Update regarding the changes in German tax legislation which impact on the real estate industry

Germany: December 2016

In Brief

The German legislator has passed several bills changing German tax legislation, most recently on 16 December. Inter alia, the deduction of so-called 'special business expenses' will be limited and the rules for the forfeiture of losses will be relaxed subject to certain requirements.

However, the bills did not deal with German capital gains taxation on the sale of shares in a foreign resident corporation. The demand that RETT is also levied on share transfers of less than 95% is still in discussion in a working group in charge of finding possible options and a change of legislation may be discussed in 2017.

Limitation on the deduction of special business expenses

In Germany, partners of German partnerships can deduct their business expenses directly linked to the interest in the partnership, so called 'special business expenses', at the level of the partnership (e.g. interest expenses for financing the interest in the partnership).

These special business expenses are also regular business expenses at the level of the partner. In cases of non-resident partners such expenses could be treated in Germany as special business expenses as well as business expenses in the country of the non-resident partner.

To mitigate such double-dip structures the legislator passed a new rule. According to the bill such expenses can only be considered as special business expenses at the level of the partnership if the expenses are not considered as business expenses at the level of the partner, reducing its taxable income abroad.

Therefore, real estate investors that invest cross-border via partnerships into German real estate should check the tax treatment of these expenses in both relevant jurisdictions.

This regulation will be effective as of 1 January 2017.

Relaxing the loss forfeiture rules

In general, in Germany tax losses are carried forward indefinitely. However, a transfer of shares leads to a (partial) forfeiture of tax losses carried forward. The tax losses carried forward are reduced in proportion to the shares transferred where more than 25% but not more than 50% of the shares are transferred within 5 years. Where more than 50% of the shares are transferred within 5 years the tax losses carried forward are forfeited in full.

The German legislator passed a bill that offers an additional exemption from the loss forfeiture rule in case of share transfers. Under this rule, the forfeiture of tax losses carried forward and interest carried forward does not apply if the transferred entity continues to perform the same business as prior to the share transfer.

The transferred entity has to perform the same business from the period starting 3 business years prior to the share transfer until at least the date of its incorporation and none of the following events ("harmful events") must have occurred in that time period:

- The business was stopped or paused
- The business purpose has changed
- The company started an additional business
- The company has been or become a shareholder in a partnership
- The company has been or become parent to a CIT group
- Assets were transferred to the company below fair market value.

If the requirements mentioned above are fulfilled without the occurrence of any harmful events the losses will be carried forward upon application and can be utilized in future periods after the share transfer. However, these losses carried forward need to be monitored in future periods as any of the above named harmful events triggers a forfeiture of these losses carried forward.

The bill applies for share transfers taking place after 31 December 2015. But it does not apply if the business was stopped or paused before 1 January 2016.

Participation exemption for share traders

Under the current participation exemption, only 5% of the gains of a corporate investor from the sale of shares in a corporation is subject to CIT and – if applicable – TT. However, this participation exemption is not available for share traders. The term "traders" is interpreted broadly such that at present ordinary corporations can fall under this definition.

According to the new bill, this definition is to be restricted to those financial businesses in which credit institutions and financial service institutions, directly or indirectly, hold a majority interest. Ordinary real estate holding structures will therefore be excluded. This amendment clarifies that the participation exemption applies to real estate structures however where investments are only held on a short term basis.

This rule will be effective as of 1 January 2017 and applies for shareholdings acquired after 31 December 2016.

No Exit gain taxation for share deals

In accordance with a number of Double Tax Treaties ("DTT") with other jurisdictions such as Luxembourg and The Netherlands, Germany is entitled to tax gains stemming from the sale of shares in real estate companies, i.e. companies that directly or indirectly own predominantly German real estate assets. However, this right to tax the gains of non-resident shareholders is at present exercised under domestic law only, if the real estate company has either a German seat or German place of management and the shareholding of the vendor is at least 1%.

The proposal of a committee of the Federal Council (*Bundesrat*) to amend the domestic tax law such that non-resident shareholders also become subject to German Corporate Income Tax ("CIT") on gains stemming from a sale of shares, even if the real estate company disposed of has neither a German seat nor place of management (please see our Real Estate Tax Services NewsAlert No. 18/2016_Germany) was not implemented. It remains to be seen whether this rule will be implemented in future years.

RETT in share Deal scenarios

In Germany, share sales of less than 95% of the shares in real estate companies are generally not subject to real estate transfer tax.

No amendments to this rule will be implemented this year. However, a working group of the Ministries of Finance of the Federal States has started to work on draft legislation to come in the near future. One option discussed is to reduce the threshold for share sales being subject to RETT to 75%.

Our understanding is that some of the Ministries of Finance of the Federal States aim to launch draft legislation during the course of 2017.

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