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United States Real Estate Investment

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The current United States real estate investment market might be described as "opportunistic" yet it remains perhaps the most active broad market in the world. It has evolved into and continues as a major public market for real estate securities – both debt and equity. This and other economic and political factors have sustained substantial interest among foreign investors in United States real estate investments, who continue to view the United States as the country providing the best opportunity for capital appreciation.[1] Many of these investors prefer private rather than public investments. Thus, it is timely to address again those matters we typically bring to the attention of foreign investors who are considering a United States real estate investment program.

This summary focuses on the investor planning to enter the United States real estate investment business; that is, to acquire an investment portfolio rather than a single property, or publicly-traded securities. The most common property investments by foreign investors are in multifamily properties, with retail, industrial, office and hotel properties rounding out the top five, respectively.[2] This summary further focuses on the equity investor primarily interested in acquiring completed and leased commercial properties, but its lessons translate well across all real property investments.

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1 Source: Association of Foreign Investors in Real Estate 2013 Foreign Investment Survey.

2 Source: Association of Foreign Investors in Real Estate 2013 Foreign Investment Survey.

This summary is divided into three sections:

I. General United States legal requirements.
II. United States tax rules (primarily, Federal income tax) applicable to the investment program.
III. Other United States practices and procedures that may be applicable to the investment program.

This summary does not cover applicable foreign tax rules or legal requirements. Nor does it attempt to cover the innumerable ancillary issues which may be of importance in particular situations. For a particular program, portions of our discussion may require adaptation to the specifics of the program. Our discussion also is based upon current laws which are, of course, subject to change.

For purposes of this summary, we have assumed that each United States real property interest will be owned by a separate domestic subsidiary of a common domestic parent corporation and that the affiliated group (the "Group") will file its Federal income tax return on a consolidated basis. While this is a commonly used structure, another structure may be more appropriate to the tax situation of the particular investor.

Finally, as in any general discussion, the reader should be aware that this summary is not intended to serve as an all-encompassing treatise. It cannot be overemphasized that this summary is not a substitute for the proper professional guidance and advice that must be sought as to the particular aspects of each program.

General United States Legal Requirements

The acquisition of United States real property by the Group will subject it to the full range of Federal laws and of State laws in those States in which the Group invests. The most pertinent of these laws are discussed in summary form in this section and, to a lesser extent, in Section III. We emphasize that the various laws discussed below are, at best, a sampling of the many laws which might be relevant to the Group's investment and management decisions. A complete listing of all such laws is, of course, beyond the scope of this summary.

Governmental Approvals

In the case of the customary acquisition of real property in the United States, there are no direct governmental approvals or consents required. Although there are various governmental permits that must be obtained, these are all ministerial in nature and are granted upon the filing of a proper application without discretion on the part of the governmental authority. An example is a certificate of authority for a non-domestic corporation to conduct business in a particular State. In the United States, corporations which are formed under the laws of one State (or foreign jurisdiction) must qualify to do business in another State. This qualification is accomplished merely by filing an application with the designated State governmental office which then issues the requisite certificate of authority, usually within a day or two.

In the case of full-service hotels and resorts and other properties that involve the sale of wine or liquor, there are substantive licensing requirements which may impact on foreign investors. These licensing requirements are primarily State law requirements and vary widely among the States. A not uncommon requirement is disclosure of the ultimate beneficial owners of the property. Moreover, many States limit or prohibit the granting of retail sales licenses (*e.g.*, for bar or restaurant operations) if the ownership includes any person involved in the production or distribution of wines or liquors. In some States, for example, a party may not obtain a retail sales license if there is any direct or indirect ownership, however small, in such party by an entity licensed to engage in the production or distribution of wine or liquor. In other States, ownership interests below 5% are permitted. In most States, but not all, investment structures are available which can mitigate the impact of these requirements. Thus, an investor interested in properties involving the

sale of wine or liquor should understand the liquor license requirements of the pertinent State early in the investment process.

Governmental Regulations

There are numerous laws which limit or prohibit the acquisition of United States real property by non-resident aliens or by corporations that are controlled by non-resident aliens. Many of these laws apply only to mineral resources or to agricultural property. Very few States apply them to commercial real estate. As these laws vary broadly, it is not possible to summarize them in this summary, other than to say that they should be reviewed before each acquisition. However, so few States have laws prohibiting commercial acquisitions that they are unlikely, as a practical matter, to impact significantly on the Group's investment program.

Coming back into favor in recent years, the EB-5 program provides visas for foreign investors who create or save at least 10 American jobs (excluding those held by the investor's immediate family) through an investment of at least $1 million in American real estate (or, in some areas of the country, $500,000). Since the investment can be in either real estate equity or mortgage type debt, these platforms are both flexible and evermore prevalent.

Governmental Reports

Numerous governmental reports must be filed in connection with the acquisition, ownership and disposition of United States real property by non-resident aliens or corporations controlled by non-resident aliens. The primary non-tax reports are:

a. Pursuant to the International Investment Survey Act of 1976 (commonly called "IISA"), various reports must be filed with the United States Department of Commerce upon the acquisition or disposition of United States real property by foreign persons or entities and in connection with the property's operation. In addition, every five years (2013 being such a year) a survey report on existing investments must be filed. These reports are confidential and may only be used to collect data on foreign investment in the United States.

b. Pursuant to the Agricultural Foreign Investment Disclosure Act of 1978 (commonly called "AFIDA"), a report must be filed with the United States Department of Agriculture when a foreign person or entity acquires or disposes of agricultural land. The definition of agricultural land under AFIDA is broad enough to require a filing even though the property is, upon acquisition, used or to be used for commercial purposes. AFIDA filings are public.

c. A few States require foreign corporations and, in some cases, foreign-controlled corporations to report acquisitions and, in some cases, dispositions of real property within the State. These reports are generally confidential and more in the nature of special registrations than detailed disclosure returns.

d. Pursuant to the Currency and Foreign Transactions Reporting Act (commonly called the "Bank Secrecy Act"), transfers of funds or other monetary instruments into or out of the United States must be reported to the United States Department of Treasury if they exceed $10,000 in amount or value and if they are made by means of cash or bearer instruments. These reports are required rarely, except by inadvertence, as transfers of funds are customarily made through the banking system.

Exchange Controls

The United States currently has no laws that, under ordinary circumstances, restrict or prohibit the movement of capital or profits to or from the United States. Although there are some governmental reporting requirements in this regard, such

as under IISA and the Bank Secrecy Act (see paragraphs 3(a) and (d) above), these laws impose no restrictions on capital movements themselves.

Extraordinary Authority Laws

In special circumstances, the Federal Government has broad powers over foreign-owned assets in the United States. These powers, which arise primarily from the Trading with the Enemy Act and the Alien Property Custodial Regulations and Foreign Asset Control Regulations issued pursuant to the Act, permit the seizure or "freezing" of foreign-owned assets during a war or in the event of a national emergency. National emergency has been fairly broadly construed by the Federal Government. Thus, examples of instances where the Federal Government has exercised this extraordinary authority are the sanctions against Iran, Iraq and Libya. In addition, other laws, such as the Helms-Burton Act, which relates to assets expropriated by the Cuban Government, purport to create similarly broad authority for sanctions.

Following the September 11, 2001 terrorists acts, the US PATRIOT Act was enacted. Among other things, the Act provides for broad reporting requirements by many "financial institutions" including "persons engaged in real estate closings and settlements". In connection with financing transactions, foreign investors should expect a significant degree of required disclosure regarding both beneficial ownership and sources of funds. In equity transactions, there are also heightened disclosure requirements, but none are so burdensome as to impede transactions in the ordinary course.

Real Estate Laws

As a general matter, real estate law is primarily State law and is also primarily common law. This is very different from the civil law jurisdictions, where there is typically a national civil code applicable to real property and court decisions are predicated upon deductive reasoning from the civil code rather than inductive reasoning from prior court decisions.

Although there is a basic similarity among the State laws, largely because all but Louisiana derive from the English common law, there are also major differences. As an example, from the mid-'70s to the early '80s there were many court decisions on whether a lender may require repayment of a mortgage debt upon transfer of a mortgaged property. A number of States, led by California, decided that a lender may not require repayment absent proof that the transfer would materially impair the lender's security — an almost impossible burden of proof to meet. However, a majority of the States enforce provisions in the mortgage loan documents that properly provide for repayment upon transfer. Thereafter, this issue was resolved by Federal legislation permitting enforcement of such provisions.

There are, of course, innumerable aspects of United States real estate law which are pertinent to the Group's proposed program. Although it is beyond the scope of this summary to summarize all of them, we have listed below a few aspects which, in our experience, are often unfamiliar to foreign investors.

a. The United States courts have broad authority in civil cases to issue orders requiring the parties to perform or refrain from performing specific acts. This authority is commonly referred to as "equity" and the orders as "injunctions". For example, if the seller of property wrongfully dishonors a contract of sale, the purchaser customarily may sue in equity for an injunction compelling the seller to transfer title to the property to the purchaser.

b. The use of penalty provisions in contracts to compel performance is prohibited as a general matter of law throughout the United States. However, so-called "liquidated damages" provisions are permitted. These are provisions which provide for specified monetary damages where the actual damages arising from a breach of contract are, at the time of contracting, difficult or impossible to ascertain. The obvious issue is what constitutes a "penalty" as opposed to liquidated damages clause. Although admittedly there is no clear distinction between a penalty and liquidated damages, the law is clear that, if a "penalty" is involved, the provision is unenforceable.

For example, a contract provision requiring a reasonable downpayment against the purchase price under a contract of sale for real property is generally upheld as a permitted liquidated damage provision and not considered a penalty. Thus, upon breach by a purchaser, the seller may retain the downpayment without proof of actual damage. In New York, downpayments of 10% of the purchase price are customary (except in very large transactions) and have been found by New York courts to be reasonable (*i.e.*, not a penalty). However, a downpayment of 25% or 30% would, except in the most extraordinary circumstances, be found to be a penalty and thus refundable to the defaulting purchaser. (The purchaser would, of course, remain liable for any actual damages caused by its default.) On the other hand, in other States, courts have required sellers to return all or a portion of the downpayment (even one of less than 10% of the purchase price) where the seller subsequently sells the property and can be shown not to have suffered actual damages. In addition, in California, judicial interpretation of statutory liquidated damage provisions essentially limits downpayments to a much lower amount than in New York (with a statutory cap of 3% in certain residential transactions).

c. Many States have laws which limit the amount of interest which lenders may charge borrowers. There are two broad categories of these laws. First, in many States, compound interest is, as a matter of common law, unenforceable. Second, almost all States, as a matter of statutory law, directly limit the rate of interest that may be charged by a lender. These latter laws are called usury laws. There have been times when the limitations set by usury laws had a direct impact on financing transactions. However, as a result of the high interest rates in the United States in the '80s, most States have significantly raised the usury rate limits or have eliminated all limits for commercial transactions.

d. As a general matter, title to real property is transferred by delivery by the seller to the purchaser of a properly executed deed. The purchaser's title is perfected as against third parties by recordation of the deed in the public records. This is substantially different from the system of governmental registration of land title used in many civil law jurisdictions. Basically, in the American recording system, all matters which affect land titles must be recorded in the proper governmental office to affect third parties, including third parties who have no other knowledge of the matter. The governmental recording office does not certify or register the state of title but merely allows all interested parties to review its records. However, all persons are deemed by law to have knowledge of the recorded documents.

   We also do not have a system of notaries as is used in civil law countries. We do have a system of notary publics who are persons licensed to authenticate signatures. As many real estate documents require authentication to be recorded, a notary public is frequently involved in real estate transactions. However, the scope of the notary public's involvement is strictly limited to the authentication of signatures.

   As indicated above, title to a particular property is determined by a review of the documents recorded against the property. This review is generally handled by a title insurance company. Title insurance companies are regulated insurance companies that examine the public records and prepare reports describing the state of title to the property. At the closing of the purchase, the insurance company issues a title insurance policy that is based upon its report and that insures the status of title as shown on the policy. The insurance company charges a single premium, payable upon issuance of the policy, based upon the amount insured (*i.e.*, the purchase price in an owner's policy or the amount of a loan in a mortgagee's policy). The premium charges vary across the United States as they are regulated by State insurance commissioners. The policy is in force so long as the insured has any interest in the property or title liability with respect to it.

e. Commercial mortgage loans in the United States are typically non-recourse. That is, the borrower has no personal liability for repayment of the loan, and the lender must look for repayment to the proceeds of sale of the property. In

the event of a default, the lender sells the property through a "foreclosure". The procedures for foreclosure vary widely among the States. In about one-half of the States foreclosure is effected through a court proceeding (typically referred to as "judicial foreclosure") which may take anywhere from sixty days to two years (depending upon whether the foreclosure is contested). If a foreclosure order is granted, the mortgaged property is then sold at a public auction, usually within thirty to sixty days after the order is issued. The lender may bid at the auction and use its debt as payment. Thus, unless a third party wishes to bid more than the lender's debt, the lender usually "buys-in" the property in satisfaction of its debt.

In other States, foreclosure may also be completed by means of a public auction without a court proceeding (unless the borrower contests the sale). This procedure, known as "non-judicial foreclosure", requires thirty days or more (approximately 110 days in California) and has essentially the same results as a judicially ordered sale.

In all cases, foreclosure is considered to be an equitable remedy of a lender. Thus, if contested, a court will consider a wide variety of equitable defenses. As a consequence, it is quite difficult to foreclose a mortgage in the United States unless there is a monetary default or clear proof of impairment of security (such as unrepaired damage to the property).

Even in the case of a loan that appears to be recourse on its face, there are limits on the ability of a lender to recover any deficiency after foreclosure. In most States, courts will generally conduct "fair value" hearings after a foreclosure sale to determine the fair market value of the property. The lender's claim against the recourse borrower will be limited to the excess of the amount of the debt over the fair market value. In some States, there are specific statutory limits on recovery of any deficiency. For example, in California there can be no recovery after a non-judicial foreclosure, nor after a foreclosure of a so-called "purchase money mortgage", a mortgage taken back by the seller of property.

f. To be valid, legal agreements affecting real property in the United States must, in virtually all cases, be in writing and signed by the party to be bound. However, they need not be prepared or signed by a notary; they are valid if signed by the parties. Thus, a mere exchange of letters, when read together, can constitute a valid agreement (e.g., a contract of sale, a lease or even a deed) between the parties. However, title documents, such as deeds and mortgages, must be recorded to bind third parties, and recording does require certain further formalities, such as formal acknowledgment of execution by a notary public.

g. In many States, as an exception to the general rule stated in paragraph (f) above, real estate brokerage agreements are not required to be in writing. As a result, significant litigation not infrequently arises over brokerage claims. Foreign investors not familiar with real estate brokerage customs in the United States are advised to be cautious in this area as unexpected claims can arise.

h. Legal documents in the United States are lengthy. In part because of the lack of precision in American common law and in part due to a general style of practice, United States lawyers tend to draft contracts, leases and the like with great attention to detail. Moreover, unlike most civil law jurisdictions, there are few, if any, implied covenants, warranties or representations in commercial transactions. Thus, these matters must be dealt with in the appropriate documents.

Legal Liability

An owner of real property in the United States has general legal liability for all claims arising out of the ownership, use and occupancy of the property. As between the owner and third parties with contractual relationships with the owner

(such as lenders, tenants, contractors and suppliers), the owner through its contracts can limit this general liability for claims related to such contracts. In most States, however, an owner can completely exculpate itself from liability only for claims not involving its negligence or willful misconduct. The details of State law vary, of course. Thus, for example, in New York an owner may not effectively exculpate itself from claims involving its own negligence under a lease but may exculpate itself for other claims its tenants may have arising out of their use and occupancy of the leased premises. As indicated above, exculpation from any personal liability under a mortgage is customary in the United States and is generally enforceable.

An owner also has general liability owed to third parties with whom it does not have a contractual relationship (such as persons injured on property). This liability will, in most cases, be based upon a general standard of negligence. This standard is often stated in terms of whether the owner failed to exercise the prudence of a reasonable man under the circumstances and whether the owner or its acts were the proximate cause of the injury.

In a few cases, an owner has absolute or essentially absolute liability for injury or damage caused by events concerning its property. In most cases, absolute liability is imposed by statute and involves circumstances deemed by a legislature to be particularly hazardous. In a few instances, absolute or essentially absolute liability has been imposed by American courts for circumstances they deem to be especially hazardous.

Property owners in the United States protect themselves from general liability as property owners in two ways. First, property owners generally use separate entities for each property owned in an attempt to limit all potential liability to a single asset. The consolidated group structure assumed herein is consistent with this approach. The types of customary investment entities are discussed further in paragraph 11 below.

Second, property owners carry insurance to limits deemed by them to be economical. Commercial public liability insurance is available in the United States. It will essentially cover general liability claims with respect to real property. One would typically expect to find the following form of insurance program:

a. Space tenants would be required to carry commercial public liability insurance, naming the Group as an insured, with limits of $1,000,000 to $3,000,000 for average tenants and perhaps to $5,000,000 for larger tenants. In the case of single-user property, particularly industrial property, the limits might be higher. In the case of small properties, the limits might be lower.

b. The Group would carry a general blanket policy covering all of its property with a limit of, perhaps, $10,000,000, with deductibles for the insurance coverage effected by the tenants.

c. The Group would also carry an excess layer or umbrella policy, again covering all of its properties, to such higher limit above $10,000,000 as it felt necessary.

In addition to the foregoing, the Group will also carry, or require its tenants to carry, insurance for fire and casualty (including earthquake in certain areas such as California, when and to the extent the cost is not excessive), boiler and machinery, rent loss or business interruption, as well as other forms of insurance that relate to damage to the property owned by the Group as opposed to damage to third parties or property owned by third parties.

In the case of hotels and other public accommodation facilities, specialized forms of insurance may be required and higher coverage on public liability insurance is generally obtained. For instance, if on-premise liquor service is available, “dram shop” coverage should be obtained. Moreover, for hotels there are special coverages such as innkeepers' liability insurance.

Lease Remedies

As a general matter, most commercial leases in the United States provide for the following remedies in the event of a default by a tenant:

a. In the case of monetary defaults, such as the failure to pay rent or the failure to pay additional rent arising out of costs incurred by the landlord to cure a tenant's default, the landlord may sue the tenant directly for the recovery of the monies due. Such lawsuits are usually brought by a landlord only if the fact situation is simple and the tenant is creditworthy.

b. In the event of a default that can be cured by the landlord (such as a failure to pay insurance premiums or real property taxes or a failure to make a repair), the landlord can effect the cure and charge the tenant, as additional rent payable on demand, for the costs and expenses incurred. In addition, a landlord will typically have the right to seek an injunction compelling a tenant to specifically perform those acts required to cure a default. Even though this latter remedy is broadly stated, it is seldom used because courts are reluctant to grant an injunction for such purpose unless the particular acts required to cure the default are uniquely within the ability of the tenant to perform.

c. In the event a tenant becomes bankrupt, the landlord's rights are essentially governed by the Federal Bankruptcy Code. Under the Federal Bankruptcy Code a bankrupt tenant, subject to Bankruptcy Court approval, may elect to affirm or reject its lease. If the lease is rejected, the landlord has a claim, as a general creditor, for all rent due and owing up to the date of rejection or such later date as the tenant vacates the premises. The landlord also has a general creditor's claim for the lesser of (i) the monetary damages permitted by the lease or (ii) the greater of one year's rent or 15% of the rent for the remaining term of the lease, not to exceed three years. If the lease is affirmed, the landlord is entitled to receive all rents due and owing and "reasonable assurances" that the tenant will perform in the future its obligations and covenants under the lease. In addition, if the lease is affirmed, then, notwithstanding any contrary provision of the lease, it may be freely assigned to a third party, subject to "reasonable assurances" that the assignee will perform its obligations and covenants under the lease. This provision of bankruptcy law will, of course, enable the representative of the bankrupt tenant to realize upon any bonus value in the lease for the benefit of the bankrupt estate. The Bankruptcy Code provisions governing the assignment of leases in shopping centers are more favorable to landlords as a result of an intense lobbying effort by owners of, and lenders to, shopping centers.

d. Leases generally provide for two other alternative courses of action when a tenant defaults:

   - the right to terminate the lease, dispossess the tenant and sue for damages; and
   - the right to reenter the premises and dispossess the tenant without terminating the lease, to relet the premises and to collect from the tenant any difference between the rents received (less the expense of reletting) and the rents stated in the lease.

   There is a general principal in American common law that "the law abhors a forfeiture". Thus, American courts are often reluctant to enforce the remedial provisions of a lease that lead to its termination or to loss of possession by a tenant. As a consequence, American courts have developed a number of legal and equitable doctrines intended to protect the possession of a tenant. Courts resort to these doctrines when they feel that dispossessing a tenant is somehow unfair or unconscionable. If this sounds less than precise, it is because one can find contrary decisions on apparently similar fact patterns. That is, in one case a court may issue a dispossess order because a tenant is one day late in paying rent and in another case, on apparently the same facts, the court will invoke a legal or equitable

doctrine that prevents issuance of the dispossess order. As a general matter, one can say that the remedial provisions of a lease are effective only in the event of a clear and material default by a tenant.

With respect to the two alternative courses of action indicated in clauses (i) and (ii) above, the first remedy (*i.e.*, terminating the lease and dispossessing the tenant) is generally the preferred and most efficacious remedy. American courts have severely restricted the use of the second remedy (*i.e.*, reentry without termination). Moreover, in a few States, reentry without termination may limit or eliminate a tenant's obligation for future rent payments.

With respect to a landlord's damage claims, the standard measure of damages upon the termination of a lease when a tenant defaults is the sum of (a) the rent owed to the landlord to the date of termination plus (b) the bonus value of the lease (which is the excess of the rents payable under the lease for the remainder of its term over the fair market rental value of the premises when the lease is terminated) discounted to present value. This measure of damages, which is derived from the English common law, has not been uniformly accepted by American courts. Some courts have applied the contract measure of damages — *i.e.*, the actual damages suffered by landlord — rather than the more traditional real estate measure of damages, but this approach remains the minority position.

Landlords in the United States often require some form of security for the performance of the tenant's obligations under the lease, particularly for smaller tenants. This security often takes the form of a "security deposit", whereby the tenant literally deposits a specified sum (generally one or two months' rent), sometimes in the form of a letter of credit, with the landlord as security for its performance under the lease. Alternatively, in appropriate situations, landlords may request third-party security, such as a guarantee by a parent corporation of a subsidiary's performance or a guarantee by a shareholder or group of shareholders for their corporation's performance. Such guarantees do not typically require governmental approval in the United States (although the home jurisdiction of a foreign corporation might have laws requiring governmental approvals).

We note here that American banks, unlike foreign banks, may not directly guarantee the obligations of a customer. However, insofar as financial obligations are concerned, American banks may issue letters of credit that, in most cases, are the equivalent of a financial guarantee as the bank commits to make the funds available should the specific conditions arise without regard to the credit-quality of the parties in the underlying transaction.

Conflicts of Law

In the United States, a large body of law has developed to determine which State's law should be held to govern in multi-State transactions. As a general matter, in commercial transactions the parties may themselves elect which State's law should govern so long as the State selected has reasonable contacts with the transaction. In most real property transactions, however, even though it may be possible to select another State's law to govern, the parties generally select the law of the State in which the real property is located. This is because the law of that State, generally called the situs State, must govern certain of the remedial provisions of the document, such as the foreclosure provision of a mortgage or the termination provisions of a lease. Thus, it is practical and logical to have a situs State's law govern the entire document.

However, this general practice does not hold in loan transactions where the usury or other laws of the situs State are unfavorable. In such cases, out-of-state lenders will generally arrange the transaction so as to permit a choice of their home State's law to govern the note (and, thus, the interest provisions of the loan), although the mortgage and all other security documents will be governed by the situs State's law. In addition, on occasion, but not often, a contract of sale will

be governed by the law of a State other than the situs State. This might arise where both the seller and the purchaser and their counsel are from out of State and prefer to use their home State law.

Foreign (*i.e.*, non-United States) law is almost never made the governing law of documents dealing with United States real property. In theory, such law could be used to govern contracts of sale, notes and other documents which did not directly deal with title or remedies. However, foreign law, in addition to being unfamiliar to most parties, would present material proof problems if litigation arose over the document.

Judicial Jurisdiction

There are more than fifty separate judicial systems in the United States, comprised primarily of the Federal courts and the various State courts. The jurisdiction of these courts (*i.e.*, their authority to hear and decide controversies) is established and limited by both the Federal Constitution and Federal laws as well as applicable State laws. Such jurisdiction covers both the subject matter of the dispute and the parties involved in the dispute.

To illustrate, the *general* jurisdiction of Federal courts extends to all cases and controversies arising under Federal law, and to cases and controversies arising under State law provided more than $75,000 is in dispute and the parties are citizens of different States or countries (called "diversity of citizenship").[3] Thus, in a State law case, if either criterion is lacking and no basis of special jurisdiction exists, the Federal courts are not authorized by law to hear the case. In addition, however, the courts must also have jurisdiction over the persons or property involved in the matter. Hence, without special factors, if a citizen of, say, Wisconsin proposes to sue a citizen of, say, Florida regarding a business transaction in one of the States, he cannot sue in the Federal court in New York even if the subject matter criteria are met because that court would lack jurisdiction over the persons involved.

This is an area of great complexity; however, it is relevant to foreign investors. As a general matter, foreign investors desire to avoid subjecting themselves to the jurisdiction of the United States courts. As real property is an immovable, it is impossible to avoid this jurisdiction totally. However, the ultimate investor (*i.e.*, individual owner or corporate parent) can and usually does take appropriate steps to avoid subjecting itself personally to the jurisdiction of American courts.

For example, if a foreign parent corporation itself acquired United States real property, it might face United States litigation not only as to matters involving the real property but also perhaps as to a broader range of matters. Within limits, this potential may be avoided by use of properly formed and operated subsidiaries.

Investment Entities

This summary assumes the use of regular corporations in a holding company structure as the investment format. In the United States corporations are very easy to form — a process which can be completed in a couple of days — and to maintain. Except in extraordinary situations, essentially arising where a shareholder ignores the basic formalities of maintaining the corporation, shareholders have no personal liability for claims against the corporation.

Another commonly used investment vehicle is the partnership, especially the limited partnership. A limited partnership is generally formed by the filing of a certificate of limited partnership[4] and is governed by an agreement of limited partnership signed by an agreement of limited partnership signed by all of the partners. A limited partnership must have

[3] The Federal courts have *special* jurisdiction over a wide variety of matters, but we are limiting the illustration for the purposes of simplicity.

[4] New York requires the publication of a notice in a newspaper as well, but this is an unusual requirement.

at least one general partner who must be generally liable for the limited partnership's obligations. Quite often, a corporation with limited assets is used as the general partner. As long as a limited partner does not partake in the management of the limited partnership beyond actions permitted by the applicable limited partnership law, the limited partner is not liable for limited partnership obligations beyond its actual and committed capital.

Limited partnerships are popular investment entities in that they do confer limited liability and because they are so-called "pass-thru" entities for United States tax purposes. As "pass-thru" entities, the limited partnership does not pay Federal income tax[5]; rather its tax attributes (its income, gain, loss, deductions and credits) are allocated to its partners who report them on their personal tax returns. Generally this tax regime produces a lower overall tax as entity level taxes are avoided. For many foreign investors the limited partnership tax regime is not attractive as they would, as limited partners, have to file personal tax returns in the United States. For other foreign investors, such as German investors, substantial tax benefits are achieved through this approach.

Since the adoption of statutes authorizing the formation of the limited liability company or LLC in Wyoming in 1977, the LLC has become the entity of choice for private real estate investment entities. The LLC is quite similar to the limited partnership except that no member (which is what the owners of LLC interests are called) need be personally liable for the obligations of the LLC. In effect, there need be no general partner. Moreover, many State statutes allow for single member LLCs. The LLC may be formulated so that it will be taxed as a partnership or as a corporation. Although the LLC has become the vehicle of choice, typically replacing the limited partnership in domestic transactions, it has not been as useful for foreign investors as its liability and tax attributes for home country purposes may not, as yet, be clear or as advantageous as those available by using other vehicles.

In what may be the beginning of the next evolution in real estate investment entities, use of both public and private real estate investment trusts or REITs has dramatically increased as the restrictions applicable to the same have lessened. The REIT is essentially a form of taxation rather than a form of judicial entity. Although subject to complicated tax rules, a REIT is essentially a "pass-thru" vehicle which does not pay tax at the entity level. REITs do offer a publicly-traded alternative for real estate investors. REITs also offer, for certain selected investors, a private, alternative investment vehicle to the corporation.

General United States Tax Rules

United States citizens and residents and domestic corporations are generally subject to tax on their entire worldwide net income.[6] However, foreign corporations ordinarily are subject to United States tax only upon income derived from sources within the United States. The method of taxation depends upon whether such income is passive (such as dividends, interest and rents from net leased real property) or active (such as industrial or commercial profits from a United States trade or business or rentals from actively managed real property). The provisions of any applicable tax treaty also must be considered.

United States Federal Income Tax

Based upon our assumption that the investor will acquire a portfolio of investment properties, we have further assumed, as noted above, that each property will be acquired by a separate subsidiary of a common United States parent

[5] A very few jurisdictions, New York being one, tax unincorporated businesses. A partnership is subject to such taxes.

[6] Except as otherwise indicated, our discussion is based upon the Internal Revenue Code of 1986, as amended (the "Code").

corporation.[7] The Code permits affiliated domestic corporations with a common domestic parent to file a single, consolidated tax return if they meet the consolidated return requirements (essentially, an 80% or greater ownership test). As a consequence, the tax losses generated by some members of the Group can be applied to offset the taxable income generated by other members. Although the rules governing the "carryforward" of net operating losses ("NOLs") permit a single corporation to use current NOLs to reduce future taxable income (with, essentially, a 20-year carryforward period), the consolidated return may allow the Group to benefit from a member's NOLs before the member itself could. If, as is often the case, a portfolio of real estate investments generates a mix of tax losses and taxable income, there is a present value advantage to the consolidated return approach.

The Group's taxable income from the investment program will be subject to taxation at the rates applicable to domestic corporations. The highest effective corporate Federal income tax rate is currently 35%.[8]

For Federal income tax purposes, taxable income basically equals gross income less deductions for items such as the following:

- Operating expenses, which include all ordinary and necessary expenses paid or incurred in owning and operating the investment.
- Interest, including all interest and similar charges on indebtedness incurred to acquire or operate the investment. (Interest payable by domestic corporations to a foreign affiliate, however, is subject to special limitations upon its deductibility.)
- Certain taxes, generally including all State and local taxes on real property, personal property and income. Federal income taxes are not deductible.
- Depreciation, which is discussed below.

In general, the foregoing categories of deductions will not include (a) the cost of acquiring the investment (which may, however, be recoverable through depreciation), (b) the cost of additions, improvements or major repairs to the investment (which also may be recoverable through depreciation) and (c) principal repayments on indebtedness. There are, of course, many exceptions to the very general rules given above, but these exceptions are best dealt with on a case-by-case basis as they arise.

The allowance for depreciation is granted by the Code whether or not an investment actually depreciates in value. It is based upon the cost of acquiring the investment. This cost includes not only the cash paid by the purchaser but also bona fide indebtedness the purchaser incurs in connection with the investment or to which the investment was subject when acquired. The cost also includes expenses incurred by the purchaser in making the acquisition.

To illustrate, assume the Group acquired an investment for $30,000,000 by paying $10,000,000 in cash and acquiring the investment subject to $20,000,000 in third-party mortgage debt. Further assume the Group's expenses for the

[7] The assumption made above that the Group will acquire the investments through a United States holding company structure is a material assumption. It is not necessarily a recommended investment structure, but merely an assumption made to simplify the scope of this summary.

[8] For taxable income over $10,000,000.

acquisition totaled $1,000,000, including counsel's fees, transfer taxes, title fees and other expenses. The Group's cost of acquisition (called its "basis") would be $31,000,000.[9]

To compute the allowance for depreciation, the Group's basis must first be allocated between the "non-depreciable" and the "depreciable" portions of the investment. Basically, for real property, the allocation is between (a) land and (b) the buildings and other improvements on the land. This allocation is based on fair market values of each at the time of acquisition. To continue the foregoing illustration, assume the land was valued at $6,000,000 and the buildings at $25,000,000. In such a case, only the $25,000,000 would be subject to the allowance for depreciation.

The costs of capital additions, improvements and major repairs are also subject to the depreciation allowance in the same way as the initial investment. Thus, in each year, the aggregate depreciation allowance is the sum of the allowance on the initial investment and the allowance on the later capital expenditures.

Once the basis in the depreciable assets has been determined, the annual allowance (deduction from income) for depreciation is computed by applying certain statutory rates. In the case of nonresidential real property placed in service after May 13, 1993, the rate is 2.564%, corresponding to an assumed asset life of 39 years computed on a straight-line basis.[10] This rate is applicable for the life of the investment or, if earlier, the expiration of the asset life period. Thus, if the depreciation allowance is based upon the 39 year rate and the investment is held for 45 years, there is no depreciation allowance for the last 6 years, except for the allowance arising from capital expenditures made after acquisition.

Thus, using the $25,000,000 depreciable basis of our illustrative case, the Group is entitled to an annual deduction of $641,000 for depreciation when it computes its net taxable income from the investment.

Given the foregoing, the Group's net income from the investment may be determined. If the Group files a consolidated tax return, its net income for Federal income tax purposes will be determined on an aggregate basis for all investments rather than on an investment-by-investment basis. That is, the Group may offset taxable income from some investments against tax losses from others. For simplicity, we have assumed that the Group has only the single investment used in our illustration.

[9] Note that, if the existing mortgage were refinanced after acquisition, the basis in the property would not be changed except to the extent any net cash proceeds were invested in the property. For example, if a day after acquisition the mortgage were refinanced with a new $22,000,000 mortgage and none of the net proceeds were invested in the property, the basis would remain $31,000,000.

[10] For residential real property, the statutory rate is about 3.636% corresponding to an assumed asset life of 27.5 years, computed on a straight-line basis. A taxpayer may elect to write off depreciable real property on a straight-line basis over 40 years. In addition, certain personal property used in connection with the buildings (but not components of buildings) will be depreciable at faster rates than are shown above. However, such personal property will likely constitute less than 15% of the aggregate depreciable basis and is not discussed herein for the sake of simplicity.

To continue the illustration, assume the Group, for a given year, has (a) gross income from the investment of $3,800,000, (b) operating expenses, interest payments and State and local taxes totaling $2,800,000 and (c) an annual depreciation allowance of $641,000. Further assume the Group made no capital expenditures (*i.e.*, for additions, improvements or major repairs) or principal repayments on its debt. The Group's net taxable income would be:

Gross Income		$3,800,000
Deductions:		
Operating expenses, interest and State and local taxes	$2,800,000	
Depreciation:	$641,000	
		$3,441,000
Taxable Income:		$359,000

This net taxable income would be taxable in accordance with the following rate schedule:

Net Taxable Income	Rate
Up to $50,000	15%
$50,001 to $75,000	25%
$75,001 to $100,000	34%
$100,001 to $335,000	39%
$335,000 to $10,000,000	34%
$10,000,000 to $15,000,000	35%
Above $15,000,000 to $18,333,333	38%
$18,333,333	35%

The 39% bracket represents a 5% surcharge to phase out the effect of the 15% and 25% rates. The Federal income tax due in the illustration would be $122,060.

If we assume that the Group had gross income of 10% less (or $3,420,000), then it would have had an NOL for the year in question of $21,000. This NOL could be carried back for two years and forward for 20 years and applied against Federal taxable income arising in such years.[11]

Under certain circumstances, the Group could be liable for "alternative minimum tax". The alternative minimum tax is generally determined by applying a rate of 20% to a base consisting of the sum of regular taxable income plus certain

[11] Absent an election not to carry back an NOL, it is first carried back to the earliest year to which it can be carried and, if not fully utilized, then to the next earliest year. It is then carried forward to each succeeding year in order. An NOL attributable to an investment cannot be carried back to years before the investment was acquired.

"preferences" and other adjustments, less an exemption amount. The exemption amount is $40,000, but is phased out by $0.25 for each $1.00 by which the regular taxable income plus preferences and adjustments exceeds $150,000.

In calculating alternative minimum tax, one of the adjustments added to regular taxable income involves depreciation. As applied to facts similar to ours, the difference between depreciation calculated on a 39 year straight-line basis (at 2.564%) and depreciation calculated on a 40-year straight-line basis (at 2.5%) would be added to regular taxable income to determine the alternative minimum tax base. The regular tax is payable in case the amount of the alternative minimum tax is lower than the regular tax.

However, in our example, the Group, as a small business corporation, will be exempt from the alternative minimum tax liability. Any corporation first incorporated after 1997 that has average gross receipts of less than $5,000,000 for its first taxable year is a small business corporation (and its alternative minimum tax is zero) for its next tax year and continues to be treated as a small business corporation exempt from the alternative minimum tax so long as its average gross receipts for all future three-year periods do not exceed $7,500,000.

In a well-structured real estate investment program, the Group should expect to incur tax losses for several years. This assumes that acquisitions are leveraged, as is customary in United States real estate investments. If the Group were to acquire properties with little or no leverage and did not otherwise have debt in the investment structure, it would likely realize taxable income from its investment. Whether or not and to what extent leverage is appropriate is dependent upon many factors, including the Group's current and projected taxable income, the accounting impact, the Group's cash resources, applicable mortgage interest rates and the current and anticipated yields from acquisitions.

Assuming a successful investment program, the Group should expect to incur regular taxable income from investments as they mature. This can generally be expected to occur some 4 to 7 years after acquisition (assuming, again, customary leverage). The timing of this crossover is obviously dependent upon the structure and performance of each investment.

Treatment of Capital Gains

The Group will also be subject to Federal income taxes on the gain realized on the sale or other disposition of its investments. The Code permits certain tax-free exchanges of real property and also permits certain deferrals of tax payments in cases where the sales price is paid over time. However, unlike certain foreign tax laws, the Code does not permit tax-free rollovers of investments (*i.e.*, sales of investments with reinvestment within a specified period), except in cases of destruction, theft and eminent domain (expropriation) where the proceeds of the conversion are reinvested in similar property.

For corporations, such as the Group, the capital gains realized on the sale or exchange of its investments would be taxable at the same rates as ordinary income.

The amount of gain is basically the difference between the net sales price and the Group's adjusted basis in the investment. The net sales price is the gross sales price, including indebtedness assumed by the purchaser and indebtedness to which the investment is subject when sold, less the expenses of sale. The adjusted basis is, generally, the Group's original basis in the investment, plus capital expenditures and less depreciation allowances (whether or not taken) on the investment and capital expenditures related to it.

To continue the illustration, assume that five years after the Group acquired the investment for $31,000,000 it sold it for a gross sales price of $50,000,000. Further assume the Group's expenses of sale were $1,500,000, it had incurred no capital expenditures and it had claimed annual depreciation deductions of $641,000. The Group's Federal income tax (assuming no other income or deductions) would be computed as follows:

Gross sales price:		$50,000,000
Less expenses of sale:		$1,500,000
Net sales price:		$48,500,000
Less: Original basis	$31,000,000	
Less accumulated depreciation ($641,000 x 5)	$3,205,000	
Adjusted basis:		$27,795,000
Net capital gain:		$20,705,000
Tax:		$7,246,750

Note that if the Group had no other United States investments, it could be liquidated and the net proceeds of the sale distributed to the foreign parent without further United States tax. If the Group remains in place because it owns other United States investments, the proceeds, if distributed by the parent of the Group to its foreign parent, could be subject to Federal withholding taxes, as discussed in the next section.

Federal Withholding Taxes

The Group would generally be liable for Federal withholding taxes on dividends paid to the Group's stockholder at the rate of 30%. This rate is usually reduced, most often to 5% or 15%, under United States tax treaties (but some more recent treatises eliminate withholding tax altogether on dividends made by 80% subsidiaries to their corporate parents).[12] Such withholding tax is only applicable to "dividends" from the Group. Distributions which are not dividends are treated as a return of capital, which is not subject to the withholding tax, to the extent of the investor's basis in its stock of the holding company.

Distributions will be treated as dividends to the extent of the current or accumulated "earnings and profits" of the Group. Earnings and profits are analogous to, but not exactly the same as, taxable income. The major differences for present purposes are:

a. "Earnings and profits" are computed based upon a 40-year depreciation schedule and thus will slightly exceed taxable income, assuming the Group elects to compute its depreciation deductions upon a 39 year schedule.

b. Federal income taxes paid or accrued for the taxable year are generally deductible in computing "earnings and profits".

While detailed discussion of "earnings and profits" is outside of the scope of this summary, we will apply the discussion so far to our illustrative case. The annual difference in depreciation rates between a 39 year and a 40 year depreciation schedule is .064% or $16,000 per annum based upon a $25,000,000 depreciable basis. In the illustration, the Group had

[12] In recent years, most US tax treaties have been renegotiated to deny their benefits to foreign parent corporations owned by nontreaty shareholders.

a pre-tax cash flow of $1,000,000, an after-tax cash flow of $877,940 and taxable income of $359,000. Assuming no "earnings and profits" adjustments other than depreciation ($16,000) and Federal income taxes ($122,060), the Group's "earnings and profits" for the year would be $242,940. Thus, a full distribution of its after-tax cash flow would be a dividend to the extent of $242,940 and a return of capital to the extent of the balance, being $635,000. This return of capital should not ultimately be subject to withholding tax to the extent it does not exceed the investor's investment in the stock of the holding company, although in some cases it may be necessary to pay withholding tax on the full amount and apply for a refund after the end of the year.[13]

If a return of capital distribution does exceed the investor's basis in such stock, the excess is taxable as a capital gain and is subject to withholding. As the distribution is from a United States real property holding company (because the Group holds a real estate investment), the capital gain is subject to FIRPTA (discussed below).

There is also a United States withholding tax at the rate of 30% on interest payments to foreign persons. (This withholding tax does not apply to "portfolio interest" paid on certain instruments held by persons not owning, directly or by attribution, 10% or more of the voting power of the borrower.) However, the 30% rate is reduced, often to zero, under many tax treaties. Depending upon the foreign tax consequences for the Group's stockholder, these treaty provisions offer the possibility to fund the investment program with parent company debt. Subject to the so-called "earnings stripping" rules (discussed below) and assuming that the debt is bona fide debt for tax purposes, such interest payments would create a Federal income tax deduction for the Group without United States interest income to the foreign parent.

The "earnings stripping" rules may, however, limit such interest deductions. If applicable, these rules restrict the deduction for interest paid to a foreign parent (or interest on debt guaranteed by the foreign parent) to 50% of "adjusted taxable income." Adjusted taxable income is taxable income, after adding back depreciation and certain other expenses. These rules only apply if the Group has a debt to equity ratio of more than 1.5 to 1 and only to the extent that the foreign parent receiving the interest is exempt from tax (*e.g.*, under a tax treaty). Because of the add-back to taxable income for depreciation, often the earnings stripping rules will not result in the disallowance of interest paid to a foreign parent. Also, the disallowed portion of the interest expense may be carried forward and deducted later, subject to the 50% of adjusted taxable income limitation in each carryforward year.

The interest payments on parent company debt, if deductible, will also reduce earnings and profits, thus reducing, and possibly eliminating, United States withholding taxes on distributions. That is, the "dividend" portion of any distribution would be reduced or eliminated. For example, the above illustration assumes an equity investment of $11,000,000. If, instead, $4,800,000 were in the form of parent company debt carrying an interest rate of 7.5%, the annual interest charge would be $360,000. Assuming this interest charge were fully deductible under all applicable Code provisions, the Group would have a tax loss of $1,000 and its "earnings and profits" for the year would be negative.

As indicated above, given a normal amount of leverage, the investment program will often generate little or no Federal taxable income initially (*e.g.*, over the first 4 to 7 years). However, assuming a successful program, when investments are sold large capital gains will be realized, generating substantial current earnings and profits. Thus, even if the ordinary earnings from investments can be distributed to the parent free of United States withholding tax, the tax will likely apply after sales of investments.

[13] The Internal Revenue Service takes the position that all distributions are subject to withholding tax pending final determination of "earnings and profits" for the year. Most tax practitioners believe that the Internal Revenue Service's position is incorrect.

FIRPTA

Under the Foreign Investment in Real Property Tax Act of 1980, the transfer of the shares of a United States real property holding company by a foreign person is subject to tax at the regular United States rates. Thus, if the Group's foreign stockholder transfers its investment (*i.e.*, the stock of the United States parent of the Group), any appreciation in value of the group may be subject to tax.

The transfer of a direct United States real property interest by a foreign person is also subject to FIRPTA, but, because of the Group structure, any sale of a real property interest would be made by a domestic corporation. Thus, the gain recognized on such a sale would be subject to the regular Federal income tax, as discussed above.

FIRPTA also provides for withholding by the purchaser of real property or shares of a United States real property holding company from a foreign person. The withholding is generally imposed at the rate of 10% of the amount realized on sale. But the withholding can be reduced or eliminated by following a specified procedure which, in effect, is the filing of a pro forma tax return for the proposed sale.

State and Local Taxes

In addition to Federal income taxes, the Group will generally also be subject to State and local income and capital gains taxes in those jurisdictions in which it owns real property. These taxes vary widely from State to State and among localities within each State. Generally, these taxes are moderate as compared to Federal taxes, particularly as they are deductible in computing Federal income taxes, although recently State and local income tax rates have generally increased. Because of the great variance among these State and local taxes, it is not possible to summarize them in this summary. They should, of course, be specifically reviewed in the context of each prospective investment.

In many States, including California and New York, the acquisition of real property generally results in its revaluation for ad valorem real property tax purposes. Obviously, any prospective increase in real property taxes should be taken into account in the evaluation of the property.

Lastly, the transfer of real property in the United States is subject to State and local transfer taxes. In most, but not all, jurisdictions, the seller pays these taxes. Thus, transfer taxes are most likely to arise in the Group's sales of its investments. In some jurisdictions, New York City being one, the transfer taxes are comparatively high (combined state and city rate of 3.025% of the gross sales price for large commercial properties as compared to about 0.1% in many jurisdictions). Moreover, some jurisdictions, New York City again being one, impose transfer taxes on transfers of controlling interests in real property (such as the transfer of the stock of a corporation which owns real property). Even in those jurisdictions in which a seller customarily pays transfer taxes, an investor should understand the scope and amount as they might affect the investor's exit strategy.

General United States Procedures

Multi-national enterprises must, of course, be familiar with and adjust to the customs, practices and procedures of each country in which they do business. This is particularly true in the real estate business, primarily because real estate is immovable property and, thus, especially subject to local customs, practices and procedures. We have listed below some of the principal matters in this area that we feel an investor should take into account in formulating its investment program. We have, of course, been very selective in the matters included in order to keep this part of the summary reasonable in length.

Internal Management

The United States real estate market is not only broad and varied but also rapidly changing. Because of the distances and time differences between the United States and foreign countries as well as across the United States, an investor will benefit from a well-defined internal and, as discussed below, external management structure. Appropriate executives should be available to receive reports, advice, recommendations and proposals from the investor's counsel, accountants and other professional advisers in the United States and from third party brokers, managers, tenants and sellers. This is necessary in order to permit the investor to establish a close working relationship with its advisers, to become knowledgeable about United States real property and to establish the requisite presence in the marketplace. Perhaps more importantly, this is fundamental to the investor's image and credibility in the United States market. As large and diverse as the United States market is, major new investors can become widely known quickly. The reputation established by the investor in the early part of its investment program is of obvious importance. This reputation depends not only on the soundness of the investor's investments but also on the market's perception of the investor's management as "deal makers" and responsive investors. Too often credibility problems are created by a lack of a timely response, whether yes or no.

Advisers

For the same reasons that well-defined internal management is important, it is important to establish a proper team of advisers. Beyond mere professional competency, the investor is best served by having a carefully selected, well-coordinated group of advisers. This will serve not only to provide the investor with quality advice but also to enhance the investor's credibility in the United States market.

A basic question is the appropriate source of advice about investment management. For the initial phase of formulation and implementation of an investment program, we generally recommend selecting a single adviser with the experience and expertise to assist in formulating the program and to advise as to the investor's initial investments in its primary target areas. The obvious alternatives to this approach are to retain several advisers or to create in-house advisers by hiring individuals from United States firms. In our experience, the latter may be excessively expensive in the initial phase of a program, although it is a reasonable medium-term goal.

The use of a single business adviser on an essentially exclusive basis for an appropriate period of time, as opposed to multiple advisers, has, we think, several advantages. First, advisers retained on such a basis will typically put more time and effort into answering the investor's questions and resolving problems than advisers retained on a non-exclusive basis. As the initial phase of an investment program is essentially an educational process, this extra time and effort should provide long-term benefits. Second, the single adviser approach avoids a cacophony of advice which is often more confusing than helpful. Third, this approach assists in building a well-coordinated team early on and then facilitates implementation of the important start-up phase. Fourth, by using one adviser an investor should spend less for advice that if it used multiple advisers. Fifth, the appointment of a single adviser for an appropriate period does not prevent an investor from obtaining advice from other sources. Such alternative advice may be sought from many others on several bases, including direct retention of others for special projects. Suffice it to say that there is generally more advice available on any given matter than can reasonably be absorbed.

Compared to in-house capability, the single adviser approach has initially, and we emphasize initially, two primary advantages. First, it is generally less expensive, and, second, it is much easier to effectuate. However, once the program has been implemented and an investor has a firmer idea of the potential scope of its investments and its managerial needs, we would recommend that the investor consider the use of in-house investment management capability. Unless the

investor pursues passive investments such as net leases, sound on-going investment management in the United States is generally preferable.

In establishing the appropriate investment management system, the investor should be aware that different types of properties require different types of management. Commercial office buildings have very different management requirements than residential apartment complexes. Retail properties generally require management familiar with regional and national retail chain operators as well as requirements for tenant mix at the retail property.

Hotel and resorts not only require specialized management but also often involve management by a regional, national or international chain. Although volumes have been written on the benefits and burdens of chain management as well as the need for prospective owners to understand the proposed management arrangements, far too often investors find that they did not understand the "business" well enough when the investment was made. When the downturn in the hospitality sector occurred most recently, the learning experience was expensive and cost many investors dearly. With the new uptick in hotel occupancy and development, the question is whether these costly lessons will be remembered and applied.

Third Party Debt

Perhaps the most dramatic changes in United States real estate investment over the past decade have been in the lending area. Up to perhaps 1987/88, real estate investments were largely financed by conventional mortgage loans. Over the next 5 to 7 years, lending declined rapidly as the real estate markets crashed. Out of that highly negative environment, first through the Reconstruction Trust Corporation and then through conventional sources, a large Collateralized Mortgage Backed Securities ("CMBS") market was created. As the market worked its way through the defaulted debt portfolios, investment bankers and others formed mortgage conduit programs in order to create product for their CMBS offering. Over the same period both commercial bank and insurance company risk-based capital rules fed the momentum of change by favoring rated CMBS over whole mortgage loans and the market blossomed.

Following the most recent economic downturn, there was a virtual collapse of the capital markets as a financing source. CMBS issuances in 2007 exceeded $225 billion, but virtually none were issued in 2010. In 2011 and the first two quarters of 2012, issuances had begun to return but still reached only approximately $50 billion. Traditional lenders initially tried to fill the void, but often took more conservative stances than those previously taken in the capital markets. The Dodd-Frank Financial Reform Act provided new regulations for CMBS, requiring (among other things) that issuers maintain at least 5% of the risk of their issuances moving forward. With the introduction of CMBS 2.0 into the market, the capital markets appear to be alive again. Interest rates remain remarkably low from both traditional lending institutions and in the capital markets.

Favorable financing has, of course, several advantages to investors. First, it permits a more diversified portfolio because the available equity funds will acquire more properties. Second, assuming the income from the additional properties is more than enough to cover payments on the additional debt, the investment will generate more profit. Third, because interest is deductible for tax purposes, United Sates income taxes are reduced. Fourth, as an intangible, if new financing is obtained for an acquisition, the investor obtains some measure of comfort about the quality of the investment because the lender must also find the investment sound or it would not make the loan.[14]

[14] Source: *New York Times*, July 5, 2012. http://www.nytimes.com/interactive/2012/07/05/business/Bad-Loans-Come-Due.html?_r=0.

Third party financing also carries a risk, however: the fixed debt service charges must, of course, be paid without regard to available cash flow and the loan must be paid at maturity. Thus, in a bad market, an investor may be forced to advance additional funds to pay the debt service and avoid foreclosure. However, assuming non-recourse financing — which is customary in the United States — this risk is partially offset by the fact that the investor has also reduced the amount of its capital at risk. Thus, in the case of a bad investment as opposed to a bad market, the investor may elect to walk away from the investment rather than invest further capital.

One further point should be noted. To date relatively few investors (principally foreign investors and REITs) have purchased properties on an all-cash basis. During the latest downturn, the need for financing was evidenced when its unavailability caused the number of conveyance transactions to fall below any meaningful number. Investors should keep in mind that, except in very favorable markets, it is often easier to dispose of leveraged investments than unleveraged investments. Conversely, long-term debt (as is typically required for real estate investments) is often not pre-payable. Therefore, if interest rates available in the market fall below the face rate of the note, the net effect would be to drive down the value and sale price of the property.

Leasing

An investor's leasing program will, of course, be completely dependent upon its investment policy and acquisitions. To the extent the investor acquires passive investments, such as single-user net leased properties, the leasing program is wholly subsumed in the acquisition policy. Assuming, however, the investor acquires multi-user office buildings, the leasing program is not only important to the acquisition (in valuing the property) but also to the success of the investment.

Leasing programs for multi-user office buildings are largely dictated by the competitive rental market which, within a general range, sets the rental value of the property, the term of leases and the terms and conditions of the tenancy (*i.e.*, sublet and assignment rights, renewal rights, etc.). Within such a range, the leasing program set for a property is as much an art as a science.

Over the last several years, the leasing market in most major urban areas has swung rather dramatically from one favoring landlords to one favoring tenants and in some cases is now swinging back toward one favoring landlords. These cyclic swings in the market do materially affect lease terms and therefore place a premium on carefully analysis of an investment's potential revenue stream and, thus, value. While many perceive the current markets as permitting opportunistic acquisitions, the investor should carefully ascertain the particular characteristics of the market in which the proposed acquisition is located, the competitive position of the property within its market and the profile of the property's current tenancies.

Lease rental terms are not uniform across the United States. In some locations, rentals are quoted on a "net" basis, meaning that a tenant pays its proportionate share of all taxes and operating expenses in addition to its basic rent. However, in many locations commercial office leases provide for a tenant to reimburse the landlord only for costs in excess of the costs in the year in which the lease is executed; that is, increases in costs, not all costs. This is yet another example of the complexity of the United States market.

Property Management

The necessity for property management will depend upon the nature of the investor's investment program and the type of business adviser it retains (or the in-house staff it establishes). Assuming the investor does not invest in net leases, it will require on-site managers to look after the day-to-day operations at the property. In almost every community, there are local managers as well as local offices of regional and national management concerns available to provide property

management services for almost all types of properties. Property management contracts (except for hotel and resort properties) in the United States are relatively straightforward and should not have any particular tax or other legal ramifications. They do not require governmental approvals.

In selecting a business adviser or advisers, the investor should consider its investment and property management capacity. Many advisers have essentially no property management capacity; other advisers have more property management capacity than investment advisory capacity. With respect to the former, most have supervisory management capacity — that is the capacity to monitor the performance of local property managers. Thus, the investor's decision as to business advisers may well dictate certain decisions as to local property management. The investor should also be aware that, if it engages the property manager to be in charge of leasing as well as property management, the property manager is typically willing to reduce the management fee in order to gain the substantial brokerage fees for leasing.

Should an investor elect to create in-house investment management, it must also decide whether to include direct property management capacity as well. The investor could decide to have in-house investment management but to retain local property managers. Alternatively, the investor could seek to create in-house property management capacity as well as for all or part of the Group's investments. This would, of course, require a far larger organization. To some extent, that decision may be influenced by the investor's acquisitions: it would be far more difficult and expensive to provide direct management capacity for a very geographically diverse portfolio. However, if the investor concentrates its investments as to both property type and geographic location, in-house local management capacity is more feasible.

Hotel and resort management contracts are, of course, quite different in nature than management contracts for commercial, retail and residential properties. Beyond the basic complexity of the hospitality business and its more national or international scope, hotel and resort management contracts are generally long-term in nature (25 or more years with renewals), cede significant controls to the manager and cannot easily be cancelled by the owner.

Accounting

As a general matter, real property investments in the United States are accounted for on a historic cost less depreciation basis with depreciation also being shown as a charge against income. This financial accounting treatment is comparable to the tax accounting treatment discussed in Section II; however, financial statements usually differ from tax returns in various ways. For example, depreciation rates are customarily different, because tax depreciation is generally at the fastest available rate whereas financial depreciation is generally at or near the slowest rate.

The United States financial accounting approach is directly contrary to the European approach where, as we understand it, real property companies may elect to use fair market value accounting for assets. Under the European approach, depreciation is neither a balance sheet nor an income statement item, and changes in fair market value of assets are both.

Using again the illustration set forth in Section II, the asset entry on the balance sheet for the hypothetical investment as at the end of the fifth year of ownership under United States accounting rules would be:

Real Estate Investment at cost:	$31,000,000	
Less accumulated depreciation (assuming a 45 year life):	2,777,777	
		$28,222,222

Using the European fair market value approach, the same balance sheet entry would be:

Real Estate Investment	$50,000,000

Turning to the liability side of the balance sheet, if it is assumed that the $20,000,000 mortgage loan used in the illustration was a standing (*i.e.*, non-amortizing) loan, both the United States and European balance sheets would have a mortgage loan entry of $20,000,000. The net effect, as between the two approaches, is that, under the United States approach, shareholders' equity would be reduced by an aggregate of $2,777,777 by the end of year 5, whereas, under the European approach, shareholders' equity would be increased by $19,000,000 (with the entry being to a revaluation reserve account).

As can be seen from the foregoing, real property investments will have a generally negative effect upon a corporation's financial statements under United States accounting procedures. In fact, a highly successful, highly leveraged real estate company can easily have a large negative net worth and a large disparity between cash flow and reportable net income (because of the depreciation charge against earnings) even though its portfolio has significantly appreciated in value.

The foregoing discussion is, of course, a very simplified presentation of the most basic accounting rules.

Real Estate Business

In conclusion, we would like to note a few of our personal perceptions about the real estate business, based upon our work as counsel and observations of our clients' businesses from the counsel's perspective.

First, successful real property investment is a combination of being at the right place at the right time with the right capital. It is very much a supply and demand marketplace with very definite cycles. If one hits on the up cycle one can literally make millions, and, if one misses the cycle, one can lose millions.

Second, as the proper point in the cycle cannot always be hit, one also needs staying power because one cannot always be at the right place at the right time. Although the real property market has been quite volatile in recent years, more typically one must hold any particular investment for a relatively long period (10 to 15 years) in order to realize the full potential from the investment. This attribute of real property investment is enhanced by the relatively illiquid nature of the investment to begin with. Unlike stocks, bonds and other such investments, real property is not easily disposed of at any particular time.

Of equal importance in a cyclic industry, one must also be prepared to dispose of assets. Simply holding for the long term does not necessarily create the greatest ultimate return.

Third, as a separate point but also as a summary of the foregoing observations, real estate investment is, as one of our clients has put it, a business of risks where the successful investors identify and seek to control or provide for the risks. This is particularly true in highly leveraged investments where the margin of safety is quite narrow. Because of the complex nature of the factors which affect real property values and the longer-term nature of investments, the business is essentially a speculative one, and the investor can expect a certain number of problem or loss investments. In general, to achieve the profits one expects from a speculative investment one must develop an investment program that controls losses and realizes upon gains.

We mention the foregoing points because we view real estate as a rather classical free marketplace business, where the greater risks bring greater rewards. As a consequence, it is not as simple a business as it may appear on the surface, yet it holds out to the same astute investor an opportunity for exceptional profits.

Lastly, as indicated in paragraph 1 of this Section III, a very important aspect of the investment procedure is establishing and maintaining one's credibility in the real estate market. There is still a general feeling among United States real estate professionals that foreign investors are more difficult to close with than domestic investors. Closing transactions on an expeditious basis is, of course, the goal of both sellers and brokers, and investors who became known as "deal makers" are the investors who attract the attention of sellers and brokers.

The "deal maker" concept comprehends three areas: (a) the ability to make a timely investment decision, (b) the ability to negotiate and conclude contracts of sale and (c) the ability to close under such contracts. The basic perception in the marketplace is that foreign investors generally do not perform very well in the first two areas because of a slowness to make decisions and a lack of understanding of the American style of negotiation. That is, even if the United States management or adviser favors the transaction, the ultimate foreign investor or parent must approve the investment decision as well as the major contract issues. This approval process not only slows down the transaction but may result in it being aborted late in the process because the ultimate investor or parent has belatedly focused on the transaction or has simply changed its mind.

Of course, many foreign investors have, directly or through their advisers, successfully established credibility in the United States; for the most part, these are investors who accommodate themselves to the pace and style of the real estate business in this country, and thus attract proposals from sellers and brokers. The basic point is that the investor with credibility will see more of the better deals sooner.

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