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Foreign Investment in U.S. Real Estate

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One need only walk on a major New York City avenue to witness explosive growth in commercial real estate. U.S. owners, operators, and developers (OOD) are always in need of capital, and foreign markets are eager to supply it. Yield-starved investors, seeing signs of rising inflation, have long understood the benefits that accrue from purchasing hard assets in U.S. denominated currency to protect their capital. Although the U.S. Treasury market may be more secure, it has no upside, and with the threat of rising rates from the tapering off of quantitative easing, investors are savvy to seek a safe haven in U.S. real estate.

The number one driver of foreign investment is higher potential investment returns, followed by financial stability and investment expertise. U.S. core assets, defined as trophy properties with steady rent rolls in stable markets, can potentially yield close to an 8% return. Value add, which carries some risk, can rack up returns ranging from 8%-13%, with opportunistic deals, representing an even bigger gamble, potentially delivering even greater rewards.

A significant portion of the foreign capital recently introduced has come from investors seeking safety from sovereign risk amid concerns about stability of assets in their home country. According to Jones Lang LaSalle's Capital Markets Overview (Q2 2014), foreign investment in Manhattan for the period ended June 30, 2014 reached \$6.0 billion in closed transactions, accounting for 30% of total investment sales activity in

the marketplace, and there appear to be no signs of slowing.

Chinese investors in particular, amassed vast amounts of personal wealth over the past 10-15 years as their country benefited from globalization, industrialization, automation and urbanization, are now seeing slower growth, driving them to enter new markets. Geopolitical events in the Middle East are similarly encouraging capital to enter the United States.

Although U.S. real estate development can deliver solid returns, foreign investors face certain obstacles – especially in the areas of U.S. taxation and deal structuring. Depending on tax treaties in place between their home country and the United States, off-shore investors may have to comply with sometimes onerous U.S. regulations and an increasingly complicated tax code. The Foreign Investment in Real Property Tax Act (FIRPTA) generally subjects profits to U.S. tax rates, which are high from a global perspective. There is also a branch profits tax, which effectively amounts to a second level of tax levied on foreign corporations. Individual investors and family offices face a third hurdle - the personal estate tax.

These many levels of taxation lead to a number of important questions: Are there legal ways to avoid reporting transactions in the US? Can double taxation be avoided? How can investment dollars be repatriated efficiently?

Larger OODs may have the expertise and successful track record needed to attract foreign capital, and can generally absorb the costs of managing tax and regulatory requirements. However, smaller OODs may not have the established infrastructure to handle the compliance and administrative burden that foreign capital deals demand. Small OODs are also often not in a position to be able to afford the upfront expenses of bringing on board a professional staff equipped to deal with these areas. Not only is a foreign capital deal expensive to mount, the penalties for non-compliance can be severe. These OODs stand to benefit the most from retaining outside accounting, legal and consulting firms who are equipped to structure viable tax solutions and have the experience and expertise to help navigate the maze of regulations and reporting requirements.

One way to mitigate the double layers of taxation attributable to the branch profits tax is for the foreign investor to invest directly in U.S. real estate deals. Direct investment by an individual is a tax efficient strategy, but comes at a cost: loss of anonymity to the U.S. government by being on record with the IRS and potentially being subject to U.S. estate tax. Because of these two factors, investors often choose to invest via a foreign corporation. However, foreign corporations are subject to the BPT, necessitating additional tax structuring to mitigate a potential second layer of taxation.

One tax efficient structure involves creating a foreign corporation that holds a leveraged U.S. corporate entity, known as a “U.S. Blocker.” In addition, foreign investors should consider lending into real estate deals. Lending into the US market versus committing equity is typically more tax efficient. Another tax technique is to structure the transaction as a domestically controlled REIT. By selling shares, rather than the underlying property, the second level of taxation can be avoided. Foreign governments can also consider a regime specific to them, Section 892 of the Internal Revenue Code, which can reduce withholding taxes for sovereign foreign nations to zero.

In choosing whom to hire to streamline the taxation and compliance process, it is crucial to consider the ongoing

monitoring needs and adjustment demands that can arise. For example, during the “Great Recession” many leveraged U.S. Blocker structures were adjusted, with debt contributed to equity, as a result of the debt becoming a tax burden rather than a benefit. A firm with experience can assist with monitoring and adjusting investment structures and can make a complicated process much less so.

OODs should be cautious when structuring deals with foreign capital. The compliance burden and complexity can quickly overrun an OOD’s office infrastructure. Owners should go into raising foreign capital with their eyes wide open as to what compliance responsibilities will be. And experience counts. A firm that can get it done should be a developer’s first call.

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