

The tax framework for US-managed hedge funds investing in Germany

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Despite the credit and liquidity crises, hedge funds are attracting investment not only from traditional sources such as large asset managers, pension funds and wealthy families, but also from new players such as sovereign wealth funds¹ and the Asian central banks.²

Traditionally, the US has been the largest foreign investor in other countries as well as a leading target for hedge fund investors. While the US remains the world's largest and most liquid financial market, with US\$56.1 trillion in assets, nearly one-third of the global total, Europe's financial markets are collectively approaching the size of the US market with US\$53.2 trillion in assets (both 2006 figures).³

Within Europe, Germany continues to be an interesting market for hedge fund investments,⁴ with investment opportunities including a broad base of attractive mid-sized companies, a nonperforming loan market and attractive real estate prices.⁵

Hedge funds seeking to invest in Germany should understand the local tax framework and its implications, especially for the asset classes they most frequently invest in, including real estate, nonperforming loans, credit card and consumer debt, bonds, publicly traded shares, private equity and music rights, film rights and other intellectual property.

General considerations

Hedge funds usually organize parallel structures for onshore US investors and offshore investors. US taxable investors typically invest through vehicles that are transparent for US tax purposes. This allows investors to preserve the character of the underlying investment income earned by the funds with respect to capital gains and other preferential items. A transparent structure also generally permits the flow-through of foreign taxes as credits to US taxable investors.

Non-US investors, as well as US investors who are exempt from US taxes, usually invest through an offshore corporation. This serves to mitigate Unrelated Business Income Tax (UBTI) issues for US tax-exempt investors and tax reporting requirements for foreign investors.

Some funds employ master-feeder structures in which both the onshore fund and the offshore fund invest through a single offshore entity. If it is not actually a partnership, the offshore entity will usually be treated as one for US tax purposes. In either structure, funds frequently set up holding platforms in favorable treaty locations (e.g., Luxembourg, the Netherlands, Mauritius and Cyprus) which would hold a variety of investments in various target countries.

From the perspective of a management company, US hedge funds are usually managed out of the US with subadvisors providing assistance from financial centers such as London, Zurich, Singapore, Hong Kong and Tokyo. Offshore investors often rely on the US trading safe harbor⁶ to avoid a taxable presence in the US.

Management company issues

Among the few countries offering safe harbor rules similar to those of the US,⁷ allowing the mitigation of permanent

1 The Carlyle group has recently sold a minority stake to the Abu Dhabi government.

2 Blackstone sold a US\$3bn stake to the investment arm of the Chinese government before going public.

3 McKinsey Global Institute *Mapping Global Capital Markets—Fourth Annual Report*, January 2008, p. 11.

4 In 2006, Germany ranked among the Top 10 recipients of capital inflow for the reported asset classes that include foreign direct investment, equity securities, debt securities, and lending and deposits, McKinsey Global Institute *Mapping Global Capital Markets—Fourth Annual Report*, January 2008, p. 49.

5 The Urban Land Institute mentioned Munich and Hamburg among the Top Ten real estate markets for 2007, *Emerging Trends in Real Estate Europe 2007*, p. 30.

6 Sec. 864(b)(2) Internal Revenue Code (IRC).

7 Sec. 864(b) IRC.

establishment (PE) exposure, are the UK,⁸ Singapore and Hong Kong. However, most European countries, including Germany, do not offer such a trading safe harbor. If advisors or subadvisors in Germany negotiate contracts on the behalf of offshore (i.e., non-German) investment funds, there is a significant risk that the local management company's activities will create a PE for the funds. If a German fund manager has a subadvisor relationship with a US investment manager, its activities also could create a PE for the US investment manager.

In any event, the creation of a PE in Germany could have a significant tax impact. Profits allocated to the German PE may be subject to an effective German tax rate of as much as 47 percent. To mitigate such exposure, the scope of the activities of a German subadvisor typically would be well-defined in a subadvisory agreement, and the subadvisor's employee agreements would lay out clearly the scope of the permitted activities.

The risk of creating a PE is especially high for asset classes that require activities to be performed on the ground in Germany, such as real estate investments and workouts of nonperforming loans. In such cases, careful tax planning can mitigate the risk of an unwanted tax liability for the fund or the European platform holding the asset. Some activities may be outsourced, such as the daily management of German real estate investments. Other nontax issues may arise. For example, activities such as nonperforming loan workouts may be subject to regulatory oversight and require country or region-specific licenses before they can be performed.

Tax consequences of investments in Germany

Listed stock/private equity investments

Capital gains of offshore funds from the sale of shares in both listed and unlisted companies are subject to German corporate income tax if the investment exceeds one percent of the share capital (so-called material shareholding).⁹

Even though the effective tax rate may currently be as low as 1.3 percent of the capital gain, this risk should be considered when structuring investments into Germany through a European holding location. Otherwise, funds that employ transparent structures may end up filing tax returns for all of their investors. For example, if an offshore partnership fund sells a material German shareholding, all investors in the funds would be subject to German tax, resulting in a substantial compliance burden. German tax law generally does not allow funds to fulfill such obligations by making lump-sum payments

without revealing the identity of the investors in the transparent partnership.

At the target level, profits are currently subject to a 15 percent corporate income tax and a 5.5 percent solidarity surcharge that is levied on the corporate tax due. An additional trade tax levied by municipalities effectively runs to between 7 percent and 14 percent of the taxable income, leading to a current overall German income tax burden of approximately 23 percent to 31 percent. Before the Tax Reform Act 2008, the overall tax burden amounted to approximately 38 percent to 40 percent.¹⁰

The German trade tax allows only 75 percent of any interest paid on any form of debt to be deducted for trade-taxable income. Additionally, rental or leasing payments are partly treated as nondeductible for purposes of determining the trade tax.

The recently amended interest-capping rules have had an important impact on assessing the optimum amount of leverage for private equity deals.¹¹ Under the Tax Reform Act 2008, the German thin-cap and anti-debt pushdown rules were replaced by an earnings-stripping rule. According to the new rule, tax relief for interest expenses will be limited to 30 percent of the taxable income of the German target before (net) depreciation, interest expenses and taxes. The new rule captures interest on both bank loans and shareholder loans. Interest disallowed under the interest-capping rules can be carried forward indefinitely but increases the interest expenses in subsequent years.

The interest-capping rules will not apply unless net interest expenses (i.e., after deduction of any interest income) exceed EUR 1m (approx. US\$1.57m). Under an escape clause, the interest-capping rules are not applicable if the business' debt-to-equity ratio (under its IFRS stand-alone financial statements) does not exceed the debt-to-equity ratio in the highest-level consolidated audited accounts under IFRS. Under certain circumstances, German generally accepted accounting principles (GAAP) consolidated accounts or US GAAP consolidated accounts may be used.

When applying the escape clause, it is important to determine whether the leverage at the holding company level would be relevant for the leverage of the German target, or whether the debt-to-equity ratio at the level of the investment fund or even on the investor's level would be decisive.

Another exemption applies if the German special purpose vehicle (SPV) is not part of a group, i.e., if its interest is held by various investors and its accounts are not consolidated in either of the investor's accounts.

⁸ The UK Investment Management Exemption (IME) allows offshore funds to be managed in the UK with regard to certain asset classes if certain prerequisites are fulfilled.

⁹ Sec. 49 para 1 no. 2 lit. (f) German Income Tax Act.

¹⁰ The Annual Tax Bill 2008 was enacted December 29, 2007.

¹¹ Sec. 8a Corporate Income Tax Code.

A careful analysis of the facts and circumstances is highly recommended.

In addition, the German legislature amended the “change of control rule.”¹² The direct or indirect transfer between 25 percent and 50 percent of the shares or voting rights in a corporation to one acquirer or persons related to the acquirer within five years results in a pro rata forfeiture of any tax loss carryforwards. Should the transfer exceed 50 percent, all of the tax loss carryforwards are forfeited. This rule also applies to any interest carried forward.

The new rules will affect the economics of private equity transactions. In the past, buyers paid premiums for companies with net loss carryforwards.¹³ Under the new rules, loss carryforwards will be forfeited in many cases. Previously, private equity investors could reduce the effective tax rate of target companies by granting shareholder loans within the limits of the safe harbor rules. Now, introduction of leverage requires careful tax planning. The issue is exacerbated because the 30 percent limit relates not only to shareholder debt but also to bank debt. However, because treaty benefits for dividends payments may not be available due to the recently revised German anti-treaty shopping rules, debt funding may still be favorable in many cases.

In general, US individual investors can credit only foreign withholding taxes (e.g., German dividend withholding tax) against their personal tax liability. Taxes paid at the level of the German target generally are not available as a credit at the investor level. Accordingly, it may make sense to treat the German target as transparent from a US federal tax perspective. Under the check-the-box rules,¹⁴ the owners of a US or foreign entity can choose to treat the entity as a corporation or partnership¹⁵ for US tax purposes. As a result, the income of the German target company would be realized directly by US investors in a transparent fund and be taxable on a current basis.¹⁶ US investors also may claim a tax credit for taxes paid at the level of the German target, subject to various limitations. Filing a check-the-box election requires that the income or loss of the foreign entity be calculated under US tax principles.

According to the regulations, every non-US entity has a default status.¹⁷ In some cases, a different classification can be achieved by filing a timely election on Form 8832.

¹² Sec. 8c Corporate Income Tax Code.

¹³ Under old law, Sec. 8 para. 4 Corporate Income Tax Act causes the forfeiture of net loss carryforwards only if more than 50 percent of the shares in a corporation are transferred and the fair market value of newly infused assets (cash, etc.) after the ownership transfer exceeds the fair market value of the assets (including self-generated goodwill) of the corporation before the ownership transfer (anti-stuffing test).

¹⁴ The US entity classification rules are contained in Treas. Regs. 301.7701-1 et. seq.

¹⁵ If an entity has only one shareholder, it would turn into a disregarded entity rather than a partnership for tax purposes.

¹⁶ Sec. 702(a) IRC.

¹⁷ Treas. Reg. 301.7702-3(b).

In Germany, the following types of entities are available for business ventures:

- *Offene Handelsgesellschaft* (general partnership)
- *Kommanditgesellschaft* (limited partnership, or KG)
- *Gesellschaft mit Beschränkter Haftung* (limited liability company, or GmbH)
- *Aktiengesellschaft* (corporation, or AG)

According to the regulations,¹⁸ an AG is considered a *per se* corporation. The filing of a check-the-box election is therefore not possible and an AG will always be treated as a corporate body for US tax purposes.

However, for a limited liability company, a timely check-the-box election may be filed to treat the company as a partnership. The compliance burden of reporting the foreign entity’s activities based on US tax principles may be justified by the potential benefit to US individual investors of claiming a credit for the taxes paid at the level of the foreign entity.¹⁹

In some instances, hedge funds acquiring minority shares may not be able to change the classification of an entity without the majority owner’s consent. That could mean that US taxable investors would not be able to credit any entity-level taxes against personal tax liability. However, in an exit scenario such as an Initial Public Offering (IPO), US investors might be able to claim long-term capital gain treatment from the sale of the stock in the foreign corporation, as long as the shares were held for at least 12 months before the sale.

US individual investors also may benefit from a 15 percent tax rate on dividend income if the dividend qualifies as Qualified Dividend Income (QDI).²⁰ Dividends may qualify for such treatment if they are received from a Qualified Foreign Corporation, which is any corporation eligible for benefits of a comprehensive income tax treaty with the US, including an exchange of information program.²¹ In order to be eligible for the benefits of a US income tax treaty, a Qualified Foreign Corporation must satisfy the relevant income tax treaty’s limitation of benefits provision.

If the foreign target is treated as a corporation, the US rules relating to Controlled Foreign Corporations (CFC) or Passive Foreign Investment Companies (PFIC) may apply. Since non-US source income in principle is taxed only upon remittance to the US, the US tax code includes provisions to prevent the deferral of US tax on certain

¹⁸ Treas. Reg. 301.7701-2(b)(8).

¹⁹ In practice, many funds do not pass foreign tax credits to investors due to the administrative burden of tracking tax credits available to a changing portfolio of investors.

²⁰ Sec. 1(h)(11) IRC. Please note that the QDI rules are scheduled to sunset after December 31, 2009.

²¹ Sec. 1(h)(11)(C) IRC. For a list of qualifying treaties see Internal Revenue Bulletin 2006 47.

types of highly portable passive income (such as interest, dividends, certain capital gains, rents and royalties) where there is little business rationale for earning the income outside the US.

Controlled Foreign Corporations

A Controlled Foreign Corporation is one in which “US shareholders” own or are considered to own more than 50 percent of the total combined vote or value of the corporation’s stock on any day during the taxable year of the corporation.²² “US shareholders” are US citizens, resident individuals, domestic partnerships, domestic corporations, trusts or estates that directly or indirectly own 10 percent or more by vote of the foreign corporation.²³ For every year in which an entity qualifies as a CFC, US shareholders may be required to include their ratable share of Subpart F income in their taxable income.²⁴

Subpart F income includes several types of income. For hedge funds, the most important type may be foreign personal holding company income (FPHC),²⁵ which typically includes dividends, interest, royalties, rents and gains from sales or exchanges of property.

If a company qualifies as a CFC for US federal tax purposes, any gain from the sale of the shares in that company will not benefit from the 15 percent tax rate applicable to long-term capital gains but instead will be taxable at ordinary rates to the extent of certain earnings and profits of the CFC at the point in time when the shares are sold.²⁶ Dividends received from a CFC that are sourced out of FPHC income are also not eligible for treatment as Qualified Dividend Income.

Passive Foreign Investment Corporations

A Passive Foreign Investment Corporation (PFIC) is a foreign entity that holds assets of which more than 50 percent is held for the production of passive income or, alternatively, which receives gross income of which 75 percent or more is passive.²⁷

In general, US taxable shareholders of a PFIC should elect to treat the PFIC as a Qualifying Electing Fund (QEF) by attaching Form 8621 to their tax return.²⁸

If a QEF election is made, the current earnings of the PFIC are included in the taxable income of US shareholders on a current basis, and the income received by the PFIC retains its character.

If no QEF election is made, an excess distribution or gain from the sale of the PFIC stock is spread over the years in which the shareholder held the stock and any amounts allocated to years prior to the current taxable year are taxed at the highest ordinary income tax rates in effect in those prior years. In addition, the IRS charges interest as if these payments had actually been taxed in an earlier year.²⁹ Dividend payments received by a US individual taxpayer from a PFIC do not qualify for treatment as Qualified Dividend Income (see above).³⁰

The rules applying to PFICs complement those applying to CFCs. The PFIC rules apply without regard to the number of US shareholders in the foreign entity, if the foreign entity meets the definition of a PFIC. The CFC rules supersede the PFIC rules in many cases in which both apply.³¹

Anti-treaty shopping rules

Germany revised its anti-treaty shopping rules effective January 2007.³² The revised rule may lead to a definitive determination of German dividend and royalty withholding tax for non-US investors and any US investors who cannot rely on the benefits of a the US-German double-tax treaty because, for example, they did not provide a timely residence certificate to the funds or because the fund did not pass on tax credits to its US investors due to the administrative burden.

Full or partial treaty or European Union (EU) directive relief from German withholding taxes is available only to the extent that a foreign company has shareholders who would be entitled to the same relief if they received the income directly from the German company, or alternatively, if the foreign company passes all of the following tests:

1. There are economic or other important nontax objectives for the interposition of the foreign company. A recently issued circular³³ holds that objectives such as improved cost efficiency, coordination or internal organization will not qualify.
2. The foreign company derives more than 10 percent of its gross income from its own commercial activities, not including income from shareholdings or income from commercial activities outsourced to third parties. However, the circular provides that a foreign company can meet this requirement *if* it is an active management holding company for at least two directly owned subsidiaries. Management activities entail situations in which policy decisions are made by the foreign parent company and

22 Sec. 957(a) IRC.

23 Sec. 951(b) IRC; Treas. Regs. 1.951-1(g); Sec. 7701(a)(30) IRC.

24 Sec. 951(a)(1)(A)(i) IRC.

25 Sec. 954(c) IRC.

26 Sec. 1248 IRC.

27 Sec. 1297(a) IRC.

28 Sec. 1295 IRC.

29 Sec. 1291(a) IRC.

30 Sec. 1(h)(11)(C)(iii) IRC.

31 Sec. 1297(e) IRC.

32 Sec. 50(d) para. 3 German Income Tax Act.

33 German Ministry of Finance, Circular IV B 1—S 2411/07/0002, dated April 3, 2007.

oversight is exercised on behalf of the subsidiaries. This means setting general group policies, as opposed to performing day-to-day management functions, but it must be carried out regularly.

The policies by a management holding company have to be documented in writing since verbal directives given to lower-tier subsidiaries are not accepted by the German tax authorities. Activities conducted in branches outside the foreign company's country of tax residence do not generate qualifying income under the income test.

In the case of a management holding company, qualifying income for purposes of the 10 percent test includes dividends, interest and royalty payments received from managed subsidiaries.

The circular further confirms that the anti-treaty/anti-directive shopping provision does not apply to capital gains realized by a foreign company on the sale of shares in a German subsidiary. With respect to such gains, the general anti-avoidance legislation continues to apply.³⁴

3. The foreign company maintains its own business premises and infrastructure sufficient for enabling it to participate in the business community. Typically, these situations are closely scrutinized by the German tax authorities, which may request copies of financial statements, rental agreements, employment contracts and telephone bills.

Listed foreign companies do not fall within the scope of the anti-shopping rules, provided that a significant number of shares are regularly traded on a recognized stock exchange. The same principle applies to certain foreign investment funds structured as corporations.

The new anti-treaty/anti-directive shopping rule may trigger a withholding tax exposure whenever a German dividend or royalty is paid to a foreign company that neither satisfies the aforementioned requirements nor is a qualifying shareholder (i.e., one that would also be eligible for the claimed relief if he owned the German paying entity directly). In practice, many hedge funds and private equity funds may find it difficult to comply with the new rules and claim treaty benefits with regard to dividends paid by German entities to Luxembourg and Dutch holding platforms.

There is debate over whether the extended scope of the new German anti-shopping provision might potentially violate EU law since it could be viewed as going beyond what is covered by the anti-avoidance clause of the EU's parent subsidiary directive. However, these issues have yet to be resolved.

Taxpayers should consider creating a limited partnership above the German structure. Distributions made by a

³⁴ Sec. 42 German General Fiscal Code. See below for the recent amendment of this rule.

German partnership to its foreign interest holder should not be subject to any withholding taxes in the absence of a branch profits tax in its home jurisdiction. Careful planning is required, and professional advice should be sought, since this strategy may not be appropriate for all investors.

Under current law, the withholding tax on dividends and royalties effectively amounts to 21.1 percent before any reduction by tax treaty or EU Directive. In the case of platform structures of hedge funds and private equity funds, this withholding tax may arise whenever the strict requirements of the anti-treaty shopping rules cannot be satisfied. Since capital gains taxes are not covered by the new rule, investments that are undertaken in view of a subsequent trade sale or IPO should not be affected by the tax law change.³⁵

Investments in German real estate

Investments in the attractive German real estate market require especially careful tax planning. Germany imposes income tax on rental income as well as on capital gains derived from real estate located within its boundaries,³⁶ and also typically reserves the right in treaties to levy taxes on rental income and capital gains from the sale of German real estate.

However, few treaties allow Germany to impose a tax on the sale of German companies which have substantial real estate holdings. Accordingly, the interposition of a treaty blocker may result in significant tax savings.

Under current law, nonresident companies, such as offshore funds structured as corporate entities, are taxed at a rate of about 16 percent. If shares of a treaty blocker holding the real estate are sold and properly structured, the effective tax rate from the sale may be reduced to less than one percent.

Individuals holding German real estate through a transparent structure (e.g., a US partnership) are subject to German tax on their share of the rental income or capital gain at tax rates as high as 47 percent. Consequently, every direct or indirect investor in real estate could have to file a German tax return.

A direct investment may lead to prohibitive compliance costs in real estate investments, because profits are generated at the exit phase and taxable current returns are modest due to depreciation and third-party financing. If a blocker is used, only the blocker entity would have to file a local German tax return. For US CFC investors, US PFIC rules and the consequences of filing a check-the-box election for US federal tax purposes must be considered.

From a US perspective, investments in foreign real estate generally do not lead to US Effectively Connected Income

³⁵ Sec. 43(a) para. 1 Income Tax Code. As from January 1, 2009 the dividend withholding tax will increase to 26.375 percent.

³⁶ Sec. 49 para 1 no. 2 lit. f (capital gains), and no. 6 (rental income).

(ECI) for offshore investors.³⁷ Therefore, investments in foreign real estate might well be managed from the US.

Moreover, real estate management activities conducted in Germany must be limited in order to prevent the creation of a German PE. If a PE is created in Germany, income from real estate may be subject not only to income tax but also to trade tax.

Additionally, Germany generally levies a 3.5 percent real estate transfer tax on the direct or indirect transfers of real estate or real estate holding companies. However, careful planning may mitigate this tax.

German real estate investment trusts

Effective January 1, 2007, Germany introduced real estate investment trusts (G-REITs), which must take the form of a listed corporation and can hold German and foreign real estate—including foreign real estate companies if certain requirements are met—with an exception for German residential real estate.³⁸

In order to avoid taxation at the level of both the G-REIT and the investor, the G-REIT itself is exempt from taxation.³⁹

Withholding tax will be levied on distributions to nonresidents. Distributions will be treated as if they were dividend payments. As a result, distributions to nonresident investors will be subject to withholding at a rate of 26.375 percent. Distributions to nonresident investors in treaty countries may enjoy the treaty benefits applicable to dividend payments.

Since investors will not be able to hold 10 percent or more of the interest in a G-REIT, the withholding tax rate applicable to nonresident minority shareholders is relevant.⁴⁰ Therefore, US investors will be subject to a 15 percent withholding tax, and the lower 5 percent treaty rate will not be available.⁴¹

Investors in nontreaty countries, such as offshore funds in corporate form, will face a 26.375 percent withholding tax rate.

In order to prevent the accumulation of tax-free reserves, 90 percent of the G-REIT's book profits must be distributed each year.⁴²

Depending on their foreign tax credit position, the unavailability of lower withholding tax rates might put foreign investors at a disadvantage when investing in a G-REIT.

37 Sec. 864(c)(4)(A) IRC.

38 Sec. 1 REIT Act.

39 Sec. 16 REIT Act.

40 Sec. 11 para. 4 REIT Act.

41 Art. 10 DTA.

42 Sec. 13 REIT Act.

As G-REITs must be established as listed corporations, a check-the-box election is not available for US investors.⁴³ It will not be tax-efficient for US investors if the G-REIT holds non-German real estate investments and is taxed on profits derived from or in connection with the real property in the country in which the property is located. Noncorporate US investors will not be able to claim a credit for tax paid in the target country.

It also may be attractive for US funds to buy units in local German investment trusts (*Sondervermögen*). These trusts generally are exempt from both CIT and trade tax. However, they are subject to regulatory restrictions which limit excessive leverage, and also include other rules on eligible assets and regulatory reporting requirements.

Investments in nonperforming loans

Investments in loans generally should result in a German tax liability only if they are secured by German real estate or ships registered in Germany.⁴⁴ In such cases, a German tax return would have to be filed.⁴⁵ If such secured loans are held through transparent vehicles (e.g., partnerships), the investors in those vehicles would be required to file tax returns.⁴⁶

Without taking into account any other available treaty benefits, the compliance costs alone should justify holding loans through a holding platform. From a compliance perspective, only the holding companies would have to file a tax return in Germany. The investors' names would not have to be disclosed.

Another benefit of setting up a holding company in a country which has a tax treaty with Germany would be that most such treaties do not allow Germany to levy a tax on interest payments, even if the underlying loan is secured by German real estate or German-registered ships.

In the US, it is not always clear whether the safe harbor rules of Sec. 864(b) of the Internal Revenue Code (IRC) cover the acquisition and a potential subsequent work-out of the acquired loans.

Outside the US, many countries anticipate greater regulatory supervision of loan origination activities. For example, Germany requires issuers of loans to hold a valid banking license or a license issued by another EU country (a so-called EU pass).

In addition, some debtor residence countries may require the issuer to possess a valid banking license (e.g., Italy).

43 Treas. Regs. 301.7701-2(b)(8).

44 Sec. 49 para 1 no. 5 lit. c German Income Tax Act.

45 Sec. 43 following German Income Tax Act do not provide for a withholding tax on interest paid on shareholder loans.

46 There is no filing requirement if the loans are not secured by German real estate or ships registered in Germany.

Therefore, consideration should be given to where a loan origination platform is set up and also whether the regulatory framework of the debtor's resident country requires another special purpose vehicle.

Germany's new general anti-abuse rule

In the Annual Tax Bill 2008, Germany revised the general anti-abuse rule.⁴⁷ The goal of the revision was to make the rule more precise and effective by defining the term "abuse of law."⁴⁸ Effective January 1, 2008, the new anti-abuse rule applies when a taxpayer or a third party realizes a tax benefit from an "inappropriate" specific structure which was not intended by law. If the taxpayer can demonstrate sufficient business reasons to justify the specific structure chosen, the general anti-abuse rule would not apply. The tax authorities bear the burden of proof as to whether or not a structure is inappropriate.

Transfer pricing

Transfer pricing rules also were amended by the Tax Reform Act 2008.⁴⁹ In principle, transfer prices will be determined using the comparable uncontrolled price method.

When a comparable uncontrolled price cannot be determined, other pricing methods with limited comparability, appropriately adjusted, should be used. If there is a bandwidth of prices with limited comparability, the median within the confined bandwidth should be used as the transfer price. Where prices with limited comparability are not available, a hypothetical arm's-length comparison needs to be performed. The mean of the range of prices thereby determined should be used as the transfer price unless the taxpayer can prove that another price within the bandwidth of the hypothetical comparison has a higher likelihood of being regarded as arm's-length in nature.

Repercussions of having German investors investing in offshore funds

German investors are keen to invest in offshore hedge funds and increase their exposure to alternative asset classes. In order to avoid lump-sum taxation on income derived from offshore funds, German investors typically will urge fund managers to comply with certain year-end and daily reporting requirements.

Depending on the structure of the fund, certain tax data may have to be submitted to the local German tax authorities or may even have to be published in the German Electronic Federal Gazette (*elektronischer Bundesanzeiger*). Some fund managers fear that fulfilling these reporting requirements could expose them to scrutiny by the German tax authorities or even allow competitors to reverse-engineer tax figures, thereby revealing the fund's investment strategy. These fears are largely unfounded. An obligation to comply with German tax reporting should not normally hinder a fund from accepting German-sourced funding, even if the fund also has exposure to German assets.

Conclusions

The investment climate in Germany is becoming more favorable. With a strong economy and many opportunities, Germany should be an appealing venue for hedge funds investors.

However, periodic tax law changes require investors to monitor developments and, if necessary, adjust their investment structures to address challenges posed by new or amended laws.

In particular, the recently revised anti-treaty shopping/anti-directive shopping rules require careful planning in order to mitigate tax risks.

In addition, the new interest-capping rule and the new change-of-control rule necessitate proactive tax planning. It remains to be seen whether peer pressure from the UK and France, which have recently introduced REITs, will force Germany to revise the current G-REIT Act to make these vehicles more attractive to investors.

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47 The Annual Tax Bill 2008 was enacted December 29, 2007.

48 In the US, Congress may also codify the economic substance doctrine this year despite the administration's continued opposition as part of the "Farm, Nutrition and Bioenergy Act of 2007."

49 Sec. 1 para. 3, Law to Prevent Tax Evasion.

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