# FIRPTA Reform Impacts Investment Opportunities in US Real Estate

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In recent months, much has been written to describe the reforms to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) contained in the Protecting Americans From Tax Hikes Act of 2015 (the Act), which have been widely considered the most significant changes to FIRPTA since its enactment over 35 years ago. Less has been said, however (beyond generic statements that foreign investment is likely to increase generally), about how the reforms will impact investment opportunities in U.S. real estate.

To capitalize on investment opportunities created by the Act's changes to FIRPTA, real estate companies should consider how increased foreign investment is likely to impact the demand for different asset types and geographies, the mix of foreign investment between debt and equity, and the ways in which foreign investments are structured.

## Recap of New FIRPTA Reform

The FIRPTA reform provisions went into effect on December 18, 2015, and encompass three important changes. (See December 18, 2015, client alert "New FIRPTA Reform: The Long-Awaited Game Changer for US Real Estate.") First and perhaps most significantly, the Act completely exempts "qualified foreign pension funds" and certain subsidiaries of such funds from FIRPTA taxation. Second, the Act increases the ownership threshold from 5 percent to 10 percent for the amount of publicly traded real estate investment trust (REIT) stock that foreign investors can own without being subject to FIRPTA taxation upon sale of the stock or receipt of a dividend. Third, the reform clarifies how a REIT may determine whether it is domestically controlled for purposes of FIRPTA: Under the new rules, REITs may presume (unless they have knowledge to the contrary) that all shareholders with less than 5 percent ownership are U.S. persons who count toward the 50 percent ownership threshold required for a REIT to qualify as domestically controlled.

## Investment Opportunities Created by the Reform

The upshot of the new FIRPTA rules is that it will be easier for U.S. real estate owners to attract foreign investment. Higher after-tax returns will make real estate investments more attractive for foreign investors than the risk-adjusted returns available from U.S. and off-shore non-real estate investment opportunities. According to a recent survey by the Association of Foreign Investors in Real Estate, 64 percent of respondents indicated that they intend to increase their investment in U.S. real estate in 2016. However, given the nature and contours of the FIRPTA changes, the increased foreign investment may have an uneven impact in terms of types of assets, geographic markets, types of investments and investment structures.

## Expanding Asset Type and Geographic Focus

Significant foreign investment in U.S. real estate has tended to flow toward core office properties and other trophy assets in gateway markets such as New York City, Washington, D.C. and Boston, although in recent years, foreign investment in nonoffice assets has been growing. According to a report by the commercial real estate analytics firm CoStar, in 2015, 34 percent of foreign investment was in office, 26 percent in industrial (largely due to the sale of one large portfolio), 14 percent in multifamily, 12 percent in hospitality and 10 percent in retail.

With prices for marquee real estate assets in gateway cities already at record levels, foreign investors may seek higher returns in secondary markets and accelerate growth in emerging asset types, including student and senior housing. New after-tax risk-adjusted returns may make these secondary markets and emerging asset classes even more attractive.

## Opening Channels for Equity Investments

Prior to the reform, a foreign investor could often make more significant tax-efficient debt investments in U.S. real estate than it could equity investments. This lower tax on debt investments made equity investments less attractive on a relative basis for foreign investors.

Foreign investors exempt from FIRPTA or able to make greater equity investments without being subject to FIRPTA under the new rules may seek to shift investments from debt to equity. Increased equity investments through joint ventures, real estate funds or REITs could in turn increase the availability of capital and result in better sponsor terms, shorter fundraising cycles and higher REIT valuations.

On the flip side, shifts away from debt could cause moderate tightening of financing supply, which may result in improved lender terms, including higher interest rates. This could have significant implications for real estate borrowing.

## Structuring Considerations

Under the pre-reform FIRPTA rules, foreign investors often set up complex investment structures, including U.S. corporate tax blockers and passive investment strategies, to increase the tax efficiency of their U.S. real estate investments. However, the increased complexity often limited the flexibility of foreign investors in managing and selling their investments. For example, a foreign investor might have sought to invest in U.S. real estate through a domestically controlled REIT in order to avoid FIRPTA on an exit from the investment. This required a domestic co-investor willing to provide 50 percent or more of the required capital through the REIT, as well as an ultimate disposition of the real estate via a sale of the REIT shares (as opposed to a sale of the property). The new FIRPTA rules will reduce the need for some of these more complex investment structures for certain investors.

## Conclusion

The new FIRPTA reform measures reduce barriers to foreign investment in U.S. real estate and may lead to a swell in such investments. The ability of foreign investors and U.S. sponsors, investors and lenders to capitalize on the investment opportunities created by the new rules will depend on their respective ability to understand and anticipate how the swell will impact specific markets, investment types and structures, as well as their agility navigating these new opportunities.