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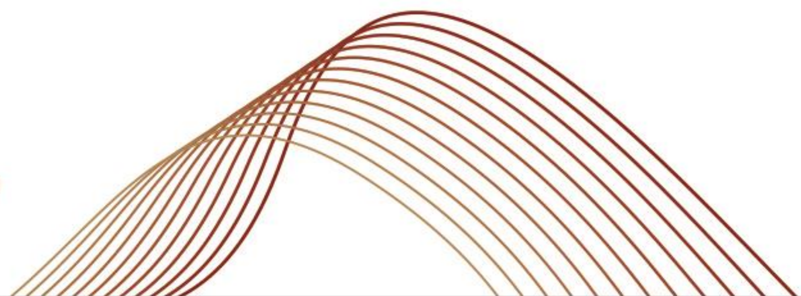

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German Real Estate Transfer Tax – Intended Cut Back of Share Deal Privilege

By Dr. Christopher Wolff, Dr. Jan Gernoth & Uwe Halbig

On 21 June 2018, the finance ministers of the German federal states discussed how to tighten German Real Estate Transfer Tax ("RETT") law.

German RETT law distinguishes between whether German real estate is acquired directly via an asset deal or indirectly via the acquisition of a company or a partnership, i.e., a share deal. An asset deal will inevitably trigger RETT (between 3.5% and 6.5% of the property value depending on the location of the sold property). However, for share deals, the existing German RETT law allows structures with underlying real estate to be acquired without triggering RETT.

Based on the information we have obtained to date (noting that this may be supplemented or amended as the proposals are finalized), the key elements of the finance ministers' proposals are:

I. Extension of ''Change of Ownership Rules'' to Companies

Currently property holding partnerships and property holding companies are treated differently. If, in a partnership, ownership of at least 95% of the partnership interests directly or indirectly changes within a period of five years (the "Cooling Period"), RETT will be triggered (the so-called "Change of Ownership Rule"). Whereas, for companies, a sale of the entire share capital in a company does not trigger RETT, provided each new shareholder owns less than 95% of the shares in the company.

It is proposed that the application of the Change of Ownership Rules will be extended to companies, i.e., that a Cooling Period will also apply to companies.

II. Extension of the Cooling Period from Five to Ten Years

Currently the Cooling Period is five years. As such, an investor often acquires real estate owned by a partnership in a RETT-efficient way by acquiring the partnership interest in two steps: firstly, the investor acquires 94.9% of the partnership interests and, following the expiry of the Cooling Period, then acquires the remainder (e.g. by executing a call option already agreed in connection with the acquisition of the first tranche of 94.9%).

It is currently proposed that this Cooling Period is extended to a ten-year period.

III. Reduction of "Equalisation-Threshold" from 95% to 90%

The underlying intention of German RETT law is to tax the acquisition of real estate — irrespective of whether the real estate is acquired directly (i.e., via an asset deal) or indirectly (i.e., via a share deal). Therefore, RETT applies where an investor acquires 100% of the shares in a real estate holding company.

In addition, the legislation provides a threshold for share deals at or above which the shareholder is treated for RETT purposes as if it owned 100% of the shares—this threshold is currently 95%. Above this threshold, the investor is obliged to pay RETT on the full tax value of the real estate, even if it indirectly owns less than 100%.

The proposal include the reduction of this threshold from 95% to 90%, in which case RETT will be triggered if at least 90% of the partnership interest in a partnership/shares in a company will be transferred within the Cooling Period.

IV. Next Steps and Risk of a Retroactive Effect of the Change

Currently, only key points of the political agreement of the finance ministers of the German federal states have been published. The ministers agreed to prepare draft legislations to implement this proposal. It is unclear how long it will take for a first draft of the proposed legislation to be published and to what extent the finance ministers' proposals, as set out above, will be included. However, there is a strong political willingness to change the rules related to the privilege of the share deal as the discrepancy of treatment of share deals compared to asset deals is perceived as unfair. Therefore, there is only a short timeframe left to review existing structures and to optimize the existing structures for the future rules:

- Generally the legislator must not amend tax laws in a manner which is disadvantageous to the taxpayer (this principle has been confirmed multiple times by the German Constitutional Court). In this regard, German jurisprudence distinguishes between amendments with "Unreal Retroactive Effect" (*Unechte Rückwirkung*) and "Real Retroactive Effect" (*Echte Rückwirkung*).

- An Unreal Retroactive Effect occurs where a change of law results in an increased tax burden for an event which is initiated prior to, but completed after the change in law. There is often an Unreal Retroactive Effect where there is a change in law relating to ongoing taxes (e.g., (corporate) income taxes, trade taxes) and such change occurs towards the end of the fiscal year. The legitimacy of each amendment to tax legislation has to be assessed on a case-by-case basis but, in principle, amendments during a fiscal year are permissible as a taxpayer's liability arises only at the end of the fiscal period and the tax payer must accept that the German legislator is entitled to amend legislation at any point during the then-current assessment period, which may impact the tax liability for the whole assessment period.

- Real Retroactive Effect means that a change in law increases a tax liability that has arisen prior to the relevant amendment. Since RETT is triggered as the acquisition of German real estate arises (e.g., the asset/share purchase agreement is signed), the tax burden is determined on the basis of the tax legislation applicable at that point in time. Therefore, if RETT legislation is amended, the changes have a Real Retroactive Effect.

Amendments with Real Retroactive Effect are permissible only in very rare circumstances. These circumstances include (i) where there is unconstitutionality of the existing law, (ii) where the change is required in order to clarify legal uncertainty (*Beseitigung einer unklare Rechtslage*), (iii) where there are overriding reasons relating to the public interest (*zwingende Gründe des Gemeinwohls*), and (iv) where there is uncertainty from a taxpayer perspective as to the continuation of the existing law. The first three exemptions are not applicable to the proposed changes to RETT legislation. We also consider that, at this early stage, the existing proposals of the finance ministers are still too vague to harm the confidence of, or create uncertainty for, the taxpayer in the continuation of the existing law. Therefore, a Real Retroactive Effect should only be possible after the draft legislation has been submitted to the parliament.

V. Outlook

The finance ministers of the federal states have asked the heads of the federal and state finance ministries to start the drafting process for the proposed legislation. We are expecting first drafts to be available (at the earliest) after the summer break of the German parliament in September 2018 and believe that it will take some time to agree to amendments which are acceptable to all parties. In the meantime, we recommend reviewing existing structures in order to ensure that these structures will be optimal for the future rules.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Frankfurt lawyers:

Dr. Jan Gernoth
49.69.907485.101
jangernoth@paulhastings.com

Dr. Christopher Wolff
49.69.907485.113
christopherwolff@paulhastings.com

Uwe Halbig
49.69.907485.105
uwehalbig@paulhastings.com

Paul Hastings LLP

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