Update on the draft German tax legislation (JStG 2018) and ECJ decisions with impact on foreign investors owning German real estate

Germany: July 2018

In Brief

The German Federal Ministry of Finance has published a draft bill for the Annual Tax Act 2018 on 25 June 2018. If passed, the changes announced in the draft bill will affect foreign investors with German real estate investments, i.a. the draft changes concern taxation of the sale of shares in real estate rich companies as well as the taxation of exit gains of non-resident taxpayers. This draft bill does not cover changes to the RETT regime on share deals which are expected to be published separately.

Further, the ECJ ruled that the German substance requirements for WHT exempt cross border dividend distributions under the parent subsidiary directive are in breach of EU law.

Amendments regarding taxation of non-residents

Sale of shares in a non-resident corporation with German real estate assets

Under the various double tax treaties with other jurisdictions, Germany reserved the right to tax capital gains arising from the sale of shares in a corporate entity holding German real estate assets, provided that the assets of the company consist of more than 50% directly or indirectly held German real estate.

However, under the current domestic tax law such capital gain will only be subject to German Corporate Income Tax (CIT) if the corporate entity being disposed of has its residency or place of management in Germany. Accordingly, the sale of shares in a non-resident corporate entity with the place of management and legal seat outside of Germany is presently not taxable in Germany.

Under the draft provision, capital gains on a sale of shares by a non-resident in a non-resident corporate entity will be subject to tax in Germany if the value of shares stems directly or indirectly at more than 50% from German real estate at any time within one year preceding the sale of the shares.

The existing local tax exemption according to which only 5% of the gain will be taxed as non-deductible business expenses will generally be applicable to share sales by corporate shareholders. Non-resident corporate shareholders that do not qualify as traders would therefore only be taxed on 5% of the gain at a tax rate of 15.825% (CIT+ solidarity surcharge). Under the current draft bill, the tax should only apply to profits arising from the uplift in value post 31 December 2018.

Furthermore, the implications of past decisions of the Federal Court of Finance on this draft legislation have to be monitored by corporate shareholders going forward.

Changes to the loss forfeiture rules

Under the current wording of the law, corporate tax losses carried forward in Germany are partially forfeited in case of share transfers between 25% to 50% and fully forfeited in case of share transfers above 50%. Further details of this rule are available here.

With resolution effective from 29 March 2017 (2 BvL 6/11), the Federal Constitutional Court declared, parts of the loss forfeiture rule are unconstitutional and bounds the legislator to rearrange the loss forfeiture rules for corporations for share transfers between 25% and 50%. The draft bill is to amend the respective regulation regarding the harmful transfer of 25%-50% of shares such that loss forfeiture rules due to change of ownership between 25% and 50% are disapplied from 1 January 2016.

However, the disapplication solely relates to partial loss forfeiture of 25%-50%. Full loss forfeiture remains applicable in case of share transfers of more than 50% at present. A corresponding lawsuit is currently pending at the Federal Constitutional Court.

Update on the denial of tax exemption on cross-border dividends within the European Union

The European Court of Justice had already confirmed that the former version of the German substance requirements for applying the benefits of the EU parent-subsidiaries on cross border dividends to foreign EU shareholder violates European Law (please see previous NewsAlert). In its latest decision, the ECJ now declared the current version of the legal text as contrary to European Law with his decision dated 14 June 2018 (C-440/17). According to the European Court of Justice, the treaty override rule is violating the freedom of establishment and the parent-subsidiary directive.

The tax authorities have already issued a new circular based on the initial court case reflecting the decreased requirements for the tax exemption. It remains to be seen whether additional guidance of the tax authorities or an amendment of the law will be issued shortly.

Contact

Uwe Stoschek
Global Real Estate Tax Leader
Phone: +49 30 2636-5286
uwe.stoschek@de.pwc.com

Jeroen Elink Schuurman
EMEA Real Estate Tax Leader
Phone: +31 88 792-6428
jeroen.elink.schuurman@nl.pwc.com

Germany

Sven Behrends
Partner, München
Phone: +49 89 5790-5887
sven.behrends@de.pwc.com

Helge Dammann
Partner, Berlin
Phone: +49 30 2636-5222
helge.dammann@de.pwc.com

Marcel Mies
Partner, Düsseldorf
Phone: +49 211 981-2294
marcel.mies@de.pwc.com

Dr. Michael A. Müller
Partner, Berlin
Phone: +49 30 2636-5572
mueller.michael@de.pwc.com

Josip Oreskovic-Rips
Partner, Frankfurt am Main
Phone: +49 69 9585-6255
josip.oreskovic-rips@de.pwc.com

Uwe Stoschek
Partner, Berlin
Phone: +49 30 2636-5286
uwe.stoschek@de.pwc.com

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