Key Takeaways

Skadden

How FIRPTA and REIT Changes Will Impact Investment in US Real Estate

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On May 4, 2016, Skadden presented the seminar "How FIRPTA and REIT Changes Will Impact Investment in US Real Estate." Congressman Joseph Crowley, D-N.Y., gave the introductory remarks, and panelists included Jeffrey DeBoer, president and CEO of The Real Estate Roundtable; Craig Solomon, managing principal of Square Mile Capital Management LLC; Matthew Strotton, executive vice president, head of U.S. funds and investment at QIC; and Skadden real estate partners Meryl Chae, Evan Levy and Harvey Uris, and tax partner Sarah Ralph.

FIRPTA Reform and Investment Opportunities in US Real Estate

Congressman Crowley, who originally spearheaded the effort to move the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) reforms through Congress, provided background on the genesis of the Protecting Americans From Tax Hikes (PATH) Act of 2015, which, with its passing, constitutes the first significant changes to FIRPTA since its implementation. Congressman Crowley noted that, as the economic recession unfolded in 2008, there was a growing concern that there would not be sufficient capital available to refinance a large number of commercial real estate loans due to mature in 2009 and 2010. This concern, combined with the realization that a large amount of "foreign capital was stuck on the sidelines," spurred a renewed bipartisan push to reform FIRPTA in order to open the U.S. real estate market to foreign investment and meet the U.S.' capital needs.

The congressman noted that studies estimate that the reforms contained in the PATH Act will inject approximately $20-30 billion of additional foreign capital in the U.S.

in 2017 alone. Congressman Crowley also stated that the ability to obtain additional FIRPTA reform could turn on whether the 2015 reforms actually generate additional U.S. investment by foreigners.

Ms. Chae briefly framed the seminar and discussed the historical flow of foreign capital into U.S. markets. According to industry estimates, foreign investment in the U.S. has increased from approximately $5 billion in 2009 to approximately $88 billion in 2015. Ms. Chae then highlighted how increased foreign investment in the U.S. is likely to impact demand for real estate assets and how such investments should now be structured.

PATH Act and Expansion of FIRPTA Exemptions

Ms. Ralph provided a summary of the three major areas of FIRPTA reform created by the PATH Act. First, the law expanded the exemption for foreign investors' investment in publicly traded real estate investment trusts (REITs), doubling the potential ownership threshold from 5 percent to 10 percent, before such investors would become subject to FIRPTA upon the sale of stock or receipt of a FIRPTA dividend. Second, the act clarified that a publicly traded REIT (unless they have knowledge to the contrary) may presume that all shareholders with less than 5 percent ownership in the REIT are U.S. persons for the purposes of determining whether the REIT is "domestically controlled." Finally, and perhaps most significantly, the reform created a new exemption for "qualified foreign pension funds" and certain subsidiaries of such funds from FIRPTA taxation.

Impact on Current and Future Foreign Investment in US Markets

Characterizing the PATH Act as a "bold step" by Congress to reform FIRPTA, Mr. DeBoer highlighted that the changes would encourage new investment in U.S. real estate. Mr. DeBoer also noted that given the approximately $30 trillion in pension funds around the world, the creation of the qualified foreign pension funds exemption represented a "sea change" in the way investment in the U.S. real estate markets will be considered.

Mr. Levy stated that prior to the PATH Act's passage, the FIRPTA regime "muted risk adjusted returns" for foreign investors on equity investments in comparison to debt investments that are not subject to FIRPTA. Mr. Levy anticipates that the PATH Act will encourage a shift in investment from debt to equity now that the risk adjusted returns on equity investments are enhanced and make real estate investments beyond gateway cities and trophy assets more attractive to foreigners.

Mr. Strotton noted that the FIRPTA changes are "evolutionary" and will likely result in foreign investors "rethinking and revisiting" their investment strategy in the U.S., particularly the Australian pension fund industry, which is one of the most developed in the world. With the passage of the PATH Act, Mr. Strotton anticipates that foreign investors will seek to increase direct investment in the U.S. (by either holding assets directly or with joint venture partners), develop more infrastructure to assist in the increase of direct investments in the U.S. and look to exert greater influence over these investments.

Calling the PATH Act a "huge game changer" that has resulted in a "leveling of the playing field," Mr. Solomon predicted that foreign investors will pursue more direct investments in real estate through direct ownership, joint ventures and managed vehicles. Moreover, Mr. Solomon noted that the PATH Act presents an opportunity for small investors — who previously did not have the infrastructure to create complicated structures to avoid the FIRPTA tax — to make increased investments in more accessible secondary markets outside the usual "safe havens" of major cities such as New York and San Francisco. Such investments would permit even greater foreign capital investment in the U.S. market.

Short-Term Solutions to Clarifying Ambiguities in Reform

The panelists also noted that certain ambiguities exist in the PATH Act that will likely be clarified over time. Ms. Ralph and Mr. DeBoer noted that, for example, some questions regarding the scope of the term "qualified foreign pension funds" are being further assessed and discussed. Mr. Solomon added that he anticipates that investors will begin to employ investment strategies relying on the reforms but also come up with creative "backup" structures that will continue to protect the investments from inefficient taxes by more traditional structuring methods. Mr. Levy briefly discussed certain alternative structuring options that could be used to maximize the value of investments.

Closing Remarks

Noting the "overwhelmingly" positive reaction to the PATH Act's reform efforts, the panelists emphasized the law's potential to reduce barriers to foreign investment in U.S. real estate, spur a range of foreign investment in the U.S. and result in changes in the way the deployment of foreign capital is structured. The ability of foreign investors and U.S. sponsors, investors and lenders to capitalize on the investment opportunities created by the new regime will depend on their respective ability to navigate these new opportunities.