Update on debate on changing German RETT regime for share deals plus latest German case law on real estate company share sales

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In Brief

The German Supreme Court of Finance has recently ruled that disposal gains of non-resident corporate shareholders on the sale of shares in German corporations are exempt from German Corporate Income Tax in full if certain conditions are met.

Also the heated debate on the tightening of the German RETT Act to expand the scope of this tax to include sales of less than 95% of the company's share capital continues after the election and is becoming even hotter in the light of the forthcoming coalition negotiations. However, the latest statements suggest that the change in law will not be enacted until after 2017. Nevertheless, investors should closely monitor the legislative process.

Tax free sale of shares in German company held by non-resident corporate shareholders

Background

In most of the German double tax treaties with other jurisdictions such as Luxembourg and the Netherlands, Germany does not seek to tax profits of a non-resident shareholders on the sale of shares in German resident corporations such that these gains subject to tax in the other Contracting State – the shareholders' state of residence. As an exemption to this rule, Germany retains its right to tax such gains under certain double tax treaties for profits on the sale of "real estate rich" corporations.

However, under domestic law the right to tax the gains of non-resident shareholders only applies if the real estate company has either its seat or place of management in Germany. The legislation provides that the profit from the sale of shares is tax exempt but that 5% of the gains are deemed to be non-deductible business expenses. Therefore, effectively only 95% of the relevant profit is exempt from tax under domestic law.

The previous proposal of the Federal Council (*Bundesrat*) to amend domestic law so that non-resident shareholders also become subject to limited taxation in Germany on their gains from selling shares even if the real estate company has neither its seat nor place of management in Germany (please see our Real Estate Tax Services NewsAlert No. 18/2016_Germany) was not implemented in 2016.

Latest case law

Very recently, the German Supreme Court of Finance (Az: I R 37/15) ruled that, for non-resident corporate shareholders, profits from the sale of shares in German corporations are exempt from tax and the add-back of 5% as deemed business expenses does not lead to a German taxation of this 5% if the shareholder has neither a permanent establishment (no PE) nor a permanent representative (no PR) in Germany.

The court held the view that a corporate shareholder is only subject to tax with the profit from the share sale. In contrast the deemed 5% business expenses do not qualify as such income from the sale of shares and are therefore not subject to German taxation.

In a nutshell, these gains from the sale of shares are therefore exempt to 100% as long as the vendor does not qualify as trader in shares.

It remains open whether the legislator and Federal Ministry of Finance will either follow this verdict or take counter measures. For the time being, investors that have recently sold shares in German corporations should check whether they were taxed on these profits in Germany and whether these tax assessments are still open for amendments.

RETT in share deal scenarios

In Germany, share sales of less than 95% of the shares in real estate companies owning German real estate are broadly not subject to real estate transfer tax.

Previously, in autumn 2016 the Ministries of Finance of the Federal States started an initiative to amend the German RETT regime in this context. The respective working group compiled an initial report in March 2017 that is still subject to discussion and review by experts of the ministries given that such an amendment raises certain Constitutional and EU Law concerns. According to the latest communication by the Federal Minister of Finance of Hesse further analysis is needed before a bill can be drafted. Therefore, it is at present considered unlikely that such a change in law will be enacted in 2017.

Currently, two different alternatives are being discussed:

- Alternative I: This alternative focuses on lowering the threshold for share sales being subject to RETT from 95% to 75%.
- Alternative II: This alternative comprises three stages of taxation. Share sales exceeding 50% of the company’s share capital would lead to taxation of 50% of the real estate value at the respective RETT rate. Share sales of 75% or more of the company’s share capital would lead to taxation of 75% of the real estate value at the respective RETT rate and sales of 95% or more of the company’s share capital would continue to trigger a taxation of 100% of the real estate value at the respective RETT rate.

In addition to these two alternatives, there are multiple other changes subject to discussion, such as changing the RETT regime regarding partnerships to achieve the same taxation irrespective of the legal form of the entity holding the real estate, and certain reliefs for individuals acquiring residential real estate for their own use.

Our view

In summary, the German RETT regime is presently subject to significant discussion and investors need to monitor the legislative process closely in order to reflect the impact of German RETT correctly in their underwriting model for ongoing German real estate transactions. However, at present it is not likely that any amendments will be implemented in 2017.

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