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Insights

TAX DECREE ISSUED - GERMAN TRADE TAX DEDUCTION FOR PROPERTY COMPANIES

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SUMMARY

- Based upon a change of law as from 2021 German property companies are allowed to deliver electricity and earn income from contractual relationships with their tenants within certain thresholds without detrimentally affecting the tax-exempt treatment of their property income for German trade tax purposes (so-called extended trade tax deduction, "**ETTD**").
- While under the law there were many open questions regarding the application of the new version of the ETTD, a tax decree ("**Decree**") provides guidance on how the German tax administration interprets the new provision.
- Whereas under the previous version of the ETTD the lease of fixtures by a property company was detrimental to the application of the ETTD, the new ETTD provides relief for the lease of fixtures to a tenant within an applicable income-related threshold. However, based upon the Decree it may still be necessary to implement specific exit structures to ensure the application of the ETTD in the disposal year.
- After a draft tax decree of 22 March 2022 the final Decree provides many clarifications in relation to the delivery of electricity by the property company and with regard to the calculation of the applicable thresholds.

PRACTICAL LEGAL BACKGROUND

While German corporation tax on German property is generally triggered on the rental income and a capital gain from the sale of such property, investors are keen to avoid German trade tax ("**TT**") under the investment structure. Often this is achieved by using non-German (e.g. Luxembourg) tax resident property companies ("**PropCos**"), with management of such entities outside of Germany and satisfaction of certain substance criteria. For non-German PropCos parties rely on the assumption that no German taxable presence exists, i.e. in particular not in the form of a

management establishment. TT is triggered if a taxpayer has a German permanent establishment ("**German PE**"). The mere renting out of a German property by a non-German PropCo, however, does not trigger a German PE.

If either the legal seat or the management of PropCo is in Germany, generally PropCo qualifies as a taxpayer for TT purposes. However, TT would not be levied if the ETTD, a trade tax relief for real estate companies, is applicable.

Under the ETTD regime income from the property is exempt from TT, if PropCo exclusively carries out a limited scope of defined activities such as the management and use of its own real estate (or PropCo, in addition, generates income from capital assets or builds and sells single or double apartment houses and freehold flats).

Due to the limited scope of permitted activities, which were strictly interpreted by the Federal Tax Court, any other "harmful" activities (e.g. the lease of fixtures or supply of electricity) triggered the disapplication of the ETTD, with the effect that the entire property income of PropCo was subject to TT irrespective of the scope of such harmful activities. The same applied if PropCo carried out a commercial activity, e.g. due to participation in a commercial partnership
or other (deemed) commercial activities.

CHANGE OF LAW IN 2021

Under a change of law in 2021, the scope of permitted activities under the ETTD was widened. Previously harmful secondary activities are now permitted provided that certain property income-related thresholds
are not exceeded:

- Firstly, an annual "**10%-Electricity-Threshold**" applies regarding income from the supply of electricity

(i) in connection with the operation of facilities for the generation of electricity from renewable energy sources[1] provided that the generated electricity is supplied to the tenants of PropCo, consumed itself or fed into the public grid; and

(ii) from the operation of charging stations for electric vehicles or electric bicycles.

- Secondly, income from any other activities generated under a direct contractual relationship with PropCo's tenant[2] (e.g. income from the lease of fixtures or from the operation of a combined heat and power plant) is deemed to be harmless, provided that the resulting income from such activities does not exceed an annual threshold of 5% of the annual income from the lease of the real estate
("**5%-Tenant-Threshold**").

Within the applicable thresholds, the generation of both types of income is no longer detrimental to the application of the ETTD with regard to PropCo's income from
the use of the property itself. In contrast, the income from such permitted secondary activities would be subject to TT. Consequently, the income from such activities has to be monitored and determined for TT purposes.

GUIDANCE BY THE DECREE

The Decree contains many clarifications regarding the application of the new version of the ETTD.

Calculation of thresholds

The Decree confirms that the calculation of the 5% or 10% thresholds must be made in relation to the income from the use of the entire property owned by the PropCo. As a consequence, assuming PropCo owns more than one German property, no "property-specific" calculation of the thresholds applies. Further, the Decree says that where there is a fiscal unity the calculation of the threshold has to be performed at the level of each company (i.e. no consolidation for purposes of the ETTD). Further, the 10%-Electricity-Threshold and the 5%-Tenant-Threshold are to be tested separately with the effect that unused percentage points cannot be transferred to the other threshold.

Both thresholds are calculated in relation to the annual income from the use of the property. In this respect, the Decree clarifies that the annual net rent including heating should be compared with the income generated by the respective newly permitted secondary activity. Further, the basis for the calculation should be the actually agreed arm's length target rent (without VAT, but including operating cost); it is irrelevant whether rent is recoverable. Temporary rent exemptions (e.g. at the beginning of a contract or in a crisis) shall be taken into account with a target rent of EUR 0.

Burden of proof

The question of who bears the burden of proof that income is not harmful for the ETTD, but is itself subject to TT as income from the above-mentioned secondary activities, is not clear from the mere reading of the law. According to the Decree the burden is on the tax payer.

Income from the supply of electricity from renewable sources

The Decree clarifies the following:

- If – in addition to electricity supplies by renewable sources – electricity has to be purchased by PropCo and be delivered to the tenant in order to comply with its legal obligation as landlord, it is irrefutably assumed that such purchased electricity (even from non-renewable sources) is deemed to be electricity from renewable sources for the purposes of the ETTD,
  with the effect that such purchase is not harmful for the application of the ETTD.

- The PropCo does not need to own the electricity generation system, but the leasing of such equipment by PropCo is considered as sufficient.
- Self-consumption of generated electricity by the real estate property company is not harmful for the ETTD. However, this does not include electricity produced and initially fed into the grid, which is then (re)purchased again.

Supply of electricity from the operation of charging stations for electric vehicles or electric bicycles

With regard to the second alternative of the 10%-Electricity-Threshold the Decree contains some specific examples:

- If PropCo rents out the parking spaces and the installation and operation of the charging station is then carried out by a third party, this is not considered as harmful for the application of the ETTD.
- If PropCo (as operator) provides the tenant with the charging infrastructure and supplies electricity such income is considered as income from the supply
  of electricity irrespective of whether the supply is made to the tenant or third parties, if no separate consideration is agreed for making the charging infrastructure available.

Income from the operation of a combined heat and power plant

Whereas the new ETTD provision does not explicitly deal with income from the operation of a combined heat and power plant, the Draft Decree aims to provide further guidance.

It says that if PropCo supplies heat to the tenants by means of a combined heat and power plant, according to the Draft Decree income earned for heat supply is considered as part of PropCo's use of its real estate with the effect that such income would be exempt from TT. However, income for the delivery of electricity to tenants from a combined heat and power plant should only be allowed within the 5%-Tenant-Threshold. Exceptionally, the first alternative of the 10%-Electricity-Threshold can be applicable if the heat and power plant is operated exclusively with biomass.

LACK OF CLARITY STILL EXISTS

However, uncertainties remain even with the Decree with regard to (i) the lease of fixtures and (ii) the sale of fixtures.

Lease of fixtures

Within the 5%-Tenant-Threshold the lease of fixtures is not considered to be harmful.
In relation to income from the lease of fixtures it has to be differentiated whether the respective fixtures are being considered as "*functionally related*" to the leased property or not. Whereas income from fixtures which are regarded as being "functionally related" with the property, is qualified as

income from the use of the property itself and, therefore, would be exempt from TT, income from fixtures, which are not “functionally related” can only be generated within the 5%-Tenant-Threshold. The Decree does not provide further guidance in this context.

Sale of fixtures

Where there is an exit in the form of an asset deal usually the property is sold together with the fixtures to a third party buyer. As a consequence, the respective contractual relationship (asset purchase agreement) would not be with the tenant. It was therefore, unclear whether and to what extent the sale of fixtures would detrimentally affect the application of the ETTD in the disposal year.

On the one hand, the Decree now positively sets out that the sale or dismantling of fixtures is not considered to be harmful for the ETTD. This is because the sale is classified as the last act of the direct contractual relationship with the tenant.

On the other hand, according to the Decree the capital gain resulting from a sale of fixtures has to comply with the 5%-Tenant-Threshold. This means that in most cases the familiar ETTD problems relating to the sale of fixtures still exist. Based upon the example set out in the Decree the sale proceeds will not be taken into account when calculating such threshold. Consequently, depending upon the individual circumstances, as under the old law, there might still be the need under the new law for separation structures, where PropCo (holding the real estate property) and “FixtureCo” (holding the fixtures) are established to ensure the application of the ETTD.

CONCLUSION AND OUTLOOK

The Decree addresses many open issues, which have been discussed by the legal community after the change of law in 2021. As a result it can be reasonably expected that typical structures, which have been used in the past to ensure the application of the ETTD will not be necessary anymore in every case. However, whilst this is certainly true in relation to the current rental income of a PropCo, structures may still be needed for an exit by means of an asset deal.

When considering whether to use a non-German property company or a German property company investors will have to evaluate the pros and cons of each alternative, in particular the need to create economic substance and decision-making capability when using a non-German PropCo and the particular trade tax requirements when using a German PropCo. While the amendment of the ETTD certainly makes German PropCos generally more attractive, careful structuring and calculation of the relevant income streams will be indispensable in order to ensure a tax-efficient investment.

This Guide is based on the law as at July 2022. It provides a general summary and is for information/educational purposes only. It is not intended to be comprehensive, nor does it

constitute legal advice. Specific legal advice should always be sought before taking or refraining from taking any action.

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[1] Such as: Hydropower, wind energy, solar radiation energetics, geothermal energy and energy from biomass.

[2] Tenant within the meaning of
the Decree now includes persons who are permanent members of the main tenant's household (e.g. children, life partner).

RELATED CAPABILITIES

- Real Estate Tax

MEET THE TEAM

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