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BRIEFING

# REAL ESTATE INVESTMENT IN GERMANY

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- THE TAXATION OF REAL ESTATE ASSETS HAS A MAJOR IMPACT ON INVESTMENT AS GERMANY IS MORE HEAVILY TAXED THAN OTHER EUROPEAN JURISTDICTIONS
- A NEW VALUATION REGIME IS EXPECTED TO BE IMPLEMENTED INTO GERMAN TAX LAW BY THE END OF 2019

"AS TAX CONSIDERATIONS ARE FUNDAMENTAL TO THE STRUCTURING OF REAL ESTATE TRANSACTIONS, THEY SHOULD BE DEALT WITH AS EARLY AS POSSIBLE."

## OVERVIEW

The German real estate market is seen as an attractive investment opportunity due to the size and the strength of the national economy. However, Germany's taxation of real estate assets has a major impact on potential returns on investment as Germany is a more heavily taxed than other European jurisdictions. This briefing focuses on the taxation of non-resident foreign investors who acquire, rent and sell real estate assets in Germany. The last section touches on future changes to German tax law which might force current investors to reorganise their assets. As tax considerations are fundamental to the structure of real estate transactions, they should be dealt with as early as possible.

As a general comment, there are no legal restrictions for foreigners or non-resident persons on ownership of German real estate.

## ACQUISITION

Real estate can be acquired directly by way of an asset deal or indirectly by acquiring shares in a legal entity holding real estate (share deal). Such legal entities are typically organised as a limited partnership (e.g. GmbH & Co KG) or 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 tax authority in whose jurisdiction the real estate is located. The relevant Federal State imposes the tax, with rates currently varying between 3.5% and 6.5%. The tax base for asset deals consists of the purchase price plus other obligations to be fulfilled by the buyer. The buyer and seller are both liable to pay RETT but, in practice, the former 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 status of the real estate-owning entity acquired (corporation or partnership) and the size of the shareholding transferred (between 95% and 100% transferred or total shareholding of the buyer although changes to these thresholds are expected: see the final section of this briefing). The tax base for share deals is the tax value of the real estate, which needs to be assessed by the tax authorities.

However, certain acquisition structures that mitigate RETT in a share deal have evolved as a matter of common market practice. Details of such acquisition structures need to be considered in each case as they may risk being subject to general anti-tax avoidance legislation.

"THE ACQUISITION OF REAL ESTATE BY SHARE DEAL OR ASSET DEAL GENERALLY TRIGGERS CAPITAL GAINS TAXATION ON THE SELLER."

### Income Tax

The acquisition of real estate by share deal or asset deal generally triggers capital gains taxation on the seller. (An exemption from capital gains tax for the asset sale by an individual holding real estate as private estate investment for more than ten years may apply in some cases). However, the buyer may be held liable for certain of the seller's taxes if it acquires a business as a going concern by way of an asset deal. In the case of a share deal, the buyer acquires all the tax liabilities of the acquired entity indirectly and should deduct the potential burden of these taxes from his price offer.

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

### Value Added tax ("VAT")

The sale of real estate by way of an asset deal is either "VATable" (in other words, within the scope of VAT) but VAT-exempt or "non-VATable" (in other words, outside the scope of VAT) as a transfer of a business as a going concern under German VAT law.

However, in the case of a VAT-exempt sale, the seller might opt to charge VAT on the transaction for buildings with VATable leases in order to obtain credit for input VAT (e.g. on non-residential (commercial) buildings). In this case, the reverse charge mechanism is applicable. Under the reverse charge mechanism the liability to pay VAT to the tax authority switches to the recipient of the supply, i.e. the buyer.

Share deals have to be analysed when structuring the transaction 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) VAT-exempt.

The applicable VAT rate is currently 19%.

“FOREIGN INSTITUTIONAL INVESTORS OFTEN MAKE USE OF SPECIAL PURPOSE VEHICLES (“SPVS”) IN ORDER TO INVEST IN THE GERMAN REAL ESTATE MARKET.”

### Investment Structures for Non-Resident Investors

Foreign institutional investors often make use of special purpose vehicles (“SPVs”) in order to invest in the German real estate market. These SPVs are often set up as limited liability companies in the form of Luxembourg S.à r.l.s or Dutch B.V.s. Such structures typically aim to limit German taxation to the corporate income tax of 15% plus the solidarity surcharge (an additional 5.5% on the corporate income tax amount) and to exclude further taxation in the form of trade tax or withholding tax in Germany. However, such structures may create practical business limitations as they require the business to avoid creating a permanent establishment in Germany. Further, they have to face German anti-tax avoidance and treaty overriding regulations. Therefore, such structures have to be carefully analysed in each individual case when structuring a transaction.

## RENTAL PHASE

### Income Taxation

Non-resident individuals holding, directly or via a “look-through” partnership without business income, an investment qualifying as a private real estate investment for tax purposes receive rental income in Germany which is subject to individual income tax only. All other investors receive business income (see the trade tax implications below). In general, income (less business expenses) is subject to individual or corporate income taxation. The deduction of certain expenses is limited, e.g. the interest expense from debt financing for business income is subject to the German earnings stripping rule (Zinsschranke) with a cap of 30% of the EBITDA. Tax rates for individual investors depend on their German taxable income and range between 14% and 45% plus the solidarity surcharge (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 the solidarity surcharge (5.5% of the corporate income tax amount).

Depending on the nature of the business and the structure of the investment, business profits might be subject to German trade tax. However, if certain conditions are satisfied, the rental income may be treated as trade tax-exempt under the extended trade tax deduction rule (erweiterte Gewerbesteuerkürzung). Trade tax is levied by the municipality where the business is located. The tax rates range currently from 7% to 19.25%. Individuals receiving business income might be able to deduct,

“IN GENERAL, THE TAX AUTHORITIES REQUIRE THAT NON-RESIDENTS MAINTAIN BOOKKEEPING IN GERMANY, UNLESS AN INDIVIDUAL EXEMPTION IS GRANTED.”

to a certain extent, effectively assessed trade tax from their individual income tax liability.

In general, the tax authorities require that non-residents maintain 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 ensure payment of the tax, the tax authorities might require the lessee to withhold taxes as prepayment of the tax liability of the lessor.

Special provisions apply for foreign investment funds from 2018. In contrast to the previous fund taxation scheme, investment funds are no longer tax-transparent but subject to corporate income tax (and - only if the private estate investment character is not present - trade tax) on their German income from the rental phase and the sale of the assets. Only investment funds with special investment criteria and not more than 100 investors (Spezial-Investmentfonds) may opt for a transparent taxation regime.

### VAT

Leasing of real estate qualifies as a supply of services 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 to treat its supply as a VATable service in order to claim its input VAT. This VAT option/election is common market practice for business premises as it allows the investor/lessor to claim credit for the input VAT on construction works. If the supply or service of a lessor of business premises is not subject to VAT and the lessor can, therefore, not opt for a VAT-liable lease, it is common practice to increase the rent or lease payment to compensate the lessor for its inability to obtain credit for its input VAT (which represents an actual cost to the lessor).

### Property Tax

Real estate is subject to Property Tax (Grundsteuer) levied by the municipality in which it is located. This taxation is based on tax rates set by municipalities individually and a tax base which is assessed by the tax authorities and calculated on the basis of a valuation from the year 1964 (1935 for the former East Germany).

The Federal Constitutional Court recently decided that taxation based on a valuation from the year 1964 conflicts with the constitutional principal of equal treatment and required the government to replace the current valuation system by the end of 2019 (see the outlook in the last section).

“UNDER GERMAN LAW, PROPERTY TAX CAN BE PASSED ON TO THE LESSEE AS ANCILLARY CHARGES TO THE RENT.”

Under German law, Property Tax can be passed on to the lessee as ancillary charges to the rent.

### 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 includes trade tax exemption of capital gains from the sale of real estate under certain conditions. In the case of an asset sale by 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 ten years.

The divestment via a share sale of a German-resident corporation is subject to (corporate) income taxation for non-resident investors (unless an applicable double taxation treaty limits German taxation rights).

## OUTLOOK AND FUTURE CHANGES

### Capital Gain Taxes

As the direct sale of real estate in Germany or the sale of shares in a corporation resident in Germany is subject to (corporate) income taxation for non-resident investors (unless an applicable double taxation treaty limits German taxation rights), typical inbound investment structures often make use of SPVs resident outside Germany (see above). Such structures are set up in order to avoid German capital gains taxation by selling shares in a non-resident corporation.

The current draft of the 2018 tax bill includes a provision to establish a tax liability on the capital gain from the sale of shares in non-resident corporations deriving more than 50% of their value directly or indirectly from German real estate at any point in time within a 365 day period prior to the sale. Such provision will become effective from 2019 and will constitute the German taxation rights granted under Article 13 paragraph 4 of the OECD Model Convention. In addition, Germany has signed the Multilateral Convention initiated by the OECD and opted for an amendment in several existing treaties of the capital gains clause for the sale of shares in an entity holding immovable property (Article 9 of the Multilateral Convention).

In light of this amendment, investors in existing investment structures with foreign non-resident SPVs should review their structures and decide whether to carry out a reorganisation before the end of 2018.

"THE FEDERAL STATE TAX MINISTERS SEEM TO BE IN FAVOUR OF A SYSTEM CONSISTING OF THE VALUATION OF THE LAND IN ACCORDANCE WITH STANDARDISED GROUND VALUES PLUS CONSTRUCTION COSTS OF THE BUILDINGS."

### Real Estate Transfer Taxes

The German conference of federal state tax ministers (Finanzministerkonferenz) recently published a press release stating that the ministers plan to tighten the current RETT provisions for share deals: the relevant participation threshold (i.e. the size of the shareholding in the SPV the transfer of which gives rise to RETT) will be reduced from 95% to 90%, the holding period for existing shareholders will be extended from five years to ten years and changing more than 90% of the shareholders of a real estate owning corporation within ten years will also give rise to a RETT charge.

### Property Tax

Following the decision of the Federal Constitutional Court (see above), a new valuation regime is expected to be implemented into German tax law by the end of 2019. It is not yet clear what this regime will look like in detail. However, the federal state tax ministers seem to be in favour of a system consisting of the valuation of the land in accordance with standardised ground values plus construction costs of the buildings.

As stated, 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 soon as possible, including seeking legal advice.

# FOR MORE INFORMATION

**Should you like to discuss any of the matters raised in this Briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.**

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