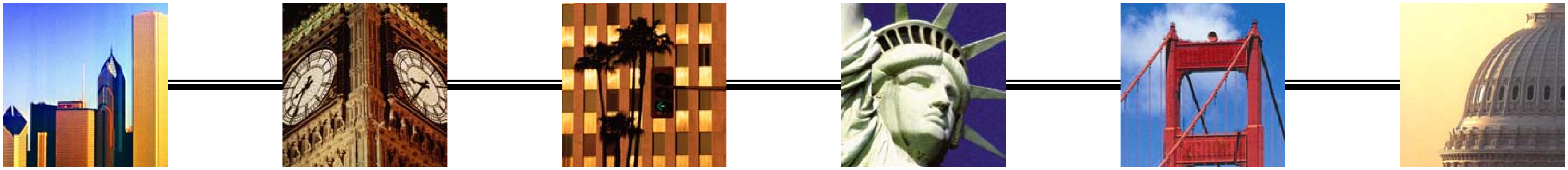

ABA SPRING CLE PRESENTATION
International Real Estate Investing

Selected U.S. In-Bound Real Estate Investment Issues: Strategies and Structures

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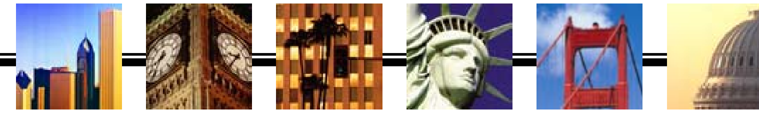
FIRPTA OVERVIEW - BASIC SCHEME

- Glossary of Terms
  - Code - Internal Revenue Code of 1986, as amended, and regulations issued thereunder
  - ECI - Income effectively connected with the conduct of a US trade or business
  - FDAP - Income that is fixed or determinable annual or periodic
  - FIRPTA - “Foreign Investor In Real Property Tax Act” - main provisions found in §897 of the Code.
  - Permanent Establishment - Concept found in US tax treaties to preclude benefits to non-passive investors conducting business or otherwise having extensive nexus to US



FIRPTA OVERVIEW - BASIC SCHEME cont.

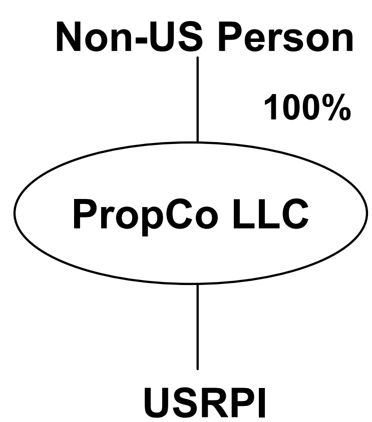
- USRPI - United States real property interest, includes direct interests in US real property as well as interests in domestic USRPHC (other than solely as a creditor)
- UBTI - Unrelated business taxable income
- USRPHC - corporation or other entity 50% or more of whose real estate plus trade or business assets consist of USRPIs
  - Determined on fair market value basis
  - Taint lasts 5 years, or Seller's holding period, if shorter

Code § 897 - Basic Rule

- Generally, foreign investor not taxed in US on gains from investor property
- However, gain recognized by non-US person from disposition of USRPI is treated as if ECI
  - US source income of non-US person that is ECI is subject to tax in US - Code §§871(b) and 882(a)
    - Need to consider possible treaty benefits - may limit taxation of US source ECI to income attributable to a Permanent Establishment
    - Code §1445 creates special withholding scheme for real estate gain treated as ECI
    - Unless establish amount of gain (on which 30% withholding applies) payor required to withhold 10% of sales proceeds

Form of Ownership Alternatives

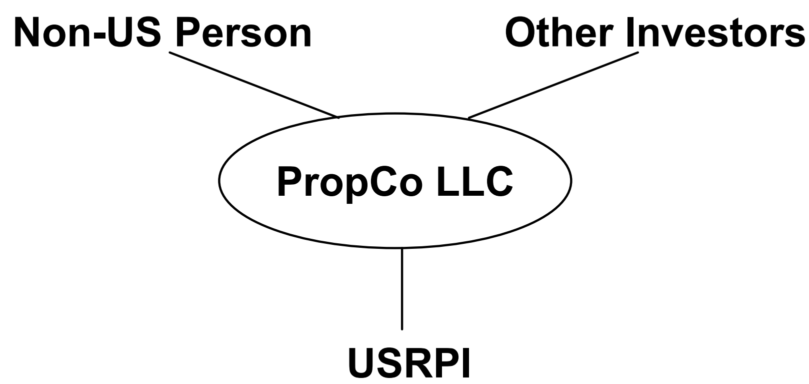
- Direct ownership of disregarded entity by non-US person



- Taxed as direct ownership by non-US person
  - single level US tax
    - reduced capital gains rate available for individual
    - applicable marginal rate on ordinary income
  - requires filing of US tax return by non-US person
  - US estate and gift tax regime applies
  - FIRPTA withholding required on sale of USRPI or PropCo LLC interests

<u>Form of Ownership Alternatives</u> - cont.

- Ownership of equity interest in US partnership or entity taxed as partnership



- Substantially similar tax consequences to non-US person as disregarded entity
  - Requires US tax return - partnership and individual
  - US estate and gift tax regime <u>may</u> still apply
  - PropCo LLC required to withhold (Code §1446) with respect to non-US person's allocable share of gain if USRPI is sold
  - Buyer must withhold on sale of PropCo LLC interests

Form of Ownership Alternatives - cont.

- Ownership by foreign corporation (per se corporation or entity electing to be taxed as corporation under US “check the box” rules)

Non-US Person

Foreign Corporation

USRPI

- No US tax return required by non-US persons
- Can transfer stock of foreign corporation free of US tax
- 35% corporate rate applies to ordinary and capital gain income from FC’s sale of USRPI
- FC’s gain subject to Branch Profits Tax
  - exception for sale pursuant to plan of complete liquidation (with special timing restraints on liquidation completion)
  - may be treaty relief
- No loss pass-through
- FC’s Sale of USRPI subject to FIRPTA withholding

Form of Ownership Alternatives - cont.

- Direct ownership of US Corporation - USRPHC

Non-US Persons

US Corporation

USRPI

- No US tax return required by non-US persons
- No FIRPTA tax on sale of US Co's USRPI
- FIRPTA tax on sale of stock applies
- No Branch Profits Tax
- 35% tax on ordinary and capital gain income received by US Corporation
- Potential deferral of home jurisdiction tax
- 30% withholding applicable on dividends
  - Possibly treaty relief
  - Foreign tax credit in home jurisdiction may be available
  - Withholding not applicable to liquidating distributions

Who is Investor?

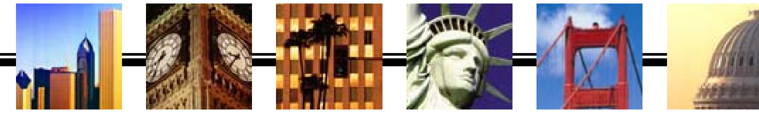
- Taxpayer in home jurisdiction
  - More likely to be a treaty beneficiary
  - May have a foreign tax credit available in home jurisdiction
- Tax-exempt in home jurisdiction
  - May be eligible for treaty benefits (if not, US tax may be significant reduction to returns in comparison to investment alternatives)
  - Treaty benefits may even extend to tax-exemption in US on certain income
- Foreign Government Entity
  - Code §892 Concerns
    - Direct (or through flow - through vehicle) ownership of real property may disqualify entity for benefits of §892 on all US source income
    - Dividends from a “controlled commercial entity” not free of U.S. tax

Use of Leverage

- US source interest income may qualify for exception from FDAP withholding under “portfolio interest exemption”
  - Code §§871(h) and 881(c)
  - However, interest payments to 10% shareholder subject to 30% withholding
  - Use of non-voting stock structure may permit avoidance of withholding (with possible treaty reduction)
  - “Contingent interest” also not eligible for portfolio interest exemption
- Earnings stripping rules under Code §163(j) applicable to limit interest deductibility for corporation
- Participating debt structures may provide additional benefits
  - participation feature must be reasonable under all of the facts and circumstances to maintain “debt” characterization

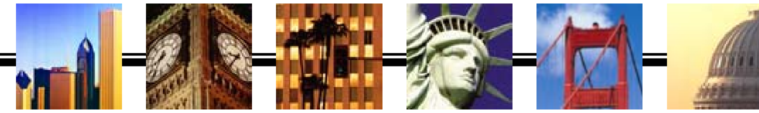
Use of Leverage - cont.

- FIRPTA withholding on sale of note
- FDAP withholding or interest if portfolio interest exemption not applicable and no treaty relief available
- If investment returns comprised of significant current yield, leverage may afford advantageous structure



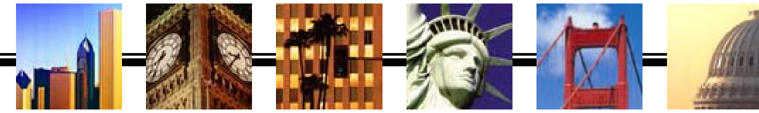
Summary of Basic Considerations

- No “one size fits all” solutions
- Specific characteristics of investor and investment must be carefully analyzed
  - character and timing of income flows
  - available treaty provisions
  - business objectives of client



Utilization of REIT Structures - Basic Considerations

- What is a REIT?
  - Organizational and governance requirements
    - Corporation, trust or association otherwise taxable as corporation
      - “Check the box” election of corporate treatment satisfies requirement
    - transferable shares
    - managed by one or more trustees or directors
    - minimum 100 shareholders
    - not closely held - five or fewer “individuals” owning 50% or more by value of shares
  - Asset and Income requirements must be met quarterly or annually

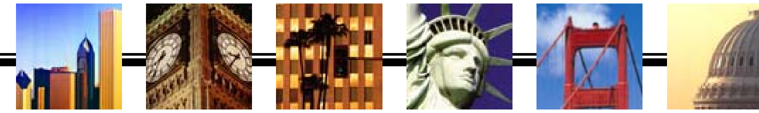


REIT Requirements - cont.

- 95% of REIT annual gross income must be
  - dividends or interest plus income qualifying under 75% income test
- 75% of REIT annual gross income must be
  - rents from real property
  - interest on obligations secured by real estate or interests in real estate
  - gain from sale of real property (excluding Code §1221 “dealer property”) (note constraint on use of REIT as a pooled investment fund-type vehicle)
  - dividends and gain on sale from other REIT shares
  - income and gain from foreclosure property
  - loan fees and option payments
  - short-term investment income
  - safe harbor short term gains

REIT Requirements - cont.

- 75% Asset Test
  - Tested on last day of each quarter for REIT's taxable year
  - At least 75% of REIT assets must be
    - cash or cash items
    - government securities
    - interests in real property
      - look-through rule for interest in partnership real property
    - mortgages
    - interests in REMICS
- 25% Asset Test
  - Tested on last day of each quarter for REIT's taxable year
  - Not more than 25% of REIT's assets may be securities (excluding government securities)
    - not more than 10% of a single issuer
    - exception for qualified REIT subsidiary

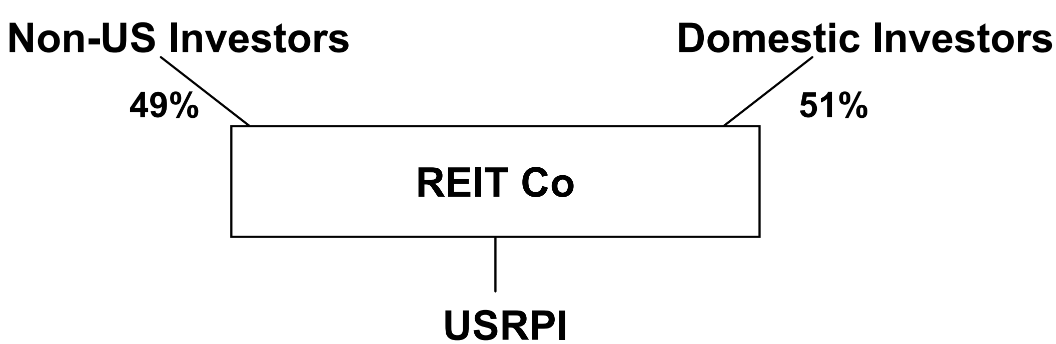


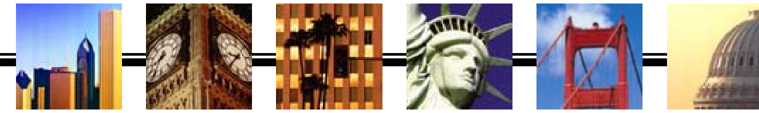
REIT Requirements - cont.

- Distribution Requirement
  - REIT must distribute 90% of its taxable income for year (other than certain capital gains, on which REIT may pay tax)
    - REIT qualification permits REIT to deduct dividends paid
      - not a flow-through
- Transferability of Shares
  - Transfer restrictions within terms of shares prohibited - unless intended to maintain REIT status
    - “excess share” provisions to assure compliance with 5/50 rule

Domestically Controlled Private REIT

- Investing through a domestically-controlled REIT may afford tax-planning advantages to non-US persons
  - Domestically-controlled REIT is not USRPHC (Code §897 (h)(2)), and shares in domestically-controlled REIT not USRPI
  - Foreign-controlled REIT treated as USRPHC; shares are USRPI (Code §897 (h)(2)), therefore, subject to FIRPTA - US tax considerations to non-US investor essentially same as for “regular” US corporation holding USRPI



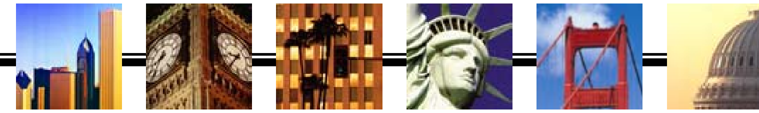


Domestically Controlled Private REIT - cont.

- A number of considerations must be reviewed in utilization of private REIT structure

Advantages of Domestically Controlled REIT

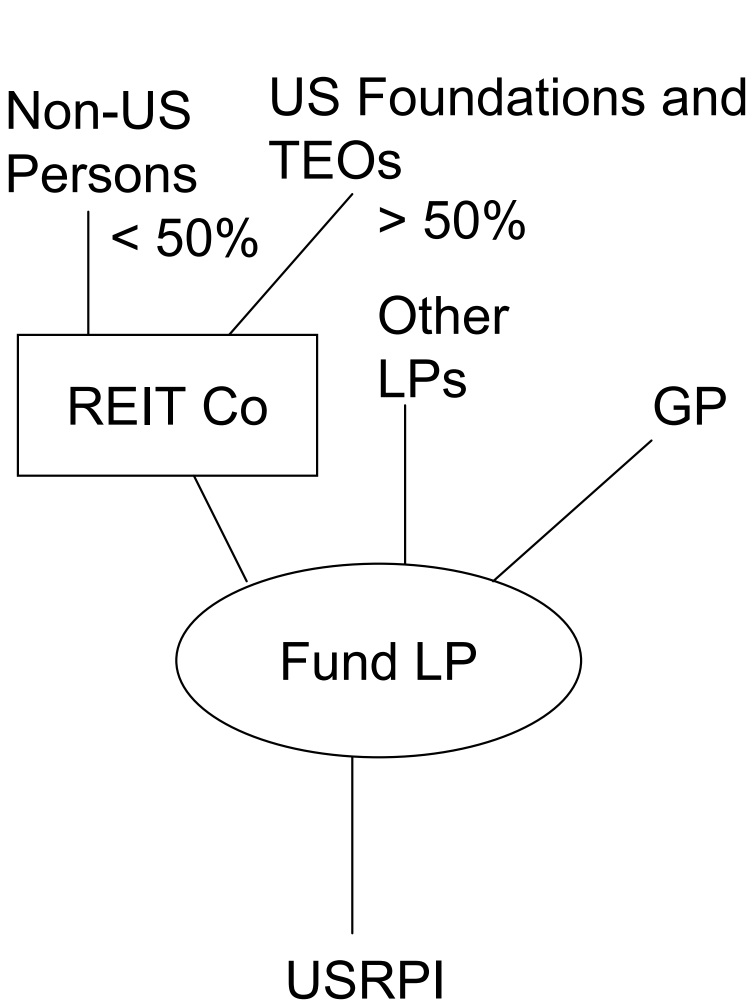
- Shares in REIT may be sold without FIRPTA tax
- Ordinary income distributions from REIT taxed as c-corp dividends
  - May be subject to reduced withholding under applicable treaty provisions
- Structure/entity is familiar to US investors, may afford easier market for shares in REIT
  - Popular structure for JV with existing public REIT
- Although capital gains distributions retain FIRPTA character (i.e., proceeds from sale of USRPI - therefore, subject to FIRPTA tax/withholding scheme), techniques to mitigate tax are possible
  - Put option for shares in connection with sale of asset(s)
  - Adoption of plan of liquidation prior to asset sales, liquidating distributions made pursuant to plan
    - 2 year maximum period for liquidation process



Disadvantages of Domestically-Controlled REIT

- Applicable treaty may apply higher withholding rate on REIT dividends, mitigating benefit of structure (see, e.g., Netherlands, Canada)
- REIT organizational, governance, income, asset and distribution requirements must be satisfied
  - Cumbersome structure to create
    - Issue mitigated when existing REIT subsidiary is utilized
  - Cumbersome structure to maintain
  - Operational limitations
    - "Good" REIT income rules create operational limitations
  - Must locate majority domestic owners as "partners"
- Domestic control difficult to assure
  - Requirement that shares be freely transferable limits ability to restrict transfers
  - Organic restrictions not available
  - Shareholder agreement amongst less than all shareholders, to which REIT is not party, may be acceptable

Use of Domestically-Controlled REIT in Fund Structure



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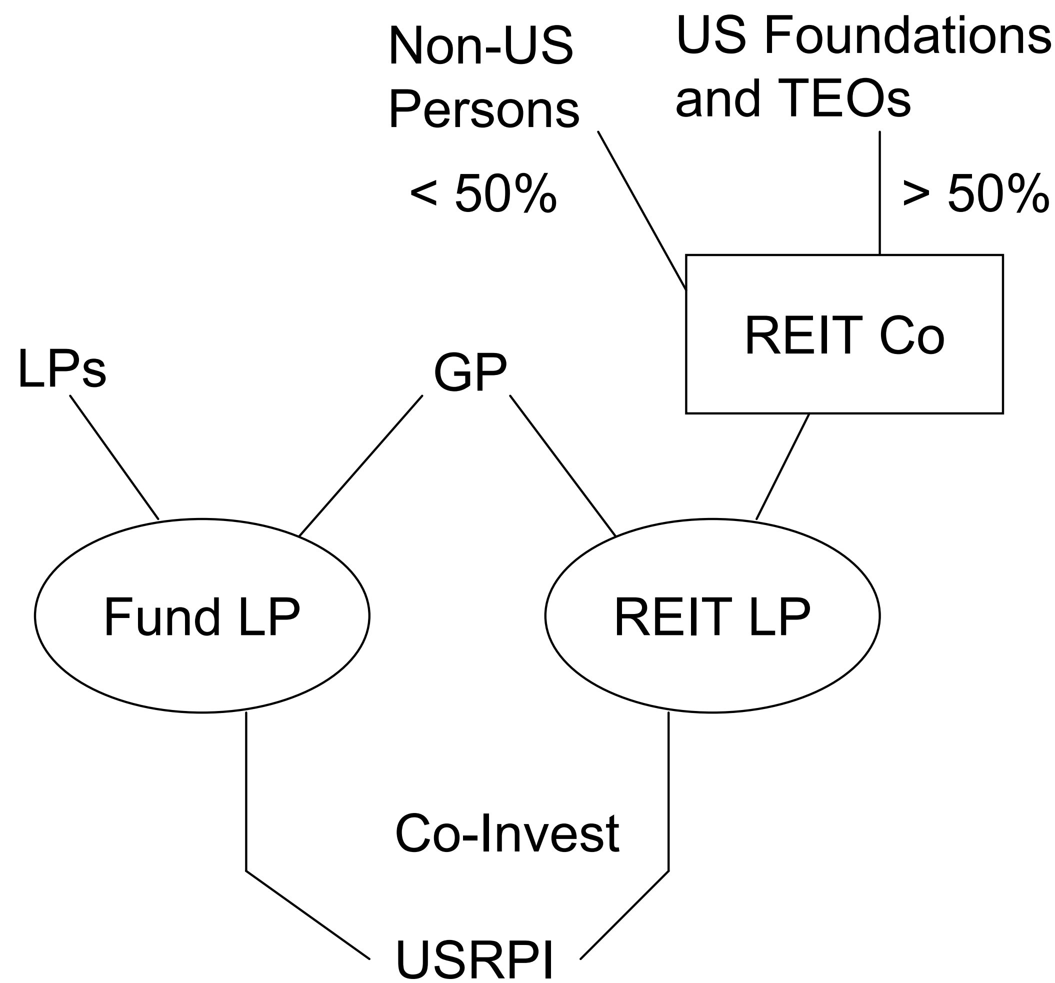
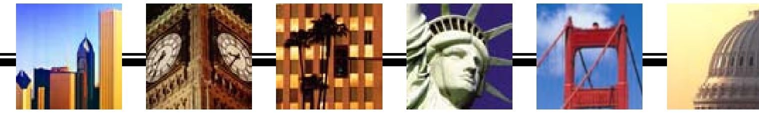


- Essentially same analysis as direct ownership by domestically-controlled REIT
  - Advantageous structure for US Foundations
    - Creates potential pool of US domestic investors to balance with non-US Persons
    - Allows US Foundations to avoid debt-financed UBTI flowing through fund
  - May enhance structure through…
    - Series of project REITs owning individual projects
      - Permits sale of REIT shares outside FIRPTA scheme



USA Patriot Act and Executive Order 13224

- Real estate transactions involving non-US persons present heightened need for familiarity with applicable rules
  - Executive Order 13224, September 24, 2001
    - Prohibits US persons (“USP’s) from participating in business transactions with Specially Designated Nationals and Blocked Persons List (“SDN”)
    - While real estate is not a specifically regulated industry, review of SDN list to confirm that transaction counterparties are not included is prudent

USA Patriot Act and Executive Order 13224 (Cont'd)

- USA Patriot Act specifically applied to "persons involved in real estate settlements and closings"
  - Treasury Department implementing regulations define "financial institutions" to whom rules apply as "institutions regulated by the Treasury Department, Federal Reserve System, FDIC, OCC, OTS, SEC, CFTC and National Credit Union Administration.
    - "Financial Institutions" involved in transactions with non-US persons will require identity verification for SDN list review
    - Rules applying to persons involved in real estate closing will be forthcoming
  - While anti-money laundering provisions of Act not likely applicable to most real estate funds, breadth of Executive Order 13224 makes review of SDN list prudent