

# Briefing

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## Editorial

*2007 was a good year for the German real estate markets. Recovery of the German economy, competitive yields, over-heated markets elsewhere and continued demand for investment opportunities resulted in record transaction volumes. We are proud to look back at a deal volume in excess of Euro 3bn, and clients confirm that it was a good decision to combine real estate and finance expertise in one practice group. In the second half of 2007 the credit crunch has cooled the markets, but also opened new opportunities. The fundamentals of the German economy and its real estate markets are still excellent. We therefore look forward to continue working with you, eager to new challenges and confident that also the new year will be a good year for real estate business in Germany.*

*We wish you a successful year 2008.*



*Thomas Ziegler, Munich Practice Group Head*

## Property

### The new German Condominium Act



*Gero Martin, Munich*

With effect as of 1 July 2007 the German Condominium Act has been amended in material aspects, which will make life easier for both owners and purchasers of condominium property. The introduction of the majority rule and the clarification of the legal capacity of the condominium owners' community are important legislative measures in order to facilitate proper management of condominium owners' joint property. If by-laws grant voting rights in proportion to ownership share, real estate investors are now able to ensure effective asset management even if they are not able to acquire all condominiums of such property, but at least 50% of the property shares. The obligatory record of condominium owners' resolution will make purchasers' due diligence processes easier.

### Majority rule

Prior to the reform of the German Condominium Act (*Wohnungseigentumsgesetz – WEG*) nearly all decisions of the condominium owners' community



(*Wohnungseigentümergeinschaft*) in respect of the administration of the property had to be taken by unanimous vote. As a consequence, individual owners were able to delay even reasonable maintenance, modernization and building measures by simply refusing their consent to the respective works. Now (qualified) **majority votes** are sufficient for the passing of resolutions on the most relevant matters, in particular

- **Structural changes and construction works**

Decisions on construction measures beyond the usual maintenance and repair of the common property can now be passed by simple **majority vote** of the condominium owners, provided, however, that all co-owners which would be (presumably) affected by such measures “beyond the level which is unavoidable in connection with living together in good faith” have given their consent to such measures. As a consequence, the consent of co-owners which will not be affected by such measures will not be necessary anymore. For instance, the expansion of a condominium by opening a supporting wall may constitute a structural modification of the common property, but a decision by majority vote would be sufficient as long as dissenting owners would not be impaired in their rights beyond the “unavoidable level”.

- **Technical modernizations**

Decisions about modernization measures which are not absolutely necessary for the ordinary maintenance of the building, such as water and energy saving measures, e.g. the installation of a new heating system, can now be taken by **qualified majority vote**, requiring the consent of at least three quarters of all co-owners who at the same time own more than a half of the co-ownership shares, provided, however, that such works do not change the special characteristics of the building and individual co-owners are, in comparison to other co-owners, not unreasonably impaired in their rights.

- **Allocation of operating and management costs**

Prior to the reform expenses for management and operation of the property were solely allocated pro rata in accordance with the share in the co-ownership. This is still the principle under statutory law, but now the owners are free to provide for another allocation by simple **majority vote**, provided that this allocation is “in line with proper management”. The owners are also free to allocate the individual operating expenses differently, e.g. to charge heating costs in accordance with the size of the condominium(s), but the management cost on a per unit basis. The above applies also for the allocation of costs for the special use of common areas (e.g. laundry rooms, party rooms) and special management expenditures.

However, a **qualified majority vote** (75% of all co-owners representing at least half of the co-ownership shares) is needed for the allocation of costs for maintenance and repair works, structural alterations or construction expenses in deviation from the principle of allocation in proportion to the co-ownership shares.

The provisions on voting rights and the calculation of a ‘majority’ of the votes have not been amended in the course of the reform. As a consequence, it is still the principle under statutory law that each co-owner has one vote, irrespective of the number of its condominiums or the percentage of its co-ownership shares (“one man, one vote” – *Kopfprinzip*). However, deviation from this principle is possible either from the beginning under the partition deed or afterwards by unanimous vote of all co-owners. Usually the owners agree on a deviating regulation, in particular on voting rights in proportion to the co-ownership shares (*Wertprinzip*) or in proportion to the number of condominiums (*Objektprinzip*). Irrespective of the strengthening of the condominium owners’ community, each individual owner is still entitled to request proper management of the property, including execution of due maintenance and repair works and the conclusion of a building insurance with sufficient coverage.

### **Legal capacity**

Formerly, the condominium owners’ community had no legal capacity and only the individual co-owners - as members of a civil law partnership – were able to

act on behalf of the community, e.g. to engage a contractor. As a consequence, each co-owner was personally, as a joint and several debtor, liable for all obligations of the condominium owners' community under such agreements. In accordance with a landmark decision of the Federal Court of Justice (*Bundesgerichtshof – BGH*) back in 2005, the condominium owners' community now has partial legal capacity. As a consequence, the condominium owners' community itself is able to enter into contracts and sue for the remedy of defects. The community is also liable for third party claims and can be sued before court. The individual co-owners remain liable for such obligations, but their liability is limited pro-rata in accordance with the respective co-ownership share. This personal liability will cease only after lapse of five years since withdrawal from the condominium owners' community, i.e. sale of the respective condominium. Irrespective of the above, the condominium owners' community can not be subject to insolvency proceedings.

#### **Record of resolutions**

The purchaser of a condominium automatically assumes all relevant rights and obligations, in particular all rights and obligations created under the by-laws of the condominium owners' community and by the resolutions passed by the condominium owners. In order to facilitate the disclosure of the latter, the property manager is obliged by mandatory statutory law to keep a comprehensive record of the resolutions. However, this applies only to the resolutions passed after 1 July 2007, thus a purchaser of condominium property will still need to seek comfort also in relation to resolutions passed before 1 July 2007.

#### **The new German Energy Saving Regulation**



*Simon Guang-Ming Kuo,  
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**On 1 October 2007 the revised Energy Saving Regulation 2007 (*Energieeinsparverordnung, EnEV 2007*) came into effect. The EnEV 2007 introduces *inter alia* a number of modernisation obligations for existing buildings and stipulates new energy specifications for new buildings. Further, the so-called Energy Pass has become obligatory also for existing buildings, which is to be presented in the case of sale or letting of residential or commercial properties.**

#### **Modernisation obligations**

It is the purpose of the EnEV 2007 to save at least 70 % of emissions and energy consumption caused by buildings within the next 10 to 15 years. Politics has realised that the guidelines and recommendations of the original version of the EnEV were not sufficient to achieve its goals. Thus, it has introduced new obligatory insulation specifications for the following works:

- **Exterior walls**, if these are replaced, built for the first time or modernised in a way that shuttering (*Verschalung*), ceilings (*Platten*) or insulation are installed, new infillings (*Ausfachungen*) are inserted in half timbering walls (*Fachwerkwände*) or if the exterior plaster (*Außenputz*) of an existing wall with a thermal transmission coefficient larger than  $0,9 \text{ W}/(\text{sqm} \cdot \text{K})$  is modernised;
- **Walls and ceilings** against unheated rooms and soil, if these are replaced, built for the first time or modernised in a way that shuttering (*Verschalung*), moisture barriers (*Feuchtigkeitssperren*) or insulation are installed, if floor constructions (*Fußbodenaufbauten*) on the heated side of the wall are built up or modernised or if ceiling sheeting (*Deckenbekleidung*) is installed on the cold side of the wall;
- **Curtain wall** (*Vorhangfassade*), if the aggregate structural element is replaced or installed for the first time or if the filling (*Füllung*) is replaced.
- **Windows**, if the aggregate structural element is replaced or installed for the first time, if the glass is replaced or if additional interior windows are built in.
- **Exterior doors**, if they are replaced.
- **Ceilings and roofs**, in the case of pitched roofs, if the ceilings under undeveloped attics or if ceilings or inclined exterior walls (including the pitched roof area) are replaced, installed for the first time or are modernised in a way that the roof covering (*Dachhaut*) or the interior shut-

tering is replaced or insulation is build in; flat roofs need to be modernised if they are replaced, installed for the first time or are modernised in a way that the roof covering (*Dachhaut*) or the interior shuttering is replaced or insulation is build in.

In the case of residential buildings with not more than two flats of which one is inhabited by the building owner, the aforesaid obligations are alleviated insofar as uninsulated rooms above the top floor ceiling which are not walkable, but accessible, do not need to be isolated prior to lapse of two years since transfer of title in the property.

**Oil and gas boilers** built before 1978 and the isolation of the respective pipes shall be replaced by 31 December 2008, unless they are low temperature boilers, high efficiency boilers (*Brennwertkessel*) or heating installation facilities whose nominal power generation capacity is below 4 kilowatt or above 400 kilowatt. Residential buildings with not more than two apartments of which one is inhabited by the building owner are excluded from the deadline and the respective boilers have to be replaced only within two years after transfer of title in the building.

The EnEV 2007 also introduced obligatory inspections of **air conditioning** units.

### **Energy Pass**

Whereas the former EnEV provided for an Energy Pass (*Energieausweis*) only for new buildings, pursuant to the EnEV 2007 an Energy Pass is to be procured also for existing buildings. The effective date for the obligation depends on the kind of buildings and its construction year, but is in any case not later than 1 July 2009. The Energy Pass shall be presented to prospective tenants or buyers and on demand to the competent authority. The Energy Pass contains information on the energetic quality of the respective building and is effective for a time period of 10 years. Currently, two qualification methods are in use one based on energy demand of the building and the other based on energy consumption. After 1 October 2008 only Energy Passes based on energy demand shall be issued. The Energy Pass can be issued only by certain qualified persons as stated in the EnEV 2007, in particular architects, construction engineers and certain craftsmen, provided in each case that they have a certain qualification. The costs for the Energy Pass vary between EUR 50.00 and EUR 1,500.00, depending on the building, the issuer and the underlying method.

Pursuant to the relevant European Directive and the Energy Saving Law (*Energieeinsparungsgesetz*) on which the EnEV 2007 is based, the Energy Pass serves for information purposes only, i.e. unless expressly agreed otherwise in the lease or purchase agreement the tenant respectively the purchaser does in principle not have any warranty claims against the landlord or seller. If the Energy Pass is not presented to the prospective tenant or purchaser the competent authority can impose a fine against the landlord or seller. The regulation does not provide for any rights of the prospective tenant or purchaser against the landlord or seller in this or any other respect.

### **Enforcement**

If the owner or landlord is in breach with the regulations of the EnEV 2007, in particular if the landlord or seller does not present the Energy Pass or if he does not fulfil its retrofitting obligations, the competent authority is entitled to charge a fine to the owner or landlord in the amount of up to EUR 50,000.00.

### **Impact on leases**

Under certain conditions the landlord is entitled to charge part of the redevelopment costs to the tenant by way of rent increase. By contrast, the tenant has no claim against the landlord that energy redevelopment measures be carried out. Pursuant to the official explanations to the Energy Saving Law, the effects of the Energy Pass under civil law, in particular with respect to sales and leases, shall not be regulated by this regulation. However, it remains to be seen how the courts will deal with these matters.

### **Exemption and Waiver**

The obligations under the EnEV 2007 do not apply to architectural monuments (*Baudenkmäler*) if the fulfilment of the requirements of the EnEV 2007 would

affect their substance or appearance or if the measures would cause unreasonable expenses. In general the competent authorities are entitled to grant waivers if the requirements cause unreasonable expenses or undue hardship, which shall be the case in particular if the necessary expenses can not be compensated by corresponding savings within a reasonable time period. Considering the aim of the EnEV 2007 we assume that the competent authorities will be restrictive in granting such waivers.

#### **Public subsidies**

There are various public subsidy programmes, in particular subsidised loans as well as non-repayable grants from KfW (Kreditanstalt für Wiederaufbau - a state-owned bank) for energetic improvements.

#### **Outlook**

Pursuant to government plans it is to be examined if major breaches of energy saving obligations are to be sanctioned by way of a tenant reduction right in relation to operating costs. Further, the Federal Government plans to further increase the energy requirements under the EnEV 2007 in two steps (2008/2009 and presumably 2012) by an average of 30% and to extend the modernisation obligations for buildings and facilities, the latter to be subsidised under the CO<sup>2</sup> building refurbishment programme (*CO<sup>2</sup>- Gebäudesanierungsprogramm*). Further, additional obligations are considered in relation to submission of supporting documentation.

## Leases

**Written form requirement for lease agreements with fixed term**



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**In the past the written form requirement for lease agreements with fixed term has been dealt with by courts numerous times. The Federal Court of Justice has dealt with the written form requirement three times only in 2007. Many court decisions on the written form requirement in the past were hard to understand for non-lawyers and make the requirement hard to fulfil. This article deals with the recent decisions of the Federal Court of Justice, which seem to take into account practical needs of the real estate business, and gives a brief overview of the written form requirement in general.**

#### **Background**

The relevant statutory provision is Section 550 German Civil Code (*BGB*) which stipulates that a lease agreement that is entered into for more than one year and is not in written form shall be considered as a lease for indefinite term.

#### **Essential aspects of the lease agreement**

The essential aspects of the lease agreement need to be stated in the written deed. The essential aspects are at least the parties to the lease agreement, the object, the term and the rent of the lease.

- **Parties to the lease agreement**

This requirement seems to be clear and easy to fulfil but the Federal Court of Justice (*Bundesgerichtshof – BGH*) had to deal with this question in 2007. The BGH has decided that a person who signs the lease agreement on behalf of a limited company does not need to add the abbreviation "i.V." which indicates that the signer has signed as representative on behalf of a third party. Pursuant to the decision such an addendum is only necessary if only one person signs the lease agreement although there are several landlords, several tenants or several partners of a civil law partnership.

- **Object of the lease**

The location and the characteristics of the object of the lease need to be determined within the written deed. The address for instance is not sufficient to determine the location if there are several rental premises at the same address. The position of the rental premises within the building needs to be described. The precise description of the object of the lease is particularly crucial if the building is still under construction and the layout of the object of the lease is not yet definite.

- **Term of the lease**

If the building is still under construction this essential part, in particular the lease start date may be difficult to capture in the written agreement. In a recent decision the BGH has confirmed an earlier ruling of 2005 pursuant to which it is sufficient if pursuant to the lease agreement the lease term starts as of handover. Thereby the BGH acknowledged that there is a practical need of the real estate industry and in particular of real estate developers for such a provision to fulfil the written form requirement. According to the recent BGH decision it is even not harmful if a handover certificate is not prepared at handover date although it was stipulated in the lease agreement that handover shall be recorded by such handover certificate. The court reasons that the purchaser who is supposed to be protected by the written form requirement is adequately warned and that it can be expected of him/her to request further information of the seller.

- **Rent**

The amount of the rent needs to be fixed in the written deed as well. Contrary to a decision of the Higher Regional Court of Koblenz the apportionment of costs of ancillary payments should also be inserted into the written deed.

#### **Formal aspects of the written form requirement**

The written form is satisfied if all essential aspects of the lease agreement, in particular the above mentioned, are embodied in one written deed and the lease agreement is signed below the text by both parties. If there are several identical copies of the agreement it is sufficient if both parties sign the copy that is designated for the other party.

If the agreement refers to annexes, e.g. a map of the object of the lease, or if the agreement is amended by amendment agreements, these annexes and amendments need to form a unity with the main part of the agreement, provided that they contain essential aspects. An actual physical connection of the lease agreement itself and/or of the annexes and amendments with the lease agreement is - contrary to older court decisions - no longer necessary. The lease agreement itself already meets the written form requirement if the deed has for instance consecutive page numbers and provisions that are linked by the context and have a uniform typeface. Annexes and amendments can be made part of the unity with the main part by a well-defined reference to the annex or in case of amendments to the main part of the lease agreement.

#### **Consequences of defects of the written form**

If the written form requirement is not met, the lease agreement is for indefinite term and therefore can be terminated at any time within the statutory termination notice period. This is the case even if the original lease agreement itself meets the written form requirement but a subsequent amendment agreement to the lease agreement does not because in such case the whole lease agreement is deemed as not fulfilling the form requirement.

#### **Remedy of written form defects**

Defects of the written form can be remedied easily if both parties would like to keep the lease. A lease agreement which itself for instance does not meet the written form requirement can be remedied by a short amendment agreement, which sets out the missing provision and is signed by both parties. Or if annexes do not validly form part of the lease agreement it is sufficient to attach the annexes and sign the deed again.

#### **Cure provisions**

Another recent BGH ruling deals with the effect of cure provisions on defects of the written form.

The lease agreement which the BGH had to decide upon contained a provision that any invalid provisions of the agreement shall not affect the rest of the agreement and that the agreement shall be performed in accordance with its purpose. The BGH has decided that such a cure provision does not impose the obligation on the parties to remedy the written form defect. The court stated that the purpose of such a cure provision would be to replace an invalid provi-

sion of an agreement by a valid provision. According to the BGH this situation is not comparable to form defects since a written form defect does not lead to invalidity of the agreement but to a different term than the one stipulated in the agreement.

It should be noted that this decision of the BGH has only dealt with a general cure provision. In practice new lease agreements often contain a specific cure provision pursuant to which the parties are obliged to remedy written form requirements if any defects in this respect should become apparent. The BGH has not indicated whether it would consider such specific cure provisions as valid. Lower courts have decided upon the latter differently.

### Summary

It is appreciated that the BGH has clarified that the addendum "i.V." in general is not required except in the above mentioned cases and that the BGH has clarified that general cure provisions do not create an obligation for the parties to remedy written form defects. Further, thankfully the BGH has confirmed its earlier ruling pursuant to which the stipulation that the lease term starts as of handover meets the written form requirement. The question whether a specific cure provision imposes an obligation to remedy written form defects is unfortunately still left open.

### Recent court decisions on repair and refurbishment obligations under residential and commercial leases



Christoph Müller, Munich

**The tenant's obligation to carry out decorative repairs at its own costs is of essential interest for the landlord. Rulings of the German Federal Court of Justice on such clauses in residential lease agreements are very tenant-friendly. In 2007 the court has retained this practice. It has ruled that a clause according to which the tenant shall bear a partial amount of the costs for refurbishment works not being due at the end of the lease pursuant to a flexible time schedule can be void, as well as a clause pursuant to which the tenant in fulfilling the refurbishment obligation was not entitled to deviate from the previous "manner of execution" ("Ausführungsart") without the prior approval of the landlord. With respect to commercial leases two Higher Regional Courts in Germany have ruled that a clause pursuant to which the tenant is obliged to execute decorative repairs according to a fixed time schedule is void. However, a final judgement of the German Federal Court of Justice in this regard is still outstanding.**

Under statutory law the landlord is responsible to keep the leased premises in good repair. This obligation can be assigned to the tenant by way of explicit agreement in the lease agreement. However, most of the lease agreements are standard agreements and therefore qualify as so-called general terms and conditions ("*Allgemeine Geschäftsbedingungen*"), which are subject to a detailed judicial control. If in the courts' opinion such a clause unfairly prejudices the tenant, it is considered void. Many clauses on decorative repairs have failed that test.

### Validity of fixed time schedules in commercial lease agreements

The German Federal Court of Justice (*Bundesgerichtshof – BGH*) considers clauses in residential lease agreements void pursuant to which the tenant is obliged to carry out decorative repairs according to a fixed time schedule, e.g. every five years. The court argues that such clauses do not take into consideration whether there is an actual need for decorative repair at the scheduled repair date or not. As a consequence it is necessary to provide for some flexibility which makes sure that such works do not need to be executed if there is no actual need. The Higher Regional Courts of Munich and Düsseldorf have ruled that these principles also apply for commercial leases. The courts argued that also for a commercial premise it does not make sense to carry out decorative repairs irrespective of a practical need. Thus, a clause stipulating a fixed time schedule for decorative repairs without flexibility had been considered an unfair prejudice also of the commercial tenant and therefore void. At present there is a case pending at the Federal Court of Justice with respect to fixed time schedule for decorative repairs under commercial leases, which has not yet been decided.

There is a significant risk that the court might follow the aforesaid upper court rulings. This would have major effects for landlords of commercial properties since such clauses are used in a large number of old commercial lease agreements. If these clauses would be declared void, the landlord would be obliged to carry out decorative repairs at his own cost. Furthermore, the tenants might even be entitled to claim damages for works they have already carried out at their own costs.

#### **Compensation clauses**

The German Federal Court of Justice has also considered clauses pursuant to which the tenant shall bear a partial amount of the costs for refurbishment works not yet being due at the end of the lease (compensation clauses) void, if the refurbishment obligation refers to a fixed time schedule. In a recent decision the Federal Court has explicitly pointed out that compensation clauses which refer to a flexible time schedule considering the actual need for refurbishment are principally valid. However, in the specific case the Federal Court considered such clause void because of the specific wording: the calculation of the (partial) amount of the costs to be borne by the tenant should correspond to the time of his occupancy since the most recent decorative repair. The court argued that it was not transparent whether the tenant's portion of costs should depend on the *specific* wear and tear of the apartment resulting from the tenant's *individual* housing habits or to the *usual* wear and tear of the apartment caused by an *average* tenant. Pursuant to the Federal Court of Justice the latter understanding would unfairly prejudice the tenant as his individual housing habits would not be relevant for the calculation of his cost contribution.

#### **Execution of decorative repairs pursuant to the former manner**

In another decision the Federal Court has ruled that a provision pursuant to which in connection with decorative repairs the tenant must not deviate from the former 'manner of execution' without the prior approval of the landlord is void. Pursuant to the wording it was not transparent whether *any* (even marginal) deviation from the former manner shall be subject to the landlord's approval. The need of an approval for any deviation would unfairly prejudice the tenant since he was not allowed to furnish his apartment according to his wishes. In addition, the court has also considered the general provision on the refurbishment obligation of the tenant void although the tenant's obligation to carry out decorative repairs and the prohibition of deviations were stipulated in two separate clauses. The court argued that both clauses must be considered as one integral provision; therefore both clauses had to be declared void since these provisions could not be separated.

#### **Recommendations**

Because of the detailed judicial control, decorative repair and refurbishment clauses in both residential and commercial leases need to be drafted with special care. It is essential that any time schedule for such works provides for sufficient flexibility to make sure that no unnecessary works have to be carried out by the tenant. Calculation of compensation payments have to be in compliance with the standards set by the courts. Alternatively, landlords might consider carrying out decorative repairs and/or refurbishment works at their own costs, but budget such expenses in a higher ongoing rent.

## Voidability of global security assignments in the event of insolvency



Sandra Hofmann,  
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## Banking, Finance

A decision of the Higher Regional Court (*Oberlandesgericht - OLG*) of Karlsruhe of 8 April 2005 which was followed by a number of consenting decisions of other higher courts provoked massive fears that global security assignments might be considered as security with incongruent (undue) coverage as a consequence of which they would be subject to the simplified avoidance pursuant to the terms of Section 131 German Insolvency Code (*InsO*), which would significantly jeopardise the security. In a recent ruling the German Federal Court of Justice corrected these decisions. According to the latter the global security assignment is not (by nature) subject to the above simplified avoidance, as a consequence of which the assignment is voidable only in case the debtor was already insolvent at the date the assigned receivable has come into existence and if the creditor had knowledge of the insolvency at that time.

### Background

The global security assignment, i.e. the global and overall assignment of claims of the assignor, which often is granted to banks as security for loans granted to the assignor, can be voided by the insolvency administrator in case of insolvency of the assignor subject to certain requirements, with the consequence that the assigned claims have to be returned by the assignee.

There are different degrees of voidability, and a rather low hurdle applies for the avoidance of a security which qualifies as incongruent coverage. The difference becomes particularly apparent in case the assignment took place within the last month prior to filing for the opening of insolvency proceedings: Whereas the assignment in case of a congruent coverage is voidable only if the assignor was already insolvent at the date the granting of security has become effective and the assignee had knowledge of the insolvency at that time, in case of an incongruent coverage the assignment is voidable without further requirements. In the above court cases this question has become particularly relevant in relation to the assignment of future (arising) claims of the assignor, i.e. claims which do not yet exist at the time of assignment, but will arise in the future. It is a particularity that insofar the assignment becomes effective not at the date of execution of the assignment agreement, but at the date the (future) claim comes into existence. In case that point of time falls into the period of time relevant for avoidance prior to the filing for the opening of insolvency proceedings, the value of the assigned receivables decisively depends on the voidability of the assignment and therefore on the qualification as congruent or incongruent coverage.

### Congruent and incongruent coverage

The Insolvency Code does not define the meaning of congruent coverage (*kongruente Deckung*). Its interpretation results from the provision for avoidance of an incongruent coverage pursuant to Section 131 InsO. In short, incongruent coverage (*inkongruente Deckung*) has to be supposed in case collateral has been granted the creditor was not entitled to. This had been questioned in relation to the assignment of future claims, because at the time of signing of the assignment agreement often the assignor is not in a position to commit to the assignment of a specific claim.

### Ruling of the Federal Court of Justice

On 29 November 2007 the Federal Court of Justice (*Bundesgerichtshof - BGH*) decided that congruency of coverage cannot be denied on the grounds that the assigned claims will only arise in the future and are not yet (fully) determined under the assignment agreement. In fact in case of a global security assignment congruent coverage shall be given if the assigned claims – although not yet determined by debtor and amount – are at least determinable which means that at the latest upon coming into existence of the assigned claims it is clear and determined which claims pass on to the creditor. Accordingly, the simplified criteria for avoidance do not apply for the mere fact that the assignment relates to future claims.

## Tax

### The new Interest Deduction Ceiling Rule under the German Corporate Tax Reform 2008



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Sandra Hofmann,  
Munich

On 1 January 2008 the German Corporate Tax Reform 2008 has entered into force. The Interest Deduction Ceiling Rule (also "Interest Stripping Rule") applies to the calculation of the taxable income for income tax purposes. The Interest Deduction Ceiling Rule limits the tax deductibility of interest expenses. Insofar it replaces the former thin-capitalisation rule, with the fundamental difference that the new rules apply to all debt financing and not only to shareholder loans, irrespective of a debt-equity-ratio.

#### General Rule

The Interest Deduction Ceiling Rule consists of a general rule and a number of exceptions thereto. According to the **general rule** net interest expenses (interest paid less interest earned) are only tax deductible up to 30 % of the tax EBITDA (earnings before interest, tax and amortisation/depreciation as calculated for tax purposes).

To the extent net interest expenses are not deductible under the new rule, they may be carried forward to subsequent tax periods, but they are lost in case of termination or transfer of the business or (partial) transfer of shares in a partnership or corporation. The new rule applies to corporations, commercial partnerships and sole proprietorships. It also applies to all entities with corporate seat outside Germany with respect to their German taxable income. According to the wording of the law, partnerships whose scope of business is limited to the mere letting of real estate property, i.e. whose total income qualifies as rental revenues, and is not qualified as trade income, do from our point of view not fall under the new rule. However, the new law applies also to non-resident corporations with such limited scope of business in Germany, i.e. to non-resident SPVs holding real estate in Germany.

#### Exceptions

The general rule does not apply if net interest expenses of the business are less than **EUR 1m p.a.** (tax threshold-*Freigrenze*). In such case, the net interest expenses are fully tax deductible. If net interest expenses are EUR 1m p.a. or more, the general rule applies to the whole amount of net interest expenses. In case of a tax group (*Organschaft*), the EUR 1m limit applies to the group as a whole. Further, the general rule does not apply if the business does not (or just on a pro-rata basis) belong to a group of companies (**stand alone clause**), and, as a re-exception in case of corporations, interest paid to a major shareholder (shareholding > 25%) or related parties of such shareholder or interest paid to third parties having recourse against a major shareholder or related parties does exceed 10% of the corporation's net interest expenses (**harmful shareholder financing**). The business is deemed to belong to a group if it could be consolidated with another entity or if the business can be controlled according to IAS 27.

Finally, the general rule does not apply if the business belongs to a group and the equity ratio (equity/balance sheet total) of the business is not lower (with 1% tolerance) than the equity ratio of the group of companies of which it is part (**escape clause**), and, in case of a corporation belonging to a group, there is no harmful shareholder financing. The qualification in relation to harmful shareholder financing applies only, if the respective liability is shown in the fully consolidated financial statements of the group and, in case of a third party financing, is secured by way of recourse against a shareholder not forming part of the group or against a related party of the latter.

#### Conclusion

In view of the above, it seems that for real estate investors the most straight forward strategy to avoid the implications of the interest deduction ceiling rule, is to spread real estate investments and corresponding financing to such number of entities that net interest expenses of each such entity do not reach EUR 1m p.a.

However, in practice banks seek to cross-collateralise such investments and have such entities as guarantors or joint and several debtors, and there is no

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certainty yet how the tax authorities will deal with such cross-collateralisation, i.e. whether the interest ceiling will be applied to such joint debtors or guarantors. This uncertainty could be avoided by a request of a binding tax letter ruling from the tax authority (*verbindliche Auskunft*).

In any way, this strategy is only an option for investments not exceeding a certain debt finance volume. For larger investments, it will need to be checked whether the investment vehicle can be structured in such way that it qualifies as stand alone business or whether the equity ratio allows for an application of the escape clause. Finally, for real estate investors it will be worthwhile to check with the tax authorities whether the new rules do not apply to German partnerships whose scope of business is limited to the mere letting of real estate. This and quite a number of other open questions relating to the application of the Interest Ceiling Rule will need to be answered by the tax authorities in the months to come.

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