Real Estate Investment Vehicles in the U.S.

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TOC

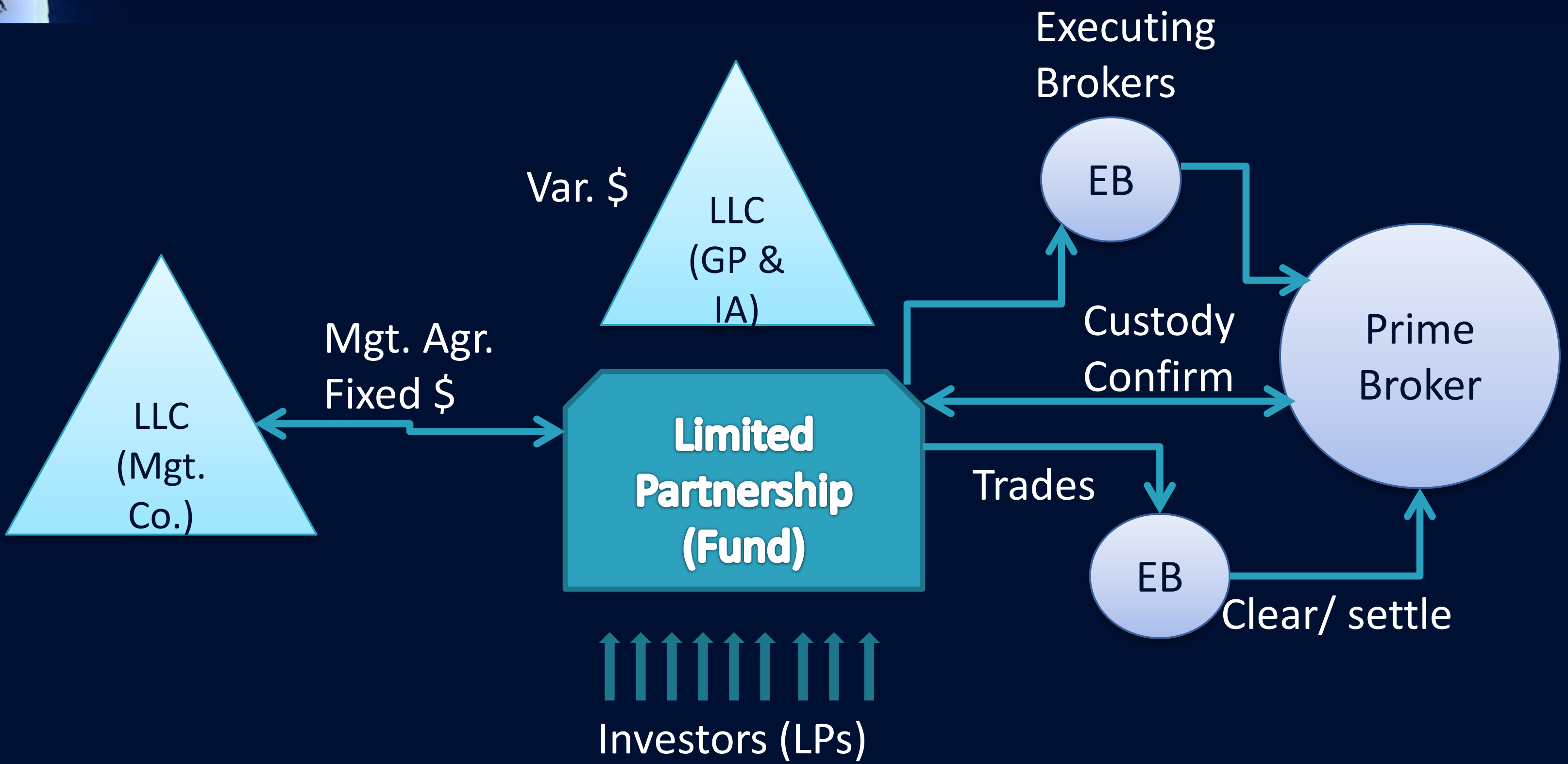
Private investment entities

- Corporation
  - Not the preferred form for domestic investor seeking to avoid entity-level taxation
  - But may be used by foreign investor in order to avoid having to personally file tax returns in the U.S.
- S Corporation
  - Avoids entity level tax but good only for U.S. citizens or permanent residents
  - Cannot have more than 75 shareholders

Pooled investment vehicles

- Limited partnerships
  - No entity-level tax (unlike a corporation)
  - Preferred form of domestic hedge fund or private equity fund
  - Tax filing obligation on foreign investor
- Limited Liability Companies
  - No entity-level tax
  - Preferred form of management company or investment advisor to hedge funds
  - Tax filing obligation on foreign investor

Typical U.S. hedge fund structure



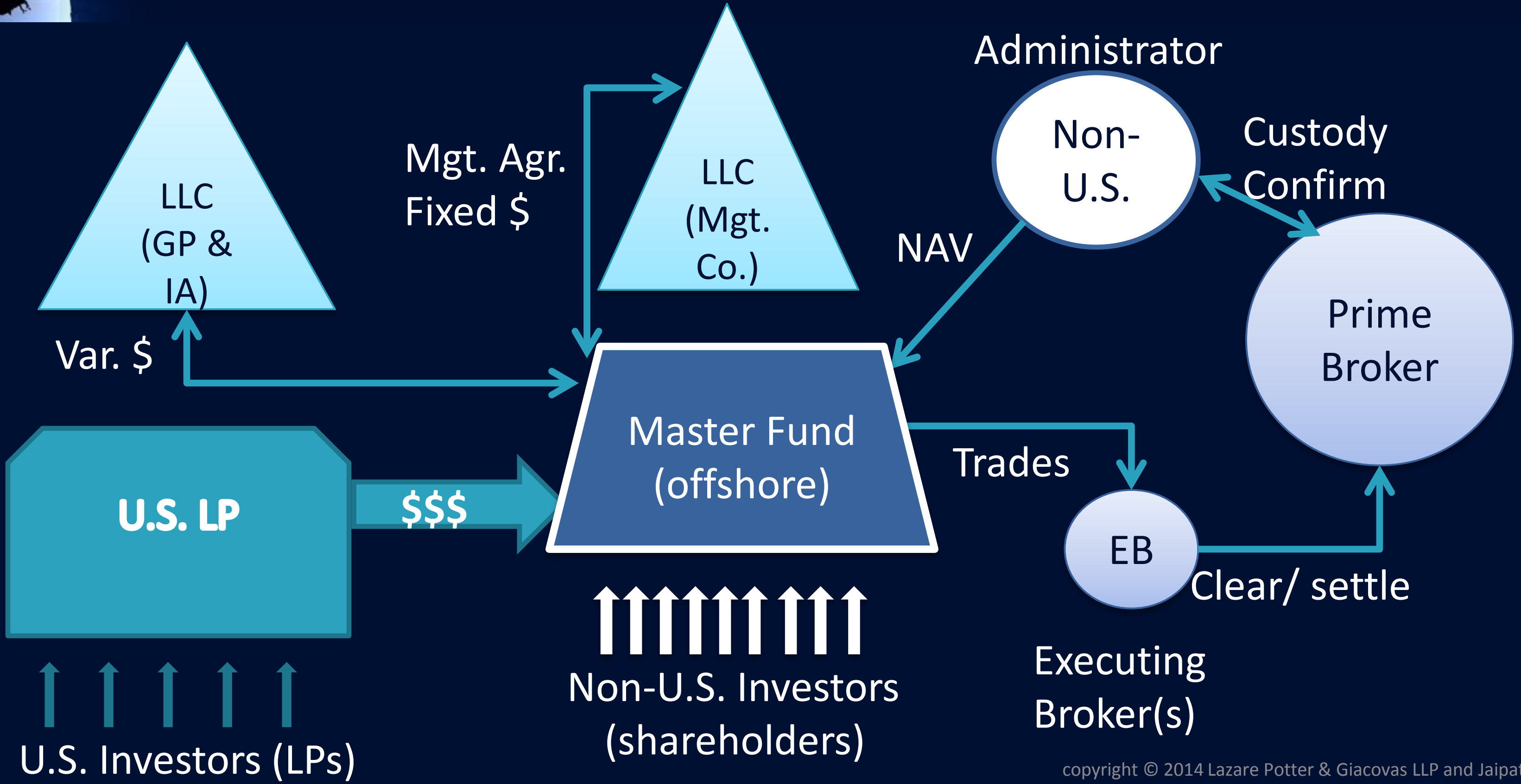
Hedge funds interests are illiquid

- More liquidity comes when interests are widely-held and traded
- Enter the publicly-traded partnership (PTP)
  - It’s a limited partnership, like a hedge fund
  - It’s interests are held by more than 100 persons
  - It’s interests are registered with the SEC and traded on a stock exchange or market
  - *But it’s taxed at the entity level as a corporation*

Recap

Type of Entity	Asset Class	No. of Investors	Tax
Hedge Fund	Narrow	Few	Good, but not for foreigners
Publicly traded partnerships	Wide	100+	Bad
Private Equity	Wide	Few	Good, but not for foreigners

Structure with foreign investors



Securities vs. Real Estate

- Foreigners generally do not pay capital gains tax when they invest in U.S. securities
- But they are subject to U.S. taxes on gains from sale of real estate

No capital gains on sale of securities

- A foreign individual or offshore fund that is not engaged in U.S. trade or business is not subject to capital gains tax for investing in U.S. securities or commodities. IRC §864(b).
  - An offshore fund is generally deemed not to be engaged in U.S. trade or business if its contact with the U.S. is limited to investing in securities issued by U.S. *corporations* and in commodities.
- Partnership is not so good from foreign investor perspective
  - If the foreign investor or the offshore funds invest in a U.S. *partnership*, the investor will be required to file a U.S. tax return.

Foreigners taxed if real estate

- General rule: A foreign investor, including an offshore fund, will not be subject to U.S. income taxation on capital gains from its U.S. investments.
- Exception: disposition of an investment in "U.S. real property interests"
    - Under the Foreign Investment in Real Property Act of 1980 (FIRPTA), U.S. tax is imposed on a foreign person's gain on the disposition of U.S. real estate
    - The gain is treated as income that is effectively connected with a U.S. trade or business
    - Withholding tax is imposed at a rate of 10 percent on the gross proceeds of the sale
    - Foreign investor is required to file U.S. tax returns and pay income tax at regular U.S. tax rates. IRC §§897 and 1445.
- Under the same act, U.S. tax is also applicable to the disposition of stock in a corporation that is a "United States real property holding corporation"
    - A corporation is a USRPHC if at least 50% of the fair market value of all of its assets is U.S. real property interests. IRC §897(c)(2).

Recap

- Domestic funds are usually limited partnerships but they do not suit foreigners
  - A solution is a master-feeder structure involving an offshore fund
- Foreigners do not pay capital gains tax and are not deemed engaged in U.S. trade or business for investments in U.S. securities
  - But they do pay U.S. tax *if* they invest in real estate

Enter REITs

- That's where REITs come in -
  - They invest in real estate (and outperform S&P)
  - They provide liquidity, a feature missing in hedge funds or private equity funds
  - There is no entity level tax for income that is distributed
  - They are like mutual funds
  - They suit many foreign investors because most do not have to pay U.S. taxes

Avoiding tax in REITs

A foreign shareholder selling REIT shares can avoid tax *if*:

- The REIT is majority-owned by U.S. persons (“domestically controlled”). IRC §897(h)(2);
- The REIT is publicly-traded and shareholder holds less than 5% of the shares. IRC §897(c)(3);
- The shareholder sells its shares after the REIT has disposed all its real property in a transaction in which gain or loss is recognized;
- The REIT does not primarily own “U.S. real property interests” (e.g. a “mortgage REIT”); or
- The shareholder is a “foreign government” and does not control the REIT.

It may also avoid FIRPTA on certain dividends

- Dividends attributable to gain from sale of real estate by a publicly-traded REIT are exempt from FIRPTA for a shareholder of 5% or less

REITs organizational requirements

- Organized as a corp. or business trust
  - Managed by one or more of the directors/ trustees
  - Beneficial ownership evidenced by transferable share certificates
- Beneficially owned by 100 or more persons
- Not have fewer than 5 shareholders that beneficially own, directly or indirectly, 50% or more voting stock

REITS asset and income requirements

- Like mutual funds, REITS are regulated entities
  - unlike hedge funds or private equity funds
- Various asset and income requirements, such as –
  - Passive investment role only
  - Distribute at least 90% of taxable income to shareholders
  - Derive most of its income from real estate held for the long run

Industry Outlook

- 18 of last 25 years, equity REITs have outperformed S&P
- In 2013, there were 183 publicly-listed REITs
    - equity market capitalization of $716b
    - daily trading volume of $4.9b
    - 60% of shares owned by institutions
- Focused on income producing real estates such as apartments, shopping centers, offices, etc.

Review of principal fund forms

Review	REIT	LIMITED PARTNERSHIP	PUBLICLY TRADED PARTNERSHIP
Form of entity	Corporation or trust but taxed like a corp. only for undistributed income; investors hold shares	General partner could be any form of entity; investors hold limited partnership interests	Same as private partnership but LPs interests are registered with SEC and traded in stock exchange
Number of investors	At least 100	One general partner and less than 100 limited partners (LPs)	If not registered with SEC, at least 100

Comparing the funds

Issues	LIMITED PARTNERSHIP	PUBLICLY TRADED PARTNERSHIP	REIT
Limited Liability	Yes, but not general partner	Yes, but not general partner	Yes, it's usually a corp.
Liquidity of Investments	No	Yes	Yes, it's publicly traded
Entity-level federal income tax	No	Yes	No, to the extent income is distributed to shareholders
Foreign investor deemed engaged in U.S. trade or business	Yes	No, its deemed a corporation	No, it's usually a corporation
Tax on investor for undistributed income	Yes	No	Generally no
Capital gain character passes to investor	Yes	No	Yes, if distribution is designated as capital gain

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