ALLEN & OVERY

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What to expect in 2019 – Legal developments in the German real estate market

1. Tightening of the "rental price brake" and limitation of rent increases after modernisation in effect since 1 January 2019

On 1 January 2019, the German Act on Supplementing the Provisions on the Rent Amount Permissible at the Start of a Lease and on the Adjustment of the Provisions on the Modernisation of Leased Property (German Tenancy Law Adjustment Act (*Mietrechtsanpassungs-gesetz*; **MietAnpG**), BGBI. 2018 I, 2648) entered into force after having been passed by the German Federal Council and the German Parliament before Christmas. The Act extends the scope of and tightens the provisions as originally introduced by the German Tenancy Law Amendment Act (*Mietrechtsnovellierungsgesetz*) in April 2015 regarding the rent amount permissible at the start of a lease in regions with critical housing shortage (so-called "rental price brake" (*Mietpreisbremse*)). The legislators believe that in this regard the Act has so far not produced the desired effects. The Act further amends the provisions regarding rent increases following modernisation in order to limit the financial burden of the lessees.

As of January 2019, the following changes apply as detailed below:

(a) Amendments to the rental price brake (section 556g of the German Civil Code (*Bürgerliches Gesetzbuch*; BGB)

(i) Pre-contractual information duties of the lessor

Whereas, in certain exceptional circumstances provided for in the rental price brake provisions, a lessor was previously permitted to charge a higher rent, i.e. a rent exceeding the comparable market rent in the relevant area by more than 10%, the lessor is now required to provide pre-contractual information to the prospective lessee if a new lease agreement is to be concluded. The criteria for such an exception are met if the previous lessee already owed such higher rent (section 556e BGB) or the residential space was used and leased for the first time after 1 October 2014 (section 556f BGB). If the lessor also wants to claim such higher rent permissible by way of exception from the prospective new lessee, he will now be obliged to inform the prospective lessee (with no corresponding request of the latter being required) in text form of such exception and, if relevant, of the amount of the previous rent. If the lessor fails to do this, he may not claim a higher rent. If the information is provided by the lessor at a later time, the higher rent can only be demanded two years after the fact.

(ii) Simplified possibility for the lessee to issue a complaint

Whereas a lessee was previously required to set out the underlying facts in the event of a complaint regarding

the agreed rent, a simple notification of the lessee containing a complaint about the amount of the rent shall now be sufficient (section 556g (2) BGB). Any repayment obligation of the lessor is thus no longer delayed by previously necessary research and requests for information by the lessee regarding the permissible rent amount.

(b) Provisions on modernisation measures

(i) Reduction of the modernisation allocation and cap (Section 559 BGB)

If a lessor has carried out modernisation measures at the leased property within the meaning of section 555b BGB, he is entitled to allocate the relevant costs to the lessees on a *pro-rata* basis. The permissible annual cap of the modernisation allocation is now reduced from 11% to 8% p.a. for the benefit of the lessees. In addition, a cap for rent increases following modernisations has been introduced. Within a period of six years, a lessor can thus only increase the monthly rent by up to EUR 3 per sqm of residential space. For monthly rents amounting to less than EUR 7 per sqm of residential space prior to the rent increase, the cap is set at EUR 2 per sqm of residential space. This does not include rent increases up to the comparable market rent in the relevant area (section 558 BGB) or rent increases due to changes in operating costs (section 560 BGB).

(ii) Simplified procedure for modernisation measures (section 559c BGB)

For measures the costs of which do not exceed EUR 10,000 per residential unit, the lessor can now calculate a rent increase by way of a simplified procedure in line with section 559c BGB. It has to be noted in this regard that the threshold amount of EUR 10,000 per residential unit reduced pursuant to section 559c (2) BGB if a rent increase based on modernisation measures was already carried out during the five years prior to the rent increase being notified. In addition, a blocking period of 5 years for rent increases carried out by regular procedure (section 559 BGB) will apply following a rent increase carried out by simplified procedure.

(iii) Sanctioning of abusive modernisation (section 559d BGB and section 6 of the German Economic Offences Act (*Wirtschaftsstrafgesetz*))

In order to protect the lessees against "eviction through modernisation", legal assumptions for a breach of duty of the lessor were created in section 559d BGB which apply in particular if the lessor uses the announcement or implementation of structural changes as an instrument to cause the lessee to terminate the lease agreement. This is supported by the newly created section 6 of the German Economic Offences Act which now imposes a fine of up to EUR 100,000 in cases of "eviction through modernisation".

2. Housing investments in urban areas – Is the political wind turning?

In the context of the still tense housing situation and the ongoing price increase of rents for newly rented residential space especially in German urban areas and metropolitan regions, we also observe that the political environment is changing more generally.

This has been reflected for quite some time by new laws and ordinances designed to prevent a "loss of traditional housing" (such as the Berlin Act on the Prohibition of Misuse (*Zweckentfremdungsverbots-Gesetz*; ZwVbG)) and/or the extension of the scope or tightening of ordinances or regulations for urban preservation as instruments of special urban planning law (*besonderes Städtebaurecht*) in order to protect certain defined residential areas against changes as regards the existence of housing and population structure.

In addition, there is a rising tendency that the competent authorities actually exercise statutory pre-emptive rights in order to prevent a possible sale to real estate investors. After the Berlin districts Friedrichshain Kreuzberg and Tempelhof-Schöneberg were trailblazers in this context,

the city of Hamburg has also already exercised statutory pre-emptive rights with the result that an acquisition envisaged by an investor in the district of St. Pauli failed. The use of statutory pre-emptive rights in order to protect lessees is also debated in cities like Munich and Frankfurt am Main.

Finally, the hereditary building right as an urban development perspective is apparently about to see a renaissance as well; instead of selling public spaces for residential construction to project developers, thought is increasingly being given to providing space by way of temporary hereditary building rights instead in order to maintain a certain level of control over the relevant plots of land.

The most recent developments are relevant in particular in the field of project development for residential space in (large) cities with a tense housing situation. Even though the aspects set out above do not present insurmountable obstacles, they clearly show that, even more than before, investment decisions should be made on the basis of solid legal advice and a profound analysis of the environment.

3. Current developments with regard to German real estate transfer tax

Already in June 2018, the German Federal States agreed in their Finance Minister Conference to considerably tighten the real estate transfer tax (**RETT**) treatment of share deals. Under current law, it is possible to transfer 100% in a real estate owning corporation without triggering RETT if two independent purchasers (legally and economically) each acquire more than 5% of the shares (e.g. with a split of 94.9% and 5.1%, as customary in the market). This shall no longer be possible in the future under the contemplated new provisions since the provisions currently applying for partnerships shall now also become applicable for corporations. In addition, the current threshold of 95% shall generally be lowered to 90% and the current monitoring period of 5 years shall be extended to 10 years. This means that the direct/indirect transfer of 90% or more of the shares in a real estate owning corporation to new shareholders within 10 years will in future be subject to RETT. Correspondingly, an immediate and complete sale of real estate owning corporations would no longer be possible without triggering RETT. In addition, the contemplated general reduction of the RETT threshold from 95% to 90% and the general extension of the monitoring period from 5 years to 10 years may also have a significant impact on the structuring of real estate owning partnerships as well as the involvement of sound RETT-blocking entities.

At the end of November 2018, the Finance Minister Conference agreed on a draft bill and requested the German Federal Government to initiate the corresponding legislative procedure. Even though the specific wording of the draft bill has not been published yet, the draft bill seemingly provides – despite considerable concerns under German constitutional law – that the new provisions are to apply with retroactive effect (possibly as of 1 January 2019). In addition, it is feared that also share transfers in prior years may contribute to RETT being triggered under the new rules. Accordingly, it seems possible that already minimal share transfers in the time after effectiveness of the new rules may trigger RETT if further share transfers were effected during the past 10 years prior to the new provisions becoming effective. Therefore, in the event of a retroactive application of the new provisions, all contemplated share transfers have to be closely examined as to whether RETT risks arise in connection with any direct or indirect prior transfers during the past 10 years.

We note, though, that considerable constitutional law concerns exist against this aspect as well, in particular as – on the basis of the most recent administrative guidance – the tax authorities may take into account indirect transfers also outside the period of (currently 5, in future) 10 years monitoring period. Finally, the new rules are expected to also prevent majority shareholders from increasing their stake (in a current 94.9% / 5.1% structure) to 100% without triggering RETT. It is expected that, in order to achieve this, the current 95% threshold for RETT purposes shall continue to apply

simultaneously to the new 90% threshold, at least for a transitional period. Thus, two thresholds would apply at the same time, which will increase the complex nature of the contemplated new provisions even more.

All in all, it is to be hoped that the provisions – which are highly questionable under German constitutional law and in many aspects also unsystematic – will still be fundamentally revised. Nevertheless, until the draft bill is published, share transfers involving (direct or indirect) German real estate have to be planned with great care.

Since, due to substantial concerns of the German Federal Government with regard to the contemplated rules, a submission of the draft bill cannot necessarily be expected in the very near future, all transactions for 2019 involving German real estate should only be implemented after a thorough analysis of the potential RETT risks involved and with already planning on a 89.9/10.1% structure.

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