Unlocking Foreign Investment in U.S. Commercial Real Estate

July 2017

by:
Kenneth T. Rosen
Randall Sakamoto
David Bank
Brett Fawley
Adam Eckstein
Michael Stern

Rosen Consulting Group
1995 University Avenue
Suite 550
Berkeley, CA 94704
510 549-4510
510 849-1209 fax
www.rosenconsulting.com

© 2017 Rosen Consulting Group
Unlocking Foreign Investment in U.S. Commercial Real Estate

The U.S. economy is one of the most attractive in the world for investors of all types because of the strength and stability of the country and the access it provides to open and fair markets. However, an arcane tax law, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) has created a burdensome regulatory environment that sends potential real estate investment capital of between $65 billion and $125 billion to other countries and other asset classes. By foregoing this real estate investment activity, the U.S. also sacrifices between 147,000 and 284,000 jobs in a variety of industries. The United States is the most valuable and stable real estate market in the world, and accordingly it should be the prime destination for investment capital, yet FIRPTA is so restrictive that foreign investment activity is more concentrated in other countries than in the United States. A repeal of FIRPTA would rapidly boost investment activity in the United States, provide needed capital for infrastructure, create jobs and contribute to GDP without a material decrease in federal tax revenues.

The FIRPTA regime unfairly penalizes foreign investment activity in U.S. real estate and effectively causes real estate investments to be treated differently than foreign investment in any other class of assets. While the initial reasoning for enacting FIRPTA was to protect domestic agricultural land from foreign ownership, the legislation and subsequent Internal Revenue Service (IRS) interpretations of FIRPTA have combined to effectively penalize foreign owners of all types of U.S. real estate, including investment interests in commercial real estate. While some countries maintain restrictions on investments in residential real estate, the United States is the rare advanced economy with substantial barriers to commercial real estate investment. Even among all of the complexities of the U.S. tax code, FIRPTA stands out as an arcane and punitive tax law that overregulates real estate investment activity and constrains economic growth.

FIRPTA imposes a tax on the gain that foreign individuals and entities recognize when they sell U.S. real property interests. Generally, for purposes of FIRPTA, U.S. real property interests include interests in U.S. real estate and interests in corporations whose assets are predominantly composed of interests in U.S. real estate. Originally, FIRPTA was a self-assessed tax, but it was later amended to establish withholding mechanisms to ensure that foreign investors would pay taxes on their profits from U.S. real estate investments. These mechanisms impair investment activity and increase the cost of doing business for foreign and domestic investors involved in certain transactions.

Opposition to FIRPTA has increased over time, culminating with a substantial, but partial, reform of FIRPTA in the Protecting Americans from Tax Hikes Act of 2015 (PATH Act). While the PATH Act increased the withholding rate under FIRPTA, it exempted certain “qualified” foreign pension funds from FIRPTA regulation and increased the amount of publicly traded real estate investment trust (REIT) shares a foreign investor may own without triggering FIRPTA taxation, among other changes. While the reform measures were a step in the right direction, a full repeal of FIRPTA is the only way to eliminate the current regulatory overreach and penalization of U.S. real estate investment activity by foreign investors.

Overbearing FIRPTA Regulations

Generally speaking, foreign investors are subject to FIRPTA taxation on their sale of an interest in a company where at least 50% of the company’s balance sheet is attributable to the value of U.S. real property. Interests in certain types of investment companies are exempted from FIRPTA where less than 50% of such companies are directly or indirectly owned by foreign persons. Under FIRPTA, a foreign investor is subject to tax of up to 35% on gains realized from the sale of a real estate asset. Additionally, some foreign investments can trigger a branch profits tax which, combined with the FIRPTA tax rate, could create a tax liability of roughly half of the gross profit of the sale of the real estate asset. In effect, a foreign investor would have to generate a pre-tax return at twice the rate of some domestic investors to achieve the same after tax investment profit. The potential for a substantial tax liability causes many global investors to invest elsewhere in countries that do not penalize foreign investors.

Beyond the penalty of a greater tax liability, the regulatory aspects of FIRPTA impose onerous regulations on real estate transactions. In nearly all cases where a foreign real estate investor is involved in the sale of an asset, regulatory documentation is required to determine the appropriate tax rates and withholding rates. The documentation rules and guidelines are complex and typically require tax accounting and/or legal experts to assist with preparation. In the case where a foreign investor sells an asset to a domestic investor, there are even regulatory requirements on the domestic investor. In a transaction involving a foreign seller, the buyer of the real estate asset is generally required to withhold 15% of the gross sales price or fair market value and remit this amount to the IRS. The withholding requirement does not have a clear adjustment mechanism where a transfer of debt or other non-real estate components offset the actual amount of funds transferred from the buyer to the seller. The IRS retains the FIRPTA withholding until the foreign seller files the appropriate form or tax return. This can be months or more than a year after the transaction closes. Not only is the seller of the real estate asset penalized as they are forced to deposit funds with the IRS, but ultimately they are unable to determine the full extent of...
the transaction cost as they will be without the withholding funds for an unknown period of time.

Additionally, the IRS applies look-through and look-back rules to real estate transactions involving a foreign investor. In essence, the look-through rules stipulate that foreign investors are assumed to be subject to FIRPTA tax on their investment in a domestic corporation unless the investors apply for and receive a determination that the company is not a U.S. real property holding company for purposes of the FIRPTA rules. The look-back rules extend for five years, allowing the IRS to impose FIRPTA tax on an investor in a company based on the assets the company held as far back as five years prior. Consequently, all parties to a U.S. real estate investment involving foreign entities must carefully ensure continuous FIRPTA compliance throughout the lifetime of the investment and beyond.

For domestic firms partnering with foreign investors, FIRPTA may limit the range of strategic investment decisions that domestic firms can consider, such as selling an ownership interest, because these decisions may affect the applicability of FIRPTA to the entire investment vehicle. This increases the complexity of co-investor relationships and may further limit market activity by domestic and foreign real estate investors. The regulatory burden of complying with FIRPTA, the actual costs of the withholding requirements and FIRPTA tax rates, and the extended length of examination create a highly punitive environment for foreign investors that prevents many from investing in the United States.

Moreover, the application of FIRPTA remains uncertain in many situations. For instance, ten years ago the Treasury Department stated that liquidating distributions of a REIT are to be treated as a sale of real estate subject to the FIRPTA tax rules rather than a sale of stock for foreigners, but not for U.S. residents. The Treasury Department further stated its intent to issue much-needed regulations to clarify the application of FIRPTA around this scenario, but has so far failed to provide clarity, leaving foreign investors unable to plan and make fully informed investment decisions. In the context of nonrecognition transactions, the convoluted FIRPTA regulations make it unclear if and when FIRPTA gains must be recognized in various circumstances, and in some situations even dictate illogical results. Additional ambiguities and inconsistencies can be found throughout the FIRPTA rules and regulations. Faced with uncertain tax treatment, and punitive look-back and look-through rules, many foreign investors simply choose to forego investing in U.S. real estate.

With its high tax rate and stringent requirements, it would be reasonable to assume that the tax receipts generated by FIRPTA taxation are an important component of federal revenues. However, because FIRPTA so effectively deters investment activity, the actual amount of tax revenue generated is minimal. The estimated net impact of FIRPTA on the federal budget was less than $50 million per year in FY 2009 to 2013, according to the Staff of the Joint Committee of Taxation (Figure 1). With total federal receipts averaging $2.7 trillion per year during the same period, FIRPTA tax revenue relative to total receipts is less than a drop in the bucket. At such a small amount, FIRPTA is essentially immaterial to the federal budget. The primary issue that FIRPTA tax receipts highlight is how effective this law is at causing foreign real estate investors to ignore the United States and invest elsewhere.

FIRPTA’s Many Costs and Distortions

The cost of FIRPTA to the U.S. economy and distortions to the commercial real estate market are substantial. FIRPTA discourages foreign investment in the United States and drives investors to other countries (Figure 2). The effect of discouraging foreign investment is a reduction in capital liquidity, distortion in relative asset pricing and the unrealized potential of creating local jobs and contributing to GDP. As with other tax and regulatory overreaches, American workers and investors pay the price for the induced market inefficiencies.

The real estate industry directly employs more than 8.8 million workers in construction, development and service-related industries. Moreover, it indirectly supports millions more in industries that support real estate, including banking and finance, accounting,
architectural, legal, and manufacturing. Inhibited capital flows distort the volume of real estate transactions, hurting the owners of assets and those they directly and indirectly employ. The artificially deflated transaction activity and liquidity may decrease the attractiveness of new development, which contributes to the further aging of the U.S. capital stock, as well as continued shortages in housing and some types of commercial real estate in local markets.

FIRPTA increases the costs and regulatory burdens of investment in the U.S. on real estate investors. Foreign investors typically prefer taking a minority stake in U.S. real estate interests so as to prevent FIRPTA taxation, but as a minority ownership interest holder, a foreign investor would need to incur transaction costs on at least double the number of investments to deploy the same amount of capital as a sole ownership interest holder. For many large-scale investors with investment mandates in the hundreds of millions of dollars range, the universe of investable assets that contribute to efficient investment strategies is relatively limited.

**FIRPTA Constrains Foreign Investment**

The United States is the largest beneficiary of foreign investment into equities or bonds in the world, translating into trillions of dollars of foreign capital. The country is a primary destination for foreign capital of all types as it uniquely offers return potential driven by a growing economy and population combined with the stability and safe haven nature of investing from the strong rule of law. Foreign direct investment (FDI) is an effective gauge of capital flows and investor interest, and also highlights the openness of the economy to external investment sources. The United States attracted 22% of global inward FDI stock in 2015, by far the largest recipient of foreign capital. As the largest equity, bond and real estate markets in the world, all else equal, we would expect global capital to flow into each of these asset classes in similar proportion. In the equity and sovereign and corporate bond markets, foreign investment is roughly on par; however, in the commercial real estate sector, foreign investors hold only 5% of commercial real estate by value (Figure 3). While we would not expect the share of commercial real estate holdings to match foreign holdings in the equity and bond markets, the foreign share of commercial real estate is much too low given that the United States is the deepest, safest and most liquid real estate market in the world. In the absence of few other differences that would affect investment activity, the disparity in real estate investment can be attributed exclusively to FIRPTA.

**Liquidity is Key in Real Estate: FIRPTA Disproportionately Harms Small and Mid-Sized Markets**

The recovery from the last downturn in the commercial real estate market was uneven in recent years, dominated by gateway cities and coastal markets. The weaker tenant demand drivers in the center of the country and in smaller metropolitan areas, combined with financial industry regulation, constrained lending by banks and other capital sources. With fewer lending options, real estate investment and development was much more difficult in these regions. A sensible improvement in liquidity, or the availability of capital, without weakening loan underwriting criteria would benefit real estate markets throughout the country. Foreign investment capital could improve liquidity as the repeal of FIRPTA would spur investment activity in a range of markets and for assets with lower property values. In areas where the commercial real estate market recovery was weak, an inflow of investment capital could revitalize cities and neighborhoods.

One of the FIRPTA distortions is that it drives investment capital to a small number of large markets (Figure 4). The scale of property values and business conditions in the largest cities allows global investors to invest with positive return potential. Global investors can allocate investment capital more efficiently at scale, often investing hundreds of millions of dollars in one transaction, in major metropolitan areas. To invest the same amount in smaller markets would require a substantially greater number of assets, which is more costly to manage, and prevents many foreign investors from...
entering these markets. If foreign capital was allocated by geography roughly similar to domestic investor allocations, more than $56 billion of investment capital would have gone to smaller and mid-sized metropolitan areas in the last five years.

Under the FIRPTA regime, the concentration of foreign investment activity in a handful of markets is apparent. The largest cities with the highest property values garnered the vast majority of foreign investment capital. Similarly, foreign investment flowed to assets with higher property values such as central business district (CBD) office buildings. The analysis of historical investment activity by foreign investors highlights the size and scale that foreign investors must deploy in order to achieve positive return potential under the FIRPTA regime. Furthermore, recent transaction activity highlights the predominance of foreign pension funds, sovereign wealth funds and other institutional and sophisticated investors that have the expertise and human capital resources to navigate the labyrinthine complexity of FIRPTA compliance. Many smaller investors, particularly those willing to invest in mid-sized markets, choose to avoid investing in U.S. real estate altogether because of FIRPTA. In the last five years, investment from abroad in commercial real estate totaled approximately $280 billion (Figure 5).

Liquidity is key to efficient property markets. The last recession and the slow pace of recovery underscored the negative effects of the lack of investment capital. A repeal of FIRPTA would increase the amount of investment capital that could be deployed regardless of the business cycle, and a wider availability of capital could provide greater stability to asset values, particularly in markets where the current pool of investors is smaller.

**Helping Stimulate Infrastructure Investment**

The need for improvements in infrastructure across the country is apparent and a repeal of FIRPTA could facilitate the implementation of public-private partnerships for infrastructure projects. The application of FIRPTA to infrastructure ownership remains somewhat unclear. Under an announcement and regulations issued in the past few years, the IRS took the position that some types of infrastructure assets could be considered real property interests. The designation as real property potentially imposes FIRPTA taxation on infrastructure projects and has substantial implications for public-private infrastructure projects. The ambiguity of FIRPTA’s application to public-private infrastructure projects may dissuade some foreign private investors from participating in the proposed infrastructure plans. Fewer participants in the public-private partnership program could delay or eliminate some infrastructure projects and would preclude some of the intended job creation and benefits of repairing or replacing crumbling infrastructure.

A repeal of FIRPTA would be the clearest indicator that global investors could contribute to the much-needed infrastructure improvements and the public-private partnerships as proposed by the administration. The American Society of Civil Engineers (ASCE) gave U.S. infrastructure another failing D+ grade in its latest 2017 report card and estimated that the U.S. needs to spend $4.6 trillion on maintenance and improvements between 2016 and 2025 to compensate for decades of underinvestment and achieve a passing B grade. The ASCE also estimates that existing sources of public and private funding will total just $2.5 trillion during the same period, leaving a funding gap of $2.1 trillion (Figure 6). U.S. infrastructure will require an “all-of-the-above” approach to close this enormous funding gap and the U.S. will need to attract foreign and domestic private capital in much larger sums than are currently being raised in the private market. Foreign investors need confidence that their investments will not be subject to FIRPTA taxation in order to commit capital on the scale necessary to begin to make up the funding deficit.

**FIRPTA Repeal Would Unlock Investment Capital**

FIRPTA constrains investment activity and affects how global investors allocate capital. In effect, FIRPTA drives investment away from the United States and to our global competitors, supporting jobs in other countries. Many investors would prefer to invest in the largest...
and most liquid real estate market in the world, but are precluded from doing so by the onerous FIRPTA regime. A repeal of FIRPTA would attract these global investors to the United States and unlock a large volume of investment capital.

The positive aspects of the commercial real estate market attract some investors despite FIRPTA. Many of these investors only invest in U.S. commercial real estate because they are able to utilize certain transaction structures that minimize or eliminate their FIRPTA tax exposure. For global real estate investors currently in the United States, a repeal of FIRPTA would spur additional investment activity. Some foreign investors (other than sovereign wealth funds) will shift from minority interests in property to full ownership, developing in-house asset management and property service divisions or utilizing third-party service providers. Most investors will increase the amount of investment in the United States. For many, the constraints on investment prevented effective portfolio allocation and commercial real estate as an asset class became under-allocated relative to other asset classes. Private equity data firm Preqin reported that, as of year-end 2016, institutional investors had an 8.9% average allocation to real estate, as compared to a 10.0% allocation target. The institutional investors surveyed jointly manage assets in excess of $50 trillion, so a 110 basis point underallocation translates to more than a $550 billion underinvestment in real estate globally. Moreover, many institutional investors continue to substantially increase their target allocations to real estate as an asset class. A repeal of FIRPTA would likely spur additional investment in commercial real estate to more efficiently balance investment portfolios.

Foreign investors frequently cite FIRPTA as the primary deterrent against allocating capital to the United States real estate market. A repeal of FIRPTA would increase the investment capital flow into commercial real estate, improving liquidity for local real estate markets throughout the country. For the relatively small number of investors that are currently active market participants, most would increase capital allocations and commercial real estate holdings in the United States, and many would expand investment strategies to include small and mid-sized metropolitan areas. For some investors, the limitations of FIRPTA on majority ownership interests prevents investment in properties with lower values or in smaller metropolitan areas. Within a diversified real estate portfolio, a minority interest in a smaller property combined with the burden of FIRPTA withholdings often does not provide sufficient investment return potential. Under the FIRPTA regime, many foreign investors are forced to ignore metropolitan areas where property values are lower.

A much larger opportunity exists for foreign investors excluded from the market by FIRPTA. The complex regulatory environment, withholding requirements and FIRPTA tax rate increase the cost of investment, effectively reducing the return potential of real estate investments. In effect, the same property can have a much lower return potential for a foreign investor. Many global real estate investors are individuals or family offices that are unwilling to undertake the burden of FIRPTA regulations. With a repeal of FIRPTA, foreign investment capital will be unlocked and likely target a wide range of opportunities as this pool of capital has a diverse range of investment criteria and strategies. These investors may seek investment and development opportunities in secondary markets, bringing investment capital to communities that struggled to attract real estate investors in recent years.

RCG estimates that FIRPTA repeal would generate an initial increase in international investment in commercial real estate of between $65 billion and $125 billion. Much of this additional capital is already sitting on the sidelines and available for immediate deployment. In fact, global capital committed to private real estate funds but not yet deployed is at an all-time high of $254 billion, with $151 billion specifically targeted at North American assets. Global commercial real estate brokerage firm Cushman & Wakefield estimated that $435 billion of total debt and equity funds were available globally for direct real estate investment in 2017, an increase of nearly $100 billion since 2013. Foreign investors would immediately explore deals that they would not otherwise have considered and very quickly begin deploying large sums of already-raised capital into U.S. real estate if the punitive burden of FIRPTA and confusion regarding compliance were removed from the investment decision.

In order to determine the potential investment activity unlocked by a repeal of FIRPTA, RCG analyzed data on foreign investment in real estate in the United States and globally, foreign direct investment, and cross-border investment in a range of asset classes. RCG also analyzed investment activity in other countries that attract a significant amount of institutional investment capital and do not have an impediment to investment such as FIRPTA. Additionally, RCG conducted a series of interviews and surveys to gauge the potential increase in investment by investors currently active in the real estate market as well as investors that have decided against investing in the United States because of FIRPTA. While each investor has their own capital formation and deployment strategy, the overwhelming response was that a repeal of FIRPTA would spur a substantial increase in investment by those currently in the market and a quick pivot to investing in the U.S. for those not currently active because of FIRPTA.

The information RCG received from commercial real estate developers and investors, and from potential investors, reinforces findings from industry surveys and research publications. More than three-quarters of the members of the Association of Foreign Investors in Real Estate (AFIRE), the leading industry association for offshore investors, acknowledged that FIRPTA relief would have a positive or major impact on their allocations to U.S. real estate.

The estimated increase in foreign investment of between $65 billion and $125 billion is a fairly conservative to mid-level estimate that reflects the current global economic environment, commercial real estate fundraising capabilities, the amount of capital for real estate
investment raised globally but not yet deployed, and portfolio allocation trends. As part of the interviews and surveys conducted by RCG, we gathered information on the estimated increase in investment by respondents and utilized the range that included the greatest number of responses and excluded outliers. Investor sentiment and economic performance in the U.S. and globally will influence how much investment is ultimately unlocked by FIRPTA repeal. However, as the U.S. is the most attractive and liquid commercial real estate market in the world providing a long history of positive investment returns and strong rule of law that minimizes investment risk, the flow of investment from global investors could be even greater.

**FIRPTA Repeal Would Create Jobs and Increase Domestic Investment**

The addition of $65 to $125 billion in cross-border investment would have a meaningful impact on liquidity in the commercial real estate market and a meaningful impact on the U.S. economy. Increased foreign investment would directly spur demand for real estate related transactional services, property renovations and development, lending activities, and asset management services. Beyond these segments, FIRPTA repeal would support broad employment growth throughout the entire economy, spurred by business-to-business demand and increased income and wages.

RCG estimated the total economic impact that increased investment and capital inflows would have on the U.S. economy. This includes the direct demand for goods and services generated by increased commercial real estate transactions, indirect demand for goods and services generated by support of the direct activities, and induced demand generated by increased household income and spending.

The influx of new international capital would generate between $26 and $49 billion in total economic activity, a boost of 10 to 30 basis points to U.S. GDP (Table 1). The level of new activity would support an additional 147,000 to 284,000 jobs throughout the economy and increase income by $8 billion to $16 billion.

The jobs created by the repeal of FIRPTA would span the entire economy. The increased investment activity would directly and indirectly support the creation of 97,000 to 187,000 jobs, in the construction, finance and real estate-related industries, as well as a wide range of supporting industries. The wages and other income generated by employees and business owners in these industries would spur additional household spending and induce further demand for goods and services that would be distributed broadly throughout the economy. The induced effect of increased capital flows to the U.S. would generate an additional 50,000 to 97,000 jobs, primarily focused in the healthcare, wholesale and retail trade, and leisure and hospitality industries.

The economic impact analysis demonstrates the magnitude of the costs exacted on the U.S. economy by FIRPTA. The costs are pervasive throughout the entire economy and extend well beyond the commercial real estate industry. Eliminating FIRPTA would create jobs in a range of industries including construction, finance, manufacturing and retail in cities and communities across the country.

**Time to Repeal FIRPTA is Now**

FIRPTA is a highly punitive and arcane tax law that drives real estate investors away from the United States. The onerous regulatory environment increases the costs of investing in real estate for foreign investors and even for some domestic investors. The substantial tax rate and increase in expenses can turn a good investment opportunity into an unprofitable investment, a fact that deters many global investors from operating in the United States. The substantial effectiveness of FIRPTA is a testament to the severity of its regulations - most global investors would rather invest in less dynamic countries than the United States rather than undertake the burden of FIRPTA regulations and taxation. Because so many investors elect to remain outside of the United States, the amount of foregone investment is substantial. Foreign capital can improve liquidity, an important factor in mitigating volatile business cycles and swings in asset values. The increased pool of investors could bring much needed capital to regions of the country that have yet to recover from the last downturn. The repeal of FIRPTA could also spur infrastructure investment as the potential applicability of FIRPTA regulations to public-private partnerships may deter some global companies from partnering to improve our infrastructure. The positive effects of FIRPTA repeal would go far beyond the real estate industry. The investment activity would generate new jobs and contribute positively to GDP without a material decrease in federal revenues. The Foreign Investment in Real Property Tax Act represents an opportunity to repeal a burdensome and punitive regulatory environment that is detrimental to the economy.