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GERMANY SIGNS NEW BILATERAL TAX TREATIES WITH LUXEMBOURG AND THE NETHERLANDS: IMPACT ON REAL ESTATE TRANSACTIONS AND STRUCTURES

Germany signed bilateral tax treaties (the "New Treaties") with Luxembourg and the Netherlands on April 12 and April 23, 2012, respectively; the New Treaties replace former treaties (1958/73/09 and 1953/80/91/04, respectively). The most salient new features of the New Treaties are the provisions dealing with capital gains derived from the disposal of shares (and other equity instruments) in real property–owning companies ("Real Estate Companies"). Both New Treaties are expected to enter into force on January 1, 2013, subject to notification by the contracting states of the treaties' ratification by their respective legislatures. The New Treaty with Luxembourg comprises a protocol consisting of five sections, while the New Treaty with the Netherlands comprises a protocol with 19 sections.

INCOME AND CAPITAL GAINS FROM GERMAN REAL ESTATE

German Domestic Law

German domestic tax law provides that nonresident shareholders of a German resident company are subject to German capital gains taxation upon the disposal (or deemed disposal) of the company's shares, but only if their shareholding amounts to at least 1 percent of the company's outstanding shares. German domestic law does not differentiate between Real Estate Companies and other companies.

Conversely, when German real estate is held by a foreign Real Estate Company—i.e., one that is not resident in Germany by virtue of its statutory seat or principal place of management—Germany does not impose any capital gains tax when shares of the Real Estate Company are disposed of by nonresident shareholders.

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Existing (Old) Bilateral Treaties

Under the existing treaties with Luxembourg and the Netherlands, Germany's right to tax capital gains derived from the disposal of shares in German corporate entities (including Real Estate Companies) is restricted irrespective of the holding percentage: only the jurisdiction where the disposing interest holder is resident for tax purposes—say, Luxembourg or the Netherlands—may tax a capital gain from the alienation of shares in a German company. Hence, under current law, capital gains derived by shareholders resident in Luxembourg or the Netherlands cannot be taxed in Germany. In most instances, such capital gains will also remain tax-exempt in the Netherlands and Luxembourg by virtue of the participation exemption (*Schachtelprivileg*).

New Bilateral Treaties

Deviating from the current treaty provisions, the New Treaties stipulate that in certain instances where interest in Real Estate Companies is sold or otherwise disposed of, the resulting capital gain can be taxed in the country where the property is located.[1] (The New Treaties define the term "Real Estate Company.")

Since Germany does not impose tax on capital gains from the disposal of shares in nonresident foreign Real Estate Companies (or other corporate entities, for that matter) under its domestic tax law, the New Treaties will result in a charge for German capital gains tax only when the Real Estate Company is tax-resident in Germany by virtue of either its statutory seat or its principal place of management and control. Capital gains resulting from the disposal of shares in SPVs that are tax-resident abroad (e.g., in Luxembourg or the Netherlands) still would not be subject to tax in Germany when the disposing shareholder is not resident in Germany.

Who Is Affected?

The amendments of the New Treaties will therefore be relevant only to those structures or transactions in which German real estate is held by a German Real Estate Company and the disposing shareholder is tax-resident in Luxembourg or the Netherlands. The New Treaties can also affect structures that involve: (i) corporate entities established in different jurisdictions whose principal places of management are in Germany (e.g., through the appointment of asset managers, property managers, or other advisors with excessive functions), or (ii) entities that immigrated to Germany by creating German statutory seats:

- For a *Luxembourg shareholder* of a German Real Estate Company, the New Treaty provides that Germany has the right to tax a capital gain when *more than 50 percent* of the value of the corporate entity directly or indirectly consists of German real estate.

- For a *Dutch shareholder*, the capital gain would be taxable if *more than 75 percent* of the assets of the German Real Estate Company directly or indirectly consist of German real estate (excluding real estate assets used: (i) for the business operations of the company, or (ii) by the company's shareholders for their business purposes in Germany). However, capital gains will be taxed in Germany only when the disposing shareholder held more than 50 percent of the shares prior to the disposal. Capital gains resulting from a reorganization, merger, demerger, or similar transaction can be taxed only in the jurisdiction in which the shareholder is resident (say, the Netherlands).

What Are the Consequences?

If a capital gain is subject to taxation in Germany according to German domestic law and the New Treaties, it is, in principle, (partially) tax-exempt.

- German domestic tax law provides that 95 percent of the capital gain realized by a *corporate shareholder* from the disposal of shares in a corporate subsidiary is tax-exempt (resulting in an effective tax charge of approximately 0.79 percent).
- If the shares are held by a *private individual*, 40 percent of the capital gain would be exempt, and the remaining part of the gain would be subject to tax at ordinary rates.

However, the (partial) tax exemption for capital gains will not apply if the foreign shareholder qualifies as a financial undertaking (*Finanzunternehmen*) that realizes the capital gain in a short-term proprietary trading transaction

1 Similar provisions can be found in other recent double-taxation treaties signed by Germany, e.g., treaties with Cyprus and Spain (both of which entered into force on January 1, 2012).

(*kurzfristiger Eigenhandelserfolg*). According to the case law of the German Federal Fiscal Court, a company holding an SPV (in which a real property project is developed or held) that subsequently disposes of the SPV shares may qualify as a financial undertaking, and the capital gain resulting from the disposal of the SPV shares might therefore be taxable at standard rates (15.83 percent corporate income tax, including solidarity surtax).

Currently the German federal government has not published plans to extend the domestic tax rules to include capital gains from the disposal of foreign entities owning German real estate.

Other Capital Gains on Provisions

Under the New Treaty with Luxembourg (Article 13(6)), capital gains on shares realized by an individual taxpayer formerly resident in one contracting state who emigrated to the other contracting state may be taxed by the first-mentioned state to the extent the gains relate to the period during which the taxpayer was a resident of the first-mentioned state, provided he had resided in that state for a period of at least five years. The other state (the location of the taxpayer's current residence) must grant a step-up in basis to prevent double taxation with respect to those gains.

The same rule applies under the New Treaty with the Netherlands, except that there is no reference to a five-year period during which the taxpayer must have resided in the first-mentioned state.

Collective Investment Funds, Investment Companies, and Pension Funds

Under the protocol to the New Treaty with Luxembourg (Section 1), it is explicitly confirmed that the New Treaty applies to collective investment funds and investment companies. In practice, this provision will benefit Luxembourg UCITs (SICAR, SICAV, SICAF, and FCP) when they are derived from German-source dividends.

The protocol to the New Treaty with the Netherlands provides in Section XIX that collective investment schemes may claim treaty protection to the extent their investors would be entitled to such protection without the interposition of the investment scheme.

By virtue of Section VIII of the New Treaty with the Netherlands, a Dutch pension fund is entitled to the reduced withholding tax rates for dividends, provided that more than 75 percent of the beneficiaries, partners, or participants of the pension fund are individuals resident in the Netherlands or Germany who are entitled to benefits from the pension fund pursuant to services rendered to a Dutch employer.

Interaction With EU Directives

Section 3 of the protocol to the New Treaty with Luxembourg provides that the EU direct tax directives (the Parent-Subsidiary Directive, the Interest and Royalties Directive, and the Merger Directive) override the provisions contained in Articles 10, 11, 12, 13, and 22 of the New Treaty. No such provision is in the Dutch treaty.

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