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Property tax reform 2022: a comparison of tax burdens and the need for contractual action in real estate transactions

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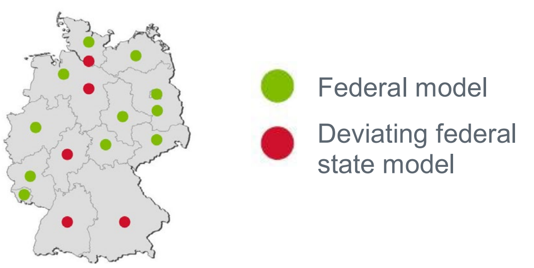
Introduction

In Germany, property taxes play an important role in municipalities finances. They are one of the most important sources of municipal revenue. Property tax is levied on all kinds of real property, including commercial and residential buildings as well as agricultural and forestry enterprises. Property tax is to be differenciated from property transfer tax. While the latter applies to the transfer of properties, property tax is applied to the pure holding of property. Municipalities receive an estimate of around15 billion euros annually from property tax. In April 2018, the German Constitutional Court (*Bundesverfassungsgericht*) declared the property tax unconstitutional in its current form and set a deadline for a reform. Without a timely reform, this essential source of revenue would have been lost.

At the end of 2019, the legislative proposal for the property tax reform passed the parliament. Since 1 July 2022, property owners are required to submit a property tax declaration to determine the property tax value under the reformed tax. The deadline for submission was initially set for 31 October 2022. The federal ministry of finance recently extended it to 31 January 2023. The property tax value will be determined with the effective date 1 January 2022 (*Hauptfeststellungszeitpunkt*). The new property tax will be levied from 1 January 2025 onwards. Hereby, the legislator granted the tax authorities two years to process with the expected wave of estimated 36 million property tax returns and to issue respective tax assessment notices.

Five federal states made use of a possibility given by the constitution to draft their own legislation, which is deviating from the federal property tax model. The illustration below shows the applicable models in each federal state.



In this article, to illustrate the differences between the new property tax models applicable we compare the federal model with the models in Hesse and Bavaria on the basis of a model case.

We are concluding this overview with the need for contractual action for real estate transactions taking place in and around the time of effective date up until the tax year 2025.

Constitutional background

The property tax reform became necessary following the German Constitutional Court's decision in April 2018 of the unconstitutionality of the current model. The court held, that it violated the principle of equality set out in Article 3 of the constitution. Central element of the old system was a periodic recurrence of the main determination for a properties reference value, in German referred to as the "*Einheitswert*", which is the relevant value for the assessment of the property tax. Yet, this periodic recurrence has never been carried out. As a result, the *Einheitswert* that is currently still determining a real properties value for the purposes of the property tax is based on values dating back to 1964 in West Germany and to 1935 in East Germany.

The federal model

The majority of the Federal states follow the federal tax model. Saarland and Saxony provide for minor deviations (different tax base). The three-tier tax system, which also existed in the old system, is retained in principle. Its three variables now consists of a new property tax value (*Grundsteuerwert*) as the relevant value expressing the tax base, a tax base multiplier (*Steuermesszahl*) and an assessment rate (*kommunaler Hebesatz*), which each municipality determines individually. The core element is the new property tax value, which replaces the previous properties reference value.

The federal model is based on the assumption that the ownership of real property reflects a taxpayer's ability to pay. For the determination of a real property's value, the federal model applies adjusted versions of a discounted cash flow method (*Ertragswertverfahren*) and an asset value method (*Sachwertverfahren*). The methods are well known and proven in practice in the real estate sector.

Since the new property tax values will be most definitely in almost all cases significantly higher than the current values, the applicable tax base multipliers have been reduced. They now provide for per-mille rates of between 0.31 and 0.34 as opposed to the previous 2.6 and 3.5.

The federal state models

Bavaria, Baden-Württemberg, Hamburg, Hesse and Lower Saxony drafted their own new property tax models.

In contrast to the federal model, the models in Bavaria and Hamburg are driven by the principle of equivalence. The property tax is primarily used to finance municipal infrastructure. The larger the real property, the greater its share ratio on the infrastructure used or available for use. This justifies a proportionately higher tax burden. In Bavaria, therefore, the new property tax value is referred to as equivalent amounts. They are to be determined for the land as such as well as for residential and other usable space in buildings. A tax base multiplier is applied to the equivalent amount determined.

In Hamburg, equivalent amounts are determined in a similar way. However, Hamburg takes into account the location of the real property as well. For the equivalent amount of the regular residential areas, a reduction of the tax base multiplier is provided for. For this purpose, a differentiation is made between good and regular residential locations. The reduction applies to regular residential locations as well as to certain socially subsidized housing properties.

In Baden-Württemberg, only two factors are taken into account: the area of the property and the ground reference value (*Bodenrichtwert*). The building on the property is irrelevant. This is based on the idea that the ground reference value sufficiently reflects the potential economic benefit of the municipalities' services and use of resources.

In Hesse and Lower Saxony, too, it is assumed that real property in sought-after locations typically goes hand in hand with a greater offer of municipally financed infrastructure. However, the ground reference value is only one indicator that reflects this. In Hesse and Lower Saxony, the concept of equivalence familiar from Bavaria and Hamburg is corrected by a location-related factor, which is based on the ground reference value and can be seen as an indicator of a higher ability to pay.

Comparison of tax burdens

The different tax burdens of the models outlined above shall now be illustrated by an example. For that purpose, we take a fictionally consumer market and place it in three fictitious municipalities in North Rhine-Westphalia, Hesse and Bavaria. In order to assure comparability, we assume the same municipal assessment rate of 500% and the same ground reference values in all three cases (*ceteris paribus*).

For the application of the asset value method according to the federal model, the following property information is required: Property area (here: 2,235 sqm), gross floor area (here: 1,250 sqm), year of construction (here: 2012), normal production costs (here: EUR 896/sqm), construction price index (here: 116%), useable economic life (here: 30 years), ground reference value (here: EUR 1,100/sqm), average ground reference value of the municipality (here: 1000/sqm).

On the basis of this real estate information, further values are to be taken from the appendices 36 to 43 of the valuation law ("BewG"). In total, about 15 different parameters are required for the calculation.

In our example, the application of the asset value method in the federal model leads to a property tax value of EUR 2,327,243, resulting in a property tax payable of EUR 3,956 (EUR 2,327,243 x 0.00034 x 500%).

For the determination of the property tax to be paid in Hesse only four of the above mentioned property information and none of the values from the appendices 36 to 43 BewG are required. The result is a property tax payable of EUR 3,675.

In Bavaria, on the other hand, only two of the above-mentioned property information items are applicable. The result is a property tax payable of EUR 3,572.

With the exception of Bavaria and Hamburg, the location of the property in particular can lead to considerable differences in the amount of property tax to be paid. In the case of properties with significantly above-average standard land values, this effect becomes particularly significant. If we take the example outlined and apply a ground reference value of EUR 5,000, the result would be an unchanged property tax of EUR 3,572 in Bavaria. Yet, it would amount to EUR 5,786 in Hesse and EUR 14,329 in North Rhine-Westphalia.

Need for action in real estate transactions

The property tax returns have to be submitted by the respective owners of the real property. The new property tax has to be paid by the owner on 1 January 2025. For real estate transactions taking place in the meantime, we recommend to consider a number of contractual adjustments.

Firstly, it is recommendable to include a clause according to which the seller declares that he has duly fulfilled his obligation to submit the property tax return (Sec. 228 BewG) and that he will provide the buyer with a copy of the tax return submitted.

Depending on the individual case, for the buyer retaining a right to review and, if necessary, the right to make adjustments to the tax return, could be appropriate.

Secondly, since the property tax is payable by the new owner as of 1 January 2025, it should be ensured that the new owner is aware of all tax notices issued in the future relating to the property tax. The corresponding notices (or at least copies thereof) should be made available to the new owner by the seller. The contract should entail a respective obligation.
Thirdly, in the event that the competent tax office applies values in the property tax assessment notice that deviate from the values submitted in the tax return, the buyer should be put in a position to participate sufficiently in potential appeals or disputes. A respective contractual provision should be provided for.

Lastly, appropriate legal consequences in case of a breach of these obligations outlined should be provided for for new tax disadvantages as a result of the breach. Such tax disadvantages may constitute for example in late payment surcharges. A purchase agreement should provide for respective tax indemnifications in favor of the purchaser.

The specific need for contractual action can only be assessed on a case-by-case basis. Real estate transactions carried out on the basis of the new law until the new first property tax assessment notices are issued should be examined keeping aspects outlined in mind.

Note

This overview is solely intended for general information purposes and may not replace legal advice on individual cases. Please contact the respective person in charge with GÖRG or respectively the author Dr. Adalbert Rödding on +49 221 33660-624 or by email to aroedding@goerg.de. For further information about the author visit our website www.goerg.com.

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