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U.S. Real Estate Fund Structures to Accommodate German Investors

The U.S. real estate market continues to be one of the most attractive investment markets for foreign investors, including German investors. While German investors such as German real estate funds have traditionally invested directly in U.S. real estate in recent years, German funds also have increasingly invested in U.S. real estate funds as limited partners. In order to attract German investors as limited partners, U.S. real estate funds need to have certain structures in place that can accommodate these overseas investors in light of the German legal, regulatory, and tax constraints. This article provides an overview of some of the considerations that U.S. real estate fund sponsors and managers will need to take into account in structuring U.S. real estate funds to attract German investors, especially German closed-end funds that act as feeder funds in Germany by raising capital from German investors and then investing this capital as a limited partner in the U.S. real estate fund. partner in the U.S. real estate fund.

Onshore Investment. As a general rule, German investors prefer to structure their investment in a U.S. real estate fund as an onshore (i.e., U.S.) investment, which subjects their fund income to U.S. taxation. This is somewhat counterintuitive since the typical overseas investor often prefers to invest through an offshore vehicle in an effort to minimize exposure to U.S. taxation. The reason for this anomaly is that German investors can take advantage of certain aspects of the U.S.-Germany Income Taxation Treaty (more technically known as the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital and to Certain Other Taxes of August 29, 1989). As a general rule, Article 6 of the Treaty, together with the implementing legislation and regulations in Germany, effectively provides that income from U.S. real estate investments by German investors will be taxed only in the United States, rather than in Germany. In Germany, the investor's income will be added to the investor's total taxable income for purposes of determining his or her tax rate (the so-called *Progressionsvorbehalt*); however, the investor's eligible income from U.S. real estate will not typically be taxed in Germany if the Treaty applies. As a result, a key consideration for German investors, in particular German closed-end funds that pool investments from German individual investors, which invest in a U.S. real estate fund is whether the U.S. real estate fund will be structured such that the German feeder fund and indirectly, its investors, can take advantage of this Treaty provision.

The application of the Treaty is of particular concern to German closed-end funds that raise capital from a large pool of German investors through a public offering in Germany, as these investors often wish to take advantage of the substantially lower taxes on their U.S. source income. For example, a German feeder fund subscribes for a limited partnership interest in a U.S. real estate fund by making a significant capital commitment. The German feeder fund secures payment of that commitment through a bank loan or other interim financing and then starts syndicating its limited partnership interest to a German investor through a public offering. The feeder fund may typically require a minimum investment amount of $15,000 or $20,000 from German investors.

Assuming, for example, that the German investor receives an annual return of eight percent before taxes on a $100,000 investment, the investor's tax situation is significantly affected by the application of the Treaty. Assuming that such income is the investor's only income from U.S. sources, the investor would only have to pay taxes in the United States with respect to the taxable income on this investment. Even when the income is ordinary income rather than capital gain for U.S. tax purposes, and after applying any available exemptions and even when taking into account state taxes, the effective tax burden — and thus the return on investment after taxes — for a German investor would be significantly lower than if the Treaty did not apply. Otherwise, the $8,000 income from the investment would be added to the taxable income in Germany and would be taxed at German tax rates. Assuming that the investor falls within the typical target group for closed-end funds, he or she is likely to be subject to a considerably higher effective tax rate in Germany with respect to his or her total taxable income than the lower effective tax rates at the federal and state level in the United States if the Treaty applied. Thus, the investor could expect that the effective post-tax return on this hypothetical $100,000 investment would be considerably higher if the Treaty applied than if the income from the investment were included in his or her German taxable income and subject to German taxes.

As a result, structuring a U.S. real estate fund such that German investors can take advantage of the benefits under the U.S.-German Double Taxation Treaty is often a critical factor for attracting capital commitments from German investors, in particular German closed-end feeder funds that raise capital from a large number of individual German investors in a registered public offering.

German Investment Tax Act. Application of the U.S.-Germany Income Taxation Treaty is not the only German tax consideration when structuring a U.S. real estate fund that appeals to German investors. Another key consideration is ensuring that the U.S. real estate fund does not trigger certain taxes on fictitious income that would have a punitive effect under the German Investment Tax Act (*Investmentsteuergesetz*). This Act generally applies to investments in so-called foreign investment funds. An investment in a U.S. real estate fund would not be attractive to German investors if the punitive tax regime of the German Investment Tax Act was triggered.

The German government is currently contemplating certain revisions to the German Investment Tax Act and related regulations such as limiting the definition of foreign investment fund, which is currently very broad. Depending on the scope of the amendments to the German Tax Act as ultimately enacted, structuring German investments in U.S. real estate funds may become considerably easier.

Hedge Funds. The U.S. real estate fund will need to ensure that it does not qualify as a hedge fund or fund of hedge funds for German tax purposes. In a letter guidance from June 2, 2006, the German Federal Department of Finance (*Bundesministerium der Finanzen*) has identified certain criteria for determining whether a fund qualifies as a single hedge fund or a fund of hedge funds. Qualities of a single hedge fund or fund of hedge funds include:

- The fund at issue makes investments pursuant to the principle of risk diversification
- The fund observes no restrictions with respect to its investment strategy in choosing from certain specified asset classes such as securities, derivatives, certain futures contracts, and investments in corporations whose market value can be readily determined
- The fund may use leverage by engaging in unrestricted borrowing for the joint account of its investors or by using derivatives
- The fund may engage in short sales
- Investments in entities not listed on a stock exchange or traded on an organized market are limited to 30 percent of the value of the fund

Use of Limited Liability Companies (LLC) Versus Limited Partnerships. A key consideration in structuring a U.S. real estate fund to make it attractive for German investors will be its use of limited partnerships in structuring its investments — and whether the fund itself is organized as a limited partnership. While as a general matter, the German tax authorities consider a limited partnership organized in the United States a pass-through entity for German tax purposes, the German tax authorities have adopted a different approach with respect to LLCs organized in the United States. Rather than affording them the equivalent tax treatment as limited partnerships, the German Federal Department of Finance has taken the position that each LLC must be assessed on a case-by-case basis to determine whether it satisfies certain criteria established by the Department of Finance in a letter guidance dated March 19, 2004. The Department of Finance rationale is that since an LLC has characteristics of both a corporation and a partnership, the relevant determination is whether the LLC at issue is more akin to a corporation or to a partnership under German legal principles (i.e., whether the entity would be more like a German corporation or a German partnership). While it may be feasible to structure an LLC such that it would satisfy enough of the criteria to qualify as partnership, the preferred — and safer — approach has been to simply use a limited partnership instead of attempting to develop the appropriate LLC structure. The use of pass-through entities from a German tax perspective is a critical component for ensuring the application of the U.S.-Germany Income Taxation Treaty and avoiding the punitive tax regime of the German Investment Tax Act. However, certain investment structures may exist for using LLC entities such as in combination with a limited partnership, where the investment structure may satisfy enough of the criteria by the German tax authorities to qualify for pass-through entity status for German tax purposes. Therefore, as a strategic matter, a U.S. real estate fund seeking to attract German investors should be organized as a limited partnership and should structure its investments using limited partnerships. Such limited partnerships also should be reviewed to ensure that they qualify as pass-through entities for German tax purposes.

German Offering. In a typical German feeder fund structure, the German fund sponsor such as a German bank or publicly traded investment company establishes and procures the funding for a German limited partnership, which in turn makes a capital commitment to a U.S. real estate fund for a limited partnership interest in the fund. The German fund sponsor will then syndicate this limited partnership interest by offering ownership interests in the German feeder fund to German investors in a registered public offering or a private placement, or a combination of both. This investment and offering structure must comply with U.S. securities laws and German laws governing the distribution and offering of fund investments. Accordingly, the U.S. real estate fund and the fund sponsor will typically enter into a distribution agreement that governs the distribution and offering of the feeder fund interests in Germany by taking advantage of Regulation S under the U.S. Securities Act of 1933. Since the offering in Germany will often not be limited to accredited investors (as defined under the U.S. securities laws), the distribution and offering activities must be limited to non-U.S. persons. The German fund sponsor will typically be responsible for compliance with these requirements. Likewise, the German fund sponsor will typically ensure that the German investors comply with the USA PATRIOT Act and related rules and regulations.

The German fund sponsor will be responsible for conducting the offering in compliance with the German laws governing the distribution and offering of the feeder fund interests in Germany. In addition, the German fund sponsor will be liable for the information in the private placement memorandum in the case of a private placement, or the fund prospectus in the case of a public offering. If the German fund sponsor makes an offering that is not restricted to a limited number of high net worth individuals or institutions, a prospectus in German will have to be prepared in accordance with German law and submitted to the German securities or financial services regulatory authority, the *Bundesanstalt für Finanzdienstleistungsaufsicht* or *BaFin,* for approval. The German fund sponsor is typically responsible for preparing the offering prospectus and obtaining regulatory approval. It also is customary in Germany to obtain the opinion of an independent auditor concerning the contents of the prospectus. The German fund sponsor is liable for the contents of the prospectus vis-à-vis the German investors.

Investments in the German feeder fund will typically be highly illiquid and German investors are expected to hold their interests for the entire duration of the U.S. real estate fund. The feeder fund interests will not typically be listed or quoted on a stock exchange.

A German prospectus differs from a customary U.S. private placement memorandum in a number of ways. The U.S. real estate trust will need to be prepared to provide additional information for inclusion in the German prospectus such as the track record, historical performance, and background information of prior U.S. real estate funds managed by the same investment manager, information about the management team, information about real estate assets in which the U.S. real estate fund has invested, the allocation of distributions, and other details of the limited partnership agreement of the U.S. real estate fund. The German fund sponsor will typically include a range of projected returns on investment in the German feeder fund. In addition, images are typically a key component of the prospectus, which will contain high quality photographs of any real properties in which the U.S. real estate fund has invested.

Reporting. Even though as a pass-through entity, the German feeder fund may not be subject to taxation in Germany, the fund will nevertheless have to prepare an annual report and tax return in accordance with German Generally Accepted Accounting Principles (GAAP). The annual report will be provided to the German investors and the information from the German tax return will be used by the German investors to prepare their own tax return in Germany.

Accordingly, the U.S. real estate fund must provide the German fund with additional information — beyond the information contained in the Schedule K-1 for U.S. investors — to enable the German fund to prepare its annual report and tax return. A key issue is that the accounting treatment of real estate transactions and investments may differ under German GAAP and U.S. GAAP or U.S. tax accounting. In addition, the U.S.-Germany Income Taxation Treaty may not apply to certain income due to the nature of the investment or the deal structure employed. Accordingly, the German feeder fund may have to recharacterize certain items for German GAAP purposes or determine the tax treatment for German tax purposes. However, the information needed by the German fund should in general be readily available to the U.S. real estate fund.

In addition, depending on the structure of the U.S. real estate fund and its investments, the U.S. real estate fund may have to become subject to certain reporting and publication obligations under the German Investment Tax Act in order not to trigger the punitive taxes under that Act for the German investors.

Recalls and Recontributions. As a general matter, recall or recontribution provisions whereby the limited partners of a U.S. real estate fund are required to return distributions previously made to them under certain circumstances such as for indemnification purposes, pose challenges for German feeder funds. It is not customary in Germany for investors to return distributions received other than capital that has been returned to the investor. However, certain structuring solutions may exist to address these challenges.

Properties and Investment Activity. The German investors will typically be concerned that the U.S. real estate fund limits its activity to real estate investments in the United States; otherwise, there is uncertainty as to whether the favorable provisions of the U.S.-Germany Income Taxation Treaty will apply. Given the breadth of real estate investment structures and the types and classes of real estate that exist in today's markets, careful consideration must be given as to whether these provisions of the Treaty apply to a particular investment structure and property type.

This discussion is intended to provide only a general overview of some of the issues involved when structuring an investment by German investors in a U.S. real estate fund. This discussion is by no means complete. Given the relative complexity of these cross-border transactions, the U.S. real estate fund and the German fund sponsor are advised to retain counsel experienced in these transactions to develop the appropriate investment structure.