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TAX INFO

Aktuelle Entwicklungen im deutschen Unternehmenssteuerrecht

Recent Developments in German Business Taxation

No. 35 | July 30, 2014

Input VAT deductibility in case of mixed used buildings

Proportion of deductible input VAT relating to mixed used buildings is generally determined based on an area based allocation formula.

With judgment dated 7 May 2014 (V R 1/10), the Federal Fiscal Court (*Bundesfinanzhof*, BFH) in principle confirmed its prior jurisprudence regarding the deductibility of input VAT in case of mixed used buildings. At the same time, however, the court renounced a formerly expressed opinion according to which the taxpayer could in certain cases choose the calculation method of input VAT ratio. It rejected a decision of the Fiscal Court Münster, which had come to the conclusion that the incompatibility of input VAT allocation under current German law with European law gives reasons for the taxpayer to choose the calculation method of input VAT ratio. Nonetheless, the interpretation of certain input VAT provisions compliant with European law gives leeway for tax planning.

The decision of the BFH focuses on the input tax deduction pursuant to Sec. 15 Value Added Tax Act (VATA). According to that provision, an entrepreneur is entitled to deduct the amount of input VAT paid on the (input) supply of goods or services received in connection with the (output) supply of goods and services rendered by the entrepreneur as long as the (output) goods or services are not carried out VAT-exempt. Should the goods or services be used for mixed purposes, the entrepreneur is required to allocate the input VAT pursuant to sec. 15 (4) s. 1 VATA by way of an appropriate estimated allocation to output supply of goods and services which are carried

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Should further analysis or explanation of the subject matter be required, please contact a member of our Tax team or the lawyer with whom you normally consult.

Düsseldorf
Latham & Watkins LLP
Königsallee 92a
40212 Düsseldorf
Tel +49.211.8828.4600
Fax +49.211.8828.4699

Frankfurt
Latham & Watkins LLP
Reuterweg 20
60323 Frankfurt am Main
Tel +49.69.6062.6000
Fax +49.69.6062.6700

Hamburg
Latham & Watkins LLP
Warburgstrasse 50
20354 Hamburg
Tel +49.40.4140.30
Fax +49.40.4140.3130

Munich
Latham & Watkins LLP
Maximilianstrasse 13
80539 Munich
Tel +49.89.2080.3.8000
Fax +49.89.2080.3.8080

out subject to VAT or VAT-exempt. With respect to the allocation ratio, three different methods are up for discussion: (i) area based allocation formula (so-called *Flächenschlüssel*, allocation according to the ratio between area rented out subject to VAT and total area), (ii) turnover based allocation formula with regard to the object (so-called *objektbezogener Umsatzschlüssel*, allocation according to the ratio between turnover subject to VAT and total turnover, all related to the mixed-used object) and (iii) turnover based allocation formula with regard to the overall enterprise (so-called *gesamtunternehmensbezogener Umsatzschlüssel*, allocation according to the ratio between turnover subject to VAT and entire turnover of the enterprise). Sec. 15 (4) s. 3 VATA provides for the primacy of the area based allocation formula. The turnover based allocation formulas are, according to that provision, only applicable, if no other allocation is economically feasible.

In the case at hand, the taxpayer allocated the input VAT amounts according to the turnover based allocation formula with regard to the object. The tax authorities, however, applied the area based allocation formula – to the detriment of the taxpayer. The Fiscal Court Court Münster (8 December 2009 – 15 K 5079/05) regarded the application of a turnover based allocation formula as permitted due to the fact that the primacy of the area based allocation formula provided for in German law is not compliant with European law. Accordingly, the taxpayer is entitled to claim direct application of the Directive 77/388/EWG (Sixth VAT Directive). The directive contains the turnover based allocation formula as a general rule.

The decision of the Fiscal Court Münster was reversed and referred back to the fiscal court by the Fifth Senate of the BFH. The BFH reasoned that Sec. 15 (4) VATA is compliant with European law and has to be observed. The BFH now explicitly does not hold on to its prior jurisprudence (decision dated 22 August 2013 – V R 19/09) pursuant to which the primacy of the area based allocation formula only applies to object-related input VAT amounts, which need to be rectified pursuant to Sec. 15a VATA (primarily input VAT amounts in connection with acquisition, production or expansion costs).

The mechanism of economic allocation of input VAT in Sec. 15 (4) VATA allows for all types of allocation formulas. Accordingly, Sec. 15 (4) VATA meets the requirements of European law. Although Art. 17 (5) of the Directive 77/388/EWG specifies the allocation based on turnover as the preferential allocation method, the member states are entitled to provide for deviating allocation formulas should such formula allow for a more precise allocation. As a rule, the area based allocation formula is best suited to represent the economic situation. However, whether and when no other method of allocation is possible pursuant to Sec. 15 (4) s. 3 VATA has to be interpreted compliant to European law.

Consequently, one should apply the allocation formula which allows for the most precise allocation of input VAT amounts. Usually, this is the area based allocation formula. However, the turnover based allocation formulas are preferable, if the facilities of the premises (ceiling heights, thickness of walls, interior) differ a lot. In such a case, the input VAT allocation should be

conducted by means of a turnover based allocation formula. The turnover based allocation formula with regard to the object should be applied if the input VAT amounts relate to the use of a building (e.g. leasing and letting). Should the building in question be an office building which serves the whole enterprise and is accordingly related to the output supply of goods and services, the turnover based allocation formula with regard to the overall enterprise should be applied.

Overall, the decision of the BFH should be appreciated. The interpretation of the senate results in a reasonable economic allocation of input VAT amounts. Undue hardships, which could be found in the past in particular in connection with mixed used buildings with differing facilities, should be avoided in the future. However, it can be expected that the tax authorities will scrutinize every case using a different allocation formula than the area based allocation formula. Taxpayers should be prepared to explain and justify the admissibility of the allocation formula chosen.

Submission to the European Court of Justice with respect to other questions in connection with input VAT deduction

With decision dated 5 June 2014 (XI R 31/09), the Eleventh Senate of the BFH decided to submit several questions regarding input VAT deduction pursuant to Sec. 15 (4) VATA to the European Court of Justice. First of all, according to the senate, it is doubtful whether it is justified that – pursuant to recent jurisprudence of the BFH – in case of acquisition and production costs the use of the whole building is relevant for input VAT deduction. This means that the respective input VAT cannot be allocated directly to areas used for VATable purposes or areas for tax-exempt purposes as it is the case for the input supply of goods and services in connection with the use, the preservation or the maintenance of the building where the input VAT deduction depends on a direct allocation. Only the services which cannot be directly attributed have to be split pursuant to an allocation formula.

Although the direct allocation of acquisition and production costs can be burdensome in the individual case, such allocation appears to be more suitable than the currently used allocation principles. Direct allocation can be advantageous for taxpayers if the production costs for the areas used for VATable purposes exceed the costs for areas used for tax-exempt purposes.

YOUR GERMAN TAX TEAM

Full Spectrum of Tax Advice Combined with Strong Cross-border Experience

Dr. Thomas Fox

Partner, Munich/Düsseldorf

T +49.89.2080.3.8160
+49.211.8828.4616
E thomas.fox@lw.com

Dr. Tobias Klass

Partner, Hamburg

T +49.40.4140.3287
E tobias.klass@lw.com

Stefan Süss

Partner, Munich

T +49.89.2080.3.8041
E stefan.suess@lw.com

Dr. Götz T. Wiese

Partner, Hamburg

T +49.40.4140.3136
E goetz.wiese@lw.com

Dr. Anders Kraft

Counsel, Frankfurt

T +49.69.6062.6646
E anders.kraft@lw.com

Dr. Philipp Lukas

Associate, Hamburg

T +49.40.4140.3416
E philipp.lukas@lw.com

Dr. Stefan Mayer

Associate, Munich

T +49.89.2080.3.8094
E stefan.mayer@lw.com

Dr. Felicitas Mayer-Theobald

Associate, Munich

T +49.89.2080.3.8095
E felicitas.mayer-theobald@lw.com

Lisa M. Sönnichsen

Associate, Frankfurt

T +49.69.6062.6650
E lisa.soennichsen@lw.com

Verena Stoecker

Associate, Hamburg

T +49.40.4140.3369
E verena.stoecker@lw.com