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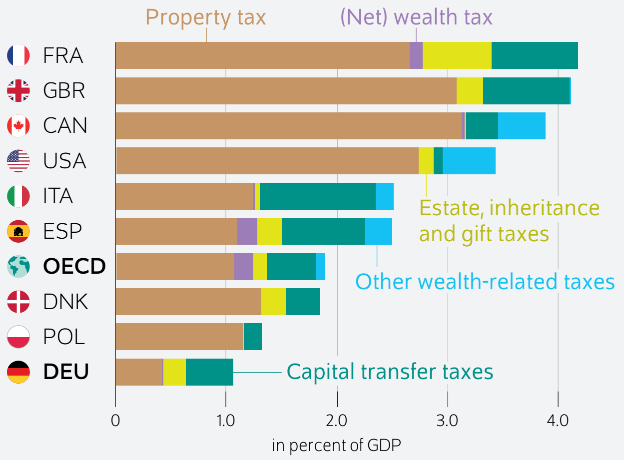
AT A GLANCE

Real estate taxation reform: tax land values, abolish privileges

By Stefan Bach and Sebastian Eichfelder

- Report describes the status quo of real estate taxation in Germany and outlines reform proposals
- Property tax: strengthen value-based taxation, double revenue in the longer term
- Income taxation: include capital gains and limit tax avoidance, such as those using limited liability companies
- Inheritance tax: end preferential treatment of housing companies
- Real estate transfer tax: significantly limit share deals and other similar tax arrangements, favor first-time homebuyers
- Tax revenue could be increased by 27 billion euros a year overall

In Germany, real estate is taxed at rather low rates, such, as via the property tax; a reform could increase both revenue and the efficiency of the tax system



Sources: OECD, authors' own depiction.

Property tax: strengthen value-based taxation

Income tax: include capital gains and limit tax avoidance

Inheritance tax: end preferential treatment of housing companies

Real estate transfer tax: limit share deals significantly

Possible additional tax revenue: 27 billion euros per year

FROM THE AUTHORS

"The real estate taxation reforms outlined here could reduce wealth and income inequality, as real estate is practically exclusively owned by the upper 50 percent of the wealth distribution. It is primarily high-net-worth individuals who have been benefiting from real estate tax privileges, and it is not appropriate to give this group preferential tax treatment." — ***Stefan Bach*** —

DATA

The value added of the real estate industry in Germany is currently **about ten percent** of GDP.

Real estate taxation reform: tax land values, abolish privileges

By Stefan Bach and Sebastian Eichfelder

ABSTRACT

Real estate is taxed at comparatively low rates in Germany, with primarily the affluent benefiting from numerous existing tax privileges. This Weekly Report describes the current state of real estate taxation in Germany and outlines reform proposals that could increase tax revenue, improve the efficiency of the tax system, and reduce wealth and income inequality. In the case of property tax, value-based taxation should be strengthened, which would double revenue in the longer term. Income tax should include all capital gains and tax avoidance opportunities for real estate investments should be restricted, in particular those using limited liability companies. With regard to inheritance tax, it would be advisable to no longer provide housing firms with preferential treatment. In the case of the real estate transfer tax, share deals and similar arrangements should be taxed equally; if necessary, first-time homebuyers could be given preferential treatment. All in all, tax revenue would increase by around 27 billion euros per year, or 0.7 percent of GDP, if such reforms were implemented. The additional revenue could be used to reduce the tax burden on earned income, especially for middle income households.

In an international comparison, Germany taxes middle and higher earned incomes from employment and self-employment heavily via social security contributions and income tax. In contrast, the tax burdens on high incomes, investment income, and wealth have been reduced considerably in recent decades. With regard to wealth and capital gains taxes, Germany can even be considered a tax haven: The property tax is very low and the wealth tax has not been increased since 1997. Inheritance tax revenue is low and there are also numerous tax avoidance opportunities and loopholes for large inheritances. Capital gains are tax privileged or even tax exempt.

Debates on increasing taxes on high incomes and wealth mostly concentrate on the top personal income tax rates, corporate taxation, reintroducing the wealth tax, or increasing the inheritance tax.[1] In this context, the German public typically neglects significant tax privileges in real estate taxation, which benefit the highest levels of the income and wealth distribution in particular.[2] For example, property values for property taxes have not been renewed for decades. The real estate transfer tax has many loopholes, especially for transfers of real estate companies (share deals). In the context of income tax, capital gains on personal assets are tax exempt after a holding period of ten years while acquisition costs and maintenance expenses for rental properties are tax deductible. When using property companies, the tax on rental income can be limited to 15.8 percent and the capital gains tax can be widely avoided even if the seller undercuts the ten-year holding period.

Real estate and building land are scarce production factors. Urban development and housing policies limit land use just as much as environmental and climate change policies

1 Cf. for example Stefan Bach, "Steuersenkungen: untere und mittlere Einkommen entlasten!," *Wirtschaftsdienst* 100, no. 3 (2020): 170ff. (in German; available online); Clemens Fuest and Andreas Peichl, "Acht Elemente einer grundlegenden Reform des Steuer- und Transfersystems," *Wirtschaftsdienst* 100, no. 3 (2020): 162ff. (in German; available online); Sebastian Eichfelder, "Braucht Deutschland eine neue Unternehmenssteuerreform?," *Deutsches Steuerrecht* 56, no. 45 (2018): 2397ff.

2 Christoph Trautvetter, "Immobilienmärkte (be-)steuern," *Info Steuergerechtigkeit* no. 19 (2020) (in German; available online).

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or the existing interests of residents and other “insiders” (“NIMBY”). High construction standards, supply constraints (such as in the designation of building land), immigration, the growth of attractive metropolitan areas (such as Berlin), and low interest rates have led to a sharp rise in real estate prices. The resulting profits mostly benefit the wealthy and are only moderately taxed, if taxed at all. As wealthier classes tend to reinvest their surpluses, real estate demand increases and predatory pricing occurs, as the “poorer” groups cannot keep up.

Increases in land value and relatively low-risk returns without major economic activity are commonly known as economic rents. Economic theory claims that such rents can be taxed heavily without creating economic distortions. From a meritocratic point of view this is fair, as these incomes have arisen by chance or speculation without any productive economic activity. Real estate also cannot avoid taxation by moving abroad. Thus, the taxation of economic rents is a classical economic advice for tax policy. Thus, it seems debatable for Germany, as a high-technology and engineering nation, to provide tax privileges for investments in portfolio property. Instead, there is a still a high tax burden on earned income and risky investments with major growth potential, for example in digitalization, renewable energy, or in other innovative markets.

Tax revenue: stagnating property tax, booming real estate transfer tax, declining income tax losses

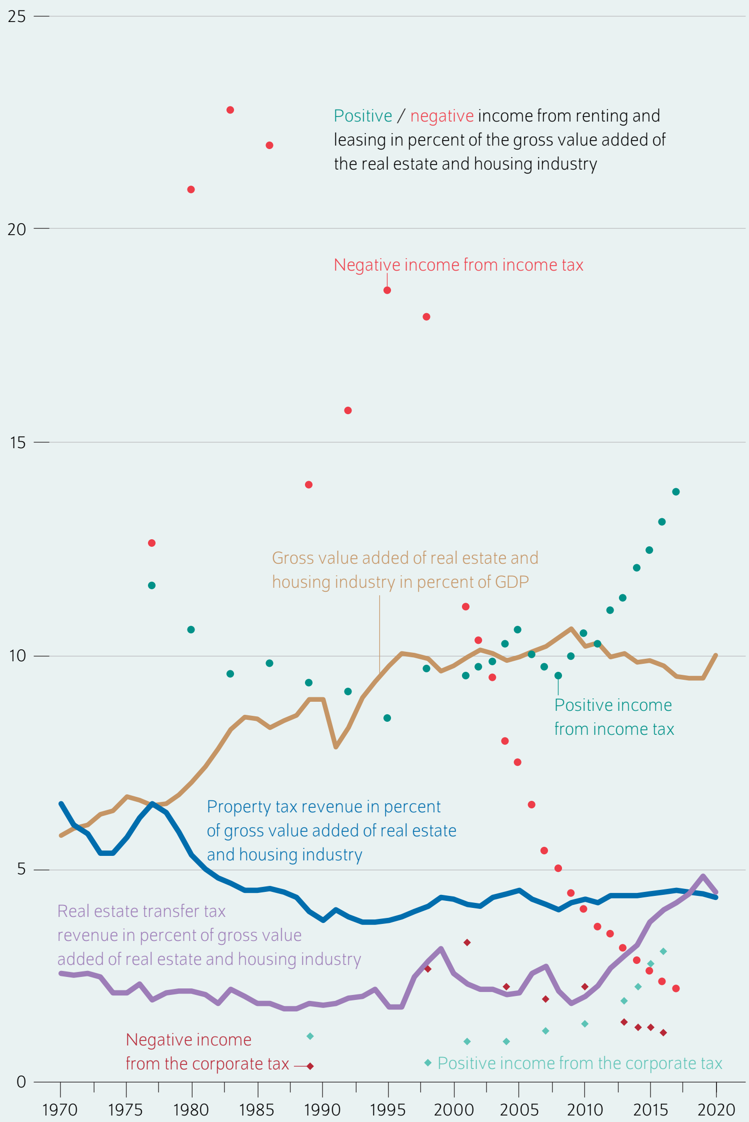
Time series based on the national accounts and tax statistics illustrate the overall economic significance of the real estate industry, its taxation, and privileged treatment in income taxation (Figure 1). The share of gross value added of the real estate and housing industry of GDP increased to around ten percent by the end of 1990s and has remained at this level. In contrast, property tax revenue in relation to the gross value added of the real estate and housing industry has remained stable since the 1970s. Revenue from the real estate transfer tax has increased significantly since the end of the 1990s, especially over the 2010s.

Income taxes include taxable income from real estate, which is broken down separately into positive and negative income (losses) in the personal income and corporate income tax statistics. The statistics show that the real estate sector generated considerable tax losses in the past that more than exceeded positive taxable income twice and resulted in tax savings. This indicates significant tax avoidance opportunities, since real estate used accelerated depreciation schemes (e.g., declining-balance depreciation or bonus depreciation, especially in the 1990s) and capital gains on private assets remained tax exempt after the minimum holding period. This created a strong incentive to sell real estate tax exempt as soon as possible, with the purchasers being able to deduct their acquisition costs by depreciation. In fact, real estate investments can be deducted from taxes several times while increases in value are tax exempt.

Figure 1

Gross value added and tax revenue of the real estate industry since 1970

In percent of GDP or in percent of gross value added



Note: Personal Income tax statistics were collected in a three-year cycle until 2001 and until 2016 for corporate income tax statistics.

Sources: Federal Statistical Office, income tax statistics, national accounts.

Property tax revenue has declined in significance since the 1970s while real estate transfer tax revenue has markedly increased over the past decade.

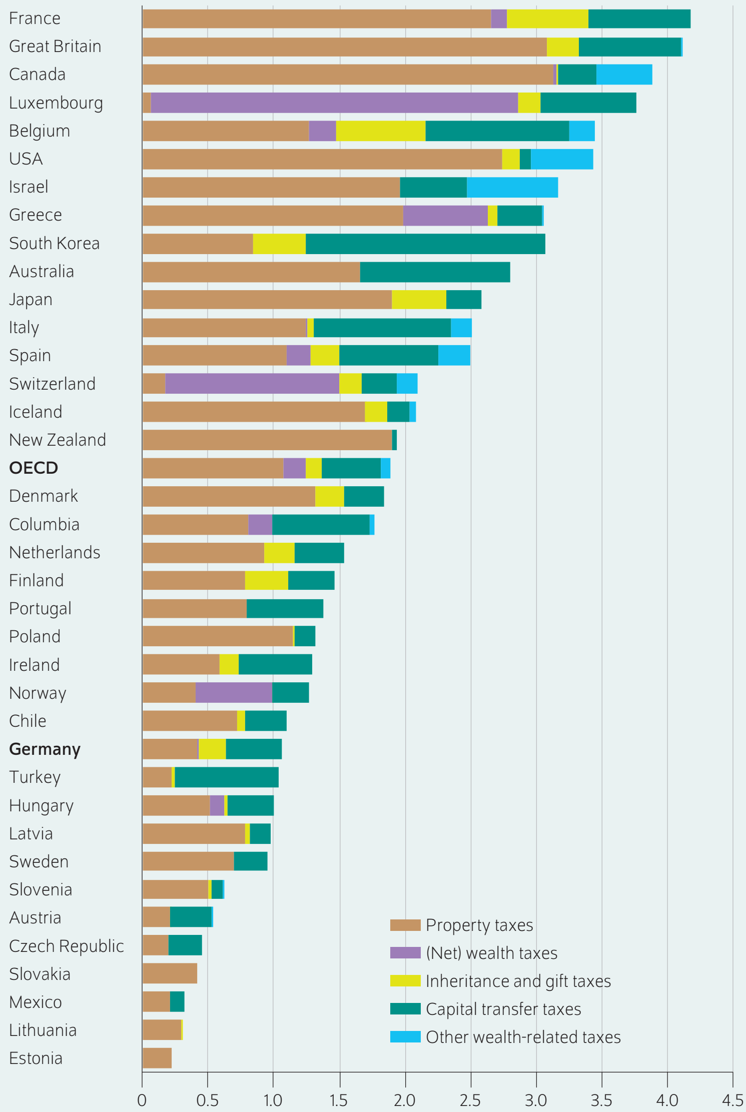
These tax avoidance opportunities were reduced by the abolishment of declining-balance depreciation or bonus depreciation and the restriction of loss allocation schemes. Nevertheless, losses from renting and leasing for personal and corporate income tax still added up to eleven billion euros in 2016.[3]

3 This does not yet take into account offsetting of losses within positive income from renting and leasing (for example, from several properties).

Figure 2

Revenue from wealth-related taxes in OECD countries, 2017 to 2019

Share of GDP in percent



Source: OECD.

In a number of countries, property tax revenue is many times higher than in Germany.

Paths to more effective and uniform real estate taxation

Property tax: tax property values!

In many other countries, the property tax rate is several times higher than in Germany (Figure 2). In Great Britain, Canada, the U.S., and other Anglo-Saxon countries, owners pay 2,000 euros or more for owner-occupied homes in good locations. In European countries such as France, Italy, Spain, Denmark, and Poland, the property tax is above the OECD average.[4] In contrast, a privately owned home or apartment in Germany, even in metropolitan areas, usually costs only 200 to 400 euros in property tax per year.

The property tax relied on outdated real estate values that have not been renewed in decades. The western federal states[5] use values from 1964 and the eastern states[6] use even older values from 1935, which were only roughly extrapolated to 1964 value ratios. Following a decision of the German Federal Constitutional Court,[7] the tax bases of the property tax must be redefined by 2025 and then regularly updated. With the 2019 Property Tax Reform, the federal states were allowed to deviate from the new federal regulations and levy their own property tax bases.

The new federal property tax model uses a two-step approach. Standardized land values[8] consider the land value of the properties, while the building values are determined by multiplier methods using the average rent in the municipality. The valuation of business property relies on cost method (production and acquisition costs; *Sachwertverfahren*). This "federal model" is expected to be implemented in most states.[9] Lower Saxony, Hamburg, and Hesse are planning a model that will apply a flat rate to land values while Baden-Württemberg passed a pure land value tax. Bavaria is planning to tax according to the plot area and floor space without considering the value of real estate.

Economic theory provides strong arguments for strengthening the land value component of the property tax. Land value taxation places a heavier burden on economic rents, which occurs primarily when there is inelastic supply in metropolitan real estate markets, thereby reducing the pass-through of property taxes to occupants. This also supports the balance of interests within municipalities, as municipal infrastructure services are reflected in real estate prices. Furthermore, land value taxation promotes housing policy goals, such as securing the supply of real estate and limiting urban sprawl, as it provides incentives for the intensive use of attractive and high-priced building land.

4 Cf. OECD, *Revenue Statistics 2020* (2020) (available online); OECD, Fiscal Federalism 2016. *Making Decentralisation Work* (2016) (available online). In these countries, however, the property tax frequently also finances public services such as water supply, sewage disposal, waste disposal, and schools. In contrast, water, sewage, and waste fees in Germany are often more than double the property tax. These fees are levied at a flat rate per person or per household and therefore have a regressive effect on household income, like a flat or poll tax.

5 Baden-Württemberg, Bavaria, Bremen, Hamburg, Hesse, Lower Saxony, North Rhine-Westphalia, Rhineland-Palatinate, Saarland, and Schleswig-Holstein.

6 Brandenburg, Mecklenburg-West Pomerania, Saxony, Saxony-Anhalt, and Thuringia.

7 Decision of the German Federal Constitutional Court from April 10, 2018 1 BvL 11/14 (in German; available online).

8 The standard land values are the average site values for land, which are determined by the municipal expert committees for land values based on the official purchase price records (§ 196 Federal Building Code).

9 Haufe online, *Die Bundesländer und ihre Modelle* (in German; available online). Berlin, Thuringia, Rhineland-Palatinate, Bremen, Saxony-Anhalt, Brandenburg, Mecklenburg-Western Pomerania, and Schleswig-Holstein (likely North Rhine-Westphalia as well) want to implement the federal model. Saxony and Saarland want to modify it slightly.

Land value taxation mostly burdens high-income individuals, who tend to live in better locations, and relieves low-income individuals, who tend to live in worse locations. In contrast, the Bavarian government taxes all sites with the same value per square meter—fancy neighborhoods close to the city center as well as large housing developments in socially disadvantaged areas. Nevertheless, a pure land value tax gives occasion to distributional concerns too, as older residents with lower incomes may also live in good locations. In the case of a pure land value tax, this leads to disproportionate burdens, especially for low-intensity building development—for example, for a widow with a low pension in a single-family house in a prime location. Therefore, some states hesitate to implement a pure land value tax and want to reduce the land value component in the federal model.

Municipalities have promised to implement property tax reform in a revenue-neutral way. In the long term, however, we would recommend increasing property tax revenue to improve communal services (e.g., social housing) and to reduce less efficient forms of taxation (e.g., high taxes on earned income). A doubling of the property tax burden would increase tax revenue by 15 billion euros per year (Table). In return, the municipal share of local business tax revenue could be reduced. This revneue fluctuates strongly with the economic cycle and therefore has procyclical effects on municipal investment. However, this would mean major reforms in how tax revenues are distributed among the federal, state, and local governments.

Income taxation: assessment of capital gains and limit tax avoidance

Capital gains on real estate held as private assets are regularly not subject to the personal income tax if the minimum holding period of ten years is satisfied. In contrast, capital gains on shares, funds, or other securities are subject to a withholding tax of 26.4 percent (including what is known as the solidarity surcharge) In addition, income from wages and self-employment is subject to tax rates of up to 50 percent. To eliminate this imbalance, capital gains and losses should be taken into account for tax purposes regardless of the holding period. They should be subject to the personal income tax and, in the case of real estate, should be considered as part of the earnings from rentals and leases.

As capital gains from private sales transactions at least partly represent an inflationary adjustment, it seems appropriate to provide allowances or reduced tax rates for this type of income. This also accounts for the fact that corresponding income typically accumulates in one, which drives the progressive tax rate up. Therefore, we suggest granting the progression-mitigating distribution of extraordinary income over five years old and, if necessary, reduced taxation (§ 34 Sections 1, 3 Personal Income Tax Code).

Furthermore, owner-occupied real estate may be sold due to changes in life circumstances. For example, residential property is frequently sold as a consequence of a house moving for professional reasons, with the revenue being invested in a new property in another city. For this reason, it should be made possible to transfer capital gains from owner-occupied residential property to newly acquired real estate and thus to postpone taxation into the future (analog to § 6b of the Personal Income Tax Code). However, this possibility should not be open for rented properties in both the commercial and residential sectors in order to avoid tax privileges for rent and leasing businesses.

Table

Fiscal effects of real estate taxation reform

Long-term annual effects on revenue, estimated for 2022

Reform	Revenue effects	
	Billion euros	Percent GDP
Increasing the property tax		
Especially by strengthening value-based taxation	15.0	0.40
Reforming taxation of real estate income		
Abolition of the extended reduction of business income for real estate companies (§ 9 no. 1 sentence 2 et seq. Business Tax Act)	1.5	0.04
Abolition of the tax exemption for corporate capital gains	3.5	0.09
Capital gains taxation	6.0	0.16
Abolition of preferential treatment of housing company transfers under the inheritance tax	1.0	0.03
Revenue-neutral real estate transfer tax reform		
Limiting tax avoidance, especially by share deals, preferential treatment of home ownership, reducing tax rates	0.0	0.00
Overall	27.0	0.73

Source: Authors' own calculations.

A popular tax arrangement in the area of rented real estate involves property companies, usually in the form of a limited liability company, which in turn can be held via a holding company.[10] Such arrangements provide two main benefits: First, rental income at the level of real estate businesses is exclusively subject to the corporate tax and the solidarity surcharge, but not the local business tax due to the business tax exemption of pure real estate businesses (§ 9 Section 1 Sentence 2 Business Tax Code). This reduces the tax burden to 15.8 percent at the level of the real estate subsidiary and to 17.1 percent at the level of the holding company. Considering that other sources of income can be taxed by up to 50 percent, this provides a large tax privilege for real estate companies.

Second, if the holding sells the shares of the real estate subsidiary, the effective tax burden on the capital gain is typically not larger than 1.5 percent (§ 8b Sections 2, 3 Corporate Income Tax Code). That holds even if the holding period is less than ten years, as long as the gains are retained at the level of the holding.

This tax privilege should be eliminated to curb tax avoidance. The business tax benefit for real estate companies dates back to a time when the burden of the property tax was much higher than nowadays, business tax was deductible

10 Trautvetter, "Immobilienmärkte (be-)steuern," "Immobilienmärkte (be-)steuern," *Info Steuergerechtigkeit* no. 19 (2020) (in German; available online). 14.

as a business expense, and the corporate income tax rate was based on the top personal income tax rate. At the latest since the 2008/2009 corporate tax reform, this provision is no longer a method of avoiding double taxation, but is simply a tax privilege. The same holds for the de facto exemption of 95 percent of capital gains for shares held via a holding company. Unlike dividend distributions, there is no double taxation of capital gains of shareholdings at the level of the company and the level of the shareholder.[11]

According to the estimates for this report, taxing capital gains and limiting tax privileges in real estate could generate additional revenues of around 11 billion euros a year, which should be even higher in the future due to rising real estate prices (Table). Of this expected additional revenue, about 1.5 billion euros are attributable the business tax privilege of real estate companies,[12] 3.5 billion euros to the capital gains privilege of holding companies,[13] and six billion euros to the taxation of income from private sales transactions.[14]

Inheritance tax: abolish housing company privileges

For inheritance tax purposes, transfers of housing companies are treated as preferential transfers of business assets (pursuant to § 19a of the Inheritance and Gift Tax Code). The tax authorities apply this benefit to all housing firms with more than 300 apartments.[15] Although the Federal Fiscal Court significantly restricted the application of preferential treatment in a 2017 decision,[16] the tax authorities nevertheless continue to apply it. As a result, 80 percent of the inheritance (*Regelverschonung*) or even all of it (*Vollverschonung*) remain tax exempt, while inheritance taxes at a rate of up to 50 percent are levied on non-preferential transfers.

While the massive preferential treatment of business assets already appears to be undue and presumably also unconstitutional in the case of other branches, this holds even more true for housing firms with more than 300 apartments. In fact, this benefit is only granted for large housing firms, providing a tax benefit compared to smaller competitors. This seems to be a clear violation of the German constitutional principle of taxation corresponding to economic ability to pay (*Leistungsfähigkeitsprinzip*). In addition, in the housing industry such tax benefits do not seem to be required. This is because residential real estate is generally a liquid asset that can be encumbered with loans. Hence, inheritance tax does not jeopardize business successions and jobs, nor does it lead to distortions on the real estate markets. Instead, the tax privileges for large housing firms in § 13a Inheritance and Gift Tax Code distort the housing market as well as competition of small and large firms. Removing this tax privilege for large housing firms would generate additional annual revenues estimated at about one billion euros (Table).[17]

Real estate transfer tax: reforms needed, favor first-time buyers

The real estate transfer tax rates increased considerably over the past 15 years. Since 2016, the Geman states may determine the tax rates themselves. Previously, it was 3.5 percent (until 1996 2.0 percent) countrywide. Most states increased the rate to 4.5 to 6.5 percent; only Bavaria and Saxony kept the old tax rate. The tax revenue increased from six to almost 16 billion euros (or from 0.26 to 0.42 percent of GDP), probably helped by a booming real estate market.

However, the real estate transfer tax does not tax real estate transactions equally. While it is usually paid without major collection issues for smaller transactions (such as for owner-occupied homes), there are tax avoidance schemes for major investors that give them a de facto competitive advantage on the real estate market.

One popular avoidance opportunity is the share deal. In this type of deal, the seller transfers shares a corporation in which the real estate is "packed" instead of the real estate itself. According to the current legal status, such an arrangement is tax exempt as long as at least 90 percent of the company's shares (i.e., practically 90 percent of the real estate) are not sold. Thus, share deals below an acquisition threshold of 90 percent remain tax-exempt despite the restrictions imposed by the amendment of the Real Estate Transfer Tax Code of May 12, 2021. Unit deals, in which exclusively the usage rights or the income from the property are sold and not the property itself, remain tax exempt as well.[18]

A comprehensive reform of the real estate transfer tax that generally prohibits such artificial arrangements would be very useful. To this end, the acquisition threshold for real estate companies should be reduced to such an extent (for example, to 25 percent) that all structured tax avoidance arrangements are included. In return, only the share that is being sold should be taxed.[19] Furthermore, contractual arrangements should be covered, which do not sell the property itself, but only the rights to the income from the property

11 Double taxation can occur in the case of retained earnings that are already taxed by the corporate income tax of the subsidiary. This could be avoided by allowing the holding company to expand acquisition costs to include retained earnings of the subsidiary. In this way, the retained earnings of the real estate subsidiary that have already been taxed would not be taxed again.

12 Estimates based on Federal Statistical Office, "Gewerbesteuerstatistik 2016," Fachserie 14, Reihe 10.2 (2021) (in German; available online).

13 Estimates based on Federal Statistical Office, "Körperschaftsteuerstatistik 2016," Fachserie 14, Reihe 7.2 (2021) (in German; available online).

14 Estimates based on Federal Statistical Office, "Lohn- und Einskommensteuer 2017," Fachserie 14, Reihe 7.1 (2021) (in German; available online); we well as Federal Statistical Office, "Körperschaftsteuerstatistik 2016" (in German; available online).

15 Cf. R E 13b. 17 Section 3, Sentence 2 of the Inheritance and Gift Tax Guidelines 2019 (in German; available online). In this way, the tax authorities intend to limit the benefit to genuine housing companies and exclude asset management.

16 Ruling from October 24, 2017. II R 44/15 (in German; available online).

17 Cf. Bundesministerium der Finanzen, *27. Subventionsbericht des Bundes: 2017-2020* (2019): 19 (in German; available online).

18 Cf. Wissenschaftliche Dienste Deutscher Bundestag, *Unit Deals im Grunderwerbsteuerrecht. Ausarbeitung WD 4 – 3000 – 117/19* (in German; available online).

19 Trautvetter, "Immobilienmärkte (be-)steuern," "Immobilienmärkte (be-)steuern," *Info Steuergerechtigkeit* no. 19 (2020) (in German; available online). 13.

(i.e., unit deals). In return, the reform should contain regulations that prevent excessive taxation better than at present (for example, no taxation in the case of restructuring within a firm group). This would allow the real estate transfer tax to continue to fulfill its function of skimming off profits from real estate capital gains and to act as a substitute for not levying value-added taxes on real estate transactions.

A moderate tax allowance for the real estate transfer tax might be useful for first-time homebuyers. This would strengthen the competitive position of first-time homebuyers and therefore support wealth creation of households without property. However, it must be considered that the real estate transfer tax is borne by the sellers to a significant extent, primarily in metropolitan areas with high real estate prices.[20] A general tax cut might therefore simply lead to higher selling prices.

Overall, we recommend a revenue-neutral reform of the real estate transfer tax for fiscal and distributional reasons. Additional revenue from limiting tax avoidance opportunities should be used to support taxpayers with low assets, for example via allowances for first-time homebuyers, as well as to avoid double taxation, such as in the case of firm group restructurings.

Conclusion: tangible revenue with positive effects on distribution

In the long term, the reforms outlined here could yield additional tax revenue of about 27 billion euros per year, or 0.7 percent of GDP (Table).[21] This revenue could be used to reduce the high tax burden on earned incomes of the middle classes or to more effectively promote wealth accumulation in these groups.

In our calculations, we do not account for tax incentives and adjustments of economic behavior. However, as abolishing tax privileges will not create any relevant additional tax distortions, we expect that the proposed reforms would improve the efficiency of the German tax system. Moreover, the inequality in wealth and income distribution would be reduced, as real estate is held almost exclusively by the top 50 percent of the wealth distribution and, in particular, by the top 10 percent. The latter in particular are likely to benefit frequently from real estate tax privileges. It is not justified to provide this group with tax privileges compared to the rest of the German population.

20 Clemens Fuest, Carla Krolage, and Florian Neumeier, "Who Bears the Burden of Real Estate Transfer Taxes? Evidence from the German Housing Market." ifo Working Paper No. 308, 2019 (available online).

21 Revenue effects were estimated in a scenario in which the reforms are fully implemented over the longer term and under the economic conditions in 2022 (after the coronavirus recession has been overcome).

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