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GUIDE

Overview of structuring UK real estate for German fund investors

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Introduction

The UK continues to be an attractive jurisdiction for many European, American and Asian fund managers acquiring real estate. According to the overseas entity register at UK Companies House, Jersey, Guernsey, and BVI remain popular jurisdictions for holding UK real estate, with over 58,000 companies listed as owning UK real estate from those locations. In a vast majority of cases, these holding companies are facilitating inward investment to the UK from other jurisdictions.

As with any cross-border investment, careful structuring advice needs to be taken to:

- avoid any potential return being eroded by inefficient structuring (such as double taxation); or
- avoid (where the assets are held by a fund) holding investments in a way that breaches the fund manager's local regulation.

This article focuses on German fund managers and the requirements for investing into UK property via real estate holding vehicles, such as Jersey or Guernsey entities.

It is estimated that German investors (with a combined assets under management of €307 billion) make up just over 10% of the top 200 investors in UK real estate and are second only to the US in terms of the number of large fund managers investing into the UK from around the world[1].

We have significant expertise in customising Jersey and Guernsey entities to meet the specific needs of German investors and ensuring compliance with the German capital investment code. Additionally, we can provide the ongoing management services for these entities.

Capital Investment Code (KAGB)

The KAGB (Kapitalanlagegesetzbuch) is the German investment code that regulates the investment of capital by German entities in various asset classes, including real estate. The KAGB applies to German investment funds that invest in real estate assets and sets out specific rules for their operation and management.

In summary, the key provisions of the KAGB related to real estate investment include:

1. *Authorisation and supervision*: German investment funds that invest in real estate must be authorised and supervised by the German Federal Financial Supervisory Authority (BaFin).
2. *Eligible investments*: German real estate investment funds can invest in a wide range of real estate assets, including commercial, residential, and mixed-use properties. Developments are permissible provided that the development is expected to complete within a reasonable timeframe and the expense of the development will not exceed 20% of the total fund assets[2].

[1] According to ResearchGermany Report on the top 200 UK real estate investors as at 2021

[2] KAGB, Section 2, Subsection 5, Section 231

3. *Diversification:* German real estate investment funds must maintain a diversified portfolio of assets to minimise risk.
4. *Valuation*: German real estate assets must be regularly valued by independent appraisers to ensure accurate pricing and transparency.
5. *Liquidity:* German real estate investment funds must have sufficient liquidity to meet investor redemptions.
6. *Reporting:* German real estate investment funds must provide regular reporting to their investors, including financial statements, investment strategy, and performance data.

Overall, the KAGB provides a framework for the safe and effective investment of capital in real estate assets, while protecting the interests of investors and ensuring transparency and accountability.

Investments in real estate investment companies

The KAGB governs 'AIF Capital Management Companies' (i.e. **German AIFMs**), including how they can invest in real estate investment companies, such as Jersey or Guernsey companies owning UK real estate, on behalf of the funds they manage.

These rules mean both the structuring and documentation need to be tailored to comply with the KAGB.

Typically the German AIFM will be required to hold the shares in the property holding company (**Propco**) as the legal owner holding on behalf of the fund it manages. This stems from a provision of the KAGB which requires the German AIFM to hold 100% of the capital and the voting rights in the company directly or indirectly[3], with an ability to amend the Propco's articles of association.

The German AIFM can invest in real estate companies where they do not have 100% capital and voting rights, however the value of holdings in real estate companies with a minority interest cannot exceed 30% of the relevant fund's value[4].

Depositary Requirements

The KAGB requires the fund's depositary to have the same oversight powers in relation to a Propco as it has in relation to the fund itself, which is usually ensured by an agreement between the German AIFM and the Propco known as a negative declaration or duty of care agreement, and an investment agreement.

Within these documents will be confirmations that the Propco will not dispose of an asset without the consent of the depositary, and a requirement for depositary consent for any disposal of the German AIFM's shares in the Propco.

Amendment to constitutional documents

The German AIFM is required to ensure the objects of the Propco are in line with the fund objectives, such as being limited to the [direct or indirect] acquisition, holding, management and disposal of real estate. The standard objects for Jersey or Guernsey companies are usually much broader so there is usually a requirement to amend the memorandum and articles of association of the Propco to restrict its objects as necessary.

Reporting

The depositary will need monthly Propco accounts which provide the basis for a statement of the assets held by the Propco in line with the KARBV (the German Capital Investment Accounting and Valuation Ordinance).

Types of real estate investment companies

Typically a standard company has been most popular and more easily understood for German investors. This affords the requisite control that is required under the KAGB.

[3] KAGB, Section 2, Subsection 5, Section 234(6)

[4] KAGB, Section 2, Subsection 5, Section 237

However, there are a number of UK real estate assets held in Jersey Property Unit Trusts (**JPUTs**), and to a lesser extent Guernsey Property Unit Trusts (**GPUTs**). These trust structures are required to be managed by a trustee which is 'orphaned' from the investor, in other words not within the ownership chain of the German AIFM. This can cause issues around the KAGB's usual AIFM control requirements, and given that the concept of a trust is not recognised in German law, it often means that the JPUT/GPUT structure is wound up on acquisition of the underlying real estate asset by a German AIFM.

The JPUT/GPUT structure is, however, popular with large pension funds or sovereign wealth fund investors as it affords tax transparency with regards to income and gains (provided the trustee makes a transparency election or exemption election). The income and gains are taxed in the hands of the investor and can avoid potential double taxation, or simply avoid a layer of tax which those types of investors would not ordinarily be subject to had they owned the asset directly.

This level of tax transparency is not applicable in the same way with standard companies, as the income and gains are taxed at the company level as opposed to the investor level. Once tax is paid at the company level, income and capital can be passed up to the shareholders free from any withholding tax at the Jersey/Guernsey level. Depending on the tax status of the shareholders, there could be additional tax payable in the jurisdiction of the investor on the amounts passed up by the company.

To capture the advantages of investing via JPUTs/GPUTs there may be potential solutions to allow German AIFMs to invest via JPUTs/GPUTs where they are the direct or indirect owner of 100% of the units on behalf of the fund. If the asset is held via 2 Jersey or Guernsey nominee companies on bare trust for the benefit of a JPUT/GPUT, and the legal owner of the shares in the nominee companies is the German AIFM, this may be able to offer the benefits of the transparent tax treatment of a JPUT/GPUT whilst affording the AIFM control required by the KAGB. The JPUT/GPUT trust instrument can also be amended to provide the AIFM with certain unitholder rights to change/veto certain actions of the trustee (such as a disposal) and restrict the JPUT/GPUT's investment objectives to comply with the usual German AIFM requirements.

As with any structuring, specific tax advice would need to be undertaken to understand the tax analysis for each type of holding vehicle, with due regard to the investor base, as it may not always be convenient for the tax to be attributable at the investor level.

Contacts

If you would like to discuss the legal and governance around the structuring of Jersey or Guernsey entities for German AIFMs please do not hesitate to contact us.