A GRETT-ABLE SITUATION: NEW TRENDS IN GERMAN REAL ESTATE TRANSFER TAX ON SHARE DEALS

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From a historic perspective, German Real Estate Transfer Tax ("gRETT") is a transaction tax triggered by the transfer of title held in real estate located in Germany. For decades, the German Real Estate Transfer Tax Act ("gRETT Act") followed an approach driven by the legal transfer of title pursuant to applicable civil law. This also applied to direct or indirect share deals regarding German or foreign entities holding real estate located in Germany. Because gRETT is a transaction tax originally imposed on the transfer of legal title, commercially driven concepts that commonly appear for income tax purposes were not relevant.

As originally enacted, only the direct or indirect transfer of 100% of either a partnership holding German real estate (a "Real Estate Holding Partnership" or "R.E.H.P.") or a company holding German real estate (a "Real Estate Holding Company" or "R.E.H.C.") was deemed to be similar to an asset purchase of real estate for gRETT purposes.[1]

The terms R.E.H.P. and R.E.H.C. are not limited to legal entities belonging to real estate developers or real estate investors but include all partnerships and companies that own real estate located in Germany. Thus, all direct or indirect transfers of a participation in such legal entities require the assessment of a potential gRETT liability. This applies even if the "transfer" of real estate held by the legal entity is not the main focus of the transaction, such as an M&A transaction involving a manufacturing entity or an intra-group transfer of shares pursuant to a merger or demerger within the group.

gRETT can apply to all share transfers that revise the ownership chain of an R.E.H.P. or R.E.H.C.; it does not matter whether this share transfer involves an R.E.H.P. or an R.E.H.C. only indirectly. Also, a share transfer regarding a foreign direct or indirect shareholder of an R.E.H.P. or R.E.H.C. is relevant. The gRETT debtor is either the R.E.H.P. or R.E.H.C. or the direct or indirect shareholder depending on the gRETT-able event. The taxpayer is obligated to notify the responsible German tax office of the change in ownership. If the notification is not filed, this non-compliant conduct is typically discovered in a tax audit, when the tax officer checks the requested group charts.

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NEW COMMERCIAL APPROACH TO INDIRECT SHARE DEALS

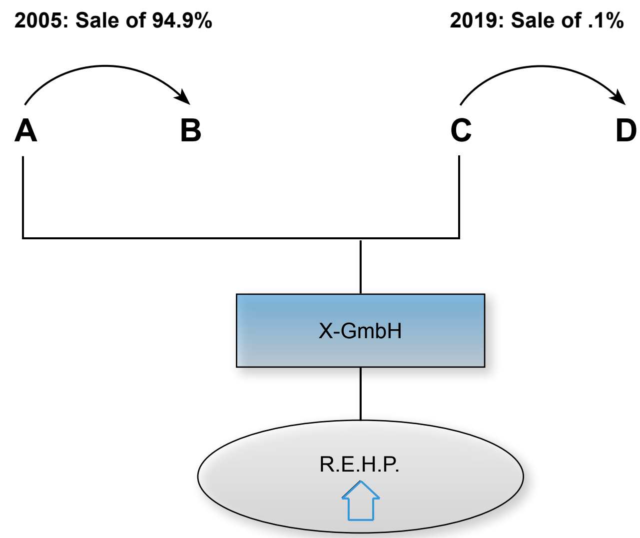
In 2000, the law changed regarding share transfers. From that point, a direct or indirect transfer of a 95% interest in an R.E.H.P. or R.E.H.C. is subject to gRETT.

[1] Sales of shares of an R.E.H.P. holding German real estate have been subject to gRETT since 1996. Sales of interests in a partnership owning German real estate have been subject to gRETT since 1999.

The underlying premise of the change in law is that no significant difference exists between a transfer of a 100% interest in an R.E.H.P. or R.E.H.C. and a transfer of a 95% interest in an R.E.H.P. or R.E.H.C. Consequently, a transfer of a 95% interest in an R.E.H.P. or an R.E.H.C. has become subject to gRETT. This was the beginning of a limited commercial approach to the understanding of what kind of share deal should be subject to gRETT.

From that rather limited beginning, the legislator and the tax authorities have expanded this commercial approach step-by-step. In particular with respect to indirect transfers of participations held by companies in an R.E.H.P., this commercial approach has been expanded significantly. A decree published by the Federal Ministry of Finance on November 12, 2018,[2] (the "Decree") significantly changed the gRETT treatment of share deals indirectly affecting an R.E.H.P. in a tiered ownership structure. The following examples illustrate this tendency:

Example 1:



"No significant difference exists between a transfer of a 100% interest in an R.E.H.P. or R.E.H.C. and a transfer of a 95% interest."

The gRETT Act provides that the direct or indirect transfer of at least 95% of the participation held in an R.E.H.P.'s assets to new partner(s) triggers a gRETT liability only if a participation of 95% in total is transferred within five years to new partner(s).

The Decree modifies the rule in a tiered structure where a corporation owns shares in an R.E.H.P. The five-year limitation no longer applies. Any direct or indirect transfer in X-GmbH triggers gRETT irrespective of this five-year period.

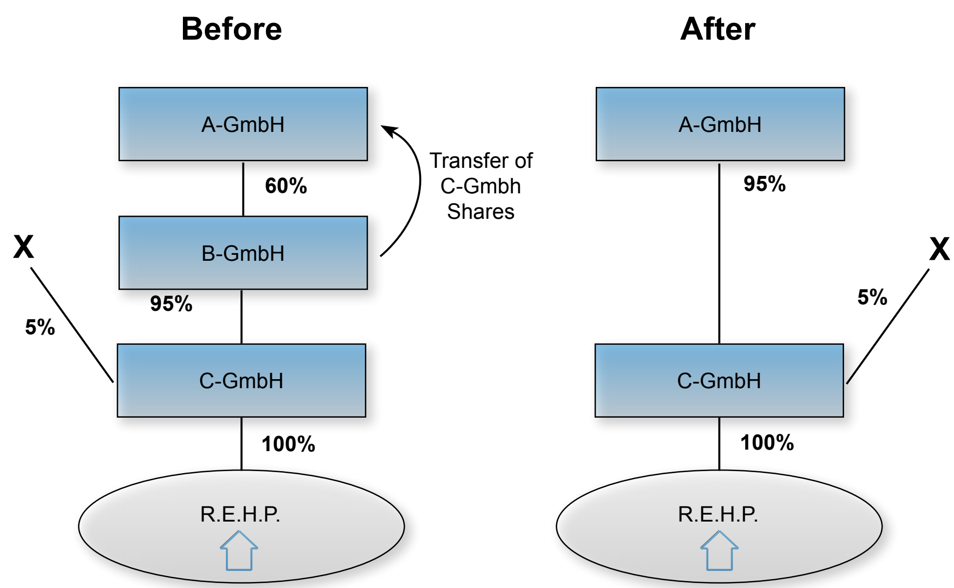
The scope of the decree is illustrated in Example 1. There, X-GmbH was owned until 2005 by A and C. In 2005, B acquired from A 94.9% in X-GmbH and became therefore a new indirect partner of R.E.H.P., while C still held 5.1% in X-GmbH. In 2019, C sells 0.1% of the shares in X-GmbH to D. Since then, B, C, and D hold the entire shares of X-GmbH which owns 100% of R.E.H.P. At all times, A, B, C, and D are unrelated to each other.

Before this Decree. it was the common understanding that the transfer of 0.1% of the shares in X-GmbH from C to D in 2019 would not trigger a gRETT liability,

[2] Decree dated November 12, 2018, Federal Tax Gazette 2018 II, p. 1314 ff.

because B held 94.9% of the shares in X-GmbH for more than five years. However, the Decree changes the result. Under the Decree, the transfer of 0.1% of the X-GmbH shares by C to D in 2019 triggers a gRETT liability. It does not matter that 99.9% of the shareholdings in X-GmbH have been held by the same shareholders in the same percentages for five years or more. The German tax authorities qualify B and D as new (indirect) partners of R.E.H.P. due to the transfer of 95% of the shares held in X-GmbH in two sales, separated by as much as 14 years, among independent parties.

Example 2:

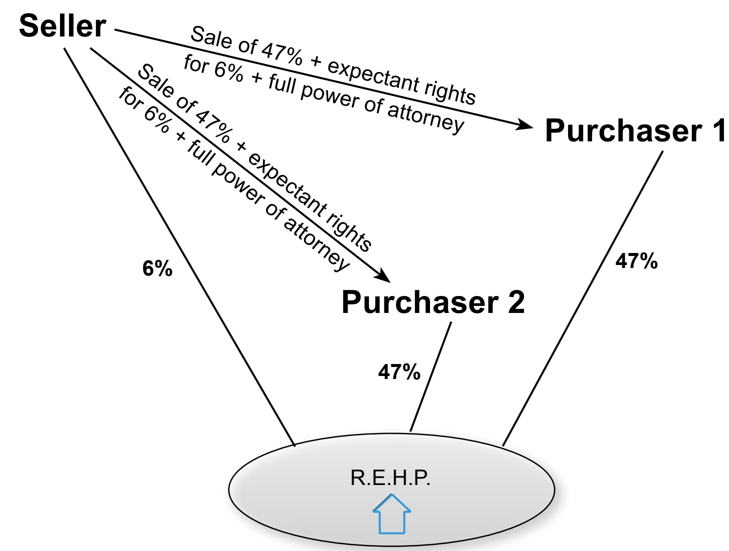


By way of the said Decree, the Federal Ministry of Finance applies a new interpretation that inflicts with the compression of a multi-layer chain of shareholdings in an R.E.H.P. held directly or indirectly by a company. The new approach is based on a commercial view that 95% ownership equates to actual ownership subject to a minority interest.

In the past, a compression of a multi-layer chain of shareholdings in an R.E.H.P. triggered a gRETT liability only when the direct partner of an R.E.H.P. (*i.e.*, C-GmbH in Example 2) was substituted, for example, by a merger. Compression of the ownership chain was not subject to gRETT if the shares of an upper-tier member was removed from the chain of ownership. Consequently, in Example 2, the transfer of shares in B-GmbH to A-GmbH did not trigger a gRETT liability.

According to the tax authorities' new interpretation of the still unchanged gRETT Act, the transfer of shares in B-GmbH to A-GmbH results in a new 95% shareholder of C-GmbH, which redefines C-GmbH as a new partner of R.E.H.P. The transfer of shares in B-GmbH to A-GmbH triggers a gRETT liability for 100% of the real estate held by R.E.H.P. because of the deemed transfer of at least 95% of the participation held in R.E.H.P.'s assets to R.E.H.P.'s deemed new partner C-GmbH.

Example 3:



According to the new interpretation of the still unchanged gRETT Act by the Decree, the transfer of the mere right to enjoy the benefits of a direct or indirect 95% participation in an R.E.H.P. is also treated as a taxable transfer of German real estate owned by an R.E.H.P. The following are examples for possible ways how to enjoy such benefits:

- The grant of an option to acquire (i) the shares held in the direct or indirect partner of the R.E.H.P. or (ii) the interest in the R.E.H.P, which cannot be withdrawn unilaterally from the option holder.
- The voting rights or profits rights held by the title holder of 95% of (i) the shares in the direct or indirect partner of the R.E.H.P. or (ii) the interest in an R.E.H.P. have been transferred to a third party already prior to the transfer of the legal title.
- A deferred transfer of legal title in a transaction that immediately grants to the acquirer the risks and rewards of ownership in 95% of (i) the shares in the direct or indirect partner of the R.E.H.P. or (ii) the interest in the R.E.H.P.

Even the grant of a full irrevocable and open-ended power of attorney could be viewed as a taxable transaction. Under the Decree, both the terms of the power of attorney and the facts surrounding its operation must be taken into account in determining whether the grant triggers a gRETT liability. The result is a lack of certainty as to tax exposure. This is illustrated in Example 3, where the sale of two separate and unrelated transfers of 47%-interests in R.E.H.P. to Purchaser 1 and Purchaser 2 could trigger exposure to a gRETT liability under the Decree, if Seller has granted Purchaser 1 and Purchaser 2 additionally a full joint power of attorney to exercise his partner's rights in R.E.H.P.'s general assembly and to sell his 6% interest for him, even though the Seller has transferred less than 95% of the interests in R.E.H.P.

These new interpretations of the unchanged gRETT Act provisions are controversial, and their validity is questionable. Taxpayers receiving an assessment notice in this context should carefully consider an appeal.

DRAFT BILL EXPANDS SCOPE OF GRETT

Following this administrative expansion of share transfer transactions considered to be subject to gRETT, the German Ministry of Finance published a draft bill[3] (the "Draft Bill"), which proposed changes to the gRETT Act provisions applicable to share deals in a way that further expands the commercial approach to an R.E.H.P. and R.E.H.C. The Draft Bill exposes more share deals to gRETT, which is imposed at the rate between 3.5% and 6.5% of the real estate value. The Draft Bill reflects the government's view that share deals are merely an instrument of illegitimate but legal tax structuring, in particular, in cases of high-volume real estate transactions.

The Draft Bill expands the scope of harmful share deals that are subject to gRETT. The new rules shall apply to the following list of direct or indirect transfers of (i) partnership interests held in an R.E.H.P. and (ii) shares held in an R.E.H.C.:

- A gRETT liability shall be triggered by the transfer of a participation in an R.E.H.P. if, as a result of the transaction, at least 90% of the interests in the R.E.H.P. have been transferred directly or indirectly to new partners within the preceding ten-year period in multiple transactions. In comparison to the existing law, more transactions are covered because the triggering level of share transfer has been reduced by five percentage points and the period looked at has been expanded by five years.
- For the first time, the Draft Bill provides for a provision according to which any transfer of a share held in an R.E.H.C. shall trigger a gRETT liability if, as a result of that transfer, at least 90% of the shares in an R.E.H.C. are transferred directly or indirectly to new shareholder(s) within a period of ten years. This new calculation will include each shareholding at each level, while the current gRETT Act includes only shareholdings of at least 95%.
- In the case of an R.E.H.C., any claim for a legal transfer or any legal transfer of the R.E.H.C. shares, which results either directly or indirectly in a unification of at least 90% (formerly 95%) of an R.E.H.C. in one hand, shall be subject to gRETT.
- In the case of an R.E.H.C., any claim for a legal transfer or any legal transfer of at least 90% (formerly 95%) of an R.E.H.C. – either directly or indirectly – shall be subject to gRETT.
- gRETT is imposed on 100% of the value of the real estate even when the total direct or indirect transfer is limited to as little as 90% of the shares of an R.E.H.C. or the interests in an R.E.H.P.
- The minimum period for holding the participation in an R.E.H.P. shall be extended from five years to ten years after the transfer of the real estate by the partner to an R.E.H.P., which is a precondition for the gRETT exemption applicable to the transfer of real estate to an R.E.H.P. in accordance with the transferor's participation in an R.E.H.P.
- The minimum period for holding the participation in an R.E.H.P. shall be extended from five years to ten years and 15 years, respectively, before the transfer of the real estate to the partner of an R.E.H.P., which is a precondition for

[3] Draft Bill published on the website of the Federal Ministry of Finance on July 31, 2019.

the gRETT exemption applicable to the transfer of real estate from an R.E.H.P. to its partner in accordance with the transferee's participation in an R.E.H.P.

- All these gRETT transactions must be reported on a timely basis to the appropriate German tax authorities.

The Federal government withdrew the Draft Bill on October 24, 2019. It is anticipated that a revised bill will likely be introduced in 2020. The Federal government announced that the Draft Bill will be reworked within the first six months of 2020. High-volume share transactions continue to be viewed by the Federal government as illegitimate, but legal, if they avoid gRETT. In that regard, certain commentators proposed that the trigger that exposes a share transaction to gRETT should be reduced to 75% of the shares of the company. Other commentators cautioned that taxpayers will develop new structures for avoiding gRETT if the government tightens the gRETT anti-abuse rules. Still other commentators suggested that extending the holding period from five years to ten years would be in breach of German constitutional law. Finally, several experts highlighted the negative impact the reform would have on the housing market. According to the information received, a completely new concept for specific real estate holding entities, which at the beginning was in the main focus of the lawmaker, seems to be unlikely, as it is unclear how such specific real estate holding entities shall be defined.

PATH FORWARD

Lobbying Activity

Groups with differing agendas as to gRETT have been lobbying actively, focusing on political parties, the Federal government, the German states, and the legislature. No clear way out of a messy situation is readily apparent. In general, legislators are eager to increase gRETT revenue for the German states.

On the other hand, the real estate industry is lobbying against change. However, it seems unlikely that this gRETT reform can be stopped as the intention to raise the gRETT revenue is backed by the story of so-called fair taxation. The supporters of this gRETT reform point out that ordinary citizens cannot use advantageous share deals when buying a family home. For that reason, they are subject to gRETT, while real estate developers, companies, and wealthy individuals who use share deals can avoid paying gRETT.

It is to be expected that the gRETT Act shall become even more complex and less predictable. Alternatively, it might be worth simplifying the law and reducing the gRETT rates significantly instead. Not long ago, the gRETT rate was 3.5% in all German states. Now, each state is free to set its own gRETT rate. Consequently, the gRETT rates vary between 3.5% in Bavaria and Saxony and 6.5% in other German states. The higher the gRETT rates are, the more attractive share deals become. Regrettably, this approach has not gained traction in political discussions.

Prognostication

At the end of the day, the gRETT reform is not about fairness but only about increasing the gRETT revenue for the German states in times of already well-funded public budgets. From a share deal perspective, it is likely that the gRETT Act will be revised to link the tax to transfers of commercial value of real estate located in Germany. Under this approach, share deals will become more often subject to gRETT if an R.E.H.P. or an R.E.H.C. is involved.

Structuring real estate acquisitions by way of a share deal has become much more difficult in recent years as a result of decisions made by the German tax authorities. Even though the Draft Bill was withdrawn, there is no political will to retain the status quo. The withdrawn Draft Bill will be reworked by June 2020 and will likely provide lower transfer thresholds for the imposition of tax and longer holding periods to be met in order to escape aggregation of transfers. With the likelihood of new legislative proposals an almost forgone conclusion, the lobbying activity has focused on the adoption of a set of grandfathering rules for existing ownership and structures.

Although the gRETT reform was originally intended to focus on real estate developers and big real estate investors with high-volume real estate transactions, the anticipated gRETT reform will hit also ordinary companies and partnerships that own real estate used as a business asset. These ordinary companies and partnerships face an increased risk of an additional gRETT burden whenever a reorganization occurs regarding global structures above an R.E.H.C. or an R.E.H.P.

"Ordinary companies and partnerships face an increased risk of an additional gRETT burden whenever a reorganization occurs regarding global structures above an R.E.H.C. or an R.E.H.P."

Existing real estate investment structures should be assessed to confirm their alignment with the new trend set out in the current decrees of the German Federal Ministry of Finance and in the new draft bill expected in 2020.

Monitoring of Ownership

Group structures should be checked for effectiveness in light of anticipated revisions to the gRETT rules. Groups with operations in Germany may wish to consider the establishment of a single real estate company that should own all German real estate used within the group. It would provide facilities to group members and would not be affected by future internal reorganizations.

Real estate investments done by way of a share deal, which were finalized by end of 2019, are still subject to the currently applicable gRETT rules.

Existing call options and put options with respect to a direct or indirect participation in an R.E.H.P. should be reviewed to determine whether measures should be taken to adapt to the new gRETT interpretation found in the Decree. Similarly, existing call options and put options covering shares held directly or indirectly in an R.E.H.C. should be reviewed to determine the effect of likely new gRETT legislation on exercise.

If a direct or indirect participation of less than 90% is held in an R.E.H.C. or an R.E.H.P., it might be worth considering an increase of this participation so that it will exceed the 90% threshold – but not the 95% threshold – while the current gRETT rules are still in effect. This should be done only with the understanding that a retroactive effective date is not off the table.

The intended reduction of the 95% threshold to 90% or less will mean that an R.E.H.P. and an R.E.H.C. with a large number of direct and indirect partners or shareholders will need to monitor changes in the ownership chain of each of their members closely. Those changes may trigger gRETT imposed on the R.E.H.P. and R.E.H.C.

A stock exchange proviso in the new draft bill might help listed companies. However, such a proviso would not help unlisted companies or partnerships that are either an R.E.H.C. or R.E.H.P., or directly or indirectly hold shares in an R.E.H.C. or interests in an R.E.H.P.