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Upcoming German tax law changes relevant to real estate investments

17 September 2018

On 1 August 2018, the German Ministry of Finance published the amended draft bill of the Annual Tax Act 2018 which will be subject to further discussions in the parliament in the coming months.

Furthermore, the States' Ministers of Finance have agreed on the key points to reform the real estate transfer tax with a view to reducing tax avoidance schemes in relation to share deals. On the basis of the Ministers' proposal, the German Ministry of Finance is expected to issue a draft law before year-end.

What are the proposed tax measures? And what will be the impact on German real estate investments made via Luxembourg? We answer these questions in our Tax Alert.

Annual Tax Act 2018

Amongst other things, the draft bill comprises the following key points in relation to investments in German real estate:

- **Capital gains on the sale of shares in property-rich companies**

Currently, non-residents selling shares in property-rich companies are only subject to German taxation if the company sold has its registered seat or place of effective management in Germany. A company is considered as property-rich if, at any point in time during the 365 days preceding the sale, it derived more than 50% of its value (directly or indirectly) from German immovable property.

The draft bill extends Germany's taxation right to the sale of foreign property-rich corporations and shall only apply to sales and increases in value after 31 December 2018. Accordingly, when a Luxembourg company sells another Luxembourg company that owns German real properties, capital gains realised upon disposal would be taxable in Germany under the new tax rules.

However, the impact of this tax law change should be limited for institutional investors. German tax law provides for a 95% exemption on capital gains realised upon disposal of a participation (under certain conditions). This exemption would also apply in cases where a Luxembourg company sells a Luxembourg property company with German real properties.

In practice, such capital gains should even benefit from a full tax exemption. Based on case law of the German Federal Tax Court, non-resident companies selling shares in German resident companies may benefit from a full exemption. This case law should also apply to the cases captured by the extended scope of the draft bill.

- **Capital gains on the disposal of German real properties**

The draft bill comprises a key change for non-residents with direct investments in German real estate since the income from the sale of German real estate shall be extended and, going forward, also includes any changes in value (positive or negative) of assets in economic relation to the real estate.

In practice, this may, in particular, have an impact in the context of debt waivers for the benefit of non-resident corporations holding German real estate.

The draft bill is in contradiction to (and intends to override) a decision of the German Federal Tax Court according to which the income from such debt waivers for the benefit of a non-resident property company does not fall within the scope of the German limited taxation right in relation to German real estate.

In a tax treaty context, Germany should not have any taxation rights from such debt waivers since (i) its taxation rights under a double tax treaty are limited to the income from immovable property (which does not capture the income from a debt waiver) and (ii) the state of residence of the non-resident property company should have the taxation rights of such income.

Given that many investments in German real estate are made by Luxembourg property companies, this very issue has been a serious concern for many institutional investors in the past. The long-awaited decision of the German Federal Tax Court, which had finally brought legal certainty, may now be undermined by the new German tax rules.

From an economic perspective, the taxation of income linked to debt waivers makes no sense at all. When a debt waiver needs to be performed (before the liquidation of a property company), it means that a real estate investment was loss-making. While the losses incurred in relation to the real property should be available to offset extraordinary income in relation to debt waivers, the mechanism of German minimum tax rules would (above EUR 1m) only allow these losses to offset 60% of the income, resulting in an effective taxation of 40% of the income.

One way to circumvent this issue is to perform the debt waiver in the same fiscal year in which the German real estate is sold (at a loss) as the limitation on the use of tax losses only applies to tax losses carried forward to subsequent tax periods.

- **Real estate transfer tax (“RETT”)**

The German State Ministers of Finance further proposed certain amendments to German RETT rules that may have a major impact on investments made into German real properties.

German RETT is generally applied on the acquisition price of German real properties. The RETT rates applied in the different Federal States of Germany range from 3.5% to 6.5%. Hence, RETT is an important aspect when it comes to real estate investments in Germany.

When German real estate is owned via companies or partnerships, the transfer of shares or partnership interests may, under certain conditions, not trigger German RETT. The rules applicable in these circumstances are particularly complex and characterised by anti-abuse motives.

The following proposals are currently being discussed:

- The direct or indirect transfer of at least 95% in a German property-owning corporation triggers German real estate transfer tax (RETT). RETT is also triggered if one person reaches a shareholding of at least 95% in a German property-owning corporation.

  This threshold is proposed to be reduced from 95% to 90%.

- Moreover, the direct or indirect transfer of at least 95% of the interests in a property-owning partnership to (one or more) new shareholders within five years triggers German RETT.

  This provision shall be extended to property-owning corporations. Accordingly, the acquisition of 90% in a property-owning corporation by two co-investors would trigger German RETT.

  Furthermore, the five year-period shall be extended to 10 years.

These proposals on RETT would result in a significant increase of RETT triggering events which would impact real estate investors and corporations alike. Despite the fact that German RETT Law provides for an exemption for group restructurings (with a fairly limited scope of application), it is very easy to trigger RETT in case of reorganisations where participations are moved within a group as even the indirect transfer of companies owning German real estate triggers German RETT.

Changes to the tax law may have a critical impact on your investments in German real estate. Our German desk, led by ATOZ Partner and Head of Transfer Pricing, Oliver R. Hoor, is uniquely placed to provide guidance and help ready your Luxembourg business in preparation for the entry into force of the law.

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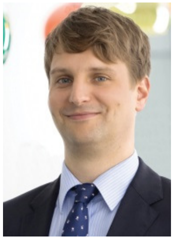

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