Low Taxes on German Real Property Investments

Word is spreading that Germany is no longer a high tax jurisdiction. Indeed, with an aggregate profit tax rate of slightly below 30 %, Germany currently has the lowest profit tax rate among the industrialised G7 countries. With such rate Germany is on the same level with countries generally perceived as low tax jurisdictions, e. g. Luxembourg.

Few know that it gets even better than that when looking at German rental income or capital gains from sale of German real property. Low taxation combined with Germany's comparatively low pricings and upside potential are quite an attraction for international property players. Ample reason to take a closer look at the details as well as tax planning options from the perspective of foreign investors - who are heeding the call and have accounted for roughly 2/3 of all property transactions in 2007.

If structured diligently, income from real property is only taxed at 15.825 % in Germany. It is important to note, (i) that this rate not only applies to rental income but also to capital gains, (ii) that offshore investors lacking tax treaty protection are not discriminated and (iii) that private investors should use a corporate entity as property holding vehicle – and design the structure with care.

The trick is that the investor needs to avoid being treated as a trading or service business. If that can be achieved, rental income and capital gains will be exempt from German Trade Tax of around 15 %. In effect, such Trade Tax exempt investment income would then only be subject to the 15.825 % mentioned above in the hands of a foreign corporate holding vehicle.

Given the drastic tax difference between trading income (≈30 %) and investment income (≈15 %) anyone can imagine that Germany's tax authorities are not very relaxed in conceding investment income. Quite the contrary, the taxman is more than happy to take advantage of the most minimal "technicalities" of the property investment which may trigger trading type income. A good example is a recent case in which the investor not only rented out real property for EUR 13.000 per month but also movable property for minuscule EUR 230 per month. The Supreme Tax Court held that the lease of movable property constitutes trade income and that the investor is thus treated as trader making him subject to Trade Tax on his entire income – including of course - the rental income.

This case shows, that avoiding such pitfalls is crucial to the low tax rate. The idea is to structure the investment with as many defence lines against trading income as possible. Inter alia, the following should be considered in this context:

- German or foreign acquisition entity. EU acquisition entities for example are protected by various EU legislation from discrimination in Germany. The same is true for taxation as EU entities enjoy tax treaty protection. In contrast, German entities are subject to any and all

negative domestic tax changes – without being protected by an EU or tax treaty – and thus, subject to a greater risk.

- Generate pure real property income. The case above illustrates what risks are involved in mixed income streams.

- New German thin capitalisation regulations. These new regulations restrict interest deductions exceeding 30 % of EBITDA. It is important to know that these restrictions apply to any kind of interest whether paid to a shareholder or to a bank. Given the traditionally high leverage used in property investments, the new thin cap regulations need to be considered carefully and the prescribed annual interest threshold of EUR 1 million per entity should be taken advantage of. Thus, for example, a leverage of EUR 20 million at an interest rate of 5 % will be completely disregarded and safe as all interest will be deemed deductible no matter what the EBITDA may be. However, if the interest amount exceeds the prescribed threshold only by EUR 1, the general regime is applicable and the 30 % of EBITDA rule applies to the whole interest amount. Thus, we will likely see a trend to splitting or setting up more entities and single property vehicles because the EUR 1 million threshold applies per company.

- EU holding location. Although not strictly required, traditional EU entry points for offshore investors have been Luxembourg and the Netherlands. Luxembourg has increased its weight by recently signing a tax treaty with Hong Kong through which a lot of funds including such offshore are channelled. Cyprus is also a jurisdiction to look at as it should not tax foreign source property income or apply dividend withholding tax on the transfer of profits to an off-shore location lacking a tax treaty.

- Transaction taxes. These consist of VAT and real estate transfer tax. The latter amounts to 3.5 % and 4.5 % (Berlin) of the transaction value. Tax planning opportunities exist, e. g. if the investor is willing to only acquire 94 % of a property holding company. VAT can be managed, however, due to the sheer magnitude of the rate of 19 % on the transaction value – with care.

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