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By PwC Deutschland | 14 August 2023

Extended trade tax deduction for compensation payment in connection with premature termination of lease

If the parties to a rental agreement mutually and prematurely settle the ongoing dispute on the validity of the rental agreement by way of final payment of the lessee, the lessor is entitled to claim the extended trade tax deduction for use of own real estate according to Section 9 No. 1 2nd Sentence Trade Tax Act.

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Legal background: According to Section 9 no. 1 2nd Sentence of the Trade Tax Act (TTA) enterprises, which exclusively manage and use their “own real estate”, may - upon application - make a deduction of that part of the trading income which relates to the management and use of their own real estate. This alternative (i. e. the extended deduction) takes the place of the deduction under Section 9 No. 1 1st Sentence TTA (lump sum deduction of 1.2% of the assessed value of the real estate).

Case of dispute

On 3 November 2010, the plaintiff, a limited partnership (as lessor), concluded a commercial lease agreement (lease of business premises) with D-GmbH (tenant). In this lease contract the plaintiff agreed to convert the rental space, a landmarked Area A (i. e. space and buildings with historical value) and to let it to the tenant for use. Both parties agreed that the lease should commence on 1 August 2012 and run for a fixed term of 15 years.

After several postponements, it was mutually agreed that the lease was to begin on 20 January 2015 and the rental space be made available no later than 21 January. The reason for the delay was, among other, a subsequent request by the tenant for reconstruction measures.

Ultimately and after repeated disputes, the parties signed a Final Agreement dated in December 2015 under which the lease was terminated in return for payment by the tenant of €4,750,000 (referred to in the final agreement as "compensation payment").

The payment of the final amount was recorded as income by the lessor. In the 2015 trade tax return, he applied for the extended trade tax deduction according to Section 9 No. 1 2nd Sentence TTA which the tax office refused.

Decision

The Supreme Tax Court agreed with the decision of the lower tax court who granted the extended deduction and rejected the appeal of the tax office as unfounded. The conclusion of a transaction originally and primarily intended for the transfer of the right of use is part of managing the real property, even if the leased property had not yet been made available for use. Moreover, it is not relevant that the parties to the rental agreement had referred to the final payment as „compensation for damages“.

The activities permitted in addition to the management of own assets and real estate (which permit the extended deduction) are listed exhaustively in Sec. 9 No. 1 Sentences 2 and 3 TTA (i. e. „…. *or which, in addition, manage residential buildings or build and sell single-family houses, two-family houses or condominiums*“).

The extensive reconstruction measures carried out by the plaintiff do not lead to a commercial rental activity pursuant to Sec. 15 (2) Income Tax Act (ITA) but rather stay within the limits of private asset management. The rebuilding measures serve to convert the rental property according to the individual ideas of the tenant. The conversion work and the concluded rental agreement are to be seen in conjunction and as a whole; the reconstruction work is a result of and directly connected with the rental agreement and thus enjoys the use

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(fruit) and benefits from the substance to be preserved.

In an earlier judgment of 21 August 1990 (case: VIII R 17/86) the Supreme Tax Court has held that the owner, when receiving a compensation payment prior to the transfer of the rental property, generates income pursuant to Section 24 No. 1 letter a in conjunction with Section 21 ITA (rental income) and thus is still within (the privileged) realm of private asset management.

Source:

Supreme Tax Court, decision of 25 May 2023 (IV R 33/19), published on 3 August 2023.

Keywords

extended trade tax deduction, rental of real property