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Synthetic Investment in U.S. Real Estate by Foreign Investors

By Jeffrey L. Rubinger on July 18, 2014

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According to recent reports, [foreign investment in commercial U.S. real estate exceeded \\$38.7 billion in 2013](#) - a 40 percent increase over 2012. Leading the way in 2013 were investors from Canada, China, Australia, Germany, and Singapore. This represents a dramatic increase from the 2009 collapse of the U.S. real estate markets, which caused foreign investments to drop below \$10 billion.



From a U.S. federal income tax perspective, the primary obstacle facing foreign persons who invest in U.S. real estate is the [Foreign Investment in Real Property Tax Act](#) (FIRPTA), or more specifically Section 897. Under this provision, any gain recognized by a foreign person on the disposition of a USRPI will be treated as if such gain were effectively connected to a U.S. trade or business (ECI), and therefore subject to U.S. federal income tax at the graduated rates that apply to U.S. persons. Additionally, when Section 897 applies, the purchaser of a USRPI typically is required to withhold and remit to the IRS 10% of the purchase price in accordance with Section 1445.

A USRPI is broadly defined in [Section 897\(c\)\(2\)](#) as (1) a direct interest in real property located in the U.S., and (2) an interest (other than an interest solely as a creditor) in any domestic corporation that constitutes a U.S. real property holding corporation (i.e., a corporation whose USRPIs make up at least 50% of the total value of the corporation's real property interests and business assets). The regulations elaborate on the phrase "an interest other than an interest solely as a creditor" by stating that such an interest includes "any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property."

A foreign investor that directly invests in U.S. real estate through a foreign corporation may be subject to an effective tax rate exceeding 54 percent. This results from a combination of the taxes incurred under FIRPTA as well as the 30 "percent branch profits" tax. A much more tax-efficient alternative to a direct investment, that still gives the foreign investor complete exposure to U.S. real estate, would be through a total return swap.

Total Return Swaps, Generally

A total return swap is a cash-settled bilateral contract, in which each party agrees to make certain



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payments to the other depending on the value and distribution performance of the underlying asset. An investor may enter into a total return swap either (1) to simulate an investment in the underlying asset without actually acquiring the underlying equity (i.e., a synthetic long position), or (2) to divest oneself of the economic exposure to a particular asset without actually disposing of the underlying asset (i.e., a synthetic short position).

Given that the definition of a USRPI includes “any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property,” prior to 2008 it was not clear whether a total return swap that was tied to U.S. real estate would be considered a USRPI and therefore subject to FIRPTA. In a taxpayer friendly ruling, the IRS confirmed in [Revenue Ruling 2008-31](#) that a foreign investor that invests synthetically in U.S. real estate through a total return swap would not be subject to FIRPTA.

The Ruling

At issue in the Ruling was whether an interest in a total return swap, the return on which is calculated by reference to a broadly based real estate index, was a USRPI for purposes of Section 897.

Facts. A foreign corporation (FC) enters into a swap (which qualifies as an notional principal contract (NPC) for U.S. federal income tax purposes) with an unrelated counterparty that is a domestic corporation (DC). The swap is tied to the performance of the “Index,” which is maintained and widely published by taxpayer X. Neither FC nor DC is related to X.

The Index seeks to measure the appreciation and depreciation of residential or commercial real estate values within a metropolitan statistical area (MSA), a combined statistical area (CSA) (both as defined by the U.S. Office of Management and Budget (OMB)), or a similarly large geographic area within the U.S. The MSA, CSA, or similarly large geographic area has a population exceeding one million people.

The Index is calculated by reference to (1) sales prices (obtained from various public records) (2) appraisals and reported income, or (3) similar objective financial information, each with respect to a broad range of real property holdings of unrelated owners within the relevant geographic area during a relevant testing period. Using proprietary methods, this information is weighted, aggregated, and mathematically translated into the Index. Because of the broad-based nature of the Index, an investor cannot, as a practical matter, directly or indirectly, own or lease a material percentage of the real estate, the values of which are reflected by the Index.

Pursuant to the swap, FC profits if the Index appreciates (i.e., to the extent the underlying U.S. real property in the particular geographic region appreciates in value) over certain levels. Conversely, FC suffers a loss if the Index depreciates (or fails to appreciate more than at a specified rate). During the term of the swap, DC does not, directly or indirectly, own or lease a material percentage of the real property, the values of which are reflected by the Index.

Holding. Without much analysis, the IRS concludes that, because of the broad-based nature of the Index, the NPC does not represent a “direct or indirect right to share in the appreciation in the value ... [of] the real property.” Accordingly, FC’s interest in the NPC calculated by reference to the Index was not a USRPI for purposes of Section 897.

Planning Opportunities

As a result of the dramatic rise in foreign investment in U.S. real estate and the U.S. federal income taxes imposed under FIRPTA, foreign investors should once again consider investing in U.S. real estate synthetically through a total return swap. As noted above, the IRS ruled that a foreign investor that enters into a total return swap that is tied to a broadly based U.S. real estate index will be exempt from FIRPTA. There are many different U.S. real estate indices that would allow a foreign investor to gain exposure to U.S. real estate (both residential and commercial) through a total return swap.

For example, the [S&P/Case-Shiller Home Price Indices](#) track changes in the value of residential real estate both nationally as well as in 20 different metropolitan regions in the United States. The [S&P/GRA Commercial Real Estate Indices](#) measure the change in commercial real estate prices by

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property sector and geographic regions throughout the United States. While this type of investment is clearly not appropriate for a foreign investor that wants to purchase a second home in a warm weather state or be a direct investor in a large commercial development, it would be appropriate (and much more tax efficient than a direct investment) for a foreign investor that simply wants to gain exposure to U.S. real estate without being subject to U.S. federal income tax.



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