BAKER TILLY ROELFS

Newsletter Real Estate

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Content

A. Baker Tilly Roelfs merges with TPW Group

Baker Tilly Roelfs and TPW Group announced to merge. This strategic merger is a logical expansion of the existing consultancy and service portfolio – in terms of content and geographical location – for both Baker Tilly Roelfs and TPW Todt & Partner GmbH & Co. KG, one of the largest partner-managed interdisciplinary auditing companies in Hamburg. With this step, TPW Group not only acquires a nationwide presence at twelve Baker Tilly Roelfs' locations throughout Germany, but will also be integrated into the global Baker Tilly International network. Thus, the company will gain access to 154 partner firms with more than 27,000 employees in 133 countries. Baker Tilly Roelfs will expand its presence in Hamburg and northern Germany significantly and thus continue to pursue its strategy of playing a leading role, both qualitatively and quantitatively, in all principal centers of commerce and industry in Germany. The merger implicates that 20 TPW partners and 250 employees will join Baker Tilly Roelfs in Hamburg. Consequently, a staff of about 1,050 will be posting total annual sales revenues of almost €135 million in Germany. The merger is due to be completed in the course of the next few weeks, once the implementation agreements have been finalized. After a certain transition period the new company will be operating under the name of Baker Tilly Roelfs in future.

The range of services provided by TPW comprises auditing, tax consulting, legal advice and financial services. Traditionally, a strong focus has been placed on the maritime sector. During the past few years the Group has also been developing and expanding its legal and tax consultancy services in the real estate sector.

For further information about TPW, please refer to: www.tpw.de

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B. Real Estate AIFs under German Investment Code ("KAGB") – current developments

The latest information on the new regulation for real estate funds by the German Investment Code ("*Kapitalanlagegesetzbuch* – KAGB") has been provided with our Real Estate Newsletter of August 2013. The KAGB created a uniform and comprehensive supervisory and regulatory framework for Alternative Investment Funds (AIF) and their managers. The KAGB has been in effect for almost two years now. According to the Federal Financial Supervisory Authority ("*BaFin*"), 38 closed domestic public AIFs have been granted marketing authorization since the KAGB came into effect, including the first quarter of 2015. 23 of such funds are part of the asset class of real estate. What has changed since the introduction of KAGB and what are the future developments of real estate AIFs under KAGB?

During the first year after the KAGB came into force, newly founded financial investment management companies of real estate funds had to face substantial legal uncertainties as regards the KAGB's interpretation with regard to the creation of new funds. Such uncertainties affected in particular the preparation of the investment conditions, on which the legal relationship between the AIF and its investors is based. The investment conditions stipulate inter alia the acquirable investment properties and the costs to be chargeable to the AIF. The initial lack of clear provisions and samples caused some substantial delays in the approval process of public AIF's investment conditions by the BaFin; in some cases the entire process lasted for several months. The question to what extent the conditions must be aligned to the net asset value[1] was subject to several discussions.

However, since mid-2014 all essential issues have been clarified and the pending applications for public AIFs at BaFin have been approved. In the meantime, BaFin has published sample investment conditions including model clauses as well as numerous BaFin leaflets and circulars, as such providing legal certainty on the BaFin's legal position.

However, several questions on the KAGB's application still remain. Such questions include inter alia the frequency of the determination of the net asset value, the acquisition of non-risk-spread AIFs and the components of the total expense ratio.

Determination of net asset value – once or several times a year?

Pursuant to Art. 297 Sec. 2 sentence 1 KAGB, a private investor interested in acquiring an AIF share must be informed on the latest net asset value or the latest market price during the subscription period and before conclusion of the contract. As there is no functioning secondary market allowing for a creation of reliable market prices for AIFs, it is our opinion that such information must always refer to the net asset value. In general, the determination requires a considerable amount of time.

[1] Der Nettoinventarwert ergibt sich aus den Verkehrswerten aller Vermögensgegenstände abzüglich der Verbindlichkeiten des AIF (vgl. § 168 KAGB).

Therefore, it would be highly appreciated if the net asset value would have to be determined only once a year within the scope of the annual report, unless no particular business transaction occurs (*e.g.*, an acquisition of further property).

Acquisition of non-risk-spread AIFs:

With regard to non-risk-spread AIFs, the risk-spreading requirement pursuant to Art. 262 Sec. 1 KAGB is not fulfilled. This includes inter alia real estate AIFs investing into real estate rented out on a long-term basis. Pursuant to Art. 262 Sec. 2 KAGB, a share in a non-risk-spread AIF may only be acquired by investors subscribing for a share of at least EUR 20,000 and with specified experience and know-how[2]. It has not been finally clarified yet, what kind of experience will be required in each individual case and in what form the financial investment management companies' compliance with the requirements is going to be monitored. Further, based on our experience, the BaFin is increasingly requiring certain hedging measures before granting the marketing authorization for non-risk-spread AIFs. Such hedging measures require inter alia the financial investment management company to guarantee by certain clauses within the partnership agreement that even in case of inheritance, donation or disposal, the shares will only be transferred to qualified investors meeting the legal requirements with regard to experience and know-how[3].

Total expense ratio

Each capital investment's substantial investor information muss state a total expense ratio[4] including the total annual costs in relation to the net asset value. So far, there is no clear definition which costs must be included. In particular, the inclusion of financing costs, maintenance costs and costs on the level of property companies are highly disputed. In practice, the current trend is that the total expense ratio contains widely differing costs. Therefore, the legislator's intention to provide for a comparison of different AIFs is currently possible only to a very limited extent. For prudential reasons, the cost definition should be interpreted in a wider sense and the relevant costs should be included in case of doubt.

Even if many questions regarding the KAGB remain unclear, the next AIF regulations are already pending. In particular the "MiFID II" (Regulation on Markets for Financing Instruments) and the PRIIPS directive (Packaged Retail and Insurance-based Investment Products) will have a significant impact on the sale of AIFs.

The MiFID II directive came into effect on July 3, 2014 and must be converted into national law by the EU member states by July 3, 2016. The MiFID II provisions concern in particular financial service providers and banks. However, pursuant to Art. 34f GewO (German Industrial Code) financial intermediaries will be subject to stricter requirements as well. Pursuant to Art. 3 Sec. 1 of the MiFID II directive, the member states are entitled to exclude certain intermediaries from the directive's direct

[2] The requirements are stipulated in Art. 1 Sec. 19 Number 33 letter a clauses bb to ee KAGB.
[3] The requirements are stipulated in Art. 1 Sec. 19 Number 33 letter a clauses bb to ee KAGB.
[4] For details, cf. Art. 270 Sec. 1 in conjunction with Art. 166 Sec. 5 KAGB

scope. However, in such a case the provisions for such intermediaries must be regulated on a national level and in accordance with the MiFID II's provisions (*e.g.*, in form of the Regulation on the Intermediation of Financial Assets - "*Finanzanlagenvermittlungsverordnung*").

The MiFID II directive in particular provides for a tightening of the approval and organization requirements as well as for a fundamental revision of the sales processes' rules of conduct. Financial investment management companies are directly affected if their products are distributed via securities firms or banks. The intended regulations on an improved transparency of costs might inter alia have an impact on the sales prospectuses' information and on key investor information. On December 19, 2014, the European Securities and Markets Authority (ESMA) has released its final report on the MiFID's Level-II measures. Such report shall provide the basis for the legal acts delegated by the EU Commission which have to be enacted by July 3, 2016 in order to substantiate the directive and to clarify any doubts.

The PRIIPS regulation requires for certain products to include a basic information sheet (max. 3 pages) which must contain any substantial information on the product, in particular with regard to risks and costs. The regulation applies inter alia for closed investment funds and is going to amend the investor information as currently provided for by the KAGB to a large extent. The regulation shall only come into effect from December 31, 2016. A transitional period until the end of 2019 is intended for closed investment funds which are currently required under the KAGB to prepare substantial investor information. The three financial supervisory authorities EBA/ESMA/EIOPA (European Banking Authority/European Securities and Markets Authority/European Insurance and Occupational Pensions Authority) are currently dedicated to support the European Commission in preparing delegated acts which are meant to further substantiate the regulation's content (Level-II procedure).

In conclusion, even two years after the KAGB came into effect some important questions with regard to the Code's application have not been clarified yet. However, during the past two years many uncertainties with regard to BaFin could be clarified in various meetings and discussions with representatives from the industry and associations. Nevertheless, the industry must be prepared for further EU regulations in this context.

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C. Corporate Real Estate Management in Germany – an underestimated optimization potential

In Germany, corporate real estate is still regarded as mere production or administration facility, i.e. as the necessary place of performance. It is consequently regarded as fixed assets which have been erected or acquired someday, and have been used, maintained and finally depreciated.

The estimated value of German corporate real estate (i.e. every property owned by a company and serving as equipment or place of performance) amounts to ca. 3,000 billion Euro. Approximately 70 to 75% of real estate used by German companies is owned by the respective company. As such, the German ownership rate is – compared to other countries – very high. By way of example, the US rate amounts to only ca. 20% and the Asian rate to ca. 30%.

Therefore, it is all the more surprising that Corporate Real Estate Management („CREM“, generally defined as the management of the necessary business property portfolio) is comparatively weak amongst German companies. One must assume that only about one half of the major corporations and one third of the medium-sized companies has implemented and is using CREM. Consequently, the major part of companies has a substantial optimization potential. There is a particular need to catch up as regards the control of land consumption, CREM integration into the corporate structures as well as a centralization of all real estate-related tasks and competences.

Studies revealed that a company can reduce its real estate costs by an average of 30% by implementing a well-organized CREM. Depending on the relevant industry, the corporate real estate costs amount to an average of 10 to 20% of a company's overall costs. In particular with administration- and knowledge-intensive companies, property-related expenses often represent the second largest cost position after personnel costs. In relation to an average office building's construction costs, annual real estate costs amount to ca. 10% of the total investment. With regard to intensively used properties, such ratio might even be higher. Moreover, studies have shown that an efficient CREM cannot only reduce costs but can also increase work productivity.

In summary it can be wise to optimize the existing CREM on a regular basis or, where this has not been done yet, to implement CREM. This is in particular supported by the cost-saving potential and the opportunity to increase the efficiency of work organization and work processes.

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D. VAT on the supply of electricity, heat, water and waste disposal by the landlord – ECJ judgment of April 16, 2015

With its preliminary decision of April 16, 2015 (reference number 1-42/14), the European Court of Justice (ECJ) has taken a stance deviating from the former German financial administration's view and the common practice with regard to the turnover taxation of advance payments on operating costs or operating cost statements.

If a landlord legally waives his right for exemption from VAT pursuant to Art. 4 No. 12 UStG (German Value Added Tax Act), the financial administration hitherto considered the supply of electricity, heat, water and waste disposal by the landlord to the tenant to constitute dependent ancillary services to the principal service (rent) and consequently assumed for rent, advance payments on operating costs and the annual operating cost statements to be subject to a uniform VAT rate of 19%. With regard hereto, the landlord's tax deduction rate is irrelevant (*e.g.*, 7% on water supply).

In its above decision, the European Court of Justice stated that the renting of a property and a parallel supply of electricity, heat, water and waste disposal as well as the rendering of further services might constitute independent services which have to be considered separately from a VAT perspective.

In the relevant case, a Polish administrative court had requested the ECJ to comment on two substantial questions:

1. Is there a delivery of goods or a rendering of services from the landlord towards the tenant, if the landlord acquires such goods and services from a specialized third party, whereas the landlord is the contractual partner of the supplier or service provider and merely passes on the costs to the tenant?
2. If so: Do the deliveries of goods and the provision of services constitute independent services which have to be assessed separately from a VAT perspective or do they constitute ancillary rental costs?

According to the ECJ, the answer to the first problem depends on who is responsible to select the contractual partner, quality, quantity and time of performance. If the landlord has the power to decide such facts, the ECJ clearly assumes an acquisition by the landlord from his contractual partner and a (subsequent) delivery to the tenant. The tenant directly uses such services; however, he has not acquired them from a specialized third party.

Consequently, the first question must be affirmed if the landlord merely concludes a contract for the services and passes on the relevant costs to the tenant.

As regards the second question, the ECJ has not submitted a clear and general statement.

The ECJ stated that the relevant turnover's characteristics had to be determined and that it had to be decided for each individual case whether there was one single supply

or several independent services. The structure of the rental agreement can be an important indicator for the classification of the service.

As an example for a single supply, the ECJ presented a rental agreement which included, besides of the rent, also the provision of several additional services incurring ancillary costs whose non-payment would result in a termination of the tenancy. According to the ECJ, the agreement was not only concluded in order to regulate the use of the property but also in order to provide a contractual basis for a single supply.

As an example to show the opposite, the ECJ stated cases where the consumption of electricity, gas and/or water can be controlled, measured and invoiced by installing separate meters. In such cases the services rendered by the landlord are generally deemed as services separate from the renting.

As a result of the ECJ's decision, it is no longer possible to tax future advance payments on operating costs and operating cost statements with a flat VAT rate of 19%. Rather, it must be examined for every individual case, whether the rental agreement constitutes a single supply or several independent services. If the examination results in a single supply, the former calculation of operating costs will remain unchanged. However, in case of several independent services one must further examine which VAT rate applies for each individual service. For example, water supply must be invoiced with a reduced tax rate of 7% and real estate tax must be invoiced exclusive of VAT.

The strict application of the Court's decision will cause substantial additional expenses on behalf of landlords and property managers. This is due to the examination and classification of the individual tenancies and the related services. At the same time the decision leaves room for discussions with regard to future tax audits and the respective assessment of services.

So far, the German financial administration has not stated its opinion on the decision and it remains to be seen how the financial administration is going to handle such cases in future.

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E. No tax relief for energy-efficient refurbishments

In our last newsletter we reported that the Federal Ministry of Economics and the Federal Ministry of Finance had submitted a term sheet on a tax relief for energy-efficient refurbishments. However, in the meantime the grand coalition has agreed to not introduce any tax incentives for energy-efficient refurbishments in 2015. This is in particular based on the intended reduction of the tax relief for craftsman services (Art. 35a EStG – German Income Tax Act), by which the tax incentive was meant to be financed. In particular the CSU (Christian Social Union) had strictly opposed this financing measure.

Consequently, the German government does not provide any tax encouragement for energy-efficient refurbishments. However, façade renovation costs, for example, can be claimed as directly deductible income-related expenses or operating expenses. With regard to income from rent and lease, such income-related expenses can also be deducted over a period of 5 years if they are related to residential buildings and meet certain conditions (Art. 82b EStDV (German Income Tax Ordinance)). This allows for a better utilization of the income-tax related progression effect.

However, it should be noted that pursuant to Art. 6 Sec. 1 No. 1a EStG expenses which usually constitute directly deductible income-related expenses must be capitalized as manufacturing costs if such expenses incur within three years from the property's acquisition and exceed 15% of acquisition costs.

Therefore, we recommend getting individual tax advice before taking any appropriate measures.

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F. Realization of profits from work performances under commercial law

By letter of April 8, 2015, the „Institut der Wirtschaftsprüfer (IDW)“ has submitted to the Federal Ministry of Finance (“BMF”) its opinion on the BFH judgment of May 14, 2015, on architects and engineers’ realization of profits.

Pursuant to the BFH judgment, an architect’s or engineer’s profits from planning services are deemed realized if the contractual provision of planning services resulted in a claim for installment payments pursuant to Art. 8 Sec. 2 HOAI (fee structure for architects and engineers). According to the BFH judgment, the assumption of a profit realization is not subject to partial acceptance. Broadly speaking, in the relevant case the installment payment did not constitute a received advance payment but taxable income, without any (partial) acceptance on the service recipient’s part.

The IDW is of the opinion that the relevant case does not constitute a profit realization, neither from a trade law nor from a tax perspective. Consequently, the IDW requests – should the BMF agree with the BFH’s decision – to implement a transitional arrangement; without such transitional period profits from previously received advance payments would have to be realized immediately, i.e. in the first outstanding assessment period.

Underlying facts

Pursuant to Art. 252 Sec. 2 No. 4 sentence 2 HGB (German Commercial Code), profits may be posted at the closing date only if they are deemed realized. With regard to work performances this is the case if the service recipient has received and accepted the work. The same does apply for long-term construction contracts in the absence of an agreed partial acceptance. The risk is generally transferred upon service recipient’s acceptance. Consequently, profits are deemed realized upon (partial) acceptance of a work. Only the non-defective performance of the work constitutes the provider’s final remuneration claim (Art. 631 BGB (German Civil Code)). After this date, previously received installments do not have to be returned any more.

If the parties have agreed upon installment payments with a provisional payment character pursuant to Art. 632a BGB, such installments do not constitute – despite of service recipient’s payment – a (partial) acceptance and consequently do not constitute a transfer of risk, either.

The HOAI’s service phases do not constitute acceptable partial deliveries. The BMF generally considers a performance divided into services phases as single supply, unless the parties additionally agreed upon partial deliveries. Thus, installment payments do not constitute a (partial) acceptance pursuant to Art. 8 Sec. 2 HOAI.

Pursuant to IDW, the determination of profits according to accrual basis accounting is subject to the generally accepted accounting principles, which also include the realization principle; consequently, the IDW does not consider the relevant profit realization to be in line with applicable tax law.

We shall keep you informed about how the BMF is going to handle the BFH judgment.

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G. German investors say “Ja, bitte!” to U.S. real estate investments

German investment in U.S. real estate has more than doubled since 2012. According to Feri EuroRating Services, there has been a significant reallocation of German real estate investment from Western Europe to the U.S. since 2012, with the U.S. investment increasing from 6 to 15.3 percent and Western Europe investment decreasing from 13.4 to 8.7 percent. So what has German investors increasingly looking to the U.S. for their real estate investments?

The perceived stability of U.S. real estate investments

Although tax motivation is always a driver for German investment in U.S. properties, the financial investment perspective is propelling German investors more and more. With the U.S. dollar strengthening and the euro financial crisis ongoing, the perception is that the German economy will lag along with Europe, driving down the number of homeland investment opportunities. That perception also drives a “flight for safety” mentality. In such a climate, the U.S.’s economic independence and the resilience of its hard assets (like high demand property) have made U.S. investments much more appealing than Eurozone investments.

There is no other market in the world like the U.S., with stable returns on a broad mix of real estate investments. U.S. real estate is a durable, proven asset class in a risky world, with real estate returns outperforming stocks and bonds and extremely low interest rates, especially in Europe where some treasury rates are negative. Leading real estate organizations in the U.S., such as the National Association of Real Estate Trusts (NAREIT) and the National Council of Real Estate Investment Fiduciaries (NCREIF), have predicted 60 to 90 basis point increases in returns on investments of all property types from 2020. On top of that, the current U.S. economy features low interest rates, improving unemployment and minimal inflationary concerns. All of these

reasons make the U.S. an attractive option for German investors, especially given their propensity toward long-term cash-flowing real estate investments in core markets.

Additionally, the popularity of in-town locations to millennials and the aging babyboomer population in America have driven high demand for multi- and single-family residential investments, both favored by German investors in recent years. These opportunities are concentrated in major cities like New York, Washington, Chicago, Los Angeles, and San Francisco, which are already popular gateway cities for cash-flowing properties and long-term exit strategies. Furthermore, the Southeastern U.S., especially Atlanta, has become a hot real estate market with its low cost of living, geographic advantages (including the world's busiest airport and its central location), weather, young skilled labor pool and evolving technology sector attracting real estate investment, particularly in the residential and industrial markets.

Tax-efficient investments that improve ROI

Taxes are always a factor when considering real estate investments, and there are many reasons why German investors look favorably on U.S. real estate investments over investments at home.

First and foremost, U.S. capital gains tax rates are lower than German rates. In the U.S., long-term capital gains (holding period of a real estate property greater than a year) are generally taxed at 20 percent in the top tax margin bracket of 39.6 percent. Compared to the German rate of 25 percent capital gains tax and a 45 percent top tax margin bracket, it's no surprise that German investors look favorably on the U.S.

But there are other plenty of other reasons. German investors can ensure the earnings of their U.S. investment vehicle are subject to tax only once (i.e. no branch profits tax or corporate tax) by investment directly into a U.S. limited partnership or through a foreign partnership. They can also potentially avoid U.S. estate tax on the value of real estate by forming non-corporate foreign entities to hold the real estate investment.

Additionally, if an investment is financed, German investors can also use the double tax treaty with the U.S. to qualify interest payments as deducible in the investment entity when paid and not subject to income tax withholding.

Given the ongoing perception of U.S. stability juxtaposed against Eurozone financial troubles and the substantial tax benefits to be realized, German investors will likely continue to increase their U.S. real estate investments in the coming years. Potential investors should make sure they are getting proactive advice to ensure the best possible return on their investments.

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HA&W has been recognized as a “Best of the Best Accounting Firm” in the United States. Since 1952, clients throughout the U.S. and in more than 40 countries have counted on HA&W to build value, manage risk and drive growth. As the largest tax, audit and business advisory firm headquartered in Georgia, our expertise across a broad range of services and industries provides clients with winning financial practices and insights to help them grow at every stage of their business lifecycle.

To learn more about HA&W, visit www.hawcpa.com.

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Baker Tilly Roelfs develops solutions which are tailored to the precise needs of individual clients and proceeds to implement them to the highest standards of quality and efficiency. On the basis of an entrepreneurial consulting philosophy, the partners with responsibility for clients form interdisciplinary teams of specialists who meet the requirements of the particular project exactly. The interdisciplinary competencies are divided among the following eleven Competence Centers: Financial Services, Fraud • Risk • Compliance, Health Care, Pension Plans, Private Clients, Public Sector, Real Estate, Restructuring, Sport, Transactions and Valuation. In Germany, Baker Tilly Roelfs has 800 employees on its payroll at twelve different locations. Global consulting is in the hands of 154 partner companies with more than 27,000 employees in 133 countries. These firms are all members of the worldwide Baker Tilly International network of independent accounting, auditing and consulting companies.

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