



WTS – Information with regard to the Annual Tax Act 2009

Annual Tax Act 2009 – Changes for Rental Income of Non-Resident Companies

The Annual Tax Act 2009 includes a number of proposals that will become effective as from FY 2009. The draft Annual Tax Act 2009 has been approved by the German Bundestag on November 28, 2008. It will still have to be approved by the German Bundesrat. The approval is scheduled for December 19, 2008.

One of the intended changes relates to non-resident companies that generate rental income from German real property without creating a permanent establishment in Germany. According to the new Sec. 49 (1) No. 2 f aa of the Draft German Income Tax Act (D-GITA) rental income derived by those non-resident companies from German real property will be qualified as business income from FY 2009. This regulation should eliminate the unequal treatment of non-resident and resident corporations.

1. Content of the New Regulation

Until now the income from the lease of German real property generated by non-resident companies that have no permanent establishment in Germany is qualified as rental income according to Sec. 49 (1) No. 6 GITA.

According to the draft Annual Tax Act 2009 this rental income will be re-qualified to business income since the existing Sec. 49 (1) No. 6 GITA is subsidiary to Sec. 49 (1) No. 2 f D-GITA. Therefore, in the future the current rental income as well as the capital gains will be equally treated.

The new Sec. 49 (1) No. 2 f aa D-GITA aims at the qualification of rental activities of non-resident companies as business income. Thus in the future all rental income of non-resident companies will be qualified as business income, regardless of its asset administering or business character.

If the Annual Tax Act 2009 will be approved by the German Bundesrat an assimilation of the income qualification of non-resident and resident companies will be achieved.

2. Regulations of the Current Law

2.1 Differences between the Determination of Capital Gain and Current Rental Income

According to the current law rental income of non-resident companies from the lease of real property falls under Sec. 49 (1) No. 6 GITA, regardless of the legal form. Therefore, the income will be calculated on a cash-flow basis.

The income of non-resident companies would only be qualified as business income if they were obligated to keep books and records according to Sec. 238 et seq. of the German Commercial Code (GCC) and Sec. 8 (2) German Corporate Income Tax Act



(GCITA). In general this should not apply to non-resident companies that only generate rental income and do not have a permanent establishment in Germany. If there is no obligation to keep books and records as a consequence these companies do not have business assets and liabilities in the meaning of Sec. 4 and 5 GITA. Even a foreign duty to keep books and records does not suffice to re-qualify the company's income. Non-resident companies without a permanent establishment in Germany generally only generate business income by the sale of domestic real property. In this case the profit determination for the sale follows the general rules of Sec. 4 et sqq. GITA.

According to the current regulations income of non-resident companies from real property has to be calculated according to two different tax accounting methods. Current income is calculated on a cash-flow basis and income from the sale of a property is calculated on accrual basis.

2.2 Disadvantages for Non-Resident Companies by Leasing Domestic Real Estate

The current German tax rules discriminate non-resident companies compared to resident companies in case of lease of domestic real estate. Non-resident companies cannot benefit from specific privileges of the income determination that domestic companies can claim. Non-resident real estate companies that do not have a permanent establishment in Germany, can currently claim a tax depreciation rate for buildings of max. 2 % to 2.5 % according to Sec. 7 (4) S. 1 No. 2 GITA. The tax depreciation of 3 % (Sec. 7 (4) S. 1 No. 1 GITA) is refused to non-resident companies in the absence of business assets.

Other advantages that the non-resident companies currently cannot claim are:

- transfer of capital gains to assets for reinvestment, Sec. 6b (1) resp. Sec. 6c GITA
- creation of reserves according to Sec. 6b (3) resp. Sec. 6c GITA
- depreciation to fair value in case of a lasting impairment of value, Sec. 6 (1) No. 1 S. 1 GITA.

All these examples cause disadvantages with respect to liquidity for cross-border investments compared to sole national investments.

3. Legal Consequences of the Re-qualification of Rental Income as Business Income

The German Legislator's intention of the amendment of Sec. 49 GITA declaredly is:

- to eliminate the discrimination of non-resident companies compared to resident companies with respect to the claim of the above described advantages,
- to enable non-resident companies to create business assets without having permanent establishment by the lease of domestic real estate.

If the new regulations as proposed come into effect, the following needs to be considered for tax purposes:



3.1. Real Property as Business Asset of Non-Resident Companies

As, beginning 2009, the income of non-resident companies from the lease of real property will be calculated on accrual basis, it appears that the domestic real property will be qualified as business asset as from 2009.

3.2. Scope of Business Assets

In general all assets that are exclusively and directly used for the purpose of the business are qualified as business assets. As the asset administrating non-resident companies in general are not obliged to keep books and records according to domestic regulations, the question is what the scope of the domestic business assets would be? It should be assumed that the assets that are directly linked to income from German sources should form the domestic business assets (i.e. liabilities, receivables from rents, lease accounts, etc.).

3.3. Value of Business Assets

It is questionable at which value the assets will be transferred to the business assets on January 1, 2009. As for purposes of the calculation of a capital gain from the sale of the real property the net book value is decisive, we assume that this value will also be decisive for the opening balance sheet as of January 1, 2009. Therefore, no unrealized gains should be realized by the re-qualification of the real property as business asset. It should be certain that it will not be qualified as a contribution at market value (Sec. 6 (1) No. 5 GITA) that would lead to a realization of built-in gains. We should like to mention though that the above is only applicable for real property that has been purchased after December 31, 1993.

3.4. Consequences for current leases

Furthermore, in the professional literature the question is raised at what point in time the determination of income needs to be made on accrual basis. Generally, the income is determined on a cash-flow basis according to Sec. 4 (3) GITA if there is no duty to keep books and records and if no books and records are kept voluntarily.

According to Sec. 141 of the German General Tax Code (GGTC) the duty to keep books and records accrues if the total turnover of the preceding calendar year exceeded 500,000 Euro or the profit of the business income was more than 50,000 Euro. This duty only arises upon request of the tax office for the subsequent calendar year.

From a practical point of view, it should always be possible to make a transition from the respective foreign GAAP to German Tax GAAP (Sec. 4 (1) GITA). As generally, cross-border investments in corporate structures are being made using special purpose vehicles and as most of these special purpose vehicles keep books and records, this should not be relevant in practice.

If the law becomes effective as proposed, the unequal treatment (as mentioned above) of resident and non-resident tax payers should be omitted. In the future, non-resident companies should be able to claim for the same advantages as resident companies:



- transfer of capital gains to assets for reinvestment, Sec. 6b (1) resp. Sec. 6c GITA
- creation of reserves according to Sec. 6b (3) resp. Sec. 6c GITA
- depreciation to fair value in case of a lasting impairment of value, Sec. 6 (1) No. 1 clause 1 GITA
- depreciation of 3 % for buildings according to Sec. 7 (4) S. 1 No. 1 GITA.

3.5. Limitation of Interest Expense Deductibility

To some extent, there is an uncertainty how the new regulation will influence the earnings stripping rules. The interest barrier rules are presently also applicable for non-resident companies. The question now that the assets of a real estate administrating company qualify as German business assets is to what extent domestic and foreign assets need to be included for purposes of the Exit Clause calculation.

According to our opinion, this uncertainty should not be applicable special purpose vehicles that have solely been established to purchase and administrate German real estate property as these companies generally have no substantial foreign business assets.

4. Non Affected Scopes

The extension of Sec. 49 (1) No. 2 f GITA and the re-qualification of the income as business income have extensive consequences for the income determination, but the scope of the German Trade Tax Act (GTTA) is not affected by this new law regulation. Still according to Sec. 2 (1) GTTA, a permanent establishment is required in order to be subject to German Trade Tax. Therefore, also in the future, non-resident special purpose vehicles that have no permanent establishment in Germany are not subject to Trade Tax.

Finally it needs to be mentioned, that the revised wording of the Sec. 49 (1) No. 2 f aa D-GITA has no effect on the qualification of the income on an international level. The re-qualification of the income as business income according to German law has no influence on the income qualification of the existing double tax treaties between Germany and other countries. That means the income that non-resident companies generate according to Sec. 49 (1) No. 2 f aa D-GITA, under the double tax treaty should rather be qualified as rental income than as business income.

5. Summary

With the proposed introduction of Sec. 49 (1) No. 2 f aa GITA the rental income of non-resident companies will be re-qualified to business income. The assets of the companies will qualify as business assets from January 1, 2009 onwards. We assume that from this re-qualification no built-in gains should be realized.

The current income is supposed to be determined on accrual basis.

Furthermore, the qualification of the assets as business assets has several advantages, such as:



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- transfer of capital gains to assets for reinvestment, Sec. 6b (1) resp. Sec. 6c GITA
- creation of reserves according to Sec. 6b (3) resp. Sec. 6c GITA
- depreciation to fair value in case of a lasting impairment of value, Sec. 6 (1) No. 1 clause 1 GITA
- depreciation of 3 % for buildings according to Sec. 7 (4) S. 1 No. 1 GITA.

However, there are still some open questions with regard to the interest barrier. These questions would need to be analyzed in each single case.

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