S&K

Introduction to German tax optimized inbound real estate transactions

Despite the euro crisis, Germany has remained economically stable over the last three years. This resulted in an outperformed real estate investment market starting at the end of 2013.

Although the boom years of 2005-2007 are not back, 2014 and 2016 are seen as a period in which the growing market in Europe on real estate deals and real estate investment opportunities are further attractive.

This booklet guide has been prepared by tax, corporate and real estate lawyers. I would like to thank Alexander Bellheim, Elie Kaufman and Marcel Schuster for their support.

The pocket guide 2018 focuses mainly on tax issues arising in acquisition and sale structures and provides practical advice to deal with such obstacles.

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Content

1. Acquisition structures

1.1 Investment in German real property directly

When acquiring real estate directly in Germany, transfer taxes, in particular VAT and real estate transfer tax ("RETT"), should be considered as additional purchase price components.

1.1.1 Legal steps

From a legal perspective, a typical buyer scenario consists of the following steps:

a. Due diligence

Prior to the acquisition of real property, a due diligence is conducted in almost all cases, dealing generally with legal and economic situation of the property (e.g. assessment on legal title, encumbrances on the property, lease agreements and rental income) as well as technical aspects (e.g. condition of the property, required capital expenses). The due diligence regularly also covers environmental aspects, whereas the level of such environmental due diligence may vary depending on the type of property and may reach from obtaining of confirmations that the property is not registered in the register on contaminations (*Altlasten*) to the conduct of examinations and tests on site such as drilling of the soil, for example in industrial properties.

In certain cases the parties agree on an exclusivity period for the time of the due diligence and negotiations. It is also not unusual that parties agree on a non-disclosure agreement in this context.

b. Sale and transfer agreement

In case of positive results of due diligence and economic agreement the parties enter into a sale and transfer agreement. The agreement has to be notarized in front of a German notary and generally addresses the following main topics:

- Agreement on the sale and transfer of the property;
- Payment of the purchase price is subject to fulfilment of certain conditions precedent which are typically:

  - Obtaining of any public authorization or waiver of any pre-emption right (*Vorkaufsrecht*) of public authorities in relation to the property;

  - Registration of a priority notice (*Vormerkung*) for the benefit of the purchaser in the land register of the property, which shall secure the rank of purchaser's right to acquire the property until formal transfer of ownership occurs.

  - As a case may be deletion of existing third party rights encumbering the property, such as land charges (*Grundschulden*) or mortgages (*Hypotheken*) for the benefit of banks (see also below "*c. Financing*").

- Transfer of possession: following payment of the purchase price possession of the property is generally transferred to the purchaser. From this point the purchaser carries all risks and obligations and is entitled to all rights and benefits generated from the property.

- Warranties given by the seller on the legal title to the property and to a limited extent on the condition of the property.

- Liability: In agreements regarding existing properties it is common that the liability of seller is limited to a vast extent.

- Costs: It is market standard that costs and taxes arising from the sale of the property such as notarial costs, real estate transfer tax and registration costs are paid by the purchaser.

c. Financing

If the acquisition of the property is financed by a bank or credit institution, such lender will require that a security is registered on the property prior to disbursement of the funds, generally a prior ranking land charge (*Grundschuld*). The registration of the land charge prior to the transfer of ownership requires the agreement and participation of the seller. The sale and transfer agreement will generally provide that the seller agrees to the registration of such security instrument under the condition that the funds may be used for payment of the purchase price only and, as the case may be, are to be paid directly to the seller.

In refinancing scenarios in which the original financing of the seller has to be repaid and the land charge registered for the seller's banks are to be deleted, a payment and completion mechanism via a notarial trust arrangement between seller, purchaser, their respective banks and the notary as neutral party is often applied in which payments and exchange of documentation are made via the notary.

d. Transfer of ownership

In a classical asset sale scenario, the ownership of the property is formally transferred only upon registration of the purchaser as new owner in the land register. The registration is subject to payment of real estate transfer tax by the purchaser. The registration process may take a few months.

1.1.2 Tax issues

a. Real estate transfer tax

The acquisition of German real estate property is subject to real estate transfer tax ("RETT" or in German *Grunderwerbsteuer*). RETT is imposed on the agreed consideration (usually purchase price) at a rate between 3.5% and 6.5%. The rate depends on the Federal State (*Bundesland*) in which the real property is situated (c.f. overview in the Appendix).

It is usually agreed between seller and buyer in the underlying property purchase agreement that RETT shall be borne by the purchaser. Accordingly the tax authorities usually submit the RETT assessment to the buyer. The RETT assessment note is issued by the local tax office competent for the region where the property is located. In most cases, the tax base for RETT assessment purposes is the purchase price.

Practical advice

Sometimes, a buyer wishes to acquire undeveloped land in order to commission a construction company to erect a building (for example a shopping mall) afterwards. If there is a legal or factual connection between the property purchase agreement and the construction contract, the tax base for RETT assessment purposes might be the entire consideration paid for acquiring the undeveloped land and for erecting the building afterwards.

In order to have a sound liquidity plan, a project developer acquiring undeveloped land should analyse beforehand whether the future consideration to be paid for the erection of a building triggers additional RETT.

b. Value Added Tax

Generally, the disposal of assets levies VAT. The acquisition of a business includes the transfer of many assets (e.g. commodities, rights and allowances). To simplify the taxation of acquisitions and protect the companies from a high VATable debt, the transfer of a going concern (*Geschäftsveräußerung im Ganzen*) is not subject to VAT. In this case it is required that the sold assets are available to the buyer for long-term use after the acquisition. The long-term continuation of the business must be ensured. The purchaser replaces the seller after the transfer.

Please note that this also applies for the acquisition of rented property.

Practical advice

Concerning the transfer of real estate, the following clause should ensure the VAT position:

> "The purchase price is meant to be a net amount that does not include any VAT. The Seller and the Purchaser unanimously assume that the sale and transfer of the Properties under the Agreement qualifies as a non-taxable transfer of a business as a going concern within the meaning of Sec. 1 para 1a German Value Added Tax Act (*Umsatzsteuergesetz* – "UStG") which is not subject to VAT. The Parties will disclose the contractual stipulation as well as any further information required to determine the VAT treatment to their respective competent Tax authority within the VAT declaration period of the execution of this Agreement."

c. Amortization

While any building is subject to straight-line depreciation, land cannot be depreciated on an ongoing basis.

The basis for the annual depreciation (*Absetzung für Abnutzung*) of buildings is the acquisition costs of the building. The costs for acquiring the land are not taken into consideration.

Usually the depreciation rates are about 2% to 3% (please see below under section 2.1.6).

1.2 Investment in German real estate owning partnerships

1.2.1 Legal steps

If the investment shall be made through the acquisition of interest in a limited partnership (*Kommanditgesellschaft*) which owns German real estate, the following aspects are to be considered:

- The legal due diligence will, in addition to the situation of the property, deal with the partnership owning the property, in particular whether the interests to be acquired are encumbered with third party rights and and the financial situation of the partnership.
- Shareholders of partnership consist of at least one general partner (*Komplementär*) and one limited partner (*Kommanditist*).
- Agreements on the sale and transfer of limited partnership interest (*Kommanditanteil*) do not require notarization under German law in principle. If the general partner is a limited liability company (*GmbH*) and in addition to the partnership interest also the shares in the general partner shall be sold (which requires notarization, see below 1.3.1) notarization in relation to the sale of the limited partnership interest may under certain circumstances also become necessary.
- Legal title to the property remains unchanged at the level of the partnership. Consequently, the agreement will not provide for a condition precedent such as the registration of a priority notice or waiver of pre-emption rights.

1.2.2 Tax issues

German partnerships are transparent for income tax purposes. In general, income tax / corporate income tax is triggered on the level of each partner. However, for trade tax purposes the partnership itself is subject to taxation.

a. GmbH & Co. KG

A commonly used partnership in Germany is the *GmbH & Co. KG*. This legal form combines the advantages of partnerships with the limited liability of corporations. In a GmbH & Co. KG structure, a German limited liability corporation (*GmbH)* is the only general partner (*Komplementär*). The liability of the other partners (*Kommanditisten)* is limited to the amount of their respective capital contribution.

To profit from the benefits of a GmbH & Co. KG from a tax perspective, certain principles have to be observed. The GmbH & Co. KG is usually subject to trade tax, if it remains a commercial business or deemed to conduct commercial businesses. To avoid a commercial qualification, beside the general partner, a limited partner needs to be appointed as manager of the partnership. This must be established in the articles of association. Further it is required that the partnership only is involved in passive asset management activities or administering property.

b. Real estate transfer tax

The acquisition of interest in a partnership owning German real estate is subject to RETT if a buyer acquires interest of at least 95% in such partnership within a period of five years. Even an acquisition of less than 95% of interest in a real estate owning partnership triggers RETT provided that together with other partnership interest that has been transferred within the last five years the 95%-threshold to new partners is met or exceeded.

When acquiring interest in a German real estate owning partnership, the tax basis is not taken from the purchase price for the acquisition of interest (or a portion of it). Instead, a special valuation procedure is applicable. This procedure contains a simplified discounted cash flow model which also takes the age of the building into account. This valuation procedure usually leads to a so called requirement value (*Bedarfswert*) between 60% and 80% of the market value of the German real property.

Because of the difference between the market value and the requirement value of real property, the German Federal Tax Court has asked the German Constitutional Court to decide on the constitutionality of the aforementioned valuation procedure. As a consequence, assessments of the requirement value of German real property are usually issues together with a notice of provisional status (*Vorläufigkeitsvermerk*).

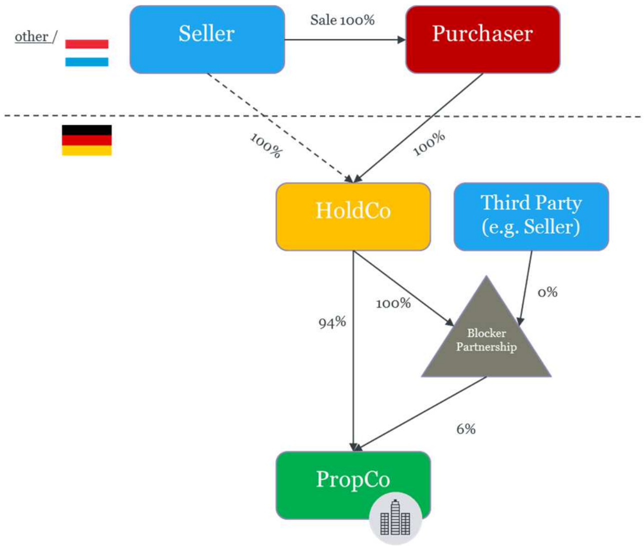
RETT planning

In general, the actual amount of RETT to be paid in the course of a transfer of real estate or interest in a real estate owning partnership is not at the discretion of the parties involved. Any measures taken by the parties to artificially minimise the tax base for RETT purposes (e.g. the purchase price in the purchase agreement is lower than the one actually paid) will be disregarded by the German tax authorities.

Anti-RETT-blocker provision

Since 7 June 2013 a new provision has been in effect to prevent so called RETT-blocker structures. Prior to that date, RETT-blocker structures were common practice. RETT could be avoided by interposing a partnership holding more than 5% of the shares in a property owning company for more than five years.

The following example illustrates a common RETT-blocker structure used prior to the change of law:



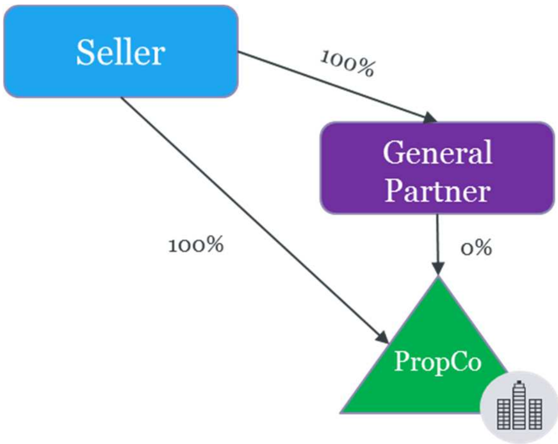
The avoidance of RETT by using such structure is no longer possible. Pursuant to the new anti-RETT-blocker provision, an economic substance-over-form approach applies: Every acquisition is subject to RETT if after an acquisition of participation rights a legal entity holds directly or indirectly an economic ownership of at least 95% of the interest/shares in a real estate owning company.

94/6 RETT-blocker model

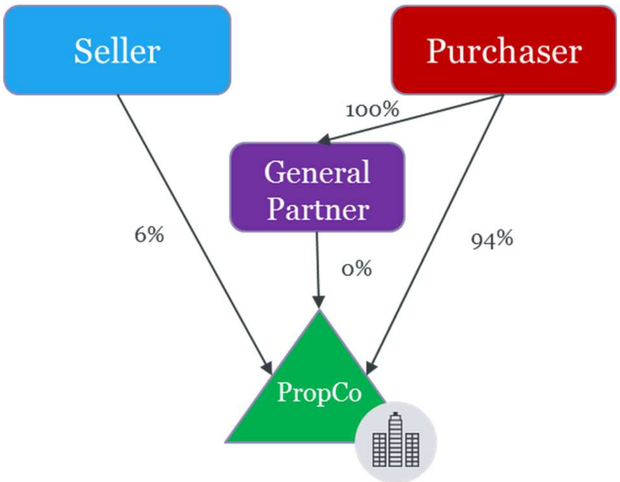
An alternative and (still) suitable way to avoid RETT in partnership structures is the so called 94/6-model which works in the following way: The purchaser acquires only 94% of the interest in a partnership owning real estate in Germany while the seller continues to hold the remaining interest of 6%.

In this scenario no RETT is triggered since the 95% threshold is not reached or exceeded as illustrated below:

Before the acquisition:



After the acquisition:



Economic Ownership

It is important to note a decision of the German Federal Tax Court of 9 July 2014 which refers to indirect transfer of interest in a real estate owning partnership.

In the case decided by the Court, the seller transferred 94.4% of interest in a real estate owning partnership to a new partner and continued to hold the remaining interest of 5.6%. Further, the seller and the buyer amongst others agreed that the buyer has the right to acquire the remaining 5.6%-interest for a fixed price. The right to receive profits from the 5.6%-interest was also transferred to the buyer. According to the Federal Tax Court, the economic ownership of the remaining interest of 5.6% in the partnership was transferred to the buyer. Thus, from an economic perspective, the 95%-threshold was exceeded since the buyer acquired directly 94.4% of interest in the real estate owning partnership and indirectly (economically) the remaining interest of 5.6%. Since the 95%-threshold was exceeded, RETT was triggered in the aforementioned case.

Practical advice

With regard to partnerships, it is not sufficient to merely look at the civil law holding structure anymore. In the future, an economic substance-over-form approach should be considered as well. It should be avoided that the seller that keeps a small percentage of interest (i.e. at least more than 5%) transfers the right to receive profits to the buyer and/or grants an irrevocable option to the buyer to acquire the remaining 5.6%-interest for a fixed price. Otherwise, RETT might be triggered.

1.3 Investment in German real estate owning corporations

A potential buyer could also invest in a corporation that has title to German real estate. In this case, the corporation (e.g. a German *GmbH*) would be subject to tax in Germany since it is not transparent for tax purposes.

1.3.1 Legal steps

In case the investment occurs through the acquisition of shares in German corporations, typically by limited liability companies (*GmbH*), the following aspects shall be considered in addition to the aspects of a classical asset acquisition:

- Similar to limited partnerships, the due diligence will deal also with the legal situation of the companies to be purchased.

- Share and transfer agreements regarding the shares in GmbH's require notarization in front of a German notary.

- The ownership of the property remains unchanged with the company. The change of shareholding at the level of the company occurs immediately upon conclusion of the notarized assignment (*Abtretung*) in the shares sale and transfer agreement. The new shareholders of the GmbH will be registered in the commercial register. The registration is compulsory but not a condition precedent for the acquisition of legal title to the shares.

- In case of the financing of the acquisition, banks will generally require, besides a land charge on the property, additional security such as pledges over shares in the company (*Anteilsverpfändung*) as well as pledges over bank accounts (*Kontoverpfändungen*) and the security assignment and transfer of claims and movable assets (*Sicherungsabtretung und Sicherungsübereignungen*).

1.3.2 Tax issues

In general, an acquisition of at least 95% of the shares in a corporation owning German real estate is subject to RETT. Further, the acquisition of any percentage of shares in a corporation triggers RETT if thereby at least 95% of the shares are combined in one hand (e.g. a shareholder already holding 94% of shares in a reals estate owning corporation acquires additional shares of 2%).

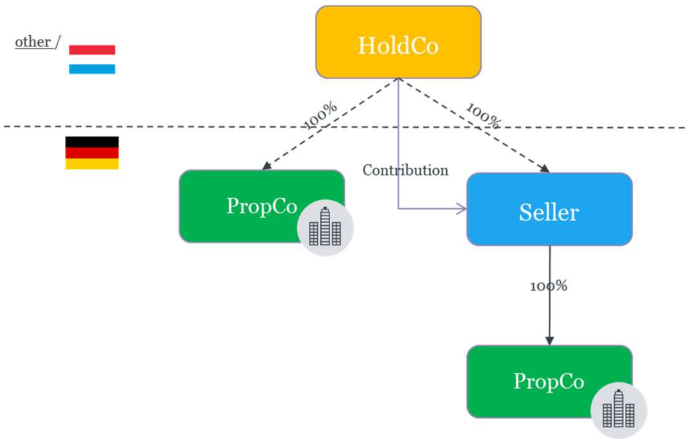
Concerning the tax base, please see above at 1.2.2.b. The applicable RETT rates depend on the location of the real estate and are specified in the Appendix.

Intra-group-privilege

Pursuant to the group exemption provision, no RETT is levied in case of specific group-internal reorganization measures (e.g. mergers, spin-offs, split-ups, change of legal form) if certain additional conditions are met.

According to the new regulation, the scope of the group exemption provision also includes contributions as well as other transactions on the basis of the articles of association of a corporation. The provision is first applicable to acquisitions that have been transacted after 6 June 2013.

The following chart illustrates the new scope of the intra-group privilege:



In the example above, HoldCo contributes its shares in a real estate owning corporation ("ProCo") into its Subsidiary. Before the contribution, HoldCo held all shares in PropCo. After the contribution, the Subsidiary is the sole shareholder of PropCo.

In the past, such contribution would have been subject to German RETT. Under the intragroup privilege, RETT is no longer triggered due to the extended scope of the new law.

Practical advice

If it is intended to change the intra-group shareholding structure, it should always be considered whether the target shareholding structure can be implemented by a reorganization measure that is within the scope of the intra-group privilege.

In the example above, RETT would be triggered if HoldCo sold all of its shares in PropCo to its Subsidiary. Thus, the above example also illustrates how RETT can be avoided by making a contribution instead of selling the shares in PropCo.

1.4 Investment through European holding entities

Some investors choose to establish a European holding entity in order to manage their European and German based real estate companies. Traditionally, Luxembourg has been a popular jurisdiction for establishing such holding company due to its favourable double tax treaty protections.

In the event an entity established under the laws of another jurisdiction directly or indirectly acquires at least 95% of a German real estate owning company, RETT is triggered. It does not matter whether the entity acquiring the shares is situated in Germany or in another jurisdiction.

Further, according to the anti-treaty shopping rules it is important that certain significant substance requirements have to be met for foreign entities to benefit from withholding tax reductions and exemptions under an applicable Double Taxation Treaty or the EU-Parent Subsidiary Directive when repatriating profits from a real estate owning German company to its foreign shareholder. In order to be entitled to such tax reliefs, certain requirements have to be met:

- Relevant economic reasons for the interposition of the foreign entity must exist.
- Engagements in commercial transactions through a business organization appropriate to the business purpose.

2. Ownership in real estate

2.1 Ongoing taxation

2.1.1 Income tax for individual buyers

Foreign investors are subject to non-resident taxation (*beschränkte Steuerpflicht*) in Germany with respect to all of its rental income and capital gains resulting from German real estate investments if no treaty relief is available.

a. Rental income

The rental income resulting from German real estate is – for individual investors – subject to German income tax at a progressive rate from a minimum of 15% on income exceeding € 8,355 to a top rate of 45% for income exceeding € 250,731. A 5.5% solidarity surcharge is taxed on personal income and, where applicable, church tax at a rate of 8% or 9% of the income tax.

The same applies for income concerning shares on a property holding partnership.

Determination of taxable income

The taxable income is determined for individuals by cash accounting. Non-commercial partnerships are transparent and determine their taxable income the same way. Only commercial partnerships and corporations need an accrual basis accounting (*Betriebsvermögensvergleich*).

b. International tax aspects

Pursuant to Article 6 of the OECD Model Treaty, earnings from renting property are attributed to the country where the property is located (*Belegenheitsprinzip*). All German double taxation treaties entered into in the past follow this standard.

Thus, property located in Germany applies to Germany for tax purposes.

2.1.2 Corporate income tax for corporate buyers

Corporate buyers are subject to limited tax liability in Germany with respect to all of his rental income and capital gains resulting from German real estate investments with no treaty relief available.

Rental income

The rental income resulting from German real estate is subject to German corporate tax at the flat rate of 15% plus solidarity surcharge in the amount of 5.5% levied on the corporate income tax assessed. The overall tax rate amount therefore is 15.825%. The tax for rental income is calculated on basis of rental income received in excess of expenses and costs attributable to that income (including interest payments). The income is generally calculated on a cash basis ("*Zufluss-/Abflussprinzip*") and the corporate investor is obliged to file a tax return in Germany.

The same applies concerning shares on a partnership holding real estate if the limited partner is a corporate entity.

2.1.3 Trade tax

Partnership level

Although a German partnership is transparent for income or corporate tax purposes, it could be subject to trade tax provided that the partnership carries out a trade business (in Germany). Since the purpose of the partnership is to acquire real property, trade tax liability at the level of the partnership would only occur if it qualified as a commercial partnership (i.e. if the general partner is a corporation and the sole managing director of the partnership) or if the partnership trades with real estate (frequent acquisition and disposals). In order to qualify as non-commercial, the partnership must not pursue commercial or trade activities but only engage in administering property (*Vermögensverwaltung*) such as administering real estate in Germany. To avoid the classification as a deemed commercial partnership at least one (corporate or individual) limited partner of a partnership needs to be appointed as manager of the partnership in addition to the general partner.

Leasing could also be qualified as business income if the landlord performs significant special additional services alongside with the mere letting of the property.

Trade tax amounts to approximately 14% depending on the applicable trade tax rate of the municipality where the partnership is domiciled.

In general, the trade tax base equals the tax base for income tax purposes. However, there are certain add-back and deduction rules which have to be taken into account when calculating the trade tax base.

25% of all interest would be added back, as would 25% of the finance charge component of lease, rental and license payments. The financing charge component in determined on a lump-sum basis (i.e. 25% of payments for moveable property and 50% of payments for real estate) is regarded as finance charge component.

Please note that under the German Trade Tax Act certain legally authorised activities benefit from an extended trade tax exemption. The distinction between profit and impermissible income corresponds with the distinction between passive asset management and active commercial management. A company engaging exclusively in the management of its own real property can enjoy the trade tax exemption for income derived from the real estate management (i.e. rental income). In order to ensure the extended trade tax exemption, the company should avoid a frequent change in tenant and certain other services (e.g. cleaning and security services). To assure a non-commercial trade of property, it is important to avoid buying and selling three units of properties within a period of five years (*Drei-Objekt-Grenze*).

Foreign corporation level

Please note that a foreign corporation is only subject to trade tax if it maintains a permanent establishment (*Betriebsstätte*) in Germany. A permanent establishment is any fixed place of business which generally gives rise to income or value added tax liability in a particular jurisdiction.

To avoid real estate tax it is important to minimise management activities. Also relevant can be further services from the lessor through his own employees (i.e. caretaker services).

The Federal Fiscal Court has classified in the past that renting real property in Germany would generally not create a permanent establishment.

2.1.4 Real estate tax (Grundsteuer)

Real estate tax (*Grundsteuer*) is levied for each calendar year on real property. Real estate tax is imposed on a specific tax value (*Einheitswert*). This tax value is regularly about 20% to 50% of the market value of the real estate. The actual real estate tax amount depends on the multiplier (*Hebesatz*) as determined by the municipality where the real property is located. Real estate tax is deductible as a business expense.

The taxable object of Real estate tax is real estate (e.g. land and buildings). It is computed by the assessed value multiplied by the basic federal rate. This result is multiplied with the municipal percentage.

2.1.5 Value Added Tax

In general, German Value Added Tax (VAT) is imposed on delivers and services at a general tax rate of 19%, while the reduced rate stands at 7% only applying to certain provisions.

Turnover from rental activities is exempt from VAT. But there is a possibility to choose that rental turnover is included in the VAT regime. Condition is that the lessor is regarded as an entrepreneur and uses the leased property for a fully taxable business. The corporate investor can opt to treat the rental income as triggered by the VAT regime, provided that recipient is an enterprise who uses the property for trading purposes which are not excluded from input tax relief (*Vorsteuer*).

It is important to mention that the acquisition of real estate is also tax-exempt if it is qualified as a transfer of a going concern (*see above*). As a consequence, the purchaser will be considered, as the legal successor of the vendor when it comes to the obligation to adjust formerly claimed input-VAT pursuant to Sec. 15a German Value Added Tax Act. According to this provision, input-VAT adjustments have to be made with respect to input-VAT claimed in connection with real estate provided that the factual circumstances relevant for the input-tax originally claimed will have changed within a period of ten years after the expenses had incurred. An adjustment of input-VAT is required if the real estate (or part of real estate), the expenses were invested in, is not rented out anymore at all or is not rented out to the former extent in a VAT-taxable way.

2.1.6 Deductibility of expenses

The investor (individual or corporate) can deduct certain expenses on the basis that they incurred in relation to the rental income or capital gains.

Now the deductibility of expenses shall be briefly described. Please note that this description is not a comprehensive list of all deductible business expenses but is limited to examples of typical costs.

a. Interest payments

Interest payments made by an investor are only deductible on condition that they are economically related to rental income or capital gains. In general, a loan granted in order to finance the acquisition fulfils this condition. However, the earning stripping rules have to be observed if the interest expenses exceed the threshold of EUR 3 million per year.

b. Tax depreciation

Costs for the erection of a building can be depreciated over 50 years (i.e. at annual rate between 2% and 3%). This depreciation rate is standardized and the tax payer cannot claim higher depreciation even if he can bring evidence that the property's technical lifetime is shorter; extraordinary depreciations reflecting extraordinary events (e.g. partial destructions) are possible. Please note that depreciation does not apply to land, as opposed to buildings. Therefore, the acquisition price for the property has to be divided between land and building.

c. Net operating losses

Net operating losses ("NOLs") can be carried forward an unlimited period of time. However, the use of NOLs is subject to the "minimum taxation". According to the minimum taxation rule NOLs can be offset against the profit up to an amount of EUR 1 million without any limitation. NOLs exceeding this amount could only be used in the amount of 60% of the remaining profit.

Germany has very strict change-of-control rules. NOLs forfeit in their entirety if directly or indirectly more than 50% of the shares in a corporation within five years are transferred. In case more than 25% but less than 50% of the shares in a corporation having NOLs are transferred the NOLs forfeit in the percentage of the shares transferred.

2.2 Repatriation of profits

2.2.1 General tax aspects

As described above, a corporation is not transparent for tax purposes. As a consequence, the profits remain in the company. Repatriation is possible if the German entity is distributing dividends to the shareholder. These dividends are in general subject to German withholding taxes in the amount of 26.375%.

2.2.2 International tax aspects

Under some circumstances it is possible to avoid or at least mitigate such withholding taxes.

a. EU Parent Subsidiary Directive

The EU Parent Subsidiary Directive provides that no withholding tax will be triggered if the parent company obtaining dividend payment is a corporation located within the EU holding at least 10% of the shares of the holding corporation.

b. Double taxation treaties

Investors benefiting from treaty protection may benefit from withholding taxes relief under applicable tax treaties. Depending on the facts of the case, three types of reductions concerning withholding tax are available. Generally, German withholding tax on dividend payments to US-shareholders shall not exceed 15%. If the US-shareholder is a company that directly owns at least 10% of the voting stock of the German entity paying the dividend. It is even possible to reduce the withholding tax to 0%. For instance, if a US-shareholder holds at least 80% of the German corporation for at least 12 months and provided that specific other limitations on benefits-tests in terms of the Treaty are met.

Please note that taxpayers must apply for the respective withholding exemption at the German Federal Tax Office (*Bundeszentralamt für Steuern*). Alternatively, if the dividend distribution has occurred already, taxpayer can apply for a (full or partial) refund of withholding tax with the same authority.

c. Cash trap

Cash trap is a process describing that every net cash flow is directly distributed into a shareholder account. The exceeding cash is only reduced by operating costs and debt service.

2.3 Tax aspects of financing real estate investments

In most cases, cross-border real estate investment structures are predominantly debt financed.

2.3.1 Interest barrier rule

German tax law provides for a limitation on the deductibility of interest expenses for German or foreign buyers (*Zinsschranke*).

Under the interest barrier rule, interest expenses are tax-deductible provided that the net interest expense (interest expenses minus interest income) does not exceed 30% of the taxable EBITDA ("30% test"). EBITDA is defined as taxable income before application of tax deductions for depreciation and amortization, plus interest expense less interest earnings.

Generally, the 30% test is applied to each legal entity. That means each subsidiary has to be tested whether the interest expenses exceed 30% of the taxable EBITDA. There are three exceptions under which the interest barrier rules are not applicable (i.e. interest expenses are fully deductible) to German or foreign investors with domestic real estate activities:

De minimis tax threshold

Under this exception the interest barrier rule is not applicable to the extent that the annual net interest expenses (per taxable entity) amount to less than € 3 m. If the threshold is exceeded, the full interest expenses fall under the interest barrier rules.

Non-group entities

If the borrower and potential buyer of a debt financing is not a member of a consolidated group were also creditor is a member of the interest barrier, the provision is, as a rule, not applicable provided that there is no "harmful debt financing" as described below. The borrowing company is part of a consolidated group if it is included in that group's consolidated financial statements prepared according to IFRS, local GAAP or US GAAP.

Escape clause

An escape clause is applicable if the "equity ratio" of the tested borrower is not less than the "equity ratio" of the consolidated group (2% tolerance) provided that none of the entities in the consolidated group is "debt financed harmfully" in the meaning of the interest barrier rules. The equity ratio is the ratio of equity (calculated under the applicable GAAP) to its balance sheet total. Certain adjustments, such as elimination of interests held in other group companies, have to be considered in determining the equity percentage of the company has to be considered at borrower's level. Generally, the determination of the equity ratio is based on the financial statements provided under IFRS or, in default of such information, under local GAAP.

The escape-clause is only applicable if the borrowing company can demonstrate that there is no "harmful debt financing" for German tax purposes. This can be assumed if no more than 10% of a group company's net interest expenses (i.e. not only the interest expense of the German tax payer) is paid to a related party outside of the consoli-dated group.

Practical advice

Certain structures allow avoiding or at least mitigating the non-deductibility of business expenses, in particular certain structures exist with focus on German real estate investments:

- Interest payments can be allocated to entities which are not subject to the German interest barrier rule. A German company may be financed by equity injections of a foreign group company. The company abroad is not subject to the German interest barrier rule. Thus the financing of this foreign company by credits abroad (i.e. in order to make equity payments) should be tax optimized. Further tax optimized structures can apply between group companies. Bond loans may be subscribed or interest-bearing loans granted to affiliated foreign companies.

- Injection of supplemental equity through a capital increase and a profit retention may improve the equity ratio of the whole group or the German entity. This offers the possibility to benefit from the escape clause. In this context mezzanine financing instruments and restructuring of shareholder loans into equity should also be contemplated.

- A tax optimized utilisation of the taxable EBITDA can be achieved by restructuring fixed interest loans in variable interest-bearing loans. Further possibilities are the splitting of operating units and the spin-off of business activities. This allows a multiple utilisation of the German interest barrier rule threshold.

2.3.2 Trade tax add-backs / deductions

Generally, the profits of the real estate owning entity are subject to trade tax. The tax base may be different from tax base for corporate income tax due specific add-backs and deductions as set out in the German Trade Tax Act (e.g. add-backs of interests, rent and leasing expenses). Interest payments exceeding a tax free amount of € 100,000 are not fully deductible for trade tax purposes.

Under specific circumstances it is possible to deduct or avoid trade taxes completely. The extended deduction concerns entities that only hold and administrate real estate and is only granted upon application. Furthermore, it is not relevant which kind of entity is holding the property, thus partnerships and corporations can benefit from this extended trade tax deduction (*erweiterte Gewerbesteuerkürzung*). It should be considered that other activities may infect the whole entity for tax trade tax purposes. There are just a few activities which are harmless in this concerning.

3. Disposal of German real estate

3.1 General tax aspects

The foreign seller (individual or corporate investor) of real estate directly is generally subject of the non-resident taxation in Germany with respect to all profits concerning the disposal (capital gains).

3.2 Tax on capital gains

3.2.1 Selling German real property directly

Investors selling property in Germany directly are subject to income tax and under some circumstances subject to trade tax. In case of a period of at least ten years between the acquisition and the disposal no income tax will be triggered (*privates Veräußerungsgeschäft*).

If the investment is not subject to a double taxation treaty, Germany has the right to tax capital gains according to the German tax law.

3.2.2 Sale of shares in real estate owning partnerships

A sale of an interest in a real estate owning partnership is classified as a sale of real estate directly (from a tax perspective) and the capital gain resulting from this sale is subject to income tax as in Germany. As a resul,t any capital gain concerning this sale would be subject to German taxation.

3.2.3 Sale of shares in real estate owning corporations

An alternative exit scenario could be a sale of the shares in the corporation instead of a sale of the real estate by the corporation.

Under German corporate income tax is tax-exempt income of a corporation disposal by a corporate investor. Only 5% of the capital gain deemed to be non-deductible expenses. Therefore, an amount of 95% is effectively exempt for corporate income tax and trade tax purposes. The remaining 5% are taxed in an amount of overall 15,825% corporate income tax and at a rate of 7% to 17,5% with trade tax, depending on the location of the vendors business.

The disposal of shares in a corporation by an individual investor is 40% income tax-exempt. Only 60% of capital gains are subject for income tax and trade tax purposes (*Teileinkünfteverfahren*). Condition for this tax exemption is that the investor was shareholder with a minimum share of 1% during the last five years.

Double taxation treaty

In mist double taxation treaties Germany has entered into Germany provides the right to tax capital gains resulting from the sale of shares in a corporation only in the jurisdiction where the shareholder is located, unless the shares are attributable to a (German) permanent establishment of the seller. Therefore, if corporate investor could participate from such a favorable double taxation treaty and it does not maintain a permanent establishment in Germany, the sale of the corporation shares, and as a result the sale of the real property, is tax free in Germany.

Please note that Germany has concluded new double taxation treaties recently where share disposals in German real estate owning corporations are now subject to German taxation.

3.2.4 Holding structures

Benefits can be reached if the foreign holding disposes shares on a German corporation. Even if the holding is subject to limited tax liability and no exclusion by double taxation treaty is levied, German corporate income tax declares that only 5% of the capital gains are triggered, overall about 0.8%. Furthermore, without a permanent establishment of the foreign holding in Germany no trade tax will be triggered.

Please note that under some circumstances these structures to avoid corporate income tax can be qualified as abuse of taxation and corporate income tax, however, would be triggered if the interposed company has now substance.

No German taxation will be triggered if a foreign corporation (holding the German corporation) is sold.

3.3 Real estate transfer tax (RETT)

Real estate transfer tax (RETT) is triggered when the property is sold directly or if at least 95% of a partnership / corporation is sold. Further, RETT implications are described under the section on acquisition structures.

The same principles should be considered when deciding whether the sale is not subject to VAT (going concern principles) or whether the parties should opt for VAT.

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4. Appendix - Real estate transfer tax rates in Germany

State	Tax rate (*1 October 2017*)
Baden-Wurttemberg	5.0%
Bavaria	3.5%
Berlin	6.0%
Brandenburg	6.5%
Bremen	5.0%
Hamburg	4.5%
Hesse	6.0%
Mecklenburg-Western Pomerania	5.0%
Lower Saxony	5.0%
North Rhine-Westphalia	6.5%
Rhineland-Palatinate	5.0%
Saarland	6.5%
Saxony	3.5%
Saxony-Anhalt	5.0%
Schleswig-Holstein	6.5%
Thuringia	6.5%

5. Exhibit – Real Estate Investment Trusts

This exhibit deals with Real Estate Investment Trusts (REIT) on the basis of a short overview describing the relevant information. REITs are treated as a transparent investment vehicle opening real estate investments for a larger part of investors comparable to the investment in stocks.

In Germany, REITs are obligated by the German REIT Act to be organized as a joint stock corporation with corporate seat and place of management in Germany. Specific provisions admit the structure of REITs, e.g. about the volume of its minimum shares, shareholder structure.

REITs business objective is renting, leasing and capital gains realized by real estate disposals (at least 75% must be derived from real estate). According to the German REIT Act these trusts are not allowed to trade in property. Only under specific circumstances reorganizations are possible. Furthermore, at least 90% of the profits have to be distributed to the shareholders.

Tax aspects on REITs level

Under the above requirements these trusts are exempt from corporate income tax and trade tax. However, they are subject to real estate transfer tax (RETT) and real estate tax.

Tax aspects on investor's level

Profit distribution from the REIT is qualified as dividends. Thus, taxation is subject to regular taxation on shareholder level and levied by withholding tax at a rate of 25% plus 5.5% solidarity tax. The partial income regime (*Teileinkünfteverfahren*) is not applicable. The corporate shareholder is subject to corporate income tax and trade tax at an overall tax rate of approximately 30%.

Please note that no European harmonization is in place. Thus, dividends taxed at least in an amount of 15% on the REIT level are tax exempt to 60% for business shares of individual investors or 95% for corporate investors. Consequently, REITs have to show the composition of incomes in their financial statement concerning prior tax charges.

The EU Parent Subsidiary Directive does not apply for REITS as no investor can hold 10% or more of the shares (i.e. minimum threshold under the Directive cannot be met). Withholding tax are levied for foreign investors generally with a reduced rate of about 15% .