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German Tax and Legal News

Lower tax court clarifies application of RETT rules in case involving downstream merger of partner into its partnership

Broad interpretation of RETT-triggering events taken in case involving real estate-owning partnership.

In a decision dated 17 April 2019 that was published in April 2020, Germany's lower tax court of Cologne provided a broad interpretation of the partnership rules that are applicable for real estate transfer tax (RETT) purposes when it ruled on the effect of a change of the partners in a German real estate-owning partnership. The tax court of Cologne considered the change of a German real estate-owning partnership's limited partner (a direct partner) by way of a merger of that partner into the partnership (a downstream merger) to be an event triggering RETT, as opposed to a mere shortening of the ownership chain that would not trigger RETT. The decision of the lower tax court of Cologne is in line with an earlier decision of the lower tax court of Duesseldorf dated 29 March 2017 (an appeal of which is pending before the German federal tax court (BFH)).

Under the German RETT rules, RETT generally is triggered under the following circumstances:

- Direct transfers of real estate located in Germany;
- Where 95% or more of the shares in a German real estate-owning company are directly or indirectly transferred to a new owner;
- Where 95% or more of the shares in a German real estate-owning company are directly or indirectly combined for the first time in the hands of a new shareholder; or
- Where there is a 95% or greater direct or indirect change of the partners in a German real estate-owning partnership.

Based on the German RETT rules, the mere shortening of a real estate-owning entity's shareholder chain (e.g., through mergers involving existing direct and indirect shareholders) generally is not considered a RETT-triggering event. It has long been disputed between German tax practitioners and the tax authorities whether the shortening of a chain of partners in the case of a real estate-owning partnership that involves a direct partner in the partnership (a downstream merger or upstream merger of a direct partner) constitutes a RETT-triggering event.

In the case that was decided by the lower tax court of Cologne, the 100% limited partner in a real estate-owning partnership was merged downstream into the partnership. As a result, the shareholder of the partner that was merged out of existence changed from being an indirect partner in the real estate-owning partnership to being the direct 100% limited partner in the real estate-owning partnership. Although such a downstream merger generally would qualify as a mere shortening of the shareholder chain, and no new shareholder was introduced into the ownership structure, the lower tax court decided that the partnership rules that apply for RETT purposes provide for a RETT-triggering event in a case where 95% or more of the direct interests in a partnership are transferred to new direct partners in the partnership. According to the court, the fact that the shareholder of the partner that was merged out of existence already was an indirect partner in the German real estate-owning partnership should not be determinative for purposes of the RETT rules, i.e., it did not mean that there was no RETT-triggering event. In the court's view, only in cases where a German real estate-owning partnership's shareholder chain is directly or indirectly shortened and the change qualifies as a mere shortening of the shareholder chain would such a change not constitute a RETT-triggering event.

The lower tax court of Duesseldorf reached a similar result in its 2017 decision involving an upstream merger scenario, where the direct partner in a German real estate-owning partnership merged upstream into its shareholder.

An appeal of the lower tax court of Cologne's decision is pending before the BFH (as is the appeal of the decision of the lower tax court of Duesseldorf). Affected taxpayers that have been subject to German RETT under a comparable fact pattern should carefully monitor further developments.

It should be noted that certain changes to the current RETT have been proposed that would expand the partnership RETT rules to apply to corporations as well. The proposed RETT rules currently are in the legislative process, and the result and the timing of any changes are currently unclear. However, it appears likely that the proposed changes would enter into effect as from 1 January 2021. Further developments regarding the legislative process should be monitored by interested parties.

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