

# Federal Fiscal Court clarifies determination of German rental income for foreign investors

With decision dated 7 December 2016, published on 5 April 2017, the Federal Fiscal Court (FFC) clarified to what extent foreign investors investing in German real estate are subject to German taxation. Without a permanent establishment or representative in Germany, foreign investors in Germany are subject to German taxation only with regard to their German source income such as rental income or capital gains from dispositions of German real estate. The court ruled that a "profit" from a waiver of a loan relating to German real estate shall not be taken into account.

**Since 2008 foreign investors with rental income or capital gains from real estate located in Germany are deemed to earn commercial income and no longer non-commercial rental income as it was the case before 2008. This change in the classification of income has an impact on how the taxable profit is determined. While non-commercial income is typically determined on a cash-flow basis and only takes into account direct expenses, commercial income is determined using accruals accounting and usually takes into account all income derived from the commercial business and all related expenses.**

The FFC confirmed in the ruling that although foreign investors earnings are deemed commercial income, in the case of investors German permanent establishment, only the commercial income directly

connected to the leasing and letting and disposal of German real estate is subject to German taxation; thus taxation only extends to the rental income and capital gains derived from German real estate. Exclusively these two categories of income are relevant and only those expenses incurred in generating such income can be deducted as business expenses.

What this means in practice is shown in the case the FFC has ruled upon. A Luxembourg S.à r.l. disposed of a piece of German real estate. The disposal proceeds were not sufficient to settle the outstanding debt. Therefore the exceeding shareholder debt was waived. A loan waiver generally reduces debt and, as a result, triggers a waiver profit. The tax authorities historically classified waiver profits as part of the commercial income of the S.à r.l. applying the usual methodology for determining commercial income. As

S.à r.l. had no permanent establishment in Germany and no representative. S.à r.l. was therefore only taxable on its rental income and capital gains derived from its German real estate. The FFC held that the waiver profit qualifies neither as rental income nor as capital gains from the disposal of German real estate and, therefore, denied that the waiver profit is treated as taxable German source income. If the income of S.à r.l. had been determined according to the general principles applicable to commercial income, the waiver profit would have been part of the commercial income. In the restrictive concept suggested by the FFC with regards to the determination of commercial income in the context of German non-residents' taxation, the waiver profit was disregarded as neither qualified as rental income nor as capital gains from German real estate.

This narrow interpretation by the FFC works both ways and thus prevents a loan waiver profit from becoming subject to German non-residents taxation. But it may, of course, also limit the amount of expenses that are tax-deductible in Germany. If a real estate investment is financed in a foreign currency and debt increases due to fluctuating currency rates, the

debt increase may also not become relevant for the non-residents' income determination regarding German source rental income or capital gains. Thus, such a currency-related expense might then also not reduce German real estate income. The same principle would likely be applied to currency gains.

On a positive note, the decision of the FFC certainly facilitates the restructuring of German real estate investments made by foreign investors.

As a final remark, it must be noted that the tax authorities have so far not formally adopted the court decision as being generally applicable.

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