REPRINT FINANCIER WORLDWIDE MAGAZINE

TALKINGPOINT

Investing in the US real estate market

REPRINTED FROM
JULY 2018 ISSUE


FINANCIER WORLDWIDE corporatefinanceintelligence

www.financierworldwide.com Issue 187 July 2018

THIS ISSUE:

FEATURE
Regulating cryptocurrencies: virtually inevitable?

SPECIAL REPORT
White-collar crime

ROUNDTABLE
Financial institutions – compliance & risk management

Strengthening AML protection through AI

FIs can employ AI to analyse large amounts of data, to filter out false alerts and identify complex criminal conduct.

FINANCIER WORLDWIDE corporatefinanceintelligence

FINANCE & INVESTMENT

Investing in the US real estate market

FW moderates a discussion on investing in the US real estate market between Jill Starrs, Bob Bauer and John Warner at UHY LLP.

THE PANELLISTS

Bob Bauer
Tax Partner
UHY Advisors
T: +1 (314) 615 1238
E: rbauer@uhy-us.com

Bob Bauer is a tax partner at UHY Advisors. He works with multiple private equity investment structures in rental real estate and property development. He serves on UHY Advisors' board of directors. He leads the real estate domestic and international tax practice teams.

Jill Starrs
Principal
UHY LLP
T: +1 (314) 615 1272
E: jstarrs@uhy-us.com

Jill Starrs is a principal at UHY LLP. She provides attest services to US and multinational real estate investment companies and private equity funds. She is firm subject matter expert on reporting under International Financial Reporting Standards and is responsible for over 50 audits annually of real estate companies and private equity real estate funds.

John Warner
Senior Tax Manager
UHY Advisors
T: +1 (314) 615 1278
E: jwarner@uhy-us.com

John Warner is a senior tax manager at UHY Advisors. He is a member of the real estate team, providing planning and compliance services to real estate organisations and specialises in helping non-resident investors meet US tax reporting obligations.

FW: How would you describe the state of the US real estate market over the last 12 months or so? What factors are impacting investment activity in this space?

Bauer: The US real estate market has experienced sustained growth over the last 12 months. Investment in US commercial real estate is the third-largest asset class of investment in the US economy. A slow, steady growth economy, little inflation and historical low interest rates are still supporting new investment and development.

Starrs: We are seeing competition to deploy equity and capital into real estate assets. This has been one of the driving factors in the steady increase of real estate prices over the past 12 months. Continued growth and expansion of ecommerce is impacting warehousing positively and retail negatively. Investment in multifamily continues to be strong, and demand for multifamily housing has been high.

FW: When financing and structuring a real estate investment in the US, what, in your opinion, are some of the key considerations that should be made?

Bauer: A legal structure that provides for one level of tax, expected annual cash distributions to investors, how management incentive fees are determined and the risk tolerance of the investor are key considerations. Debt and equity capitalisation upon entity formation are also important when considering the investor's level of risk tolerance and annual cash flow projections. The cash distributions made during the operation of the property are typically tax free, as they will be sheltered by depreciation deductions on the property.

Warner: Investors should consider whether to structure the entity to include multiple properties with multiple investors and a single manager, or whether to structure the transaction so the investor has more control with fewer partners. Private investors will want to consider how ownership will be taxed for US estate tax purposes.

Starrs: Other factors include the investor's time horizon to commit capital to an investment and the reputation of the real estate manager or registered investment adviser (RIA).

**FW: How should foreign investors go about determining the appropriate

ownership vehicle for US property, and how might this affect the treatment of income?

Bauer: Investors should try to eliminate their exposure to US estate and gift tax laws and minimise their income tax consequences. The reduction in the corporate tax rate from 35 percent to 21 percent will influence the choice of entity. That rate reduction provides a great opportunity for foreign investors who want to invest in US real estate. A foreign investor should consider paying the 21 percent corporate tax rate, which is 1 percent more than the 20 percent pass through capital gain rate, to avoid the possible application of US estate tax, which is 40 percent. This can be accomplished by using a tiered corporate structure to invest in the US property.

Warner: Preferred capital structures can also impact the selection of a legal entity. If investors are from a favourable tax treaty country, then withholding rates for interest and dividends might be lower than the 21 percent corporate rate. A leveraged capital structure might make sense and the use of US holding companies with foreign corporation owners should be considered.

FW: In terms of reporting obligations, how do international financial reporting standards (IFRS) and fair value reporting impact US real estate investments?

Starrs: Companies that report under IFRS may gain or improve access to foreign investors and global capital. Certain foreign investors demand IFRS reporting in order to comply with public company filings in their own country and to comply with group audit standards and component reporting. IFRS reporting facilitates comparability to other investments of investors outside the US and increases transparency related to valuation of real estate investments. IFRS is principles based, whereas US GAAP is rules based, therefore, reporting under IFRS incorporates additional judgment. For example, IFRS provides for the reporting entity to make an accounting policy election to report investment properties at either fair value with unrealised gains and losses recorded in current profit and loss, or the historical cost model, with disclosure only of fair value. Volatility of earnings resulting from fair market value adjustments when reporting at fair value is a consideration for investors and equity partners.

FW: How are recent requirements introduced by the Internal Revenue Service (IRS) – such as new disregarded entity reporting obligations and new audit rules for partnerships – impacting US real estate investments?

Bauer: Many owners are reconsidering the need for disregarded entities because the IRS added another level of compliance with the issuance of new regulations requiring domestic disregarded entities that are fully owned, either directly or indirectly by a foreign person, to be treated as a domestic corporation, obtain an employer identification number and file form 5472, along with a pro-forma 1120, or they will be subject to a $10,000 penalty.

Warner: New audit rules for partnerships demand that partnership entities, rather than individual partners, are responsible for paying any tax, interest and penalties relating to IRS audit adjustments in the current period. There could be different partners in the partnership when the tax is paid versus when the tax was incurred, therefore partners in the current period could be liable for a former partner’s tax burden. Investors should closely review partnership agreements to ensure that partners who received the benefit from a deduction or a deferral of income that is later adjusted by the IRS will bear the cost of such adjustment.

> “PREFERRED CAPITAL STRUCTURES CAN ALSO IMPACT THE SELECTION OF A LEGAL ENTITY.”
>
> JOHN WARNER
> UHY Advisors

> “INVESTORS SHOULD CONSIDER THEIR GOALS AND EXIT STRATEGY AND ADDRESS THEM WHEN STRUCTURING THE INVESTMENT VEHICLE AND AGREEMENTS.”
>
> JILL STARRS
> UHY LLP

FW: How would you characterise the impact of rising awareness and demand for increased IT risk management on investment in the US real estate market?

Starrs: IT risk management is extremely important and will continue to be. Focus from real estate investors and equity partners on security, transparency and trust in real estate sponsors and RIAs will significantly influence investment decisions. Privacy concerns, data protection and breach preparedness are a few of the areas that we think real estate investors and equity partners want to see addressed before committing equity to real estate sponsors and RIAs. The recent General Data Privacy Regulation (GDPR) mandated in the EU will likely accelerate demand for similar regulations in the US. Focus on third- and fourth-party risk is also growing; therefore, expect more scrutiny on internal controls at real estate managers, including demand for system and organisational controls (SOC) reports from real estate and property managers.

FW: What essential advice would you offer to foreign real estate investors in US property to maximise returns while complying with regulatory and other obligations?

Bauer: Incorporate flexibility in the operating or partnership agreement to address unforeseen economic, legislative and market cycle changes in the US and other countries. Regulatory changes in the US and other countries could change an investor's overall yield. Having flexibility in the agreement provides the opportunity to address those changes in the most favourable manner for the investor.

Starrs: Investors should consider their goals and exit strategy and address them when structuring the investment vehicle and agreements. Create efficient operating structures and understand the annual fees charged to the real estate properties. Always focus on the core reason you are investing and make sure that the real estate investment is right for you.

Warner: Work with an adviser who can help you navigate the complex regulatory environment. The rules are always changing, and having an adviser who is up to date on industry changes is vital.

FW: Looking ahead, how do you expect opportunities for real estate investors to unfold in the US over the coming months? Are any particular trends and developments likely to shape activity?

Starrs: We expect the real estate market to continue to be robust in the coming months. Interest rates are beginning to rise, but we do not anticipate it significantly depressing the market. The volatility in global stock markets so far this year may encourage investment in US real estate, since it is the third-largest asset class and tends to be less volatile in the short term than other financial markets.

Bauer: The US economy is projected to continue to grow at a stable rate, and changes from the US tax reform, particularly the lowering of the corporate income tax rate, will attract foreign investment. Investors still have an appetite and the resources to invest in US real estate, which will continue to support growth in the market. ■

“REGULATORY CHANGES IN THE US AND OTHER COUNTRIES COULD CHANGE AN INVESTOR'S OVERALL YIELD.”

BOB BAUER
UHY Advisors