A GUIDE TO REAL ESTATE INVESTMENTS IN GERMANY
# Watson Farley & Williams: Key Facts

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OVERVIEW

The German real estate market is considered an attractive investment area in Europe due to the size of the market and economic stability in the country. The following guide sets out some key considerations for those considering investing.

This guide covers the main legal and tax aspects of investing in real estate in Germany. It summarises types of property rights and ownership, covers certain aspects of the sale and purchase agreement, describes the process of the transfer of title, and mentions major aspects relating to building and planning restrictions (and environmental law). All these should be taken into consideration in any real estate transaction relating to German real property.

Under German tax law, the taxation of real estate investments can have a major impact on ultimate return on investment, especially given that Germany is often considered as a more heavily taxed jurisdiction than other European jurisdictions. Given that tax considerations are fundamental to the structure of a real estate transaction they should be dealt with as early as possible. Part B of this guide focuses on the taxation of the acquisition, rental and sale of investment.
Parties – who can own real estate?
Generally all individual and legal entities with legal capacity, whether resident or non-resident, can invest in and own real estate. This includes legal entities under private law, e.g. stock corporations (AG) or limited liability companies (GmbH) as well as legal entities under public law. Commercial real estate is often owned by insurance companies, banks, investment companies, funds or real estate holding companies.

Unlike the entities mentioned above an unincorporated civil law association (a partnership with unlimited liability of its partners, Gesellschaft bürgerlichen Rechts, GbR) does not have any legal capacity for owning real estate since it is not registered with any official register and neither are its partners. Therefore when acquiring real estate property as a civil law partnership, all partners must sign the sale and purchase agreement and must be entered into the land register.

Types of property rights in real estate
Ownership
Land in Germany is typically held either by rights in rem (e.g. ownership, hereditary building rights, mortgages, land charges and easements) or by relative rights which are generally contractual rights (e.g. commercial or residential leases). While any right in rem requires registration with the relevant land register, the relative/contractual rights cannot be entered into any official or public register. The strongest right in rem is ownership (Eigentum) which consolidates both the ownership of land and buildings.

Hereditary building rights
Hereditary building rights (Erbbaurechte) grant the ownership of a building together with the long term right to use but not to own the related land. Hereditary building rights are saleable and inheritable and the respective building can be encumbered in the same way as ownership, subject to the hereditary building right agreement (Erbbaurechtsvertrag). Hereditary building rights are granted for set periods, customary terms are between 30 and 99 years. The tenant of the hereditary building right usually pays an interest on such building right (Erbbauzins). Upon expiry of the term of the hereditary building right the owner of the land becomes the owner of the building while the former tenant of the hereditary building right receives a compensation for the disposition of its right to the building.

Easements
An easement is a means of providing security in rem of certain rights to a piece of land that in turn is owned by another person. Such right to the land can either be a right of use (e.g. right of way or a passing right) or a right of tolerance by the owner of the land (e.g. tolerance of a boarder building). The easement must be registered with a land register and may not be deleted without the approval of the holder of the associated right.

Property charges
The classic means of providing security for the financing of the purchase of a property is to encumber the land with mortgages or land charges. If a borrower does not fulfil his obligation under a loan the lender may satisfy the debt by realising the property charge, e.g. by auctioning the land. Whilst the mortgage is a so-called accessory right which is strongly linked to the contractual claim referred to in the corresponding loan agreement, the land charge is an abstract right and can remain independent of a contractual claim and may even exist notwithstanding an existing claim only for the purpose of securing a certain rank in the land register. Nowadays, due to its greater flexibility, the land charge is the most favourable security in real estate finance transactions.

Forms of ownership in real estate
German law differentiates between the following types of ownership:

Sole ownership
In the event of sole ownership (Alleineigentum) the sole owner is the only person authorised to control and dispose of the respective land.

Co-ownership
When holding co-ownership (Miteigentum) more than one person own an undivided share of land. However, each co-owner is entitled to dispose of its share of land.

Joint ownership
In case of joint ownership (Gesamthandseigentum) the land forms part of the jointly held assets, e.g. by a civil law partnership or any association without legal capacity. Each joint owner is entitled to a share of the joint property but it is not entitled to dispose of its share independently.

In case of the death of an individual, their land or their share of land held as a co-owner/joint owner generally forms part of their estate.
Sale and purchase agreement

Notarisation

German real estate sale and purchase agreements require notarisation by a German public notary – just having it in writing is not sufficient for a legally binding transfer of real estate. Furthermore, German law differentiates between the contractual obligation to transfer land and the collateral transfer which must be declared by the so called conveyance of ownership (Auflassung). If a real estate transaction consists of collateral agreements which are closely linked to a sale and purchase agreement where neither can stand alone, e.g. construction contracts, lease agreements, finance agreements etc., then the entire contractual package requires notarisation even if such collateral agreements have been concluded prior to the sale and purchase agreement. Notarial costs in a German real estate transaction depend on the value of the land and buildings.

Description of the object of purchase/land register

The sale and purchase agreement shall contain a precise description of the object of purchase, i.e. the land to be sold and transferred. In addition, any fixtures (wesentliche Bestandteile) and fittings (Zubehör) of the building and encumbrances are also part of the description of the object of purchase. The most important document containing the required description of land is the land register (Grundbuch). It is divided into three sections (Abteilungen) and the reference list (Bestandsverzeichnis). The reference list contains a detailed description of the real estate and should correspond with the cadastral plan, see below. Section I lists the former and current owner of the land. The ranking follows the historical sequence of ownership. Section II contains all relevant covenants and restrictions (Belastungen und Beschränkungen), e.g. hereditary building rights, easements, pre-emptive rights, etc. to the land and Section III lists the land charges and mortgages.

The land register is a public document granting public reliance (öffentlicher Glaube). Thus, for the benefit of the purchaser, the content of the land register is decisive since it is deemed to be correct. Consequently, title of land can be acquired from a person or entity registered as owner in the land register even if they are in fact no longer the legal owner. Given the public reliance on the land register, both parties are advised to review the most recent extracts of the land register prior to signing the sale and purchase agreement.

Cadastral plan

The cadastral plan (Kataster) indicates the location and size of the land. It is kept with the real estate offices (Liegenschaftsämter). Pursuant to German law, partial areas of cadastral units which have not been measured yet (Teilflächen noch nicht vermessener Grundstücke) may also form the object of a real estate sale and purchase. In case of acquiring a partial area it is recommended to mark the respective area in a site plan to be enclosed with the sale and purchase agreement.

Purchase price

The purchase price of real estate primarily depends on whether or not the property is leased, an undeveloped site, or developed real estate. If the object of the purchase is a developed site and has been accurately surveyed the parties will generally agree on a fixed purchase price. However, in many cases, the purchase price cannot be finally assessed upon signing/notarisation of sale and purchase agreement. This may result from a number of facts or circumstances, such as:

- The building authority in charge has not yet granted a building permit (Baugenehmigung) or even a preliminary building permit (Bauvorbescheid); or
- If the object of purchase is a residential property (Wohnimmobilie) or a commercial property (Gewerbeimmobilie), then the value may depend on the tenancy or lease agreements yet to be concluded and the rental income; or
- If the object of purchase is a partial area of a cadastral unit (Teilfläche eines noch nicht vermessenen Flurstücks), then it has to be finally surveyed and valued.

Furthermore, for tax reasons purchase price is often split into two with one portion dedicated to the land and the remaining portion dedicated to the building(s). It may equally be recommended to further divide the purchase price into a portion to the land and even a further portion to the respective fittings (Zubehör).

In a German real estate transaction it is customary that the payment of the purchase price is not due until the purchaser has secured its legal position regarding the forthcoming ownership of the respective real estate. In order to protect the purchaser, and to ensure the purchase price becomes due, the parties usually apply for registration of a priority
notice (Auflassungsvormerkung) in the land register and instruct the notary to provide for the registration process. The priority notice protects the purchaser’s claim to a correctly ranked entry in the land register and anticipates that a third party is able to acquire the respective real estate prior to the transfer of title. Alternatively, payment of the purchase price can be made immediately after the signing/notarisation and will then be deposited into an escrow account administered by the notary as trustee. However, the setup and administration of an escrow account generates additional costs.

Financing of purchase price
There are several options for financing real estate acquisitions. The purchaser can clearly pay the purchase price from its own capital or reserves. But a customary way of financing real estate is a bank loan to be taken by the purchaser for at least a portion of the purchase price. The banks generally insist that the purchaser is able to provide a certain amount of the purchase price from its own capital and, additionally, they demand collateral such as land charges (see above). For transactions involving large individual properties or real estate portfolios a common alternative to the conventional bank loan is the use of capital market products such as bonds, receivables or credits derivatives. In principal, such a way of financing involves a transfer of the relevant financing to a special purpose vehicle which then issues tranches of securities drawn from the portfolio. The special purpose vehicle refinances the purchase of the land through the issuing of securities. Both the purchaser and the financing bank, and, in certain cases also the seller are stakeholders in such special purpose vehicle.

Special focus: share deal
Besides the acquisition of the estate by way of an asset deal, it can also be acquired indirectly by acquiring shares in the legal entity holding ownership of the real estate (“share deal”). Share deals are often tax driven since under certain structures the real estate transfer tax (Gründerwerbsteuer) can be avoided. Notary costs are, however, frequently incurred since the purchase of shares in a private limited company (GmbH), or a limited partnership (GmbH & Co. KG), also require notarisation. The acquisition of shares in a legal entity holding ownership in real estate, however, entails some risks:

- The purchaser of a share in a real estate entity is not in a position to be granted a priority notice entered into the land register as security for the acquisition of the real estate. This results from the fact that the direct owner of the real estate remains the notarised entity and only the shareholding in such entity will change to the purchaser. Therefore, the purchaser shall receive an alternative security protecting him in case the owner decided to sell the real estate to a third party prior to the transfer of the shares in the real estate entity to the purchaser.
- Furthermore, unless otherwise agreed by the parties, the purchaser will assume any liabilities of the real estate entity and any outstanding or incorrectly assessed shareholder contributions.
- It must be taken into consideration that in case of a share deal the real estate asset cannot be used as security for financing the purchase price because the purchaser (who is the borrower of any financial means) is not the notarised owner of the real estate to be encumbered. Hence, alternative security, such as a pledge of shares, etc. must be considered.
- Finally, any warranties given as to the company holding property are only as good as the person or entity giving such warranties.

Transfer of title/registration of owner
Under German law the transfer of title to land is subject to two substantial criteria:

- Conveyance of property (Auflassung)
- Entry into land register (Grundbuch).

The conveyance of property is a mandatory agreement between seller and purchaser regarding the transfer of ownership of the real estate. It is required in addition to the sale and purchase agreement and must be declared by both parties in the presence of a notary. Commonly, the conveyance of ownership is declared within the sale and purchase agreement and hence does not require a separate notarisation.

The entry into the land register completes the sale and purchase of a real estate and makes the transfer of property effective in rem. By entry of the purchaser’s name in section I of the land register the transfer of title is completed and the purchaser becomes the owner of the property.
Special focus: priority notice
The registration process of the land register usually takes several weeks or even months to complete. In the time between the date of signing the sale and purchase agreement and the registration in the land register the purchaser’s claim to become owner of the real estate is unsecured and may even become unenforceable if the seller sells and transfers the respective property to a third party.

In order to protect the purchaser and its contractual claim, the parties to the sale and purchase agreement usually provide for the registration of a priority notice (Auflassungsvormerkung). The priority notice is a special German law focused security right which is registered in section II of the land register and protects the purchaser’s claim to obtain title to the real estate and to a correctly ranked entry in the land register. The registration process of a priority notice takes much less time than the actual transfer of title and can usually be obtained within a few days. The priority notice is valid until it is deleted from the land register.

Building/planning restrictions
In Germany, the construction, alteration, change in use and demolition of a building structure always requires a building permit in accordance with state building regulations. The requirements for obtaining a building permit are contained in building regulations of each individual German state. However, building regulations are standardised throughout Germany. Pursuant to the standard rules, each project involving construction, change or structures being demolished must comply with the specifications of zoning law and building regulations. The zoning law covers the so-called land-use planning and distinguishes two levels of detail: The first level is the land utilisation plan (Flächennutzungsplan) which is a preparatory plan; the second level is the development plan (Bebauungsplan) which is the legally binding plan that shows the permitted use of the land.

Development plan
The first stage of land use planning has been completed when the land utilisation plan is made public. The second stage commences with the preparing of a development plan (Bebauungsplan). Whether and how a piece of land may in principal be developed and built on is governed by public planning law. The urban development permissibility of a building project depends on the development categories in which the area/site to be developed is situated. The federal building code provides for three different development categories:

Designated development area
- If a piece of land falls within the scope of a local development plan (Bebauungsplan) which contains specifications regarding the type and extent of the development, areas to be developed and the local public access areas, then the building project is generally permitted.

Developed areas without local development plan
- Development is also permitted inside continuous build-up areas for which a local development plan does not exist. However, this only applies if the type and extent of the building project, the construction method and the area which is to be built upon fit into the surrounding area and development infrastructure.
Non-developed area

- If the land is not located within a continuous build-up area and if there is no local development plan, then a building project is only permitted provided that it does not conflict with public interests, that the development infrastructure is assured and that the building project is a privileged project, e.g. agricultural plants, power plants etc.

Building permit

Once the plans for a building project have been drawn up and prior to its implementation, a building permit (Baugenehmigung) must be obtained. The requirements for a building permit vary according to the different statutory laws of the federal German states. In order to obtain a building permit a written application accompanied by a number of documents required by law must be filed with the competent building control authority (Bauaufsichtsbehörde). If the building project complies with local development plans and if it does not infringe any public-law requirements, then the local authority will issue the building permit, possibly by attaching additional requirements (Auflagen) e.g. relating to fire protection and building safety. The neighbours adjacent to the site will be notified and given an opportunity to comment. Within a statutory term they may file objections against the building permit and, under certain circumstances, may hinder the progress of construction work by initiating legal proceedings. However, this occurs where there are grounds to believe that the building permit infringes regulations specifically provided for the protection of neighbour interests.

Environmental

Protection of the environment is a very important issue in Germany. According to the German Constitution (Grundgesetz) the state is responsible for the protection of the “natural basis of life”.

Low-energy construction methods

New buildings must comply with the Energy Saving Act (Energieeinsparungsgesetz) in conjunction with the Energy Saving Regulation (Energieeinsparungsverordnung). The Energy Saving Regulation provides for specific standards regarding the conservation of energy through heat insulation and water consumption which must be observed by property developers. A further requirement stipulated in the Energy Saving Regulation is the Energy Pass (Energieausweis), which documents, amongst other things, the energy needs of a building.

Waste Law

Waste management is an integral part of environmental protection. The main issues to be resolved are the avoidance of waste and the proper recycling or converting of materials into energy. Production plants and other real estate development projects must comply with extensive waste prevention regulations.

Soil protection

Inherited environmental liability is one of the critical issues in real estate sales and is often subject to an extensive due diligence initiated by the purchaser. Liability for inherited environmental obligations is mainly governed by the Federal Soil Conservation Act (Bundesbodenschutzgesetz). It states that contamination should be avoided and, in addition, precautionary measures should be taken. Contaminated soil must be cleaned up. Under German environmental law it is not only the party having caused the contamination which is held liable and obliged to remedy the damage. In general the authorities follow the principle of choosing the most effective means of averting danger and may decide between a number of possible parties. It can either be the causing party (as far as it can be identified) or the owner of the real estate or the party exercising actual control, such as a tenant, even if such party has neither caused nor even been aware of any soil contamination.

Since there are a large number of inherited environmental liabilities in Germany, the risk of assuming liabilities is frequently a major issue in negotiations of real estate transactions. It is especially recommended that the purchaser undertakes a thorough due diligence review prior to acquiring certain pieces of land. Sale and purchase agreements generally contain detailed representations and warranties and/or other provisions on environmental liability. This allows a risk assessment and the allocation of risks between the parties concerned.
**Acquisition**

Real estate might be acquired directly by way of an asset deal, or indirectly by acquiring shares in a legal entity holding ownership in real estate (a share deal). Such legal entities are typically organised as a limited partnership (e.g. GmbH & Co KG) or as a limited liability company (e.g. GmbH).

**Real estate transfer tax**

Real estate asset deals are subject to Real Estate Transfer Tax ("RETT"). RETT is levied by the relevant tax authority where the real estate is located. The level of taxation is decided by the respective Federal State and rates vary between 3.5% and 6.5%. The tax base for asset deals is the purchase price plus other obligations to be fulfilled by the buyer. The buyer and seller are both liable to pay tax, the RETT, however in practice the buyer usually has to bear the full RETT and other transaction costs (e.g. notary costs).

RETT may also apply in a share deal, depending on the legal form of the real estate entity acquired (corporation or partnership) and the respective shareholding (at least 95% transferred or total shareholding of the buyer). Moreover, acquiring a direct or indirect economic participation of at least 95% in real estate owning entity also triggers RETT. The tax law provision regarding the determination of the tax base for share deals has been recently declared unconstitutional for all transfers after 1 January 2009 and is currently under legislative revision. Subject to certain preconditions restructuring measures carried out by entities within a group may benefit from a specific exemption. By using certain acquisition structures it can be possible to mitigate RETT in a share deal. Details of such acquisition structures need to be considered in each case individually as they may bear the risk of contravening anti-avoidance legislation.

**Income tax**

The acquisition of real estate by share deal or asset deal generally triggers capital gains taxation on the seller. However, the buyer might be held liable for certain taxes of the seller if it acquires a business as a going concern by way of an asset deal. In the case of a share deal, the buyer indirectly acquires all tax liabilities of the acquired entity.

The purchase price for buildings acquired through an asset deal or a share deal with a partnership as real estate owning entity can depreciate over the useful life of the asset which is normally 33.3, 40 or 50 years. In case of a share deal with a corporation as owner of the building the depreciation of the current book value remains unchanged and no step-up of the book value is possible. The purchase price of land is excluded from annual depreciation.

**VAT**

The sale of real estate by way of an asset deal is either "VATable" but tax exempt or "non-VATable" as a transfer of a business as a going concern under German VAT law. However, in the case of a tax exempt supply the seller might opt for a tax liable transaction for buildings with VATable leases in order to collect input VAT (e.g. on non-residential (commercial) buildings). In this case the reverse charge mechanism is applicable.

The structure of any share deal transaction has to be analysed to see whether they are subject to German VAT law at all, as they can be treated as a non-VATable transfer of a business as a going concern, or they can be VATable but (unless the seller opts out) tax exempt.

The applicable VAT rate is currently 19%.

**Foreign investment structures**

Foreign institutional investors can often make use of special purpose vehicles ("SPVs") in order to invest in the German real estate market. Those SPVs are often set up as limited liability companies in the form of a Luxembourg S.à r.l. or a Dutch B.V. Such structures typically aim at limiting the German taxation to the corporate income tax of 15% plus solidarity surcharge (an additional 5.5%) and to exclude further taxation with trade tax or withholding tax in Germany. However, such structures mean that there may be practical business limitations, as they require that no permanent establishment be created in Germany. Furthermore, they have to face German anti-avoidance and treaty overriding regulations. Therefore, such structures have to be carefully analysed in each individual case depending on the structure of the transaction.
Rental phase

Income taxation

The income of non-resident individuals or non-business partnerships with an investment qualifying as a private estate investment for tax purposes, which receive rental income in Germany are subject to individual income tax only. All other investors receive business income (see trade tax implications below). In general, the income (less business expenses) is subject to individual or corporate income taxation. The deduction of expenses is limited for certain expenses, e.g. the interest expense from debt financing for business income is subject to the German earnings stripping rule (Zinsschranke). The tax rates for individual investors depend on their German tax liable income and differ between 14% and 45% plus an additional tax (solidarity surcharge) of 5.5% of the income tax amount plus, in some instances, church tax. Corporate investors are subject to the corporate income tax rate of 15% plus solidarity surcharge (5.5% thereon).

Depending on the business and the structure of the investment, the business profit might be subject to German trade tax. Trade tax is levied by the municipality where the business is located, and rates differ currently from 7% to 17.5%. Individuals receiving business income might deduct to a certain extent trade tax from their individual income tax burden. Certain requirements must be fulfilled for the rental income to be treated as trade tax exempt under the extended trade tax deduction rule (erweiterte Gewerbesteuerkürzung).

In general, the tax authorities require that non-residents maintain the bookkeeping in Germany, unless an individual exemption is granted. Tax declarations have to be filed annually with the relevant tax authority. Tax prepayments are payable each quarter of the year. In order to secure the tax payment the tax authorities might require the lessee to withhold taxes as prepayment on the tax burden of the lessor.

VAT

Leasing of real estate qualifies as a service under German VAT law and is VATable but VAT exempt. Where the lessee uses the real estate for VATable services or supplies the lessor might opt/elect for a VATable service in order to claim its input VAT. Such VAT option is common market practice for business premises as it allows the investor to claim for the input VAT on the construction works. In case the supply or service of a lessor of business premises is not subject to VAT and the lessor does not opt for a VAT-liable lease, then the market standard requires an increase of the lease payment to compensate the lessor for its input VAT damage.

Exit

The sale of real estate is subject to German individual or corporate income tax and, possibly, trade tax (see above). The trade tax exemption rule generally includes trade tax exemption of capital gains from the sale of real estate. In cases where a direct investment of a non-resident individual which is treated as non-business investment for tax purposes, the seller might benefit from the tax exemption for capital gains from real estate sold after a holding period of at least 10 years.

Please note that this is a brief overview – but as tax considerations are fundamental to the structure of a real estate transaction, these considerations should be dealt with as early as possible and our advice sought.

This guide should not be relied upon without taking further advice. If you would like to discuss any of the issues raised in this guide, please get in touch with a member of our team below, or your regular contact at Watson, Farley & Williams.
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