FIRPTA Changes Could Be Great for Investment Sales

For the past two years, the investment sales market in New York City has performed better than during any other two-year period I have seen in my 32 years brokering here. Values have soared due in large part to enhanced fundamentals, plentiful financing and an extremely acute supply/demand dynamic that has been skewed heavily in favor of demand. While this demand has been broad-based, foreign capital has been a significant component of the tremendous demand we have witnessed. And this foreign demand could be ready to surge to even greater heights.

Robert Knakal

Until recently, foreign investors in U.S. real estate were disadvantaged by a law that should never have been put into the tax code to begin with. The Foreign Investment in Real Property Tax Act of 1980, referred to as FIRPTA, unfairly (relative to other non-real property investments in the U.S.) imposes excessive tax barriers on foreign capital investment in American real estate. FIRPTA has been the central obstacle to greater capital investment by non-U.S. investors.

Based on the fears of some politicians in the Midwest, who were originally concerned about limiting foreign control over U.S. farmland, FIRPTA was proposed and passed by Congress 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 over and above the tax burden they would be faced with if they invested in any other type of asset.

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.

Political support for FIRPTA reached its peak in the mid-1980s 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 U.S. municipalities. 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?

By virtue of FIRPTA, real estate is the subject of discrimination relative to other types of investments in the U.S. Thus, FIRPTA unfairly treats U.S. real estate as an asset class. For many years, we have advocated that U.S. policymakers eliminate or modernize FIRPTA. Recently, tremendous progress was made.

Since 2008, reform efforts headed by Representatives Kevin Brady and Joe Crowley and Senators Mike Enzi and Robert Menendez have been consistent and recently produced tangible results. Assisted by a critical reform proposal from the administration, on Dec. 18, 2015, President Barack Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), which accomplished three significant FIRPTA reforms.

First, the PATH Act increased from 5 to 10 percent the ownership stake that a foreign investor can take in a publicly traded REIT without triggering FIRPTA liability.

Second, the act removed the tax penalty that FIRPTA imposes on foreign pension funds that invest in U.S. real estate.

Third, the act clarified when a listed REIT can be considered controlled by U.S. persons so that sales of its stock are not subject to FIRPTA. I recently heard an industry expert say that sovereign wealth funds did not benefit from these changes. The fact is that some sovereign wealth funds are pension funds and others are now looking at ways to convert part of the funds' structures into pension fund structures.

We have seen time after time that participants in the commercial real estate investment sales market are highly motivated by and reactive to changes in the tax code. When capital gains taxes were changed in 1986, 1998 and 2012, investors reacted, causing significant spikes in property sales. We expect the reaction from foreign investors to these changes to FIRPTA to produce similar results. With the future of the investment sales market in New York City trending downward, this could be something to either minimize the downward trajectory or even cause the trend to reverse course. Here's to hoping the latter is the case.

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