FOCUS ON LEGAL ISSUES

Using Private REITs for Joint Ventures with Foreign Investors

by Edwin "Brick" Howe, Jr., CRE

In recent years there has been increasing interest in structuring a joint venture between one or more U.S. investors in real estate and one or more foreign investors as a private real estate investment trust, or REIT. (The term "investor," as used below, is equally applicable to a plurality of investors.) This piece will 1). set forth an outline of this structure and its tax implications; 2). describe (as an illustration) a transaction on which I and others in my law firm worked recently that might be described as "the latest thing off the boat" in this sector; and then 3). analyze some variations that may be made on the theme, depending upon the status of the parties to the investment and their respective tax and other requirements.

A REIT is a corporation, or a business trust taxable as a corporation, that essentially pays no federal income tax at the REIT level. Rather, the shareholders are taxed on dividends received from the REIT – at the shareholder's ordinary-income rate on dividends corresponding to the REIT's ordinary income or at the shareholder's capital-gain rate on "capital gain dividends" corresponding to the REIT's capital gains. By way of contrast, as a general rule, a corporation is taxed at the corporate level and its dividends are taxed a second time at the shareholder level. Thus, REITs for the most part share the characteristic of "tax transparency" with partnerships and with limited partnerships and limited liability companies not electing to be taxed as corporations.

In years gone by, REITs were subject to numerous, complex, and very burdensome legal requirements, including severe restrictions on management and the rule that they must pay out as dividends at least 95 percent of their REIT taxable income. These were, and are, not applicable to the other tax-transparent entities. Partnerships and limited partnerships were therefore the preferred vehicles for many years for U.S./foreign joint investment in U.S. real estate. (The limited liability company is a form of entity that has received widespread acceptance in just the last few years.)

Since then, Congress and the IRS have lightened up considerably on REITs. The applicable legal requirements are still numerous and complex but they are now just tolerably burdensome. Among the major remaining strictures is that the REIT's gross income must consist, to at least a specified minimum percentage, of income related to real estate (informally called "good REIT income"). In addition, effective January 1, 2001, the minimum dividend payout rate will drop from 95 percent to 90 percent. At the same time, there have been major changes in the international tax field which have boosted the popularity of private REITs.

Until 1980, if a foreign investor's investment in U.S. real estate—directly or through a tax-transparent entity—was properly planned, there would never be

any federal income tax payable, including tax on capital gain realized at the time of sale. In December 1980, Congress enacted the Foreign Investment in Real Property Tax Act, or FIRPTA, making it effective retroactively for some six months. (In the last 20-odd years, Congress has become very fond of retroactivity in tax legislation.) FIRPTA introduced a broad-based tax, at rates ranging from 20 percent to 35 percent, on a sale by a foreign investor of U.S. real estate or an interest in a tax-transparent entity or corporation holding U.S. real estate. Capital gain dividends paid by a REIT are also subject to FIRPTA. Section 897(h)(2) of the Internal Revenue Code provides an exemption for dispositions of shares of a domestically-controlled REIT (a "USREIT"), defined as a REIT more than 50 percent by value of the shares of which are owned by U.S. persons; the U.S. investor must, of course, be prepared to make a genuine investment equal to more than half the value of the USREIT. This exemption is *not* applicable to capital gain dividends paid by a USREIT. Section 897(h)(2) is one of the few ways to plan around FIRPTA. Indeed, it may be the only way.

Of course, the foreign investor could sell its USREIT shares to anyone and claim the benefits of section 897(h)(2). But the sale of a minority interest in a USREIT is unlikely to fetch as high a price as the sale of the foreign investor's shares in conjunction with the sale of the USREIT's real estate. In recent years, a technique to achieve the latter result has been developed. The U.S. and foreign investors set up a private USREIT (*i.e.*, a non-publicly-traded USREIT with two or more, but very few, principal investors). In the USREIT's governing documents, the foreign investor is essentially given the right, exercisable before the sale, to put its shares to the principal U.S. investor on the basis of the anticipated sale price of the underlying real estate. The price is payable by a non-recourse note of the U.S. investor that is secured by a pledge back to the foreign investor of the shares sold. The note itself is in effect payable when the real estate closing has taken place.

In the spring of last year, a deal containing a major twist on the structure just described arrived at our office. Our client was a Dutch pension fund. The counter-party was a publicly traded USREIT (the "Investor REIT"). The parties wished to invest a specified amount in a *portfolio* of six to eight properties, to be jointly selected over the ensuing year or two. This presented some interesting new issues. The following description of our resolution of these issues outlines the basic structure that was adopted but, for the sake of clarity and brevity, it leaves out some of the less consequential details and simplifies others.

The Income Tax Treaty between the U.S. and The Netherlands provides that dividends paid by a U.S. corporation to a Dutch pension fund are generally exempt from U.S. income tax. However, a Protocol to the Treaty withdraws the exemption in the case of capital gain dividends paid by a REIT. Since it is unlikely that the entire portfolio would be sold simultaneously, the gains on sales would result in capital gain dividends taxable to our client if all of the properties were held by a single REIT. The solution was to set up a separate USREIT (a "Venture REIT") for each property and incorporate in its governing documents the put procedure described above. The parties entered into a Framework Agreement which contained their respective capital commitments, the program's investment criteria, etc., and to which were attached forms of the other documents to be used for the investments. Because the Investor REIT has no control over the composition of its shareholdership, it was decided to add to the investor group, with an investment of about 9 percent, another U.S. financial institution in an effort to "insure" the Venture REITs' status as USREITs.

As the portfolio and asset manager of the properties, the Investor REIT was to receive compensation based on performance (called a "promote" in the industry) equal to a percentage of net operating income after all parties had received the return of their investments and a specified return on the investments. The promote was to be portfolio-wide, netting the losers, if any, against the winners. The parties determined that the most efficient way to accomplish this was to insert a Master Limited Partnership, or MLP, between the investors and the Venture REITs. The investors would hold interests in the MLP, which would in turn hold the Venture REITs' shares. The MLP Agreement was to be signed at the same time as the Framework Agreement.

Then, just before the closing of the first investment in late summer, there was introduced in Congress a bill, retroactive—of course—to the preceding July, whereunder REIT status would be denied to any entity owned more than 50 percent as to vote or value by any one person. The term "person" includes the MLP and may also include other

shared-distribution structures, which risk being classified as partnerships for tax purposes. So, as each investment has been funded, the MLP has been bypassed and the investments have been made directly in the shares of the Venture REITs. The parties also signed an additional agreement to put the MLP back into the loop if the proposed legislation dies or to negotiate in good faith the next-best alternative to the MLP if the proposed legislation becomes law.

While the proposed legislation is an unwelcome snag, it is not regarded as a critical hurdle at this time. Because of its residual nature, the promote will not begin to be payable for some years to come. Indeed, the same parties are proceeding with a second, similar investment program, notwithstanding the proposed legislation.

Now, let's look at a couple of variations. There are doubtless many others, but these examples will give you a taste of how small changes in the fact pattern can affect the outcome.

Suppose that the facts of the structure just described stand as they are but that the principal U.S. investor is not a REIT. That would do away with the snag introduced by the proposed legislation. Because of the dire consequences of the Investor REIT's failure to meet the minimum standard for "good REIT income"—loss of REIT status—the Investor REIT wants every possible dime of its receipts to be good REIT income. Income constituting a special distribution on shares of a REIT, whether received directly or through an entity like the MLP, is good REIT income. Fees are not. A U.S. investor other than a REIT, however, could receive the promote in the form of fees paid pro-rata by the Venture REITs, rendering an MLP unnecessary.

Now suppose that the foreign investor is someone other than a Dutch pension fund. It won't have the benefits as to ordinary dividends that our Dutch client has. These will be subject to U.S. income tax at the rate of 30 percent, or lower treaty rate. (The coming reduction in the minimum dividend payout rate from 95 percent to 90 percent may provide at least some relief here.) But it *will* have the benefit as to gains on sales of USREIT shares provided by section 897(h)(2). To me, that is the elegant part of this structure. Section 897(h)(2) is *statutory*, available to all who come, not a creature of a tax treaty that is available only to a select few. REI25

NOTE

The foregoing is merely an outline of a potentially useful structure and should not be relied on as legal advice. This is definitely something you should not try at home.

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Edwin "Brick" Howe, Jr., CRE, *is a lawyer practicing for 35 years in a range of areas, including real estate, business, and international law, taxation, and litigation management. He is currently senior counsel to Howe & Addington LLP, the New York City law firm he founded in 1970. He is also president of The Roseville Company LLC, a consulting firm based in Westport, CT, where he serves on the Town's Land Acquisition Committee and its Architectural Review Board.* [redacted]