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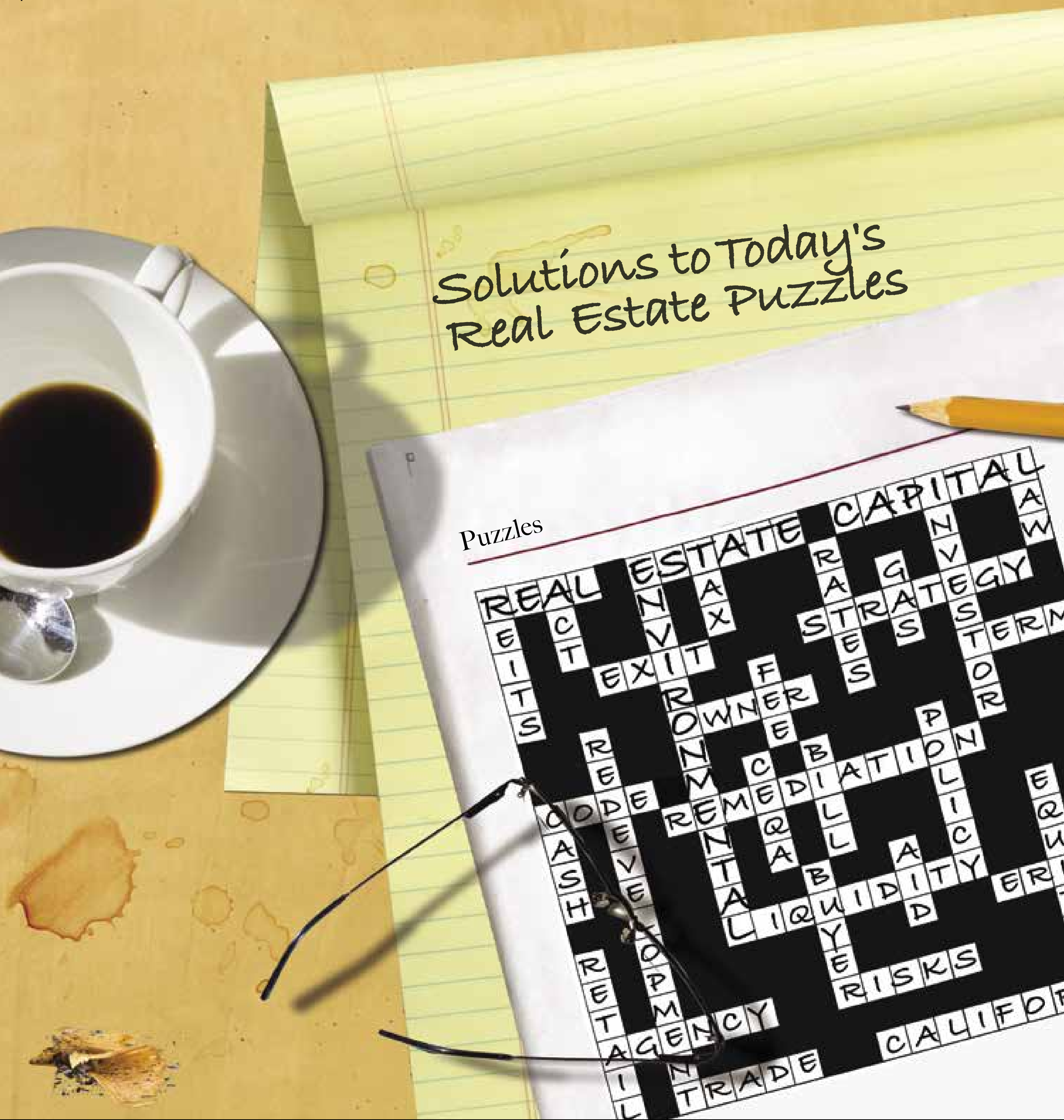

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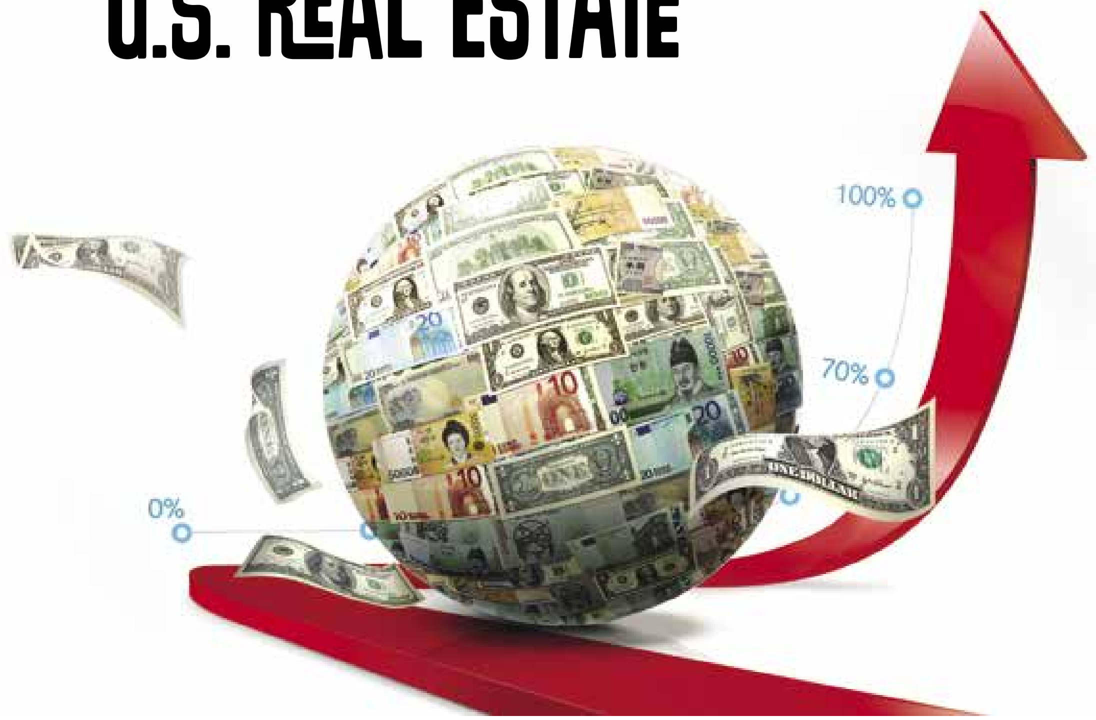
BRINGING NON-U.S. CAPITAL INTO (AND BACK OUT OF) U.S. REAL ESTATE



by John M. Ferguson and Edward L. Glazer

On the heels of a thawing real estate trans–actional market in the United States, many investment managers and real estate owners (including many of the public REITs) are experiencing a corresponding uptick in the availability of institutional capital for this asset class. Not surprisingly, the capital seems to be following the deals.

Following the financial crisis of 2008, many investors ensure "this time will be different." Most have become much more thoughtful and measured about not only the investments they make, but with whom they partner. One key element, however, is not different: the complexity of bringing non-U.S. capital into (and back out of) U.S. real estate.

Aggregating capital from different types of investors is always a challenge. Taxable, tax-exempt, U.S., non-U.S., ERISA pension, and investors of other stripes often have differing – and competing – tax, commercial, and other goals. Then there's the Foreign Interest in Real Property Tax Act (FIRPTA). Because domestically-controlled real estate investment trusts (REITs) are the most tax-efficient FIRPTA planning tool, the greatest challenge continues to be simultaneously satisfying U.S. owners and investors and non-U.S. investors.

Getting Out Isn't Easy

Since June 2007, the most efficient structure from a U.S. tax perspective for non-U.S. investors is to hold each property in a separate, domestically-controlled REIT and to dispose of the property by selling the stock of the REIT. In other words, a non-U.S. investor would seek a majority U.S. partner and would exit not in a traditional real estate transaction, but instead in what is effectively an M&A deal. In such a transaction, the REIT stock buyer would need to preserve REIT status post-closing. In certain property types, sizes, and markets, this may limit the pool of buyers, as one of the REIT rules is that five or fewer individuals (giving effect to certain attribution and ownership look-through rules) not own more than

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50% of a REIT. This “5/50 rule” often eliminates individual, family, family office, closely-held partnerships, and certain other potential buyers. A deREITing acquisition would be a disaster for both the seller and the buyer. The buyer would own a C-corporation and could not liquidate without setting off a 35% federal tax on the built-in gain imbedded in the corporation and would have to pay corporate tax on the income of the now C-corporation. Because the REIT would be deREITed retroactive to the beginning of its current calendar year, the seller would lose its desired tax result because the REIT is not a REIT at the time of the sale. In addition, the pool of buyers is further limited because buyers seeking like-kind exchange transactions under Section 1031 of the Internal Revenue Code cannot buy REIT stock, and because some buyers simply just don’t want to buy REIT stock.

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Selling stock in a domestically-controlled REIT requires that a buyer conduct due diligence and seek additional deal protections such as representations, warranties, indemnities, and possible cash holdbacks relating not only to the real estate, but also with respect to the REIT being purchased. Buying a company, and any potential liabilities which may arise from its historical operations, adds incremental risk. For example, a REIT does not pay U.S. federal income taxes so long as it earns good REIT income, holds good REIT assets, meets certain ownership tests, dividends out 90% of its taxable income, and otherwise qualifies as a REIT. But, if REIT status fails, then C-corporation entity level tax is imposed (typically 35% before state taxes) on its profits. Consequently, in addition to extra deal protections, the transaction may also yield a lower purchase price to offset the incremental assumed risk.

The Cost of Capital

For the non-U.S. investor, however, if properly executed, these burdens are worthwhile; exiting via a sale of REIT stock allows the non-U.S. investor to repatriate its capital free of U.S. federal income taxes. But, from the perspective of the U.S. capital invested in the property (which by definition is a majority of each domestically-controlled REIT seller), the same burdens exist without any corollary gains.

In the context of joint ventures between a foreign investor and a U.S. operator (such as a public REIT) with the U.S. operator owning more than 50% of the REIT, an added issue arises when the partners do not wish to exit at the same time, thereby raising the prospect of a buy/sell exercise. The non-U.S. partner is not able to buy out the U.S. partner, but instead must replace the U.S. partner with another U.S. partner to retain domestically-controlled REIT status. If the U.S. partner buys out the non-U.S. partner, it would receive a stepped-up basis in the REIT stock purchased (but not in the stock it already owns). Unlike purchasing partnership interests, the U.S. partner in such a scenario is not able to elect to receive a stepped-up basis in the property owned by the REIT. As a result, in such a scenario, if the property has a fair market value significantly in excess of its then tax basis, the U.S. operator is not able to liquidate the REIT without incurring a significant tax on the gain. The U.S. operator must then continue to own the property in the REIT with a lower tax basis, reduced depreciation deductions, and, in the case of a U.S. operator which is itself a REIT, a larger distribution requirement.

Greenshoots

In the context of properties which were well-suited for the domestically-controlled REIT structure in the first instance, namely large properties or portfolios likely to trade in the institutional markets, a transaction could be structured to afford the U.S. tax benefits of selling stock in a domestically-controlled REIT to the non-U.S. partner, while such non-U.S. partner shoulders a greater portion of the corresponding burdens of selling REIT stock.

Specifically, the non-U.S. partner or partners in a joint venture, multi-investor, or fund context could be given the choice at exit to elect between having all the partners sell REIT stock or to instead simply sell in a "normal" real estate transaction. The parties could agree to obtain bids and an understanding of all material terms for both transaction formats.

Once the best alternative bids were established, in the event the non-U.S. partner selected the sale of REIT stock format, the U.S. partner would participate in such transaction, and as a condition thereof the non-U.S. partner would ensure that the U.S. partner is not disadvantaged by having done so. In particular, the sale proceeds would be adjusted to allocate any pricing "haircut" solely to the non-U.S. partner and the non-U.S. partner would either make solely in the first instance, or

otherwise stand behind and make whole the U.S. partner for, any incremental representations, indemnities, or other contractual differences undertaken as compared to those which would have been provided in the simple real estate transaction.

Congress to the Rescue

On November 19, 2013, U.S. Senate Finance Committee Chair Max Baucus (D-MT) released a discussion draft that includes favorable changes to the FIRPTA rules. The discussion draft would override Notice 2007-55 by providing that certain distributions made by a domestically controlled REIT, including liquidating distributions, can be made without foreign investors incurring a FIRPTA tax. Tax-efficient structuring could then be achieved without the need to sell REIT stock. Property could be sold in a traditional real estate transaction and the proceeds of the sale could be distributed to the non-U.S. investor or investors as a liquidating distribution without the non-U.S. investors incurring the FIRPTA tax. In addition, the discussion draft would provide an exemption for FIRPTA to certain foreign pension plans. If these provisions should become law, the tax impediments to bringing non-U.S. capital into U.S. real estate would be significantly reduced. ■

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