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Memorandum

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German Tax Reform Act 2018 – A Speed Read on Tax Implications for Real Estate Investors

On November 23, 2018, the German Federal Council (*Bundesrat*) approved the Tax Reform Act of 2018 (the "**Tax Reform Act**"; *Gesetz zur Vermeidung von Umsatzsteuerausfällen beim Handel mit Waren im Internet und zur Änderung weiterer steuerlicher Vorschriften*), which was passed by the German Parliament (*Bundestag*) on November 8, 2018.

The Tax Reform Act introduces, inter alia, changes for foreign investors that acquire and hold German real estate through non-German corporations, e.g. through Dutch B.V.s or Luxembourg S.à.r.l.s. Based on the Tax Reform Act, profits from the sale of shares in these foreign real estate corporations will, under certain conditions, be subject to German non-resident taxation. In addition, value changes on assets and liabilities in connection with German real estate will also be subject to German non-resident taxation.

1. Investment in German property through foreign real estate corporations

a) Taxation of capital gains on the sale of shares in foreign real estate corporations

i. Previous legal situation

Capital gains generated by non-resident taxpayers from the sale of shares in foreign real estate corporations have traditionally not been subject to German taxation, even if the foreign corporations held German real estate. So far, under German law, capital gains were only subject to tax if the corporation of which the shares were sold had either its effective places of management or their statutory seats in Germany (sec. 49 para. 1 no. 2 e) bb) Income Tax Act (**ITA**)). These requirements were not met in typical structures, since foreign real estate corporations usually have neither their effective place of management nor its statutory seat in Germany. As a result, gains generated by non-resident taxpayers from the sale of shares in foreign corporations holding German real estate were not subject to non-resident taxation in Germany.

ii. Extension of the non-resident taxation - sec. 49 para. 1 no. 2 e) cc) ITA

The Tax Reform Act introduces sec. 49 para. 1 no. 2 e) cc) CITA. Under the provision, capital gains generated by non-resident taxpayers from the sale of shares will be subject to non-resident taxation. However, this only applies if, at some point within a period of one year prior to the sale of the shares, 50 percent of the book value of the assets of the foreign real estate corporation is comprised of German real estate. The non-resident taxation only applies if the seller of the shares held at least 1 percent of the share capital within the last five years prior to the sale.

The extension of the non-resident taxation may lead to potential double taxation issues of the capital gains generated by non-resident taxpayers (potential resident taxation in the country of residence and non-resident taxation in Germany). The majority of double taxation treaties entered into by Germany with other states stipulates that Germany has the right to tax the capital gains in these cases.

iii. Commencement

The provision applies for the first time to sales that occur after December 31, 2018. Capital gains are only subject to German non-resident taxation to the extent that the gain stems from changes in value that occurred after December 31, 2018.

b) Taxation of changes in value of assets in connection with German real estate

i. Previous legal situation

Previously, changes in the value of assets and liabilities that are economically connected to German real estate, such as debt from the financing of German real estate, were not subject to German tax. As a result, for example, a profit from the waiver of debt against a non-resident taxpayer on a loan used to finance German real estate has not been subject to German tax.

ii. Extension of the non-resident taxation - sec. 49 para. 1 sent. 2 f) sent. 4 ITA

Changes in value of assets and liabilities that are economically connected to German real estate will be subject to non-resident taxation. For this purpose, sec. 49 para. 1 sent. 2 f) sent. 4 ITA was newly introduced, so that, for example, profit from the debt relief is now subject to German tax if the debt was used to finance German real estate. If and to what extent a potential resulting double taxation can be avoided in these cases must be assessed on a case-by-case basis.

iii. Temporal application

The provision applies for the first time to changes in value occurring after December 31, 2018.

2. Participation in foreign real estate via German corporations

In addition to the extension of the non-resident taxation, the concept of foreign income pursuant to sec. 34d ITA (*ausländische Einkünfte*) was extended accordingly. In the future, income from the sale of shares in corporations will be regarded as foreign income pursuant to sec. 34d ITA. This is only the case if (i) the corporation has its effective place of management and its statutory seat in Germany and (ii) at some point, within a period of one year prior to the sale of the shares 50 percent of the book value of the assets of the corporation is comprised of foreign real estate. Due to the extension of the foreign income concept, foreign taxes on profits from the sale of shares in corporations that hold foreign real estate can be credited to the German tax of resident taxpayers or reduce the German tax base in accordance with sec. 34c ITA.

3. Practical consequences

The extension of the non-resident taxation to capital gains generated by non-resident taxpayers and to changes in the value of assets and liabilities related to German real estate has, depending on the individual case, an impact on the taxation of investors. Of particular welcome is that changes in value are only recognized if they occur after December 31, 2018, so that there is a grandfathering for value changes before that date. Existing structures should be examined to determine whether, and if so to what extent, the changes from the Tax Reform Act have tax consequences for investors in the event of an exit or on the current taxation. In addition, it should be examined whether valuations on December 31, 2018 are sensible. When setting up new acquisition structures, adverse tax consequences should be minimized.

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