MAYER BROWN ROWE & MAW GAEDERTZ

Taxation of Investments into German Real Estate

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1. Scope

The purpose of this memorandum is to give an overview of the tax implications associated with a foreign investor acquiring German real estate. The following description distinguishes between a direct commitment, an investment through a permanent establishment, and the investment through a German limited company (GmbH). This memorandum is based on the assumption that the foreign investor is comparable to a German corporation ("Corporate Investor"). Furthermore, if a reference is made to the provision of a double taxation treaty this reference means the OECD model tax treaty ("Double Taxation Treaty").

2. Direct investment

2.1 Corporate Income Tax

The Corporate Investor is 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.

2.1.1 Rental Income

The rental income resulting from German real estate is subject to German corporate tax at the rate of 25 percent plus solidarity surcharge in the amount of 5.5 percent levied on the corporate income tax assessed. The overall tax rate amounts therefore to 26.4 percent. 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 calculated on an actual basis ("*Zufluß-/Abflußprinzip*") and the Corporate Investor is obliged to file a tax return in Germany.

2.1.2 Capital Gains

Capital gains are also subject to German corporate income tax at the rate of 26.4 percent (including solidarity surcharge). Capital gains amount to the difference between the purchase price and the sales price, taking into account the disposal costs. The depreciation on the property (building) made in the preceding fiscal years reduces the purchase costs and thus increases the taxable capital gain.

2.1.3 Deductibility of Expenses

As mentioned above, the Corporate Investor can deduct certain expenses on the basis that they are incurred in relation to the rental income or capital gains. In the following 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 the typical costs.

2.1.3.1 Interest Payments

Interest payments made by the Corporate Investor are only deductible on condition they are economically related to rental income or the capital gains. In general, a loan granted in order to finance the acquisition fulfills this condition.

If the loan were granted by a shareholder or a related party, the German thin capitalisation rules in Section 8a German Corporate Income Tax Act (*Körperschaftsteuergesetz*) must be observed.

Loans granted by the shareholder or a related party thereto

Interest paid to a shareholder holding more than 25 percent of the equity of the investing company is not deductible as a business expense, if

- the loan granted exceeds 150 percent of the equity of the company (Safe Haven), unless the debt is granted at arm's length. No Safe Haven is available for profit participating loans;
- the interest payments to shareholders exceed Euro 250,000 per business year.

The thin capitalisation rules also apply if the loan has granted or by a related party to the shareholder: "realted party" is defined in Section 1 para. 2 of the Foreign Transaction Tax Act (*Außensteuergesetz*).

The Foreign Transaction Tax Act provides that a party is a related party if:

- a party holds a direct or indirect interest of at least 25 percent in the taxpayer or is able to exercise controlling influence on that taxpayer; or
- a third party has a substantial holding in both the party and the taxpayer or is able to exercise a controlling influence directly or indirectly over both; or
- the party or the taxpayer is in a position, when agreeing the terms of business relations, to exercise on the taxpayer or the party influence independent of such business relations or if one of them has its own interest in the realisation of income of the other party.

Loans granted by third parties

Payments made to a third party (e.g. a bank) are also subject to reclassification, if and to the extent:

- the third party could take recourse to the shareholder (or a related party thereto) of the company; and
- a so called "back-to-back" financing arrangement (or similar agreements) is in place.

Cover: Financial District, Frankfurt/Main

According to a Circular issued by the Federal Ministry of Finance ("Circular") "recourse" means legally enforceable rights of the lender against the shareholder (or a related party thereto), for instance pursuant to a guarantee or a mortgage. Even in case such a (legal) claim is in existence no reclassification of the interest payments into hidden profit distribution will occur if no back-to-back arrangement is in existence.

"Back-to-back" means that

- the shareholder (or a related party thereto) of the financed company maintains e.g. bank accounts with a financial institution; and
- the bank granting the loan could take recourse on this bank deposit.

The burden of proof is with the financed company. A conformation by the lending third party stating that no backtoback arrangement is in place will be sufficient to avoid adverse tax consequences. If these conditions are satisfied a reclassification of the interest paid by the company to third party lender will only occur to the extent the shareholder (or a related party thereto) receives interest payments on the deposits involved in the back-to-back arrangement.

Example

A foreign company acquires a German real property for 100. The annual rental payments shall amount to 15, the interest payments shall be 12, and the depreciation costs of the real property shall be 1. For the purposes of this example it is assumed that there are no other business expenses, that the foreign company does not maintain a permanent establishment in Germany (i.e. no German trade tax applies), and that no safe haven is available for the foreign company. The tax rate of the foreign company amounts to 26.4 percent.

- No thin capitalisation rules applicable: In this case the taxable income of the foreign company amounts to 2 (15 -12-1) and the actual tax burden is 0.528 (2 x 26.4 percent).
- Loan subject to thin capitalisation rules: The taxable income of the foreign company amounts to 14 (15 - 1) since no interest deduction is available. The tax burden increases to 3.696 (14 x 26.4 percent).

2.1.3.2 Subsequent Costs

The deductibility of costs arising in connection with the development or repositioning of a real property depends on whether these costs are classified as maintenance expenses or acquisition/manufacturing costs. Maintenance costs are fully deductible in the year of payment. Aquisition/Manufacturing costs have to be depreciated over the useful life of the building. In essence, the analysis has to be done on a case-by-case basis.

Acquisition of Real Property

Acquisition costs are all expenses necessary to acquire a real property (i.e. the purchase price) and to put it into business-operating condition to the extent that these costs can be separately allocated to the real property. The costs of acquisition also include incidental expenses as well as subsequent costs of acquisition. For example, real estate transfer tax, notarial fees, court fees and installation costs regularly qualify as acquisition costs.

Development/Refurbishment of Real Property

Substantial development or refurbishment measures may lead to (subsequent) manufacturing costs. Manufacturing costs are expenses arising out of goods consumed and services used in producing an asset, enlarging it or substantially improving it beyond its original setting. If a real property is substantially improved (which is regularly the case if the value in use of a building is – above the regular modernisation – significantly increased), the costs paid by the Corporate Investor will be classified as manufacturing costs. The German Income Tax Act assumes a substantial improvement if the overall modernisation expenses within a period of three years after the acquisition of a real property exceed 15 percent of the original acquisition costs (excluding VAT). In this case, the incurred costs are not immediately deductible but can be depreciated over the useful life of the building. If the development costs were not classified as (subsequent) manufacturing costs but as maintenance costs they are fully deductible upon payment. Examples for subsequent manufacturing costs are the installation of an alarm device, roller blinds or marquees. Also measures to increase the noise protection or the weather insulation of a building are regarded as subsequent manufacturing cost and must be depreciated over the lifetime of the building. In the context of these examples please note that the term "manufacturing costs" or "subsequent manufacturing costs" is not defined in the law but is based on case law and decrees issued by the Federal Ministry of Finance.

2.1.3.3 Depreciation

Costs for the erection of a building can be depreciated over 50 years (i.e. at an annual rate of 2%). This depreciation rate is standardised and the tax payer cannot claim for higher depreciation even if he can bring evidence that the property's technical lifetime is shorter. Extraordinary depreciations reflecting extraordinary events (e.g. partial destruction) 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.

2.1.3.4 Loss Carry Forward

Net operating losses ("**NOLs**") can be carried forward an unlimited period of time. However, the use of NOLs is subject to the so-called "minimum taxation". According to this minimum taxation rule set out in Section 10d German Income Tax Act (*Einkommenssteuergesetz*) NOLs can be offset against the profit up to an amount of Euro 1,000,000 without any limitation. NOLs exceeding this amount could only be used in the amount of 60 percent of the remaining profit.

Example

The interest payments by a foreign company exceed its rental income in year 01 by Euro 2,000,000. These NOLs could be carried forward by the foreign company without time limitation. In year 02 the foreign company makes a profit (before taxes) in the amount of Euro 1,500,000.

The NOLs generated in year 01 could be used as follows:

Euro 1,000,000 of the NOLs could be offset against the profits of year 02 without limitation. The remaining year 02 profit in the amount of Euro 500,000 is subject to the "minimum taxation". A further use of the NOLs is limited to 60 percent of this remaining profit, i.e. Euro 300,000. Hence, the NOLs could be offset in the total amount of Euro 1,300,000 against the year 02 profits and the foreign company is subject to taxes with the remaining profit of Euro 200,000. Any unused NOLs (i.e. Euro 700,000) could be carried forward for an unlimited period of time and be offset against future profits.

2.2 Trade Tax

No trade tax will become due as long as the Corporate Investor does not maintain a permanent establishment in Germany nor carries on a trade or business in Germany (i.e. activities which not only qualify for the administration of assets). The holding of German real estate itself does not constitute a permanent establishment (see Section 4.1.1 below).

2.3 Real Estate Transfer Tax

The acquisition of German real property is subject to real estate transfer tax. Real estate transfer tax is imposed on the agreed consideration (usually purchase price) at a rate of 3.5 percent. The German Real Estate Transfer Tax Act (*Grunderwerbsteuergesetz*) rules that all parties to the purchase agreement are liable for the real estate transfer tax. In practice, however, seller and buyer usually agree that real estate transfer tax shall be borne by the purchaser. Accordingly the tax authorities submit the assessment of the real estate transfer tax to the buyer. This tax assessment is issued by the tax authorities where the property is located. As mentioned the tax base is in most cases the purchase price. But there are situations where no purchase price is paid especially for the property, e.g. if the real property forms part of the assets of a company which is sold to the purchaser. If the purchaser buys shares rather than the property itself the share purchase also triggers real estate transfer tax but the tax basis is not taken from the purchase price for the shares (or a portion of it) but instead by applying a special evaluation procedure. This evaluation procedure contains a simplified depreciated cash flow model which is based upon a multiplier of the annual average rents generated through a certain period of time. In practice, this method results in a value of the property which is between 60% and 80% of its fair market value. Some structures include an indirect transfer of the property by selling the shares in a real estate owning entity in order to take the benefit from the lower tax base. In general, the actual amount of real estate transfer tax to be paid in the course of a transfer of real property is not at the discretion of the parties involved. Any measures agreed between those parties to "cosmetically" minimise the tax base for the real estate transfer tax (e.g. the purchase price in the purchase agreement is lower than the one actually paid) will be disregarded by the German tax authorities.

2.4 Real Estate Tax

Real estate tax (*Grundsteuer*) is levied for each calendar year on real property. Real estate tax is levied 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.

3. Investment by holding interest in a German partnership

Instead of an direct investment, the Corporate Investor could acquire real property through a German partnership (such as a limited liability company - Kommanditgesellschaft "KG"). In principle, a participation of a foreign person as general or limited partner of a KG could constitute a permanent establishment of the investor. In this case, the tax consequences described in Section 4.1 below would apply. For the purpose of this section, however, it is assumed that an acquisition through a KG will not lead to a German permanent establishment of the Corporate Investor.

3.1 Corporate Income Tax

A KG is transparent for income tax purposes and the profit or losses of the partnership will be attributed to the partners of the KG in accordance with their interests in the KG (unless otherwise agreed between the partners). As a result, the Corporate Investor would be subject to German corporate income tax with its portion in the KG's profit similar to a direct investment as described in Section 2.1.

3.2 Trade Tax

Although a KG is transparent for German income tax purposes it could be subject to trade tax provided that the KG carries out a trade or business (in Germany). Since the purpose of the KG is to acquire real property a trade tax liability at the level of KG would only occur if it would be deemed to be "trading in real estate". According to German court decisions and the German tax authorities a taxpayer is always considered to be dealing in real property if he acquires and sells more than three pieces of real property during a period of five years. In case of large real estate transactions, e.g. large apartment houses, German courts have ruled that only one real estate sold could be sufficient for the assumption of "trading in real estate". Letting could also be qualified as business income if there are significant special additional services by the Landlord alongside the mere transfer of possession for use or if there is a swift, constant change in tenants. In the case of a hotel letting, this would apply to any services relating to the hotel business. This will be assumed in case of letting organized in a hotel-type way or if janitor, surveillance, cleaning and other services of this kind would be rendered. Therefore, if several real property investments are intended the acquisitions should be made by different KGs. Furthermore, any additional services to the tenants should not be provided by the KGs but by a third party. If the KG would be deemed to be trading in real estate it would be subject to trade tax rates in an amount between 9 to 25 percent depending on the applicable trade tax rate of the municipality where the KG is domiciled. For example, the current trade tax multiplier in Frankfurt/Main amounts to 490 which equals a trade tax rate of 19.68 percent. Please note that trade tax is deductible as a business expense at the level of the partners. In general the trade tax base equals the tax base for income tax purposes. However, there are certain add-back and deduction rules set out in the German Trade Tax Act which have to be taken into account in calculating the trade tax base. One important add-back obligation is the rule that KG would be obliged to add-back half of the interest paid for long term debt (i.e. debt granted for a period longer than twelve months) to the trade tax base. This means that the trade tax base will be in general higher than the tax base for income tax purposes provided that the real property is financed by long term debt.

3.3 Real Estate Transfer Tax

Any acquisition of German real estate is subject to real estate transfer tax in the amount of 3.5 percent of the purchase price. Furthermore, if the Corporate Investor would acquire an interest of more than 95 percent in a real estate owning KG this purchase would trigger real estate transfer tax. In this regard, real estate transfer tax would also be triggered if more than 95 percent of the interest in the KG has been transferred within a period of five years. This means, that even an acquisition of less than 95 percent of the partnership interest by the Corporate Investor could lead to real estate transfer tax provided that the remaining percentage has been transferred during a period of five years before the purchase.

Example

An interest of 45 percent in a real estate owning KG has been sold to a third party in January 2001. If the Corporate Investor purchases more than 49 percent (i.e. 50 percent or more) of the interest in this KG in May 2005 this acquisition would be subject to German real estate transfer tax even though the interest of the Corporate Investor in the KG is below 95 percent. The liable taxpayer, however, would be the KG itself.

3.4 Real Estate Tax

Holding the real property will trigger real estate tax as described in Section 2.4 with the KG as liable tax payer. The partners of a partnership, however, are also liable for unpaid real estate tax.

3.5 Sale of the Partnership Interest

In case the Corporate Investor would sell its interest in the KG it is unclear how this sale must be classified for tax purposes. German legal commentators argue that such a sale cannot be considered as a sale of real property and any capital gain is tax free in Germany. Pursuant to a decree issued by the German Ministry of Finance, however, a sale of an interest in a real estate owning partnership must be classified as a sale of real estate and the capital gain resulting from this sale is subject to tax in Germany. As a result the German tax authorities would most likely classify the sale of the partnership interest by the Corporate Investor as a sale of real estate and any capital gain resulting from this sale would be subject to German taxes. It should also be noted that such a sale could trigger real estate transfer tax provided that the conditions

mentioned in Section 3.3 are met. The liable tax payer, however, would be the purchaser in case that he acquires more than 95 percent of partnerships' interest or the partnership itself if more than 95 percent of the interest in the partnership has been transferred within the last five years.

4. Corporate investor maintaining a permanent establishment or is acting through a permanent agent in Germany

The Corporate Investor is liable to German income tax on income from a trade or business if it had a permanent establishment or a permanent agent in Germany.

4.1 Permanent Establishment

4.1.1 Creation of a Permanent Establishment

In general, a permanent establishment of the Corporate Investor is set up in Germany if it has a fixed place of business in Germany which serves its business activities. Letting is insufficient to give rise to a permanent establishment. The Corporate Investor does not create a permanent establishment in Germany if it just holds legal title to German real property which is leased to a third party. However, if the Corporate Investor develops and refurbishes real property by means of its own resources and personnel a permanent establishment has to be assumed if such work is performed over a period of more than six months. Also the maintenance of its own office space through which leased property would be managed would constitute a permanent establishment in Germany.

4.1.2 Income Taxation of the Permanent Establishment

The primary impact for the Corporate Investor having a German permanent establishment is that it has to calculate its income on an accrual rather than a cash basis. The principles regarding the deductibility of certain business expenses described above applies accordingly. The corporate income tax rate would also amount to 26.4 percent (including solidarity surcharge).

4.1.3 Trade Tax

If the Corporate Investor has a permanent establishment in Germany he is subject to German trade tax just because of its legal form. The actual trade tax burden depends on where the permanent establishment is located (see Section 3.2). The overall tax burden of the Corporate Investor (i.e. corporate income tax, solidarity surcharge and trade tax) would then amount to approximately 38 percent taking into account that trade tax is deductible as a business expense. German trade tax, however, could be avoided if the activities of the Corporate Investor are limited to the management of assets and the Corporate Investor elects for the application of the "extended exemption regime" (*erweiterte Grundstücks-kürzung*) under the German Trade Tax Act. This exemp tion, however, is only applicable if the Corporate Investor would be considered as not in the business of trading in real estate as described in Section 3.2.

4.1.4 Real Estate Transfer Tax

The acquisition of a real property through a permanent establishment is subject to real estate transfer tax at a rate of 3.5 percent.

4.1.5 Real Estate Tax

The description above regarding real estate tax applies.

4.2 Permanent Agent

The effect of a permanent agent is that the income of the Corporate Investor, which could be allocated to the permanent agent would be subject to German income tax. A permanent agent would be assumed if, for example, a third party could enter into contracts on behalf of the Corporate Investor. As mentioned above, Corporate Investor's rental incomes and capital gains are already subject to German (limited) income tax liability. Furthermore, a permanent agent does not trigger trade tax. Hence, the question whether the Corporate Investor has a permanent agent in Germany is not relevant. It should also be noted that the description regarding real estate transfer tax and real estate also applies in case of a permanent agent.

5. Investing through a GmbH

Alternatively, Corporate Investor could invest through a GmbH into German real estate. In this case, the GmbH would be the liable taxpayer in Germany.

5.1 Corporate Income Tax

A GmbH is subject to German corporate income tax with its worldwide income at rate of 26.4 (including solidarity surcharge), i.e. with its rental income and possible capital gains. The descriptions of the deductibility of business expenses described above applies accordingly.

5.2 Trade Tax

The GmbH is also subject to German Trade Tax due to its legal form and the overall tax burden (corporate income tax, solidarity surcharge and trade tax) amounts to approximately 38 percent. The "extended exemption regime" could also be used by the GmbH provided that the GmbH is not deemed to be trading in real estate. This could be achieved by using a separate GmbH for each investment (or limiting the business activities of the respective GmbH to these real property investments) and complying with the necessary holding period.

5.3 Real Estate Transfer Tax

The acquisition of a real property by a GmbH triggers 3.5 percent real estate transfer tax levied on the purchase price. The acquisition of more than 95 percent of the shares in a GmbH holding German real estate is also subject to real estate transfer tax.

5.4 Real Estate Tax

The real property acquired by a GmbH will trigger real estate tax. As described above the actual amount depends on where the real property is located.

5.5 Dividends

Any after tax profits could be distributed to the Corporate Investor in the way of a dividend payment. Dividend payments by a GmbH are in principle subject to withholding tax in the amount of 20 percent plus solidarity surcharge. However, this withholding tax could be reduced by the applicable double taxation treaty or by the "parent-subsidiary directive". The Double Taxation Treaty reduces the withholding tax rate to 5 percent provided that the shareholder of the GmbH classifies as a corporation holding more than 25 percent of the interest in the GmbH. The parent-subsidiary directive provides that no withholding tax will be triggered if the recipient of the dividend is a corporation located within the European Union holding more than 20 percent of the shares of the GmbH.

5.6 Sale of the Shares in GmbH

An alternative exit scenario could be sale of the shares in the GmbH instead of a sale of the real estate by the GmbH. Pursuant to Article 13 para. 4 of the Double Taxation Treaty the right to tax capital gains resulting from the disposal of shares in a company is (also) with the country where the company is resident, if the assets of the company consist of more than 50 percent of immovable assets. However, certain double taxation treaties do not include such a provision. For example, the double taxation treaty between Luxembourg and Germany provides the right to tax capital gains resulting from the sale of shares in a corporation only to the country of residence, unless the shares are attributable to a (German) permanent establishment of the seller. Therefore, if Corporate Investor could participate from such a favourable double taxation treaty and it does not maintain a permanent establishment in Germany the sale of the GmbH shares, and as a result the sale of the real property, is tax free in Germany. The sale of more than 95 percent of the share of a GmbH triggers real estate transfer tax with the purchaser being the liable taxpayer.

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