

Reform of subsidies for owner-occupied housing in Germany

Major changes in the tax treatment of residential property in Germany have produced far-reaching consequences, as Dr Joachim Degner explains

AT the beginning of 1987 the treatment of residential property for tax purposes changed in the Federal Republic of Germany. The Act for the New Regulation of Tax Subsidies for Owner-Occupied Property (Residential Property Subsidies Act) constitutes a genuine reform. The main emphases of the subsidies have been substantially altered, producing far-reaching consequences for financing methods as a result. Much greater importance is attached to the owner's own capital than in the past.

Deduction of mortgage interest abolished

Two points at the centre of the reform are the elimination of income tax on owner-occupied residential property and the abolition of the deduction from tax of mortgage interest, which was permitted up to the end of 1986. The subsidy is granted irrespective of the degree of indebtedness. The maximum amounts of subsidy have also been increased.

The second pillar of the subsidy system for owner-occupied housing — the building-saver subsidy — is not affected by these changes.

The previous system

Up to the end of 1986, a person's own four walls were subsidised in the context of the famous section 7b of

the Income Tax Act. According to this, every owner-occupier could, for a period of eight years, deduct 5% of the construction or purchase cost of his house (up to certain maximum amounts) from his taxable income. The maximum amounts laid down for the cost of the house (excluding the cost of the site) were:

- DM200,000 for one-family houses and owner-occupied apartments and
- DM250,000 for two-family houses.

For the second and subsequent children, DM600 could additionally be deducted from the amount of tax payable, also for a period of eight years (the "children's allowance").

In addition, the so-called extended debt interest deduction was introduced in November 1982 as a temporary measure to encourage housing construction. From that time onwards, and lasting for three years, interest payments up to a maximum of DM10,000 per year could also be deducted from the taxable income in respect of newly constructed owner-occupied homes. This measure was withdrawn at the end of 1986.

Quite apart from the subsidy provisions, for over 100 years in Germany owner-occupied dwellings had also been subject to income tax; tax had to be paid on the use of it, ie a notional rent (the so-called "rental value") was calculated, which was added to

the other income annually as "income from letting and leasing" and taxed. This notional rental value amounted to 1.4% of the "standard value" of the house. The standard value was, in turn, a value for tax purposes fixed in a uniform manner.

Within the framework of this tax system, however, it was also possible to charge the professional expenses; interest charges, for example, up to the equivalent of the rental value could be offset against tax. If, however, the interest charges were lower than this amount or the house was already free from debt, the difference was subject to income tax in full.

The new tax subsidy system

Specifically, the following changes have been made to the tax subsidy system for *owner-occupied* property (the system remains unchanged for rented housing):

1. Section 7b of the Income Tax Act has been replaced by a new section, 10e. The maximum amount for the real property subsidy has been increased to DM300,000 and applies uniformly to one- and two-family dwellings and owner-occupied apartments. This means that for residential property acquired or completed since 1 January 1987, 5% of the purchase or construction costs can be offset against tax annually as exceptional expenditure for a period of eight years up

→ 32

← 31

- to the maximum amount of DM300,000. Half of the real property costs can be included in this maximum amount (this, too, is a new feature).
2. The so-called "children's allowance" amounting to DM600 annually will in future apply from the first child onwards and not from the second onwards as hitherto.
 3. The liability of owner-occupied property to income tax has been abolished. If a person has cleared his own home of debt, he will now live not only rent- and encumbrance-free but also tax-free. For many owner-occupiers this removes the obligation to file an income tax declaration.
 4. Every owner-occupied dwelling is treated in the same way. It no longer makes any difference if it is a one-family dwelling, a two-family dwelling or an owner-occupied apartment. The construction of a new residence and the acquisition of second-hand property are accordingly treated in the same way.
 5. For dwellings built or acquired before 1 January 1987 there is a 12-year transitional arrangement, ie nothing will change as regards the subsidy system for owner-occupiers who have hitherto paid tax on their dwelling in accordance with the so-called excess calculation (the excess of the rental value over professional or running expenses); it is not possible to change over to the new subsidy system under section 10e. The abolition of the tax on owner-occupation will nevertheless benefit this group of people, too.
 6. The possibility of offsetting against tax expenditure incurred during the construction and acquisition phase — in particular the cost of raising the money — will be retained for the future. This also applies to renovation and modernisation work in second-hand houses, where this has been carried out before moving in.
 7. This subsidy can be claimed once

Housing finance from all sources¹ in the Federal Republic of Germany in 1985

Source of finance	Payments for all housing construction		New commitments for housing construction	
	(DM million)	(%)	(DM million)	(%)
All bauparkassen ²	44,406	41.3	24,741	46.9
Private bauparkassen	(29,942)	(27.8)	(16,389)	(31.0)
Public bauparkassen	(14,464)	(13.5)	(8,352)	(15.8)
All mortgage banks	28,390	26.4	12,983	24.6
Private mortgage banks	(19,284)	(17.9)	(7,885)	(14.9)
Public banks	(9,106)	(8.5)	(5,098)	(9.7)
Savings banks	29,218	27.2	12,722	24.1
Life assurance companies ³	5,506	5.1	2,348	4.4
Funds from providers of capital	107,520	100.0	52,794	100.0

1. Excluding commercial banks and public funding.
2. Including deposited amounts.
3. Private and public sector.

in a person's lifetime — twice for married couples for two properties — and account will be taken of any tax concession already granted under the terms of the old section 7b of the Income Tax Act.

Loan interest more important

In addition to the tax on owner-occupation, the deduction of interest payments for owner-occupied dwellings has also been abolished. The new subsidy system for owner-occupied housing is thus neutral as regards financing. In other words, it makes no difference whether the owner-occupied home has been financed by the owner's own capital or by outside funds.

Interest charges on outside capital and any subsequent increases in interest rates for loans must in future be met by the owner without any contribution from the tax authorities. The incentive for as high an amount of indebtedness as possible is thus removed, and financing is put on a more solid basis once again.

The importance of one's own capital is increased

Those who will profit most from the new subsidy arrangements are the middle and lower income groups who are currently on the threshold of home ownership in the Federal Republic. These people are, in fact, obliged to contribute a relatively high proportion of their own capital, as

they would not otherwise be able to meet the financial burdens.

Under the interest deduction system, on the other hand, the people "rewarded" were those who financed their house purchase with as much outside capital as possible, ie the higher income groups.

The marked increase in recent years in the number of auction sales under execution of owner-occupied property in the Federal Republic is due above all to the fact that the proportion of outside finance (up to 100% in some cases!) was often too high.

The direct connection between the proportion of own capital and the risk of an auction sale under execution can be easily illustrated by the German building-savers who acquire residential property; building-savers finance their purchases with an above-average proportion of own capital (about 40%) and are at the same time involved in a much lower proportion of auction sales.

It was furthermore remarkable that virtually all leading politicians — both in the Government and in the Opposition — supported the principles of the new tax subsidy system. ■

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