

German Real Estate Transfer Tax: The end of so-called 94/6 Partnership Structures?

German Federal Fiscal Court severely tightens framework for acquisition structures by using beneficial ownership as the standard for the attribution of indirect participations.

Key Subject of the Decision

With a ruling published on 10 September 2014, the Federal Fiscal Court has severely tightened the framework for many structures which aim to avoid real estate transfer tax upon transfer of partnership interests. Real estate transfer tax is triggered irrespective of the seller continuing to hold more than five percent of a real estate holding partnership, if such partnership interest is to be attributed to the purchaser from an economic perspective. The decision of the II. Senate of the Federal Fiscal Court addresses the impact of contractual instruments between the interest holder of a minority interest in a property owning partnership and a third party acquirer on the allocation of the minority partnership interest and, consequently, on the indirect change of ownership under Sec. 1 para. 2a Real Estate Transfer Tax Act (RETTA). In the case at hand, such contractual instruments led to an economic allocation that differs from the civil law situation.

Case Facts

In the case at hand, parties described in the decision as A and B were the sole limited partners of a property owning limited partnership. A held 18 percent and B held 82 percent of the interest in the partnership. The general partner of the partnership was a limited liability company (GP GmbH), with no interest in the assets of the property owning partnership, the sole shareholders of which were also A and B. A and B transferred all shares in the GP GmbH to another party described as X. Whereas A transferred its limited partner's interest to X, B only partially transferred its interest in the partnership to X and continued to hold 5.6 percent of the partnership interests. As a result, X held all shares in the GP GmbH and 94.4 percent of the interest in the property owning partnership.

In addition, the parties agreed on a "double option" consisting of a call option — pursuant to which X could request the transfer of the remaining interest at a fixed price — and a put option pursuant to which B could request the transfer if X had not opted for the transfer after the lapse of five years and two months following closing at an equally fixed price. Besides, B and X entered into several contractual instruments:

- B transferred all profit rights related to the minority interest to X.
- X issued a loan to B in the amount of the purchase price to be repaid by X upon transfer of the remaining interest.
- B authorized the representative of X to exercise all rights related to the minority interest and make any and all statements against any third party.

Content of the Decision

The Federal Fiscal Court came to the conclusion that — for purposes of real estate transfer tax (RETT) — all interests in the property owning partnership were transferred — directly and indirectly — to purchaser X, so that real estate transfer tax was triggered.

Generally, RETT is triggered pursuant to Sec. 1 para 2a RETTA if at least 95 percent of the partners of a partnership owning real estate change directly or indirectly within a period of five years. The direct transfer of interest is based on the actual legal change of ownership from a civil perspective; the economic perspective is not taken into account. In the case at hand, 94.4 percent of the interest were directly transferred to X, which was undisputed by all parties.

The crucial point was the treatment of the minority interest of 5.6 percent which B continued to hold. In the Senate's opinion, the indirect change of ownership is — unlike the direct transfer of ownership — to be assessed in accordance with economic principles. The indirect transfer, according to the court, cannot be based on civil law principles since civil law does not provide for an indirect change in ownership of a company. Whether the prerequisites of Sec. 1 para 2a RETTA are met and RETT is triggered should be based on economic principles.

Such an approach is not completely new; the Federal Fiscal Court has already stated such opinion in previous decisions (e.g. in the ruling from 24 April 2013 – reference no. II R 17/10). However, until now the economic approach has been applied and interpreted very restrictively. This reflects the general concept of Real Estate Transfer Tax Act which generally ties to civil law. With this in mind, the Federal Fiscal Court had decided that Sec. 39 para 2 no. 1 General Tax Act (GTA) (attribution of ownership pursuant to an economic approach for tax purposes) was not (or only in a few exceptional cases) to be applied for real estate transfer tax purposes (Federal Fiscal Court of 22 September 1982 – reference no. II R 61/80). The taxation on the grounds of an economic allocation of assets was, hence, exceptional. Therefore, attribution rules like Sec. 39 and 42 GTA were hardly ever applied for real estate transfer tax purposes.

With a view to the Federal Fiscal Court's recent decision, following such argument will no longer be possible. In the case underlying the decision, the Court attributed the remaining 5.6 percent of interest to purchaser X due to the contractual instruments concluded between the parties. X was deemed to have become the sole interest holder for real estate transfer tax purposes.

In detail, the Senate stated that the mere conclusion of the double option alone would not have caused the attribution to X for real estate transfer tax purposes. The attribution of ownership is determined on the grounds of an overall picture of the facts and circumstances of the case. In any event, the following criteria point into the direction of a transfer of economic ownership:

- The acquirer obtains a legally established position with regard to the future acquisition, that cannot be withdrawn
- The substantial rights of the interest are transferred to the acquirer
- Economic opportunities and risks of the investment lie with the acquirer

The Senate attributed the interest share of 5.6 percent to X and stated that the overall-picture-approach does not require the fulfillment of each and every criterion usually required in case of the transfer of economic ownership.

Review and Guidance

The Federal Fiscal Court confirmed but also tightened its case law on applying an economic approach for real estate transfer tax purposes in exceptional cases. The court also strengthened the economic approach to the disadvantage of certain structures involving the transfer of real property by admitting the application of attribution rules like Sec. 39 GTA in the context of real estate transfer tax law. As a result, contractual instruments may lead to deemed acquisitions triggering RETT.

As every case will be considered individually, legal uncertainty increases for tax-optimized real estate acquisition structures. However, this decision also provides landmarks by which solid structures may still be established going forward:

- Economic ownership principles must be considered for indirect changes of real estate holding partnerships.
- The conclusion of a double option alone does not lead to a change in economic ownership.
- Economic ownership is transferred in case only voting rights remain with the legal owner of the participation, at least if these voting rights are diminished by contractual instruments.
- Similar structures should be tested carefully prior to enactment with a focus on the remainder of substance in the hands of the legal owner of the minority interest.
- Substantial rights must remain attached to the legal ownership to avoid the impression of an economic erosion of ownership by the other contractual party.

In light of this decision, it must be expected that the II. Senate of the Federal Fiscal Court will make the next step along this line to the disadvantage of taxpayers in a currently pending appeal proceeding (II R 18/14). In that case the court must decide whether an indirect transfer of ownership and RETT is triggered if the former interest holder establishes a trust relationship, being the trustee for a third party trustor. The local Fiscal Court of Munich (decision of 12 February 2014 – reference number 4 K 1537/11) concluded that according to the principles to be applied, ownership had not been transferred to the trustor due to the fact that mere contractual connections do not suffice for such an attribution for real estate transfer tax purposes. Against the background of the case at hand, the Federal Fiscal Court likely will overrule such decision.

Conclusion

Despite this decision, tax-optimizing structuring involving the transfer of real estate will still be possible. However, contractual instruments between a seller retaining a minority interest and a third party who acquired the majority of interest must be reviewed carefully in light of the recent tendencies in real estate transfer tax case law, so parties can minimize the risk of triggering real estate transfer tax.

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