U.S. GIVES GLOBAL INVESTORS A GIFT: HOPES TO GET ONE BACK IN 2016

By Catherine Ann Marshall

America has given global real estate investors a surprise gift in the hopes of getting one back.

The surprise Christmas present was the removal of some "punitive" taxes on U.S. real estate investments. Changes passed unexpectedly by Congress Dec. 17, 2015, and signed into law by President Barack Obama the next day, eliminate the tax on real estate dispositions by foreign pension funds, and allow any global investor to own up to 10% of a U.S. REIT without triggering capital gains tax.

As a result of this tax relief, commentators expect global investors will give the U.S. the gift it was hoping for - new rounds of global real estate capital flowing into the American market starting this year.

POTENTIAL TO SPUR A FLOOD OF NEW CAPITAL

Many international investors were already bullish on U.S. property investment prior to the changes to the Foreign Investment in Real Property Tax Act, known by the tongue-twister "FIRPTA". According to a Fall 2015 survey of some of the largest global real estate investors, the U.S. is the most attractive country in the global real estate market. Nearly two-thirds of the respondents - who were surveyed prior to the FIRPTA changes - expect to buy more U.S. property this year.

But the head of the organization that conducted the survey, the Association of Foreign Investors in Real Estate (AFIRE), said he is certain that changes to FIRPTA will bring even more foreign real estate investment into the U.S. According to AFIRE CEO Jim Fetgatter the changes are "a huge deal." However, because they came unexpectedly after languishing in Congress as proposed legislation for years, Fetgatter says it will take some time for investors to incorporate the new rules into their international real estate investment strategies.

In earlier surveys, in 2012 and 2014, AFIRE members said that relief from FIRPTA would have the greatest impact on their international real estate investment strategies in the U.S. With close to 200 members from 23 countries representing nearly $2 trillion U.S. in global real estate assets, AFIRE represents an important group of industry opinion leaders.

Jeff DeBoer, head of a coalition of business and labour organizations – including AFIRE – who lobbied for the tax change, characterized FIRPTA in a letter to Congress as a "punitive," "anti-competitive" law that could result in levies as high as 54.5%.

In a statement shortly after the FIRPTA changes were announced, DeBoer said that "breaking down the tax barriers would mobilize new international investment in real estate".

A chorus of other commentators also heralded the FIRPTA changes as important to global investors in real estate. Leading Canadian law firm Osler called them "a powerful incentive for non-U.S. pension funds to increase the amount of capital devoted to U.S. real estate." International law firm MacGuire Woods said "this provision should significantly reduce the once nearly stifling effect of FIRPTA on foreign investment in U.S. real estate." Global legal giant Skadden described FIRPTA reform as "the long-awaited game changer for U.S. real estate."

TRANSACTION AND PRICE IMPACTS

Indications are that 2016 transaction volumes and prices will respond to the FIRPTA changes based on an estimate of significant new capital inflows starting this year.

Despite the positive outlook, many commentators have avoided putting a dollar figure on the expected impact of the tax change as they don't know exactly what FIRPTA's drag on investment has been.

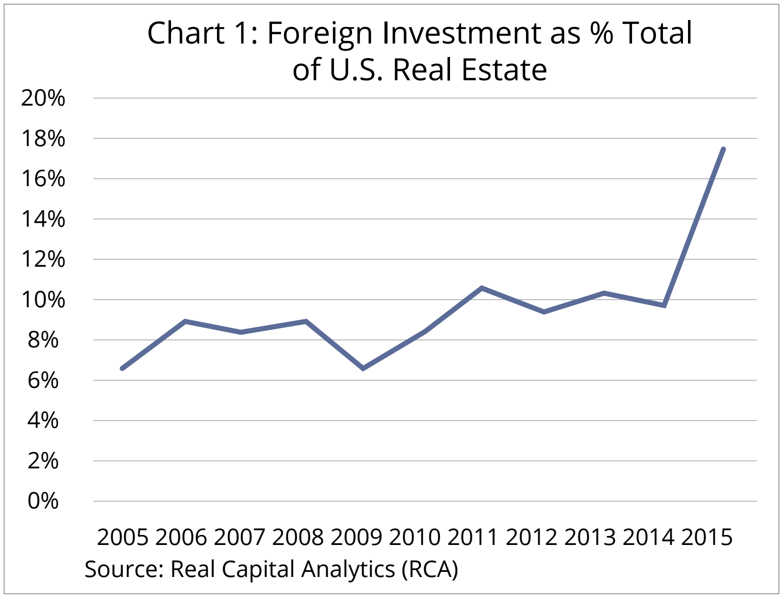
However, an indication of FIRPTA's negative impact on Sovereign Wealth Funds (SWFs) comes from the SWF Institute. An article posted on the Institute website says its proprietary database shows that SWFs invested more than $33 billion U.S. in the global real estate market in 2015: $18.84 billion in non-U.S. real estate compared to $14.49 billion in U.S. property. In addition, the website suggests U.S. investment would have been even lower had it not been for a special provision in American law that allowed SWFs to build legal structures to take advantage of their special status in U.S. law as extensions of governments.

One forecaster who has been willing to estimate the impact of the FIRPTA changes is Economist Ken Rosen, Chair of the Fisher Center for Real Estate and Urban Economics at the University of California Berkeley. Rosen expects an additional $20-30 billion U.S. in commercial real estate investment could materialize in 2016. Using the $25 billion mid-point of the range and comparing that to Real Capital Analytics (RCA)'s estimated average foreign investment since 2010 suggests that FIRPTA's liberalization could increase foreign real estate investment by almost 60% over the next year.

In the longer term, James Corl, managing director at private equity firm Siguler Guff & Co. expects an even bigger impact. He believes that hundreds of billions of additional capital could potentially flow into U.S. real estate in the long term. "Foreign pensions are such a low percentage of foreign investment in U.S. real estate because of FIRPTA," Corl said.

Jim Costello, a Senior Vice President at RCA who specializes in global real estate market intelligence, also anticipates long term growth in capital investment by both pension funds and REIT investors. "When you knock down barriers, capital always finds its way to take advantage of it," he said.

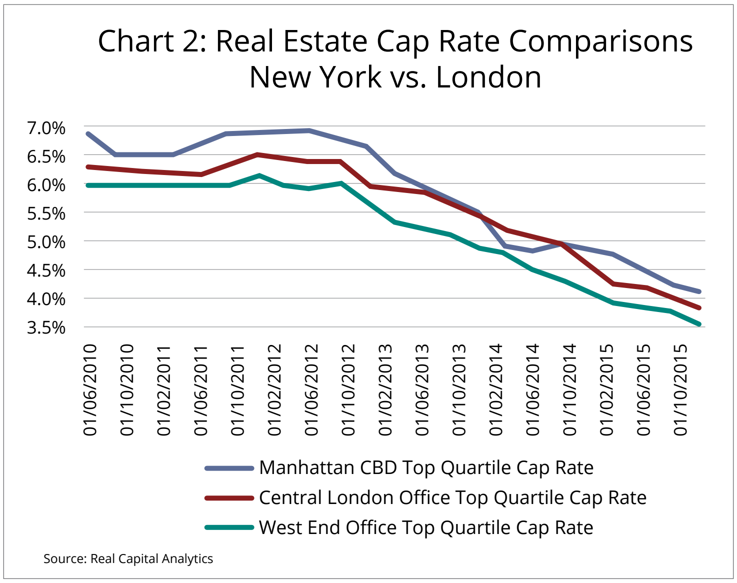
If these expectations materialize, it will add further momentum to already strong flows of foreign investment. Cross-border investors in U.S. real estate had their most active year in 2015 (Chart 1). Foreign investors were involved in almost 17.5% of all transactions, up from just 8% in 2010.



Although real estate investment has globalized significantly, with the value of worldwide cross-border investment tripling worldwide between 2010 and 2015, the U.S. has seen a disproportionate share of this growth. Based on RCA estimates, over the 2010-2015 period foreign investment into the U.S. has jumped 700%.

FIRPTA's liberalization should impact more than just transaction volumes. Prices may also increase.

Pundits have used a comparison of two very similar cities, London and New York, to demonstrate FIRPTA`s negative price impact on U.S. prices. As Chart 2 shows, New York office prices historically offered investors a going-in yield premium of up to 1% over West End London office. RCA's Costello says the FIRPTA changes may reduce the premium in future. However, the gap in yields may never go away even if FIRPTA is completely abolished due to non-tax differences such as London`s landlord friendly lease structure.



SAVING THE FAMILY FARM

Real estate is not the only asset class affected by the changes. Agricultural land as well as infrastructure are also caught up by the tax.

The history of FIRPTA was that it was originally signed into law in 1980, ostensibly aimed at saving “the family farm” from foreign interests. But, in addition to farmland, it ended up applying to all land and buildings (and related infrastructure). Ironically, it seems to have had little impact on the agricultural sector it was intended to protect.

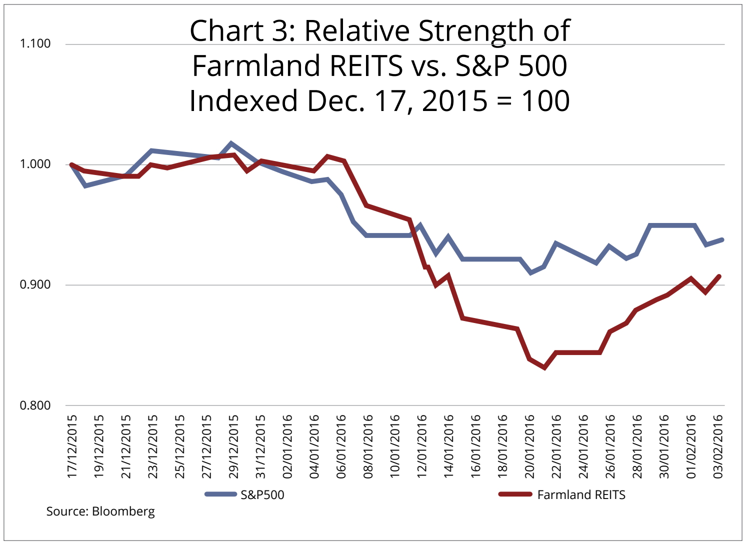
Jon Brorson, Managing Director of Agricultural Management for Chicago-based Mesirow Financial, said that the reaction by his industry to FIRPTA has historically been minimal because most agriculture investors have been domestic. As a result, he doesn’t expect much of an impact in 2016.

However, Brorson anticipates there will eventually be an uptick in capital inflows into U.S. farmland based on recent discussions with global investors. “I’m more sanguine than the rest of the market on the effects of the changes we have seen so far,” he said.

IMPACT ON REITS AND DIRECT REAL ESTATE INVESTING

REITs are the most immediate way that large investors can take advantage of the FIRPTA changes, as the new rules allow a single foreign entity to own up to 10% of a REIT without incurring capital gains tax.

However, consistent with Brorson's outlook, the farmland REITs in the U.S. (tickers FPI, LAND and AFCO combined into an equally weighted index) in Chart 3 don't appear to be benefitting from an uptick in foreign investment flows as they have generally underperformed the broad stock market, represented by the S&P 500 index, since the FIRPTA announcement.



In contrast, there is evidence that the new FIRPTA rules are attracting strong investment flows into U.S. commercial and multi-family real estate REITs. The largest and most liquid REITS, which are captured in the MSCI REIT index, have been outperforming the S&P 500 index (Chart 4). This is a reversal of the stronger performance of the S&P500 index as compared to the real estate REIT index throughout 2015.

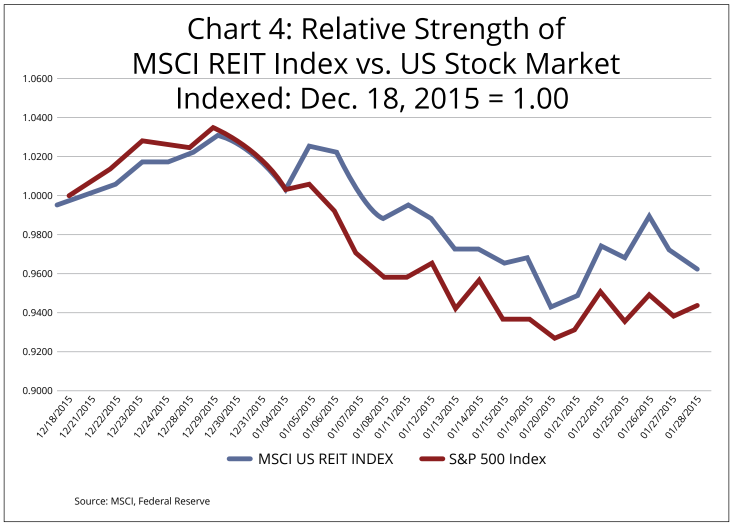


Chart 4: Relative Strength of MSCI REIT Index vs. US Stock Market Indexed: Dec. 18, 2015 = 1.00

It’s not surprising that the impact of the FIRPTA announcement would show up in the largest and most liquid REITs as they are the easiest avenue for investors to quickly take advantage of the tax changes. It seems likely that the relatively strong performance of the REITs is a harbinger for additional flows into the direct real estate market later in the year.

DETAILS OF THE FIRPTA CHANGES

FIRPTA has been described as punitive as it singles out real property - including real estate - owned by foreigners for special tax treatment. In contrast, U.S. stocks and bonds enjoy tax-free capital gains.

FIRPTA was designed to equalize the capital gains tax rates paid by international and U.S. taxpayers (i.e. at rates of up to 35% for corporations and between 20-40% for individuals). However, international pension funds were singled out, as they did not receive the same tax-free status of U.S. pension funds. So the recent changes to FIRPTA rectified this inconsistency by exempting “qualified foreign pension funds”, and entities wholly owned by such funds, from capital gains taxation.

Although the regulations to implement the legislative change have not been released, it has been speculated that this change will apply to global pension funds who invest either directly, through joint ventures, or through fund vehicles.

Another important change announced in the FIRPTA liberalization is that any non-U.S. investor can now hold up to 10% of a publicly traded U.S. REIT without triggering FIRPTA upon sale of the stock. Previously, FIRPTA was triggered upon sale or a capital gain distribution if a foreign investor held more than 5% of a U.S. REIT’s shares. This provision also exempts the capital gains tax on distributions due to the sale of buildings owned by the REIT.

MIND-NUMBINGLY COMPLEX

The FIRPTA changes announced in December represent partial steps toward full tax liberalization. But the reality is that many global investors in real estate are still subject to the impact of FIRPTA which, according to experts, is expensive as well as mind-numbingly complex. As a result, these foreign investors will continue to be put off by potentially high taxes, as well as the costly legal and accounting experts needed to estimate the potential tax bill.

Although FIRPTA is supposed to equalize the capital gains treatment on both American and foreign investors, in certain cases foreigners face a much higher tax bill than U.S. tax filers - as high as 54.5% - due to other taxes on foreigners' profits being applied. To add insult to injury, additional state and local taxes may also apply.

Another aspect of the tax that deters investment is the withholding requirement on foreign sellers of U.S. real estate. As a result of the withholding requirement investors only receive just 90% of the proceeds from a sale, while the other 10% is held back to ensure the tax will be paid.

To demonstrate the most severe potential consequences of the FIRPTA withholding requirement, a report co-authored by Costello models the sale of a low-growth investment. The scenario was based on a $300 million investment in a Chicago office building sold after 10 years for a pre-tax gain of $28 million representing a 9.3% return (assume no depreciation).

Because of the withholding requirement, investors only received $295 million in sale proceeds with almost $33 million held back pending the investors filing a tax return and the IRS evaluating and determining the tax payable. Assuming a lengthy evaluation of the tax return, the investors were out-of-pocket almost $5 million of their initial capital, which translates into a -1.6% capital loss for a significant period of time. In summary, Costello's report shows that in cases where the property has little to no appreciation, investors receive less than they paid for the building until the IRS adjudicates the tax return and remits the after-tax proceeds.

The last aspect of FIRPTA that deters investment is the requirement for foreign investors to file U.S. tax returns. This means these investors are potentially subject to the investigatory and subpoena powers of the IRS. Some organizations who may have nothing to hide still find this prospect to be nothing short of daunting.

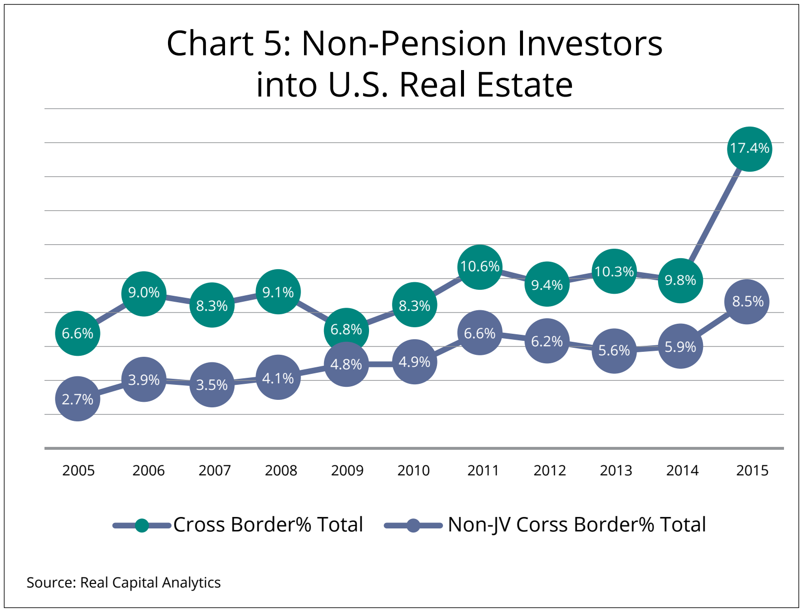
WHAT COULD GO WRONG?

Even with the best of forecasts, there are always risks that things will not turn out as expected.

Although the FIRPTA changes appear to be an unambiguous boost to U.S.-bound capital flows, there are risks to the forecast of between $20-30 billion in additional foreign investment in 2016.

WITHHOLDING RATE INCREASES TO 15%

Although foreign pension funds will be liberated from withholding the proceeds from U.S. sales, all other foreign investors will now face an even higher withholding rate - 15% unless they create expensive legal structures to avoid FIRPTA. This could put a chill on investment by non-pension fund investors. The importance of this group of investors is estimated by the blue line in Chart 5.



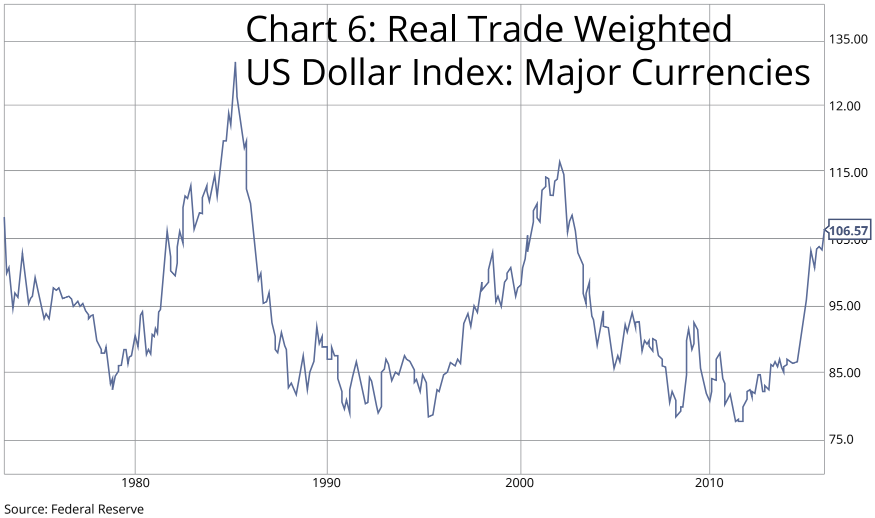
U.S. ECONOMY SLOWS TO STALL SPEED IN A GLOBAL SLOWDOWN

Economic data is underscoring the international headwinds the U.S. faces as the rest of the global economy slows. In January 2016, the IMF reduced its forecast for U.S. growth in 2016 to 2.6% from the forecast of 2.8% it made in October 2015. While the economy remains "resilient" overall, the strong U.S. dollar is weighing on manufacturing, and low oil prices are curtailing capital investment, the IMF reported.

STOCK MARKET CONTINUES TO FALL

REITs trade more like stocks than real estate in the short term. So continued poor stock market performance during 2016 may stem capital flows to REITs as investors may wait on the sidelines for the market to bottom before they invest aggressively.

IMPACT OF A STRONG U.S. DOLLAR



Although it is widely accepted that investors cannot successfully "time" the currency market, the swift run-up of the U.S. dollar against a wide number of currencies (represented by the trade-weighted dollar) could be daunting, deterring investment in 2016.

GLOBAL INVESTORS HOPING FOR ANOTHER GIFT

The U.S. is well known for its pro-business orientation. Unfortunately, that orientation has been sorely lacking in its tax treatment of foreign real estate investors over the past 35 years. Partial steps toward tax liberalization have arrived right when the U.S. seems to need a shot of stimulus from foreign capital investment, and it appears likely that investors will respond in 2016.

But the gift that investors worldwide are looking for is a complete removal of FIRTPA. That would be the gift that keeps on giving.

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Catherine Ann Marshall, CFA, is a global real asset investment consultant at RealAlts who advises on international real estate investment strategies.