

# No extended reduction in case of tax pool

Real Estate Tax, Germany

BAKER & MCKENZIE

## Newsletter

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## Federal Tax Court denies extended trade tax basis reduction for real estate entities, if rental income is derived from letting to tax pool members

In its decision dated 15 May 2011, the Federal Tax Court took issue whether a real estate holding entity shall benefit from the “extended base reduction” for Trade Tax purposes. It came to the conclusion that the benefit shall not be granted to the extent the rental income is derived from letting to tax pool members.

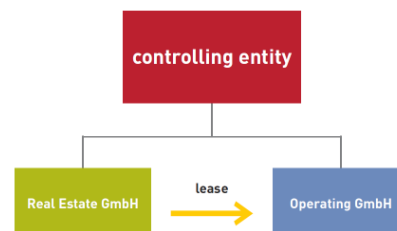
### The Extended Reduction

German Trade Tax (TT) on a trade or business is not solely levied based on pre-tax earnings. Starting from the profit for (corporate) income tax purposes, the basis for TT purposes is adjusted by applying numerous add-backs and reductions.

For investments into German real property, the extended reduction for trade tax purposes is one of the most effective instruments to reduce the tax levied on the rental income derived. In a nutshell, the extended reduction has the effect that income resulting from the administration and use of real property of the respective entity is eliminated from the basis of TT. It is a prerequisite for the extended reduction that the respective entity is engaged - apart from insignificant exceptions - only in administering and using its own real property and capital.

### The Decision

The Federal Tax Court (FTC) ruled that the extended reduction is not available to enterprises to the extent that they obtain their rental income from letting to tax pool members. The judgment took issue with a common construction in company and tax law as follows:



“Real Estate GmbH” leased its real estate exclusively to “Operating GmbH”. Both were subsidiaries and tax pool members of and with the same shareholder. The Operating GmbH deducted its lease payments as operating expenses and the Real Estate GmbH showed these as operating income.

For purposes of trade tax, the Real Estate GmbH made use of the extended reduction for trade tax purposes, since it qualified for the tax benefit in view of its personal activities.

The FTC did not accept the extended reduction. It concluded from the generally applicable rules concerning trade tax pooling that the application of the extended reduction in this case had to be denied as a result of the tax pooling concept. The court did recognise the legal and trade tax independence of the tax pool subsidiaries, including their own respective entitlement to utilise the trade tax reduction rules. However, to the opinion of the FTC the general principles of tax pooling have the consequence that the extended reduction is not available in the case at issue. This limitation only applies to the extent that the lease income is from within the tax pool; the extended reduction remains available for other lease income.

### Consequences

Taxpayers who have been claiming the extended reduction and who at the same time generate their lease income (at least partially) from leases to tax pool members, have to expect the disallowance of the extended reduction.

An escape would be available in case the tax pool was terminated, unless there are other good reasons for its retention. A termination should be possible during the current fiscal year.

An amendment of the corporate group structure could yield a similar result for tax purposes and without endangering the extended reduction for the operating company.

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