INBOUND INVESTMENT IN GERMAN REAL ESTATE

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Tags
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International Tax
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INTRODUCTION

Investments in German real estate are attractive to international investors. Low interest rates and positive economic conditions exist in Germany. The demand for commercial and residential rental properties has increased in urban centers such as Berlin, Düsseldorf, Frankfurt, Hamburg, Cologne, Munich, and Stuttgart. In these circumstances, it is expected that Germany will remain an attractive market for real estate investments.

Germany provides reliable political conditions, which are advantageous for a successful investment. However, there is an increasing complexity to the general legal conditions, and the success of a real estate investment strongly depends on proper structuring of the investment in a tax-efficient way.

This article provides an overview of the tax consequences of inbound investments in German real estate.

Different investment structures are compared:

- Holding the property directly,
- Holding shares in a property company, and
- Holding interests in a property partnership.

In addition to income tax, German real estate transfer tax aspects are discussed, and planning opportunities to reduce or eliminate German trade tax are explored.

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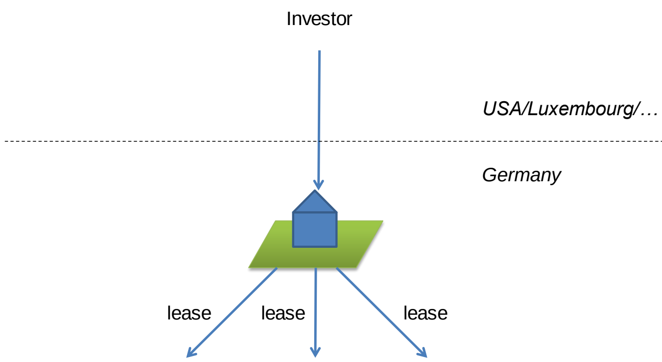
DIRECT INVESTMENT

Fig.: Foreign investor based in the U.S. or Luxembourg holds German real estate directly.



Income Tax

The income of a foreign individual or company derived from a property located in Germany is subject to a limited tax liability (*"beschränkte Steuerpflicht"*) and generally benefits from provisions that avoid double taxation of the income generated in Germany. In general, German double taxation treaties ("D.T.T.'s") provide the right to tax income resulting from real estate to the country in which the real estate is located.[1] This also applies to income derived from real estate generated by a commercial business.[2] Of course, if the investor is a U.S. tax resident, the U.S. retains a residual right to tax the income under the "saving clause" of the D.T.T. with the U.S. in virtually all circumstances.[3]

In the case of an individual investor, the German income tax (*"Einkommensteuer"*) rate depends on the amount of the taxable income reported by the individual. The tax rate is progressive and can amount to as much as 45% (plus a solidarity surcharge of 5.5%, combined at 47.475%, and if applicable, church tax).

In the case of a corporate investor, the corporate income tax (*"Körperschaftsteuer"*) rate amounts to 15% (plus solidarity surcharge of 5.5%, combined 15.825%).

The rules for determining taxable income from rental properties are almost the same for individuals, partnerships or corporations. The acquisition costs of non-residential buildings are usually depreciated at an annual rate of between 2% and 3%. Expenses incurred regarding the real estate investment (*e.g.*, property management fees) are generally deductible for tax purposes.

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1 See for instance Art. 6 (1) O.E.C.D.-D.T.T.; Art. 6 (1) D.T.T. between Germany and the U.S.; Art. 6 (1) D.T.T. between Germany and Luxembourg.

2 See for instance Art. 6 (4) O.E.C.D.-D.T.T.; Art. 6 (4) D.T.T. between Germany and the U.S.; Art. 6 (4) D.T.T. between Germany and Luxembourg.

3 See Art. 1 (4) of the D.T.T. between Germany and the U.S.

With respect to the deduction of interest expenses, special restrictions apply. According to the so-called interest barrier rule (*"Zinsschranke"*),[4] interest expense is deductible for tax purposes only to the extent that the expense does not exceed 30% of the so-called "Tax E.B.I.T.D.A." of the respective property entity, *i.e.*, the E.B.I.T.D.A. adjusted for tax purposes. Interest expenses that are disallowed by the interest barrier rule can be recorded as interest carryforwards and may, under certain circumstances, be deducted for tax purposes in future financial years. Note that the interest barrier rule does not apply if the relevant interest amount (*i.e.*, interest income minus interest expenses) is less than €3 million per annum.

Trade Tax

German trade tax (*"Gewerbesteuer"*) is a special tax for entrepreneurs that perform commercial activities in Germany. The trade tax rate depends on the municipality where the real estate (or the business) is located. The average tax rate amounts to 15%.[5] Trade tax is not a business expense for income tax purposes. However, in the case of an individual who is subject to income and trade tax, the trade tax can be partly deducted from income tax liability.[6]

Investments in real estate can often be structured in a way that no trade tax applies if the investor simply holds real estate and leases it to other parties. However, in case of commercial business activity (trading property), German trade tax will almost always apply.

Commercial vs. Non-commercial Activities

The income from the mere leasing of a property typically is not considered to be "commercial" income. Rather, it is considered to be income from property management (*"Vermögensverwaltung"*). As a consequence, mere leasing activity is usually not subject to German trade tax.

Income from leasing is considered to be commercial income and, therefore, subject to German trade tax only when circumstances exist which are typical of commercial activities. These circumstances include the conduct of a business model involving a high number of customers renting for short periods or the provision of further services that are not typical of a non-commercial owner/lessor.

The factors that distinguish commercial leasing operations from non-commercial leasing operations also apply to foreign investors. Therefore, if properly structured, a foreign investor who directly invests in German real estate may be able to avoid trade tax.

Avoidance of a German Permanent Establishment in Case of Leasing Real Estate

A foreign investor, who directly invests in German real estate, is subject to trade tax only if there is a permanent establishment, for trade tax purposes, in Germany.

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4 See Sec. 4h German Income Tax Act (*"Einkommensteuergesetz"*).
5 *E.g.*, 17.15% in Munich, 16.1% in Frankfurt/Main or 14.35% in Berlin.
6 If the trade tax rate of the local municipality exceeds 13.3%, the exceeding trade tax cannot be deducted. See Sec. 35 (1) German Income Tax Act.

> *"If the only activity of a lessor in Germany is the simple lease of property, a permanent establishment of the lessor will usually not be established. The lease of property itself is not considered as a commercial business."*

Under German local tax law a German permanent establishment is any fixed place of business or facility that serves the business of an enterprise.[7] The fixed place of business must serve the enterprise for a certain minimum period of time and must be at the disposal of the enterprise.

If the only activity of a lessor in Germany is the simple lease of property, a permanent establishment of the lessor will usually not be established. The lease of property itself is not considered as a commercial business.

Where, however, the lessor provides further services through its own employees to the *lessee*, such as maintenance of the building, caretaker services, and the like, a permanent establishment could exist. This would bring the lessor within the charge to trade tax. Consequently, investments are often structured in a way that such services are rendered by a third party service provider. It is believed that this should enable the foreign investor to avoid a German permanent establishment, at least, if the service provider is not supervised by the lessor and if the lessor has no right to use the fixed place of business of the service provider. Note that a recent judgment of the Federal Tax Court suggests that a different conclusion can exist in specified circumstances.

Similarly, the lessor should not retain any rights of use regarding the leased property; mere lease activity exists only where the lessee has the right to use the property. If the lessor has the right to use parts of the property and actually uses them for its business, a permanent establishment of the lessor's business can exist. An example of such use is a storage room for the maintenance documents or other items of property. Use of the property by the lessor is important because the existence of vacant space in the rented building should not constitute a permanent establishment. Empty space is not considered to be used by the lessor.

Care must also be taken to avoid an "agency permanent establishment" (*"Vertreterbetriebstätte"*).[8] If a third party service provider is involved in the management of the property, it should not engage in any management activities that are necessary for the conduct of the business. If it does, an agency permanent establishment may exist. Thus, for example, a third party services provider should not be allowed to conclude or cancel any agreements in the name of the lessor.

Similarly, management activities in Germany must be minimized with respect to the property to prevent a management permanent establishment from existing. Note that relatively minor management activities will not rise to the level of a permanent establishment. Thus, for example, an asset or facility manager who is responsible for making only minor business decisions in Germany is likely not a permanent establishment. On the other hand, an asset or facility manager that is allowed to sign contracts on behalf of the lessor is likely a permanent establishment.

<u>*Extended Trade Tax Deduction*</u>

Even if a business is subject to German trade tax by virtue of a permanent establishment for trade tax purposes, the so-called "extended trade tax deduction"

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[7] See Sec. 12 German General Tax Code (*"Abgabenordnung"*).
[8] See Sec. 13 German General Tax Code.

(*"erweiterte gewerbesteuerliche Kürzung"*)[9] can help to prevent a trade tax payment in the case of real estate leasing. In order to benefit from this deduction, the business activities must be limited to the management of real estate property owned by the investor and/or capital investments. All other activities are harmful. The interpretation of this provision by the German tax authorities is very strict and formal. Owned "real estate property" means legally owned real estate only. Therefore, the lease of property would, for instance, be detrimental. Operating facilities that are part of the property from a civil law perspective are not part of the "property" from a trade tax perspective. Thus, the lease of property with included operating facilities would be detrimental for the application of the extended trade tax deduction.

Comparison of Income and Trade Tax Consequences

If a foreign company or individual invests in German real estate, the question of whether the investment qualifies as a German permanent establishment for trade tax purposes is crucial. If it qualifies as a permanent establishment for trade tax purposes, the income derived from the investment will not only be subject to German income tax, but also to German trade tax if the extended trade tax deduction cannot be applied.

Example 1:

A property located in Frankfurt/Main, Germany, is leased. The taxable income from the lease of the property amounts to €1 million. The lessor is located in the U.S. or Luxembourg and maintains no permanent establishment for trade tax purposes in Germany. Trade tax does not apply.

German Tax Consequences:

	Individual as Lessor	Company as Lessor
Income Tax Rate	47.475%	15.825%
Income Tax	€474,750	€158,250
Trade Tax	No	No
Overall Tax Burden	**€474,750**	**€158,250**

Example 2:

The lessor maintains a permanent establishment in Frankfurt/Main from which numerous additional commercial services are provided to the lessee. The lessor is subject to German trade tax.[10] *The preconditions of the extended trade tax deduction are not met.*

9 See Sec. 9 no. 1 s. 2 German Trade Tax Act.

10 For individuals and partnerships a trade tax exemption in the amount of

German Tax Consequences:

	Individual as Lessor	Lessor as Company
Income Tax Rate	47.475%	15.825%
Income Tax	€474,750	€158,250
Trade Tax Rate[11]	16.1%	16.1%
Trade Tax	€161,000	€161,000
Trade Tax Deduction	€133,000[12]	No
Income Tax Burden	€341,750	€158,250
Overall Tax Burden	**€502,750**	**€319,250**

Thus, for a foreign investor, it is extremely important for German income tax to be reduced through the use of a corporation and for German trade tax to be reduced or eliminated through the absence of a permanent establishment.

<u>Exit/Sale of Real Estate</u>

If a foreign investor sells real estate that is located in Germany, most of the German double taxation treaties allocate the right to tax potential capital gains to Germany. If the investor is located in a country with which Germany has not concluded a double taxation treaty, Germany has the right to tax potential capital gains according to German local tax law. The foreign investor is subject to limited tax liability. The potential tax burden depends on the concrete income tax rate. In the case of an individual, the rate is typically up to approximately 47%, as discussed above. In the case of a corporate investor, the tax rate amounts to approximately 15%, as discussed above. Also as mentioned above, trade tax is due if the foreign investor maintains a German permanent establishment for trade tax purposes.

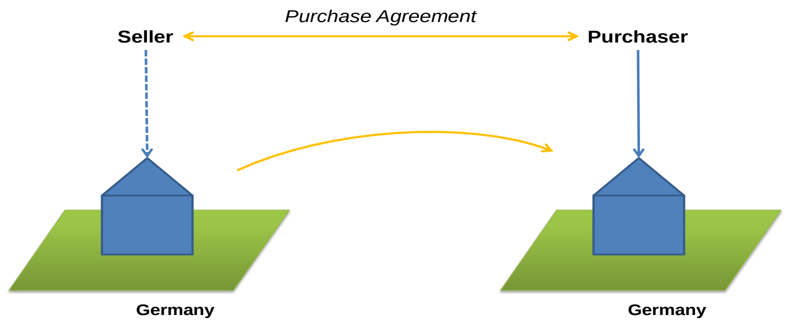
€24,500 would be applicable. This is not considered in the example.

11 Municipal trade tax rate of 3.5% (basic federal rate) x 460% (local trade tax multiplier).

12 If the trade tax rate of the local municipality exceeds 13.3%, not the whole trade tax can be deducted. See Sec. 35 (1) German Income Tax Act.

Real Estate Transfer Tax

Fig.: Real estate, which is located in Germany, is sold.



In Germany, the transfer of a property is subject to real estate transfer tax ("*Grunderwerbsteuer*," in the following: "R.E.T.T."). The tax rates vary from one German Federal State ("*Bundesland*") to another. Currently, the tax rates range between 3.5% and 6.5%.

State *("Bundesland")*	**Tax Rate**	**In Effect**
Baden-Wurttemberg	5.0%	11/05/2011
Bavaria	3.5%	01/01/1997
Berlin	6.0%	01/01/2014
Brandenburg	5.0%	01/01/2011
Bremen	5.0%	01/01/2014
Hesse	6.0%	08/01/2014
Lower Saxony	5.0%	01/01/2014
Mecklenburg-Western Pomerania	5.0%	07/01/2012
North Rhine-Westphalia	5.0%	10/01/2011
Rhineland-Palatinate	5.0%	03/01/2012
Saarland	5.5%	01/01/2013
Saxony	3.5%	01/01/1997
Saxony-Anhalt	5.0%	03/01/2012
Schleswig-Holstein	6.5%	01/01/2014
Thuringia	5.0%	04/07/2011

Asset transactions involving real estate located in Germany trigger the imposition of

R.E.T.T.[13] The tax base is the value of the consideration given by the purchaser.[14] In most cases this will be the purchase price. However, the tax base can be increased by additional benefits provided by the purchaser, such as the redemption of a mortgage by the purchaser or the grant of a royalty-free right of use in favor of the seller. The purchaser and the seller are jointly subject to tax.[15] In practice, however, most asset deal purchase agreements allocate the tax burden to the purchaser.

Example 3:

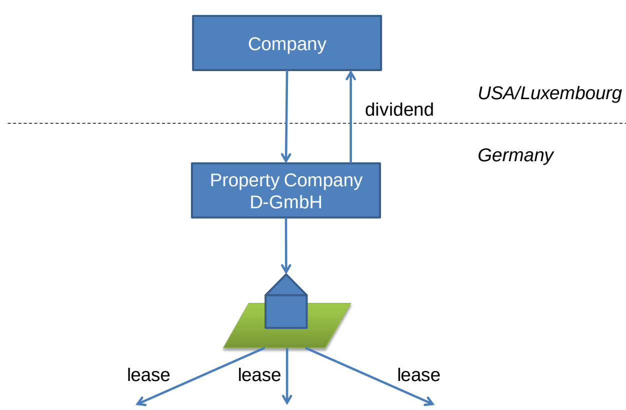
The purchase price of the property amounts to €1 million. No further benefits are provided. The property is located in Frankfurt/Main.

German Tax Consequences:

For R.E.T.T. purposes, the tax base amounts to €1 million. As the property is located in Frankfurt (Hesse), the rate of R.E.T.T. amounts to 6%. Thus, the R.E.T.T. burden amounts to €1,000,000 x 6% = €60,000.

INBOUND INVESTMENT VIA A PROPERTY COMPANY

Fig.: Foreign corporate investor acquires shares in a German property company.



If German real estate is held by a company, the income of the company is subject to corporate income and trade tax[16] in Germany.

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13 See Sec. 1 (1) no. 1 German R.E.T.T. Act.
14 See Sec. 8 (8) German R.E.T.T. Act.
15 See Sec. 13 no. 1 R.E.T.T. Act.
16 As mentioned above, the trade tax is imposed at full rates only if the extended trade tax deduction cannot be used.

The profit distribution from the German company to the foreign parent company is subject to German withholding tax. The local withholding tax rate amounts to 25% or – if substance requirements are met – to 15%. However, German double taxation treaties and the E.U. Parent-Subsidiary Directive reduce or eliminate the withholding tax rate.

In general, dividend payments to the U.S. are subject to withholding tax at a rate of 15%.[17] It can be reduced to 5% if the parent company owns at least 10% of the voting shares of the dividend-paying company.[18] The tax is entirely eliminated if the parent company owns at least 80% of the voting shares of the dividend-paying company and further requirements are met.[19] If the parent company resides in Luxembourg, the withholding tax can be eliminated under the E.U. Parent-Subsidiary Directive.[20]

The income of a German GmbH always qualifies as "commercial" and is subject to German trade tax. However, the extended trade tax deduction can be applicable. The deduction is available only if the business activities are limited to the management of real estate and/or capital investments owned by the GmbH (see above).

Example 4:

"D-GmbH" is located in Frankfurt/Main where it owns and leases property. The property is fully managed by D-GmbH. The taxable income from the lease of the property amounts to €1 million. The profits of D-GmbH are distributed to the parent company which is resident in the U.S. or in Luxembourg.

German Tax Consequences for the Rental Income:

	Company	**Company, Extended Trade Tax Deduction Applicable**
Income tax rate	15.825%	15.825%
Income tax	€158,250	€158,250
Trade tax rate[21]	16.1%	16.1%
Trade tax	€161,000	€0
Overall tax burden	**€319,250**	**€158,250**

17 See Art. 10 (2) lit. b D.T.T. between Germany and the U.S.
18 See Art. 10 (2) lit. a D.T.T. between Germany and the U.S.
19 See Art. 10 (3) D.T.T. between Germany and the U.S.
20 There are certain substance requirements for the parent company for a reduction of the withholding tax (*e.g.*, office, employees, etc.), see Sec. 50d (3) German Income Tax Act.
21 Municipal trade tax rate of 3.5% (basic federal rate) x 460% (local trade tax multiplier).

The profit distribution from D-GmbH to a parent company located in the U.S. or Luxembourg can also be subject to German withholding tax.[22] The tax rate may be reduced to 0% according to provisions of D.T.T.'s or the E.U. Parent-Subsidiary Directive.

Exit/Sale of Shares

According to German local tax law, the income of a company derived from the sale of shares in another company is tax-exempt.[23] However, a partial tax is due because 5% of the capital gain is deemed to be a non-deductible business expense, which increases the taxable income.

According to most German D.T.T.'s, profits derived by a foreign shareholder from the sale of shares of a German GmbH are not subject to German taxation. Usually, the country of residence of the shareholder has the right to tax potential capital gains. However, some recent D.T.T.'s provide special rules for the sale of shares in companies whose assets consist of more than 50% "immovable assets" – the technical term in the treaty for real estate. Where such conditions exist, the treaty may allocate the right to tax potential capital gains from the sale of shares to the country where its underlying real estate is primarily located.[24] If the target company is German and the underlying real property is located in Germany, the foreign shareholder may claim the 95% exemption of German domestic law.

Example 5:

The parent company, which is located in the U.S. or Luxembourg, sells 100% of the shares in D-GmbH. The purchase price is €1 million. The book value of the shares amounts to €500,000. Thus, the capital gain amounts to €500,000.

German Tax Consequences:

Capital gain	€500,000
Tax exemption (95%)	€475,000
Taxable income	€25,000
Tax rate	15.825%
Income Tax	**€3,956.25**

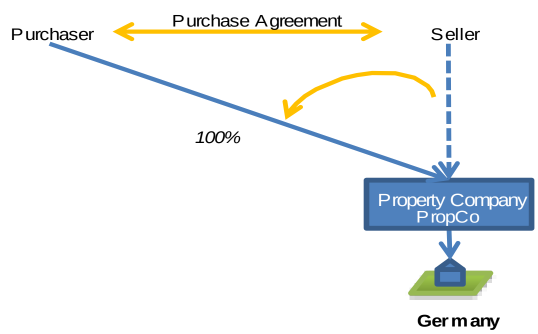
Germany has the right to tax the income derived from the sale of the shares if the assets of D-GmbH consist of more than 50%immovable assets.[25] The U.S. avoids double taxation of such income by offsetting

22 If certain substance requirements are met.
23 See Sec. 8b (2) German Corporate Income Tax Act.
24 See Art. 13 (2) D.T.T. between Germany and the U.S.; Art. 13 (2) D.T.T. between Germany and Luxembourg.
25 See Art. 13 (2) D.T.T. between Germany and the U.S. and Art. 13 (2) D.T.T. between Germany and Luxembourg.

the German tax against the domestic tax (credit method).[26] Luxembourg, in this case, exempts from tax the income which is subject to tax in Germany (exemption method).[27]

Real Estate Transfer Tax

Fig.: 100% of the shares in a property company, which holds real estate that is located in Germany, are sold.



German R.E.T.T. is triggered if at least 95% of "shares" (*"Anteil der Gesellschaft"*) in a real estate owning company are acquired by one person.[28] The shares may be acquired directly by one person or indirectly through a multi-tier participation structure. The 95% ownership trigger may also result from several steps in an integrated series of acquisitions.

The tax base is the real property value pursuant to the German Valuation Act (*"Bewertungsgesetz"*). This is a special valuation of real estate for tax purposes.[29] The person that acquires the 95% interest is subject to R.E.T.T.[30]

Example 6:

The Seller transfers all of the shares in the real estate owning company to the Purchaser. The market value of the real estate amounts to €1

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26 See Art. 23 (1) D.T.T. between Germany and the U.S.

27 See Art. 22 (2) lit. a D.T.T. between Germany and Luxembourg.

28 See Sec. 1 (3) German R.E.T.T. Act. The provision is also applicable to real estate owning partnerships. However, in the case of a partnership, every partner holds one "share" (*"Anteil der Gesellschaft"*) in the sense of this provision. This means that even a partner without participation in the assets of the partnership (*e.g.*, a general partner) is a joint owner of the partnership. As a result, a direct unification of the "shares" in a partnership in one hand is impossible. Thus, the provision of Sec. 1 (3) German R.E.T.T. Act is less important for partnerships than for companies.

29 However, the German Federal Tax Court (*"Bundesfinanzhof"*) appealed to the German Constitutional Court (*"Bundesverfassungsgericht"*) whether the use of the real property value as tax base for R.E.T.T. purposes is in accordance with the German constitution (German Federal Tax Court of 2 March 2011, II R 23/10). The German Constitutional Court has not decided yet (1 BvL 13/11).

30 See Sec. 13 no. 5 German R.E.T.T. Act.

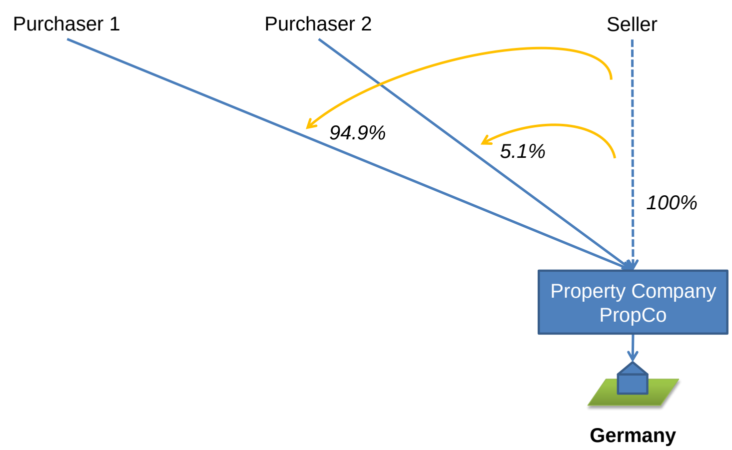
million. It is assumed that the real property value amounts to 60% of the market value. The company and the property are located in Frankfurt/Main.

German Tax Consequences:

The R.E.T.T. burden amounts to €600,000 x 6% = €36,000.

In 2013, Germany passed a law to abolish traditional R.E.T.T. blocker structures. Previously, R.E.T.T. could be avoided by the participation of an independent third party via an intermediary company or several intermediary companies. By using a multi-tier structure the economic participation of the third party could be minimized to a very small percentage rate. Now R.E.T.T. is also triggered if the acquirer's economic participation quota in the real estate owning company or partnership amounts to 95% or more.[31]

Fig.: Avoidance of R.E.T.T. in a share deal scenario.



As a result, a common way to avoid R.E.T.T. is to ensure that a third party holds immediately at least 5.1% of the shares or interests in the real estate owning company or partnership. The third party can be the seller or any other independent party.

31 See Sec. 1 (3a) German R.E.T.T. Act.

Example 7:

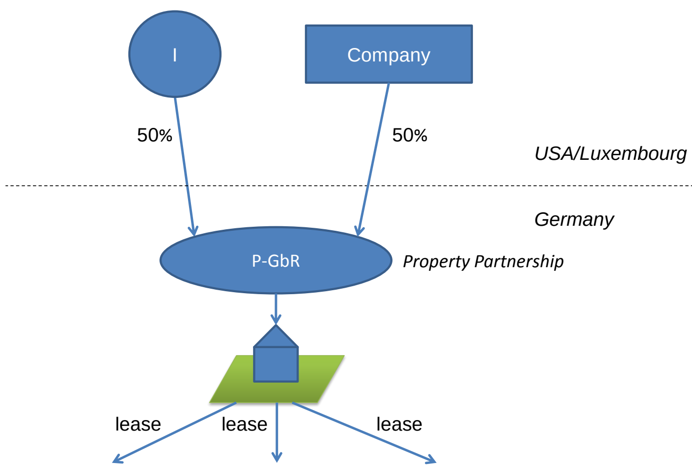
The Seller transfers 94.9% of the shares in PropCo to Purchaser 1 and 5.1% to Purchaser 2. Purchaser 2 must be independent from Purchaser 1 from a R.E.T.T. perspective.[32]

German Tax Consequences:

There is no taxable event. Less than 95% of the shares are acquired by one shareholder.[33]

INBOUND INVESTMENT VIA A PROPERTY PARTNERSHIP

Fig.: A foreign individual ("I") and a foreign corporate investor ("Company") acquire interests in a German property partnership ("P-GbR").



Under German tax law, partnerships are transparent for income tax purposes. Only the partners, but not the partnerships themselves, are subject to (corporate) income tax.

However, if the partnership is a commercial partnership, the partnership itself is subject to German trade tax.

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32 "Independent third party" for R.E.T.T. purposes means that there are no real or corporate relationships between entities or persons with respect to each other. Furthermore, there must be no agreements which result in a different allocation of the beneficial ownership in the shares pursuant to Sec. 39 (2) German Tax Code.

33 However, if PropCo is a partnership, R.E.T.T. will be triggered pursuant to Sec. 1 (2a) German R.E.T.T. Act as at least 95% of the interests in the partnership are transferred to new partners. See *Example 12*.

The qualification as "commercial" or "non-commercial" *inter alia* depends on the question of whether the partnership generates commercial income or "only" income from property management. Real estate partnerships can often be structured in a way so that they do not generate commercial income.

Example 8:

The non-residential individual, I, and a Luxembourg or U.S. company are partners in the German partnership P-GbR (participation quota: 50% each). P-GbR is the legal owner of property located in Frankfurt/Main. The taxable income from the lease of the property amounts to €1 million. The activities of P-GbR are non-commercial. There is no permanent establishment in Germany for trade tax purposes.

German Tax Consequences for Rental Income:

	Individual (50%)	**Company (50%)**
Taxable Income	€500,000	€500,000
Income Tax Rate	47.475%	15.825%
Income Tax	€237,375	€79,125
Overall Tax Burden	**€237,375**	**€79,125**

Example 9:

The activities of P-GbR are commercial due to the provision of various additional commercial services to the lessee. Therefore, P-GbR is subject to German trade tax.[34]

German Tax Consequences for Rental Income:

Trade Tax Rate	16.1%	
Trade Tax[35]	€161,000	
	Individual (50%)	**Company (50%)**
	P-GbR	
Taxable Income	€500,000	€500,000
Income Tax Rate	47.475%	15.825%
Income Tax	€237,375	€79,125

[34] For individuals and partnerships a trade tax exemption in the amount of €24,500 would be applicable but is not considered in this example.

[35] Municipal trade tax rate of 3.5% (basic federal rate) x 460% (local trade tax multiplier).

Trade Tax Deduction[36]	€66,500[37]	No
Income Tax Burden	€170,875	€79,125
Overall Tax Burden[38]	**€251,375**	**€159,625**

Exit/Sales of Interests

From a tax perspective, the sale of an interest in a partnership is treated as a sale of the assets of the partnership.

Germany has the right to tax the income derived from the sale of the interests of a real estate owning partnership.[39] The U.S. sets off the German tax against the domestic tax to avoid double taxation of such income.[40] Luxembourg exempts the income from domestic tax, which is subject to tax in Germany.[41]

Example 10:

The partners sell their interests in the non-commercial partnership P-GbR. The purchase price for each interest is €500,000. book value of each interest amounts to €250,000. Thus, the capital gain amounts to €250,000. The interests were held for about five years.

German Tax Consequences:

	Individual (50%)	**Company (50%)**
Taxable Income	€250,000[42]	€250,000
Income Tax Rate	47.475%	15.825%
Income Tax	**€118,687.50**	**€39,562.50**

36 Partly set off in the amount of the profit distribution quota, which usually equals to the participation quota.

37 If the trade tax rate of the local municipality exceeds 13.3%, only a portion trade tax may be deducted.

38 The overall tax burden of the partners is calculated by the income tax burden of the partners and partial consideration of the trade tax burden of the partnership.

39 See Art. 13 (2) D.T.T. between Germany and the USA and Art. 13 (1) D.T.T. between Germany and Luxembourg.

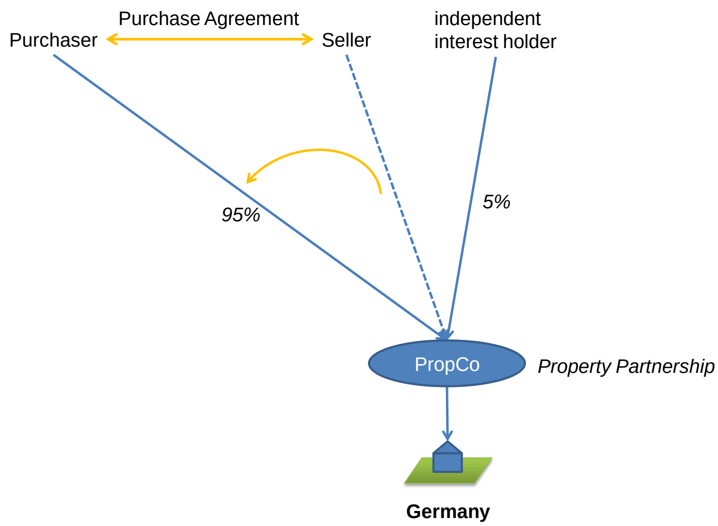
40 See Art. 23 (1) D.T.T. between Germany and the USA. The gain is treated as arising in Germany for purposes of the foreign tax credit limitation. See Art. 23 (2) D.T.T. between Germany and the USA.

41 See Art. 2 (2) lit. a D.T.T. between Germany and Luxembourg.

42 If the property was held for more than ten years by P-GbR and the individual partners held their interests in P-GbR for more than ten years, the profit from the sale of the interests would not be subject to German income tax. There was a recent decision by the Tax Court of Munich (FG Munich of July 29, 2013, 7 K 190/11) in which the court concluded that this exemption also applies for corporate partners. The case is facing appeal. German tax authorities may be of a different opinion. For individuals and partnerships a trade tax exemption in the amount of €24,500 would be applicable, but this exemption is not within the scope of this example.

Real Estate Transfer Tax

Fig.: 95% of the interests in a partnership that owns real estate located in Germany are sold.



German R.E.T.T. is triggered if at least 95% of the interests in a real estate owning partnership are transferred directly or indirectly to new partners within a period of five years.[43] This is also true if interests in the relevant amount are acquired in several successive steps within the five-year period by one or more acquiring parties. The tax base is the real property value according to the German Valuation Act.[44] The partnership is subject to R.E.T.T.[45]

Example 11:

The Seller transfers 95% of the interests in PropCo to the Purchaser. The remaining 5% is held by an independent third party. The market value of the real estate amounts to €1 million. It is assumed that the real property value amounts to 60% of the market value. The partnership and the property are located in Frankfurt/Main.

German tax consequences:

The transfer of interests is subject to R.E.T.T. The R.E.T.T. burden amounts to €600,000 x 6% = €36,000.

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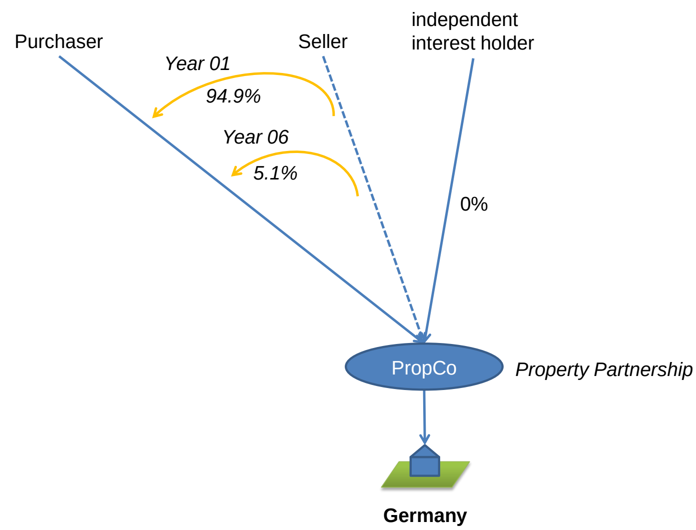
43 See Sec. 1 (2a) German R.E.T.T. Act.

44 There is the question whether the use of the real property value as tax base for R.E.T.T. purposes is in accordance with the German constitution. See footnote 29.

45 See Sec. 13 (6) no. 6 R.E.T.T. Act.

R.E.T.T. may be avoided if the seller or another partner of the partnership retains more than 5% of the interests. However, the involvement of a third party is not always an optimal solution.

Fig.: Reduction of R.E.T.T. by the acquisition in two tranches.



Example 12:

In the first year the Seller transfers 94.9% of the interests in PropCo to the Purchaser. In the sixth year (after the expiration of the five-year holding period) the remaining 5.1% of the interests are transferred to the Purchaser. The market value of the real estate amounts to €1 million. It is assumed that the real property value amounts to 60% of the market value. The partnership and the property are located in Frankfurt/Main.

German Tax Consequences:

In the first year no R.E.T.T. is triggered because less than 95% of the interests in ProCo are transferred to new partners.

However, R.E.T.T. is triggered in the sixth year. A transaction is also subject to R.E.T.T. if it results in an economic participation in the property company amounting to 95% or more.[46] The economic participation is calculated by addition of the direct or indirect participation quotas. However, due to the fact that the Purchaser had held an interest of 94.5% for more than five years, tax is not charged in the amount of his participation quota of 94.9% according to another special tax-exemption provision.[47] Therefore, R.E.T.T. is

46 See Sec. 1 (3a) German R.E.T.T. Act.
47 See Sec. 6 (2) German R.E.T.T. Act.

finally only triggered with respect to the participation quota of 5.1%. The R.E.T.T. burden amounts in total to €600,000 x 6% x 5.1% = €1,836.

CONCLUSION

There is no general answer to whether it is preferable for a foreign investor to make a direct investment, an investment into a property company, or a property partnership. Whichever structure is chosen, it is important to adopt a plan that eliminates German trade tax. German trade tax is not applicable if a permanent establishment for trade tax purposes is not constituted or if the “extended trade tax deduction” applies.

In general, investment in a property company is an advantageous structure because of the relatively low German corporate income tax rate of only approximately 15%. A property company is also a good structure with respect to a potential exit because capital gains derived from the sale of shares held by another company are almost entirely tax-exempt under German law.

Direct investment by an individual appears to be less advantageous because the tax rate is substantially greater for individuals, topping out at approximately 47%.

With respect to investments through a partnership, the tax consequences are determined at the partner level. No matter the make-up of the partnership group, operations should be carried on to avoid commercial partnership status. If the partnership is not a commercial partnership, German trade tax will not be applicable.

With respect to the German real estate transfer tax, a direct investment in the real estate is regularly disadvantageous because there is usually no way to avoid or minimize the real estate transfer tax burden.

Due to several amendments of the Real Estate Transfer Act in the past, it has become more difficult to set-up tax efficient acquisition structures for “share deals.” However, R.E.T.T. can usually be avoided if a third party is involved in the investment as co-investor. Another possibility to reduce the tax burden is the investment into a property partnership. If the investment is planned within a time-period of more than five years, the acquisition structure can be set up to avoid almost 95% of the real estate transfer tax.