Determination of Income

Tax depreciation on buildings

Straight line depreciation in accordance with German Income Tax Law

Provided a building constitutes a business asset, is not used for residential purposes, and the application for the building permit was filed after 31 March 1985, the depreciation rate for acquisition and construction costs after 31 December 2000 is 3% (for acquisitions and constructions before 1 January 2001: 4%). If this is not the case, the following applies:

- completion after 31 December 1924: 2%
- completion prior to 1 January 1925: 2.5%

Other tax depreciation regulations

- Declining balance depreciation may no longer be applied to new buildings (building application/executory contract on or after 1 January 2006).
- Depreciation on buildings undergoing redevelopment and in urban development areas as well as on historical buildings may be accelerated under certain conditions.

Financing costs

Interest and other financing costs are fully deductible as costs of earning non-business income provided there is a commercial nexus to the rental income. Where interest is incurred by a business (also applicable for corporations as well as foreign corporations with domestic income), the so-called earnings stripping rules must be observed. The earnings stripping rules place an annual cap of 30% of EBITDA as calculated under tax law on the net interest expenses of any business taxable in Germany. EBITIDA is the taxable profit prior to application of the earnings stripping rules plus interest expenses and tax depreciation less interest income. Unused deduction volumes may be carried forward to the following business years, however, this tax EBITDA carry forward is limited to a maximum period of five years. Non-deductible interest expenses may on principle be carried forward indefinitely to the following years (interest carry forward). There are certain exceptions to the application of the earnings stripping rules. In particular, the earnings stripping rules do not apply where the balance of interest expenses versus interest income is less than €3 million (de minimis threshold). However, the Federal Tax Court (BFH) has asked the Federal Constitutional Court (BVerfG) to decide whether the earnings stripping rules breach the general principle of equality enshrined in the constitution.

Repair and maintenance expenses — acquisition-related construction costs

Regarding the distinction between immediately deductible repair and maintenance expenses and subsequent costs of construction that are only deductible by way of depreciation, German tax rules stipulate that expenses for repair and modernization carried out within three years of the purchase of the building also fall under acquisition-related construction costs if the expenses exclusive of VAT exceed 15% of the original acquisition costs of the building. Otherwise, they are deemed repair and maintenance expenses, for example, where regular annual maintenance is concerned.

Trading in real estate is deemed to be commercial where purchase and sales activities exceed the limits of private asset management. It results in the taxation of profits from the sale of real estate irrespective of the period of ownership. Furthermore, where trading in real estate is commercial, no ordinary depreciation on the value of buildings is permitted since the real estate represents current assets held for trading. The sale of up to three properties within a five-year period (in the case of members of the industry: ten-year period) must in principle be regarded as private asset management (except for, inter alia, ‘big tickets’). Since the period for private sales transactions has been extended to ten years for plots of land and since trade tax is credited as a lump sum against the income tax this distinction has become less significant.

Intention to generate income in the case of losses from rental and usufructory leasing (tax deferral schemes)

The lack of an intention to generate income and thus the non-recognition of losses from rents and leases for tax purposes is assumed in exceptional cases where the income is not expected to exceed the costs of earning non-business income for the entire period of the expected use of the property (Lieblingsrente, hobby activity).
In the event of participation in tax deferral models (Steuerstundungsmodelle), losses may not be deducted from subsequent profits unless they originate from the same income source (§ 15b Income Tax Act).

Private sales transactions
Profits from the sale of land are subject to tax if the time elapsed between purchase and sale is less than ten years. Exceptions apply where the property is owner-occupied. The profit or loss is the difference between the selling price and the cost of purchase or construction, less depreciation, write-offs and selling costs.

Taxation of Alternative Investment Funds
According to the Capital Investment Act, real estate investors can invest in several different Alternative Investment Funds (AIF) such as the German open-ended AIF (Sondervermögen), the closed-ended investment limited partnership (Investmentkommanditgesellschaft, InvKG), investment stock corporations (Investmentaktiengesellschaften, InvAGs) and foreign investment vehicles. The taxation of the AIF is regulated by the Investment Tax Act which so far includes three different regimes for the taxation of investment funds, the taxation of partnership-type investment companies and the taxation of corporation-type investment companies.

Taxation as investment fund
Open-ended AIFs which, according to the principles of risk diversification, invest only in certain asset types such as real estate, etc. and are controlled by supervisory authorities, can in principle qualify as investment funds. Apart from other requirements that must be met, the AIF must observe certain financing limits and there may be no active entrepreneurial management of the assets. AIFs are considered to be ‘open-ended’ if investors have the right to redeem their shares at least once a year. Taxation as investment fund follows the transparent regime, but only to a certain extent (eingeschränktes Transparenzprinzip), as laid down by the Investment Tax Act, i.e. income generated by the fund is taxed at the level of the investor, with the tax being levied irrespective of whether profits are distributed or retained. Domestic investment funds are exempt from corporate income tax and trade tax. Under income tax law, distributed and retained earnings of real estate investment funds are treated as investment income for the investor (§ 20 Income Tax Act). AIFs which do not meet the requirements stipulated for investment funds are treated as investment companies.

Taxation of partnership-type investment companies
Investment companies in the legal form of a German investment limited partnership (Investmentkommanditgesellschaft, InvKG) or a comparable foreign legal form are subject to the transparent taxation regime applicable to partnerships. Depending on the structure of the AIF, investors generate income from rental or usufructory leasing (§ 21 Income Tax Act), income from capital investment (§ 20 Income Tax Act) or commercial income (§ 15 Income Tax Act).

Taxation as corporation-type investment company
Corporation-type investment companies are all investment corporations that are not partnership-type investment companies. Investment funds and comparable foreign AIFs are treated as corporation-type investment companies if they fail to qualify as investment funds. Corporation-type investment companies are fully subject to corporate income and trade tax. Distributed earnings of corporation-type investment companies are treated as investment income for the investor.

On 26 July 2016, the Investment Tax Reform Act was promulgated in the Federal Law Gazette. The reform introduces new rules that are designed to simplify the taxation of income from investment funds and to avoid known tax arrangements. The above-described system of the three regimes is no longer be applied from 1 January 2018 onwards.

The core elements of the Investment Tax Reform Act are, among others:
1. Introduction of a “non-transparent” taxation regime for investment funds (open to the public), which provides for taxation of domestic income (domestic rental income, domestic profits from the sale of real estate irrespective of the holding period, and domestic dividends) at the level of the fund (except for tax-exempt investors), for a partial exem-
ption of income from investment funds involving a lump-sum payment at the level of the investor depending on the investment structure of the fund, and for annual taxation of the appreciation of the unit as advance lump sum (Vorabpauschale).

2. The general possibility of continuing the previous taxation regime for special investment funds when exercising the so-called transparency option provided that a catalog of tax requirements and the rules governing trade tax exemption are observed. Due to the elimination of income equalization for tax purposes, the income is allocated to investors in proportion to their holding period.

Transition from the present regime is performed by means of a fictitious sale of the units as of 31 December 2017 for all funds simultaneously. The new investment taxation rules are to be applied from 1 January 2018 onwards.

**Trade Tax**

Every operational business with a permanent establishment in Germany is subject to trade tax, which is an impersonal tax. Commercial real estate companies are also subject to trade tax. These companies may reduce their trade income by a flat rate of 1.2 % of the assessed value of the real estate increased to 140 %, if the real estate constitutes part of their business assets. As an alternative, real estate companies may apply for the option of a higher reduction in the amount of the trade income allocated to the management and utilization of their own real estate. This is subject to the following provisions:

- asset management only (ancillary activities having no detrimental impact are the management and utilization of a company’s own capital assets and the care of residential buildings, and the construction and sale of single-occupancy or duplex housing and owner-occupied apartments; the earnings from these ancillary activities are subject to trade tax),
- no utilization of the real estate within the business establishment of a shareholder, and
- no co-letting of permanently installed equipment and/or movable assets (so-called ‘business fixtures’) and no provision of ancillary commercial activities by the real estate company.

**Real Estate Tax**

Like trade tax, real estate tax is an impersonal tax, i.e. the owner’s personal circumstances are disregarded almost without exception. The taxable object is real estate (for example, land and buildings). Real estate tax is computed as follows:

\[
\text{assessed value (values as at 1 January 1964; new German federal states as at 1 January 1935 or substitute tax base)} \times \text{basic federal rate (for agricultural and forestry undertakings: 6%, otherwise old federal states: 2.6-3.5%, new federal states 5-10%)} = \text{base value} \times \text{municipal multiplier (for example, Frankfurt/Main as of 2013: 500%, agricultural and forestry undertakings: 175%)} = \text{real estate tax}
\]

At the moment, there are several cases pending that address the question of whether valuing real estate using assessed values is unconstitutional. Until a decision is handed down, assessed values of real estate are therefore only determined provisionally and may subsequently be amended officially by the financial authorities, if necessary. Under certain circumstances, owners can apply for a partial waiver of 25 % of the assessed real estate tax for the preceding calendar year by 31 March of the following year, provided the owner is able to prove that the gross profit generated by the property declined by 50 % or more without the owner being responsible for the decline. In the event of a total loss of gross profit for which the owner is not responsible, 50 % of the assessed real estate tax is waived. The federal states are currently planning a real estate tax reform the aim of which is, in particular, a revaluation of real estate assets. The new values are intended to apply from 2022 onwards at the earliest.

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The following transactions in particular are subject to RETT:

- contracts for sale and other legal transactions under which a party acquires a civil law right to the transfer of title to domestic real estate,
- the highest bid in a sale by way of public auction ordered by a court,
- legal transactions directed at the legal or economic exploitation of a plot of land,
- the direct or indirect change of the partners in a partnership — holding real estate — within five years through the transfer of at least 95% of the assets of the partnership to new partners (change of partners rule),
- without time limit, the direct or indirect unification or transfer of at least 95% of the shares in a company holding real estate, and
- legal transactions due to which a legal entity directly and/or indirectly holds — from an economic perspective — a minimum of 95% in a company holding real estate.

The same status as real estate is accorded to the hereditary building right and to buildings located on third-party land.

Exemptions — in particular:

- the transfer of property by reason of death or by gifts inter vivos
- the purchase of real property making up part of a decedent’s estate by joint heirs for the purpose of dividing the inheritance
- purchase by the seller’s spouse or registered civil partner
- purchase by persons related in the direct line to the seller
- re-acquisition by the trustor on cancelation of the trust relationship
- transfer to and from a community of joint owners — pro rata exemption
- transformation from joint ownership to individual ownership
- certain privileged procedures in a group of companies based on the Reorganization Act or in case of contributions and other corporate level acquisition procedures — full exemption.

The tax is computed on the value of the consideration given or the value of the real estate. The tax rate is 3.5-6.5% depending on the German federate state in which the real estate is situated.

Real Estate Value

The values of domestic real estate and commercial property are to be established separately (for inheritance tax and gift tax as well as for RETT) if so required for taxation purposes (valuation as and when required). Following the 2006 ruling of the Federal Constitutional Court that declared that the inheritance and gift tax law as currently in force violated the principle of equality enshrined in the constitution, new rules on real estate values were adopted by the legislature for inheritance and gift tax law purposes. As of 1 January 2009, real estate valuations must follow the provisions stipulated in §§157 et seq. Valuation Act, although actual circumstances and actual values on the effective date of taxation have to be taken into account. The assessment basis is now the market value (fair value) of the developed or undeveloped real estate. According to the Valuation Act, developed real estate is valued by means of the comparison approach, the income approach or the replacement cost approach:

Based on the 2015 ruling of the Federal Constitutional Court as well as on the amendment of the RETT Act with respect to the substitute tax base, the valuation of properties, in particular in cases of sales of shares in companies holding real estate, must follow the same rules as the valuation for inheritance and gift tax purposes. The application of the new real estate values for purposes of the RETT substitute tax base has retroactive effect as of 1 January 2009. For purposes of the protection of legitimate expectations, the increase in RETT for the past is only possible in exceptional cases.
**Undeveloped real estate**

property value = size of land x standard land value

The standard land value is fixed by a local committee of valuation experts in accordance with the Town and Country Planning Code (§ 179 Valuation Act).

**Developed real estate**

For developed real estate, the valuation method depends on the type of real estate (comparison approach, income approach or replacement cost approach):

1. **Comparison approach (§ 183 Valuation Act)**

   The comparison approach is used for condominium ownership and part-ownership property as well as single-occupancy houses and duplexes. It is required for the application of the comparison approach that the local committee of valuation experts has established the corresponding comparison prices and factors. Where a comparison cannot be established, the replacement cost approach shall be used.

2. **Income approach (§§ 184-188 Valuation Act)**

   The income approach is used for the valuation of residential properties for letting as well as business property and mixed-use property for which it is possible to establish a comparable rent on the local market. The real estate value established by means of the income approach is comprised of the land value (§ 184 in conjunction with § 179 Valuation Act) and the income approach building value (§ 185 Valuation Act).

3. **Replacement cost approach (§§ 189-191 Valuation Act)**

   The replacement cost approach is used for the valuation of real estate for which it is not possible to establish a comparison as well as business property and mixed-use property for which it is not possible to establish a comparable rent on the local market. The basis for establishing the building replacement cost by means of the replacement cost approach are the regular construction costs and the gross floor area less depreciation due to building age.

4. **Proof of a lower market value (§ 198 Valuation Act)**

   The provision in § 198 Valuation Act — which could be regarded as an “opening clause” — provides the taxpayer with the option of furnishing proof of a lower market value (fair value) of the real estate than the established real estate value.

**Heritable building rights (§ 192 Valuation Act)**

The valuation of plots encumbered with heritable building rights requires separate valuations of the heritable building right and the encumbered plot. The valuation method of choice in this case is generally the comparison approach, provided that comparison prices and comparison factors can be established. In all other cases, the income approach building value pursuant to § 185 Valuation Act or the building replacement cost value pursuant to § 190 Valuation Act are determined in analog.

**Value-Added Tax**

The tax rate is 19% (reduction to 7% as appropriate).

**Real estate transactions**

**Sale of a business as a going concern, § 1 (1 lit. a) VAT Act**

This applies if the essential assets (wesentliche Betriebsgrundlagen) of a business or separately managed unit (branch of activity) are transferred to a purchaser for purposes of the purchaser’s business. In particular, all essential business assets (such as rents or leases) must be transferred, and the continuation of the business must be possible without major financial efforts. The sale of a business as a going concern is not subject to VAT. It results in the continuation of the adjustment period according to § 15a VAT Act by the purchaser. Moreover, the rules and regulations regarding the liability of the acquirer of a business (§ 75 Tax Procedure Law, AO) apply.
Taxable sale of land (§ 4 no. 9 lit. a, § 9 VAT Act)
To the extent that a sale of a business as a going concern cannot be assumed, the transaction is, as a rule, deemed to be a VAT-exempt supply of land pursuant to § 4 no. 9 lit. a VAT Act. This is subject to the proviso that the transaction is governed by the RETT Act. Transfers of movable assets and permanently installed equipment are not governed by the RETT Act even if they are mentioned in the contract for sale. Such transfers are always subject to VAT. Where the transaction is a VAT-exempt supply of land, the exemption from the VAT liability can be waived (so-called VAT option). It is required, amongst other things, that the waiver is agreed in a contract notarized by a civil law notary in accordance with § 311b (1) German Civil Code. The option may be limited to particular parts of the plot. If this option is exercised, the reverse charge mechanism applies. VAT is then owed by the purchaser. VAT liability of the recipient of the service must be indicated on the invoice. An invoice without VAT must be issued. Even if agreed in the contract that RETT is owed solely by the purchaser, RETT does not increase the assessment basis for VAT.

Renting out of real estate
The renting out/leasing of real estate is generally tax-exempt under § 4 no. 12 lit. a VAT Act.

Exceptions from tax-exempt renting out
- letting of living spaces and bedrooms for the purpose of short-term accommodation of guests (7% VAT).
- short-term letting of camping sites (7% VAT)
- renting out of sites for parking vehicles (may however be an ancillary service related to tax-exempt renting out)
- letting of permanently installed equipment (business fixtures)

VAT option pursuant to § 9 VAT Act
The exemption from the VAT liability can be waived (so-called VAT option). This applies where the sale is made to an entrepreneur for business purposes. In addition, the waiver is only permissible to the extent that the tenant makes use of or intends to make use of the plot of land for transactions that do not preclude the deduction of input tax. This does not apply to legacy cases (buildings that were completed prior to 1 January 1998 and whose construction commenced prior to 11 November 1993). Limited use for VAT-exempt purposes does not affect the exercising of the VAT option (threshold 5%).

Deduction of Input VAT
Input VAT can be deducted provided the property or parts of it are used for taxable transactions.

Allocation of input VAT
If input tax cannot be clearly allocated, it must be apportioned by estimate. In this case, the determination of the non-deductible portion of input tax based on the ratio of sales which do not entitle to the input tax deduction in relation to the sales which entitle to the input tax deduction is permissible.

The tax authorities have special requirements for:
- input tax deduction where buildings are used partly for business purposes
- input tax deduction in the case of mixed-use buildings

Input tax adjustment according to § 15 lit. a VAT Act
If the circumstances for the deduction of input tax relating to a property held as a fixed asset change within ten years of its initial use, an adjustment of input tax on a pro rata temporis basis is required. There is no statutory adjustment period for current asset real estate, so that an adjustment of input tax must be made whenever the circumstances change.
Where items are introduced subsequently and become a direct part of the income-generating real estate, or services are performed on the income-generating real estate subsequently, or where subsequent acquisition or construction costs are incurred, these are each adjusted separately. The disposal or withdrawal of a plot of land can lead to a change in the circumstances originally determinative for the input tax deduction.

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Further Relevant Aspects of Real Estate Taxation
(§ 48 Income Tax Act)

Withholding Tax on construction work
If a provider renders construction work in Germany for
– an entrepreneur (Unternehmer) within the meaning of German VAT Law, or
– a legal person under public law,
the recipient is required to withhold 15% tax on the consideration (payment including VAT) for the account of the provider.

Exceptions:
– The provider submits a valid exemption certificate to the recipient at the time payment is made.
– The recipient only carries out non-taxable transactions within the meaning of § 4 no. 12 sent. 1 VAT Act and the consideration is expected to be less than €15,000 p.a.
– The consideration is expected to be less than €5,000 p.a. in all other cases.
– Construction work for apartments, if the recipient rents out no more than two residential units.

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