



Structuring Asian Investment into US Real Estate

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With the recent rise in Asian investment in US real estate, many new investors are being forced to navigate the US tax rules. Choosing the most appropriate, tax efficient structure will depend on multiple variables including the type of investor, type of real estate, length of investment, whether domestic investors will own more than 50 percent of the investment, and any applicable US treaty with the investor's home country. The article will discuss the advantages and limitations of Asian investors structuring investments through REITs, C corporations, US partnerships, and direct lending (i.e., without an intervening entity), and the potential application of new FATCA disclosure and withholding rules to each structure.

Potential structures for investments in US real estate

REITs. Although more complicated,² REITs typically provide the most tax-efficient investment structure for equity investments in US real estate, because their income is only subject to one level of US tax. The single level of tax is accomplished as REITs are entitled to deduct dividends paid, which are then reported as dividend income by the shareholders. The tax rate for international shareholders is 30 percent for a non-treaty country (such as Hong Kong) and can be lowered considerably by treaty (e.g., 10 percent under the China treaty). Individual treaties should be reviewed as some (such as Japan) have higher withholding rates for REIT dividends than non-REIT dividends.³ Typically, the reduced rate will not be available for so-called capital gain dividends, which occur when a REIT distributes the proceeds from the sale of its underlying real estate. US "FIRPTA" rules subject investors to tax on capital gains, which can

take the form of a 10 percent withholding on gross proceeds or the application of normal US income tax rates on the net income (e.g., federal rates are generally 35 percent for corporate investors whereas individuals can benefit from lower US capital gains rates, currently 20 percent after a higher 25 percent rate applies to the recapture of prior depreciation deductions).

Investors can utilize different strategies to reduce the tax on capital gains. For example, international investors can avoid US capital gain tax entirely on sale of stock in a so-called "domestically controlled" REIT.⁴ Alternatively, investors can fund their original investment through a combination of debt and equity, taking advantage of the lower tax on interest income (e.g., 10 percent under the China treaty or 0 percent for "portfolio interest" applicable to less than 10 percent owners).

Under FATCA, investors will generally be required to provide the withholding agent (the US REIT in this case) proof of FATCA status and compliance to avoid withholding. Currently, this is done through the provision of the applicable IRS Form W-8.⁵ Absent required FATCA information reporting, a 30 percent withholding tax could apply. As a general rule, FATCA applies to income that is otherwise not subject to tax under the US FIRPTA rules. This includes ordinary REIT dividends and gain from REIT stock that is not taxed in the US, such as stock sales that qualify for the domestically controlled REIT exception.

US C corporations. While REITs are often the most tax-efficient structure for investments in US real estate, they are not suitable for all investments, since only certain asset classes qualify as permissible REIT



assets. For example, an investor planning to acquire a US condo development would not do so through a REIT, as condos held for sale would be subject to a 100 percent income tax on what are characterized as “prohibited transactions.” In such cases, the most efficient option may be to structure the investment through a US “C” corporation.

A C corporation is subject to US corporate tax (typically slightly over 40 percent, which includes state and local taxes). However, this tax can be substantially reduced through proper structuring. In particular, if investors fund the C corporation with a combination of debt and equity, the net income subject to corporate-level taxation can sometimes (depending on overall leverage) be considerably reduced, because tax is imposed on net corporate income after interest deductions.⁶ As a result, for an investor with a 10 percent treaty rate for interest income (e.g., China, Japan), every dollar of deductible interest paid out to the investor trades a 40 percent corporate-level tax for a 10 percent investor-level tax on the interest income.⁷ Further, although the shareholder-level tax on ordinary dividends is 30 percent, this is often considerably reduced by treaty (e.g., 10 percent for China and Japan and 10 percent or 15 percent for Korea). Further, this dividend tax often does not apply at all for liquidating dividends that are only paid after the corporation first sells all of the real estate in a taxable transaction (sometimes referred to as a “cleansing transaction”). To facilitate this liquidating dividend exception, investors generally hold each real estate investment through a separate C corporation.

Under FATCA, structuring an investment in US real estate through a C corporation has similar implications to investing in a REIT. If the non-US investor is neither compliant with nor exempt from FATCA, withholding could apply to dividends and other payment streams (although if any such payments are subject to tax under FIRPTA, FACTA will not apply). To the extent the C corporation is capitalized with debt, FATCA will apply to interest on the debt obligation (unless “grandfathered” under FATCA). Keep in mind that

FATCA application is generally a procedural issue (e.g., currently, providing the appropriate W-8 form) and the 30 percent withholding tax is just a way to force procedural compliance.

US Partnerships. In general, structuring investments in US real estate through a US partnership will subject international investors to US tax filing and reporting obligations. A non-US investor’s share of the partnership’s operating income will be treated as effectively connected with a US trade or business (ECI) to the extent the partnership is so engaged.⁸ In addition to taxation of the foreign investor’s share of taxable operating income, on exit, the investor’s share of any gain on sale of the real estate and any gain from the disposition of an interest in a partnership holding US real estate will be subject to US tax under the FIRPTA rules. Investing through a partnership (or direct investing) is often referred to as an “unblocked” investment because the international investor is directly subject to US tax and filing requirements. This creates complexity that most avoid.⁹ However, sometimes this complexity can reduce overall taxes, especially for individual taxpayers who receive both favorable US capital gain tax rates and are often able to credit such US taxes against their home country taxes. Because most partnership income is taxed as ECI, this ECI income would not also be subject to FATCA rules.

Lending into the US. Asian investors in US real estate should consider whether it could be more tax-efficient to forego equity investments and instead structure investments solely as loans. For example, a fixed interest rate loan to an unrelated borrower can generally be structured so that it is not subject to US tax at all under the “portfolio interest” exception. Even if the loan has both a fixed and a reasonably capped participation component, the fixed rate can still qualify for the 0 percent portfolio interest exception and the participation component is taxed at the lower of the standard 30 percent rate or the reduced treaty rate (e.g., 10 or 15 percent in China, Japan or Korea). The big risk is that if the international investor is repeatedly



originating loans (and not merely investing in loans originated by others), then the entire investment could be subject to very significant taxes as a US trade or business. In the case of repeated originations of real estate loans, investors more typically would use the REIT structure discussed earlier. Finally, non-trade or business lending into the US is generally subject to the FATCA rules.

Other considerations in finding the optimal investment structure

Investors and their advisors must weigh a variety of factors when determining the optimal structure for an investment in US real estate. These factual variables include investment return and holding period expectations, as well as treaty availability and the investor's ability (or willingness) to comply with FATCA. Business considerations and the limitations inherent in different structures should be carefully considered and incorporated into the overall economic arrangement. Certain structures — such as an equity investment in a domestically controlled REIT or a pure debt investment in US real estate — may restrict the type of property acquired or how it generates its income and these restrictions may be undesirable from a business perspective. In contrast, the leveraged C corporation blocker can be almost transparent from an operational perspective, but with likely higher tax costs.

Key economic questions when determining the tax structure

What is the investment type (office, condo, hotel)?

This question is critical because a REIT is not tax efficient with for-sale assets like a condo development, as discussed above. REIT investments in hotels have to be carefully structured, which may drive up the cost and complexity of the REIT structure.

What is the country of tax residence of the investor? Is the investor located in multiple countries such that they may be eligible for multiple treaties? If there are multiple investors from different countries, what is the relative mix?

Treaty rates are critical in determining the tax implications of potential investment structures and should be modeled out. Although some structures work well regardless of treaty (such a domestically controlled REIT or loans generating portfolio interest), these structures come with significant business limitations. As a result, it is important to know whether more flexible structures are reasonably available. Asian investors coming from China, Japan and Korea have similar treaty benefits, but often investments also come through Hong Kong, for which there is no US treaty.

What is the anticipated holding period for the investment and what exit flexibility do investors have?

Investments structured through a REIT generally require at least a two-year holding period, and holding periods may also be imposed by treaty to qualify for certain reduced withholding rates (e.g., Japan). Further, the term of the investment can affect the benefit derived from using leverage (the longer the hold, the more interest that can accrue). If it is a long-term hold, a reduced treaty rate on ordinary dividend income can be particularly beneficial, even though there is no treaty benefit for back-end capital gain. Taxes on dividends from a C corporation can be avoided by delaying distributions until all of its property is sold and the C corporation is liquidated. But investors wishing to exit before the last property is sold generally will be subject to tax on C corporation distributions.



If considering a debt investment, how are the loans going to be originated, is the interest going to be fixed or participating, and how many loans are anticipated?

For most international investors, it is critical that the investor not be treated as being involved in a US lending business (which would subject to the investor to US tax on the resulting ECI). Since there is no bright line rule for when loan originating activities will create ECI, conservative investors generally limit their lending activity to an occasional one-off single loan, having any repeated loans originated by an unrelated party (with an origination fee) or use a US REIT as the lending vehicle.

Is the investor a sovereign wealth fund?

Sovereign wealth funds have a special tax exemption for dividends and capital gain from non-controlled investments.¹⁰

Are US taxes creditable in the investor's home country?

To calculate the ultimate economic impact of US taxes under any given structure, the investor (and its advisors) should review local tax rules to determine whether some or all of the US taxes are creditable against taxes otherwise payable in the investor's home country. In some jurisdictions, international investors need special requirements, such as using a state-law partnership instead of an LLC, to help ensure taxes are creditable in their home country.¹¹

Conclusion

As discussed above, a variety of potential structures are available to Asian investors in US real estate, each with different tax and business implications. Establishing the optimal structure, however, is more difficult, and requires a careful consideration of the investment property, the investor's business needs and expectations, and the tax rules (and sensitivities) particular to the investor. ★

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² REITs require significant restrictions and monitoring of income and assets, which are discussed more fully in Grumbacher, Towsner and Schneider, A Three-Part Primer on Using Private REITs for Institutional Co-Investment with Sovereign Wealth Funds in US Real Estate, *AFIRE News* (published in three parts from March to August 2012).

³ See www.irs.gov/pub/irs-trty/japante04.pdf

⁴ *Id.*

⁵ For an explanation of IRS W-8 forms, see www.irs.gov/pub/irs-pdf/iw8.pdf

⁶ In the case of a condominium, the interest is capitalized and the higher tax basis reduces the gain on sale.

⁷ Although the allowable interest deduction may be capped annually at 50 percent of EBITDA under US interest-stripping rules, the excess is deductible against future income, including gain on sale.

⁸ An investment in triple net leased property may avoid ECI treatment. In that case, non-US investors should consider making an election to be taxed on the net income from the property as if the ECI rules applied. If that election is not made, the gross rents will be subject to withholding tax at 30 percent or the lower treaty rate.

⁹ Often individual investors use a double-blocker structure to avoid being subject to US estate taxes if they should die while holding an investment in US real estate. The individual will first invest in a non-US corporation in a zero tax jurisdiction (foreign blocker), which will in turn invest in a US corporation or REIT (US blocker).

¹⁰ This exception does not apply if the sovereign wealth fund has "effective practical control" of the underlying investment, as defined under Section 892 of the Internal Revenue Code.

¹¹ See Schneider and Grumbacher, Why Many International Investors Need to Use LPs instead of LLCs for US Real Estate Investments, *AFIRE News* (Fall 2013).

¹² For simplicity, these rates only reflect US federal taxation. In some circumstances, additional state tax could be applicable.

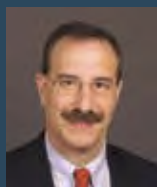


Treaty Withholding Rates in Asia

Country	Treaty	Interest	Dividends	REIT Distributions	Real Estate Capital Gains
China	Yes	10%	10%	No special REIT rules	Generally 35% (corporate investors) Generally 20% (individual investors) ¹²
Japan (A new protocol was signed in 2013 with more favorable treatment of dividends and interest, and harmonization with FIRPTA; protocol has not yet been ratified.)	Yes 0% (for limited group of beneficial owners (banks, insurance companies, pension funds, et al))	10% (general)	10% (general) 5% (recipient corporation 10% owner) 0% (recipient corporation 50% owner and holding period, Limitation On Benefit restrictions met)	10% (if REIT meets certain conditions under Article 10, paragraph 4) 0% (if recipient is pension fund and REIT conditions are satisfied)	Generally 35% (corporate investors) Generally 20% (individual investors)
Korea	Yes	12%	15% (general) 10% (recipient corporation 10% owner + restrictions on income of payor corporation)	No special REIT rules	Generally 35% (corporate investors) Generally 20% (individual investors)
Hong Kong	No	30% US standard rate	30% US standard rate	N/A	Generally 35% (corporate investors) Generally 20% (individual investors)
Singapore	No	30% US standard rate	30% US standard rate	N/A	Generally 35% (corporate investors) Generally 20% (individual investors)



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FATCA Exhibit

In 2010, the US enacted the FATCA rules to find US taxpayers that “hide” behind foreign accounts. Under FATCA, foreign financial entities register with the IRS and agree to disclose investor information (either to the IRS or the home country tax authority, depending on whether an intergovernmental agreement [IGA] is in effect). FATCA can be viewed as the US equivalent of the “know your client” rules found in other countries. If a non-US investor fails to comply with FATCA (and is not otherwise exempt), it will be subject to a 30% withholding tax on most US-source payments. FATCA is complex and remains in a state of flux. Effective dates have been repeatedly delayed and many IGAs remain to be negotiated.

Foreign financial entities (as defined under FATCA) are generally required to register with the IRS and obtain a “Global Intermediary Identification Number” and provide it to withholding agents. They may also need to enter into an agreement with the IRS to supply investor information (called an “FFI agreement”). Foreign financial entities are subject to a host of new documentation and diligence requirements

regarding the identification and status of their account holders. Non-financial foreign entities do not need to register with the IRS, but may need to disclose substantial US owners to withholding agents to avoid FATCA withholding. In general, all non-US investors will be required to document their FATCA status to withholding agents, which in many cases can be done by providing the applicable IRS withholding certificate (Forms W-9 or W-8, including the new Form W-8BEN-E for non-US entities that incorporates the various FATCA categories).

Many, if not most, US source payments could be subject to FATCA withholding, but it will not apply to any income classified as effectively connected with a US trade or business (ECI). Since FIRPTA treats certain real estate income as ECI, this income will not be subject to FATCA withholding. On the other hand, if FIRPTA does not apply (for example, to dividend and interest income), FATCA generally will. Structuring any investment in US real estate requires an analysis of the ECI/FATCA consequences and the impact of the attendant tax and reporting requirements.