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PRIVATE EQUITY

ALTERNATIVE TYPES OF FINANCING – THE REFERENCE BOOK FOR ENTREPRENEURS AND INVESTORS

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Real Estate Private Equity – Taxation for Foreign Investors

Private equity as a form of financing and investment has increasingly gained ground in the real estate business in recent years. Foreign private equity investors – especially Anglo-American private equity investors – have previously undertaken large investments in the German real estate market. Simultaneously, institutional investors increasingly view real estate as an attractive form of investment. As a result, therefore, foreign private equity investors should ask themselves the following important question: What taxes will be due if I invest directly or indirectly via corporations or partnerships in German real estate? Apart from the acquisition financing aspects, particular attention should be given to exploring ways to avoid being subject to German trade tax.

Acquisition of German Real Estate

A foreign investor can invest in German real estate in different ways. Besides a direct acquisition, he can acquire German real estate via a corporation or a partnership. The possibility to depreciate the acquisition costs and the structuring of the financing are often key factors in determining the format of the acquisition, especially in the event of cross-border financing. Through a tax-optimised structuring, the financing costs may significantly reduce the tax burden in Germany.

In the case of a direct acquisition, the foreign investor can offset his financing costs with rental income and capital gains upon the sale of German real estate. He may depreciate his acquisition costs; for business assets the depreciation rate is usually 3 percent, otherwise 2 percent.

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Unlike in the case of a direct acquisition of German real estate, the foreign investor cannot depreciate his acquisition costs for a shareholding in a corporation if he acquires a corporation owning German real estate. In addition, without further structuring he cannot offset his financing costs with the corporation's income from German real estate. However, a tax-optimisation can be achieved by using another corporation as a holding. The financing costs are deductible at the holding level even though the dividend distributions by the subsidiary to the holding are 95 percent tax-exempt. Furthermore, tax-optimisation is achievable by creating a fiscal unit *(Organschaft)* between the holding and the subsidiary. Therefore, the holding must hold at least 50 percent of the majority of the voting rights in the subsidiary. A tax consolidation also requires a profit transfer agreement between the holding and the subsidiary; its duration must be at least five years.

If the foreign investor acquires a partnership owning German real estate, rather than a corporation, he can depreciate his acquisition costs. The depreciation rate depends on whether the shareholding is held by the foreign investor as a business or a private asset.

If the foreign investor acquires German real estate via a foreign or German corporation, the German thin capitalization rules *(Gesellschafterfremdfinanzierung)* need to be adhered to. These German thin capitalization rules limit the possibility to finance the acquisition of real estate by way of shareholder loans. The interest on such debt is restated as non-deductible dividend payments *(verdeckte Gewinnausschüttung)* to the extent that the debt-equity ratio of 1.5:1 has been exceeded. Shareholder funding in this respect means direct shareholder financing, financing by affiliates („related parties“) of the shareholder, or financing through unrelated parties with a right of recourse against the shareholder provided that the shareholder holds more than 25 percent of the shares in the corporation. Therefore, if the acquisition of German real estate is financed partially by bank loans, the bank may not have any rights of recourse against the foreign investor or a party related to the foreign investor.

The German tax authorities have recently issued new guidelines that facilitate the financing by unrelated parties. According to these guidelines, the thin capitalization rules only apply with respect to third party debt in the case of back-to-back financing (i.e. in cases where the shareholder or a related party receives interest on any long-term deposit which is offered as security to the bank). Therefore, back-to-back financing will not be assumed where interest bearing long term receivables are excluded from the security package granted to a third party creditor. It is, however, not detrimental if the corporation itself or the partnership of which the corporation is the shareholder grants the bank securities.

In addition to the deductibility of the financing costs and the possibility of depreciating the purchase price, German real estate transfer tax has to be considered when acquiring German real estate. The real estate transfer tax, levied at a rate of 3.5 percent, is generally imposed on any obligation to buy or sell German real estate. In general, the seller and the purchaser are liable for the real estate transfer tax, whereas the purchaser usually agrees in the purchase agreement to pay the tax. The tax base is the purchase price or any other consideration paid for the acquisition of German real estate. The tax authorities may not adjust the purchase price upwards if it is below market value. If the foreign investor acquires all shares in a corporation or partnership owning German real estate, the acquisition also triggers real estate transfer tax. In this case, the real estate transfer tax is not based on the purchase price, but on the so-called *Grundbesitzwert*, which corresponds to about 60 to 80 percent of the market value. The acquisition will not trigger real estate transfer tax if the foreign investor acquires less than 95 percent of the shares.

Holding of German Real Estate

Since German tax treaties allow Germany the right to tax income from German real estate, rental income is subject to German income or corporate tax irrespective of whether the foreign investor holds the German real estate directly or via a corporation or partnership. If the foreign investor is an individual, his rental income is subject to German income tax between 15 and 42 percent provided he invests in German real estate directly or via a partnership. Subject to German corporate tax are foreign corporations holding German real estate directly or via a partnership. The corporate tax rate is 25 percent for retained and distributed profits. In addition, a solidarity surcharge of 5.5 percent on the income or corporate tax is levied.

Subject to the German minimum taxation rules, net operating losses, which arise during the investment or leasing period, can be used to offset the rental income. In general, after offsetting the first million of net operating losses, any remaining net operating losses can only be used to offset 60 percent of taxable income in the respective taxable year.

In addition to income or corporate tax, the rental income can be subject to German trade tax. In principle, a company that carries out business through a permanent establishment in Germany is subject to trade tax. The tax rate is between 9 and 13 percent depending on the municipality in which the business is carried out. Trade tax may be avoided through appropriate structuring. If the real estate is held by a corporation or partnership which does not carry on a trade or business *(vermögensverwaltende Gesellschaft),* the foreign investor can receive the income from German real estate free of trade tax. If the investor deemed to be „dealing in real estate" *(gewerblicher Grundstückshandel),* the rental income derived from the German real estate will be subject to trade tax. However, according to German court decisions and the German tax administration, an owner is always considered to be dealing in real estate if he acquires and sells more than three objects of property within five years. With respect to large-scale property (hotels, business towers) the German tax authorities may assume the owners to be „dealing in real estate" even in the case of less than three objects. Based on these difficulties to distinguish and on the fact that dealing in real estate is regularly assumed retrospectively, a permanent establishment in Germany is perhaps best avoided. For this purpose, the foreign investor may not have a German physical presence and the place of management may not be located in Germany. The German real estate itself owned by the foreign investor does not constitute a physical presence in Germany for German trade tax purposes. The place of management is where the decisions for the day-to-day management are executed. If the German real estate should be administered by a German asset manager, the asset management agreement may not lead to a shifting of the management to Germany.

Sale of German Real Estate

If a foreign individual sells German real estate, the taxation depends on whether the German real estate is held as a business or a private asset. The sale of German real estate, which is held as a private asset, is only subject to German income tax if it is sold within a period of ten years after its acquisition. On the other hand, the sale of German real estate, which is held as a business asset or by corporations, is always subject to German taxation.

In principle, pursuant to German tax treaties, the sale of a shareholding in a corporation owning German real estate is not subject to German tax. It depends on the qualification of the partnership and whether the capital gains upon a sale of an interest in a partnership is subject to income or corporate tax. If the partnership carries out business or is deemed to carry out business *(gewerblich geprägt)*, the capital gains are subject to German taxation. A partnership is deemed to carry out business if only the partners are personally liable and only these or non-shareholders are authorised to manage the partnership. On the other hand, the sale of interests in a partnership, which does not carry on a trade or business, by an individual is only subject to German tax if the ten year minimum holding period is not met. If a foreign corporation holds an interest in such partnership, the capital gains are subject to German corporate tax.

Summary

Taxation of foreign investors depends on whether they invest in German real estate either directly or via a corporation or partnership. In the case of a direct acquisition or via a partnership, the investor himself can depreciate the acquisition costs. When using a corporation as an intermediary, only the corporation can depreciate the acquisition costs of the German real estate. With respect to the structuring of the investment, it should be noted that the investment does not trigger German trade tax, if the investor does not carry out business through a permanent establishment in Germany. If the German real estate is administered by a German asset manager, the activities of the asset manager should not lead to a shifting of the management to Germany. Independent of the structuring of the acquisition of German real estate, the rental income and the capital gains are, in principle, subject to income or corporate tax in Germany. The sale of shares in a German corporation owning German real estate is usually tax exempt in Germany. This is different for the sale of interests in a partnership owning German real estate unless the interests are held as a private asset and the holding period of ten years has expired. With adequate structuring, the real estate transfer tax applicable to a transfer of at least 95 percent of the company's shares may be avoided.