U.S. Real Estate Funds and FIRPTA

Structures to Maximize Net Returns to Non-U.S. Investors

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Cooley LLP

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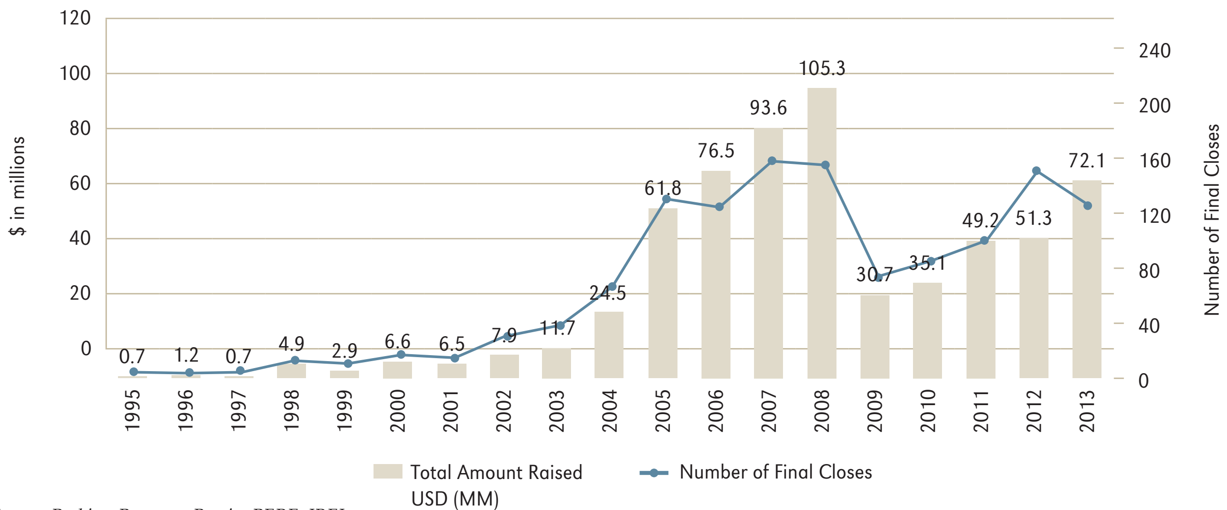
NON-U.S. INVESTORS IN U.S. REAL ESTATE FACE SUBSTANTIAL COMPLEXITIES AND COSTS RESULTING FROM THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT OF 1980, OFTEN CALLED "FIRPTA." THIS PAPER EXAMINES A VARIETY OF OPTIONS FOR MITIGATING COSTS AND OPTIMIZING NET RETURNS FOR INVESTMENTS SUBJECT TO FIRPTA'S REACH.

THE CLOSED-END REAL ESTATE FUND MARKET

Many of the largest institutional investors have been direct investors in real estate for decades. However, widespread interest in closed-end real estate funds is a more recent phenomenon, as detailed in Chart I. In the late 1990s, real estate fund managers in the United States began to develop opportunistic fund strategies that sought to generate high returns by both targeting properties that needed to be turned around in some fashion, and by being more aggressive with leverage. Strong returns in opportunistic strategies in the early part of the last decade drove dramatically increased fundraising for closed-end real estate funds, a trend that reversed only with the Great Financial Crisis (GFC).

Over the last three years, the market has rebounded from its GFC trough, though it is still far below the unsustainable market peaks of 2007 and 2008. It has also evolved. Up to the GFC, opportunistic strategies dominated the closed-end fund market: more than 80% of the funds being raised targeted that strategy. The market turn caught many of these funds with portfolios that were highly levered and more than fully priced, and the value of many of these funds melted down. As Chart II shows, by 2013 interest had diversified to a degree, and the niche sectors of distressed and debt — which were not factors at all in 2007 — had begun to develop a significant following. In addition, there was an increased interest in core real estate, either executed directly by large institutions or through separate accounts or joint ventures where end investors had more control.

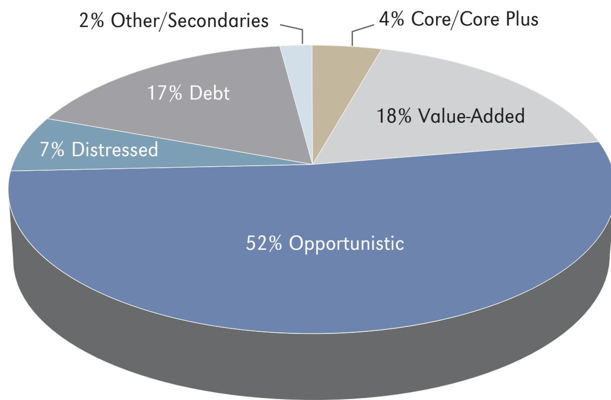
CHART I GLOBAL CLOSED-END REAL ESTATE FUNDRAISING 1995–2013



Source: Probitas Partners; Preqin; PERE; IREI

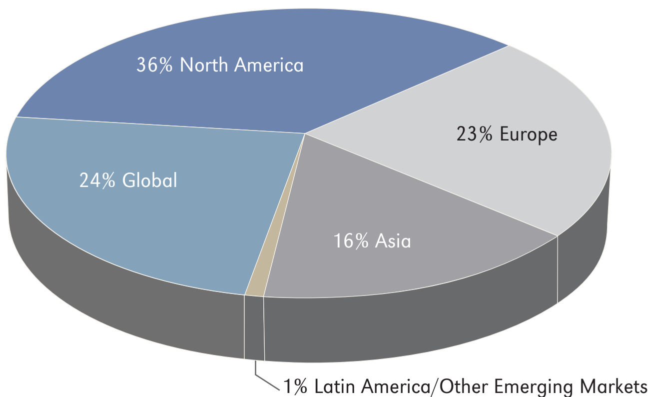
Another development was the increased internationalization of the market. In the late 1990s the market was led by U.S. headquartered managers, and even in their global funds there was a strong focus on U.S. properties. Chart III shows that by 2013 the market had become more diverse. Though 36% of the funds raised that year specifically targeted North America there was strong interest in Europe and Asia as well, both directly and through global funds.

CHART II GLOBAL CLOSED-END REAL ESTATE FUNDING BY STRATEGY IN TERMS OF CAPITAL RAISED (USD), 2013



Source: Probitas Partners; Preqin

CHART III GLOBAL CLOSED-END REAL ESTATE FUNDING BY GEOGRAPHY IN TERMS OF CAPITAL RAISED (USD), 2013



Source: Probitas Partners; Preqin; PERE; IREI

One factor that has not changed in the fundraising dynamic is the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). This law creates obstacles for many foreign investors desiring to invest in real estate in the United States and de facto limits foreign capital targeting U.S. real estate investments.

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FIRPTA: AN OBSTACLE FOR NON-U.S. INVESTORS IN THE U.S. MARKET

FIRPTA taxes non-U.S. investors on gains from U.S. real property investments, including gains derived from many real estate investment funds, at effective rates up to 35% (and, when the branch profits tax is added, the effective rate can jump to 54.5%). Along with the tax bite, FIRPTA requires non-U.S. investors to file U.S. tax returns and submit to the investigatory and subpoena powers of the IRS — an unwanted intrusion for nearly every non-U.S. investor. (Appendix A describes the basics of FIRPTA in more detail.)

Legislation has been introduced from time to time that would abolish, or significantly reduce the effect of FIRPTA. There is legislation pending in both the Senate and the House of Representatives that would make significant changes to FIRPTA. In addition, the Obama Administration has proposed its own modifications to FIRPTA however, as of the time of the writing of this paper, it is unclear whether any of the proposals will ever become legislation.

There is no "silver bullet" that resolves all of the issues FIRPTA presents to non-U.S. investors. Yet, some recent innovations that mitigate the impact of those tax and tax reporting obstacles have begun to open the flow of new non-U.S. capital to U.S. real estate funds and assets. Non-U.S. investors report that they are attracted by the opportunity to capitalize on distressed investment opportunities in the United States and to participate in what many believe could become a period of exceptional returns. Customized solutions are necessary to address these FIRPTA issues, but the structures are becoming more commonplace and the economic benefits are readily quantifiable.

In many cases an approach may solve one problem (the filing requirement) but not address the other (the tax-paying obligation). In addition, the up-front costs of tailoring a tax-effective strategy for an individual investor or private equity fund can be high. Conversely, a structure, once chosen, is generally scalable for additional investments or can help to accommodate additional investors. Given the right circumstances and mix of investors, non-U.S. investors with sufficient resources have the ability to work with private equity fund sponsors to utilize creative solutions available today to help address their needs and enable them to invest on a less frictional basis in the multitude of opportunities available in the U.S. real estate markets.

U.S. real estate fund sponsors utilize several structures (often in combination) to reduce the U.S. tax costs associated with investment in U.S. real estate — these include blocker corporations (including the so-called "Leveraged Blocker"), private REITs, and high-yield debt instruments. The costs and benefits of these strategies, including complexity of establishment and administrative costs, are illustrated in Table I.

As Table I illustrates, the Standard Blocker can solve the tax filing problem without solving the tax payment problem, while the private REIT may solve both or solve neither, depending on the circumstances. Only the Leveraged Blocker and the high-yield debt structures can provide relief for non-U.S. investors by potentially reducing their U.S. tax obligation significantly while also eliminating the U.S. tax return filing requirement.[1]

TABLE I COMPARISON OF COSTS AND BENEFITS OF VARIOUS U.S. REAL ESTATE INVESTMENT STRUCTURES

Structure/ Considerations	Effective U.S. Tax Rate on Distributions[2]	Non-U.S. Investor Tax Filing Obligation	Barriers to Formation	Expected Costs
High-Yield Debt Investment	Can be as low as 0%	No	High–Upside must be limited	Medium
Leveraged Blocker (and alternatives)	Can be between 20% and 35%	No—Blocker files	High–Complexity	Medium–High
Private REIT	Can be between 0% and 54.5%[3]	Yes, but only in certain cases[4]	Medium–High	Medium–High
Standard Blocker	Up to 40%–54.5%[5]	No—Blocker files	Low	Low–Medium
Direct Investment	Up to 54.5%	Yes—Direct	None	Low

HIGH-YIELD DEBT INVESTMENT

FIRPTA rules do not apply to interests in U.S. real estate that constitute "straight debt" investments. Straight debt for this purpose means in general that (i) the debt is not convertible into an equity interest in the underlying property, (ii) the interest rate on the debt is not tied to the performance of the underlying property, and (iii) the upside is capped. If the debt investment is structured in this manner, and assuming that the instrument qualifies as debt for U.S. federal income tax purposes, then a non-U.S. investor could fully escape U.S. tax under FIRPTA on repayment of the debt instrument.

The challenges to this structure are obvious:

- The instrument cannot be economically equivalent to an equity investment, so some (generally significant) upside will not be retained by the non-U.S. investor;
- An unrelated party must be found to invest a material amount alongside the non-U.S. investor as equity in order to support the characterization of the non-U.S. investor's investment as debt; and
- The non-U.S. investor may not be able to retain significant control rights over the borrower or the property itself.

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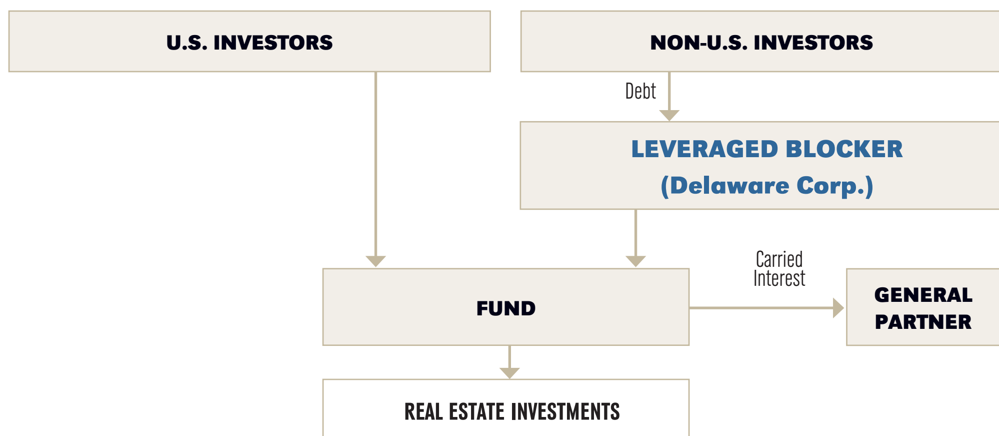
If these challenges are surmounted, however, the high-yield debt investment structure offers the prospect of significantly enhanced economic returns, free from U.S. taxes.

LEVERAGED BLOCKERS

The Leveraged Blocker is a Delaware (or other U.S.) corporation that is capitalized with a mix of loans and equity from its investors. The goal of this structure is to shield non-U.S. investors from the U.S. tax filing requirement that FIRPTA imposes, while at the same time reducing the effective rate of U.S. tax non-U.S. investors will bear on their investment.

LEVERAGED BLOCKER STRUCTURE



- **Leveraged Blocker pays U.S. tax on realized gains at effective tax rates that can be between 20% and 54.5% effective rate applicable to Standard Blockers**
- **Non-U.S. investors capitalize blocker with debt and equity — a 3:1 ratio is common**
- **Interest rate on debt determined by, among other things, creditworthiness of underlying assets and type of investment (i.e., development, income-producing property)**
- **Interest repayment on debt reduces net taxable income of blocker**
- **If structured properly, interest payment will be free of withholding tax and dividend payment on profit will have low withholding tax**

Whether the Leveraged Blocker meets the goal of reducing a non-U.S. investor's effective rate of U.S. tax on a U.S. real estate investment depends on a number of factors, each of which is specific to a particular investment. Appendix B to this paper details mechanically how the Leveraged Blocker structure is intended to work, but the main structuring component is the interest deduction associated with a leveraged investment that the Leveraged Blocker uses to reduce the amount of the Leveraged Blocker's income that is subject to U.S. tax.

While each investment is unique, it is safe to say that a favorable Leveraged Blocker structure would likely have some or all of the following features, each of which should be thoroughly vetted with counsel:

- Non-U.S. investors each individually holding less than 50% of the Leveraged Blocker's capital (to help ensure interest deductibility) — thus, a minimum of three investors is mandatory.
- A mix of investors that will minimize the amount of withholding on interest payments the Leveraged Blocker makes. Examples of such a mix of investors include:
  - At least three non-U.S. investors, none of which holds 50% or more of the Leveraged Blocker's capital and all of whom are either residents of a jurisdiction that has a tax treaty with the United States which provides for a 0% withholding on interest,[6] or are non-U.S. governments;
  - Non-U.S. investors that are not residents of a jurisdiction that has a tax treaty with the United States., each of whom holds less than 10% of the Leveraged Blocker; or
  - A combination of the above;
- A market-based debt to equity ratio sufficient to maximize the effectiveness of the leverage, taking into account property-level debt (perhaps 50%–75% leverage);
- A reasonable interest rate on the debt that takes into account (among other things) creditworthiness and type of cash flow from the underlying real estate assets; and
- Non-U.S. investors who reside in a jurisdiction that has a tax treaty with the United States to take advantage of reduced withholding rates on dividends.

Appendix C provides an example, purely for illustrative purposes, of the tax efficiencies that can potentially be obtained on the right set of facts; however, as stated previously, each investment is unique and will present its own range of potential tax savings. A key factor in the potential tax savings is the length of time the leverage will be outstanding — the longer the leverage is outstanding, generally speaking, the greater the tax savings. Thus, a Leveraged Blocker structure, although tax efficient, may not be the best structure for a shorter-duration investment.

It should be noted that the Leveraged Blocker could be an expensive and complex structure to establish and organize; however, most of the expense and time is usually attributable to negotiations with potential investors. One way to minimize costs would be for a group of aligned investors to present a fund sponsor with a requested Leveraged Blocker structure.

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The Leveraged Blocker is a viable structure to tax-effectively invest in U.S. real estate, particularly for larger, scalable, non-U.S. investors. Despite the careful tax planning, complexities and costs necessary to ensure the effectiveness of the Leveraged Blocker structure, non-U.S. investors may find the tax savings to be significant.

ALTERNATIVE STRUCTURES FOR NON-U.S. INVESTORS IN U.S. REAL ESTATE

The following structures, noted briefly in Table 1, are alternatives to the Leveraged Blocker and high-yield debt structures and include private REITs and the more typical Standard Blocker as well as a variation on the Leveraged Blocker.

There is no "one-size-fits-all" structure to address tax issues. Non-U.S. investors may prefer the private REIT and Standard Blocker structures over the Leveraged Blocker structure for their simplicity, because they are more common in the market, "user-tested," and in the case of the Standard Blocker, for its relatively low cost. In addition, the specifics of a particular real estate fund or investment (including whether income is expected to come from operations or sale, or whether an exit can be effected through a share sale or an asset sale) will drive sponsors and investors toward one or another particular investment structure.

In the case of the variation on the Leveraged Blocker structure detailed on page 10, non-U.S. investors and fund sponsors may decide to investigate this strategy for its flexibility. Potential tax savings exceeding those of the Leveraged Blocker may justify the costs of additional complexity, expense, and tax risk inherent with a relatively untested strategy.

PRIVATE REITS

Created by statute, a real estate investment trust (REIT) is a unique, tax-efficient type of holding vehicle that is created to invest in real property assets. By effectively eliminating net tax at the corporate level, a REIT passes pre-tax income through to investors when they receive distributions and thus subjects investors to only one level of tax (as opposed to the general "double-tax" U.S. tax regime that applies to corporations and their shareholders).

REITs that invest in the United States are, by definition, composed primarily of investments in U.S. real estate. As a result, certain distributions from private REITs to non-U.S. investors, or gains those investors realize from the sale or exchange of REIT shares, are normally subject to FIRPTA tax.[7] There is an exception to this rule, however, for "domestically-controlled" REITs.

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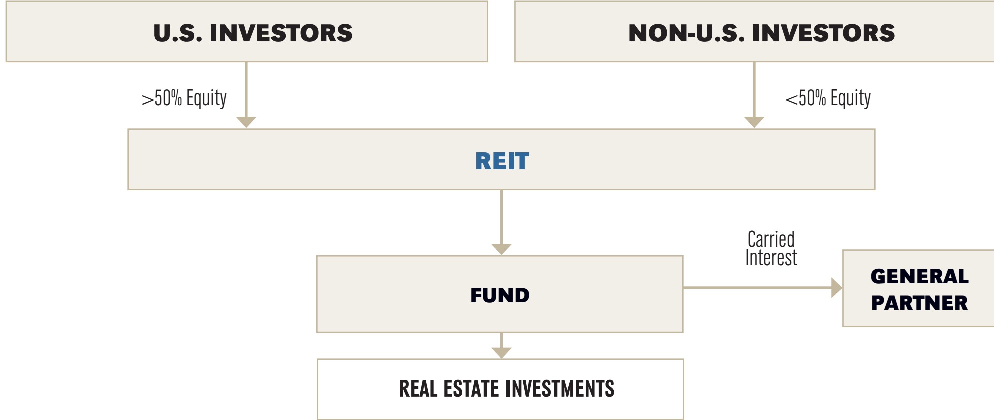
A disposal of shares in a domestically-controlled REIT does not trigger FIRPTA tax or filing obligations. These REITs, however, must be structured in a particular way to demonstrate domestic control — specifically, U.S. investors must hold more than 50% of the capital of the REIT and non-U.S. investors cannot otherwise exercise control over the REIT. This structure has been relatively common for non-U.S. investors to utilize for U.S. real estate investment, particularly in so-called "club" deals or deals where the non-U.S. investor can maintain some level of input on the structure and exit of the investment.

DOMESTICALLY CONTROLLED REIT STRUCTURE



- **REIT must be more than 50% held by U.S. persons to be "domestically controlled"**
- **Sales of underlying real estate can still trigger FIRPTA tax and filing requirement to non-U.S. investors**
- **Benefit to non-U.S. investors may therefore be limited to reduced withholding rates on dividends paid by REIT (as compared to Standard Blocker), or for funds that invest in non-capital gains producing assets, or public or other domestically-controlled REITs**

A private equity real estate fund could also utilize a domestically controlled REIT to moderate tax liability by forming a fund comprising both U.S. and non-U.S. investors. The fund would hold shares in a REIT (or potentially in multiple REITs), each of which in turn owns U.S. real property. If the fund is able to exit its investment through a sale of its REIT shares, or if instead the REIT is the investor in the fund and the non-U.S. investor is able to exit its investment through a sale of REIT shares, non-U.S. investors can avoid U.S. tax as such a share sale would not be subject to FIRPTA or other U.S. taxes.

However, in the private equity fund context, this exit strategy may be difficult to guarantee. More typically, for a private equity fund using a private REIT structure, a non-U.S. investor will not achieve expected tax efficiencies. One reason is that the FIRPTA tax and corresponding tax return filing requirement still attaches if the REIT disposes of U.S. real estate and distributes the capital

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gains from the sale to its non-U.S. investors. A possible way to avoid this downside is to hold each real estate asset in a separate REIT and dispose of the shares of each REIT discretely (not up through the holding entity), assuming that this is a reasonable arrangement from a business perspective.

This amount of structuring to accommodate non-U.S. investors can be prohibitively complicated and expensive for a fund sponsor. First, the fund must organize the REIT — an often time-consuming and expensive proposition. Then, to try to maximize the potential for U.S. tax savings, the sponsor must attempt to hold each individual real property asset in a separate REIT or subsidiary that itself is exempt from the FIRPTA rules. Finally, the sponsor needs to attempt to exit the investment through a sale of the shares of the subsidiary REIT. Although recent IRS guidance suggests that a buyer of a real estate asset held by a REIT should be indifferent from a U.S. tax perspective whether the sale is of the asset itself or the shares of the REIT, in many cases a sale of REIT shares may result in a lower purchase price than a sale of the underlying assets would produce.

Even if a fund sponsor does not or cannot implement this additional level of structuring, a private REIT structure can still produce a better after-tax result than the Standard Blocker structure detailed on page 10. This is because the withholding tax that applies to dividend distributions from a REIT may be reduced from the standard 30% rate if the non-U.S. investor resides in a jurisdiction with a favorable tax treaty with the United States, such as France, Germany, the Netherlands, and the UK. The result could be the reduction of the 54.5% effective rate detailed in Table 1 to something in the range of 40%–45%. It should be noted, however, that utilizing the REIT structure still leaves open the possibility that the non-U.S. investor will have a U.S. tax filing obligation.

Notwithstanding the above, for certain types of funds for which capital gains from direct investments in real estate are not the primary expected source of income (e.g., so-called “mortgage REITs,” or REITs that themselves invest in publicly-traded REITs), the domestically-controlled private REIT can avoid the application of the FIRPTA tax rules and result in tax efficiencies to non-U.S. investors. Additionally, smaller club deals, where non-U.S. investors would be able to ensure exiting the investment through a sale of REIT shares, would have the same result.

However, for the typical, broadly subscribed private equity real estate fund, the costs of establishing and operating the private REIT structure may outweigh the limited tax benefit the structure provides to non-U.S. investors.

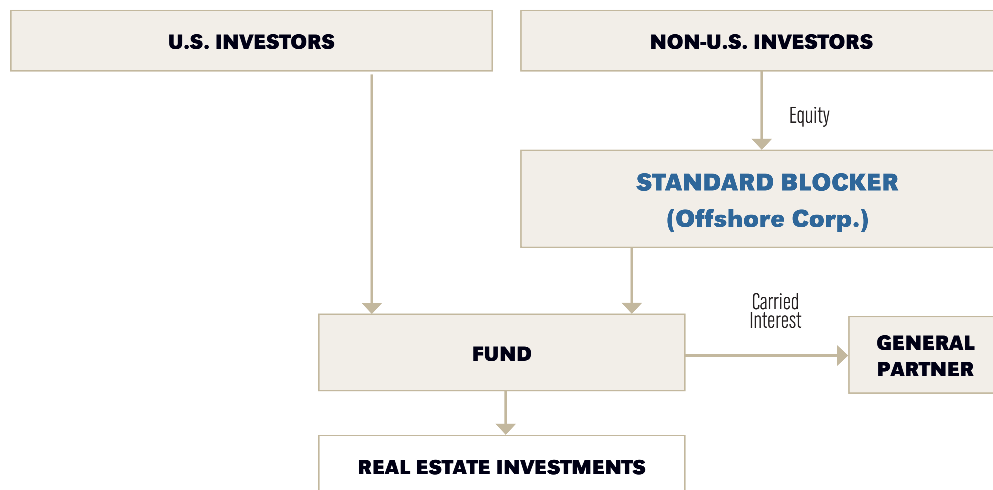
THE STANDARD BLOCKER STRUCTURE

Non-U.S. investors who do not wish to accommodate the complexities and costs of the Leveraged Blocker structure, and who are more concerned with U.S. tax filings than bearing U.S. tax costs, have the option to invest in a typical Standard Blocker structure. This investment is generally made through an offshore company, such as a Cayman Islands company, that holds an interest in a private equity real estate fund. This has been the most commonly adopted structure for the majority of opportunistic real estate funds over the past several years.

Using this structure, the blocker functions as the taxpayer, paying FIRPTA taxes and filing any required tax returns while the individual shareholders (i.e., the non-U.S. investors) are shielded from tax filing requirements. However, this approach is not tax-efficient as the blocker entity still pays the full 35% FIRPTA tax on its share of the fund's gains from disposals of U.S. real estate investments.

In addition, the blocker entity may also be subject to a second "branch profits" tax, resulting in an effective tax rate of 54.5% on the non-U.S. investor's share of the fund's real estate profits, unless the blocker resides within a jurisdiction with a favorable tax treaty with the U.S.[8] In this case, the effective U.S. tax rate may

STANDARD BLOCKER STRUCTURE



- Standard Blocker pays effective rate of tax at 54.5% (up to 35% on realized gains and a second "branch profits" tax), unless the blocker resides within a treaty jurisdiction
- Standard Blocker files U.S. income tax return — not non-U.S. investors. Non-U.S. investors are thus not subject to investigatory and subpoena powers of the IRS
- Structure is cheaper and less complex than Leveraged Blocker structure, but less tax efficient
- Blocker corporation can be formed in the Cayman Islands or other low-tax offshore jurisdiction

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be reduced to a rate ranging from 40% to 54.5%; however, any such jurisdiction would likely impose local taxes on the profits of the blocker, undermining most, if not all, of the U.S. benefit.

VARIATIONS ON LEVERAGED BLOCKER ENTITIES

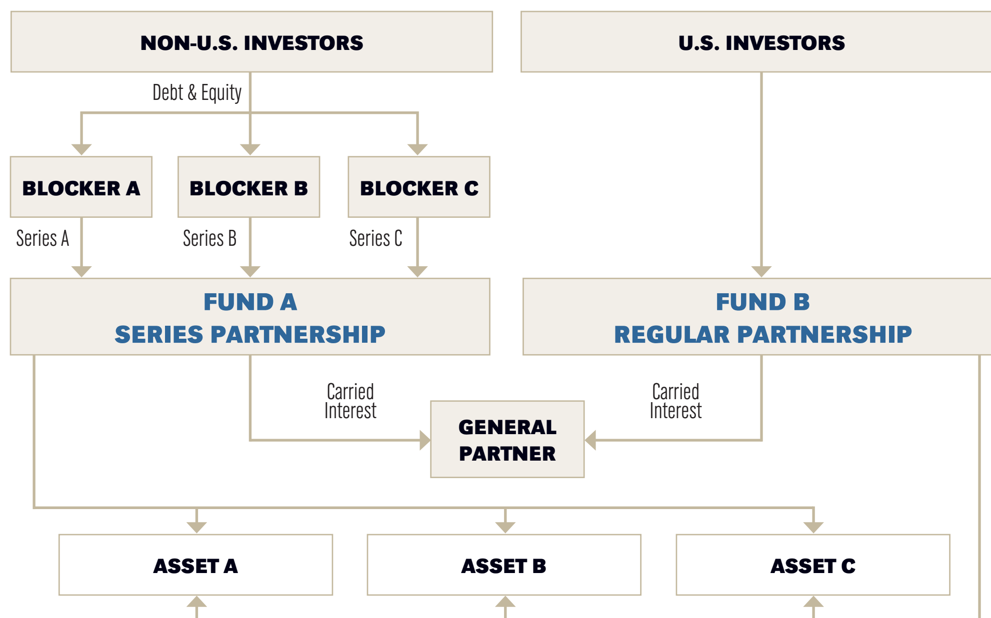
Parallel Funds. The Leveraged Blocker structure detailed on page 10 can be beneficial to real estate funds dedicated to U.S. real estate. At the same time, it can be detrimental to real estate funds with a global focus by subjecting income from non-U.S. investments to U.S. tax (because all of the fund's income would pass through the U.S. blocking entity).

For real estate funds that will make investments outside of the United States, a variation on the Leveraged Blocker structure is required. For example, a fund sponsor could establish parallel funds — one for U.S. investments and one for non-U.S. investments. Non-U.S. investors would invest directly into the fund dedicated to non-U.S. investments with no corresponding U.S. tax liability or reporting requirements, and invest through a blocking entity into the fund dedicated to U.S. investments.

Series Partnerships. In an effort to seek greater tax efficiencies, non-U.S. investors could work with fund sponsors to explore further variations and enhancements on the blocking-entity approach. For example, liquidating distributions from a corporation to a non-U.S. shareholder are not subject to the same withholding tax as dividends paid to the same shareholder. In fact, they are not subject to U.S. tax at all so long as any real estate that corporation held — directly or indirectly — has been disposed of in a taxable transaction prior to the liquidation. Thus, a structure that features an exit of a liquidating distribution rather than a dividend is an attractive structure to non-U.S. investors in U.S. real estate.

It is generally difficult under U.S. tax rules to establish this type of enhanced Leveraged Blocker structure within the traditional private equity real estate fund context. Investors' interests in a private equity fund are part of a pooled approach, and not generally made on an investment-by-investment basis, at least vis-à-vis other investors. However, it may be possible, depending on the level of U.S. tax risk and complexity an investor is willing to bear, to achieve the tax goals of this approach by using a special kind of partnership called a "series partnership."

SERIES PARTNERSHIP STRUCTURE WITH LEVERAGED BLOCKERS



- Fund A has separate "series" for each investment
- Similarly, separate Leveraged Blockers for each series, tied to each investment
- Funds flow through repayment of blocker debt and liquidating distribution — potentially more tax efficient than standalone Leveraged Blocker, but costly and complex to implement
- IRS has not ruled on the use of a series partnership with a fully "crossed" carried interest; therefore this structure carries risk of IRS challenge

A series partnership is a unique kind of partnership authorized by Delaware law in which each investment made by the partnership can be contained in a separate "series," distinct and separate from the other series and investments in the partnership.

Under this structure, non-U.S. investors would invest in a fund through separate blocker entities that are established for each underlying investment. The separate blocking entities each hold a separate series in the series partnership. When the fund disposes of a real estate investment, it distributes the proceeds to the holder of the series to which that investment relates. The non-U.S. investors are repaid on their investment through debt repayment — like the Leveraged Blocking structures previously discussed — and through a liquidating distribution of the relevant blocking entity.

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Because the blocking entity at that time only holds cash from disposal of the real estate investment to which it relates and not an interest in the other real estate investments held by the partnership (on the theory that each series is truly separate and distinct), the liquidating distribution theoretically would trigger no U.S. tax. Thus, if the structure is respected by the IRS, non-U.S. investors will have escaped withholding tax on the liquidating distributions and reduced their effective tax rate even further than the tax efficiencies the Leveraged Blocker structure is intended to provide.

The use of series partnerships is not widespread, but is becoming more common. The IRS has issued proposed regulations that provide certainty as to the treatment of separate series in a series partnership to the effect that each separate series may be respected as a separate entity for U.S. tax purposes. While the regulations are merely in proposed form, tax advisors generally believe that a properly constructed series partnership structure can provide the beneficial tax benefits described above.

Combinations of Structures. Some funds that feature multiple strategies may combine several of the foregoing structures in order to maximize the overall U.S. tax efficiency of the fund. For example, a fund that originates mortgages, invests in performing real estate loans and equity interests in real estate that are not eligible to be held by a REIT may employ a mortgage REIT for the mortgage loans it originates, may organize an offshore (Cayman) corporation to acquire interests in existing mortgages, and may organize a Leveraged Blocker to make direct investments in real estate. This combination would be more tax efficient for non-U.S. investors in the fund than if the fund simply established a Leveraged Blocker for its non-U.S. investors.

The series partnership, Leveraged Blocker, and other variations are not cost-effective solutions for smaller investors, since the start-up fixed costs involved with creating the structures are significant. More negotiations between affected parties are involved in setting up multiple blocking corporations with multiple investors, and more documents are obviously required for complex investment mixes of debt and equity. Still, for significant non-U.S. investors in moderate- to large-sized funds, investigating these alternatives in detail is a worthwhile undertaking. Once the documents are negotiated and vetted, the tax efficiencies gained and the elimination of reporting requirements should easily justify the up front costs of time and money.

CONCLUSION

Both new and established non-U.S. investors are considering making significant investments into the U.S. real estate markets to capitalize on expected distressed investment opportunities. Many U.S. investment fund sponsors are becoming more amenable to the needs of non-U.S. investors in accessing these opportunities. FIRPTA tax and associated filing obligations need no longer be barriers to non-U.S. investment in U.S. real estate. Through creative structuring approaches tailored to the various needs of different types of non-U.S. investors, their locations, and anticipated investments, fund sponsors and their advisors are now able to structure solutions to minimize FIRPTA's effects and create a win-win situation for all involved.

SPECIAL CONSIDERATIONS FOR SOVEREIGN INVESTORS

Special U.S. tax rules apply to investments in the United States by foreign governments (sovereign investors). Very generally, sovereign investors are exempt from U.S. federal income tax on interest, dividends, and capital gains. This tax exemption, however, does not apply to income derived by a sovereign investor (or an entity controlled by such investor, such as a Central Bank or a wholly-owned subsidiary) from the conduct of a "commercial activity." Commercial activities clearly include direct investment in U.S. real property.

Notwithstanding the general FIRPTA rules discussed elsewhere in this paper, sovereign investors are exempt from U.S. federal income tax on dispositions of shares of corporations that own real property (including REITs, whether or not domestically-controlled) so long as such corporations are not effectively controlled by the sovereign investor (i.e., the sovereign investor cannot own 50% or more (by vote or value) of any entity that would constitute a U.S. real property holding corporation and could not otherwise have effective practical control over any such entity and still obtain the benefits of this exemption from tax with respect to its investment in that entity).

Sovereign investors thus have a path to investing in U.S. real property unavailable to other non-U.S. investors — namely non-controlling interests in REITs (so long as the exit from the investment is structured as a sale of shares in the REIT — prior to 2007 many sovereign investors took the position that a sale by a REIT of U.S. real property followed by a liquidating distribution of the REIT was exempt from tax under FIRPTA; however, the IRS issued a notice in 2007 that effectively killed this position).

There may also be other tax-efficient routes for sovereign investors to invest in U.S. real property that are unavailable to other non-U.S. investors (including investment in convertible debt instruments) that are beyond the scope of this paper.

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APPENDIX A. FIRPTA IN A NUTSHELL

Non-U.S. persons generally do not pay U.S. tax on disposals of stocks or securities of U.S. issuers. In this regard, the United States is something of a tax haven for non-U.S. investors. Since 1980, though, this beneficial tax treatment has not extended to disposals of real estate situated in the United States.

Enacted partly to prevent non-U.S. investors from acquiring landmark U.S. properties, FIRPTA imposes a tax on gains realized from the disposition of a U.S. real property interest, an interest in real property located in the United States that includes a "fee" interest in real estate and also includes one or more of the following:

- An interest in a partnership or other "flow-through" entities that holds U.S. real estate.
- An interest in a corporation at least half the value of the assets of which are in U.S. real estate (subject to certain exceptions), referred to as a "U.S. real property holding corporation."
- Any direct or indirect right to share in the proceeds, appreciation or profits of U.S. real estate.

U.S. REAL ESTATE

In general, FIRPTA imposes a tax on gains from a sale of a U.S. real property interest by a non-U.S. person at U.S. tax rates that generally apply to U.S. taxpayers (i.e., at rates up to 35% for corporations and between 20% and 40% for individuals). This tax is collected partially through a withholding mechanism whereby the seller of the real property interest is obligated to withhold 10% of the sale's gross proceeds at the time of sale.

These gains are also treated as income that is "effectively connected" with the conduct of a U.S. trade or business, or Effectively Connected Income (ECI). A non-U.S. person that receives this type of income incurs a corresponding U.S. federal income tax filing obligation and consequently becomes subject to the subpoena powers of the IRS with respect to all of its U.S. investments.

Finally, a non-U.S. corporation that has ECI from an investment in U.S. real estate may be subject to a second entity-level tax on its real estate gains. This so-called "branch profits" tax — levied at a 30% rate on the after-tax proceeds of an ECI investment — is intended to mirror the tax that U.S. corporations withhold on dividend distributions to foreign parent corporations.

Thus, the end result of an investment in U.S. real estate by a non-U.S. corporate investor can be an effective federal tax rate as high as 54.5% — that is, an initial 35% tax on the gains from the real estate investment plus an additional 30% tax on the after-tax proceeds (30% of the remaining 65% equals 19.5% of the total gains). Additional state and local taxes may also apply. Clearly, this tax rate compared to much more favorable rates in other jurisdictions, or on other asset classes in the United States, makes real estate a less favored asset class absent some relief of this relatively high tax cost.

FIRPTA IN THE PRIVATE INVESTMENT FUND CONTEXT

Private equity funds that invest in U.S. real estate are generally organized as partnerships (or other pass-through entities) with a general partner responsible for fund management and limited partners who invest capital passively in the fund. When a real estate fund disposes of a U.S. real property interest, FIRPTA applies on an indirect basis to tax non-U.S. partners on their share of the partnership's profits from the sale. This rule applies to any disposal of a real estate interest by a real estate fund. Interposing a partnership between a non-U.S. limited partner and an underlying U.S. real estate investment does not prevent FIRPTA's application.

For example, non-U.S. investors in a U.S. real estate fund are generally subject to FIRPTA if any of the following occur:

- The fund disposes of shares in a U.S. real property holding corporation.
- The fund disposes of a U.S. LLC or other flow-through entity that holds real estate assets.
- An LLC or other flow-through entity owned by the fund disposes of U.S. real property and distributes profits up to the fund.
- The fund sells real estate assets it owns directly.

This raises two major impediments to fundraising from non-U.S. investors who have not implemented any customized tax mitigation structures:

Significant Taxes. In the typical fund context, a fund's disposal of a U.S. real property interest results in FIRPTA tax to non-U.S. Limited Partners, based on their pro-rata share of the fund's gains from the disposal. The tax is imposed at rates up to 35% for corporate investors — a significant dilution to the gross profits generated by the general partner. The tax bite is particularly severe compared with results from other U.S. investment opportunities unencumbered by comparable taxes (such as debt and equity securities). The tax impediment is particularly harsh in light of the reality that even the best performing real estate funds typically do not generate returns that equal those from venture capital, or, at least before the recent crash, from selected buyout funds.

IRS Investigatory Powers. Compounding the problem of having a tax liability on real estate investment proceeds, a non-U.S. investor subject to FIRPTA must also file U.S. federal income tax returns. A time-consuming, costly burden, federal tax filings can also entail corresponding U.S. state income tax filings in jurisdictions where the fund invests or operates. In addition, non-U.S. investors who file U.S. federal income tax returns thereby give the IRS the authority to examine all information pertaining to their U.S. investments. Thus, the IRS may issue subpoenas for documents.

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APPENDIX B. MECHANICS OF THE LEVERAGED BLOCKER STRUCTURE

Briefly, the Leveraged Blocker structure is intended to work as follows:

- Non-U.S. investors form a Delaware (or other U.S.) corporation and capitalize it with a mix of debt and equity. The proper ratio of debt to equity will depend on the facts of the particular investment and the leverage (if any) incurred at the property level. A ratio of approximately 3:1 is not uncommon.
- A private equity real estate fund disposes of a real estate asset and distributes the proceeds to its investors, including the Leveraged Blocker.
- The Leveraged Blocker pays out the proceeds from its investment in the fund to its owners as a mix of debt repayment, dividends and return of capital.
- The Leveraged Blocker is taxed on its share of the fund's income at regular U.S. tax rates applicable to corporations (up to 35%) and files a U.S. income tax return (the non-U.S. investors in the Leveraged Blocker are thus shielded from the U.S. tax filing requirement). The portion of the distributed proceeds that are attributable to repayment of interest on the Leveraged Blocker's debt should be deductible by the Leveraged Blocker and reduce the effective tax rate it must pay on its income.
- Return of capital (principal on debt and equity invested) is distributed tax-free.[9]
- Dividend payments the Leveraged Blocker makes to the non-U.S. investors attract a 30% withholding tax that may be reduced under a tax treaty. For example, reduced to 15% under each of the income tax treaties the Unted States has with France, Germany, the Netherlands, and the UK, among others (reduced to 5% under many treaties where the investor owns 10% of the Leveraged Blocker).

Impediments to the most favorable tax treatment include the inability to secure the right mix or number of investors to ensure that the Leveraged Blocker can deduct against its income interest paid to the non-U.S. investors or the unwillingness of investors to share the potentially high upfront costs in establishing the structure.

APPENDIX C. ILLUSTRATIVE LEVERAGED BLOCKER EXAMPLE

This example is purely for illustrative purposes and should not be construed as a promise of expected tax benefits. It is provided to illustrate how, given the proper set of circumstances, non-U.S. investors can substantially reduce their U.S. tax on in investment in U.S. real estate through a Leveraged Blocker. Each assumed fact is purely hypothetical and not based on any actual fund or investment.

FACTS

- Leveraged Blocker established with a debt to equity ratio of 3:1.
- Non-U.S. investors comprised of three institutional investors from the UK, Germany, and France, each of whom will hold one-third of the Leveraged Blocker.
- Each non-U.S. investor invests in the Leveraged Blocker — 75% as debt with an interest rate of 15%[10] and 25% as equity with a total equaling $100 million.
- Leveraged Blocker contributes the $100 million to a real estate private equity fund for an investment in the fund — the fund invests the full $100 million in one U.S. real estate asset.
- The fund holds the investment for two years and disposes of the investment for $160 million with $148 million being distributed to investors after profit interest paid to the General Partner of $12 million (20% of the $60 million profit).
- The fund distributes $148 million to the Leveraged Blocker — $100 million as return of capital and $48 million as profit.
- The Leveraged Blocker's net taxable income is $25.5 million ($48 million profit from the investment less $22.5 million of accrued interest).
- Thus, the Leveraged Blocker's U.S. corporate income tax is approximately $8.9 million (35% corporate income tax rate applied to the $25.5 million net profit).
- Leveraged Blocker has approximately $139.1 million to distribute to the non-U.S. investors ($148 million proceeds from the investment less the $8.9 million tax).
- The Leveraged Blocker distributes $75 million as debt repayment, $25 million as return of equity and $22.5 million as interest.
- The remaining approximately $16.6 million to distribute is distributed tax free in a liquidating distribution of the Leveraged Blocker (if the real estate fund owned other real estate assets, the distribution could instead constitute dividends, subject to withholding tax at a 5% rate.).
- Thus, the non-U.S. investors receive approximately $139.1 million in net proceeds out of the $148 million gross proceeds the Leveraged Blocker received from the fund ($148 million less $8.9 million).
- The effective U.S. tax rate on the non-U.S. investors' investment is approximately 18.5% ($8.9 million in tax paid, divided by the $48 million profit on the investment), a substantial savings over the 54.5% rate that would have applied using a standard Cayman Islands blocker.

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ENDNOTES

1. Non-U.S. governmental investors have available to them additional structuring alternatives that can minimize the impact of FIRPTA, specifically through non-controlling investments in REITs. Certain strategies that non-U.S. governments have used in the past have come under scrutiny by the IRS; however, non-U.S. governments can use the strategies contained in the paper, as well as others, to minimize the impact of FIRPTA on their U.S. real estate investments.
2. The ranges of effective tax rates provided in Table 1 are illustrative and depend on a number of factors including (but not limited to) the exit strategy for the particular investment, the type of income generated (gains vs. current income), the ability to effectively use leverage, interest rates on debt, the application of a tax treaty in the investor's home jurisdiction, and the number of investors participating in a given investment structure. Each investment is unique, but generally these structures will reduce U.S. tax rates applicable to non-U.S. investors in U.S. real estate.
3. A zero rate of U.S. tax could apply if a non-U.S. investor is able to sell shares of a private "domestically controlled" REIT. Otherwise, effective U.S. tax rates are dependent on the type of investment the REIT makes and domicile of non-U.S. investors, as more fully described in Endnote 1. REIT disposals of U.S. real property trigger tax to non-U.S. investors upon distribution at rates up to 35%. A second withholding tax applies upon distribution, which may be limited by treaty.
4. In general a non-U.S. investor will incur a U.S. tax filing obligation in a private REIT investment where the REIT is not "domestically controlled," or where the REIT disposes of U.S. real property interests and distributes the proceeds to the non-U.S. investor.
5. Reduced to the lower end of the cost range if blocker resides in a treaty jurisdiction; however, most blocker entities reside in low-tax jurisdictions to avoid the imposition of local taxes on the blocker's profits.
6. For example, residents of Austria, Belgium, Denmark, France, Germany, Luxembourg, the Netherlands, Norway, Switzerland, and the UK are eligible for a 0% withholding rate on interest paid by U.S. obligors.
7. In general, income from investments by non-U.S. investors in public REITs are not subject to FIRPTA tax so long as the investor's investment is limited to no more than 5% of the REIT.
8. In general, the same jurisdictions as those noted in Endnote 6 would be relevant here.
9. A refundable withholding tax may apply on return of capital distributions.
10. This interest rate will be determined by reference to a number of criteria, including expected creditworthiness and type of the underlying assets and what an arm's length lender would expect to receive on a loan to an entity holding those assets.

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