

Inbound Investment For U.S. Real Estate



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Course Materials

Any information taken from these course materials should be applied in a manner that is consistent with the context provided by the presenters.



Agenda



- Who Invests in U.S. Real Estate
- U.S. Taxation of Foreign Persons
- What is FIRPTA
- Ways to Invest in U.S. Real Estate



WHO INVESTS IN U.S. REAL ESTATE?

Investing In U.S. Real Estate

- Investment activity in the US commercial real estate property sector surged in 2021, increasing in volume for five of the six quarters following the onset of the pandemic.
- Investment in commercial properties in 2021 totaled nearly \$809 billion
 - This represents an increase over 2020 of over 80%.
- The previous record high in 2019 was 35% lower.
- This was despite uncertainty on inflation levels, supply chain constraints, reopening measures, and travel restrictions.

Investing In U.S. Real Estate

- Prior to the second quarter of 2020, foreign investors accounted for as much as 20% of total real estate investment activity, or \$100 billion annually.
- Global investors had their own domestic concerns during the height of the pandemic, coupled with evolving restrictions on international travel.
 - Volumes into the United States from abroad dried up to as low as only 7% of total US real estate deal activity, the lowest level seen since the global financial crisis of 2007–2008.

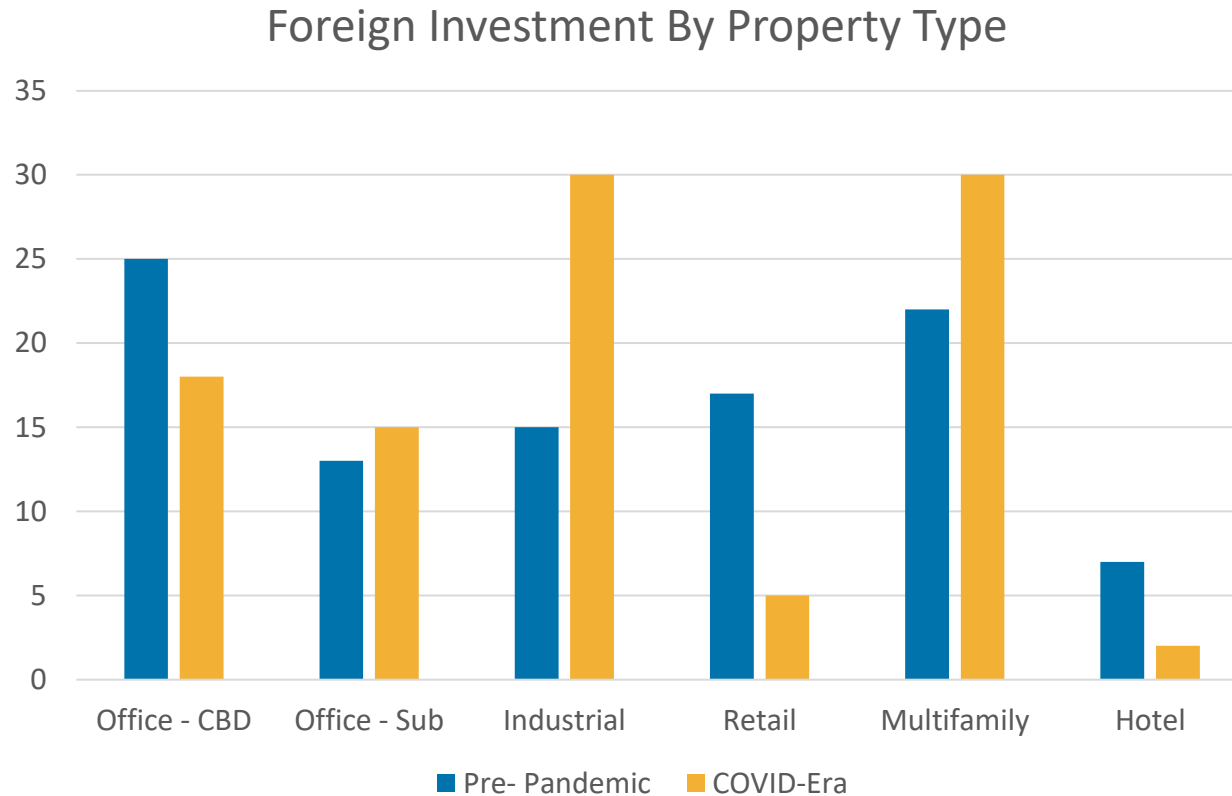
Investing In U.S. Real Estate

- In the second half of 2021 as limitations on travel were lifted with the vaccine rollout and optimism around new patterns for growth increased.
- Foreign investment saw an uptick with a \$53 billion bump in the second half, accounting for an overwhelming majority of the \$69 billion annual total from 2021.
- There is strong momentum to the return of international investment into the United States.
 - Their initial asset and geographic concentrations have, however, indicated a shift in what foreign investors may be targeting going forward.

What Does Foreign Investment Look Like?

- **Industrial, multifamily properties stayed hot; retail, office spaces lost share**
- There has been a noticeable change in pattern in the recent trends of foreign investors in comparison to their traditional property type preferences.
- On average over the three years prior to the pandemic, foreign investors overwhelmingly preferred office properties with more than a 38% share of total investment volumes, particularly concentrated in metro central business districts (CBDs) compared to suburban office parks at 25% to 13% respectively.

Exhibit 1



Industrial Investment

- **Industrial** has become the new primary target for foreign investors and grew by a sizable margin, from 15% to more than 30% of all foreign capital invested since Q2 2020.
- Foreign investors are optimistic in this sector about macro trends toward larger-scale last-mile distribution and just-in-time logistics demand.
- CBRE reports the rents in the sector have topped a record high \$9.10 per square foot, and net absorption hit a 30-year annual record at 432.5 million square feet—all signals of increased demand aimed at combatting supply chain disruptions and rising costs of transportation and construction.

Multifamily Investment

- **Multifamily** gained an increasing share of the pie, coming in second only to industrial at just under 30% of all capital invested from foreign entities into US commercial real estate.
- Foreign investors have previously targeted the sector nearly two-thirds less than domestic investors.

Retail Investment

- **Retail** has made the most notable downward shift, shedding 12% from the historic average investment share.
 - From a 17% concentration to just under 5% since the onset of the pandemic.
- While domestic investors have begun reinvesting into the sector, it still appears to be facing too many potential obstacles to entice much attention from the international community.
 - long-term work-from-home and e-retail patterns, and
 - inconsistent consumer spending in the wake of COVID-19 variants.

Office Investment

- **Office** has traditionally been a favorite of international investors and has historically often consisted of trophy assets in prime CBD locations.
- Dropped 7% from the pre-pandemic average of 25% to 18%, the second steepest pullback behind retail.

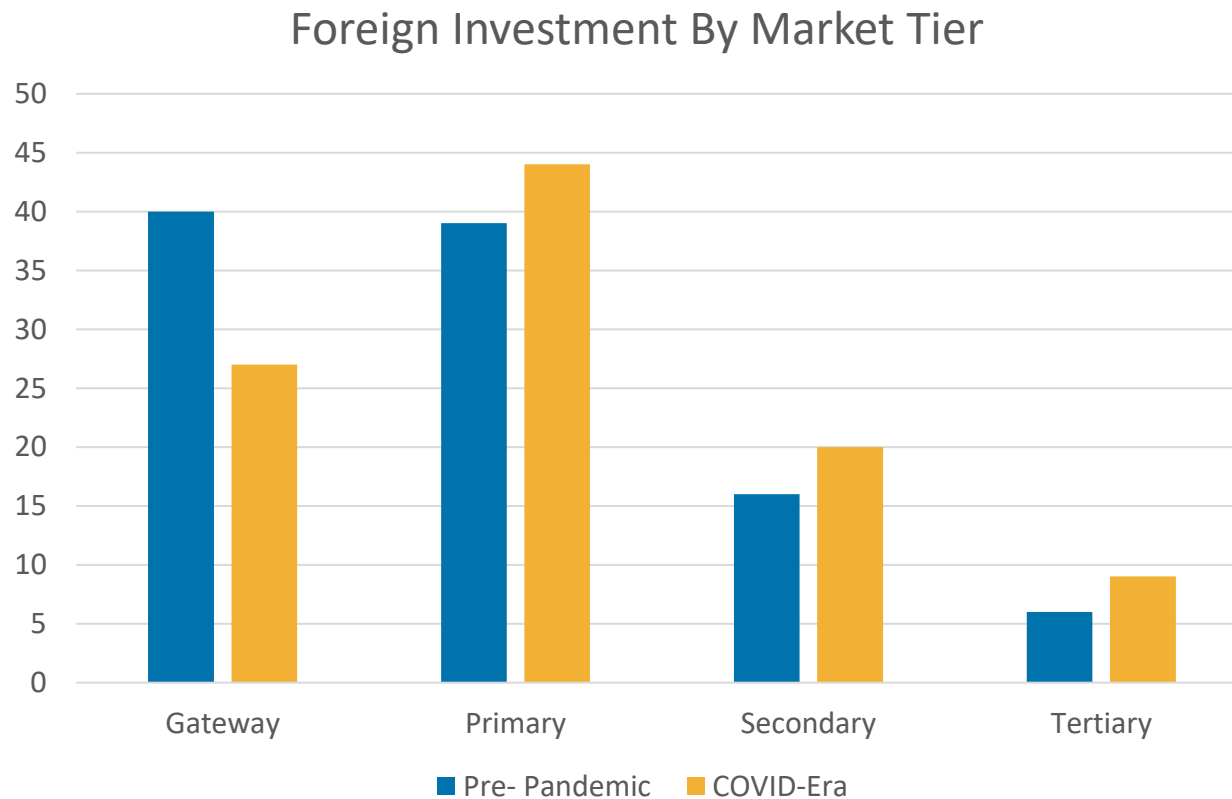
Major Gateway Exodus

- Six major US gateway markets—Boston, Chicago, Los Angeles, New York, San Francisco, and Washington, D.C.
 - have, until the onset of the pandemic, historically accounted for just under 50% of all foreign investment activity into US real estate since 2001.
- This is very different from domestic investor behavior, which has invested in the gateway markets at a 29% level since 2001.

Gateway Exodus

- Foreign concentration in gateways has declined in recent years, down to 40% on average over the past three years prior to the pandemic.
- Since Q2 2020 the draw toward some of the largest metropolitan areas has tapered off even further as seen in figure 2.

Exhibit 2



Why Gateway Exodus?

- Foreign investors are following the pandemic-era flight out of major metro areas and the de-densifying shifts in population bases.
 - Urban cores of major metro areas notched the first annual population decline in a decade in 2020, compared to increases in suburban migration during the onset of the pandemic.
- Sunbelt cities and others such as Dallas, Charlotte, Denver, Nashville, and Austin are drawing particular interest with high fundamental growth combined with low tax incentives.

Types of Foreign Funding of Investment

- Primary composition of foreign investor buyer types is largely the same as in the past.
- On average, institutional investors—equity and pension funds, sovereign wealth funds, insurers, banks, and investment managers—have been the predominant sources of international capital at 63%.
- Since the second quarter of 2020, the composition has followed a recent upward trend to 70%, the highest concentration of institutional investors in over five years, and in line with the pre-pandemic trajectory of the sector.

Where is Foreign Funding Coming From?

- Canada has always been the largest source of foreign investment in US real estate, and given proximity to the United States and familiarity with US real estate, Canadian activity increased more than doubled.
- Canadian investment generally averages \$13 billion annually, which accounts for about 30% of the global sources.
- In 2021, Canadian volumes jumped to \$27 billion, a 115% increase and the highest output volume from a single country in a long time. That volume increased Canada's global share invested into the United States to 42% of all foreign investor volume, also a record.

Where is Foreign Funding Coming From?

- **Other movers in the international community come from the Asia Pacific region.**
- Investors from Singapore in 2021 exceeded their combined past three annual volumes into US real estate, topping \$16 billion last year.
- Logistics and multifamily have been their main areas of interest.

Where is Foreign Funding Coming From?

- Investors from China, weighed down heavily by their own domestic, government-mandated deleveraging initiatives and industry complications from troubled property developers, have turned away from the US market altogether for the third straight year.
 - Prior to 2019, Chinese investors poured \$5 billion annually into the US property markets, good for roughly 9% of total global funding sources.
 - Over the past three years, those totals have dried up, even more so since the beginning of the pandemic.
 - Chinese investors are yet to surpass the \$1 billion invested since 2018 and notched the lowest point in recent history in 2021 at only \$390 million—less than 1% of total international investment activity.

Future Foreign Investment - Summary

- While foreign investment is flowing back into US commercial real estate, a few patterns have formed that indicate a shift in preferences after nearly two decades of generally consistent behavior.
- Trophy offices in New York and Los Angeles are no longer the only top targets in global investor portfolios.
- Logistics hubs and distribution centers in cities such as Phoenix, Seattle, and Atlanta have emerged right alongside them.
- Institutional investors are still the leaders in the space, and early moves from Canada and Singapore are setting the stage for the types of assets the international community could be targeting in the months and years ahead.

Future Foreign Investment - Summary

- Foreign investors are seemingly treading into new territory:
 - unfamiliar asset classes, secondary cities—all within a fundamental environment with staying power.
 - The US market continues to be an overwhelming leader in the global commercial real estate space and, despite a period of instability, draws in investors from abroad thanks to a wide range of assets and ease of doing business.

Capitalizing on the Foreign Shift

- Real estate operators and developers should consider strategic partnerships with investors from abroad who are unfamiliar with running or building a specific asset class in an unfamiliar city—be the boots on the ground.
- As international investors approach the U.S., real estate financiers should continue to offer consistency in underwriting and ease of doing business that foreign investors seek specifically from the US market.

Capitalizing on the Foreign Shift- Cont'd

- Advisory leaders in the US real estate community—consultants, brokers, etc.—have a unique opportunity to offer consistent, reliable, market insight to unfamiliar investors through the next stage of this real estate cycle, establishing long-lasting partnerships in the process.

Capitalizing on the Foreign Shift- Cont'd

- Agility and flexibility were key for the earliest re-entrants targeting the US real estate market from abroad.
- Those already with US offices were able to avoid travel restrictions altogether.
- International investors should consider establishing satellite operations in the United States, allowing for quicker access to capital, financing, and physical assets.



U.S. TAXATION OF FOREIGN PERSONS

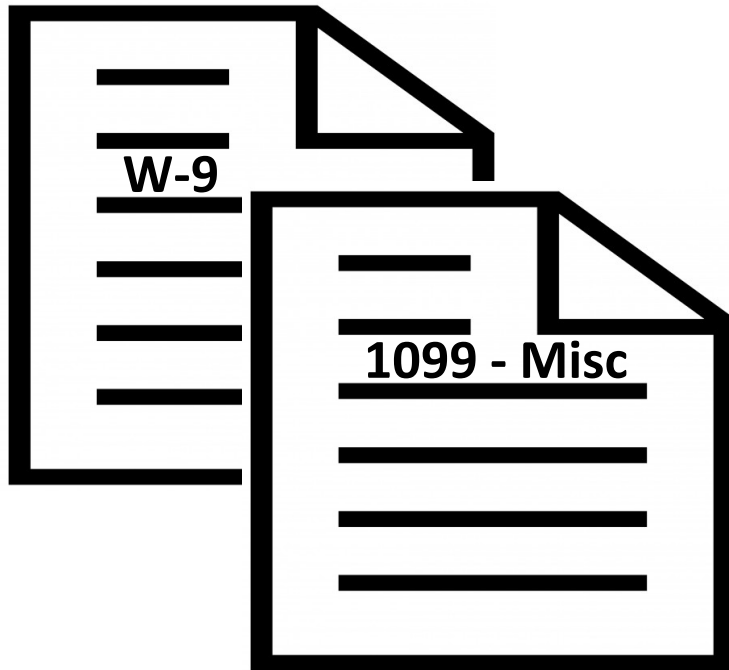
U.S. Taxation of Foreign Persons

- There are two regimes of tax in the United States.
- Under the first regime, a foreign person may be taxed on a net basis at normal U.S. tax rates.
 - on their income that is effectively connected with the conduct of the U.S. trade or business (ECI).

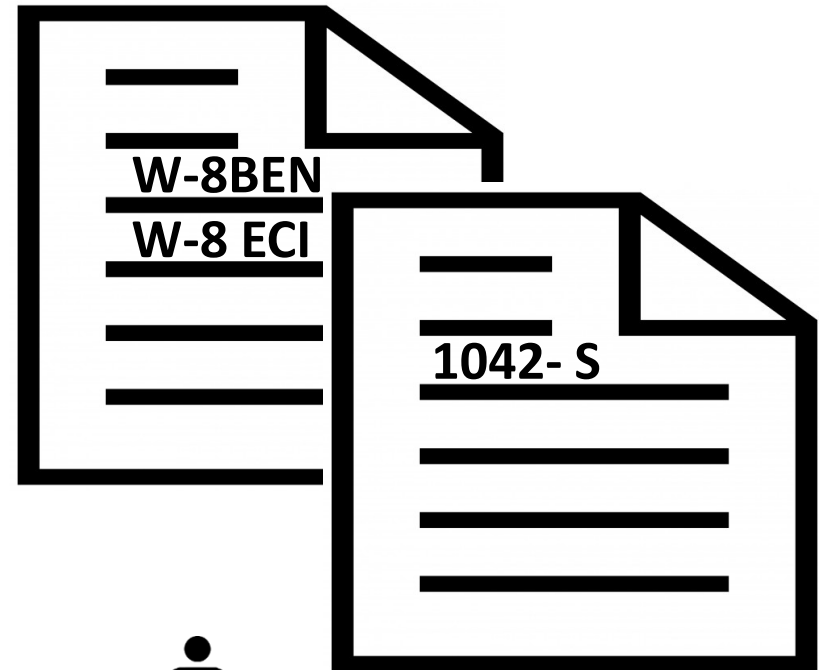
U.S. Taxation of Foreign Persons

- Under the second regime, a foreign person is subject to a 30% gross income tax on U.S. source income that is “fixed or determinable annual or periodical” (FDAP) and that is not ECI.
- FDAP income generally is income of a passive type, and includes interest, dividends, rents, salaries, wages, premiums, annuities, and remunerations.
- Generally, the U.S. tax on this type of income is collected through withholding by the payor.
- While the statutory withholding tax rate is 30%, an income tax treaty may provide for a reduced rate or eliminate the tax entirely.

Potential Documents Needed



U.S. Person



Foreign Person

U.S. Taxation of Foreign Persons

- U.S. INCOME TAXATION
 - U.S. Trade or Business Income
 - Is an ill-defined term but generally means activities undertaken in the United States that are considerable, continuous and regular.
 - A foreign person may be engaged in a U.S. trade or business as a result of its own activities in the United States or as a result of the activities conducted in the United States by its dependent agents.

U.S. Taxation of Foreign Persons

- **Partnerships** - A foreign person who is a partner in a partnership (domestic or foreign) that is engaged in a U.S. trade or business will be deemed to be engaged in that U.S. trade or business, regardless whether the partner is a limited or general partner.
- **Estate or Trust** - Similarly, a foreign person who is the beneficiary of an estate or trust that is engaged in a U.S. trade or business is deemed to be engaged in the business of that estate or trust.
- **Corporations** - In contrast, a foreign person's status as a shareholder or creditor of a corporation that is engaged in a U.S. trade or business does not cause the foreign person to be treated as engaged in the business of that corporation.

U.S. Real Estate Activities As a Trade or Business

- Whether the U.S. real estate activities of a foreign person constitute a U.S. trade or business is a question of fact that depends on the circumstances of each case.
- Examples:
 - Ownership of a single piece of U.S. real estate that is leased to tenants on a triple-net basis does not rise to the level of engaging in a U.S. trade or business.
 - Ownership of several U.S. real properties with respect to which the foreign owner's management activities (performed directly or through an agent) are substantial, regular, and continuous constitutes engaging in a U.S. trade or business.

U.S. Taxation of Foreign Persons

- U.S. INCOME TAXATION IMPOSED ON U.S. SOURCE INCOME OF FOREIGN PERSONS
 - U.S. Source Income includes:
 - Rents derived from U.S. real and U.S. personal property
 - Royalties derived from use or privilege of using intangible property in the U.S.
 - Dividends from U.S. domestic corporations
 - Interest paid by U.S. payor except:
 - Interest on U.S. bank deposits
 - “portfolio interest”
 - Capital gain is generally sourced to the residence of the seller.
However, under FIRPTA, gain on sale of U.S. real estate or stock in a U.S. real property holding corporation is U.S. sourced.

U.S. Taxation of Foreign Persons – Cont'd

- U.S. Trade or Business Income
 - U.S. source ECI is taxed on a net basis under the same income tax rates applicable to U.S. citizens, residents and to U.S. corporations.
 - “Net election” allows foreign persons to treat real estate activities as a trade or business
 - usually a beneficial because it allows the foreign person to deduct property related expenses from rental income
 - **Under FIRPTA, gain or loss on disposition of a U.S. real property interest (USRPI) is ECI.**

U.S. Taxation of Foreign Persons


- Foreign Corporations
 - Like domestic corporations, taxed at 21% on ECI (net income).
 - Additional 30% “branch profits” tax on a “dividend equivalent amount”.
 - Rate is often reduced by tax treaty.

Branch Tax Basics

- A foreign corporation is subject to the branch profits tax on ECI that it derives from the direct conduct of a U.S. trade or business or on ECI it derives through a partnership that is engaged in a U.S. trade or business.
- A foreign corporation also is subject to the branch profits tax on gain from the disposition of a USRPI.
 - but not with respect to gain from the disposition of a USRPI that is stock of a domestic corporation that is a U.S. real property holding corporation (USRPHC).

U.S. Filing Requirements

- A foreign person that derives income and is engaged in a U.S. trade or business must file a U.S. federal income tax return, unless an exception applies.
 - A foreign corporation must file a Form 1120-F,
 - A nonresident alien individual must file a Form 1040NR.
- A foreign person that is not engaged in a U.S. trade or business at any time during the taxable year generally is not required to file a U.S. federal income tax return if the person's U.S. income tax liability for the taxable year is fully satisfied by withholding.
 - BE CAREFUL! If the foreign corporation is relying on a treaty exception and does not file a tax return with Form 8833, Treaty-Based Return Position Disclosure, attached, it can be penalized \$10,000.



FIRPTA ISSUES AND DISCUSSION

Foreign Investment in Real Property Tax Act

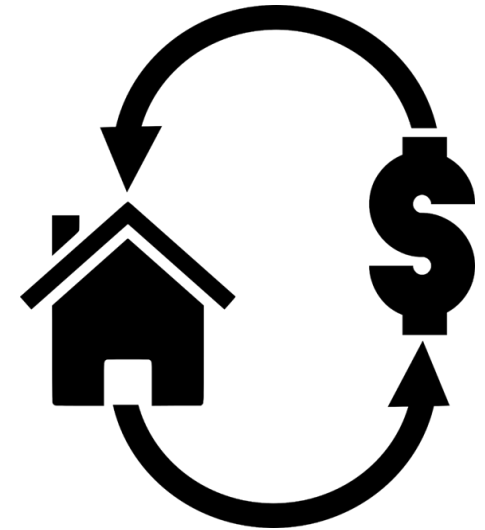
- If you are buying property from a foreign person, The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) may apply to your purchase.



Foreign Investment in Real Property Tax Act

Not just sales...

- Foreign Person Disposing of U.S. real property interest by:
 - Sale
 - Exchange
 - Gift
 - Distribution to shareholders of a corporation or to beneficiaries of a trust or estate
 - Any other transfer



What is FIRPTA?

- FIRPTA is a tax law that imposes U.S. income tax on foreign persons disposing of U.S. real estate.
- Under FIRPTA, if you buy U.S. real estate from a foreign person, you may be required to withhold 15% of the amount realized from the sale.
- The amount realized is normally the purchase price.
- The withholding is how the U.S. government collects U.S. tax owed by foreign sellers.



How Does FIRPTA Work?

- If the law applies to your purchase, then within 20 days of the sale, you are required to file Form 8288 with the IRS.
- Along with the form, you submit 15% withholding.
- It is important to know about FIRPTA, because if you do not withhold the required amount, file the form on time, and submit the withholding, penalties do apply.



**U.S. Withholding Tax Return for Dispositions by Foreign
 Persons of U.S. Real Property Interests**

OMB No. 1545-0902

▶ Go to www.irs.gov/Form8288 for instructions and the latest information.

If this is an amended return, check here

Complete Part I or Part II. Also complete and attach Copies A and B of Form(s) 8288-A.
 Attach additional sheets if you need more space.

Part I To Be Completed by the Buyer or Other Transferee Required To Withhold Under Section 1445(a)

1 Name of buyer or other transferee responsible for withholding. See instructions.	Identifying number
Street address, apt. or suite no., or rural route. Do not use a P.O. box.	
City or town, province or state, country, and ZIP or foreign postal code	
Phone number (optional)	
2 Description and location of property acquired	
3 Date of transfer	4 Number of Forms 8288-A attached
5 Complete all items that apply. Enter dollar amounts on applicable lines.	
a Amount subject to withholding at 15% ▶ _____	
b Amount subject to withholding at 10% ▶ _____	
c Withholding is at a reduced rate. See instructions ▶ <input type="checkbox"/>	
6 Total amount withheld	

Part II To Be Completed by an Entity Subject to the Provisions of Section 1445(e)

1 Name of entity or fiduciary responsible for withholding. See instructions.	Identifying number
Street address, apt. or suite no., or rural route. Do not use a P.O. box.	
City or town, province or state, country, and ZIP or foreign postal code	
Phone number (optional)	
2 Description of U.S. real property interest transferred or distributed	
3 Date of transfer	4 Number of Forms 8288-A attached
5 Complete all items that apply. Enter dollar amounts on applicable lines.	
a Amount subject to withholding at 15% ▶ _____	
b Amount subject to withholding at 10% ▶ _____	
c Amount subject to withholding at 21% ▶ _____	
d Withholding is at a reduced rate. See instructions ▶ <input type="checkbox"/>	
e Large trust election to withhold at distribution ▶ <input type="checkbox"/>	
6 Total amount withheld	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here

Signature of withholding agent, partner, fiduciary, or corporate officer	Title (if applicable)	Date	
Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed PTIN
Firm's name ▶	Firm's EIN ▶	Phone no.	
Firm's address ▶			

FIRPTA Taxation and Withholding

- Sales and other dispositions of “U.S. real property interests” (USRPIs) by foreign persons are subject to U.S. income tax and U.S. tax withholding under §1445.
 - The withholding rate is a percentage of the gross amount realized on the disposition and the type of property disposed of:
 - 0% for the disposition of property with a purchase price of \$300,000 or less if property will be used by the transferee as a residence;
 - 10% for amounts realized in excess of \$300,000 but not in excess of \$1 million if property will be used by the transferee as a residence;
 - 15% for all other dispositions and types of property.
 - The buyer/transferee must file IRS Forms 8288 and 8288-A to report the amount withheld and transmit the amount withheld to the IRS within 20 days after the disposition.

–

U.S. Real Property Interests (USRPI)

- §897(c)(1)(A)(i): An interest in real property located in the United States.
- §897(c)(1)(A)(ii): Any interest (other than an interest solely as a creditor) in a U.S. domestic corporation that was a United States real property holding corporation (“USRPHC”) at any time during the shorter of: (1) the period during which the seller held such interest, or (2) the 5-year period ending on the date of The disposition of such interest.

U.S. Real Property Interests (USRPI)

- §897(c)(1)(B): However, a corporation is not a USRPHC if (1) as of the date an interest in the corporation is disposed of, it did not own any USRPIs, (2) all USRPIs owned by the corporation at any time during the shorter of the above two periods were disposed of in fully taxable transactions, and (3) neither the corporation nor any predecessor was a RIC or a REIT at any time during those periods (sometimes called the FIRPTA “cleansing rule”).
- §897(c)(2): Definition of USRPHC – FMV of domestic corporation’s USRPIs \geq 50% of: the FMV of the sum of the corporation’s USRPIs, plus the corporation’s real property interests outside the U.S., plus any other trade or business assets of the corporation.

- The term “real property” includes:
 - Land,
 - Unsevered natural products of the land (e.g. growing crops and timber, mines, wells and other natural deposits;
 - Improvements (buildings),
 - Personal property “associated with the use” of real property (e.g. fixtures)

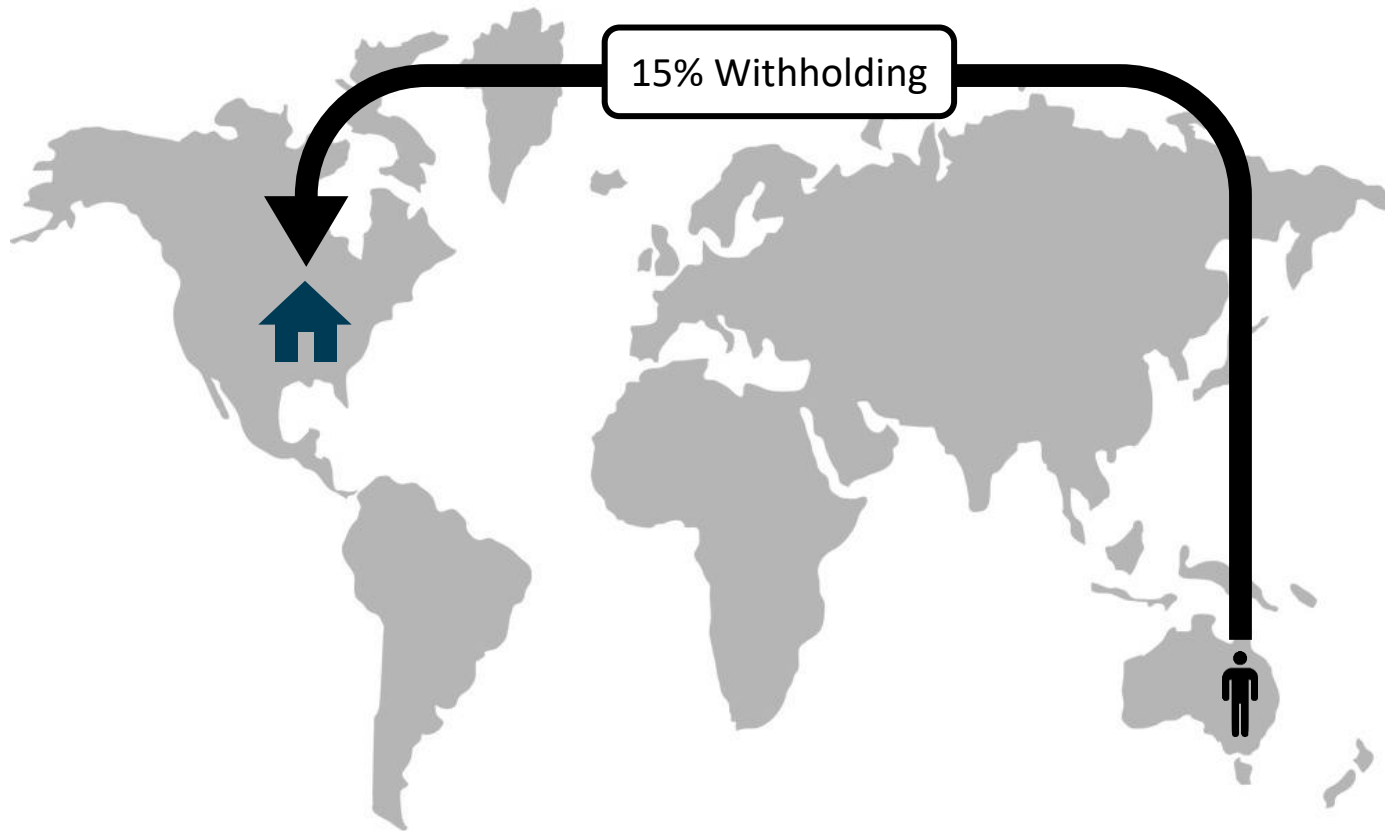
- The term “interest in real property” includes:
 - Fee ownership and co-ownership of land;
 - improvements to land,
 - leaseholds of land or improvements to land,
 - options to acquire land or improvements to land,
 - and options to acquire leaseholds of land or improvements to land.
 - Appreciation rights.
 - The legislative history also includes easements.

“Cleansing” Exception

- If stock is sold in a corporation that did not own any USRPI’s withholding may not apply.
- A foreign person disposing of an interest in a U.S. corporation must establish that the interest was not a USRPI at the date of disposition by either:
 - Obtaining a statement from the corporation or
 - Obtaining a determination from the IRS
- The taxpayer does not have to forward this statement to the IRS. ***However, they cannot rely on the corporate statement unless the corporation has met notification requirements below.***
- Effectively, the shareholder has until the due date, including any extensions, of the tax return to request the statement. The corporation then has to furnish the statement to the shareholder and the corporation has 30 days with which to notify the IRS from that point.

Sell

First question: Is the seller a foreign person?



Remember, a Foreign Person is...

- Person or entity not required to file a US resident tax return (on worldwide income)
- U.S. company owned by foreign person



FIRPTA Taxation and Withholding

- Since FIRPTA withholding is based upon the gross purchase price of the real property, it may in some cases exceed the seller's tax due on the transaction.
 - The taxpayer may apply to the IRS on Form 8288-B to reduce the withholding amount to the taxpayer's maximum tax liability with respect to the transaction.
 - Calculates withholding on net income versus gross.
 - Requires IRS approval
 - Due to the time required to process the application, Form 8288-B should be filed at least 90 days prior to the closing of the sale.
- The Foreign Transferor (Seller) files an income tax return to report **net** gain/loss and claim a refund.
 - FIRPTA withholding amounts are available as credits against the taxpayer's income tax liability

(Rev. February 2016)
Department of the Treasury
Internal Revenue Service

▶ Please type or print.

1 Name of transferor (attach additional sheets if more than one transferor)	Identification number
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Street address, apt. or suite no., or rural route. Do not use a P.O. box.

City, state or province, and country (if not U.S.). Include ZIP code or postal code where appropriate.

2 Name of transferee (attach additional sheets if more than one transferee)	Identification number
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Street address, apt. or suite no., or rural route. Do not use a P.O. box.

City, state or province, and country (if not U.S.). Include ZIP code or postal code where appropriate.

3 Applicant is: Transferor Transferee

4a Name of withholding agent (see instructions)	b Identification number
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c Name of estate, trust, or entity (if applicable)	d Identification number
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5 Address where you want withholding certificate sent (street address, apt. or suite no., P.O. box, or rural route number)	Phone number (optional)
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City, state or province, and country (if not U.S.). Include ZIP code or postal code where appropriate.

6 Description of U.S. real property transaction:

- a** Date of transfer (month, day, year) (see inst.) **b** Contract price \$
- c** Type of interest transferred: Real property Associated personal property
 Domestic U.S. real property holding corporation
- d** Use of property at time of sale: Rental or commercial Personal Other (attach explanation)
- e** Adjusted basis \$
- f** Location and general description of property (for a real property interest), description (for associated personal property), or the class or type and amount of the interest (for an interest in a U.S. real property holding corporation). See instructions.

- g** For the 3 preceding tax years:
- (1)** Were U.S. income tax returns filed relating to the U.S. real property interest? Yes No
If "Yes," when and where were those returns filed? ▶
- (2)** Were U.S. income taxes paid relating to the U.S. real property interest? Yes No
If "Yes," enter the amount of tax paid for each year ▶

7 Check the box to indicate the reason a withholding certificate should be issued. See the instructions for information that must be attached to Form 8288-B.

- a** The transferor is exempt from U.S. tax or nonrecognition treatment applies.
- b** The transferor's maximum tax liability is less than the tax required to be withheld.
- c** The special installment sales rules described in section 7 of Rev. Proc. 2000-35 allow reduced withholding.
- 8** Does the transferor have any unsatisfied withholding liability under section 1445? Yes No
See the instructions for information required to be attached.
- 9** Is this application for a withholding certificate made under section 1445(e)? Yes No
If "Yes," check the applicable box in **a** and the applicable box in **b** below.
- a** Type of transaction: 1445(e)(1) 1445(e)(2) 1445(e)(3) 1445(e)(5) 1445(e)(6)
- b** Applicant is: Taxpayer Other person required to withhold. Specify your title (e.g., trustee) ▶

Under penalties of perjury, I declare that I have examined this application and accompanying attachments, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature Title (if applicable) Date

FIRPTA Taxation and Withholding (Cont'd)

- Assets (including USRPIs) held by a partnership are treated as property held proportionately by its partners for purposes of tax liability under FIRPTA on a sale of an interest in the partnership.
- FIRPTA withholding is required on a foreign partner's disposition of an interest in a domestic or foreign partnership in which $\geq 50\%$ of its gross assets (by value) and $\geq 90\%$ of its gross assets (by value) consists of USRPIs, and USRPIs plus any cash and cash equivalents, respectively.
- No FIRPTA withholding is required if the transferee of a partnership interest receives a written certification from the partnership signed no earlier than 30 days before the disposition that the 50% and/or 90% thresholds are not satisfied, unless the transferee has actual knowledge that the certification is false.
- If a partnership has ECI, including taxable income or gain from USRPIs, the partnership must withhold U.S. tax on a foreign partner's allocable share of such U.S. income and gain.

FIRPTA Taxation and Withholding (Cont'd)

- **Publicly Traded Stock** - Tax liability is imposed on gain on sale of publicly traded stock in a USRPHC only if the seller held more than 5% of such class of stock (10% for publicly-traded REITs) any time during the shorter of
 - (1) the period during which the seller held such interest, or
 - (2) the 5-year period ending on the date of the disposition of such interest.
 - But no FIRPTA withholding on sale of a publicly-traded stock (§1445(b)(6)).

Other Exceptions for Partnerships

- FIRPTA Rules require a **domestic** partnership with one or more foreign partners to withhold tax on the disposition of a USRPI on each foreign partner's distributive share of the gain realized by the partnership on the disposition.
- Partnership withholding rules generally require a partnership—whether domestic or foreign—to withhold tax on the amount of the partnership's ECI that is allocable to its foreign partners.
- **General partnership withholding rules supersedes withholding under FIRPTA when a domestic partnership with a foreign partner disposes of a USRPI.**

FIRPTA Taxation and Withholding (Cont'd)

- USRPI does not include any interest in a domestically controlled REIT defined as a REIT whose stock at all times during a specified “testing period” was less than 50% owned (directly or indirectly) by foreign persons.
- FIRPTA does not apply to “qualified foreign pension funds.”
- Stock in a REIT which is held (directly or indirectly through one or more partnerships by a “qualified shareholder” is not a USRPI.
 - “Qualified shareholder” includes certain foreign partnerships, certain publicly-traded entities that are residents of treaty countries and certain publicly-traded foreign limited partnerships. Definition is very complex. Does not apply if an “applicable investor” actually or constructively owns more than 10% of the REIT’s stock.

Liability For Withholding

- Every person required to withhold FIRPTA tax is liable for that tax.
 - Therefore, a person who is required to withhold but who fails to do so is liable for the payment of the tax, along with potential penalties and interest.
 - The potential consequences to the party required to withhold depend on whether the foreign person subject to FIRPTA satisfies its U.S. tax.

Liability For Withholding – Cont'd

- If a person that is required to withhold under §1445 fails to do so, and the foreign person that is subject to withholding fails to satisfy its tax liability by filing a return and paying any tax due (or obtaining a withholding certificate establishing its maximum tax liability to be zero),
 - **the withholding tax will be assessed and collected from the person required to withhold. Also, that person may be subject to any applicable civil or criminal penalties.**

Liability For Withholding – Cont'd

- A person that fails to properly withhold tax under §1445 will be relieved of its withholding tax liability if the foreign person that is subject to withholding satisfies its tax liability with respect to the transaction (or its tax liability is established to be zero) by:
 - the foreign person files an income tax return and pays any tax due on the transfer; or
 - the IRS issues a withholding certificate that establishes that the foreign person's maximum tax liability is zero.

Application of U.S. Nonrecognition Provisions

- Generally, a USRPI may be exchanged by a foreign person in a tax-free exchange (e.g., IRC §332, §351, 368, 721, 1031) only if the foreign person receives a USRPI in exchange.
- Section 332 Liquidations: A domestic liquidating corporation that is a USRPHC and distributes a USRPI to a foreign parent corporation under IRC §332 will not recognize U.S. taxable gain nor will the foreign parent.
 - Exception: Domestic corporation must recognize gain on distribution of stock in a “former USRPHC” which is treated as a USRPI. If the corporation is a USRPHC after the exchange, then it is ok.
- If a foreign corporation distributes a USRPI in a §332 liquidation to its 80% or greater foreign parent, neither the distributee foreign corporation nor the distributing foreign corporation recognizes gain if: (1) distributee would be subject to U.S. income tax on subsequent disposition of the USRPI, (2) basis of the distributed USRPI to the distributee is no greater than distributor’s basis plus any U.S. gain recognized, and (3) any applicable IRS filing requirements are satisfied.

Application of Nonrecognition Provisions

- Section 351: Foreign person transfers a USRPI to a foreign corporation in exchange for stock or as a capital contribution: foreign person generally is not entitled to nonrecognition because stock in a foreign corporation is not a USRPI (Treas. Reg. §1.897-6T(b)(5))
 - Exception : Nonrecognition under §351 applies if (1) contributed property is stock in a USRPHC, (2) transferee corporation's disposition of contributed stock would be subject to U.S. taxation and certain other requirements are satisfied, (3) certain filing requirements are satisfied, (4) substantially all of the stock of the transferee corporation is owned in the same proportions by the same foreign persons who owned the stock of the USRPHC immediately before the transfer, and (5) if any of the stock in the foreign corporation received in the exchange is disposed of within one year, the transferor must recognize the realized gain proportionately. The exception does not apply if the transferred USRPI is not stock in a USRPHC.

Section 351 Example

- F is an NRA who owns 100% of the stock of DC which owns U.S. real estate and is a USRPHC.
- F contributes all of F's stock in DC to FC, a foreign corporation in exchange for all of FC's stock in a §351 exchange.
- If certain filing requirements are satisfied, this is a nontaxable exchange under §351 even though the FC stock received by F is not a USRPI – because FC's subsequent disposition of the DC stock would be subject to U.S. taxation (DC is a USRPHC).

Elimination or Reduction of FIRPTA Withholding Obligation

- Transferor delivers a certificate of non-foreign status to transferee
- Transferor has an amount realized of zero (e.g., a gift)
- Transferred property is not a USRPI:
 - Corporate stock: Transferred interest in a corporation is not a USRPI if the corporation has not been a USRPHC within the shorter of the two periods required, the transferor can request the corporation to certify that fact to the transferor, who will provide a copy of the certification to the transferee before closing. The corporation must file a notice with IRS within 30 days after sending the certification to the transferor.
 - Partnership interest: if general partner signs a statement on behalf of the partnership certifying $\geq 50\%$ of value of partnership's gross assets does not consist of USRPIs or that $\geq 90\%$ of value does not consist of USRPIs plus cash and cash equivalents and provides statement to transferee before closing, no withholding required
 - Estates or Trusts: disposition of an interest in an estate or trust is not presently subject to FIRPTA withholding

Elimination or Reduction of FIRPTA Withholding Obligation

- Nonrecognition Provisions
 - Withholding can be avoided if
 - (1) transferor notifies transferee in writing that under a nonrecognition provision (e.g., IRC §§351, 721, 1031) or under a U.S. tax treaty, transferor has no U.S. taxable gain or loss and
 - (2) transferee must send a copy of such notice to IRS within 20 days after the transfer date
 - Notice of nonrecognition transfer cannot be relied on if (1) only partial nonrecognition (e.g., boot received), or (2) transferee knows or has reason to know that transferor is not entitled to claim nonrecognition treatment

Withholding Certificates

- Withholding Certificate
 - Available when (1) transferor is exempt from U.S. income tax on the transfer, (2) transferor enters into an agreement with IRS to pay tax at a later date, or (3) tax due on the transaction is less than amount required to be withheld and IRS determines that reduced withholding will not jeopardize collection of tax
 - Application for withholding certificate must be filed on or before transfer of USRPI
 - **If withholding certificate obtained before transfer, withholding may be reduced or eliminated at closing as provided in the withholding certificate; if received later and FIRPTA tax has already been withheld, certificate can authorize early or normal refund of excess tax withheld**
 - Application for withholding certificate can be filed with IRS on Form 8288-B for certain categories of transactions, or on forms provided in Rev. Proc. 2000-35

Withholding Certificates – Cont'd

- Withholding Certificate (cont.)
 - If the application is based on actual tax liability being less than required withholding amount (including by reason of nonrecognition provision) proof must be provided that:
 - transferor has no unsatisfied FIRPTA withholding liability as a result of transferor's acquisition of the property,
 - or any such unsatisfied liability will be included in the transferor's maximum tax liability
 - Can be used to allow transferee to withhold on each payment made in a deferred payment sale or installment sale

Withholding Certificates – Cont'd

- Withholding Certificate (cont.)
 - If application submitted to IRS on or before transfer date but still pending at closing, withholding still required at closing but transferee can defer payment of withheld amount to IRS until 20 days after IRS approval or denial of application
 - In a deferred 1031 exchange, a withholding certificate cannot be obtained before closing because replacement property will not be acquired until after closing; thus, FIRPTA withholding required at closing; withholding from sale proceeds will be taxable “boot” to seller; so seller should fund withholding out of other funds if possible

Section 897(i) Election

- Effect of election is to treat a foreign corporation (FC) as a U.S. domestic corporation, solely for purposes of FIRPTA
- FC remains a foreign corporation for all other U.S. tax purposes (e.g., other U.S. income tax provisions and U.S. estate and gift tax)
- Requirements for a valid election:
 - FC must hold a USRPI;
 - FC must be entitled to nondiscriminatory treatment with respect to that USRPI under an applicable U.S. tax treaty;
 - Upon making the election, FC must qualify as a USRPHC; and
 - FC must file election with the IRS in proper form and in a timely manner.

Section 897(i) Election (Cont'd)

- Election can be revoked only with consent of IRS; election remains effective for corporation's entire remaining period of existence
- There must be a binding waiver of any U.S. treaty benefits with respect to any gain or loss from the disposition of a USRPI during the period in which the "i" election is in effect (other treaty benefits should remain available)
- Each shareholder (both foreign and domestic shareholders) must consent to the "i" election and waiver of treaty benefits and, subject to an exception, the consents and waivers must be filed with IRS

Section 897(i) Election (Cont'd)

- Advantages:
 - FC can benefit from certain U.S. nonrecognition provisions that would otherwise be unavailable without becoming a U.S. corporation for non-FIRPTA purposes
 - FC avoids FIRPTA withholding on its disposition of a USRPI (including a deferred 1031 exchange)
- Disadvantages:
 - Disclosure of foreign shareholders to IRS upon filing election
 - Election makes the foreign corporation a USRPHC.
 - Exposes any gain inherent in FC's non-USRPI assets (if any) to U.S. tax on sale of stock in FC by a foreign shareholder
 - all gain on sale of stock is subject to U.S. tax, but if FC did not make an "i" election and sold only its USRPIs, only the gain on the USRPIs would be subject to U.S. tax



WAYS TO INVEST IN U.S. REAL ESTATE

Real Property Ownership Structuring

Common objectives include one or more of the following:

- Preserve anonymity (not buy in own name)
- Consider personal use (not pay rent)
- Minimize or eliminate US income tax on rental income
- Minimize or eliminate US income tax on sale of the property
- Minimize US tax filings
- Insulate against US estate tax
- Insulate against US gift tax

Ways To Invest In U.S. Real Estate

- Is there a “best” way for a foreign person to own U.S. real estate?
- When investing in U.S. real estate a number of important factors should be considered including:
 - risk,
 - economic impacts
 - and the income tax consequences in both the United States and the investor’s home country.

Ways To Invest In U.S. Real Estate

- We are going to briefly examine seven ownership options for those acquiring U.S. real estate:
 - Direct ownership by foreign individual
 - Investment via U.S LLC (Limited Liability Company)
 - Investment via U.S. corporation
 - Investment via foreign corporation
 - Investment via foreign corporation and U.S. corporation or LLC
 - Investment with a shared appreciation mortgage
 - Domestically-controlled REIT (Real Estate Investment Trust)

Ownership Individually

NRA



USRPI

Ownership Individually

- FIRPTA Taxation
 - Gain subject to U.S. taxation. Amount realized subject to FIRPTA withholding.
- Advantages
 - Simplicity.
 - No additional entity tax return.
 - Total control and ownership in NRA.
 - Long-term capital gain tax rate of 20% applies if held for over 12 months, subject to depreciation recapture and §1250 gain.
- Disadvantages
 - No privacy.
 - All income (annual rental or capital gain at exit) is taxed to the NRA.
 - Rental income subject to tax at rate up to 37%
 - Interest and depreciation deductions often reduce or eliminate net income.
 - No estate tax protection.
 - No gift tax protection.
 - U.S. tax filings by the NRA individually.

Ownership Through Disregarded U.S. LLC



Ownership Through Disregarded U.S. LLC

- FIRPTA Taxation
 - Same as previous slide.
- Advantages
 - SMLLC provides property liability protection.
 - SMLLC is disregarded for US tax purposes, so single level of income tax.
 - Long-term capital gain tax rate of 20% applies if held for over 12 months, subject to depreciation recapture and §1250 gain.
- Disadvantages
 - All income (annual rental or capital gain at exit) is taxed to the NRA.
 - Rental income subject to tax at rate up to 37%
 - Interest and depreciation deductions often reduce or eliminate net income.
 - No estate tax protection.
 - No gift tax protection.
 - U.S. tax filings by NRA individually.
 - Local tax law treatment of the LLC should be confirmed (whether characterized as a corporation or a flow-through entity).
 - Form 5472 filing required, which requires LLC to obtain an EIN and NRA to obtain an ITIN.

Ownership Through Single U.S. Corporation



Ownership Through Single U.S. Corporation

- FIRPTA Taxation
 - Stock is a USRPI. Sale of stock is subject to tax and withholding under FIRPTA.
- Advantages
 - No US gift tax on US Co share transfers.
 - Expenses related to maintaining the property likely allowed if Form 1120 is filed.
 - 21% tax rate (plus state income tax) on both rent and capital gain on property disposition
 - Can liquidate company after real estate is sold and no second level tax.
 - No U.S. branch profits tax.
- Disadvantages
 - U.S. estate tax on death (stock in U.S. corporations included in the U.S. taxable estate).
 - 30% dividend withholding tax (unless reduced by treaty).
 - Filing of Form 1120 requires disclosure of 25% non-U.S. owners and balance sheet .
 - Corporation must obtain an EIN, which requires NRA to have an ITIN.
 - Corporation must file Form 5472.

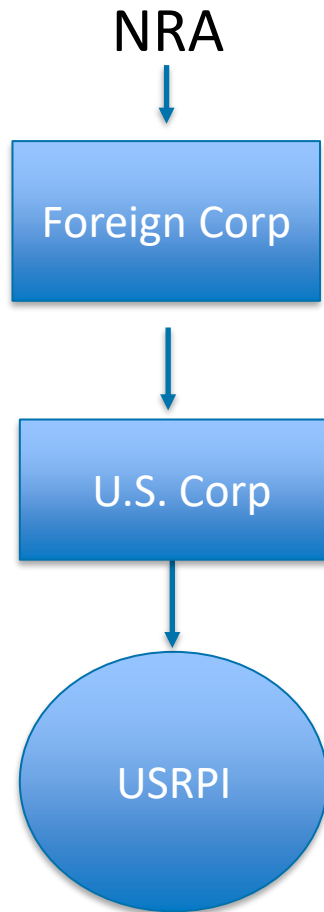
Ownership Through Single Non-U.S. Corporation



Ownership Through Single Non-U.S. Corporation

- FIRPTA Taxation
 - Stock not a USRPI; no U.S. taxation under FIRPTA on sale of stock.
- Advantages
 - No U.S. estate tax (foreign corporation shares are not included in the US taxable estate).
 - No U.S. gift tax on foreign corp. share transfers.
 - Expenses related to maintaining the property likely allowed if Form 1120F is filed.
 - 21% tax rate (plus state income tax) on both rent and capital gain on property sale.
- Disadvantages
 - Branch profits tax (30% on 79%) on any net taxable rental income if a trade or business;
 - If not a T or B, gross rent subject to 30% U.S. withholding by lessee.
 - Branch profits tax risk on sale if corporation remains in existence after property sale unless cash is re-invested in another U.S. trade or business.
 - Withholding under §1446 on taxable income at the highest marginal rate if foreign corp. invests via partnership.
 - Filing of Form 1120F requires disclosure of 50% owners and balance sheet.

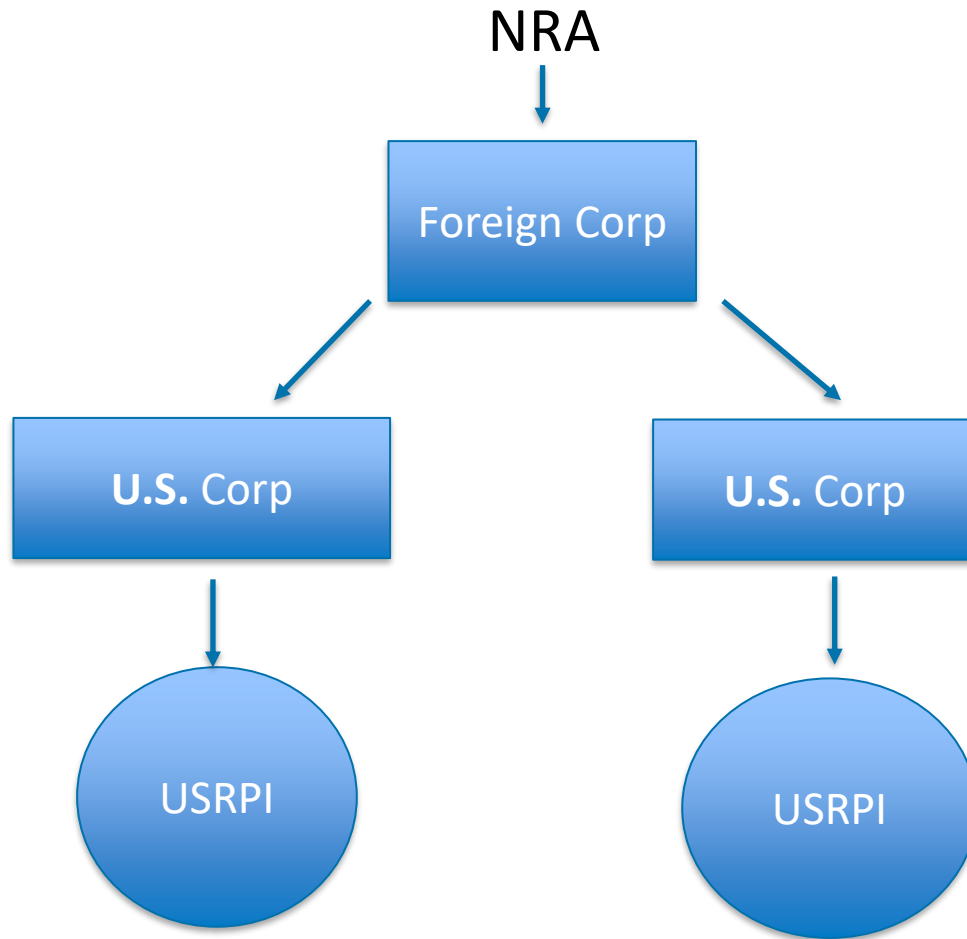
Two-Tier Corporate Structure



Two-Tier Corporate Structure

- FIRPTA Taxation
 - Stock of foreign corp. is not a USRPI; no U.S. taxation under FIRPTA on sale of foreign stock.
 - Taxation and withholding if foreign corp. sells U.S. corp. stock.
 - Sale of property by U.S. Corp. and liquidation of Corp. not subject to FIRPTA if “cleansing rule” applies
- Advantages
 - 21% tax rate (plus state income tax) on both rent and capital gain on property disposition.
 - No US gift tax.
 - No US estate tax.
 - No US branch profits tax.
- Disadvantages
 - 30% dividend withholding tax (unless reduced by treaty).
 - Cannot extract free cash from US Co. without dividend withholding tax until time of liquidation.
 - 30% interest withholding tax (unless reduced by tax treaty) on related party loans (10% ownership test – voting stock).
 - Form 1120 US tax compliance requires disclosure of identity of direct and indirect owners and balance sheet.
 - 5472 filing requirements.

Two-Tier Corporate Structure – Multiple Properties



Two Tier-Structure – Multiple Properties

- FIRPTA Taxation
 - Foreign Corp’s sale of stock of U.S. Corp. 1 or U.S. Corp. 2 is subject to FIRPTA tax and withholding if U.S. Corp. is a USRPHC
 - NRA’s sale of stock of Foreign Corp. not subject to FIRPTA taxation or withholding
 - Sale of property by U.S. Corp. 1 or 2 and liquidation of Corp. not subject to FIRPTA if “cleansing rule” applies
- Advantages
 - Can liquidate each U.S. corp. when the relevant property is sold without second level tax.
 - More protection against a claim on one property affecting entire portfolio.
- Disadvantages
 - Complexity.
 - Cost of multiple entities, multiple tax returns, etc.
 - Cannot file consolidated returns under Foreign Corp.

Ownership Through Shared Appreciation Mortgage

Foreign Corp



Loan – Fixed
interest rate
plus % of
appreciation

US Real Estate
Venture

Shared Appreciation Mortgages

- *Example:* Foreign corporation Y makes a loan of \$1 million to domestic individual Z, secured by a mortgage on residential real property purchased with the loan proceeds.
 - The loan agreement provides:
 - Lender Y is entitled to receive fixed monthly payments from Z, constituting repayment of principal plus interest at a fixed rate.
 - The agreement also provides that Y is entitled to receive a percentage of the appreciation value of the real property as of the time that the loan is retired.
 - The obligation in its entirety is considered debt for federal income tax purposes and receipt of final payments do not constitute a disposition of USRPI.
 - However, if the obligation is sold, FIRPTA applies.

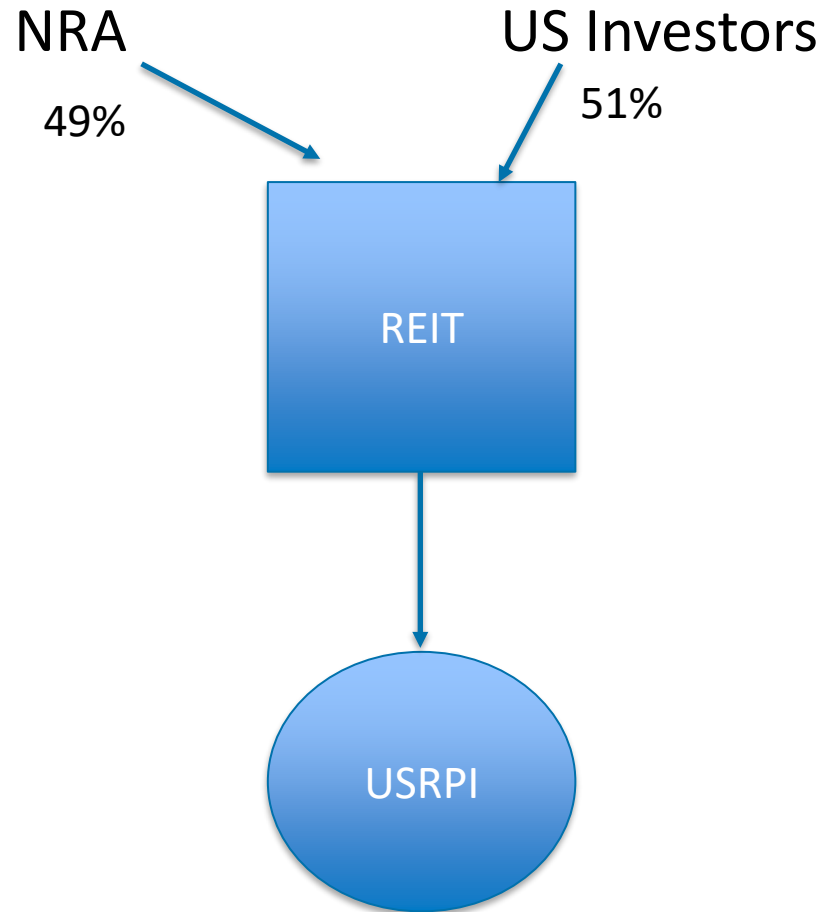
Shared Appreciation Mortgages

- Payments that are treated for U.S. federal income tax purposes as payments of principal or interest on debt obligations do not give rise to gain or loss that is subject to FIRPTA.
- Thus, if foreign corporation Y in the above example holds the shared appreciation mortgage to maturity, it will not be subject to FIRPTA on the receipt of either the monthly payments or the final payment of principal and interest.
- Y would be subject to FIRPTA, however, if it sells the debt obligation prior to the maturity.
- Special rules can apply for installment obligations. Gain or loss realized on the receipt of principal payments on installment obligations that constitute USRPIs may be subject to FIRPTA if the recipient is required to recognize the gain or loss under 453.

Ownership Through Shared Appreciation Mortgage

- FIRPTA Taxation
 - Right to share in property's appreciation is generally a USRPI
 - Receipt of share of appreciation under the Note is generally not a disposition; thus, no FIRPTA withholding
 - However, if Note is sold or exchanged, any gain (including equity kicker) is subject to FIRPTA tax and withholding
- Advantages
 - U.S. property owner/borrower (not the foreign owner) pays U.S. income tax on rental income from properties
 - No gift tax
 - Foreign recipient at loan maturity may pay no income tax on repayment
- Disadvantages
 - Cannot control, manage or have greater than 10% ownership interest in venture or interest withheld at 30% (absent treaty)
 - Cannot share in contingent appreciation without triggering U.S. withholding tax on interest (absent treaty exemption)
 - Cannot use property personally

Ownership Through Domestically Controlled REIT



Ownership Through Domestically Controlled REIT

- FIRPTA Taxation
 - No FIRPTA taxation or withholding on sale of REIT shares by foreign shareholder of a domestically controlled REIT
- Advantages
 - No income tax at REIT level if all income distributed
 - Sale of domestically controlled REIT shares is free of U.S. tax to foreign seller
 - No gift tax on gift of shares
- Disadvantages
 - REIT ownership and operations are complicated with multiple shareholders and investment limitations
 - Dividend tax at 30% (unless rate reduced by treaty)
 - Domestically controlled REIT transfers management and control to U.S. person
 - U.S. estate taxable asset
 - May be limited market for REIT share sale

Summary

- A lot of foreign investors are looking to invest in the U.S. real estate market
- Taxation of foreign ownership of U.S. real property is complicated.
- Advanced planning to minimize or avoid withholding is required.
- Think about the exit strategy and shareholder profile prior to structuring ownership.
- Take obligations seriously.

Questions?

