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Non-US Investors in US Real Estate: Tax Challenges and Solutions

Real Estate Update

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Investment in US commercial real estate by non-US investors is increasing. According to Real Estate Analytics, from January through August of 2013, non-US investors acquired almost $23 billion in US real estate, representing a 9% increase over the prior year and accounting for 13% of all real estate transactions in the US for that period. According to the Rhodium Group, investment by China-based investors in US real estate in the first three quarters of 2013 was nearly six times the total of such investments for 2011 and 2012 combined.

A recent survey by the Association of Foreign Investors in Real Estate found that the US is ranked by a wide margin as the leading country for real estate investments and that 81% of the respondents intend to increase their investments in US real estate.

Given this trend, real estate investment advisors and others involved in real estate transactions in the US should appreciate the importance of the tax treatment of investments in US real estate by non-US investors and understand how to structure these investments in the most tax-efficient manner possible.

Tax Impediments to Foreign Investment in US Real Estate

The primary tax impediments to foreign investment in US real estate in general and in real estate funds specifically are US income and withholding taxes.

- **Effectively Connected Income:** Although non-US investors' gains from US stock are generally not taxable, income and gain from their real estate investments are generally taxable under the effectively connected income (ECI) rules. Specifically, rental income and/or gains from the sale of US real estate are both generally treated as ECI. US source rental income allocable to a foreign investor is typically not entitled to any treaty preferences. ECI is generally taxed to such foreign investors under the same tax rates that apply to US taxpayers, and foreign investors that receive ECI are required to file US federal and state income tax returns. Finally, the FIRPTA rules described below can also transform sales of stock (or other equity interests) and/or capital gain dividends from REITs into ECI.

- **FIRPTA:** Enacted in 1980 to combat perceived unfair advantages for foreign investors in US real estate, the Foreign Investment in Real Property Tax Act (FIRPTA) imposes significant taxes on dispositions of US real property interests. Specifically, Section 897 of the Internal Revenue Code of 1986, as amended, essentially treats such gain as ECI. In addition, as explained below, complicated withholding tax rules apply with regard to US counterparties in such transactions.

- **Non-US Regulatory Concerns:** In addition to US tax issues, non-US investors can have non-US tax and regulatory concerns. For example, non-US investors may need to comply with certain informational reporting requirements in their home jurisdictions.

Structuring Solutions
Given these tax hurdles, a premium is placed on tax structuring when seeking to attract non-US capital to US real estate investments.

- **Foreign Investor as Lender:** Rather than owning a partnership interest in a fund or equity in a US real property holding corporation, a foreign investor may make a loan secured by US real estate. A non-participating loan is generally not a US real property interest, even if secured by collateral that happens to be a US real property interest and therefore is not subject to FIRPTA. Moreover, even a shared appreciation loan, which is a US real property interest, generally escapes FIRPTA taxation on its interest and principal. Accordingly, loans are often utilized to allow non-US investors to participate to some extent in US real estate investments. Note that for this strategy to work, the purported debt instruments must be treated as debt for US federal income tax purposes. By way of example, such instruments that lack a reasonable cap on the debt holder's participation in property appreciation are susceptible to being recast as equity.

  A loan that participates or shares in the appreciation of US real estate will itself be a US real property interest. However, given proper structuring, the interest on such an instrument (including the so-called shared appreciation interest) should not be subject to tax under FIRPTA. Such interest would remain taxable under general US tax rules, however. Accordingly, to increase the tax efficiency of the loan, the interest should be structured to qualify as portfolio interest, as exempt under an applicable US tax treaty, or a foreign government under Code Section 892, provided the foreign investor is defined.

A foreign government generally should be able to receive contingent and/or participating interest on a debt instrument without US tax under Code Section 892. A debt instrument with participation features must be carefully crafted to ensure that it is treated as debt for US federal income tax purposes. Moreover, the regulations under Code Section 897 might treat a debt obligation in which the payments and/or value of such an obligation are contingent upon or related to US real property interests as itself a FIRPTA interest. Specifically, regulations under Code Section 897 provide that a direct or an indirect right to share in the appreciation in value of assets of or the gross or net proceeds or profits derived from a US real property interest-owning entity may be treated as FIRPTA assets.

Upon foreclosure and/or other reductions of collateral to ownership, the FIRPTA benefits of loans generally will be lost. Using a leveraged blocker or a REIT to hold foreclosed collateral can mitigate the FIRPTA downside in such circumstances.

- **Offshore Blockers:** Instead of becoming an equity investor in a real estate fund, a non-US investor may instead become both a shareholder of and lender to a domestic corporation (a block-blocker). The blocker would in turn take the money either contributed or lent to it and invest in either a US real estate fund or directly in US real estate.

  One may acquire US real property interests in an offshore corporate entity and transfer the equity in such an entity entirely free of US tax. However, any well-advised buyer would discount the purchase price of such an offshore corporation for the embedded US tax. If this offshore corporation is formed in a tax haven, any effectively connected income will not only be fully taxable under US rates, but also be subject to an additional 30% branch profits tax. The branch profits tax can apply even to offshore corporations that are entitled to the benefits of a US tax treaty (the rate is not reduced to zero under all treaties). For these reasons, one typically sees offshore blockers only in legacy assets (acquired before FIRPTA) and/or for assets not expected to generate significant ECI.

- **REITs:** REITs are often utilized by non-US investors to either minimize or avoid US federal income taxation. A REIT is an entity that meets certain asset, gross income, ownership composition, and distribution requirements. If these tests are met, a REIT will escape corporate taxation, despite being viewed as a corporation for most US federal income tax purposes. The benefits of such corporate status include the general avoidance of state tax filings for the jurisdictions where the REIT owns assets and the conversion of rental income into dividend payments. However, with few exceptions, gains that a REIT derives from dispositions of US real property interests will be taxable under FIRPTA in the hands of a non-US investor just as if such investor disposed of the US real property interest itself. Importantly, all ordinary REIT dividends should be viewed as dividends under US tax treaties and other provisions, such as Code Section 892, and generally should not be viewed as ECI. This means such ordinary dividends are potentially subject to favorable US withholding rules under tax treaties and/or Code Section 892. Note, however, that ordinary REIT dividends are usually subject to less-favorable rates of withholding than corporate dividends under tax treaties.

- **Publicly Traded REITs:** Foreign investors that own 5% or less of a class of publicly traded REIT stock can receive capital gain distributions without FIRPTA consequences. Such capital gain distributions are viewed as ordinary dividends (potentially subject to tax treaty rates of withholding as low as 0%) provided the non-US holder has owned 5% or less of such class of shares during the one-year period ending on the date of distribution.

  Dispositions of such shares should also be exempt from FIRPTA under one or both of two exceptions. The first of these exceptions exempts holders of 5% or less of publicly traded shares from the FIRPTA rules, provided that such a shareholder has owned 5% or less of such class of interests during a five-year period ending on the date of disposition. The second exception from FIRPTA is for a REIT that has "domestically controlled" status. A domestically controlled REIT is a REIT in which more than 50% (by value) of the stock has been owned at all times by US persons during the shorter of (1) the five-year period ending on the date of the relevant transaction or (2) the period during which the REIT was in existence. Interests in such a domestically controlled REIT can be disposed of without FIRPTA tax.

- **Private REITs and Joint Ventures:** Many real estate funds utilize private REITs as holding vehicles. One advantage of such a REIT vehicle is that US tax-exempt investors in the fund are generally insulated from unrelated business taxable income without regard to their ability to obtain the benefits of the so-called fractions rule (which applies to only certain tax-exempt investors) and/or the fund's qualification under such rule.

  To attract significant non-US investors, a fund might acquire and hold each significant US real property interest in its own private REIT and exit such investment via a sale of such REIT. If the REIT qualifies as a domestically controlled REIT or if the REIT is non-controlled with respect to foreign government investors (such as certain sovereign wealth funds), the gain on the sale of the REIT allocable to these foreign investors should be free of US tax under FIRPTA. In addition, depending on the availability of tax treaties and/or Code Section 892, any operating income passed through such a REIT as ordinary dividends may qualify for favorable withholding rates, sometimes as low as zero.

Regardless of domestically controlled REIT status or non-controlled REIT status, any actual sales of US real property interests by the REIT will trigger FIRPTA tax to the non-US investors. Under current IRS guidance, this result applies even if the REIT is liquidated in connection with the sale of its asset.

Conclusion

Significant investment capital for US real estate transactions and funds has been and will continue to be raised from non-US investors. In light of this fact, it is important that real estate advisors, investors, and owners understand the tax challenges, as well as the potential solutions, involved when non-US investors invest in US real estate.

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