

Three steps to heaven

An increasingly broad fund offering has produced a potential nightmare for investors faced with comparing and assessing the tax, legal and regulatory frameworks. **John Forbes** advocates a structured approach

For the last two years, weight of capital has been the defining driver of European real estate markets. There seems to be little suggestion of availability of equity declining. So what is driving this, and what does it mean for real estate fund structuring?

Changes affecting saving for pensions across Europe – in particular rising retirement ages, increased defined contribution pension provision and pension deficits – will influence the demand for pension assets and thus have an impact on those managing institutional funds for investment. Our view is that, in general, the allocation to bonds and real property is rising and this trend is expected to continue.

Furthermore, there has been a trend towards indirect investment through funds. The managers of real estate funds who have traditionally focused on the US for institutional investment are increasingly turning to European institutions. There has also been interest in marketing such funds to high net worth individuals, either directly or through private banks.

Weight of capital is driving down returns in the main European markets. Fund managers are reacting to this in many different ways, resulting in a dynamism and variety of fund offerings that has not been seen for a number of years.

Entrepreneurial fund managers seeking to maintain the high returns that were previously achievable in the more traditional European markets are looking to invest in emerging markets – for example, in eastern Europe, India and China. More mainstream fund managers are also looking to invest outside Europe. In particular, there is a significant focus on Asia at present.

An alternative reaction to the pressure on returns in Europe is to move into lower risk (and lower return) funds ('core' and 'core plus' or 'value-added' funds). This has also required changes. Many of the tax planning and structuring approaches widely used in the pan-European property funds industry were developed for opportunity funds and therefore tend to focus on capital gains rather than income. There is no 'one size fits all' approach, and core plus and income funds typically require more complex planning.

One result of the expansion in the range of funds has been the development of a large variety of structures on offer from the different fund sponsors. The increasingly diverse investor base has added to the difficulty in creating a fund vehicle that is attractive to the anticipated investor base from a taxation and regulatory perspective, and the sophistication of fund structures has increased significantly in response.

A key problem investors face is comparing and assessing the tax, legal and regulatory framework of these. Although at first sight, there would appear to be a plethora of options available, in reality the

funds are generally assembled using fundamentally the same building blocks. Successfully structuring a cross-border real estate fund requires a three-tier approach, addressing investor, structural and local country issues.

At the first stage, the focus is on creating a fund vehicle that is attractive to the anticipated investor base from a tax and regulatory perspective. Investor issues include familiarity, flexibility, an entity's ability to accept investors' capital, regulation and tax (if any, in the hands of the investor). In practice, it is unusual to achieve a result that is equally attractive to all expected investors and structuring at this level is usually a process of managing conflicting investor demands.

Sophistication can be added by the use of parallel fund vehicles or feeder structures tailored to particular classes of investor.

A number of funds have taken this type of planning to a new level through the use of vehicles with separate cells for different classes of investors, with the cells providing a tailored tax and regulatory treatment for the investors in the cell. Regulatory issues for investors such as the ERISA rules that regulate investments by US pension funds and the VAG rules that impose restrictions on German insurance

differences appear. In general, investment in securities involves limited direct exposure to the tax regime where the asset is located. This is not true for real estate, for two reasons: most countries have very specific, and often complex rules for the taxation of real estate; and double tax treaties leave taxing rights with the country in which the property is located.

As a result, investors must pay much closer attention to local tax laws. Depending upon the type of fund and the expectation of investors, the fund sponsor might need to put a significant effort into determining the appropriate local holding structures and tax consequences. Achieving tax efficiency within the structure and at the local level is crucial for institutional investors. Most are tax exempt in their own country and therefore tax leakage within the structure represents an absolute cost. However, investors also want to be comfortable that the tax planning undertaken at the local level is appropriate to the nature of the fund.

What might be an acceptable level of tax planning, and thus of tax risk, in an opportunity fund is unlikely to be appropriate for a core fund. This assessment of risk becomes more crucial as funds move to invest in more exotic locations where tax laws and their practical enforcement might be less well tested.

Further complexity has been added by the development of individual real estate fund of funds, driven by an increasing range of assets in which they can invest. The growth in domestic real estate fund vehicles across Europe has created an opportunity for a fund of funds to invest in local country funds. There has

also been a growth in specialist property funds investing in a particular type of property asset – for example, retail, logistics or hotels. There has also been an increase in the size, number and sophistication of domestic fund vehicles.

Finally, and potentially most significant in the longer term, is the development of REIT-type regimes which create traded, tax transparent property investment companies. The SIIC regime, which was introduced in France at the end of 2003, has been a great success both in terms of entities converting to SIIC status and also in subsequent market activity. There is an expectation of the same with the imminent introduction in the UK and Germany of REIT regimes.

In view of the variety of options available, it is not surprising that no two funds look alike.

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Each year, PricewaterhouseCoopers in conjunction with the Urban Land Institute at Cambridge University produces a report, Emerging Trends in Real Estate Europe. The report is compiled from a survey of around 200 investors as well as more than 100 in-depth interviews with senior executives across Europe.

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companies, can have a major impact on the structure selected from the fund vehicle right down to asset level.

As funds have become larger, managers have sought to attract a broader range of investors from a wider variety of jurisdictions. This has added to the impetus to create more tailored vehicles to provide the optimal tax treatment for investors.

The second tier is dealing with structural issues arising from the fact that the fund vehicle is typically tax exempt or tax transparent. While this is useful in minimising entity level taxes and taxes on distributions to investors, it has drawbacks.

Typically, these entities will not be eligible to benefit from bilateral double tax agreements their country of domicile might have which reduce or eliminate taxes on interest, dividends and share sale gains. In addition, they will not be able to benefit from the EU Parent/Subsidiary Directive, which provides for the payment of dividends free of withholding tax between companies in the EU. This is usually overcome through the use of a taxable sub-holding company which benefits from treaty access or the EU Parent/Subsidiary Directive.

Although there are distinctions between real estate and other investment assets at the fund level, it is at the local level, the final tier, where the fundamental