Foreign Real Estate Investment in the US and Europe: Some Considerations and Structures for Middle Eastern Investors

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Today, real estate investments in Sao Paulo, Mumbai, Prague, Beijing and Moscow are considered prudent alternatives to investments in London, New York, Paris and Tokyo. AFIRE's January/February 2007 newsletter notes that international real estate investors continue to expand their allocation of investment funds around the world. Real estate markets in India, China and Russia have matured into hospitable investment climates by providing legal transparency and consistent, quality real estate information. However, although these markets are making a strong run, the US and (to a lesser degree) Europe remain

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favored destinations for real estate capital investment because they provide a stable, secure investment environment and, arguably, the best opportunity for capital appreciation.

In light of the foregoing, this article focuses on investment in the US and, to a much smaller extent, European real estate markets. It provides an overview of (1) tax considerations involved in foreign real estate investment, including two real estate investment structures designed for maximum tax efficiency, (2) the Shari'ah considerations involved in real estate investments and the financing structures used for such investments and (3) the anti-terrorism laws implicated by foreign real estate investment.

1. Tax Rules, Tax Efficient Structures

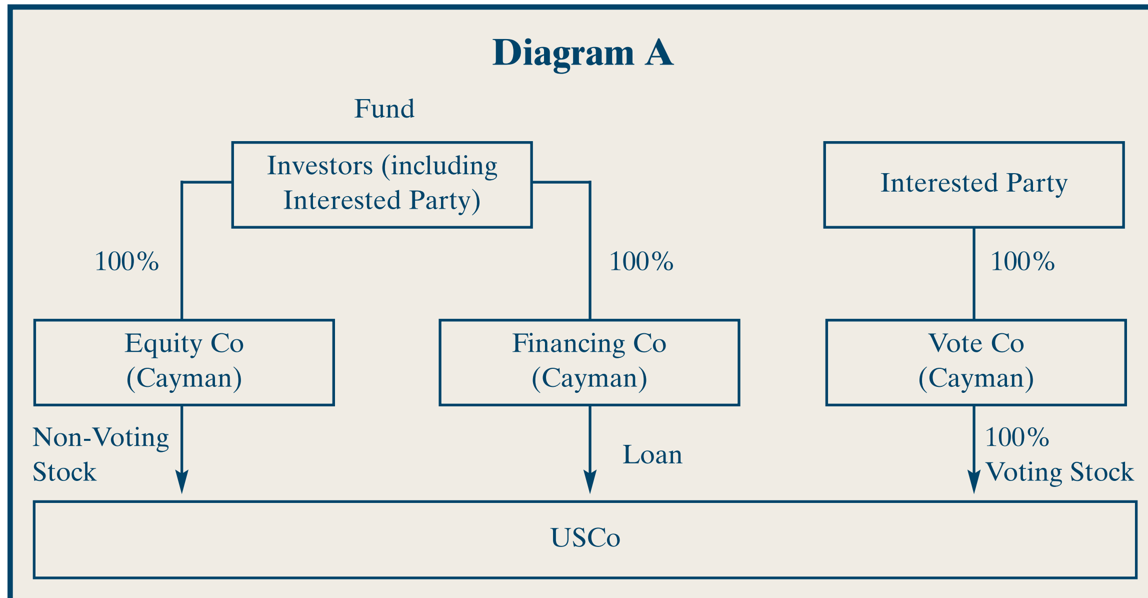
Although selection of the optimal investment structure depends on several factors, maximum tax efficiency is usually a key consideration.[1] A tax efficient structure for foreign US investments will usually take advantage of the "portfolio interest exemption" available under US tax law and will avoid, to the extent possible, the "earning stripping" rules of that law.

a. Portfolio Interest Exemption

Internal Revenue Code (the "Code") section 881(a) imposes a 30% withholding tax on the amount of interest income received by a foreign person from sources within the United States. However, under section 881(c) of the Code, the 30% tax does not apply to portfolio interest received by a foreign corporation from sources within the US (the "Portfolio Interest Exception"). This exemption is one of the key tax saving techniques used by investors from countries that do not have a tax treaty with the US. If a US company making the payment to a foreign investor can claim the Portfolio Interest Exemption, a foreign investor may be entitled to claim reduced withholding rates (or complete exemption from withholding tax). Generally speaking, the Portfolio Interest Exemption is available if (1) the obligation on which interest is paid is in registered (rather than bearer) form, (2) the obligor US company receives a certification that the beneficial owner of such obligation is a foreign person and (3) any foreign investor claiming the exemption owns less than 10% of the voting stock of such US company.

b. Earnings Stripping Rules

The "earnings stripping" rules set forth in Code section 163(j) limit, under some circumstances, the deductibility of



interest paid by a US corporation to a foreign lender that is related to the US corporation. Interest is disqualified (1) if the US corporation's debt-to-equity ratio exceeds 1.5 to 1 and (2) if, and to the extent that, the US corporation's net interest expense exceeds 50% percent of its "adjusted taxable income" (generally taxable income computed without regard to deductions for net interest expense, net operating losses, and depreciation, amortization and depletion). To avoid application of this rule, a tax efficient structure should make certain that a foreign lender is not related to any US corporation to which it lends. Such a structure would limit the maximum investment (by vote or by value) for a widely-held foreign corporate investor in the US corporation to 50%, and the maximum investment for other foreign investors (individuals, partnerships, etc.) to no more than 9.9%.

c. Investment Structures

Although the earning stripping rules are less critical than the Portfolio Interest Exemption, both should be taken into consideration when deciding on an investment structure. If applicable, both can have a significant adverse impact on an investment's economics. The two structures outlined below reflect both of these considerations, as well as the structural demands of Shari'ah principles.

(i) Voting Control Structure

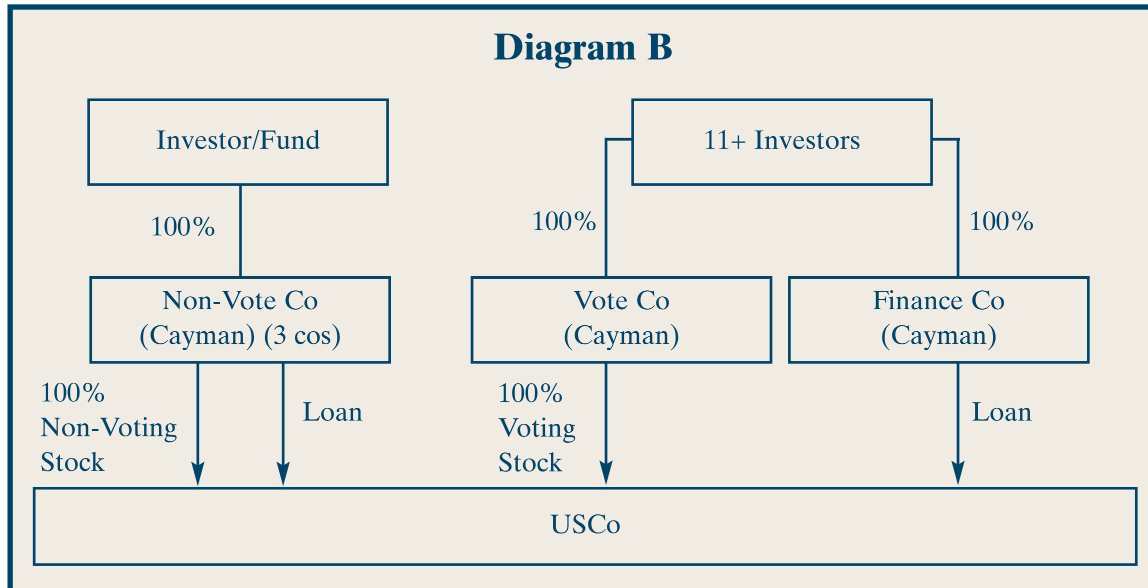
The voting control structure shown on Diagram A above (the "Voting Control Structure") illustrates a tax efficient US real estate investment by an offshore fund (the "Fund"). The Voting Control Structure both takes advantage of the Portfolio Interest Exemption and avoids application of the earnings stripping rules, and provides the Fund organizer with maximum control over its investment. Under this structure, three

offshore companies would own and capitalize a US corporation ("USCo"). The offshore companies would typically be established in the Cayman Islands, and USCo would typically be a Delaware corporation. The Cayman company that owns USCo's voting stock would be wholly owned by the party organizing the Fund (the "Interested Party"). The two other Cayman companies would own most of the economic interests in USCo. One company ("Equity Co") would own non-voting stock in USCo, and the other company ("Finance Co") would loan money to USCo. USCo would then typically enter into a joint venture with a recognized real estate manager or similar entity.

Interest payments from USCo to Finance Co would be distributed to Finance Co's shareholders (the Fund Investors) and would be the primary source of the current return paid to such Investors. All such interest payments should be exempt from US withholding tax under the Portfolio Interest Exemption for the reasons set forth above (assuming compliance with applicable registration and certification requirements). Dividends, if any, paid on the shares of USCo would be subject to a 30% US federal withholding tax, to the extent paid from current or accumulated "earnings and profits" of USCo (as determined under US tax rules), and a 10% US federal withholding tax in all other cases (except for liquidating distributions, which would not be subject to withholding tax). To avoid application of the earnings stripping rules, among other things no Fund Investor that is a widely-held corporation should own more than 50% of either Equity Co or Finance Co, and any other Fund investor (individuals, partnerships, etc.) should own no more than 9.9% of either such company. For this structure to work, the Interested Party must be able to place the Fund with an appropriately diverse group of investors, and must limit investments in USCo for its own account.

(ii) Maximum Investment Structure

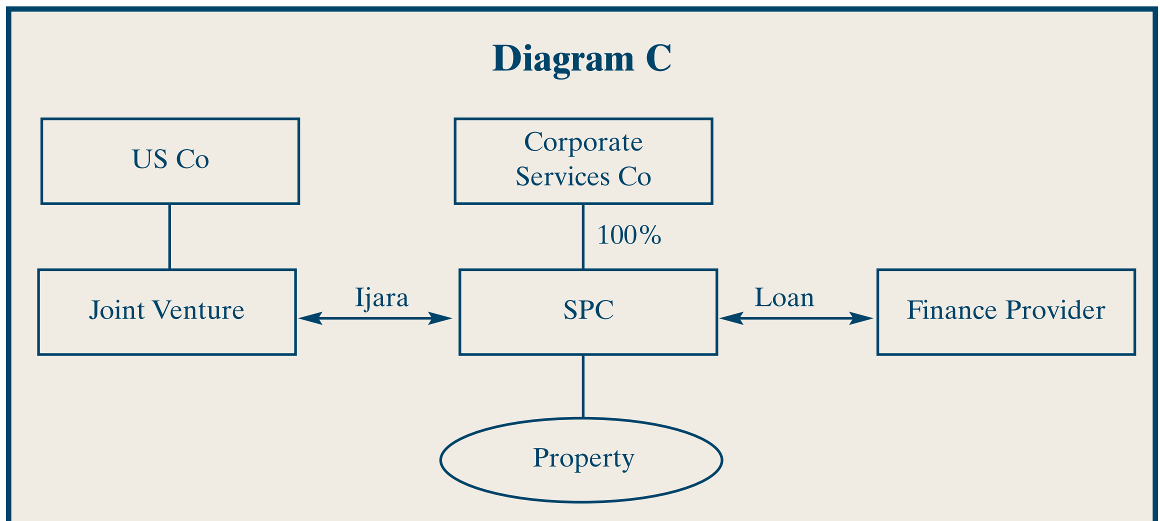
If the Interested Party would like to make a larger investment in USCo than is permitted under the Voting Control Structure, it can utilize the investment structure shown on Diagram B on the next page (the "Maximum Investment Structure"). Under this structure, the Interested Party would sacrifice control over the voting stock of USCo in order to be able to take a greater economic interest in USCo through Equity Co and Finance Co. Under the Maximum Investment Structure, five offshore companies would own and capitalize USCo. Two of the companies, Vote Co and Finance Co, would together provide at least 2% of USCo's total capitalization. Vote Co would use funds contributed to it to subscribe for 100% of the voting stock of USCo, and Finance Co would make a loan to USCo. The remaining three companies (Non-Vote Co on Diagram B), would provide the remaining 98% of USCo's total capitalization. This amount would be allocated between an equity contribution



for 100% of the non-voting stock of USCo and a loan to USCo. The debt-equity allocation in the Maximum Investment Structure would be the same as that for the Voting Control Structure.

Under the Maximum Investment Structure, the Interested Party typically gives up voting control of USCo — that is, ownership of Vote Co and Finance Co — to foreign investors known by it. Ideally, there would be 11 or more of these investors owning shares in equal proportion, which would allow these investors to claim the Portfolio Interest Exemption. None of these investors should be related to one another, and only a limited number of these investors (less than one-third) may be officers or employees of the Investors or the Fund. Assembling such a group can be time-consuming and difficult. However, under the Maximum Investment Structure all interest payments made on the loans from Finance Co and, assuming the diversity among Investors discussed under the Voting Control Structure section, Non-Vote Co should be eligible for exemption from US withholding tax. Dividends, if any, paid on the shares of USCo would be subject to the same withholding taxes and exemptions discussed above. Ultimately, although the Interested Party bears some risk that it will lose control of the voting stock in USCo, under the Maximum Investment Structure the Interested Party may own a larger economic interest in USCo than it could under the Voting Control Structure.

Finally, the reason that three or more Non-Vote Cos (rather than just one Non-Vote Co) should be established to hold USCo's non-voting stock is to avoid the application of the earnings stripping rules to loans to Non-Vote Co. Each of these Non-Vote Cos would purchase equal amounts of such nonvoting stock, and make proportionate loans to USCo. In addition, as discussed under the Voting Control Structure section, the



maximum investment by any widely-held corporate investor should be limited to less than 50% of such nonvoting stock, and the maximum investment by any other investor should be limited to less than 10% of such stock.

2. Shari'ah Compliance, Compliant Acquisiting and Financing Structures

Shari'ah-compliant investment structures enable Islamic investors to finance their investments while respecting typical corporate, credit and tax considerations. Islamic investors seek to finance their investments in ways that avoid the payment of interest, but they also look to abide by other Shari'ah requirements. For example, Islamic investors are prohibited from investing in companies (or in the case of real estate, from leasing to companies) that are engaged in activities that are considered to be harmful or un-Islamic (haram), such as gambling activities and the production of alcohol, pork products, weapons and pornography. Islamic investors also are encouraged to invest in productive assets, and are generally prohibited from investing in purely financial assets. Because of this, many Islamic investors consider real estate an ideal investment.

a. Ijara Structure

Most financing structures used in Islamic real estate investment transactions involve the use of a special purpose company ("SPC") that holds title to the real property investment. An SPC can be established, owned and operated by a corporate services company that regularly provides these services for a fee. The SPC will finance its acquisition of the property, often through a conventional mortgage loan.[2] The SPC will then lease this property to an Islamic fund company or investor (the "Venture") through a Shari'ah-compliant lease, known as an "ijara," which has elements of an operating lease and a capital (or financing) lease. The overall financing arrangement is depicted by Diagram C above.

A properly constructed ijara must

satisfy a number of Shari'ah and US tax requirements that often conflict with one another, and this tension creates one of the challenges involved in structuring these types of investments. The Venture will typically seek to be treated as the owner of the relevant real property for US tax purposes so that it can enjoy tax benefits such as depreciation deductions, notwithstanding that under an ijara, the Venture is the master lessee (and not the named owner) of the property. To achieve that tax treatment, the ijara and other related lease documents must allocate to the Venture both the benefits and burdens of ownership of the real property. However, to be Shari'ah-compliant, an ijara must allocate to the SPC, rather than the Venture, certain responsibilities that are considered to flow from the SPC's ownership of the property. In a sense, these Shari'ah principles seek to ensure that there is a fair and proper allocation of responsibilities between landlord and tenant. For example, an ijara contract should impose on the owner of a property the responsibility for major maintenance and structural repairs for such property. In addition, responsibility for property damage insurance should be allocated to the SPC, as landlord, rather than the Venture, as tenant. This tension between tax and Shari'ah requirements must be addressed carefully. In addition to the US, the ijara structure has also been used successfully in European jurisdictions such as the UK, Poland and the Netherlands. The same types of Shari'ah and tax considerations that apply in the US also apply generally in those jurisdictions as well.

Just as the ijara between the SPC and the Venture must satisfy Shari'ah requirements, so too must the existing tenant leases that will be assumed by the Venture as sublessor. Although apartment tenant leases often allocate responsibilities between landlord and tenant in a manner that complies generally with Shari'ah requirements, commercial leases often contain "triple-net" provisions that must be modified to be acceptable.

b. Istisna'a – Ijara Structure

Although the ijara structure is the most common structure for Shari'ah-compliant investment in real estate, other structures (as well as variations of the ijara structure) are also in use. For example, the istisna'a-ijara structure is a modification of the ijara structure that is used primarily to finance real estate construction. Under this structure, the Venture would hire the SPC to construct real property improvements in accordance with specifications provided by the Venture. This arrangement is known as an istisna'a. The SPC would arrange for financing from a third party finance provider to support its work during the construction phase. The SPC would also enter into one or more construction contracts for the construction of the requested improvements. Once the improvements are completed, they would then be leased by the SPC to the Venture under an ijara. The SPC would use amounts

received as rent under this ijara to pay all of the financing and other obligations incurred by it during the construction phase.

c. Murabaha Structure

In some instances, a murabaha structure has also been used to finance the acquisition of real property. A murabaha is essentially a cost-plus financing, and it involves the purchase of a property by an SPC or Islamic financial institution, and the immediate resale of such property to a Venture at cost plus an agreed profit. The total contract price would usually be paid in installments over an agreed period of time, and the obligations of the Venture would usually be secured by a mortgage. Although the murabaha structure has the advantage of placing title to the property in the hands of the Venture, prepayment restrictions and pricing constraints have limited the use of the murabaha structure. Limitations notwithstanding, this structure has been favored in France, where the ijara structure presents particular problems.

d. Shari'ah Advisors

All Shari'ah-compliant property funds are advised by one or more Shari'ah advisors who approve each fund's ownership structure, property investments and financing structures. Many Shari'ah advisors have reviewed and approved transactions using the foregoing structures. However, Shari'ah advisors do not always take the same approach to all issues, with the result that structural details or contractual provisions that are acceptable to one Shari'ah advisor may not be acceptable to another advisor. It is therefore helpful, when proposing investment structures to a Shari'ah advisor, to learn in advance the position that such Shari'ah advisor takes on various relevant issues.

3. Compliance with Anti-terrorism Laws

Recent volatility in the global stock markets may accelerate the pace of investment in US property markets as foreign investors, including Islamic investors, seek the greater stability provided by US real property investments. However, the additional requirements imposed by the USA Patriot Act, especially for Middle East investors, has somewhat offset this investment trend.

a. Overview of the Patriot Act

In response to the attacks of September 11, 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, commonly known as the Patriot Act, was enacted into law on October 26, 2001. Title III of the Patriot Act, aimed in part at combating the financing of terrorism, imposes certain obligations on US financial institutions. In general, the Patriot Act imposes greater diligence requirements on these financial institutions when dealing with foreign investors. Financial institutions must observe minimum due diligence

standards, including procedures for customer identification for accounts they open and maintain for their customers. Customer identification procedures must, at a minimum, include (a) a verification of the identity of any person opening an account by obtaining the customer's name, address, date of birth and taxpayer identification number (or, for non-US persons, a similar number from a government-issued document) and by examining such person's drivers license, passport or any other document deemed appropriate by the financial institution, (b) recordkeeping of the information used to verify the person's identity and (c) a determination of whether the person appears on any list of known or suspected terrorists or terrorist organizations (including the Specially Designated Nationals and Blocked Persons List of the Office of Foreign Assets Control). In addition, financial institutions must adopt special measures for certain accounts, transactions or foreign jurisdictions identified by the US Treasury Department to be of primary anti-money laundering concern.

b. Impact of the Patriot Act on Foreign Investors

As noted above, foreign investors typically make their investments in the US through entities formed the Cayman Islands, and/or entities formed in the US These ownership arrangements result in the application of the Patriot Act in several ways. First and most directly, the entity through which the foreign investments are being made will often need to establish a bank account at a US bank or will need to obtain financing from a US bank. In these circumstances, the US bank will require the due diligence information described above for that entity. In addition, the US bank will likely require information about the direct and beneficial ownership of that entity.

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(i) US Bank Diligence

The scope of the information that a US bank will request about the foreign beneficial owners of an entity will depend on the nature of that entity's foreign ownership. For example, if a single foreign investor is making an investment in the US directly through a Cayman company and a US company, the US bank is likely to ask the foreign

investor to provide the type of information described in Section 3a above. On the other hand, if a foreign financial institution or similar company is forming a fund consisting of a number of foreign investors, US banks have generally accepted, as a means of satisfying their diligence requirements under the Patriot Act, a certificate from the foreign financial institution confirming that it has conducted appropriate diligence on such investors and their source of funds. This certificate typically also provides that none of these investors is on any prohibited persons list maintained by the Office of Foreign Assets Control. The foreign financial institution will often also need to confirm that it will monitor transfers of interests held by the foreign investors in the fund and regularly check the names of such foreign investors against updates

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to the prohibited persons lists maintained by the Office of Foreign Assets Control.

(ii) Diligence by US Joint Venture Partners

If the foreign investor is entering into a joint venture with a US company, the US joint venture partner may require the same information about that foreign investor that a bank requests, even though the US joint venture partner may not technically be subject to the Patriot Act. As with a US bank, the US joint venture partner will seek to receive full information about the foreign investor if it is dealing with a single foreign investor. However, if the foreign investor is a fund comprised of a number of foreign investors, US joint venture partners have often accepted a certificate of the same type that would be given to US banks regarding such investors.

As a result of the greater diligence requirements that the Patriot Act imposes on US financial institutions, foreign investors may have to disclose detailed information concerning their identity and their sources of funds in order to invest in the US. However, practices that facilitate compliance with the Patriot Act (such as the delivery by the foreign investors of certifications rather than detailed investor information) have been developed and are generally acceptable to US banks and joint venture partners. Because of such practices, thus far, the implementation of the Patriot Act has been reasonable and has not materially impeded the flow of foreign investment in US real estate.

4. Conclusion

In conclusion, the same basic considerations described above apply whether a Middle Eastern investor desires to invest in real estate in the US or Europe. Because adverse tax treatment could impact the economic fundamentals of a deal, efficient tax structuring should be the investor's overriding consideration. In Europe, for example, tax issues may include VAT treatment of the acquisition and sale of property, and treatment of loans made by Finance Co. Shari'ah-compliant investors will also have to choose or develop structures that are Shari'ah-compliant and sensitive to the other legal requirements of their investment jurisdiction. Finally, many jurisdictions have adopted heightened security and anti-money laundering provisions that must be addressed in order to invest in such jurisdictions. ★

[1]Investments in the US are subject to a wide range of complex tax provisions at the federal, state and local levels, in addition to the domestic tax rules of the foreign investor's country of residence. For purposes of this brief overview, this article only touches on two important US tax rules.

[2]If an Islamic financial institution is providing the financing for the investment, it would not be necessary to use the SPC, as a subsidiary of the Islamic financial institution could fill that role, and the property would be financed by the Islamic institution rather than through a mortgage loan. Another structural variation would be to replace the mortgage loan with a beneficial participation interest in the real property and the ijara.