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Thomas Jäger
Tax Consultant and Managing Director
at LM Audit & Tax GmbH, Munich

Real Estate Tax Compliance – Recent Developments

In FYB 2018 we reported on current focal points in company tax audits. A lot has happened since then, not only in terms of case law, but also in legislation. Some of the keywords here would be "ATAD" and "DAC6", whose impacts will certainly be noticeable far beyond the turn of the year 2020/2021. In this contribution, we will once again present some current topics from our real estate practice and recommend some actions, if possible. We had to make a selection, of course, so that other perennial issues such as the temporary reduction of the value added tax needed to be left out for lack of space.

Purchase price split into land and building

One of the first activities in the tax life cycle of any rented property, is certainly to split the notarised purchase price of any real estate, plus incidental costs of acquisition such as land transfer tax, legal and tax DD, and other expert costs, particularly with the aim of determining any future assessment basis for depreciation. Disputes with the tax authority are then often bound to happen, since the tax payer is usually interested in a high building share and thus maximum building depreciation. In an ideal world, the pro-rated purchase prices for land and building should already be set out in the notarised purchase agreement. But, in our practice, we experience that splitting the purchase price into land and building is often forgotten in purchase contracts. And that although the *Bundesfinanzhof* [German Federal Tax Court] repeatedly confirmed in its judgements of 16 Sep. 2015 (IX R 12/14) and 29 Oct. 2019 (IX R 38/17) that any purchase price agreed and paid between contract parties and its split into land and building must fundamentally also be used as basis for taxation, unless such split was made only fictitiously, constituted a misuse of alternatives and failed to meet the real value ratios and appears to be unsustainable from an economic point of view. In other words: Any split of the total purchase price into land and building agreed between buyer and seller must be recognised for tax purposes, unless such is obviously incorrect. It is all the more surprising in practice that such leeway provided in case law often remains unused.

If purchase contracts lack such a split, tax authorities usually make their own determinations regarding the purchase price split by using the Excel Tool provided by the *BMF* [German Federal Ministry of Finance] often as early as during the first-time assessment, however not later than in the course of any subsequent tax audits. This so-called Excel Tool is an estimation procedure applied by the financial authority which has, in addition, been met with significant criticism in tax literature since its introduction several years ago. Essential points of criticism are inter alia the obligatory use of the so-called asset-value method, the lacking consideration of regional differences in building values resulting from the application of so-called normal construction costs of 2010 or the consideration of construction price increases only as a country-wide average of regionally different price indexes.

In current proceedings, the Bundesfinanzhof requested the BMF, in its order of 21 Jan. 2020 (IX R 26/19), to join the proceedings in order to clarify the issue whether the "*Arbeitshilfe zur Aufteilung eines Gesamtkaufpreises für ein bebautes Grundstück (Kaufpreisaufteilung)* [Tool for splitting total purchase prices for developed land (purchase price split)]" provided by the BMF can be used for dividing a contractually agreed purchase price into land and building for the purposes of assessing the depreciation for wear.

Practical tip:

Wherever possible, ensure that the purchase price split is already made in the notarised purchase agreement and, of course, that it complies best with the real value ratios. In all pending cases where the tax authority determined a different ratio and applied the so-called Excel Tool, lodge a complaint and request suspension of the proceedings.

Co-letting of operating facilities – rather a terrible end than unending terror?

If rented real estate located in Germany is held in a property corporation, normally a German limited liability company, or a commercial partnership whose management is based in Germany, any profit generated by such companies from renting is generally subject to trade tax in the full amount. An exception is the so-called extended trade-tax reduction if such companies manage and use – exclusively – their own land property or their own capital assets in addition. One of the big problems is – apart from other pitfalls – the requirement of exclusivity which results in the fact that even minor ancillary activities will void the factual trade tax exemption. Classic examples of such sideline activities that are detrimental for tax purposes are e.g. the operation of photovoltaic systems used to feed electricity into the public network or the co-renting of so-called operating facilities such as freight elevators, air conditioning systems in server rooms, likewise cold storages or kitchen systems and grease separators in catering and cafeterias but even so-called tea kitchens in office buildings.

In 3 pioneering sentences of 11 April 2019, the Bundesfinanzhof decided that:

- Hotels which co-rent a cooling system in a beer cellar as well as refrigeration units for bars and buffet systems with a volume of approx. EUR 134k or approx. 1.14 % of the entire cost of acquisition or production of the building (III R 36/15); or
- car dealerships which co-rent varnishing booths with the associated air intake and extraction facilities (III R 5/18); orr
- car dealerships with workshop that co-rent a portal washing system, lifting platforms, compressed air refrigeration dryers, as well as advertising systems and an advertising tower (III R 6/18),

cannot apply the expanded reduction, since they violate the requirement of exclusivity.

In another sentence of 18 Dec. 2019 (III R 36/17), regarding a case where a department store and a petrol station were rented out, the BHF qualified the technology belonging to the latter (lane, petrol pump, pipes and tanks) also as being operating facilities that are detrimental for tax purposes.

What is new about the above decisions is the level of detail attached to the requirement of exclusivity. Contrary to former case law of individual financial courts, no expanded reduction of the trade tax can be applied in case of the co-renting of operating facilities – regardless of the scope of the co-provided operating facilities. The law does not, according to the opinion of the BFH, explicitly provide for a de minimis limit. This very restrictive jurisdiction must be applied to all still pending cases with immediate effect. Against this backdrop, it must be assumed that tax auditors will thoroughly research the subject of the operating facilities in any upcoming tax audits. So, they might find operating facilities which the renting property company had "no longer on its radar", since – for historic reasons – those are mostly not disclosed in the asset lists of the property companies, as the purchase prices for them had not been recorded separately.

This issue is one of the reasons why at least the management of new founded real estate companies is often located abroad (e.g. Luxembourg, Guernsey, Jersey, etc.), since in such case, they can avoid the permanent establishment which is required as connecting factor for trade tax purposes (for information on the foundation of a permanent establishment by a management company, see below).

Practical tip:

This situation can often no longer be changed retrospectively. The management of the property company could, however, at least be relocated abroad for future application. As an alternative, the operating facilities which are detrimental for tax purposes might be transferred to a Fixture-Co which is separate from the renting company. Likewise, it is generally possible to transfer such detrimental operating facilities to the tenants. That will not be possible under civil law for building components such as e.g. a freight elevator, but for tax purposes, it would suffice to transfer the so-called beneficial ownership. Unfortunately, such tax-motivated solutions often fail in practice due to resistance by the tenants, which is certainly justified; i.e. not everything that is desirable from a tax point of view can ultimately be realised.

All – theoretical – solutions mentioned above also require a careful evaluation of the matter, particularly the identification of all operating facilities, because even forgetting one single one of the detrimental operating facilities would be enough to be fully exposed to trade tax, due to the lack of any de minimis limit.

In individual cases, it might even be possible to transform the former real estate corporation into an asset-managing partnership, particularly, if the limited partners are all German or foreign corporations that are additionally subject to a DTT with exemption method. Given the high complexity of such structures under civil and tax laws, we urgently recommend a careful analysis as the desire for flat-rate ideal solutions cannot be fulfilled in practice. In extreme cases, one way out might also be to sell the old and buy new, less problematic real estate.

Shareholder loans and adequate interest rate – novelties introduced by the ATAD

Real estate fund structures regularly work with a combination of equity and loans and, in terms of the latter, mostly with a combination of bank and shareholder loans. Of course, the relevant bank loans are fully secured by land charges, the assignment of shares, and the pledge of bank accounts. Shareholder loans are mostly granted without security, since no other securities are available – and thus bear higher interest rates than bank loans. A question, which has been raised for some years in this connection, is the adequacy of the interest rate to be applied to the unsecured shareholder loan. One decision by the BFH of 21 Dec. 1994 (I R 65/94) has been decisive here so far, since subsequent case law of both, the financial courts and the BFH regularly referred to it. Key statement by the BFH back then: It should be possible for loan relationships between affiliated companies to not request any securities, if the group relations in themselves already constitute a security. So, the tax authorities argue that unsecured shareholder loans should bear the (lower) interest rate applicable to secured bank loans.

Although the BFH has provided some more guidance, there is still a lack of guidance on how to assess a reasonable interest rate on such unsecured loans with the target to meet arm's length conditions. There have been cases in practice for years in which financial authorities qualify any difference in the interest rates for bank loans on the one hand and shareholder loans on the other hand as being inadequate and thus not in compliance with the arm's length principle. In many cases, this causes the initiation of a time and cost consuming exchange of statements of matters and expert arguments which ends – often after presentation of a transfer price study – in an agreement "in the middle" of the controversially discussed interest rate range. No detailed explanation will be given here on the tax aspects underlying these matters, since both, the case law and the comments and expert literature offer a hardly manageable magnitude of decisions and opinions.

The German legislator is currently making attempts to resolve the issue – in the course of the implementation of the OECD transfer pricing guidelines 2017 – in the context of the 2nd draft bill of an act to implement the Anti-Tax Avoidance Directive (ATAD Implementation Act) of 24 March 2020. Key aspect is a new Sec. 1a in the *Außensteuergesetz* [German Federal Foreign Tax Act] (AStG) named "Financing Relations". These new regulations should apply from 1 Jan. 2021.

The key element of the new regulation is the so-called "Treaty Override". It provides that the interest expense to affiliate companies – regardless of any existing double taxation treaty – should not comply with the arm's length principle, unless the tax payer is able to show credibly that he (a) is able to repay the capital from the beginning of the loan and over its term; (b) needs the financing for economic reasons and (c) uses it for the corporate purpose; or (d) that the agreed interest rate is higher than the one at which the group of companies could have refinanced it with third parties, unless the tax payer is able to show evidence that another interest rate complies with the arm's length principle. In other words: while requirements (a) to (c) should regularly be unproblematic for real estate property companies to be able to show an adequate interest rate under (d) will remain a key issue of tax audits even after the new regulations have taken effect. There is still no clear regulation as to how the arm's length interest rate is to be determined. Given the still existing option of an "escape", transfer pricing studies will probably continue to play an important role, perhaps now even more so.

Practical tip:

Transfer price studies are even today giving users a false sense of security, because it has been common practice until now that the upper limits of the presented ranges can regularly not be kept in discussions with the tax auditors. Classic counter-arguments of the tax authorities are often that the database of the "benchmarks" used is often not comparable which, in individual cases, leads to the request that exclusively real estate companies, at best even those active in the same property category, be used for making external comparisons. In practice, the situation will probably remain like it was where parties "meet somewhere in the middle".

It is desirable – but unfortunately, almost never the case in practice – to obtain, in due time before the investment, offers from banks under conditions of unsecured loans, alternatively also from one of the debt funds which are increasingly common. Currently advantageous structures are those where – in addition to the bank – a debt fund actually provided an unsecured, subordinate loan which often bears a significantly higher interest rate. If the unsecured shareholder loan granted in addition then has a similar interest rate, that has, so far, still been a very good basis for argumentation in terms of the arm's length principle. So, one does not need to be a prophet to recognise that the subject will not be less problematic even from 2021 under the new legislation of Sec. 1a of the AStG.

Notification of cross-border tax structuring (DAC6)

The 6th amendment of the Directive 2018/822 with the somewhat cumbersome title of Directive of Administrative Cooperation or shortly "DAC6" provides that member states are obliged to report cross-border tax-planning arrangements and need to introduce a relating exchange of information between the member states. Germany did not comply with the request of the EU to implement it until 31 Dec. 2019. The Directive is currently to be applied from 1 July 2020; it is particularly necessary to report such cases – generally even retrospectively – in which the first step of implementation was made after 24 June 2018. An option agreed by the EU Commission, particularly due to COVID-19, to extend the reporting periods under DAC6 was not implemented by Germany, contrary to most of the other EU member states – and contrary to original other notifications. So, the application from 1 July 2020 remains in effect, which many tax payers and their advisors failed to realise for more than understandable reasons, in the midst of COVID-19 and the summer holidays / school holidays of 2020.

Who is liable for reporting? Generally it must be noted that (inadvertent and unintended) "illegal" – because unlawful – errors in the preparation of tax returns are still subject to the obligation of a prompt correction pursuant to Sec. 153 of the AO [Abgabenordnung – German Revenue Code] and that intentional violations of the law are still subject to the regulations of tax evasion under Sec. 369 of the AO, and thus particularly to the option of an immediate voluntary declaration to avoid punishment. The reporting duty under DAC6 does, however, not focus on illegal, but rather on "illegitimate" tax arrangements. National tax arrangements are explicitly exempted so that the reporting duty is restricted to cross-border tax arrangements, i.e. those relating to foreign countries. The implementation in Germany is provided in Sec. 138d-k of the German Revenue Code (AO).

An explanatory memorandum issued in 2019 and the draft of an BMF letter of March 2020 as well as its revised version of July 2020 are available for details on the reporting duty, specifically the hallmarks of cross-border arrangements, the persons liable to report, and the technical performance of the report. Despite the currently 276 recitals on 70 pages, essential questions as regards the application in practice remain unclarified. It is very characteristic in this connection that, until the preparation of this article at the beginning of September, the BMF has been unable to publish a final BMF letter despite the fact that reporting duty must mandatorily be applied since 1 July 2020. While the long-awaited "white list" of events which are not liable to be reported as tax arrangements was significantly expanded in the draft of July 2020, it still relates mainly to obvious matters such as the use of legal tax exemptions and allowances and thus remains far behind the expectations of practitioners – and does not provide the legal certainty we need.

■ **Practical tip:**

The numerous outstanding questions include currently, inter alia, management participations and blocker structures in private equity, but also reporting duties in the use of property companies based abroad. A high-ranking representative of the German financial administration noted explicitly that e.g. the use of property companies whose management is located abroad should be a reportable event – since they result in the lack of a permanent establishment subject to trade tax – while a high-ranking representative of the Hessian financial ministry explicitly considers, given the regulatory environment, "Luxembourg fund structures" as "common in the market" and thus generally not liable for reporting. Conclusion: DAC6 is unchartered territory for all parties involved and the process of forming opinions is, in this respect, certainly far from being completed. One might be of different opinions regarding the sense and purpose of the reporting duty, since the predominant part of the reports – such as e.g. PE blocker structures or the use of Luxembourg property companies – are topics known to the financial administration based on the tax returns such companies file and from tax audits, often from the latest such audits. A real value added by such requested reports can be doubted also when it comes to cost/benefit considerations.

But given the painful sanctions of fines rising up to EUR 25,000 for tax payers and their advisors, we think that the "rule of thumb" should be to report one time too many in case of doubt. The further development, specifically the publication of the final BMF letter remains to be seen.

Management company as permanent establishment

Property companies whose management is based abroad are regularly not subject to trade tax for any income achieved by letting a real estate located in Germany – since they have no permanent establishment in Germany, that applies even if the company has only a registered office in Germany. Such companies are thus spared difficult delimitation questions such as those regarding the so-called expanded reduction of trade tax (see the paragraph above).

In their sentence of 21 Nov. 2019, the *Finanzgericht* [Financial Court] (FG) of Berlin-Brandenburg decided that a so-called management company with registered office and management in Germany justified a permanent establishment subject to trade tax for a property company whose registered office is in Germany, but whose management is located in Luxembourg. The management company was active in real estate management based on comprehensive powers of attorney for property management, it performed, inter alia, any and all rights and duties arising from existing and new rental relationships, including their new conclusion and termination, as well as the conclusion of contracts with service providers such as construction companies, craftsmen but also through janitor and cleaning work and the engagement of lawyers, etc.

One special characteristic of the dispute is that the companies had no shareholder identity, i.e. they were not affiliated companies. In addition, the executive bodies had no identity. The FG underlined that the property company as principal also exercised equivalent activities for other companies and held multi-year business relations and opportunities for a constant supervision. Contrary to the BFH case law, which had been enacted so far in similar cases, the term of a permanent establishment was interpreted extremely widely here – which is not least the reason for the vehement criticism in expert literature and the appeal proceedings now pending before the BHF under file no. I R 10/20.

Practical tip:

The use of foreign property companies, which only generate income from renting without establishing a permanent establishment in Germany pursuant to Sec. 12 of the AO, is common practice and confirmed, in view of a lacking permanent establishment subject to trade tax, inter alia by the BMF letter of 16 May 2011 (recital 15). Although it is rather unusual to provide comprehensive powers of attorney for property management to external property managers or advisors, it is the extremely restrictive application to parties which are not affiliated under company laws, and the lack of an identity of the executive bodies that makes one listen attentively – it would mean that any property and asset manager that are regularly entrusted with management will be in the focus now. In currently pending company tax audits, auditors have already started asking pointed questions on the parties involved and the duties performed by them, and even requested evidence. The tax authorities even made the existence of a so-called "mass domiciliary company" in foreign countries the subject of discussion in some cases, and asked the question of the true, so-called "factual managers". Against this backdrop, it is all the more recommendable to take the highest care when engaging German service providers and providing them with powers of attorney of all types, existing contracts should be checked and management activities of the foreign bodies should be documented carefully. To have the management of the property company sign any rental and loan agreements as well as service agreements with third parties might only be one important start here.

Jaeger@lmat.de

About the author:

THOMAS JÄGER is German tax advisor and managing director (Private Equity & Real Estate) at LM. LM Audit & Tax GmbH are focussed on international clients in the field of Real Estate and Private Equity with services ranging from Tax Due Diligence to Tax Compliance and day-to-day Tax Consulting including support during Tax Audits and – if necessary – representation at Tax Court. In the field of Real Estate all asset classes are involved from office- and logistics buildings up to hotels, car park facilities and shopping centers, The field of Private Equity comprises drafting of financial statements and tax declarations including complex partnerships income tax declarations and CFC (AStG) declarations for German investors invested in international fund vehicles.