

Purchasing Real Estate in Germany

Twelve Questions and Answers
for International Investors

As the largest economy in Europe, Germany is an interesting place for real estate investments. The German market provides a sustainable growth in several asset classes and cities.

This publication gives an overview of basic legal issues that international investors should have in mind when entering the German real estate market.

1. What does the real estate investment market in Germany look like?

The German property market has proved to be a safe haven in the aftermath of the global financial crisis and is reflecting both, the financial strength of Germany as an economy as well as strong appetite for real estate investments in general.

Institutional investors have taken advantage of the situation and heavily invested in German real estate. The overall transaction volume in 2015 has, according to Jones Lang LaSalle, approached the 55 billion Euro mark, a level exceeding the 2007 historical high. International investors played a key role and had a market share of about 50 percent. The investments focus regionally on the major commercial centers – Frankfurt am Main, Munich, Berlin, Hamburg, Cologne, Düsseldorf and Stuttgart. These cities remain of interest to investors looking for investments in the highly priced office and retail sector. However, so-called secondary cities like Bremen, Essen, Hanover and Leipzig also benefited from the ongoing real estate boom. Transaction volumes are rising, in particular as investors (and lenders) are now spreading their interest from core into other areas like core plus or specific types of properties, such as logistic hubs, hotel & leisure and manufacturing sites in other regions. Retail investments remain strong even outside the prime locations. A sustainable growth is what investors are expecting and getting in the German market.

In view of foreseeable general conditions, activity on the German investment market is expected to remain buoyant in the coming months.

Opportunistic investors are also looking into Germany as there is a sufficient number of properties in need of refurbishment and repositioning in the market allowing for more creativity and higher returns. The refinancing of large CMBS loans has been identified as a challenge early on and currently market participants are working on solutions, in particular for larger residential portfolios. Consortiums consisting of German lenders and insurers are usually the main players in this area breaking down large loans in digestible sizes.

Debt financing is available for nearly all asset classes at interest rates at a historical low.

On the real estate financing side, modern forms of financing aimed at the capital market have developed over recent years including corporate bonds or IPOs of certain real estate companies. In the public sector, infrastructure projects are increasingly brought forward hand-in-hand with private capital investors and service providers (public private partnership).

2. What are the usual steps for purchasing and conveyancing real estate in Germany?

Most international sales of commercial real estate in Germany take place with the help of one of the major international investment consultancy firms, less commonly through smaller real estate agents operating at a regional level. Further, contacts to developers, asset managers and other market players are key to identify (in particular off market) opportunities.

Sales, in which major real estate portfolios are offered by way of public tender follow defined rules and require the ability to act quickly. The most significant details which are material to anyone wishing to purchase real estate are presented in an Information Memorandum.

On the basis of this information all prospective purchasers provide their offer in a letter of intent or indicative offer. Under this letter of intent the parties also agree to carry out a due diligence procedure for the property and commit to treating their negotiations as exclusive for an agreed period. In the current market climate, exclusivity periods have become shorter and investors are required to proceed quickly with the due diligence in which all available information about the property is evaluated from the legal, tax, technical, environmental and commercial points of view. In the event of share deals, corporate and tax implications require a particular attention as well.

Following the due diligence, the purchaser communicates its decision whether or not it wishes to proceed with the investment. At the same time or immediately afterwards, a real property sale and purchase agreement is negotiated. In case of all asset deals and most of the share deals, notarization of the purchase agreement is mandatory by law (see Section 4).

There are no purchase restrictions regarding foreign entities, however, to ease the registration process with the land register, German and European types of entities are commonly utilized.

3. What are the common forms of investment?

The selection of the investment form in each case depends on a number of criteria. There are suitable solutions for many individual requirements. The most common form of investment is direct investment per asset deal, i.e., purchasing the land together with the buildings on it. As a general rule, title to buildings and title to land is not legally separate, except in special circumstances: for example in apartment ownership (*Wohnungseigentum*) and hereditary building rights (*Erbbaurechte*). In apartment ownership, the title is for specific, legally separate premises together with a co-ownership share in communal areas and installations. In hereditary building rights, the buildings are constructed and remain legally separate for the agreed duration of the right so that the buildings can be sold independently.

As an alternative, real property can also be purchased indirectly via share deal: for example, a purchaser may acquire all or a majority of the shares or interests in the company that owns the property (in most cases a special purpose vehicle). Investments in this form are particularly popular in project developments for reasons of saving real property transfer tax. An indirect purchase follows rules of its own, but careful evaluation of the property is of vital importance.

4. What are the individual steps in purchasing a property?

The terms of the purchase and all the material content of the contract, such as the description of the land/buildings, the purchase price, the payment terms etc. are set down in the real property sale and purchase agreement. This purchase agreement will create obligations to transfer title and to pay the purchase price and the declaration of conveyance. By law, this agreement must be entered into before a notary and read out and recorded in its entirety by the notary. The parties are free to appoint the notary. If the notarial form requirement is not observed, the agreement will not become binding. The notarial requirements may also extend to other agreements, for example a building contract, or, in the case of a sale and leaseback, a lease, as all agreements legally connected with the real property sale and purchase agreement, must be notarized. The lack of notarial correct form can be cured by the registration of the

transaction in the land register (*Grundbuch*). Title to the property does not pass when the agreement is made, but only once the purchaser has been registered as owner in the land register. Registration is obtained through a procedure that is dealt with by the notary's office. In the five East German states this notarial agreement in certain cases still requires special permission from the public authorities, even after notarization, because properties there may be subject to unresolved restitution matters. The purchase price falls due only after certain purchase price payment conditions agreed by the parties in the purchase contract have been met. Usually, the minimum requirements for the maturity of payment are that (i) a priority notice of conveyance (*Eigentumsvormerkung*) has been registered in the land register, (ii) that any necessary official permits have been obtained, and (iii) that documents required for the cancellation of the encumbrances not assumed by the purchaser have been obtained.

Usually, statutory liability for property and construction defects will be excluded in the purchase agreement. The purchaser is responsible for obtaining information about possible damage to the property and about the overall legal position by carrying out careful due diligence. Sellers are responsible for disclosing any damage known to them which is not easily ascertainable, and will be deemed to have acted fraudulently if they fail to do so. Sellers are fully liable for defects in title; this liability cannot be limited or excluded.

Upon payment of the purchase price, as between the parties, the right to occupy the property and the right to the "rents and profits", as well as the obligation to take over its "burdens", pass onto the purchaser. Usually, the purchaser shall be entitled to collect the rents already. This means that economic ownership is transferred to the purchaser but not yet legal title. The legal transfer of title occurs only upon registration of the purchaser in the land register.

If, for example, surveys of the soil or of certain parts of the building remain outstanding, or certain repairs are demanded, the parties commonly arrange for reasonable amounts to be retained from the purchase price. The purchase and the payment of the purchase price may be subject to certain notification requirements under tax law and banking law.

5. What is the safest way to acquire title to a property?

By requiring notarization and by the responsibilities assigned to the land registry office, German property and conveyancing law offers a high degree of reliability for the purchaser to obtain title. The seller's title, as well as existing encumbrances on the property can be verified by inspecting current land register excerpts. The land register is a public register which is kept at the local courts. There is a presumption that the land register is correct. Any party acting in good faith can rely on the information entered in the land register even in the case such information were not accurate. Thus, the concept of title insurance is not customary in Germany.

The same goes for encumbrances such as mortgages and charges, for which registration on the land register is also mandatory. If for any reason the seller is unable to transfer title as described in the purchase agreement, then the purchaser can rescind the agreement and claim repayment of the money. The purchaser is able to gain security against new encumbrances created after the sale and purchase agreement is notarized by having a priority notice of conveyance (*Eigentumsvormerkung*) registered on the real property in the land register.

6. What are the approximate incidental costs of a transaction?

The cost of the due diligence procedure will depend on the complexity of the examination, and the cost related to the sale and purchase agreement will depend on the intensity of the negotiations and of the amount of the purchase price. Technical advisors will often work on a flat-rate fee basis. Amongst lawyers, individual fee schemes usually take into consideration hourly rates. The cost of the investment consulting firm will be up to 5 percent of the purchase price, plus VAT, depending on the amount of the purchase price (at the lower end in case of larger transactions). Notary costs and court fees are fixed by law and are based on the value of the property. Finally, real property transfer tax applies (at a rate of around 3.5 – 6.5 percent, see Section 10 below). Non-cash consideration will also be taken into account in determining the basis for taxation. Usually the purchaser pays the notary's cost and the court fees and the real property transfer tax, whereas the seller bears the costs incurred to delete existing encumbrances. Each party pays its

own advisors and other costs, for example those of certifying powers of attorney or obtaining an apostille or legalization.

7. What are the legal principles governing tenancy agreements?

Tenancy agreements for a term exceeding one year must be made in writing. If this form requirement is not observed, the tenancy agreement is deemed to be entered for an indefinite period of time instead of a fixed term. Consequence of a defect of form is that each of the parties to the contract may give notice of termination in accordance with the statutory provisions without cause.

According to recent judgments of the Federal Supreme Court (*Bundesgerichtshof*) permanent physical connection of the contractual documentation is no longer required if it is clear that the documents are part of one deed. They are not registered with any public authority, and will pass to a purchaser at registration of a transfer of title in the land register. If the tenant has not yet moved into the premises, special rules will apply. Entitlement to rent is assigned to the purchaser subject to the condition precedent of payment of the purchase price. At the same time the purchaser is entitled to receive all the necessary documents for managing the tenancies.

Commercial leases commonly contain indexation clauses which automatically adjust the amount of the rent to changes of the German Consumer Price Index. In this context rent review clauses may be included under which the rent payable will be adjusted from time to time, for example on the basis of expert opinions obtained about the prevailing local rent for similar properties or about the market rent. As they are rather cumbersome to implement, these clauses are less common. Depending on the type of use, lease agreements generally run for five to ten years. The binding term in a lease agreement, during which the lease cannot be terminated by either party may not exceed 30 years.

Normally, the lease agreements contain a unilateral extension option in favor of the lessee. Many commercial leases generally will be construed as standard terms and conditions, which have to comply with strict regulation to avoid their invalidity. In this context special attention should be given to clauses regarding decorative repairs of the property. Usually all ope-

rating, services/utilities and management costs are also allocated to the tenant. These clauses should also be reviewed carefully as to their completeness. Rent guarantees usually cover at least three months' rent, plus payments on account of service charges and VAT, if any. Rent for retail premises is commonly agreed as turnover-based rent subject to a certain minimum rent. The tenant's obligation to repair and redecorate the rented premises, especially at the time of vacating the premises, differs from the statutory rules but is quite common, however, the so called "triple net-tenancies" are the exception. In these the tenant is responsible for repairs, even of the roof and structure. A large number of special rules under tenant protection laws apply to residential properties, especially limiting the landlord's right to terminate the tenancy.

8. How can the purchase of a property be financed?

Real estate financing in Germany is provided by a wide range of institutions ranging from major private banks, state owned banks (*Landesbanken*), investment banks, local banks, to mortgage banks and specialized real estate banks, but also by insurance companies, all having different types of refinancing; balance sheet/securitization/covered bonds (*Pfandbriefe*). The required loan to value (LTV) depends on the refinancing, e.g. banks issuing covered bonds could not exceed 60 percent LTV whereas other banks are more flexible. Classic German lenders' loan agreements tend to be rather short, straight forward and covenant light (compared to Anglo-American standards). However, several lenders have adopted the German version of the UK Loan Market Association (LMA) loan documentation to comply with international standards, in particular in the case of refinancing via securitization.

On the security side the most prominent security is the land charge (a special type of German law mortgage), notarized by a German notary, and registered in the land registry of the property purchased. Land charges have a nominal amount usually reflecting the loan amount and receive a rank in the land registry depending on the date of registration (usually first ranking). Land charges can be assigned by the beneficiary and in the case of a certified land charge (*Briefgrundschuld*) a transfer does not even require registration with the land registry. Two or more properties may be charged jointly by one land charge allowing cross-collateralization in rem, however, not

across national borders. Land charges give creditors the right to apply for a court administered public auction of the property and to initiate receivership. However, a land charge does not grant any right in title but merely the right to obtain a certain amount of money out of the real property. In addition, the rental income will be assigned (usually not disclosed to the tenant until an event of default occurs), as well as rights resulting from (preferable German law) property insurance policies and the purchase agreements. Rent accounts are pledged in favor of the lender. A share pledge is common where single purpose vehicles as borrowers are concerned.

Due to internationalization, the English duty of care concept (a tripartite agreement between lender, borrower and property manager) has been partially adopted obliging the property manager to comply with the cash waterfall agreed in the loan agreement and allowing the lender to replace the property manager in case of an event of default. It is not uncommon that the loan agreement is governed by foreign law, whereas all property related security is governed by German law.

The requirements of financing are usually well implemented into sale and purchase agreements allowing release of old security and implementation of new security against repayment of the existing loans in a structure administered by the notary and protecting the rights of old/new lender and seller/purchaser.

9. What are the benefits of a joint venture?

Co-investments and joint ventures are common in the German market. Traditionally co-investment structures have been common in development projects where one partner contributes to the property being developed or refurbished, and the other partner may contribute project development, planning and construction works and services. We have also seen many co-investments where international investors team up with local asset managers or other operating partners.

Most joint venture partners will be able to provide special know-how regarding deal sourcing, asset management, project development, etc.

A joint venture is advantageous because it enables both partners to optimize the combination of their resources and enables them to obtain external funds

that would not be available to them individually. Needless to say that joint ventures include corporate governance aspects which must be taken into considerations. Further, the partners might be entitled to special profit distributions (e.g., by way of promote).

10. What tax rules apply?

As mentioned above in Section 6, the acquisition of real property is subject to real property transfer tax at a rate currently between 3.5 and 6.5 percent of the consideration for the property purchase, also taking into account any non-monetary consideration. The actual amount of real property transfer tax depends on where the real estate is located (e.g., 3.5 percent in Bavaria and 6 percent in the State of Northrhine Westfalia).

Real property transfer tax also applies in the case of an indirect purchase of real property. An indirect purchase of real property is given if at least 95 percent of the shares in a company holding real property are acquired by one party or a group of related parties, or if at least 95 percent of the interest in a partnership holding real property is transferred within a period of five years.

In general, the purchase of German real estate is exempt from VAT.

However, under certain circumstances, the parties are entitled to opt for VAT on the purchase price for a building in order to enable the purchaser to claim for input VAT with regard to all expenses related to the building.

Holding German real property leads to (limited) tax liability of the building owner in Germany with regard to the rental income and, as the case may be, capital gains.

Provided that a foreign investor does not maintain a permanent establishment in Germany the tax base for rental income is the excess of the gross rental income received over expenses and costs attributable to that income (e.g. interest payments) at a tax rate of 15.83 percent for corporate investors, including solidarity surcharge (*Solidaritätszuschlag*). The tax rate for private individuals depends on the actual amount of taxable income whereas the highest tax rate currently amounts to 47.48 percent, including solidarity surcharge (*Solidaritätszuschlag*).

Capital gains are subject to the same tax rate whereas the tax base is the difference between the purchase price and the sales price, taking into consideration the costs of disposal. The depreciation deducted during the investment reduces the purchase costs and thus increases the taxable capital gain.

Furthermore, the landlord is obliged to pay real property tax. Real property tax is a local tax levied on a specific tax value which is in general markedly below the open market value of the real property. The actual tax burden depends on the municipality in which the real property is located. Real property tax is deductible as a business expense from the income derived from the real property and is usually passed to the tenant.

11. How is the property managed?

A growing number of service providers offer property-related services. Different from the UK, property managers are frequently not subcontracted by the asset manager but are contracted separately by the investor. Such agreements include technical and commercial property management, including the management of leases, as well as facility management and opportunities for developing the property and offering improvement strategies (asset management). The fees charged vary. Most common is a percentage of the total rental income. Management usually changes when a property is purchased, but it may be of benefit to keep the same managing agent in position. In the latter case the management contract will have to be assigned to the purchaser. Generally speaking these contracts will not pass to the purchaser by operation of the law in the case of an asset deal, in contrast to tenancy agreements, which automatically pass over to the purchaser (see section 7).

12. What are the land or building owner's responsibilities?

Usually because title to the land and buildings goes together, one person will be responsible for liabilities relating to both. The land owner is also responsible for access to the property, and service conduits to and from the building. The land owner has a duty to keep the property safe for others and is responsible for maintaining the land; the owner is liable for environmental risks of the soil and groundwater. In the case of soil contamination, statutory liability is with the contaminator and on previous and current land owners and

tenants, all of whom may be ordered to clean up the contamination by the authorities; in some cases this may result in high costs. The parties are free to make different contractual arrangements amongst themselves. The building owner is responsible *inter alia* for keeping the interior of the building safe, for maintaining the building and its structural integrity.

This responsibility may extend to outside areas, e.g. parking lots. Legislation in Germany is focused upon energy saving and environmental matters, which means that major maintenance works, such as a roof refurbishment, may require comprehensive improvements to the quality of the property. Green building technology has become increasingly important in new developments, however, the German industrial standards (DIN) already provide for a high degree of sustainability.

Insurance cover is available for many risks. If a building develops or contains a defect, remedies may be available against contractors, architects or experts employed in the construction. Only the contracting party will usually have these remedies; therefore, a purchaser should ensure that, where possible, these remedies are assigned to the purchaser by the seller. As and when the remedies are assigned, claims under the assignor's liability insurance will also pass to the purchaser.

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