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Investing in U.S. Real Estate Using Domestically-Controlled REITs

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Foreign investors in U.S. real estate face a number of hurdles when considering the structure of their investments. Direct ownership of U.S. real estate can subject the foreign investor to U.S. federal, state and local taxation on the income attributable to the real estate, and under current law may also result in U.S. federal income taxes on gains at exit under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). For this reason, many foreign investors choose to invest in U.S. real estate directly or indirectly through U.S. corporations (so-called blockers) that "block" the applicable U.S. tax filing and payment obligations, which are satisfied at the blocker level. Unfortunately, this subjects the investment to U.S. corporate income taxes and a sale of stock of the blocker would generally still result in tax payment and filing requirements on the part of the foreign investor under FIRPTA.

There are certain exceptions to the application of FIRPTA to a sale of stock, including for certain interests in publicly traded corporations and for certain types of foreign investors. An alternative vehicle that can rely on another exception to FIRPTA to address the foregoing concerns and significantly improve the tax efficiency of foreign investment in U.S. real estate is a real estate investment trust (REIT) with majority domestic ownership—a so-called domestically controlled REIT.

Domestically Controlled REITs

A domestically controlled REIT is a real estate investment trust for U.S. federal income tax purposes more than 50 percent of the value of the stock of which is owned by U.S. persons.

Advantages to foreign investors of investing through a domestically controlled REIT include the ability to sell the stock of the domestically controlled REIT without incurring U.S. federal income tax under FIRPTA. In addition, a domestically controlled REIT is eligible for a dividends paid deduction so that it generally will have little or no U.S. federal income tax liability. REITs (whether or not domestically controlled) are also useful vehicles for U.S. tax-exempt investors because they can generally be used to address unrelated business tax risks that can arise in the case of leveraged real estate investments.

In the context of an investment fund or a joint venture with U.S. investors or joint venture partners, it may be possible to raise sufficient domestic capital to qualify a potential REIT as a domestically controlled REIT. If necessary in order to consummate a transaction, U.S. taxable investors or joint venture partners may be persuaded to invest through the REIT—rather than alongside the REIT in a partnership or limited liability company—notwithstanding that it does not afford them the same advantages that accrue to a US tax-exempt or foreign investor.

Qualifying as a REIT

REITs are subject to a number of operational and organizational

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requirements that are beyond the scope of this article to address in depth but that must be kept in mind if a REIT is to be used as an investment vehicle. Generally speaking, REITs are intended to be broadly held passive vehicles invested primarily in real estate assets (including owned real estate, leases and mortgages) and which generate primarily passive income from real estate.

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REITs are also generally required to distribute annually substantially all of their taxable income (other than certain capital gains) pro rata to shareholders.

The requirement that REITs be broadly held is embodied in two separate rules: (1) the REIT cannot be majority-owned by five or fewer individuals (the "five-or-fewer test") and (2) the REIT must have 100 or more shareholders. The five-or-fewer test is applied by taking into account certain look-thru rules, and although it needs to be carefully checked in each case, we have found that it does not typically present an issue in the types of situations where a domestically controlled REIT is considered.

The 100 shareholder requirement may be satisfied through a private offering of common or preferred shares, as discussed below. These two organizational requirements are not required to be satisfied in the first taxable year of the REIT. Practically this means that there will generally be time after the initial investment is made to satisfy the 100 shareholder requirement. An initial failure to satisfy the five-or-fewer test, on the other hand, may be difficult to remedy after the fact, and therefore compliance with this requirement should be addressed at the outset if possible.

The REIT operational requirements are intended to ensure that the REIT remains a passive vehicle and restrict the types of business arrangements a REIT may undertake, including the terms of its leases and its development and sale activity. For example, leases under which the REIT is a landlord generally cannot include rental payments based on the net income of the tenant of the property although they may be based on a percentage of revenues or sales. In addition, REITs generally cannot provide non-customary services to tenants unless the services are provided by an independent contractor from which the REIT does not derive income or by a taxable REIT subsidiary (TRS) of the REIT. Unless certain safe harbors are satisfied, development and sale activities by a REIT—for example, the sale of condominium units or land parcels—risk being subject to a punitive 100 percent prohibited transaction tax.

REITs also may not operate hotels or nursing homes or other health care facilities, which are considered operating businesses rather than passive investments in real estate, and such properties must therefore be leased by the REIT to a third-party operator (or to a TRS if certain additional operational requirements are satisfied). In view of the various operational requirements and prohibitions that apply to REITs, potential investments must be carefully vetted to determine whether they are appropriate for REIT ownership, and the manager or general partner of the investing entity will need to undertake the task of monitoring the REIT to ensure that it does not run afoul of the rules. However, in the case of certain categories of property—for example, office and residential rental buildings—continuing REIT qualification can typically be achieved without undue difficulty.

Securities Offering Process

As discussed above, one of the requirements for REIT qualification is that a REIT must have 100 or more shareholders. This requirement may be satisfied through a private offering of shares in the REIT. Although such shares can be either common or preferred, they are typically preferred shares issued in relatively small denominations (for example, $1,000) and paying a relatively attractive coupon (for example, 12.5 percent). Since the shares are securities, they must either be registered under the Securities Act of 1933 or be offered under Regulation D or another exemption from registration under the Securities Act.

There are firms that provide services to assist REITs in meeting the 100-shareholder test. These firms

market the private offering to a limited group of individuals; all of the prospective shareholders are vetted by the firm and should be "accredited investors" in order that the offering may qualify under Regulation D. In addition, if the REIT wishes to rely on the exemption provided by Section 503(c)(7) of the Investment Company Act of 1940 rather than the real estate exemption under Section 503(c)(5) of the act, the investors must be "qualified purchasers" within the meaning of Section 2(a)(51)(A) of the act.

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The marketing materials sent to prospective investors typically include a private placement memorandum describing the real estate owned by the REIT, the ownership of the REIT and any risk factors associated with the real estate, among other things. In addition, Blue Sky counsel (specializing in state securities law) should be consulted at the start of the offering to ensure that the federal Securities Act exemption being used also exempts the private offering from substantive filings and review by state securities commissions. Certain non-substantive "notice" state filings must often nevertheless be made, and Blue Sky counsel can flag and often actually file these. Once the private offering is complete, the REIT must submit a Form D notice to the Securities and Exchange Commission, which is required when a company issues securities in a private placement using the exemptions from registration provided by Regulation D of the Securities Act. The REIT's shares should be sold through a registered broker-dealer or through an entity that is not required to register as a broker-dealer.

Sale of REIT Shares

The preferred exit for a foreign investor from a domestically controlled REIT structure is by sale of the stock of the domestically controlled REIT, as a sale of the assets of the REIT may subject the foreign investor to the FIRPTA taxes the domestically controlled REIT structure is intended to eliminate. In order to ensure the possibility of a stock sale, a REIT which is a participant in a joint venture will often insist on a provision in the joint venture documents that contemplates or requires that the exit take the form of a sale of REIT shares.

An exit by stock sale can be an issue in negotiations with a prospective buyer, who will generally want to be assured of an asset basis step-up for U.S. federal income tax purposes so that it can refresh the depreciation and amortization deductions of the business. The acquisition of stock of a REIT (like any other U.S. corporation) generally does not result in an asset basis step-up unless it is followed by a liquidation of the REIT, and the liquidation technique does not work in all circumstances (e.g., if the buyer is itself a U.S. corporation). In circumstances where an asset basis step-up cannot be achieved, buyers may discount the purchase price they are willing to pay to compensate for the loss of the tax basis step-up.

In addition, structuring an exit as a sale of REIT shares will require that the seller provide the buyer with entity-level representations, indemnities relating to entity-level liabilities (including potential tax liabilities) that typically have a long survival period, assurances with respect to the entity's REIT status and, typically, a request for the seller to deliver a tax opinion with respect to REIT status of the entity by qualified counsel, all items that would not be necessary to address if the property itself were being sold. The due diligence process with respect to acquiring an entity and auditing REIT status can be time-consuming, and certain buyers may be reluctant to accept an acquisition of REIT shares even after due diligence and the receipt of the necessary assurances because of a lack of familiarity with the REIT structure.

However, assuming that the tax basis step-up is not an issue, the provision of entity-level representations and the other items discussed above should not be an insurmountable obstacle, and it should be possible to structure a disposition as a sale of REIT shares (particularly with a more sophisticated buyer) without the need to give a meaningful discount.