TAX AND BUSINESS LAW CONSULTING

TAXATION OF NON-RESIDENT CAPITAL GAINS RESULTING FROM THE SALE OF SHARES IN REAL ESTATE-OWNING CORPORATIONS

BACKGROUND AND LEGISLATIVE AMENDMENT IN 2018

Before the amendment of the law, the disposal of shares in foreign corporations with domestic real estate assets by shareholders with limited tax liability could only be taxed if the corporation had its company seat or place of management in Germany and if the shareholder held at least 1 % of the company's share capital (pursuant to sec. 17 EStG – German Income Tax Act "**GITA**").

This tax gap has now been closed by the law "to prevent VAT losses relating to trade of goods in the internet and concerning the amendment of other tax regulations" of 11 December 2018 according to Article 13 para. 4 of the OECD Model Tax Convention, version 2017. In this context, sec. 49 para. 1 No. 2 letter e) GITA (income subject to limited taxation) has been supplemented by a double letter cc).

APPLICATION AND REQUIREMENTS

Double letter cc) covers gains from the disposal of shares in a corporation which is and whose shareholders are resident abroad for tax purposes and the disposal took place after 31 December 2018.

Further prerequisite for the limited tax liability is that
- more than 50 % of the value of the corporation's shares is based, directly or indirectly, on real estate located in Germany at any point in time during the 365 days preceding the disposal (so-called "review period") and
- pursuant to § 39 AO (German Tax Code), the shares in the corporation were attributed to the seller at that time.

It is sufficient, if the seller held at least 1 % of the share capital of the corporation within the last five years preceding the disposal. Therefore, it is not necessary for the seller to hold at least 1 % of the shares in the corporation at the time of disposal.

VALUATION OF DOMESTIC COMPANY ASSETS

The quota of 50% of domestic immovable assets as part of the total assets is to be calculated based on the book values of the company assets. If assets of an indirect shareholding are to be included, the quota of 50% is to be calculated based on a consolidated view of the assets of the companies, to which the domestic immovable assets can be directly or indirectly attributed.

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CONTACT

BDO AG
Wirtschaftsprüfungsgesellschaft

DR. HENRIK MEYER
Partner, Head of International Tax Department, Frankfurt am Main
Phone: +49 69 95941 - 266
henrik.meyer@bdo.de

LILIANE KLEINERT
Senior Manager
M&A Tax and Legal Services, Hamburg
Phone: +49 40 30293 - 553
liliane.kleinert@bdo.de

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RESTRICTIONS BY DOUBLE TAXATION TREATIES

Article 13 para. 4 OECD Model Tax Convention 2017 forms the basis for negotiating new double taxation treaties („**DTT**"). However, the extent to which a country is entitled to the right of taxation for income generated in one of the two contracting countries is agreed in an individual DTT between Germany and the respective contracting state.

If a DTT exists, Germany's right of taxation as the country in which the real estate is located is determined by whether the DTT contains a provision corresponding to sec. 49 para. 1 no. 2 letter e) double letter cc) GITA. If the prerequisites of sec. 49 GITA go further than legally permitted according to the respective applicable DTT, Germany's tax claim may be restricted. This becomes relevant in cases where the real property clause in a DTT deviates from sec. 49 para. 1 no. 2 letter e) double letter cc) GITA, e.g. contains deviating quotas which, in some cases, can only be determined at the time of disposal due to the lack of a review period (cf. Art. 13, para. 2 DTT Germany-Netherlands „more than 75% indirectly or directly" (without review period); cf. also Art. 13, para. 2 DTT Germany-Austria „predominantly" (without review period), whereby indirect shareholdings are not covered by the real property clause).

If there is no DTT, sec. 49 para. 1 no. 2 letter e) double letter cc) GITA is applicable without restriction.

CURRENT PRACTICE

The amount of additional taxable income in connection with the new legislation is likely to be rather small. Pursuant to sec. 8b KStG (German Corporation Tax Act „**GCITA**"), capital gains from the disposal of shares by foreign corporations remain fully tax-exempt (insofar, pursuant to German Federal Tax Court, judgment of 31 May 2017, case no. I R 37/15, the fiction of non-deductible operating expenses of 5 % is not applicable). In absence of a domestic permanent establishment of the seller, trade tax is also not applicable. Therefore, especially investors who cannot claim sec. 8b GCITA, namely individuals – where the German partial income system pursuant to sec. 17 GITA applies – and certain finance and insurance companies would be materially affected.

Practical application issues might arise with regard to the method by which the existence of the required criteria can be determined or reviewed. Non-resident shareholders of corporations – particularly those with micro shares – usually do not have the necessary information to determine, whether the share value of the corporation in the year preceding the disposal was based on more than 50 % of real estate assets in Germany.

Moreover, the application of the 365-day-period could be difficult, if e.g. a complete disposal of the real estate by the foreign corporation is followed by a sale of shares by a shareholder and the 365-day-period has (formally) not expired yet. The capital gain arising from the sale of the real estate itself is already taxed on the level of the real estate owning corporation, sec. 49 para. 1 no. 2 letter f), double letter bb) GITA.