Mr. Obama, Tear Down This Tax Wall

FIRPTA stymies foreign capital just when U.S. property markets need it most

BY ROBERT KNAKAL

It is widely known that New York City investment properties have far too much leverage imbedded in them. According to our estimates, there is presently about $165 billion of leverage on properties that have a negative level of equity in them. Underwriting those properties based on today's reduced values and the more conservative underwriting standards used by lenders, the appropriate level of this debt should be about $65 billion. This means that approximately $100 billion of debt would need to be extracted from the marketplace to be on conservatively sound footing.

Robert Knakal
Columnist

Clearly, this amount of de-leveraging is not going to occur for a number of reasons, including the fact that some owners have the ability and desire to keep servicing the debt even if the property's cash flow does not cover the payment. Additionally, legislative hocus-pocus will allow some deals to just keep floating downstream without forcing a real resolution. Notwithstanding these dynamics, a substantial de-leveraging must take place for our real estate market to fully correct.

In order to effectuate this de-leveraging, a massive amount of equity will be needed. One of the sources of this equity could be foreign capital. Overseas investors like the political stability the U.S. offers, and New York has always been a target for deployment of these funds. However, foreign investors in U.S. real estate are disadvantaged by a law that should have never have been put into the tax code to begin with.

I am referring to the Foreign Investment in Real Property Tax Act of 1980, commonly known as FIRPTA. U.S. tax laws and regulations impose excessive tax barriers on foreign capital investment in U.S. real estate, and should be withdrawn or modified significantly. The central obstacle to greater capital investment in U.S. real estate by non-U.S. investors is FIRPTA.

Based upon the fears of some politicians in the Midwest, who were originally concerned about limiting foreign control over U.S. farmland, Congress proposed and passed FIRPTA to limit what foreigners could do with "our property." FIRPTA requires foreign persons who dispose of U.S. real property interests to pay taxes in the U.S. on any gain realized on the disposition. This process imposes considerable administrative burdens, not only on foreign investors disposing of their U.S. real estate assets, but also on the purchasers of such properties, who are responsible for administering withholding taxes.

Additionally, the law requires foreign investors to file a U.S. income tax return at the end of the year in which they sell their real property interests.

Further political support for FIRPTA was seen noticeably in the mid-'80s, when Japanese investors were actively purchasing trophy assets in New York City, most notably Rockefeller Center. It is hard to imagine that there is any fundamental basis for this concern. Properties controlled by foreign owners are generally managed by U.S. companies, leased by U.S. companies, serviced by U.S. companies and produce tax revenue paid to New York City. The attorneys representing these investors are likely U.S. firms, as are their title insurers. What is the basis of the fear people have about buildings being owned by overseas investors? In the 26 years that I have been selling properties, I have yet to witness a foreign investor acquiring a New York property, picking it up and transplanting it back to his or her homeland.

Real estate is unfairly treated relative to other types of investments in the U.S. by foreign persons, as they are not required to pay gains taxes upon the disposition of any other assets. Thus, FIRPTA unfairly discriminates against U.S. real estate as an asset class. We believe that U.S. policy makers should move swiftly to eliminate or modernize FIRPTA.

Doing so would encourage foreign institutional investors to again look toward the U.S. marketplace. Last week, I attended Wharton's Zell/Lurie Real Estate Center's fall members' meeting in Philadelphia. One of the speakers was Austan Goolsbee, member of the Council of Economic Advisers and staff director and chief economist of the president's Economic Recovery Advisory Board. Prior to his speech, the subject of FIRPTA was discussed, and he indicated that it would be difficult to get traction for such a modification, as 90 percent of the benefit of a FIRPTA modification would flow to a foreign party.

It is difficult to understand that position, and here's why: Equity investment from any such source would stimulate our market and our economy. The U.S. and its citizens would benefit regardless of the benefit to others. The additional capital creates a healthy dynamic within our marketplace; would help to create jobs; and would allow for growth. The only message that can be derived from Mr. Goolsbee's position is that the current administration is living up to its growing protectionist reputation.

Within an economy there are four growth drivers. (1) Investment by business; (2) net export growth; (3) government spending; and (4) consumption. Consumption makes up 70 percent of our gross domestic product, and we all have seen the consumer confidence and consumer spending numbers recently. On the consumer sentiment index, the average sentiment figures are normally

> *In the 26 years that I have been selling properties, I have yet to witness a foreign investor acquiring a New York property, picking it up and transplanting it back to his or her homeland.*

in the 90 to 95 range. During the panic-induced recessions of 1973-1975 and 1980-1982, this index fell into the mid 50s. Today, we are faced with the same consumer confidence ratings, in the 53 to 54 range.

Our economic growth could be helped by using our currently weak dollar to our advantage, in the short term, by increasing our net export growth. However, the smell of a trade war is suddenly in the air, as the administration recently slapped a 35 percent tariff on Chinese tires. The Chinese responded by retaliating against U.S.-made auto parts and U.S. chickens. A trade war would have no real winners and millions of losers around the globe.

China's export-dependant economy would suffer more. It exports almost 4.5 times as much as it imports relative to the U.S. If it abruptly stopped buying Treasury debt, it would slash the value of its own mostly dollar-denominated foreign reserves. The United States would also lose. American consumers and companies would have to pay more for Chinese goods, and if China were to cut back on its purchases of U.S. Government bonds, the Treasury would have to raise interest rates, driving up the deficit even further. An all-out trade war between the world's two largest economies would wreak havoc on the global economy just as it was struggling to make a comeback.

According to a recent report, governments around the globe have planned 130 protectionist measures that have yet to be implemented. These include state aid funds, higher tariffs, immigration restrictions and export subsidies. The variety of today's protectionism demarcates it from the tariff-based economic warfare of the 1930s. Creeping protectionism presents an obstacle to economic recovery.

Even without such measures, global trade is expected to shrink by more than 10 percent in 2009. Several of these initiatives have made headlines recently. The U.S. House of Representatives recently passed a carbon tariff as part of its cap-and-trade bill (a.k.a. "cap-and-tax bill"). This was followed by the "Buy American Provisions" of the stimulus, which has incensed much of Canada. Congress has passed a bill to ban Mexican trucks from U.S. roads in direct violation of NAFTA, prompting Mexico to retaliate against U.S. farm and kitchen goods. Meanwhile U.S. trade pacts with Columbia, Panama and South Korea languish in Congress.

Obama economic adviser Austan Goolsbee.

GETTY IMAGES

The administration's actions and inactions are telling the world that the U.S. is abandoning the global leadership position on trade that both Democratic and Republican presidents have worked to maintain since the 1930s. Bill Clinton continued this bipartisan tradition by supporting NAFTA and prodding Congress to ratify the World Trade Organization and most favored nation trading status for China. Following America's lead, countries that were once largely closed economically, especially China and India, have in turn opened up to foreign goods and services. The result has been an explosion of world trade, especially since the 1980s.

The reality is that without the U.S. leading by example, the world trading order is likely to deteriorate into every country for itself. This is especially dangerous amid a global recession in which world merchandise trade volume fell by roughly 33 percent from the second quarter of 2008 to June of 2009. Reviving trade flows is crucial to restoring global growth.

The U.S. has much more to gain than to lose by embracing and working with the global community. Technology has changed the way world commerce functions, and there is much to gain from working with other nations. While total economic growth is not dependant upon foreign real estate investment, our real estate market would be enhanced significantly by the elimination of or modification to the FIRPTA laws. All this would do is put real estate on a level playing ground with every other type of investment that foreign investors can make in the U.S.

rknakal@masseyknakal.com

Robert Knakal is the chairman and founding partner of Massey Knakal Realty Services, and has brokered the sale of more than 1,000 properties in his career.