

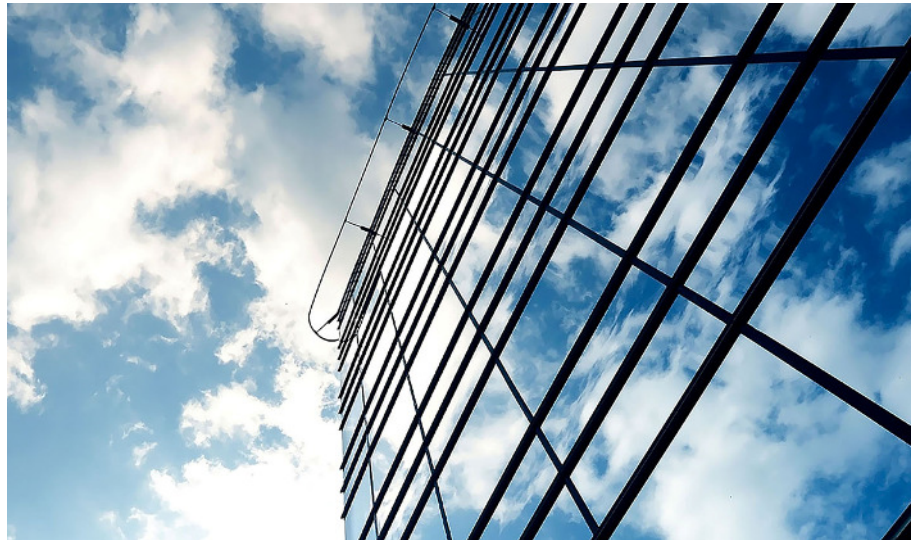
WATSON FARLEY
&
WILLIAMS

BRIEFING

HOTEL INVESTMENTS
IN GERMANY

SEPTEMBER 2016

- REASONS FOR AN INVESTMENT IN GERMANY
- ACQUISITION OF A HOTEL BY WAY OF AN ASSET OR SHARE DEAL
- TAX ASPECTS WHICH SHOULD BE TAKEN INTO ACCOUNT
- FURTHER ISSUES WHICH NEED TO BE CONSIDERED DURING THE ACQUISITION AND OPERATION OF A HOTEL IN GERMANY



A SAFE HARBOUR FOR
FOREIGN INVESTMENTS.

Overview – reasons for an investment in Germany

For various reasons the German hotel market has become very attractive for foreign investors. There are no legal restrictions for foreign or non-residential ownership of German real estate. The German economy is very strong and still growing. The German legal and political system provides the stability that foreign investors require. Finally, Germany has become a major destination for tourists in Europe and German residents are increasingly looking for attractive holiday destinations within the country. Although investment yields are under severe pressure, Germany still matches all criteria for a long-term investment in a stable and prosperous country.

It is therefore not surprising that the number of hotels (from budget to luxury), serviced apartments, student housing has increased in recent years, not only in major cities – such as Berlin, Hamburg, Munich, Frankfurt and Cologne – but also in secondary cities, which are either attractive as holiday destinations or which host strong industry and/or a successful university.

The following briefing sets out some key considerations for those contemplating investing in the local hotel market from a German legal and tax perspective.

Acquisition of a hotel by way of an asset deal or share deal

In Germany, property can be acquired directly, by way of an asset deal, or indirectly, by acquiring shares in a legal entity holding ownership in the property (a share deal).

In asset deals where the hotel is already in operation the existing lease agreement will be transferred to a purchaser of the property, pursuant to section 566 of the German Civil Code (*BGB*), meaning that the role of the landlord changes to the purchaser. However, in cases where the owner of property has concluded a management agreement (see below) with the operator of the hotel, the individual agreement needs closer scrutiny in order to assess whether the agreement can be transferred automatically or only when agreed between the parties. In the case of a share deal, the legal entities are typically organised as limited partnership (*GmbH & Co. KG*) or as a limited liability company (*GmbH*) and the existing lease or management agreement therefore usually continues (unless a consent of the operator/lessee is contractually stipulated), but without a change of the parties.

Foreign institutional investors can often make use of special purpose vehicles (SPVs) in order to invest in the German hotel market. Those SPVs are often set up as limited liability companies in the form of a Luxembourg S.à.r.l. or a Dutch B.V. An English Ltd is also a common vehicle.

German real estate sale and purchase agreements (asset deal) and the acquisition of shares in a German limited liability company (share deal) require notarization by a German notary public. The acquisition of shares in a German limited partnership, however, does not generally need to be notarised (although this depends on the particular structure of the acquisition).

Major tax aspects

Under German tax law, the taxation of real estate investments can have a major impact on ultimate return on investment, especially given that Germany is often considered as more heavily taxed than other European jurisdictions.

Hotel asset deals are subject to Real Estate Transfer Tax (RETT). RETT is levied by the local tax authority. The taxation right sits with the respective Federal State and rates currently vary between 3.5% and 6.5%. The tax base for asset deals comprises the purchase price, plus other obligations to be fulfilled by the buyer.

RETT may also apply in the case of a share deal, depending on the legal form of the real estate entity acquired (corporation or partnership) and the respective shareholding (at least 95% transferred or total shareholding of the buyer). The tax base for share deals is the tax value of the real estate, which needs to be assessed in each case by the tax authorities.

Further, the acquisition of a hotel generally triggers capital gains taxation on the seller. There is a risk that the buyer might be held liable for some of the seller's taxes if it acquires a business as going concern by way of an asset deal. In the case of a share deal, the buyer indirectly acquires all tax liabilities of the acquired entity.

The sale of a hotel by way of an asset deal is either "VATable" but tax exempt or "non-VATable" as a transfer of a business as a going concern under German VAT law. However, in case of a tax-exempt transaction, the seller may choose to opt for a

CAREFUL TAX
STRUCTURING CAN
REDUCE TRANSACTION
COSTS.

tax liable transaction for buildings with VATable leases in order to collect input VAT. In this case, the reverse charge mechanism applies.

The structure of share deals must be analysed to see whether they are subject to German VAT law at all, as they can be treated as a non-VATable transfer of a business as a going concern, or they can be VATable but (unless the seller opts out) tax exempt.

Moreover, in case of an exit, the sale of a hotel is subject to German individual or corporate income tax and – possibly – trade tax. The individual amount of taxes triggered by a potential capital gain depends on whether such exit is implemented by way of a share or an asset deal, on the tax residency of the seller/s and on various other criteria.

AVOID PROBLEMS OF GERMAN EMPLOYMENT LAW.

Employment law aspects

When acquiring a hotel that is already in operation, German employment law must also be taken into account. In particular, section 613a of the German Civil Code (comparable to the UK Transfer of Undertakings (Protection of Employment) Regulations) can apply when the owner is also the operator of the hotel.

Section 613a of the German Civil Code states that if a business or part of a business passes to another owner by legal transaction, then the latter succeeds to the rights and duties under the employment relationship existing at the time of the transfer. If these rights and duties are governed by the legal provisions of a collective agreement or by a works agreement, then they become part of the employment relationship between the new owner and the employees and may not be changed to the disadvantage of the employees within a year of the transfer.

When structuring the acquisition of a hotel that is already in operation, the potential investor should discuss employment law options with its legal advisers in advance. German employment law provides for strict dismissal protection rules that can make it costly for employers to replace staff, particularly if they have a long period of continuous employment.

GERMAN BANKS AND INVESTORS TEND TO PREFER THE CONSTANT YIELD GUARANTEED BY A LEASE AGREEMENT.

Lease agreement v management agreement

It is usual for German investors to seek a long-term lease agreement with a hotel operator. Management agreements are also used, but are much rarer.

As lease agreements usually provide a fixed lease (and often include an additional turnover based variable proportion), banks and investors in Germany tend to avoid the risk of variable compensation, which is characteristic for a management agreement.

Depending on the circumstances and the respective investor and hotel operator, a management agreement with a brand, a third party management and franchise agreement or a hybrid agreement with features of different contract structures may also be regarded as options and are worth considering.

It is crucial that the structuring (whether as lease, management, or hotel operating agreement) is discussed at an early stage between the investor/owner and the potential operator of the hotel.

Maintenance of roof and structure (*Dach und Fach*), double- and triple-net

An important and often controversial topic is the responsibility for the maintenance of the property –in particular of the roof and the building structure. In general, the owner (the “lessor”) is responsible for the roof and any structural works (at his cost) and the operator (the “lessee”) for the maintenance of all the other parts of the building. At first glance, this allocation of responsibilities seems reasonable and clear.

However, in Germany parties typically debate the details of this allocation, and often negotiate intensively regarding the specific definition of “roof” and “structure” and therefore this part of the contract requires extensive scrutiny and diligence.

In this regard, the German High Courts (*OLG*) have ruled in certain cases that General Terms and Conditions (*AGB*) that oblige the lessee to maintain the roof and structure are void pursuant to section 307 of the German Civil Code and that such obligations can be passed to the lessee only in cases where the specific contractual provision has been individually negotiated between the parties (which is often difficult to prove).

If diligently drafted, however, the General Terms and Conditions obliging the lessee to bear all costs of the objects of lease, such as rent and operating costs as well as maintenance, with the exception of the obligation for the maintenance of the roof and structure (double-net), will be regarded as valid under German law.

So-called triple-net provisions as General Terms and Conditions, which oblige the lessee not only to pay the rent and to bear all the costs related to the property but also all maintenance costs (including those for the roof and structure), are highly problematic under German law and such provisions should be individually negotiated between the parties (with sufficient proof of this) in order to avoid this provision in the lease agreement being declared invalid.



Fixtures, Furniture and Equipment (FF&E)

In Germany, a hotel operator under a lease agreement is usually responsible for the equipment of the hotel (i.e. the items necessary for the operation of the hotel). Fairly often, however, the owner offers the operator a subvention or lease reduction or other incentives to install the equipment of the hotel, with FF&E, calculated for each room. This depends on what the parties have agreed during the preliminary stages of the investment.

Further, under a lease agreement, well-known hotel operators, as a rule, tend to provide the FF&E themselves in order to secure a consistent appearance of all their properties in Germany and worldwide.

Where the owner/lessor provides the equipment of the hotel with FF&E, the owner/lessor is in general responsible only for the initial equipment and the operator is responsible for maintenance and, if necessary, replacement. This can be costly for the operator.

The identity of the owner of the FF&E (i.e. landlord, lessee or operator) can also make a difference from a tax perspective, particularly in light of the applicable RETT in asset deals.

CHECK FACTS EARLY,
NEGOTIATE
SUCCESSFULLY!

Efficient investments in Germany

As Germany provides not only a stable and prosperous environment for investments in the hotel market but also various legal and tax structures for the acquisition of the property, it is wise to address the fundamental issues above as early as possible in the acquisition/ investment process.

Further, foreign investors can find it difficult to value their offer and negotiate certain terms of the investment without having at least a basic knowledge of the object and/or the respective legal entity (ownership, existing contracts, land charges, encumbrances, neighbours, public law, labour law, construction law, potential tax risks etc.).

Therefore, it is prudent to carry out quick and efficient 'red flag' due diligence before negotiating the terms and structure of the investment or Letter of Intent, etc.

A broader understanding of a buyer's investment objectives at an early stage can not only reduce transaction costs but can also help when negotiating the purchase price and other terms of the investment with the seller, and it also enables the buyer to effectively structure and optimise any potential future exit.

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this Briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.



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