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# Accessing US Real Estate: Tax Issues

Investment in US Real Estate & Debt  
ULI/Mayer Brown Seminar

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# US Taxation of Foreign Persons

- The United States taxes foreign persons (i.e., non-US persons) in two possible ways.
  - Withholding Taxes on certain U.S. source income.
  - Income taxes on income that is “effectively connected with the conduct of a US Trade or Business”
- Tax Treaties can limit the ability or amount of tax imposed under either system.

# Withholding Tax System

- The US imposes a statutory 30% withholding tax on US source income that is “fixed or determinable annual or periodical” income (commonly known as “FDAP”).
- FDAP includes interest, dividends and rents from US sources.
- The withholding rate often is reduced by treaty on most categories of income.
- A key statutory exception to interest withholding is for “portfolio interest”.
  - Under recent changes to the law, only interest in “registered form” can qualify for the exemption. Bearer debt no longer qualifies.
  - Portfolio interest also does not include certain related party debt and debt received by banks making loans in their credit business.

# US Trade or Business Income

- If a foreign person is “engaged in a US trade or business” that foreign person is taxed on income that is “effectively connected with the conduct of that US trade or business” (“ECI”).
- Whether a foreign person is engaged in a US trade or business generally is based on all facts and circumstances.
- ECI is taxed at regular income tax rates applicable to US persons.
- A foreign person who is engaged in a US trade or business has to file a US income tax return.

# “FIRPTA”

- Gain from the sale of a “US real property interest” is subject to tax as ECI under rules enacted as part of the “Foreign Investors in Real Property Tax Act” (known as “FIRPTA”)
- A US real property interest not only includes real estate but also interests in entities that own US real estate.
  - A “US real property holding corporation” (“USRPHC”) is an entity where more than 50% of its assets are US real property interests.
  - “Real Estate Investment Trusts” (“REITs”) may or may not be a USRPHC depending on whether it holds debt or mortgages. Special rules also apply to publicly traded REITs.

# Direct Investment

German Fund  
(US Real Estate Owner)

# Taxation of Direct Investment - Example

## Assumptions:

Investment:	\$100 million
Annual Net Income (EBITDA):	\$15 million
Annual Depreciation:	\$2.5 million
Taxable Income:	\$12.5 million
Sale Price 10 Years:	\$250 million

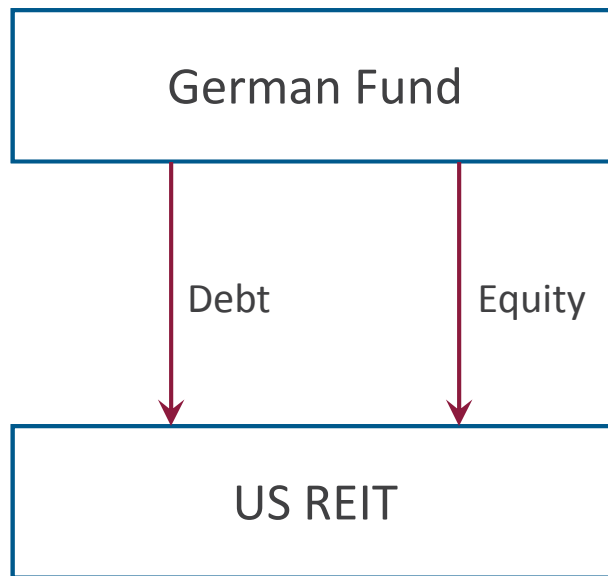
Combined Federal and State  
Income Tax Rate (40% Average)  
Branch Profits Tax Rate (5% of After-Tax Income)

## Taxation of Direct Investment - Taxes

Income Taxes on Net Income:	\$5 million per year
Branch Profits Tax on Net Income	\$375 thousand
Total Annual Taxes:	\$5.4 million
Total Annual Taxes Over 10 Years:	\$54 million
Tax on Gain (\$175 million):	\$70 million
Total Taxes Over 10 Years:	\$124 million



# Leveraged REIT Structure



# Leveraged REIT Structure Example

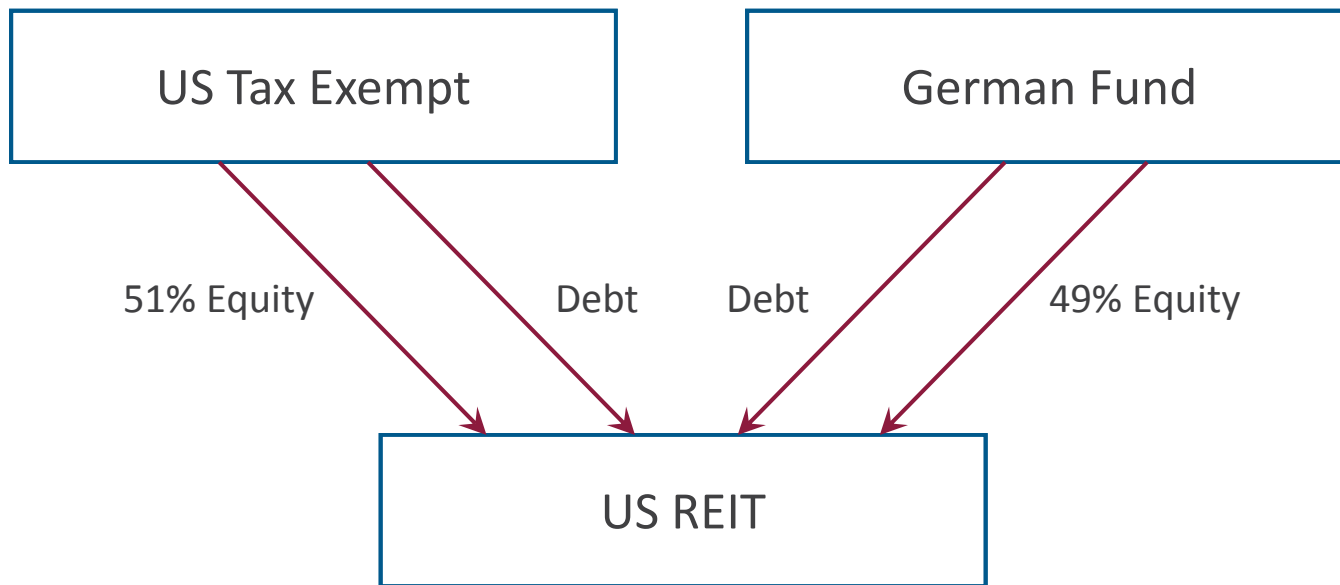
## Assumptions:

Total Investment:	\$100 million
Equity Portion:	\$50 million
Debt Portion:	\$50 million
Interest Rate on Debt:	10%
Annual Net Income (EBITDA):	\$15 million
Annual Depreciation	\$2.5 million
Annual Interest:	\$5 million
Taxable Income:	\$7.5 million
Annual Equity Distribution:	\$10 million
Sale Price After 10 Years:	\$250 million

## Leveraged REIT Structure - Taxes

Income Taxes on Net Income:	\$0 per year
Branch Profits Tax on Net Income:	\$0 per year
Withholding Taxes on Interest (0%):	\$0 per year
Withholding Taxes on Dividend (30%):	\$3,000,000
Total Annual Taxes:	\$3,000,000
10 Year Annual Tax Total:	\$30 million
Tax on Gain (\$175 million)	\$70 million
Total Taxes Over 10 Years:	\$100 million

# Leveraged Domestically Controlled REIT Structure



# Leveraged Domestically Controlled REIT Structure Example

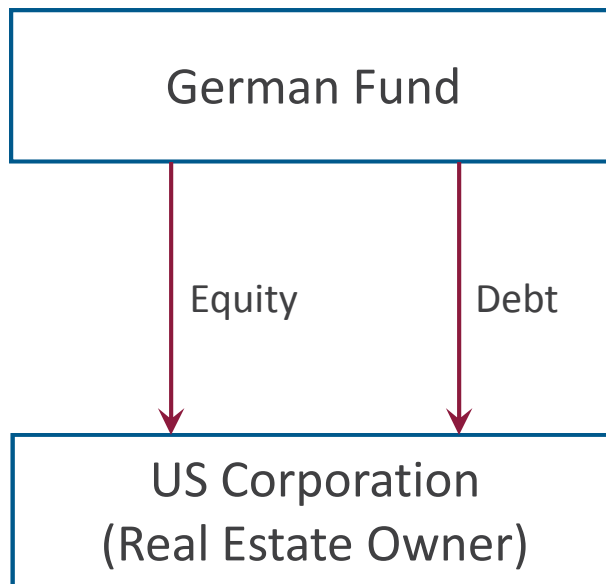
## Assumptions:

Total Investment:	\$100 million
Equity Portion:	\$50 million
Debt Portion:	\$50 million
Interest Rate on Debt:	10%
Annual Net Income (EBITDA):	\$15 million
Annual Depreciation	\$2.5 million
Annual Interest:	\$5 million
Net Income:	\$7.5 million
Annual Equity Distribution:	\$10 million
Sale Price After 10 Years:	\$250 million

# Leveraged Domestically Controlled REIT Structure - Taxes

Income Taxes on Net Income:	\$0 per year
Branch Profits Tax on Net Income:	\$0 per year
Withholding Taxes on Interest (0%):	\$0 per year
Withholding Taxes on Dividend (15%):	\$3,000,000
Total Annual Taxes:	\$3,000,000
10 Year Annual Tax Total:	\$30 million
Tax on Gain (\$175 million)	\$0 million
Total Taxes Over 10 Years:	\$30 million

# Corporate Debt Structure



# Corporate Debt Structure Example

## Assumptions:

Total Investment:	\$100 million
Equity Portion:	\$50 million
Debt Portion:	\$50 million
Interest Rate on Debt:	10%
Annual Net Income (EBITDA):	\$15 million
Annual Depreciation	\$2.5 million
Annual Interest:	\$5 million
Income After Deprec. And Int.:	\$7.5 million
Annual Dividend:	\$10 million
Sale Price After 10 Years:	\$250 million



## Corporate Debt Structure - Taxes

Annual Income Taxes on Net Income:	\$3 million
Withholding Taxes on Interest (0%):	\$0 per year
Withholding Taxes on Dividend (15%):	\$1,125,000
Total Annual Taxes:	\$3.6 million
10 Year Annual Tax Total:	\$36 million
Tax on Gain (\$175 million)	\$70 million
Total Taxes Over 10 Years:	\$106 million

## Summary of Taxes

Structure	Annual Taxes	Total 10 Year Taxes
Direct Investment	\$5.4 million	\$124 million
Leveraged REIT	\$3 million	\$100 million
Leveraged Domestically Controlled REIT	\$30 million	\$30 million
Corporate Debt Structure	\$3.6 million	\$106 million