

CLIENT ALERT

Update on German RETT Reform

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In 2019, a draft law to amend the German Real Estate Transfer Tax (“**RETT**”) Act was introduced, but has not been enacted so far. The draft law was subject to significant criticism, resulting in the government halting the legislative process to reconsider the various options and to resume the process in the first half of 2020. While no action has been taken to date, the Social Democratic Party brought the issue back into the headlines and is pushing for a finalization of the legislative process. This alert serves to provide an overview on the status of the legislative process and alternatives for a RETT reform, as well as the potential timing of such reform.

A. CURRENT STATUS

1 OVERVIEW OVER RETT IN SHARE DEALS

- Generally, RETT is realized if a person (or a group of related persons) directly or indirectly acquires shares in a company owning German real estate, with the result that such person directly or indirectly holds at least 95% of the shares in that company (“**Unification Rules**”). RETT is payable by (i) the purchaser and the seller as joint debtors in case at least 95% of the shares are transferred or (ii) the purchaser in case RETT is realized upon a transfer of less than 95% of the shares/interest.
- Further, RETT is realized if at least 95% of the interest in a partnership owning German real estate is directly or indirectly transferred to new partners (*neue Gesellschafter*) within five years (“**Transfer Rules**”). RETT is payable by the real estate-owning partnership.

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2 RETT BLOCKER STRUCTURES

- RETT exposures might be mitigated by having an unrelated third party holding 5.1% or more of the shares or interest in a real estate-owning entity.
 - Minority shareholder should generally have legal and beneficial ownership in the minority share (ramification for limitation of shareholder rights).
 - Minority partner in a partnership must hold the minority interest for at least five years after the transfer of the majority interest.

3 RETT BURDEN

- Tax rates range from 3.5% to 6.5%, depending on the Federal State in which the relevant real estate is situated.
- RETT is based – broadly and simplified –
 - in an asset deal on the purchase price of the real estate acquired
 - in case of a share deal or reorganization on a specific value to be determined for RETT purposes, which can be estimated to equal the fair market value of the real estate transferred.
- RETT is levied on 100% of the value of real estate transferred by way of a share deal or a reorganization measure.

4 CRITICISM

- RETT on share deals involving taxpayers who can afford to seek professional advice can be easily avoided by the involvement of a (professional) RETT blocker, whereas all other taxpayers are burdened with RETT.
- There is an enforcement deficit with respect to RETT on share deals, in particular where RETT is realized due to indirect transfers of shares/interest in real estate-owning companies.

B. GOVERNMENT PROPOSAL FOR A REFORM

1 STATUS OF LEGISLATIVE PROCESS

- The coalition agreement of the parties of the current federal government provides for a plan to tighten the RETT law and prevent RETT blocker structures that are politically unwanted.
- A draft law to amend the RETT law was published by the government on July 31, 2019 and commented on by the Upper Chamber of Parliament (*Bundesrat*) on September 20, 2019.
- After a first reading in the Lower Chamber of Parliament (*Bundestag*) the draft law was submitted to the Finance Committee of the Lower Chamber of Parliament (*Finanzausschuss*) for further consultations.

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- There was a public hearing of the Finance Committee on October 14, 2019 in which the draft was harshly criticized and following which the government parties agreed to defer the legislation process to the first half of 2020.
- So far the government parties have not resumed discussions on the RETT law. The Social Democratic Party is pushing for a reform, but currently there is no political agreement on the parameters.

2 PROPOSED MAJOR CHANGES IN THE 2019 DRAFT LAW

- Reduction of the thresholds from 95% to 90%.
- Extension of holding periods from five to ten years.
- Extension of the application of the Transfer Rules to corporations.
- The changes were supposed to enter into force on January 1, 2020.

3 CRITICISM OF THE 2019 DRAFT LAW

The 2019 draft law was subject to significant criticism, partly for being too broad and partly for not being broad enough. In particular the following concerns were raised:

- On the one hand there is a general expectation that RETT blocker structures will continue to be used under the new law, with a minimum shareholding or interest of the RETT blocker of more than 10% instead of more than 5%. On the other hand, a large number of companies outside the real estate industry are facing the risk of higher RETT charges.
- Generally, the need to monitor transfers of shares in listed companies due to the extended application of the Transfer Rules to corporations will increase the administrative burden of such listed companies significantly. Some tax experts even expect that an efficient monitoring of share transfers is not feasible for listed companies.
- A reduction of the thresholds requires an adjustment of the tax base, as it appears inappropriate to assess tax on 100% of the value of real estate, if only 90% (or even less) of the shares in a real estate owning entity are transferred.
- Under the currently applicable RETT law a large number of intra-group reorganizations may result in RETT although no real estate is transferred to an entity outside the group. The risk increases if the thresholds for realizing RETT are reduced. A number of commentators request a broadening of the RETT exemptions for intra-group reorganizations.
- The extension of holding periods from five to ten years is considered too long. In order to be consistent with the holding periods provided for in the German Reorganization Tax Act (*UmwStG*) some commentators request an extension of the holding periods to one not exceeding seven years.

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C. ALTERNATIVE APPROACHES

1 AMENDMENTS OF THRESHOLDS AND HOLDING PERIODS

- Position of the Social Democratic Party (junior partner of the government coalition): Further reduction of the thresholds from 95% to 75%.
- Position of the Christian Democratic Union (senior partner of the government coalition):
 - The Union appears to have significant constitutional concerns about a further reduction of the thresholds to below 90%.
 - Concerns raised during the public hearing in October 2019 should be factored in, in particular with a view to the extension of the Transfer Rules to corporations and exemptions for intra-group reorganizations.

2 PRO RATA SYSTEMS

- Position of the Left Party:
 - Realization of RETT upon the acquisition of (i) more than 50%, (ii) more than 75% and (iii) 100% of the shares in a real estate owning company. RETT would be assessed on a pro rata basis.
 - Extension of the holding periods to fifteen years.
 - No exemptions for intra-group reorganizations.
- Position of the Alternative for Germany:
 - Realization of RETT upon the acquisition of more than 50% of the shares in a real estate owning company. RETT would be assessed on a pro rata basis.
 - Limitation of the applicability to share deals, where at least 80% of the purchase price for the relevant shares is attributable to the company's real estate.
- Position of the Green Party:
 - Pro rata taxation of direct or indirect acquisitions of shares resulting in an aggregate direct or indirect shareholding in real estate-owning companies (irrespective of the purpose of the company and its assets) of more than 50%.
 - Pro rata taxation of direct or indirect acquisitions of shares resulting in an aggregate direct or indirect shareholding of more than 10% of the shares in qualifying real estate companies. A real estate company is a qualifying company if
 - at least 50% of its assets consist of real estate, of which at least 30% are situated in Germany and
 - at least 70% of the real estate is used for leasing and letting or for trading.
 - The tax base shall be the fair market value of the underlying real estate as included in the purchase price for the relevant shares.

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3 DUTCH RETT REGIME

The pro rata approaches currently discussed are partly influenced by the Dutch RETT regime, which focuses on transactions of shares in qualifying real estate companies. The following are key factors of such regime:

- Requirements for taxation to be cumulatively met
 - Acquisition of more than one-third of the shares in a company (beneficial ownership is sufficient). Acquisition by a person and its related persons/affiliates within two years are stepped together. Once the critical quota has been reached, every increase of the shareholding results in additional RETT.
 - More than 50% of the assets of the company consist of real estate and at least 30% of those assets consist of real estate situated in The Netherlands.
 - More than 70% of the real estate is used for leasing and letting or trading purposes.

The quotas are determined on the basis of fair market values. Certain assets that might be used to artificially extend the balance sheet (“ballooning”) are ignored for purposes of determining the quotas.

- Taxation principles
 - Tax basis: Pro rata share of the fair market value of the real estate.
 - Tax rate: 6% (2% for the acquisition of residential property acquired for own use).
 - Taxpayer: purchaser.

D. AVAILABILITY AND APPLICATION OF A NEW RETT LAW

1 TIMING OF LEGISLATIVE PROCESS

The Social Democratic Party is pushing to resume the legislative process and enact a new RETT law as quickly as possible. Further, the Federal States, who have the right to receive the RETT revenue, have a vital interest in a quick enactment of an amendment of a RETT law. How quickly a draft RETT law might become enacted is a question of the political agreement among the political parties. An amendment of the RETT Law would have to pass both Chambers of Parliament (*Zustimmungsgesetz*). Currently, none of the members of the Federal government coalition has a majority in any of the two Chambers or has an agreed position with any of the other parties represented in the two Chambers of Parliament that would suffice for a majority vote on any draft bill.

It is unclear whether the RETT reform will be enacted prior to the next general elections (to be held on October 24, 2021 at the latest). The partners of the government coalition might agree on:

- a compromise along the lines of the draft law published in 2019,
 - reducing the thresholds to 90%,

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- extending the holding periods to seven years, and
- exempting intra-group transactions and listed companies from RETT; or
- developing a comprehensive reform of the RETT taxation by introducing a pro rata system.

If an agreement can be reached at all, it appears more likely that this will be based on the draft law published in 2019. If no agreement can be reached, the reform process will have to be re-started from scratch after the general elections in 2021.

2 APPLICATION OF AN AMENDMENT OF THE RETT LAW

Apart from the fact that the details of an amendment of the RETT law are controversially discussed, the question arises whether an amendment might be introduced retroactively.

- Pursuant to German Constitutional Law, an amendment of the RETT law cannot be introduced retroactively for transactions for which RETT was already realized prior to the amendment coming into force. The general prohibition of a retroactive amendment of the RETT law does, however, not apply if taxpayers should expect a change of the law when the relevant RETT materializes.
- There is no clear guidance as to, when taxpayers may expect a change of the law. Generally, the latest point in time should be the final vote of the Lower Chamber of Parliament on the respective draft law, but it is also possible that taxpayers are no longer protected when draft laws are published by the legislative body.
- The draft RETT law was submitted to the Upper Chamber of Parliament on August 9, 2019 and was introduced into the Lower Chamber of Parliament on September 23, 2019; it was published on both dates. The amendments were generally supposed to apply as of January 1, 2020 without applying to transactions carried out prior to such date. Pursuant to the transition rules provided for in the draft law, broadly and simplified:
 - transactions that are taxable only due to the reduced threshold under the new Unification Rules are supposed to be affected only if the RETT event has taken place after December 31, 2019;
 - transfers of interest in partnerships carried out prior to January 1, 2020 are relevant for purposes of the reduced thresholds and extended holding periods under the new Transfer Rules only if the transferee has not qualified as a partner who has held its interest for more than five years or who was (indirectly) burdened with RETT in respect of real estate owned by the partnership (*Altgesellschafter*) as of December 31, 2019 and if the agreement on the relevant transfer agreement was concluded on or after August 9, 2019 (date of submission of the draft law to the Upper Chamber of Parliament);
 - transfers of shares in corporations are relevant for purposes of the new Transfer Rules for corporations only, if the underlying transfer agreement was concluded on or after August 9, 2019.
- While it cannot be excluded that a retroactive application of the RETT law is requested by some politicians even though January 1, 2020 lapsed without the new law having been enacted, it appears that the Christian

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Democratic Union is currently not supporting a retroactive introduction of an amendment of the RETT law. We believe that the longer the legislation process takes and the more significant the amendments are that are made to the draft law published in 2019, the less likely a request for a retroactive introduction becomes. If no amendments are enacted until the general elections in 2021, the question of retroactivity should be irrelevant.

E. OUTLOOK

It is difficult to assess whether a RETT reform will be enacted at all before the general elections in 2021 and what amendments such reform might bring. While it cannot be ruled out that an amendment of the RETT law might be introduced retroactively, the halted legislative process suggests that this is unlikely.

To seek further protection, taxpayers may consider the following measures:

- Increase of the share/interest held by RETT blockers to more than 10%;
- Seeking a RETT insurance, which is offered by a number of insurance companies;
- Seeking protection against RETT under the Transfer Rules by introducing indemnities to shareholder agreements.

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