NEW RETT RULES FOR SHARE DEALS

On 8 May 2019, the Federal Ministry of Finance has circulated a draft law to lobbying associations, inter alia, proposing several changes to the German Real Estate Transfer Tax Act ("**RETTA**") with regards to share deals. The cornerstones of this draft law are:

- Reduction of the threshold from currently 95% to 90%;
- Prolongation of the watching and holding periods from currently 5 years to 10 / 15 years; and
- Application of the partnership movement rule also to corporations.

The draft law provides that the new rules shall generally apply as of 1 January 2020 subject to certain grandfathering rules.

Key issues

- The Federal Ministry of Finance draft law includes important changes to RETT rules for share deals.
- Changes to thresholds and holding periods may require adjustments in ongoing and future transactions but also in existing partnership structures.
- Especially in the context of corporations, current practices need to be carefully adjusted.
- The transitional provisions might require acting before the end of the parliamentary summer break.

BACKGROUND

At present, a threshold of 95% is relevant for any kind of share deal in real estate owning companies.

Where the real estate owning company is a corporation, it only needs to be ensured that no person acquires directly or indirectly 95% or more of the shares in a company in order to achieve a RETT-exempt share deal transaction. While there is this restriction as to how many shares in such corporations can be acquired by one person, there is no restriction as to how many shares can be transferred at once. Therefore, it is possible to sell even 100% of the shares in a real estate owning corporation in a single transaction without triggering RETT. There are no holding periods that would need to be obeyed.

Where the real estate owning company is a partnership, the rules are more complex. Besides the rules set out above for corporations, which also apply to partnerships, the so-called partnership rule or movement rule applies, which provides that RETT is triggered if 95% or more of the interests in a real estate owning partnership are transferred (directly or indirectly) to new partners within a watching period of five years (whereby the tax authorities take the view that transfers of shares in a corporation which directly or indirectly hold an interest in the property-owning partnership need to be added together irrespective of whether these share transfers occur within a five-year-period).

While the rules for partnerships are more complex, they also provide for additional benefits. Namely, if an investor increases its stake in a partnership reaching the threshold of 95% after a holding-period of at least five years RETT will not be levied for the existing stake. Against this background, it is quite common in the German market that investors acquire in a first step only 94.9% of a real estate owning partnership and the seller retains a stake of 5.1%. After five years, the investor acquires also the remaining 5.1% increasing its stake to 100%. In such a case, RETT will be triggered, but only 5.1% of the RETT will be levied.

Politicians have criticised these rules as they would favour the big investors allowing them to buy and sell real estate without paying RETT while the man in the street has to pay RETT if he buys a private home. Therefore, the German tax authorities have been trying for nearly three years to come up with new rules narrowing the possibility of RETT-exempt share deals.

THE NEW RULES IN DETAIL

The **first change** is a reduction of the existing threshold from 95% to 90%. Therefore, in the future, the stake of sellers to be retained would increase from 5.1% to 10.1%.

The **second change** concerns the watching and holding periods for partnerships. Where currently both the watching-period for the movement rule and the holding-period for the tax-exemption are aligned (in each case five years), the new rules provide for different periods.

- The watching-period shall be extended from five to ten years, which means that RETT would be triggered if 90% or more of the interests in a partnership are transferred to new partners within a period of ten years. As before, it needs to be ensured that no indirect changes of 90% or more at the shareholders' level of the seller occurs during the ten-year-period (whereby it seems possible that, in case the seller is a corporation, the tax authorities will even consider transfers of shares in the seller which occurred more than ten years ago);
- The holding-period shall be extended from five to fifteen years, which means that an investor would hold its stake (e.g. 89.9%) for at least fifteen years before such investor could acquire the remaining stake and benefit from the exemption concerning its existing (e.g. 89.9%) stake. This extension of the holding-period may have a substantial impact on existing partnership structures where the five-year-period will not have been lapsed by the end of 2019 (and where respective put or call options exist that were tailored to address the five-year-period).

The **third change** is a real game changer as it introduces a completely new rule for share deals, namely a movement rule for corporations like the existing movement rule for partnerships. That means that under the new rules it will no longer be possible to sell 100% of the shares in a real estate owning corporation at once without triggering RETT. Rather, as it is already the case with respect to partnerships, the seller would need to retain a stake of more than 10% for a period of at least ten years. The difference to partnerships is that the exemption available for partnerships allowing an investor to increase its stake to 100% after fifteen years triggering a relatively low RETT burden will not be available for corporations.

This new rule highlights the reasoning of the proposed law changes. Direct and indirect transfers of 90% or more of interests or shares are deemed as an economical transfer of the underlying real property to a new owner.

IMPACT ON FUTURE TRANSACTIONS

The proposed rules shall apply as from 1 January 2020 onwards. Therefore, any transaction that is signed and closed before the end of 2019 would still fall under the old rules. For other transactions, it needs to be differentiated:

- Transactions that are signed and closed after 2019 are generally subject to the new rules. But even then, the old rules might still be relevant in particular cases where the investor has already acquired a stake exceeding the new threshold of 90% but lower than the existing threshold of 95%. Other than in 2000 when the threshold was lastly reduced from 100% to 95%, it will not be possible to increase an existing stake of 90% or more to 100% without triggering RETT.
- Transactions that are signed within one year before the date on which the draft law has been introduced into the German Parliament (the "**Introductory Date**") and that are closed within one year after the Introductory Date ("**Grandfathering**") shall still fall under the old rules. It is expected that the law is not introduced into Parliament before the end of the summer break. The Parliament has announced it will reconvene at the beginning of September 2019. Against that background, the relevant signing period could be from September 2018 to September 2019 and the relevant closing period could be from September 2019 to September 2020, whereby a closing between September 2019 until December 2019 would fall under the old rules anyway.
- For transactions that are signed more than one year before the Introductory Date and / or closed more than one year after the Introductory Date, the Grandfathering shall not be available, meaning that the new rules should generally apply. This could affect, in particular, forward deals that have been signed more than one year ago and/or will not be closed before 2020.

Although the draft law provides for some clarity in terms of application of the new rules, there are some uncertainties concerning the new movement rule for corporations. It is not entirely clear to what extent past share transfers have to be taken into account when calculating the total percentage of share transfers within the ten-year-watching period. It seems possible that the tax authorities will want to consider past share transfers at least if less than 90% of the shares in the relevant corporation have been transferred to new shareholders during the last ten years (although there are arguments that such interpretation of the proposed new law should be inadmissible)..

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RÉSUMÉ

With the extension of the partnership rule to corporations, it will no longer be possible to transfer immediately 100% of shares in real estate owning corporations without triggering RETT. As a result, current practices need to be aligned with the proposed draft law regarding property-owning corporations. This holds true, in particular, when new holding structures are set up.

To react to the proposed RETT changes it is advisable to determine whether the signing of transactions could and should be done before the end of the parliamentary summer break at the beginning of September 2019 and/or whether a closing still in 2019 is achievable. If this is not possible, further structuring considerations may be appropriate.

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