FIRPTA and Its Changing Effects on Real Estate and Real Asset Investments in the United States

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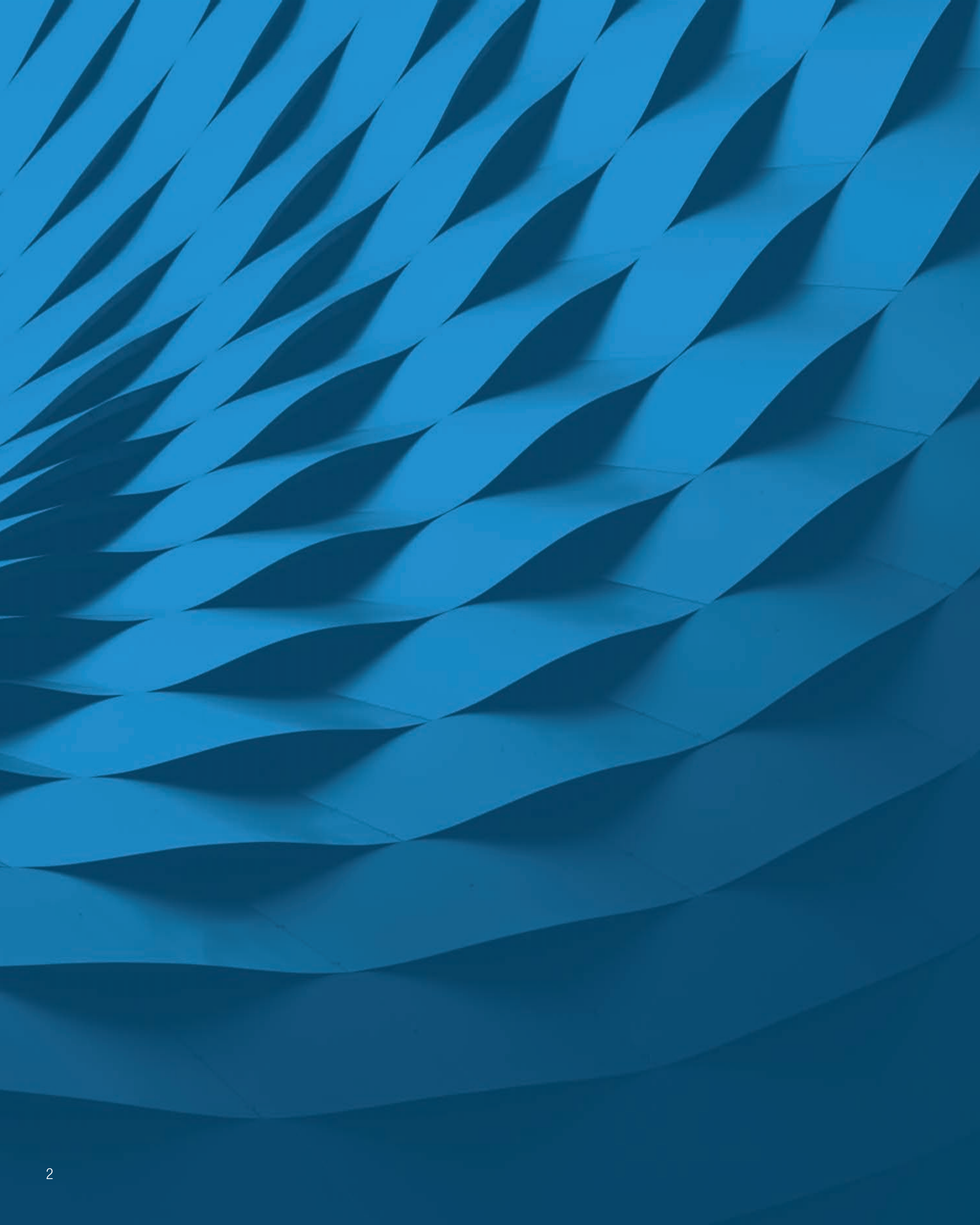
The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") was adopted by the United States Congress to tax capital gains generated for foreign investors by investments in U.S. real estate, broadly enough defined that it can apply to many investments in real assets as well.

When it was adopted, the institutional investment market for real assets was much different. Real estate investing was the largest sector of real assets investing then as it was now, but institutional investing was dominated by large firms who invested directly. Over the last dozen years, there has been a surge of capital raised internationally for closed-end blind-pool private funds, broadening the market and including investors without the size and sophistication to invest directly into these types of assets.

While certain international investors have used structures designed to minimize the impact of FIRPTA either on tax obligations or the requirement to file with the United States Internal Revenue Service, other investors have avoided any type of investment which might generate FIRPTA taxes. In December, 2015, significant adjustments were made which changed who FIRPTA applies to and how it will be implemented. Analysis of those changes and current methods for managing the impact of FIRPTA for private fund investors will make up the bulk of this paper.

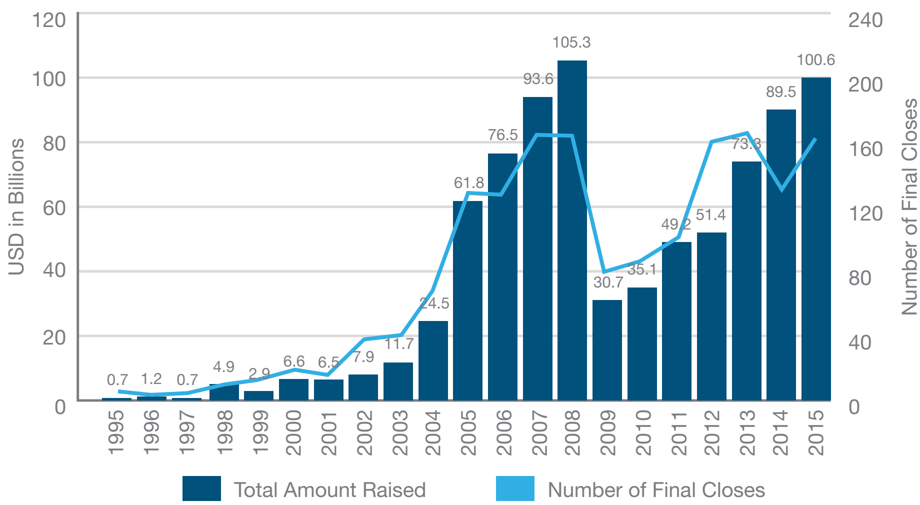


Real Estate Fundraising

To put this analysis of FIRPTA in context, background is needed on how the real assets private fund market has developed and grown. Real estate focused funds are by far the largest real asset sector and the sector most directly impacted by FIRPTA. As detailed in Chart I, it was not until 2000 that fundraising for this sector exceeded $5 billion for a single year and only began to ramp up steeply in 2003. By the market peak in 2008 just before the Great Financial Crisis ("GFC") annual equity fundraising had reached $105 billion, a level it nearly reached again in 2015.

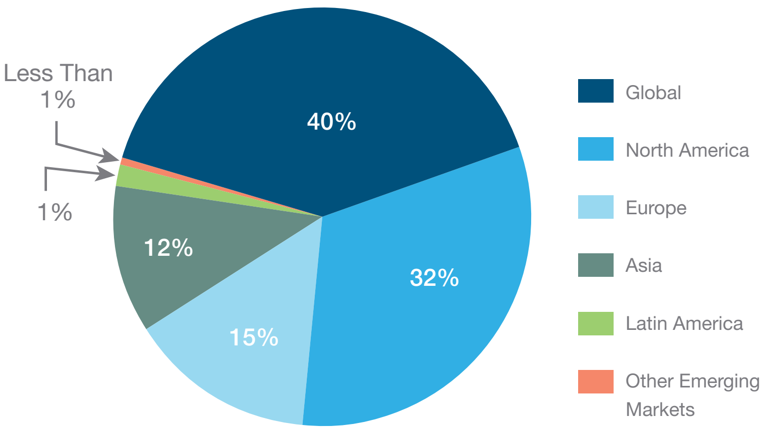
This growth in activity began with funds targeting the United States, especially by funds targeting opportunistic strategies with higher risk/return profiles. The market began to expand roughly a decade ago, first to Europe and then to Asia. However, as detailed in Chart II, the amounts raised in 2015 still heavily favor investing in North America. Over 40% of the money committed to real estate funds targeted funds with global mandates – though the vast majority of these funds are headquartered in the U.S. with significant allocations to their home market and most of these individual funds, run by very experienced managers, are quite large. Another 32% of the commitments raised last year were specifically focused on funds targeting North America, mainly the United States.

Chart I Global Real Estate Fundraising 1995-2015



Source: Probitas Partners; PREQIN; PERE; IREI

Chart II 2015 Global Real Estate Fundraising by Geography
(in terms of capital raised, USD)

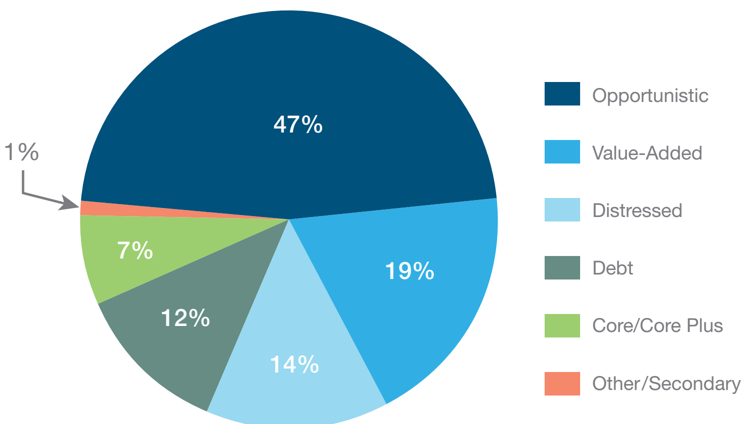


Source: Probitas Partners; PREQIN; PERE; IREI

The types of strategies that investors targeted last year were led by opportunistic funds at 47% (Chart III) while value-added followed at 19% and the rest had more scattered interest. One of the reasons for this is that the largest real estate funds tend to follow opportunistic strategies, and these large funds tend to be run by fund managers with extensive investment experience.

Core and core plus strategies were relatively unimportant, making up only 7% of money raised. Returns for projects in core strategies are so low, especially in the current interest rate environment, that it is difficult for them to support the management fees and carry that are normal in a fund structure and still generate an attractive return.

Chart III 2015 Global Real Estate Fundraising by Strategy
(in terms of capital raised, USD)

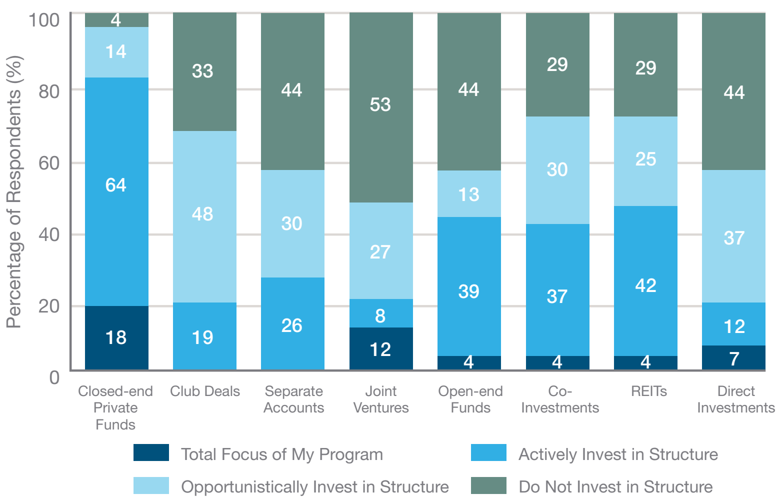


Source: Probitas Partners; PREQIN; PERE; IREI

In part because of this, more core and core plus investing tends to be done either directly by institutional investors or through joint ventures or separate accounts. As Chart IV shows, relatively few investors invest in real estate through these structures, while 82% Investors actively invest in closed-end fund structures. Investors that are focused on direct investments and joint ventures tend to be larger with staff experienced in investing directly in real estate institutions. For direct investments in the U.S., a number of international investors are active, such as sovereign wealth funds from the Gulf or insurance companies from China.

In addition, there is some degree of interest in publicly traded REITs and open-end funds as investment vehicles, but at significantly lower levels than closed-end funds.

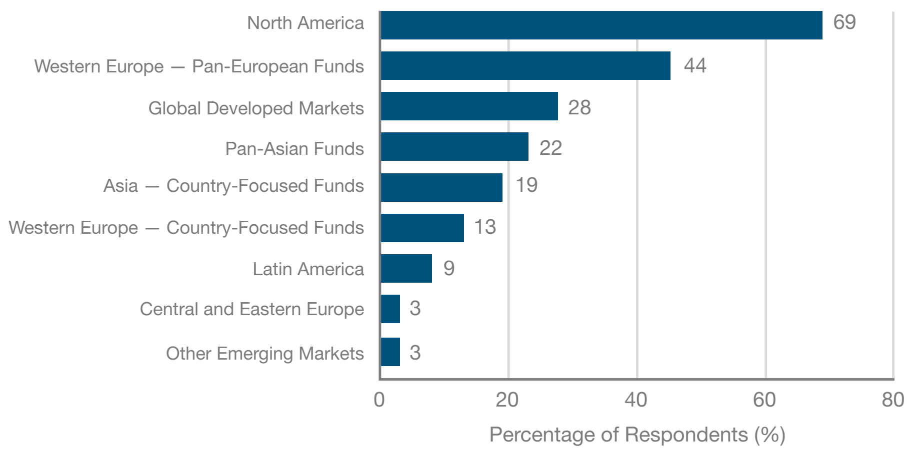
Chart IV Real Estate Investment Structures
I invest via:



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2016 Survey

Looking forward, Chart V shows that North America continues to be the market of choice for many investors overall, with 69% of them targeting it. Even for investors based outside of North America, 50% of them targeted North America, and as mentioned previously most funds with global developed market mandates have large allocations to the United States.

Chart V 2016 Real Estate Geographic Focus
For the major geographic sectors of real estate, I am mainly focused on (choose no more than three):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2016 Survey

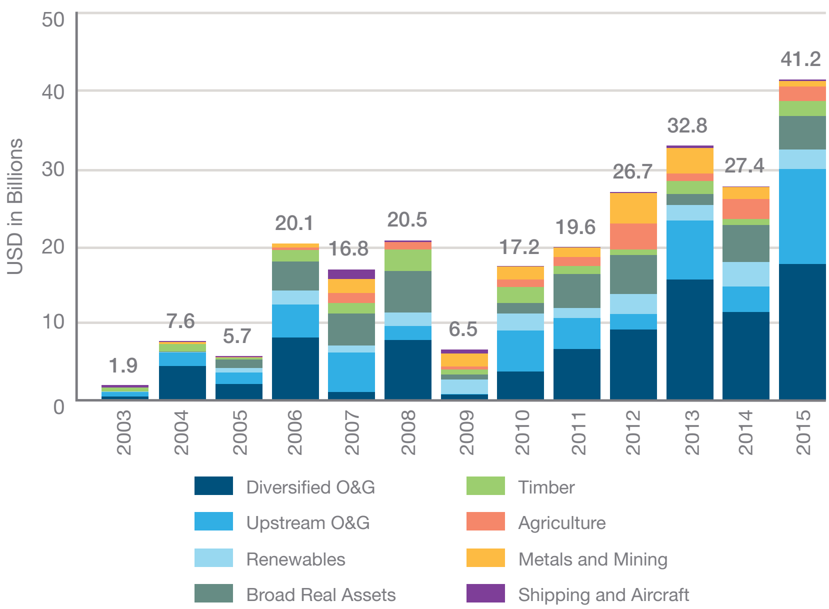
Real Assets Fundraising

FIRPTA, however, does not only impact real estate investing. Many individual investments within real assets funds – including oil and gas wells, timber and agricultural land, and mines – can clearly be captured within the definitions of FIRPTA, though others such as shipping and aviation, or oil field services typically are not.

Interest by institutional investors in closed-end real asset funds has clearly grown over the last decade (Chart VI). The driver of that growth has been private equity investment into the oil and gas sector, mainly focused on North America and the opportunities created by fracking and other alternative drilling techniques. That sector is dominated by two types of funds – upstream funds focused on exploration or producing wells, and diversified funds that usually invest both upstream and in the midstream services sector.

Interestingly, the sharp decline in oil prices that began in the summer of 2014 has not dimmed interest in this sector. Many institutional investors committed more money to oil and gas focused funds in order to pursue investments in companies under stress at discounted prices. As a result, 2015 was actually the peak year for real assets fundraising by a significant margin.

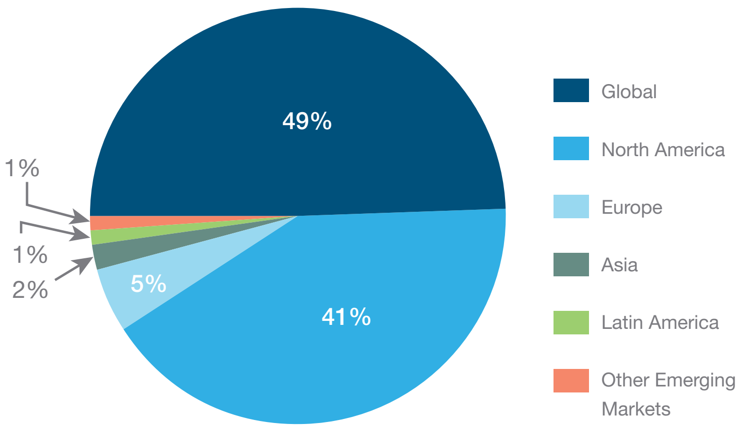
Chart VI Real Assets Global Fundraising by Strategy



Source: PREQIN; Probitas Partners

Chart VII shows that based on where funds were committed last year there is strong interest in funds targeting North America. This is primarily due to the fact that so much of the private equity oil and gas sector is focused on investments in the United States and Canada. Funds with global mandates, very often targeting agriculture, metals and mining, and timber investments, usually are investing in specific locations across the world that have a competitive advantage producing certain products or commodities.

Chart VII 2015 Real Asset Fundraising by Region

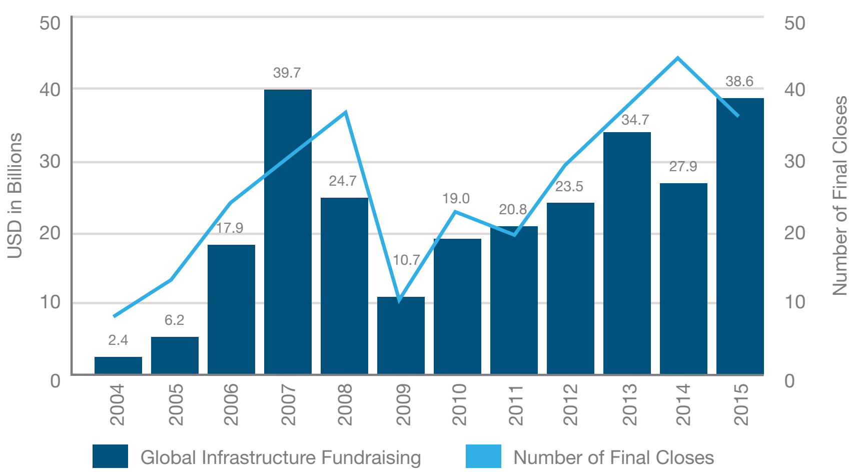


Source: Probitas Partners; PREQIN; PERE; IREI

One last area of investment that is often considered part of real asset investing is infrastructure. Since many institutional investors have separate infrastructure allocations it is covered here separately.

Fundraising for closed-end infrastructure funds (Chart VIII) shows a pattern very similar to real estate, rising to a peak before the GFC, then slowly coming back to a level just below peak in 2015, but at a level roughly 35% of the amount targeted at real estate.

Chart VIII Global Infrastructure Fundraising

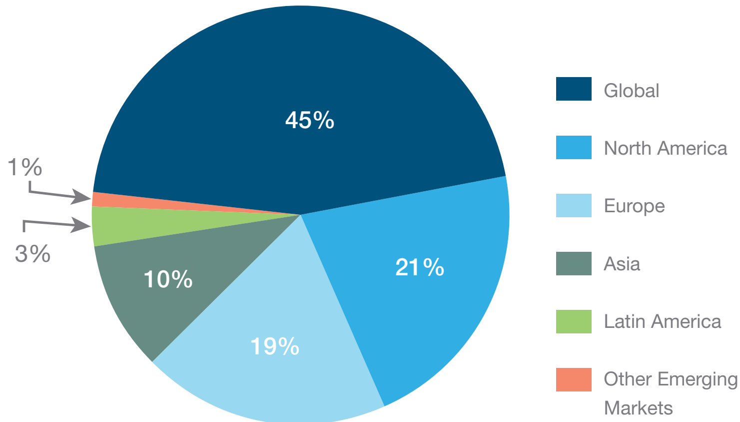


Source: Probitas Partners; PREQIN; Infrastructure Investor; Private Equity Analyst
Note: Does not include infrastructure funds of funds

The pattern of geographic interest for infrastructure is, however, very different from real estate. Australia, Canada and Europe were early adopters of infrastructure fund investing, with the United States lagging behind. Chart IX shows that North America still lags as a geography of focus, though many global funds have an allocation to North America.

The U.S. market in particular has lagged in the adoption of Public Private Partnerships ("PPPs") that have been important in other countries. Funds focused on the U.S. tend to target opportunities that may be heavily regulated but do not necessarily require a PPP agreement to complete.

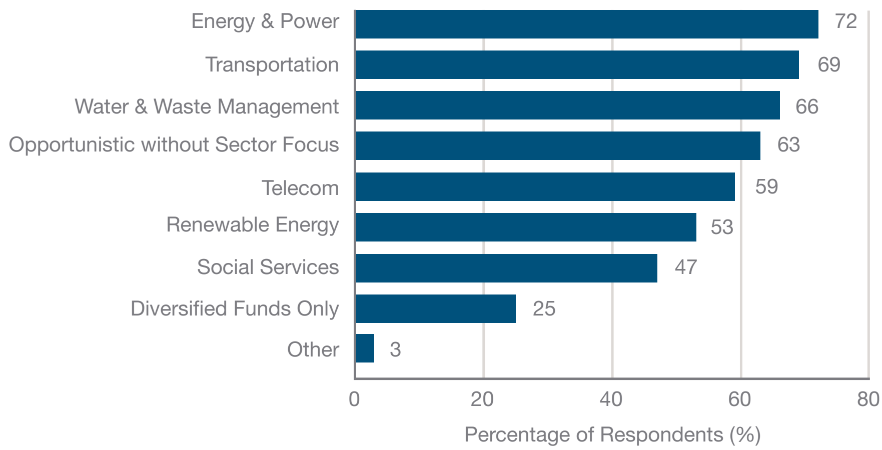
Chart IX Infrastructure Fundraising, 2015 by Region by Strategy
In terms of Capital Raised in USD



Source: Probitas Partners; PREQIN; Infrastructure Investor; Private Equity Analyst
Note: Does not include infrastructure funds of funds

Chart X shows interest in industry sectors targeted by investors is fairly broad across a number of sectors. As far as potential FIRPTA impacts, that varies not only by sector, but also by the investment structure used in each investment.

Chart X Infrastructure Industry Sectors of Interest
My firm seeks to invest in the following sectors (choose all that apply):



Source: Probitas Partners' Real Estate Institutional Investor Trends for 2016 Survey

FIRPTA: General Rules and Certain Key Changes Made by PATH Act

We now turn to summarizing the technical aspects of FIRPTA and discussing structures to mitigate its impact. FIRPTA is contained in Section 897 of the U.S. Internal Revenue Code (Code) and applies to the disposition of “United States real property interests” (USRPIs). The potential U.S. tax leakage and tax return filing requirements resulting from the application of FIRPTA have significantly impacted non-U.S. investors seeking to invest in U.S. real assets. The general FIRPTA rules are briefly summarized below.

The Protecting Americans from Tax Hikes Act of 2015 (PATH Act), which was enacted in December 2015, made a number of changes to the application of FIRPTA. The key change for investment funds is exempting certain “qualified foreign pension funds” from FIRPTA. This change is discussed in more detail, along with certain other changes made by the PATH Act.

General Rules

Disposition of USRPIs — Subject to U.S. Tax and Tax Return Filing Requirements

FIRPTA provides that if a non-U.S. person disposes of a USRPI, any gain (or loss) realized on the disposition is taken into account as if the non-U.S. person were engaged in a U.S. trade or business and such gain (or loss) were effectively connected with such trade or business. Income or gain that is treated as effectively connected with a U.S. trade or business (under FIRPTA or other applicable Code Sections) is "effectively connected income" or "ECI."

A non-U.S. person that is treated as engaged in a U.S. trade or business (under FIRPTA or other applicable Code Sections) is required to file a U.S. federal income tax return and potentially state and local tax returns. The non-U.S. person is also required to pay U.S. federal income tax on its ECI at the regular graduated U.S. income tax rates and also may be subject to state and local taxes. The maximum U.S. federal income tax rate is currently 35% for corporations and 39.6% for individuals. A non-U.S. person that is a corporation for U.S. federal income tax purposes could also be subject to an additional 30% "branch profits" tax (resulting in a 54.5% effective U.S. federal income tax rate) on the disposition of a USRPI other than an interest in "United States real property holding corporation" (as defined below). A non-U.S. individual may be eligible for the lower U.S. federal long-term capital gains rate (currently, 20%) on gain from the disposition of a USRPI.

If a non-US person disposes of an interest in a partnership for U.S. federal income tax purposes, and that partnership owns a USRPI, the proceeds realized by the non-U.S. person are treated as received from the disposition of a USRPI (and subject to FIRPTA) to the extent attributable to USRPIs held by the partnership.

Definition of USRPI

In general, a USRPI is an interest in real property located in the United States or the Virgin Islands and any interest—other than solely as a creditor—in a "United States real property holding corporation" (USRPHC).

Interest in Real Property

"Real property" consists of three general asset categories: (i) land and unsevered natural products of the land, such as crops, timber and mines, (ii) improvements on land, such as buildings or other inherently permanent structures and (iii) certain limited types of personal property associated with the use of real property. For this purpose, any object that is attached to real property and that will remain so attached for an indefinite period of time is treated as an inherently permanent structure and will, therefore, be deemed to constitute real property.

Virtually every type of ownership is an "interest" for purposes of FIRPTA, including outright ownership, co-ownership, leasehold interests, time sharing interests, as well as ownership interests for a current or future period of time. The term also includes derivative interests such as a right to share in an increase in the value of, or in profits generated by, real property. Accordingly, any type of debt instrument, including debt that is convertible into equity, having a return that correlates to the value or profits generated by real property would constitute a FIRPTA interest.

REITs

Shares in a REIT (other than a mortgage REIT) generally are treated as USRPIs. Accordingly, the disposition of REIT shares generally will be subject to FIRPTA. Distributions by a REIT that are attributable to the disposition by the REIT of USRPIs also generally will be subject to FIRPTA. There is an exception to the FIRPTA rules for certain publicly traded REITs as described below in "Certain Key Changes Made by the PATH Act—Expansion of Publicly Traded Exception for REITs."

In addition, the disposition of shares of a "domestically controlled" REIT will not be subject to FIRPTA. The PATH Act added certain presumptions regarding REIT ownership that may in certain circumstances make it easier for a REIT to qualify as "domestically controlled." The "domestically controlled" REIT exception is discussed in more detail on the next page.

Certain Key Changes Made by the PATH Act

FIRPTA — Withholding Taxes

The U.S. government facilitates collection of FIRPTA taxes through certain withholding tax requirements. A non-U.S. person is generally allowed a credit against their U.S. federal income tax liability for amounts that are withheld.

Direct Disposition of a USRPI

If a non-U.S. person disposes of a USRPI directly, the purchaser of the interest is required to withhold U.S. tax on the gross proceeds paid to the non-U.S. person. The PATH Act increased the rate of withholding from 10% to 15% for dispositions of USRPIs occurring after February 16, 2016. This same 15% U.S. tax withholding requirement applies to the purchaser of an interest in a partnership from a non-U.S. person, if 50% or more of the value of the partnership's gross assets consist of USRPIs, and 90% or more of the value of its gross assets consist of USRPIs plus any cash or cash equivalents.

Disposition of a USRPI by a Partnership

If a partnership for U.S. federal income tax purposes disposes of a USRPI, the partnership generally is required to withhold U.S. tax on the "effectively connected taxable income" (which will include FIRPTA gain or loss) allocable to its non-U.S. partners. The withholding rate for non-U.S. corporations is currently 35% and for other non-U.S. persons is currently 39.6%.

Qualified Foreign Pension Funds No Longer Subject to FIRPTA

For investment funds, the most significant change made by the PATH Act was the addition of a new exemption for a "qualified foreign pension fund" or any wholly-owned entity thereof (collectively, a QFPF) from FIRPTA taxation on certain gains from the disposition of a USRPI. This exemption from FIRPTA for QFPFs applies to gain on a direct disposition of USRPI, gain allocated to the QFPF through a partnership for U.S. federal income tax purposes and distributions received by a QFPF from a REIT that are attributable to the disposition of USRPIs.

A QFPF is defined as any trust, corporation, or other organization or arrangement that meets the following requirements:

- Organized outside of the U.S.;
- Provides retirement or pension benefits to current or former employees (or their designees);
- Has no single participant or beneficiary with a right to more than 5% of its assets or income;
- Is subject to government regulation and provides annual reporting about its beneficiaries to the relevant tax authorities; and
- Under its own jurisdiction's tax laws, either (i) contributions to it are deductible or excluded from its gross income (or taxed at a reduced rate), or (ii) tax on its investment income is deferred or at a reduced rate.

The QFPF definition raises some interpretive questions. One is whether a wholly-owned entity must be directly owned by the QFPF (or whether the QFPF can own it indirectly through one or more other wholly-owned entities). Another question is whether wholly owned means just economic ownership (so, for example, you could have another non-economic owner, such as a general partner). A further ambiguity is whether a wholly-owned entity that also earns non-FIRPTA ECI is covered by the exemption. The scope of the government regulation and annual reporting requirements is also unclear, as well as the requirement that the QFPF provides retirement or pension benefits to current or former employees or their designees. With respect to the latter requirement, it is unclear whether a fund that provides benefits to self-employed or unemployed individuals qualifies as a QFPF. The IRS is expected to issue additional guidance related to the QFPF exemption, but has not indicated the timing of such guidance.

As discussed below, the exception for QFPFs applies only to FIRPTA and not any other form of ECI.

Expansion of Publicly Traded Exception for REITs

The sale of shares of a publicly traded USRPHC (including REITs) generally is exempt from FIRPTA taxation so long as the non-U.S. shareholder owns 5% or less (by value) of the USRPHC's stock at all times. The PATH Act increased the 5% threshold to 10% solely for REITs.

Sovereign Wealth Funds

In general, Code Section 892 exempts sovereign wealth funds and other non-U.S. governmental investors (892 Investors) from U.S. tax on income received from U.S. investments in stocks, bonds and other domestic securities provided that such income is not "commercial activity" income and certain other requirements are met.

892 Investors are exempt from U.S. taxation on the sale of stock of a USRPHC or a REIT, provided that they own, directly or indirectly, less than 50% of the value and vote (and do not otherwise hold any interest which provides the 892 Investor with effective control) of the USRPHC or REIT. They are not, however, exempt from U.S. taxation on the sale of other USRPIs, nor are they exempt if a REIT disposes of its U.S. real assets and distributes the proceeds. Nevertheless, an 892 Investor that also qualifies as a QFPF can obtain the benefits of both exemptions.

As noted in the introduction, real estate focused funds are still by far the largest real asset sector, and not surprisingly FIRPTA directly impacts their U.S. real estate investments. For this reason, U.S. real estate funds that are marketed to non-U.S. investors typically offer such investors the option of investing in the fund through a non-U.S. "feeder" entity. See diagram 1. These feeders, which may be organized as non-U.S. partnerships or corporations, are typically formed in low tax jurisdictions—such as the Cayman Islands or Bermuda—and are treated as corporations for U.S. tax purposes.

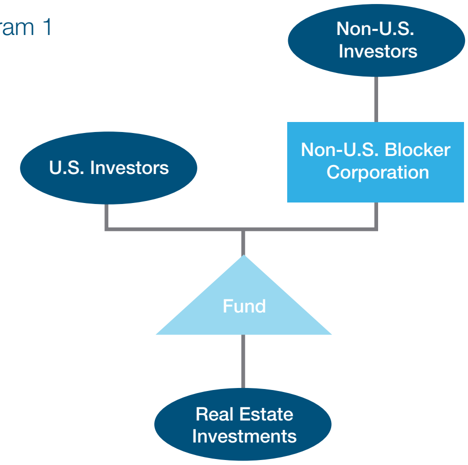
As U.S. tax corporations, the feeders protect non-U.S. investors from having to file U.S. federal and state income tax returns as a result of their investment in the U.S. real estate fund. Instead, the feeders themselves are subject to U.S. tax filings, which are handled by the fund sponsor and its advisors.

The feeders, however, are subject to U.S. taxation like any "regular" non-U.S. corporate entity. As a result, the feeders are subject to taxation on both FIRPTA gains and other forms of ECI that may be generated by the U.S. real estate fund. Currently, the rate of U.S. federal income tax on the feeders for these types of income ranges from 35% to 54.5%, and there may be additional U.S. state income taxation as well.

In other words, while the feeders relieve non-U.S. investors from the administrative burdens of filing U.S. federal and state income tax returns (and the investigatory and subpoena powers of the IRS and state taxing authorities), the feeders do not mitigate FIRPTA taxation. In fact, the U.S. taxation imposed on the feeders may be higher than the taxation that would be imposed on certain non-U.S. investors who invested directly in the fund. For example, non-U.S. individual investors may be subject to U.S. federal income taxation on certain FIRPTA gains at a current rate of 20%, while (as discussed in more detail below) sovereign wealth funds and certain non-U.S. pension plans may be exempt from FIRPTA taxation altogether.

Accordingly, many U.S. real estate funds that market to non-U.S. investors will also use REITs, leveraged blockers or other strategies in order to mitigate FIRPTA taxation. As discussed below, however, none of these strategies is necessarily a perfect solution.

Diagram 1



U.S. Real Estate Funds and Qualified Foreign Pension Funds

At first blush, the PATH Act may seem like an elimination of U.S. taxation for QFPFs that invest in U.S. real estate funds. While this may be true for certain funds that only generate FIRPTA gains, most U.S. real estate funds also generate non-FIRPTA ECI. For example, investments by funds in condominium projects, time shares, hotels and retirement/assisted living facilities usually generate ECI. Furthermore, even investments by funds in rental properties often give rise to ECI because of the activities associated with generating the rental income, such as property management, maintenance and leasing offices.

Unfortunately, as described above, the exemption in the PATH Act for QFPFs applies only to FIRPTA gains, and not other forms of ECI. As a result, the investments by many U.S. real estate funds—absent additional structuring—will not be exempt from U.S. taxation for QFPFs. The potential, however, for additional structuring to mitigate U.S. tax is discussed below.

REITs

Some U.S. real estate funds use REITs to hold some or all of their investments. See diagram 2. REITs offer many U.S. tax benefits, and can be useful to certain U.S. investors, as well as non-U.S. investors. A REIT is treated as corporation for U.S. tax purposes, but is able to eliminate U.S. corporate taxation by distributing its net income at least annually. As a result, investors in a REIT avoid being subject to double taxation. In order to qualify as a REIT, however, a number of requirements must be satisfied, including:

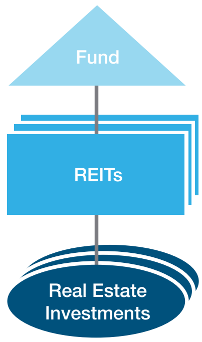
- Quarterly tests to ensure that substantially all of the REIT's assets are real estate assets or, to a lesser extent, other passive assets;
- Annual tests to ensure that substantially all of the REIT's gross income is rents from real property, interest from debt secured by real property, gains from the sale of real property, income from other enumerated real estate-related investments or, to a lesser extent, other passive income;
- An annual requirement to distribute at least 90% of its REIT taxable income (and distribute all of its REIT taxable income to avoid tax on undistributed income);
- A requirement that the REIT stock be held by at least 100 or more persons; and
- A requirement that no more than 50% of the value of the REIT stock is held, directly or indirectly, by five or fewer individuals.

As mentioned above, shares in a REIT (other than a mortgage REIT) generally are treated as USRPIs. Accordingly, if a fund sells REIT shares, non-U.S. investors are typically subject to FIRPTA taxation on any gain from that disposition. Similarly, if a REIT sells U.S. real assets (and distributes the proceeds to the fund), non-U.S. investors in the fund are subject to FIRPTA taxation on their share of the gains from that sale.

If, however, the REIT qualifies as "domestically controlled," then gains from the sale of the REIT shares are not subject to FIRPTA taxation. For this purpose, a "domestically controlled" REIT is one in which less than 50% of the fair market value of its outstanding stock is directly or indirectly owned by non-U.S. persons during the previous five years. Accordingly, if the investor base of a U.S. real estate fund consists of more than 50% (by commitment size) of U.S. persons, then REITs established by that fund may be able to qualify as "domestically controlled."

This exception applies, however, only if the fund sells the shares of the "domestically controlled" REIT. If such a REIT instead sells its U.S. real assets (and distributes the proceeds to the fund), the non-U.S. investors will still be subject to FIRPTA taxation on their share of the gains from that sale. For a number of reasons, a potential buyer may not want to acquire U.S. real assets through a REIT, and therefore a fund may not be able to structure a disposition as a sale of REIT shares in order to avoid FIRPTA taxation.

Diagram 2



REITs and Qualified Foreign Pension Funds

REITs are excellent structures for QFPFs, as they now eliminate FIRPTA taxation for such investors. Gain from the sale of REIT shares is not subject to tax under FIRPTA for QFPFs, regardless of whether or not the REIT is "domestically controlled." In addition, even if a REIT itself disposes of U.S. real assets (rather than a sale of REIT shares), a QFPF is not subject to FIRPTA taxation on its share of gains from such sale. In other words, unlike for "regular" non-U.S. investors, a REIT works equally well for QFPFs whether the exit is an asset sale or a stock sale, whether the REIT is private or publicly traded and whether or not the REIT is "domestically controlled."

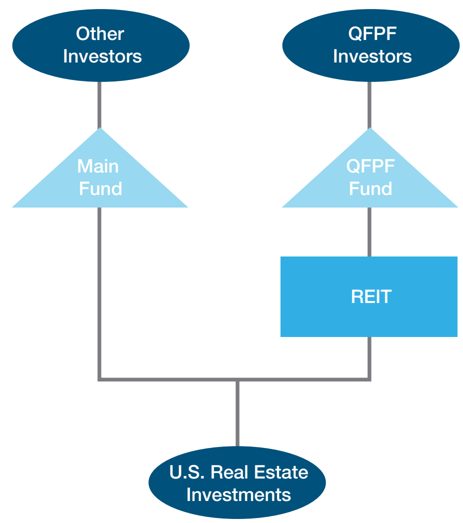
Accordingly, many U.S. real estate fund sponsors that have not used REITs for non-U.S. investors —either because the composition of the fund's investors was 50% or more non-U.S. (and therefore the REIT could not qualify as "domestically controlled") or the fund sponsor did not think that a sale of REIT shares was viable (because a buyer would insist on an asset sale)—are now (or should be) considering using REITs to benefit their QFPF investors (and as an attractive marketing tool to QFPFs).

Many investments by U.S. real estate funds, if held directly by the funds (rather than through REITs), are not exempt from taxation under the new provisions for QFPFs because the investments generate ECI as well as FIRPTA gains. Nevertheless, a number of these types of investments could be held through a REIT, which blocks the ECI and enables a QFPF to avoid taxation on disposition, either from an asset sale by the REIT or through a sale of REIT shares. For example, investments in rental properties often can be held through REITs because they satisfy the REIT asset and income tests. For other investments that also generate ECI, it may be possible to structure the investments so that part of the investment (i.e., the real estate) is held through a REIT, while the operating part of the business is held in a separate entity (either outside of the REIT or through a taxable REIT subsidiary). This bifurcated structure should allow QFPFs to avoid U.S. taxation from the sale proceeds that are attributable to the real estate portion of the investment (and be subject to U.S. tax only on the operating business portion of the investment).

As mentioned above, it may be possible for a fund simply to have all of its investors participate in REIT-eligible investments through one or more REITs. Other than the additional costs of the REITs (which may be significant), REITs may have some benefits for other investors, or at least no significant downside. For U.S. taxable investors, although losses do not flow through REITs, the REITs would protect such investors from U.S. state income tax filings. REITs may also benefit U.S. tax-exempt investors because they block "unrelated business taxable income" (UBTI), except in the case of certain "pension-held REITs," which may arise either from the nature of the underlying investments or as a result of leverage with respect to the investments. Even if UBTI is not being generated, REITs would not typically have a negative impact on U.S. tax-exempt investors (other than the cost of the REIT).

Even if it is not desirable to have all investors participate through REITs, it is possible to use REITs for QFPFs. To accomplish this structuring, a U.S. real estate fund sponsor could, for example, organize two parallel funds—one for QFPFs and one for all other investors. See diagram 3 below. The QFPF fund could potentially hold all of its REIT-eligible investments through a single REIT (with exits of each investment structured as a sale of each investment by the REIT) and invest directly in REIT ineligible investments, while the non-QFPF fund would invest directly in all of the investments.

Diagram 3



REITs and Sovereign Wealth Funds

REITs are also good investments for 892 Investors if the exit can be structured as a sale of REIT shares. Upon such a disposition, an 892 Investor is exempt from FIRPTA taxation, regardless of whether or not the REIT is "domestically controlled," so long as the investor owns, directly or indirectly, less than 50% of the vote and value of the REIT shares (and does not otherwise hold any interest which provides the 892 Investor with effective control of the REIT). Unlike a QFPF, however, an 892 Investor is not exempt from U.S. taxation if a REIT disposes of its U.S. real assets and distributes the proceeds.

Leveraged Blockers

U.S. real estate funds also often mitigate FIRPTA through the use of leveraged blocker corporations. Leverage can be used by a feeder investing through a leveraged blocker into the fund or a fund can use a leveraged blocker to hold one or more investments. See diagram 4. In the leveraged blocker structure, the blocker corporation, which is typically a Delaware corporation or a Delaware limited partnership that elects to be a corporation for U.S. tax purposes, is capitalized with both equity and debt from the fund (or in the case of a leveraged feeder, from a partnership that owns the feeder), not third-party debt. For example, a non-U.S. investor that was otherwise investing $10 million in a fund, could invest $4 million in blocker stock and loan $6 million to the blocker.

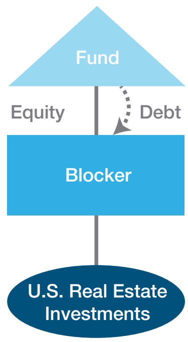
The goal of this capital structure is to reduce the U.S. federal corporate income tax payable by the blocker (currently, at a 35% rate) with deductions for the interest that is payable on the debt. For example, assume $100 million is invested in a blocker and a 2x return is achieved in five years. Ignoring current income, an unleveraged blocker would be subject to $35 million in U.S. federal income tax ($100 million of gain * 35% tax rate = $35 million). Assume instead, however, that the blocker is capitalized with $40 million in equity and $60 million in debt with a 10% coupon. Over five years, $30 million in interest would be paid on the debt. If the interest is fully deductible, the blocker would be subject to $24.5 million in U.S. federal income tax on disposition of its investments ($100 million in gain – $30 million in interest deductions = $70 million; $70 million * 35% tax rate = $24.5 million). Accordingly, in this example, capitalizing the blocker with debt would save $10.5 million in U.S. federal income tax.

For this structure to work from a tax perspective, the loans to the blocker must be respected as debt for U.S. tax purposes. Accordingly, the terms of the debt and other factors—including maturity date, interest rate, security, legal form, the debt-to-equity ratio of the blocker, and any leverage on the underlying assets—must be carefully structured. The IRS has broad latitude to re-characterize debt, in part or in whole, as equity and its ability to do so will be further enhanced if recently proposed regulations under Section 385 of the Code are finalized in their current form. Furthermore, even if the loans are respected as debt for tax purposes, there are a number of tax provisions that may limit or eliminate the deductibility of the interest payments, include the so-called earnings stripping rules.

In order to make this structure work from a tax perspective, the interest payments from the blocker to the non-U.S. investors must be free from U.S. withholding tax. Interest payable by a U.S. corporation to a non-U.S. investor is typically subject to a 30% gross withholding tax in the U.S.

One exception to this withholding tax is the “portfolio interest” exception, which generally applies to non-U.S. investors that own less than 10% of the voting power of the blocker’s equity. In a typical fund context, non-U.S. investors often will own less than 10% of the fund, so the portfolio interest exception is often available. In cases where a larger non-U.S. investor exceeds the 10% threshold, it still may be possible to qualify for the exception by structuring with two classes of stock. In such a structure, the larger non-U.S. investor would own (directly or indirectly) a class of stock with reduced (or no) voting power. This dual class structure, however, may present more tax risk. Even if the portfolio interest exception is unavailable, it is possible that interest withholding will not apply (or apply at a rate lower than 30%) because either the non-U.S. investor is resident in a tax treaty jurisdiction with the U.S. or the non-U.S. investor is exempt from interest withholding under Section 892.

Diagram 4



Leveraged Blockers and Qualified Foreign Pension Funds

As discussed above, QFPFs typically want all REIT-eligible investments to be held by one or more REITs, as they avoid U.S. tax irrespective of whether the exit is an asset sale or a sale of REIT shares. For investments, however, that cannot be held through a REIT and that generate ECI, a leveraged blocker offers the same potential benefits to QFPFs as it does for “regular” non-U.S. investors. Some non-U.S. pension funds, however, qualify as trusts for U.S. tax purposes and therefore generally are taxed at the individual rates. Accordingly, these types of pension funds may prefer to invest directly, rather than through a leveraged blocker, in order to obtain the individual rate preference for long-term capital gains.

Leveraged Blockers and Sovereign Wealth Funds

Like QFPFs, 892 Investors prefer U.S. real estate investments to be held through REITs—if the exit can be structured as a sale of REIT shares. If such an exit is not possible (or likely) or the investment is not REIT eligible, a leveraged blocker offers the same potential U.S. tax savings for 892 Investors, provided that they own, directly or indirectly, less than 50% of the vote and value of the blocker (and do not otherwise hold any interest which provides an 892 Investor with effective control of the blocker).

Publicly Traded Exception

As mentioned above, another exception to FIRPTA is for the sale of publicly traded shares of a blocker (USRPHC) or a REIT. In order to qualify, a non-U.S. investor must at all times own, directly or indirectly, 5% or less (by value) of the blocker stock (or 10% in the case of a REIT). For this purpose, it is unclear if the 5% (or 10%) threshold is measured at the investor level or the fund level. In other words, if the fund owns more than 5% of the blocker (or 10% of the REIT), the exception might be unavailable even if indirectly each non-U.S. investor in the fund owns less than the threshold.

To avoid this measurement ambiguity, some funds will establish parallel partnership vehicles—with each under the ownership threshold—for investments that are planned or otherwise likely to go public.

Of course, the other significant issue with this exception is that while there are publicly traded REITs, the vast majority of investments made by U.S. real estate funds are not, as a commercial matter, likely to be taken public. As a result, this exception is not viable for many funds.

Other Strategies

U.S. real estate funds may also avoid FIRPTA taxation by lending to fund the acquisition and development of real estate projects, rather than making an equity investment. Debt that is not convertible into equity (and that otherwise does not correlate to the value or income of the property) is not treated as a USRPI. Obviously this type of investment has very different economics compared to an equity investment. In addition, a fund that lends in this manner may be engaged in a lending trade or business, which could result in ECI to its non-U.S. investors (absent other structuring to avoid this result).

Another strategy to avoid FIRPTA is for non-U.S. investors to hold a synthetic interest in a U.S. real estate fund through an insurance company separate account "wrapper." If structured properly, the insurance product can avoid being treated as a USRPI. Nevertheless, the payments to the non-U.S. investor are typically treated as annuities, which may be subject to a 30% U.S. withholding tax. As a result, this type of product may only be viable for non-U.S. investors that are resident in treaty jurisdictions with the U.S. that reduce (or eliminate) this withholding tax or for 892 Investors. The economics of this type of investment are also not the same as a direct investment in a fund because of insurance company fees and other limits on the product to avoid being treated as a USRPI.

Other U.S. Real Asset Funds

U.S. real estate funds are not the only types of funds that must deal with FIRPTA. In fact, FIRPTA may impact a number of funds that invest in U.S. real assets, including oil and gas funds, timber funds, agriculture funds and various types of U.S. infrastructure funds. As discussed in more detail below, the FIRPTA mitigation strategies for many of these funds are limited and involve the same structures as U.S. real estate funds—REITs, leveraged blockers and publicly traded exits. Some of the funds, however, may be able to use other strategies to mitigate FIRPTA taxation.

As discussed above, the scope of FIRPTA is quite broad, and "real property" for this purpose includes not only land and improvements thereto (including buildings and any other "inherently permanent structures") but also includes unsevered natural products of the land, including oil, gas and other mineral deposits, timber and crops. FIRPTA also includes personal property if it is used predominately in connection with unserved natural products of the land, such as mining, logging and farming equipment.

Oil and Gas Funds

Oil and gas funds generally invest in four broad categories of businesses—upstream, midstream, downstream and services. Upstream businesses typically involve searching for oil and gas deposits and extracting them. For these types of businesses, it is possible to avoid the application of FIRPTA by holding only production payments, which are the right to receive a specified share of the gross production of an oil or gas well. If structured properly, production payments are treated as debt, rather than economic interests in the wells, for U.S. tax purposes, and therefore are exempt from FIRPTA (although they must also be structured to avoid U.S. withholding tax on the portion of the payments that are treated as interest).

Midstream businesses involve the transportation of oil and gas after it has been extracted, either by tanker, truck or pipeline, initial processing and storage. Downstream businesses include the refining of the products, additional transportation and sale. The U.S. assets used by both midstream and downstream businesses are generally within the scope of FIRPTA, and structuring options are typically limited to leveraged blockers (or taking the businesses public) as these types of businesses are generally not REIT eligible. The fourth sector, services, usually involves fracking, drill testing, consulting, engineering and transport. These business typically do not fall within the definition of FIRPTA (although they are often organized as flow-through entities and therefore may generate ECI).

Timber Funds

As described above, uncut timber is treated as real property and therefore is subject to FIRPTA. Standing timber is often sold by granting purchasers contractual cutting rights, which if structured properly is treated as a sale of the timber. These types of investments—as opposed to the fund itself harvesting the timber and selling cut logs—can generally be held through REITs, enabling a QFPF to avoid FIRPTA taxation. For "regular" non-U.S. investors and 892 Investors, however, a sale of timber REIT shares is typically not a commercially feasible exit and therefore structuring is often limited to leveraged blockers.

Infrastructure Funds

As mentioned above, "infrastructure" funds encompass a wide array of sectors—energy and power, transportation, water and waste management, renewable energy, telecom and social services, and a detailed discussion of each of these sectors is beyond the scope of this paper. For some of these funds, the investments may be focused on services and therefore not within the purview of FIRPTA. For many others, however, their investments will fall within the reach of FIRPTA, and the structuring solutions in many cases are quite similar to U.S. real estate and other funds—some investments may be eligible for REITs or can be bifurcated so that real estate is held through REITs and the related operating business is held separately or through a taxable REIT subsidiary. For other infrastructure investments, however, a leveraged blocker, publicly traded exit or a straight debt investment may be the only feasible options. Finally, for certain infrastructure investments there may be specialized approaches to mitigating FIRPTA based upon the unique nature of some of the assets. For example, some solar investments are designed so that the solar panels have wheels and therefore there is a position that they are not subject to FIRPTA because they are not "inherently permanent structures."

Conclusion

FIRPTA often has a significant tax impact on non-U.S. investors in U.S. real asset funds. FIRPTA is very difficult to avoid in many cases, and funds often are limited to a few structuring options—principally "domestically controlled" REITs, leveraged blockers, publicly traded entities and straight debt investments. While the PATH Act has provided an exemption to FIRPTA for certain non-U.S. pension funds, the utility of this exception is often limited with respect to investments in U.S. real asset funds because of the generation of non-FIRPTA ECI. In order to optimize this new exemption, however, such funds are beginning to expand their use of REITs and, in some cases, offer separate vehicles for non-U.S. pension fund investors.

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