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DRAFT ANNUAL TAX ACT 2009

RE-QUALIFICATION OF RENTAL
INCOME

TAX CONSEQUENCES FOR FOREIGN CORPORATIONS
OWNING GERMAN REAL ESTATE

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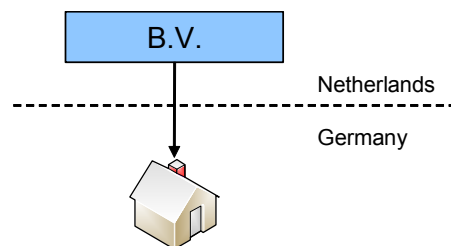


A. Draft Annual Tax Act 2009 released

- The Federal Ministry of Finance has published on 13 June 2008 a draft bill concerning the Annual Tax Act 2009. Among others, the draft regulation introduces significant changes regarding the taxation of German rental income generated by foreign corporations.
- From the FY 2009 onwards, it is proposed to deem rental income generated by a foreign corporation which solely holds and administers German property as trade income irrespective of whether the corporation maintains a permanent establishment or a permanent representative in Germany.
- These law changes should have an impact (i) on the ongoing tax compliance work as well as (ii) on the capital gains taxation of foreign companies.

B. Tax consequences for real estate owning companies

- If a foreign corporation holds directly German real estate such corporation is limited tax liable in Germany with respect to its rental earnings derived from the German real estate. Generally, according to the double tax treaties between Germany and foreign countries such rental income is only taxable in the country where the real estate is located (Germany) and tax exempt in the country of residence of the respective owner.



- Real estate which is rented out may be subject to German VAT but does generally not trigger trade taxes.

1. Current situation

- Currently, a foreign corporation that does not maintain a permanent establishment or a permanent representative in Germany and which is renting out real estate in Germany is solely subject to corporate income tax at a rate of 15.825%. Generally, trade tax will not be imposed on such rental income.
- Due to the fact that the real estate is not allocated to a trade business such real estate is considered as a private asset and not as a business asset.
- Furthermore, a real estate owning company is currently not obliged to prepare a book-keeping under German GAAP and to compile financial statements for tax purposes. It is sufficient to account for income and expenses when they are actually paid (so called “inflow and outflow principle”). Consequently, receivables and provisions do not have to be booked. Additionally, for tax purposes it is sufficient to file a statement of earnings and expenses.

2. Tax situation from FY 2009 onwards

The assumption of trade income of foreign corporations owning German real estate will lead to the following German tax consequences:

2.1 Deemed contribution of real estate to the trade business

- Currently, as mentioned above, real estate held by a foreign corporation is considered as a private asset compared to a business asset. The assumption of trade income will cause a re-qualification of the real estate as



a business asset upon commencement of the bill. The reason is that all assets used for generating trade income are considered as a business asset.

- German tax law sets out that the contribution of private assets to a trade business has generally to be made at *fair market value*. Only in cases where the acquisition of the (private) asset took place within the last three years such contribution has to be made on an acquisition cost basis reduced by the depreciations made since then. Such contribution can be made by any action of the tax payer but can also occur through a re-qualification in a business asset by way of a change in tax law.
- On the proposed enactment at 1 January 2009 the new rule might cause a deemed contribution of the private real estate at fair market value in the trade business unless the real estate was acquired within the last three years (i.e., after 1. January 2006). In case the contribution takes place at fair market value this may lead to a taxable profit realisation amounting to the difference between the book value and the fair market value (capital gains taxation).
- According to our knowledge, at this state neither the legislator nor the administration is aware of these tax consequences of the proposed change of the law. Also, in the German technical tax literature nobody has yet dealt with this issue. Therefore, it should be noted that at this point in time there is uncertainty about the tax consequences, i.e. whether the tax authorities will grant some relief.

2.2 Accounting requirements

- Generally (unless the relief for small companies applies, see below), the corporation has to prepare the book-keeping under the German GAAP rules meaning that the book-keeping standards of a trading business have to be observed. This includes also the preparation of financial statements which serve as a basis calculating the taxable profit. Therefore, the profit will no longer be calculated by comparing inflows and outflows (statement of earnings and expenses). Instead, the profit has to be deduced from the balance sheet. In particular, receivables have to be activated when they come into existence and provisions have to be made.
- For this purpose, a transition calculation from the current accounting into the German GAAP principles has to be made which may result in additional profits in future fiscal years (e.g., in case a corporation which holds receivables in an essential amount may realize an additional profit as the receivables were neglected under the inflow and outflow principles). The above mentioned transition calculation and the preparation of German GAAP accounts will trigger significant additional compliance efforts. Please note that obligation to prepare book-keeping under German GAAP applies only to financial years starting after the tax authorities have informed the taxpayer that he has to prepare book-keeping. This may lead to the transition for the first time in FY 2010. However, it would make sense under certain circumstances to change the book-keeping method at the beginning of FY 2009.
- Taxpayers, therefore, should implement the transformation work at an early stage this year and should properly analyse which outstanding payments can be settled in the course of this year.
- However, with regard to the book-keeping requirements and the obligation to prepare German GAAP financial statements, there is a relief available for small businesses if:
 - the turnover does not exceed EUR 500,000 and if
 - the profit per fiscal year is lower than EUR 50,000.
- If the business does not exceed the foregoing profit and turnover threshold the corporation may calculate its profit according to the inflow and



outflow principles. In such case, there will be no significant changes compared to the current situation.

2.3 Depreciation rates

- German tax law provides for different depreciation rates on German real property depending on whether real property can be regarded as a business asset (in such case 3%) or as private asset (in such case 2% or 2.5%). As renting out property will be create trade income the real estate should be regarded as a business asset. As a consequence, the depreciation rate should mandatory increase to 3% from FY 2009 onwards provided that real property is not used as a residential building and the building application was submitted after March 31, 1985.

2.4 Trade tax exposures

- Generally, trade tax is levied on trade income at a flat tax rate of currently of approx. 14% (depending on the municipally where the real estate is located). However, trade tax will only be imposed if a permanent establishment is maintained. Every fixed business facility or installation serving a business purpose is a permanent establishment within the meaning of German tax law. Therefore, the re-qualification of rental income into trade income should not lead to a trade tax obligation provided that no permanent establishment or a permanent representative exists in Germany.
- Based on German case law, the mere renting out of German real estate will generally not constitute a permanent establishment in Germany even though trade income is generated unless such real estate serves a trade business. The latter requires that the corporation is pursuing business from the German real property, maintains office rooms or is conducting additional activities than renting the real estate. However, if renting out

the real estate is the sole business, a permanent establishment by administering real property cannot be assumed.

- Hence, taxpayers should properly review the scope of their German activities and their disposal over premises in Germany.

3. Summary

- The proposed Annual Tax Act 2009 will cause several changes for foreign corporations owning German real estate which maintains neither a permanent establishment nor a permanent representative in Germany:
 - Upon commencement of the new law, German real property held by a foreign corporation will be reclassified by operation of law into business assets. Such re-qualification may trigger capital gains taxation which is subject to German taxation.
 - The book-keeping has to be adapted to the German GAAP standards.
 - Financial statements have to be prepared which serve as a basis for calculating the taxable profit.
 - The changing from the inflow-outflow principles to a balance sheet approach may trigger additional one-time transition profits and will cause essential administrative efforts.
 - The depreciation on the buildings should generally be increased to 3%.
 - Trade tax should remain not to be applicable provided that additional business activities or disposal over premises can be excluded.

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