is not discussed here in further detail.

The following cases are of practical relevance:

- **Tenant improvements**

In this area, we have seen that in large office and/or areas of retail space, tenant-specific improvements are regularly carried out on a greater or lesser scale,

particularly in the areas of room partitioning and interior design, which frequently involve work in the areas of electrical systems, air conditioning and fire safety. Depending on the appropriate floor space, the costs of such conversion work can easily run into 6 or 7 figure sums. A discussion with the auditor – who favours capitalisation in cases of doubt – is generally prearranged.

After the BFH classed the conversion of an open plan office into individual offices as involving the installation of partition walls (also known as plasterboard walls) as maintenance expenses (IX R 39/05 dating from 16.01.2007), on the basis of analogous application, tenant-specific alterations in offices and retail space can largely be classed as immediately deductible maintenance expenses. The situation with functional changes is different, however, if for instance, it concerns the conversion of previous office space into retail space, or of apartments into retail space. Also, according to the current ruling of the BFH (IX R 14/15 dating from 03.08.2016), capitalisation applies to the installation or renewal of built-in kitchens.

A capitalisation is also generally required if the building activity is associated with an area-related expansion through an extension or addition. The same applies when previously unavailable building components such as windows, air conditioning and ventilation systems, or previously unavailable external facilities are added.

At the practical level, this generally simple differentiation normally requires the company accountant and/or auditor to consider the technical construction details of the appropriate construction work to a greater or lesser level of intensity. In this context, it is also necessary to bear in mind that, according to the IFRS (IAS 40, real estate held for investment purposes), a different treatment – generally with a tendency for capitalisation instead of a treatment, meaning immediately deductible expenses – can come into consideration. This is another reason for viewing the specific construction steps with care and documenting their accounting treatment accordingly.

In our work, the approach of analysing planned construction work on the basis of the so-called CapEx budget and classifying it for accounting and tax purposes,

and ideally aligning it with the construction costs which actually arise at a later point in time has proven to be expedient. An approach of this kind secures the transparency which is required for all participants, meaning the domestic and foreign auditors, tax offices and the company itself with regards to their national and international accounting requirements.

Fire safety

In many cases, existing buildings are relatively old, which means that in the case of changes of tenant at the latest, comprehensive changes to the current technical fire safety standards are necessary, the costs of which often run into 7 figure sums.

In this area, initial tax audits have revealed that accordingly, in most cases, it is possible to achieve treatment as immediately deductible expenses, at least according to the German Commercial Code (HGB) and/or German tax law.

In particular, this is so, since fire safety work does not generally result in a significant improvement of the building in terms of the BMF administrative decree. A different assessment results in the case of interconnected construction work (IDW RS IFA 1, margin no. 16 et seqq.).

Additionally, an extension does not generally have to be given; in this context, the question of whether the installation of fire safety doors results in new components with previously unavailable functions can generally be answered in the negative.

Building cost subsidies for tenant installations

Tenant installations are work which a tenant carries out in his own name and at his own cost in a property which is owned by the lessor. At a practical level, these encompass conversion and/or renovation measures appertaining to the interior design of buildings which are completed by the tenant when he first moves in or after the property has been leased for a long time. There is a considerable amount of literature and jurisprudence relating to the accounting

and amortisation of tenant installations which cannot be discussed in further detail in the scope of this report.

At the practical level, a proportional or complete payment of costs by the lessor for appropriate work by the tenant is often encountered, frequently instead of or supplementary to rent-free periods or other rental agreement incentives.

In this context, the question is frequently raised as to how the costs of this kind are to be treated by the lessor in terms of the accounting of income tax, in addition to the question of the correct settlement by the tenant in terms of value added tax (VAT).

In terms of income tax, it is accordingly necessary to differentiate as to how the appropriate items are to be treated in the case of the direct completion by the lessor. If the only expenses are maintenance expenses, i.e. the rental area is simply refurbished to the latest technical level with improvements to the flooring, lighting, windows, electrical systems etc. and/or this takes place following several years of letting, then depending on the tenancy agreement, it is frequently the case that the lessor enjoys immediately deductible maintenance expenses. In practice, this requires a greater or lesser degree of coordination with the tenant regarding the work that he has planned, including the obtaining and inspection of the appropriate documentation which ideally includes an estimation of the costs. In this context, it is naturally assumed that both the legal and economic ownership remains with the lessor. Alternatively, in an appropriate tenancy agreement, treatment as a reduction in rent may also be considered possible.

Things become more problematical if the tenant adds new components to the building which did not exist before (e.g. air conditioning systems, lighting systems, staircases to other floors, etc.). In these cases, it is necessary to determine whether in addition to the ownership under civil law (§ 946 of the German Civil Code [BGB]), the economic ownership is also transferred to the lessor. In many configurations, it is evident that this is not the case, which raises the question as to whether and/or to what extent the delivery of work and services took place from the tenant to the lessor.

In our experience, assumptions of costs by the lessor for work in which the economic ownership remains with the tenant amount neither to production costs for capitalisation nor maintenance expenses, but straightforward reductions in rent (comparable to the granting of rent-free periods). In terms of VAT, these items, which are to be shown in the P&L as a sales deduction, are to be considered on the basis of the appropriate invoicing by the tenant – preferably by credit entry on the part of the lessor. Frequently to be found and the subject of later discussions with the tax auditors are invoices issued by tenants for the delivery of work and services which in fact (see above) do not constitute a delivery, but are rather based on a reduction in rent in the form of a (temporary) amendment to the agreed rent. Unfortunately, in most such cases, the tenant is liable for the VAT due to the incorrect invoicing of a service that was not provided, while the lessor is refused the input tax deduction for the received invoice. Although repairable by the lessor through an alternative treatment as a reduction in rent, in such cases, the necessity of an invoice correction in the interests of the tenant leads to avoidable administrative expenses. Since matters must be raised again in the future – often years later – and the participants are frequently no longer available, this is an unhappy situation for all of those involved.

The amendment of tax returns and the accusation of tax evasion

The accounting of large scale real estate properties through to entire real estate portfolios is a complex matter, more so because many of those involved, including the property manager who administers the estate, the domestic or foreign asset managers, the local tax consultants and the executive team at the location of the property company, which is frequently in a foreign country, have to cooperate closely. As is always the case when several people work together, mistakes are made, which may not be considered reprehensible, but rapidly create problems from the tax perspective and can mean that amendments are required to previously submitted tax returns.

In practice – a development that has been discussed in detail in the specialist literature – there is an increasing trend for the fiscal authorities to criminalise the correction of such mistakes and to forward such cases to the fines and

criminal case departments of the tax authorities due to suspicion of tax evasion. Even if, following correspondence with a greater or lesser degree of detail – sometimes with the involvement of a criminal lawyer, with which the utmost sensitivity is required in individual cases – the instigated criminal proceedings are usually dropped, the executives in the property companies understandably have a strong interest in preventing such things from happening in the first place.

The current administrative decree dating from May 2016 concerning the distinction between the declaration and amendment obligation from a voluntary declaration according to criminal law, illustrates the problem very clearly, but also provides an opportunity for exculpation for cases in which (according to margin no. 2.6 of the BMF administrative decree) the taxable entity has set up an internal company control system with the purpose of the fulfilment of the tax obligations. This can present an indicator which argues against the existence of intent or negligence according to criminal law, but does not provide exemption from an examination of the individual case.

As stated in a draft guideline dating from 1/2016 from the German Institute of Auditors (IDW) on the configuration and auditing of Tax Compliance Management Systems according to IDW PS 980, consultants currently advise the establishing of control systems with a greater or lesser degree of complexity.

In our view, however, there are no general guidelines in this case. The taxable entity should, however, be aware that the requirement for the so-called internal company control system initially originates from a decree issued by the fiscal authorities and therefore has no legal basis, i.e.: in a court of law, the general principles regarding intent and negligence apply. In this respect, we generally recommend the "middle way", which means the establishing of internal (in the company itself) and external (with the tax consultant) control mechanisms as well as their written documentation. It is also equally important for the documented checks to be carried out and continuously monitored, which should, in particular, occur on the occasion of the compilation of the monthly provisional VAT returns and on the occasion of the compilation of the annual VAT and income tax returns.

In tax audit practice it has been shown that the highest potential risk is to be found with organisational structures in which the property manager at the location of the property transfers the accounting for the property – focussing on the annual service charge accounting and invoicing– to the foreign property company, which to a greater or lesser extent, generally accepts the data without checking it, and the tax consultant in Germany is only presented with the foreign annual statement of the property company for the preparation of the tax balance sheet in Germany at the end of the year.

We therefore recommend that the tax consultant in Germany is involved in the current processes as early as possible, at least on the basis of detailed random checks and/or verifications on the occasion of the preparation of the monthly VAT returns.

In the case of more complex real estate properties or portfolios, the transfer of the accounting data of the property manager directly to the tax consultant in Germany for the current ongoing preparation of the tax balance sheet, and on this basis, the subsequent forwarding to the company for the preparation of the foreign annual financial statement, can be advisable. This approach also means that the requirements of the so-called E-balance sheet, i.e. the transfer of the tax accounting data in the format as specified by the fiscal authorities to the tax office on the occasion of the preparation of the annual tax returns takes place on a legally secure basis.

Concluding remarks

Real estate tax law is and remains an extremely complex matter both during running operations and naturally in the case of real estate transactions. Practical experience gained in the course of tax audits shows that many pitfalls can be avoided by careful prior analysis, since frequently it isn't big individual "mistakes", but rather small neglected adjustments to the individual process steps, including the VAT invoicing, which can develop into major tax audit risks over the years. In this respect, it is especially necessary to keep track of matters relating to VAT (input tax deduction in the case of buildings including the

documentation according to § 15a of the German Value Added Tax Act [UStG] and proof of the intended use of vacant building areas), but also matters relating to land transfer tax, and in the case of property companies based in a foreign country, the question of the verification of tax residency (substance).

Certain matters, such as the question of the appropriate interest rate on shareholder loans, or the question of commercial active trade or business with the operation of shopping centres, currently appear resolved or resolvable to the benefit of the taxable entity. It is to be expected, however, that both the fiscal authorities and the legislator will cater for further challenges and surprises in the area of tax law. Finally there will certainly be another tax reform after the federal elections.

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