EXTENSION OF GERMAN TAXATION OF FOREIGN COMPANIES HOLDING GERMAN REAL ESTATE

Author
Dr. Petra Eckl

Tags
Germany
Corporate Tax
Income Tax
International Tax
Real Estate

Dr. Petra Eckl is a lawyer, tax advisor, and partner at GSK Stockmann + Kollegen in Germany, where her practice focuses on tax advice in connection with cross-border and domestic transactions and tax litigation. Dr. Eckl is a lecturer at Frankfurt University and regularly publishes articles on new German tax developments.

On August 1, 2018, the German Federal government proposed draft legislation that will expand the scope of German taxation to cover the sale of shares in "real estate rich companies" by nonresident taxpayers. In the coming months, the draft will be subject to further discussion in the German parliament. The draft legislation proposes that capital gains from shares in foreign companies will be subject to German taxation if the share value consists of more than 50% German real estate. The sale of shares by certain institutional investors (*e.g.*, foreign corporations and domestic and foreign investment funds) is not expected to be covered by the draft legislation.

The draft legislation raises practical questions regarding implementation. These include questions regarding

- accounting and reporting requirements,
- methods that should be used when determining the value of German real estate and all other assets owned by a company in order to conclude that the company is a real estate rich company,
- the way in which German tax resulting from the adoption of the proposed legislation will interface with conflicting provisions of existing double taxation treaties,
- tax filing duties of a nonresident shareholder of a real estate rich company,
- identifying those nonresident investors that will be affected by the draft legislation once effective, and
- resolving possible double taxation issues when the shareholder's country of residence determines that it has the primary or exclusive right to tax gain from the disposition of shares

In addition to a straightforward set of facts, the draft legislation contains provisions applicable to loans extended to a real estate rich company by a nonresident lender.

BACKGROUND

A foreign shareholder's capital gain from the sale of shares in a foreign-based real estate rich company is not subject to German taxation under existing law. The capital gain is subject to tax only if the investor holds at least a 1% interest in the company and the corporate entity being sold has its corporate seat or place of effective management in Germany.

In contrast to the domestic legal situation, Germany's most recent double taxation treaties ("D.T.T.'s") assign Germany the right to tax such capital gains. For example, the D.T.T.'s with Luxembourg and France specify that capital gains are subject to German taxation if the share value consists of more than 50% German real estate,[1] and the D.T.T. with the Netherlands allows for German taxation if the company's assets consist of more than 75% German real estate.[2] These provisions are in line with Art. 13 (4) of the O.E.C.D. Model Tax Convention, which has contained a "land-rich company" clause since 2014. According to these provisions, all capital gains from these sales of shares are taxable in the country where the real estate assets are located, regardless of the company's other assets.

Notably, D.T.T.'s can only restrict the right to tax. They cannot establish or expand the right of a contracting party to impose tax. In practical terms, this leads to an unequal distribution of taxing rights between Germany and its treaty partners whenever the domestic law of the treaty partner does not have a similar requirement allowing gain to be taxed only if the real estate rich company maintains its registered seat or place of effective management within the treaty partner jurisdiction. The treaty partner can tax gain from the sale of shares of a German company when real estate located in the treaty partner jurisdiction comprises the principal category of assets of the German company. In comparison, Germany cannot tax gain from the sale of a treaty partner corporation even if German real estate comprises most of the assets of company resident in a treaty partner jurisdiction as long as neither the registered seat nor the place of effective management is in Germany. The draft legislation[3] is intended to correct this, establishing equivalent rights for Germany to impose tax in these cases.

DETAILED OVERVIEW OF DRAFT LEGISLATION

In order to extend the German right to tax, the following amendments to existing law are proposed:

"Capital gains from shares in foreign companies will be subject to German taxation if the share value consists of more than 50% German real estate."

Extension of the Tax Liability to Foreign Companies Under Sec. 49 EStG

New Provision

The draft provides an expansion of German tax liability to capital gains arising from the sale of shares in foreign companies that are rich in German real estate. Notably, the new Sec. 49 (1) No. 2 lit e) cc) of the German Income Tax Act (*Einkommensteuergesetz* or "EStG") will not require a registered seat or place of effective management to exist in Germany in order for German tax to be imposed – as is required by the existing Sec. 49 (1) No. 2 lit e) aa) EStG.

In the future, capital gains will be taxed in Germany when the following requirements are met:

- **Real Estate Assets of More than 50%:** Capital gains arising from the sale of shares of a nonresident company will be subject to German tax if more than 50% of the share value of the company arises from German immovable

[1] Art. 13 (2) D.T.T. Lux; Art. 7 (4) D.T.T. Fra.

[2] Art. 13 (2) D.T.T. NL. Germany's D.T.T. with the U.S. deviates from this as it currently does not contain such a provision.

[3] *Entwurf eines Gesetzes zur Vermeidung von Umsatzsteuerausfällen beim Handel im Internet und zur Änderung weiterer steuerlicher Vorschriften*, formerly *Jahressteuergesetz* 2018, BR-Drs. 372/18.

property at any time during the 365 days preceding the sale. The real estate can be held directly by the company or indirectly through shares in other corporations holding immovable property.

- **Shareholding of at Least 1%:** In line with the present legal framework, only capital gains associated with a shareholding that exceeds a 1% threshold at any time within the last five years are taxed.[4] In other cas-es (shareholding below 1% during the last five years), the sale of shares will remain free of German tax.

Determination of the Real Estate Threshold

In accordance with the 2017 O.E.C.D. Model Tax Convention, the relevant real estate threshold will be determined over a set period of time. Accordingly, capital gains will be taxed as soon as the 50% threshold has been exceeded during the 365 days preceding the sale, provided that the shares were economically attributable to the seller at this point in time.[5] It is expected that tax avoidance schemes will be prevented by looking at a period of 365 days instead of looking only at the date of the sale, as in the 2014 O.E.C.D. Model Tax Convention. If only the date of sale is relevant, the 50% threshold can be avoided by capital injections of cash, securities, or movable assets to dilute the proportion of real estate assets on the date of sale.

The real estate threshold is determined based on the book value of assets only, and liabilities are excluded in computing value. The reliance on book value leads to an incongruity that allows indirect German real estate gains to go untaxed for the shareholder of a real estate rich company when German real estate in an appreciating market is mixed with non-German real estate in a stable or depreciating market.

Example 1: Nonresident Owns Real Estate in Germany and Elsewhere

Corporation X, a nonresident company, owns two parcels of real estate. Parcel A is located in a German city undergoing significant appreciation in the value of assets. Parcel B is located in a Turkish city where values are stable when measured in Turkish Lira. On the date of acquisition, Parcel A is worth €400,000, and Parcel B is worth the Lira equivalent of €500,000. The apportionment of land value to building value is the same for both parcels and depreciation is computed under equivalent rules and useful lives in both countries. After the properties have been held for three years, the fair market value of Parcel A increases to €600,000, and the fair market value of Parcel B remains at the Lira equivalent of €500,000. This reflects increased value in terms of Lira but depreciation in the value of the Lira in relation to the Euro.

Under these facts, the book values of the two parcels should reflect that not more than 50% of the value of the nonresident corporation's shares is attributable to German real estate. However, 54.5% of the total fair market value of the nonresident corporation's shares will be attributable to German real estate.

For cases where German real estate is held indirectly, the explanatory statement on an earlier draft of the bill from the Federal Ministry of Finance suggested that the 50% threshold would be determined on a consolidated basis. However, this clarification was not included in the subsequent government draft bill.

---

[4] Sec. 17 EStG.

[5] Cf. Sec. 39 of the German General Tax Act (*Abgabenordnung* or "AO").

Date of Application

The new regime will apply to transactions occurring after December 31, 2018.[6] A revaluation of cost basis for the shares is adopted so that only net increases in value after December 31, 2018 are taxed. Since the draft law uses the term "value changes," both increases and decreases will be relevant for taxation purposes.

Impact of the Amendments

In our view, the new legislation will most likely have the following consequences:

Taxable Capital Gains from the Sale of Shares

Whether the sale of shares in a foreign real estate rich company will trigger German tax depends on the shareholder's legal form:

> **Example 2: Shareholder Is a Corporation**
>
> Corporation X has a corporate seat or place of effective management outside of Germany and holds a significant amount of shares (at least 1%) in the non-German real estate company Y. The share value of Y consists of more than 50% real estate assets located in Germany. Neither X nor Y have a permanent establishment nor permanent representative in Germany.

Under current German tax law, the capital gains from the sale of shares in this example would not qualify as taxable domestic income.

In the future, the new provision will lead to the taxation of such capital gain as domestic income.[7] However – by application of German domestic rules – the capital gains should be 100% tax-exempt. This is the result of "intercompany privilege"[8] and the Federal Tax Court decision that held the provision to tax 5% of the gain as non-deductible business expenses[9] does not apply to a sale of a foreign corporation, unless it has a permanent establishment or a permanent representative in Germany.[10]

If the selling shareholder is an investment fund in accordance with German investment tax law, capital gains should also be tax-exempt since capital gains from the sale of shares in corporations by an investment fund are generally tax-exempt pursuant to Sec. 6 (5) No. 1 InvStG.[11]

However, foreign investors who cannot claim any of the tax exemptions outlined above – such as certain finance and insurance companies to which the exemption of Sec. 8b (7) and (8) KStG does not apply[12] – are taxable on the whole capital gain.

---

6 Sec. 52 (45a) EStG.

7 Sec. 49 EStG in connection with Sec. 8 (1) of the German Corporate Income Tax Act (*Körperschaftsteuergesetz* or "KStG").

8 The intercompany privilege provision under Sec. 8b (2) s. 1 KStG sets out that capital gains received by a corporation are fully tax-exempt; however, 5% of these capital gains are considered non-deductible business expenses.

9 Sec. 8b (3) s. 1 KStG.

10 Federal Tax Court of 31 May 2017, I R 37/15, Federal Tax Gazette II 2018, p. 144.

11 German Investment Tax Act (*Investmentsteuergesetz* or "InvStG").

12 Sec. 8b (7) and (8) KStG.

Example 3: Shareholder Is an Individual

Individual A, a German nonresident, holds a significant number of shares (at least 1%) in German nonresident real estate company B. The share value of B consists of more than 50% real estate assets located in Germany. B does not have a permanent establishment or a permanent representative in Germany.

In contrast to the current law, the sale of shares by a nonresident individual will become a taxable transaction. Taking the partial-income method[13] into account, 60% of the capital gains will be taxable, and 40% will be exempt. This is also true if the selling shareholder is a partnership. In this case, the tax consequences depend on whether the partner is a corporation or an individual.

Example 4: Attribution of Shares

Individual A, a German nonresident, holds 10% of German nonresident company B (which holds no real estate assets). On July 1, 2017, A sells 9.5% of his shares in B. B acquires German real estate on March 1, 2018, and meets the German real estate threshold of more than 50% of total value. B sells all real estate holdings on February 1, 2019. A sells his remaining 0.5% of shares in B on March 1, 2019, to the individual C (also a German nonresident), who sells her shares on June 1, 2019.

A's capital gains realized upon the sale of shares on March 1, 2019, are subject to German tax under the new provision. A holds at least 1% of the shares during the 5-year period preceding the sale, and more than 50% the share value of B is attributable to German real estate during the 365 days preceding the sale. The fact that B acquired real estate to a relevant extent only after A reduced its shareholdings to less than 1%, should not justify a different conclusion. The explanatory statement to the draft legislation explains that the 1% shareholding threshold is not required to be met at the time the 50% real estate threshold is exceeded.

However, the capital gains realized by C are not subject to German taxation because the shares in B were not attributable to C[14] when B fulfilled the relevant real estate assets threshold (March 1, 2018, until February 1, 2019).

Restrictions Due to D.T.T.'s

Depending on the country of residence of the selling shareholder – whether it is a treaty jurisdiction or a country with which Germany has no D.T.T. in effect – the tax liability may vary. The rules set out above also apply to foreign shareholders that are resident in countries with which Germany does not have a D.T.T. in effect.

In cases involving a country with which Germany has signed a D.T.T., the German tax liability and right of Germany to impose tax must be assessed under the provisions of the relevant D.T.T. Several older D.T.T.'s do not contain real estate rich company clauses. Examples are the D.T.T.'s concluded with Belgium or the U.S. Under these D.T.T.'s, gains from the sale of shares in real estate rich companies are taxable only in the contracting state in which the seller is resident. Consequently, the

---

13 The partial-income method under Sec. 3 No. 40 lit c) EStG sets out that certain capital gains are 40% tax-exempt.

14 According to Sec. 39 AO.

proposed legislation will not impact investors located in the relevant treaty jurisdiction until the D.T.T. is renegotiated.

Other D.T.T.'s may result in different thresholds. For example, the D.T.T. with the Netherlands contains a 75% real estate threshold, which means that capital gains will not be liable to German tax if the share value attributable to German real estate is more than 50% but not more than 75% of the total value.

Finally, other D.T.T.'s may result in periods of assessment for determining the real estate threshold that depart from the 365-day rule under domestic law. Like all of Germany's current D.T.T.'s that contain a real estate rich company clause, Art. 13 (2) of the D.T.T. with Luxembourg stipulates that only the date of sale is relevant for determining whether the value threshold is met for German real estate. In contrast to the draft legislation, exceeding the 50% threshold on another date during the 365-day period preceding the date of sale is not relevant. This means that the capital gains of an investor located in Luxembourg, or a country with a similar provision in its D.T.T. with Germany, will be subject to German tax only if the share value consists of more than 50% German real estate on the date of sale. It is worth noting, however, that Germany will change these provisions in its D.T.T.'s by implementing the Multilateral Instrument[15] so that all German D.T.T.'s will contain the 365-day period, provided that the contracting state in each affected D.T.T. agrees to such an amendment.

Practical Implementation

Issues remain in the draft legislation regarding the determination of the real estate threshold, itself. Contrary to the usual practice of determining book values on a specific closing date, it might now be necessary to assess the book value of the underlying real estate assets on each day throughout the year in order to determine whether the 50% threshold has been exceeded at any point during the 365 days preceding the sale. Additional issues arise for the determination of the real estate threshold in the case of indirect shareholdings. The 365-day review period may also lead to double taxation as Example 5 illustrates:

Example 5: Multiple Taxation Due to the 365-Day Period

The value of the shares of -S.à.r.l. Y, located in Luxembourg, consist of more than 50% German real estate. On November 1, 2018, Y sells all its German properties and acquires real estate assets located in Country B, which account for more than 50% of the share value from the date of their purchase. On March 1, 2019, shareholder X, a German nonresident individual, sells his shares.

The capital gains realized by X are taxable in Germany under the new provision because the value of the shares in Y consisted of more than 50% immovable German property during the 365-day period. If Country B has a similar regulation, the capital gains are taxable in Country B as well. The right to tax these capital gains is also assigned to Germany according to the D.T.T. with Luxembourg as soon as the 365-day period is introduced in this treaty. Assuming that the D.T.T. between Luxembourg and Country B contains such a 365-day review period (in line with the 2017 O.E.C.D. Model Convention), the capital gains from a single sale of shares are

[15] See Art. 9 MLI.

subject to tax in two countries. Of course, the competent authorities of Germany and Luxembourg could agree to provide relief in order to avoid double taxation. The right of countries to avoid double non-taxation should not be a basis to impose double taxation where aggressive tax planning is not involved.

Further questions with regard to the practical implementation arise concerning listed foreign real estate companies:

- How will foreign share deals be monitored?
- How will the German tax authorities control tax filing duties?

"The sale of shares in foreign real estate corporations could potentially trigger (limited) domestic taxation in Germany."

Today, these and other practical questions remain unanswered.

Provisions Addressing Certain Loans

The draft legislation contains a provision stipulating that capital gains from the sale of real estate located in Germany will include changes in the value of other assets or obligations that are related to the real estate.[16] An example involves changes in the value of loans taken out to finance German real estate. Such value changes may be attributed to movements in currency value between the stated denomination of the obligation and the value of the Euro. Alternatively, they may be attributed to an enhanced credit position of the corporation issuing the debt obligation to finance the real estate.

Accordingly, income realized at the level of the debtor from a creditor's waiver of a loan that was taken out to finance real estate would lead to limited taxable earnings in Germany. In contrast to current case law,[17] there would be taxable income in Germany when a parent company waives a loan to its foreign subsidiary that was used to finance the acquisition of German real estate.

CONCLUSION

In view of the current draft law, the sale of shares in foreign real estate corporations could potentially trigger (limited) domestic taxation in Germany. In cases where the selling shareholder is either a nonresident individual or a specified foreign finance and insurance company, the capital gain might become entirely taxable in Germany.

Given that the pending changes would enter into force after December 31, 2018, any contemplated share sale transaction involving German real estate assets should be reviewed and, to the extent necessary, should be completed prior to the close of 2018, if possible.

---

16 Sec. 49 (1) No. 2 lit. f) s. 3 EStG-draft.

17 Federal Tax Court of 7 December 2016, I R 76/14, Federal Tax Gazette II 2017, p. 704.