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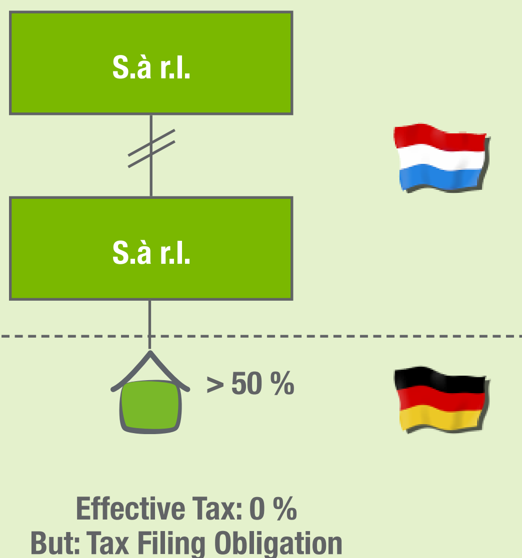
Inbound Real Estate Investments in Germany - German legislator plans tax filing obligation for capital gains from sale of shares in real estate rich companies as of 2019

July 31, 2018

On 21 June 2018 the German Federal Ministry of Finance has published the Draft Annual Tax Act 2018. If so enacted, capital gains on the sale of shares in real estate rich companies that own German properties will become subject to German tax. In particular, foreign investors are impacted by this new law.

A typical structure to invest in German real estate is to undertake the investment via Luxembourg corporations. By making use of such Luxembourg two-tier-structure, German trade tax can normally be avoided. In addition, in a share deal scenario, no German capital gains taxation applies on the capital gains generated from the sale of shares by the top-tier Luxembourg entity.

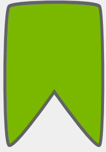


Although the double tax treaty between Germany and Luxembourg allows Germany to tax such capital gains (see **beinformed** dated 25 April 2012), under the current domestic law, such capital gains are not subject to tax in Germany, as the lower-tier company does not have its registered office or its place of management in Germany.

The Draft Annual Tax Act 2018 now broadens the scope of the German limited tax liability for non-residents by introducing a rule based on Article 13(4) of the OECD Model (2017). Accordingly, capital gains derived by a non-resident from the alienation of shares are taxable in Germany if, at any time during the 365 days preceding the alienation, these shares derived more than 50 % of their value directly or indirectly from immovable property located in Germany. The rule applies regardless of the size of the shareholding sold. From a timing perspective, the rule will apply to sales taking place after 31 December 2018 and only to the increase in value after such date.

However, the draft amendment seems to be a toothless tiger for foreign corporate investors. The Luxembourg top-tier corporate entity will benefit from the domestic German participation privilege, i.e. the capital gains from the sale of the shares in the lower-tier real estate rich company are 100 % tax-free in Germany. The 5 % add-back imposed on German corporate sellers should not apply due to recent case law (see **beinformed** dated 14 November 2017).

As a result, although the Draft Annual Tax Act 2018 sets forth such new capital gains taxation, the effective German corporate income tax in the above scenario is zero. Trade tax also does not apply to the capital gains on the sale of shares in the Luxembourg lower-tier corporate entity if the shares are not held in a German permanent establishment.



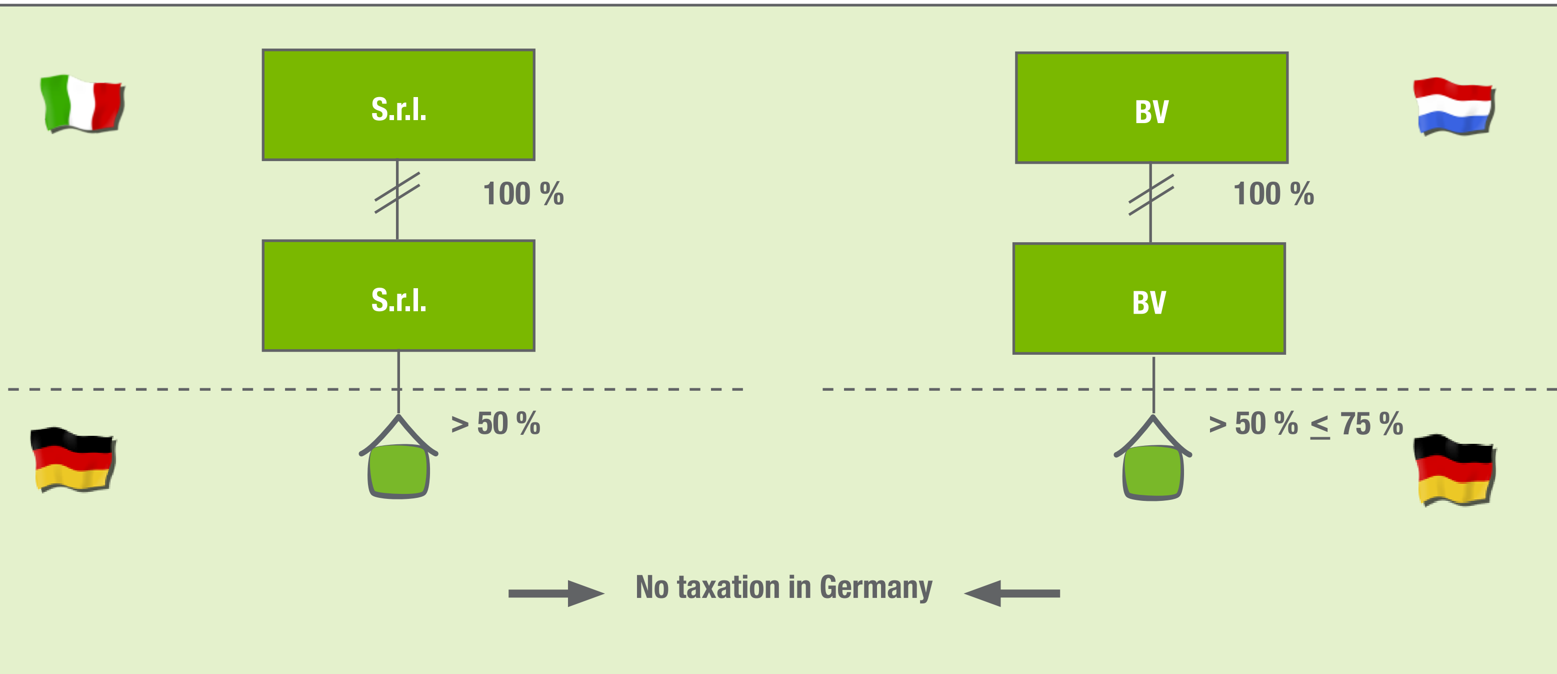
Documents to beinformed:

- Referentenentwurf (German)
- beinformed of April 25, 2012
- beinformed of January 19, 2017
- beinformed of November 14, 2017

Thus, in the end, the practical implication from the new draft law for foreign investors is that they are obliged to file a German corporate income tax return as of 2019. The tax-exemption of the capital gains for foreign corporate sellers does not release them from their filing obligation.

From time to time rumors arise whether the German domestic participation privilege will be abolished. In such a case, Germany will then tax the capital gains at a corporate income tax rate of 15 % for corporate entities if the respective double tax treaty also grants Germany the taxing right.

Germany either has double tax treaties in place which do not include a clause for real estate rich companies comparable to Article 13(4) of the OECD Model (2017) or, if they do include such a clause, such clause for real estate rich companies does not correspond to the wording of the new draft law. For example, if the above example is structured using Italian entities, under the double tax treaty between Germany and Italy, Germany does not have a taxing right as the double tax treaty does not provide for a clause for real estate rich companies comparable to Article 13(4) of the OECD Model (2017). Alternatively, if the above example is structured using Dutch entities, the double tax treaty between Germany and the Netherlands requires that more than 75 % of the real estate rich company's share value derives from real estate assets.



In both cases, Germany is not allowed to tax the capital gains under the respective double tax treaty. Such structures, however, have to be closely monitored as well. Since the Multilateral Instrument is

in place (see **beinformed** 12 January 2017), amendments to double tax treaties can be undertaken more easily and therefore more rapidly than before.

Based on the experience with the past Annual Tax Acts, it can be expected that the law will pass the German Parliament by the end of this year. Whether it will be enacted as currently drafted or will be subject to further changes has yet to be seen.

Foreign investors who are planning an exit from German inbound real estate investments should carefully watch the ongoing legislative process in Germany in order to - at least - avoid a tax filing obligation. We will keep you posted.

be in touch: Any questions? Please do not hesitate to contact us!

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