Real Estate Investments in Germany from a Tax Perspective

IN MANY CASES GERMAN TRADE TAX LIABILITY CAN BE AVOIDED IF INVESTMENTS IN GERMAN REAL ESTATE ARE PROPERLY STRUCTURED.

Executive Summary

- The trade tax rate in Germany ranges from 7% to 18%. This tax must be added to the income tax rate, which amounts to between 14% and 45% for individuals and 15% for corporate entities.
- Individuals and corporate entities are only liable for German trade tax if they have a domestic permanent establishment ("PE").
- Nevertheless, German trade tax can be avoided if the requirements for an extended deduction are met.
- There are also tax advantages to investing in real estate investment funds.

German Trade Tax

Individuals and partnerships generating commercial income in Germany, as well as corporations (in any case), are subject to German trade tax, which is a special municipality tax based on commercial income. The trade tax rate varies between municipalities and ranges from a minimum of 7% up to approx. 18%. Trade tax is levied in addition to (corporate) income tax. Income tax amounts to 15.825% for corporations (incl. solidarity surcharge) and up to 45% for individuals (plus solidarity surcharge if applicable). It is therefore in the utmost interest of investors in German real estate to avoid having to pay trade tax.

A) No PE Structure

Individuals and corporation are only liable to pay domestic trade tax if they maintain a permanent establishment in Germany for trade tax purposes; otherwise the trade tax liability is per se excluded. However, the let property itself does not, according to general opinion, constitute a PE. In addition, a German PE requires that a non-German corporation be managed from Germany or have another sufficiently stable connection to Germany. Entities can avoid a PE based on the place of management *(Geschäftsleitungsbetriebsstätte)* by performing their "day-to-day business" from outside of Germany. Granting too much power in asset management contracts and the corresponding powers of attorney are one of the typical pitfalls that can lead to an unintentional PE. Therefore, careful drafting of contracts is essential. If no German permanent establishment is intended, this issue also needs to be monitored very strictly on an ongoing basis during the asset management phase. Training sessions can be used to raise corporate awareness of the issue.

B) German PE without Trade Tax Liability

If there is a PE in Germany, trade tax can be avoided under the following conditions:

a) Asset Management Partnerships

An asset management partnership is not liable to pay trade tax on the basis of its activities and does not need to fulfil the strict requirements for the extended trade tax deduction, if cumulatively (i) the partnership does not carry out any commercial activities and (ii) if its personally liable (general) partners are not solely corporations. If a corporation is a personally liable partner, said personally liable partner must be the only partner authorised to manage the partnership. As a result, limited partnerships with a limited liability company as the personally liable partner often grant management authority to one of their limited partners in the articles of association.

Pure renting and leasing of real estate is generally not considered a commercial activity. However, leasing is no longer considered purely asset management income if there are special circumstances that cause the activity to be deemed commercial income. Trade tax liability therefore has to be examined on a case-by-case basis if, for example, the rental activity switches to a commercial lease resulting in income from business operations and therefore in a business operation subject to trade tax. If the activity goes beyond the normal scope of asset management, there is a risk that this will have a "tainting effect", causing the income generated by the company or the partnership to be classified as commercial income. This is the case, for example, if the landlord starts to engage in activities that go far beyond the normal scope of leasing.

b) Special Provision for Extended Trade Tax Deduction in Case of Real Estate Leasing

In Germany, the long-term leasing of real estate generally does not qualify as a commercial activity. For instance, an individual leasing real estate does not usually trigger trade tax. However, there are certain types of entity in Germany that trigger trade tax purely due to their legal form. Examples include corporations or GmbH & Co. KGs (German limited partnerships with a corporation as the sole general partner).

The German Trade Tax Act, therefore, contains a provision that allows entities to deduct income resulting from the lease of real estate form the trade tax assessment base if their only activity is the leasing of its own real estate ("extended trade tax deduction"). The extended trade tax deduction should allow entities that are otherwise only subject to trade tax because of their commercial legal form to be treated the same as natural persons that engage solely in the leasing of real estate, e.g. they are not liable to pay trade tax on their rental income.

The conditions that have to be met to qualify for the extended trade tax deduction are very complex, and were revised significantly as recently as 2021, though there have since been calls from a number of politicians for even further simplification. Companies need to pay very close attention to their structuring. For instance, the leasing of movable assets or operating equipment is generally not allowed – certain relief has been available for structuring since 2021. In addition, it would also be detrimental in principle (relatively strict relief available since 2021) for entities to not just exclusively lease their own real estate, but to also sub-let real estate (or even a small portion of real estate) which they are already leasing themselves. Further, in some cases – and depending on the legal form – the deduction cannot cover the trade tax on the profit resulting from an exit if certain parameters are not observed (exit concerning the last item of real estate of a portfolio during a financial year).
Moreover, performing ancillary commercial services in connection with leasing can also be detrimental from a tax perspective. Such ancillary commercial services are deemed to have been rendered if, according to general opinion, these are atypical for the leasing of real estate. Typical examples of such services include cleaning of the leased areas or other hotel style services.

As of 2021, two major exemptions have been introduced to the previously extremely strict extended trade tax regime. These exemptions provide certain relief in particular with respect to power generation and the supply of renewable energy. However, the exemptions are quite complex and the interpretation published by the tax authorities is rather restrictive.

Provided certain thresholds are observed (5% of rental revenue), ancillary activities not subject to preferential treatment are recognised which, although subject to trade tax, do not have a detrimental effect on rental income from leasing the real estate if the profit generated from the management and use of real estate owned by an entity is determined separately.

The supply of renewable energy (in particular with the exception of cogeneration units) should not lead to rental income from the real estate becoming liable for trade tax if this income does not exceed 10% of the income generated from leasing the real estate during the financial year (i.e. not the total sales revenue).

The amendment also affects income from the leasing of operating equipment or other items together with the real estate as well as from other direct contractual relationships with tenants. These also do not make trade tax payable on the rental income from the real estate provided this income in total does not exceed 5% of the income from leasing the real estate (i.e. not the total sales revenue).

It is very important to be aware of such pitfalls when structuring with a view to the extended trade tax exemption.

C) Investments in Real Estate Funds

Foreign investors may also want to consider investing in closed-ended or open-ended real estate investment funds.

Closed-ended funds are often set up as limited partnerships and are therefore usually tax transparent and, as such, are not subject to (corporate) income tax. The partnership's income is allocated to the partners and taxed at their level depending on the tax status of the partner. Trade tax can be avoided based on the aforementioned general principles and exemptions (extended trade tax deduction).

Open-ended funds and closed-ended funds that fall under the German Investment Tax Act ("**GITA**") are exempted from German trade tax under specific circumstances. Renewable energies may still be subject to trade tax in the case of funds subject to the GITA if the 5% threshold is exceeded. Moreover, certain open-ended funds may apply a specific regime under the GITA (Chapter III funds or "*Spezial-Investmentfonds*"), which is not available or lapses (with potentially severe tax consequences) if renewable energy income exceeds the 10% threshold. Structuring investment funds in a tax-efficient manner remains a complex task.

The Optimal Investment

As detailed above, there are a multitude of factors to be considered that can determine the success or downfall of a real estate investment.

However, be assured that there is always an investment opportunity to be found based on the details of the case at hand and on your own specific investment approach.

We would be happy to support your tailor made structuring!

We are there for you.

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