# US Real Estate Funds

## Structures to Maximize Net Returns to Non-US Investors

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The unique and beneficial risk-return profile of US real estate assets has resulted in the asset class playing an ever increasing diversification role in investment portfolios of US institutional investors. Despite the significance of the US real estate market in the private equity industry, where approximately $40.8 billion of capital has been raised in 2006,[1] only a small portion has been raised from non-US individuals, companies and governments ("Non-US Investors").

One of the primary reasons for the more modest amount of Non-US Investor capital being invested in US real estate assets is the US Foreign Investment in Real Property Tax Act of 1980 (known as FIRPTA).[2] FIRPTA taxes Non-US Investors on gains from US real property investments, including gains derived from many real estate investment funds, at effective rates up to 54.5%. Another reason, and perhaps even a greater impediment for many Non-US Investors, is FIRPTA's requirement that an investor file US tax returns and submit to the investigatory and subpoena powers of the IRS, an unwanted intrusion for nearly every Non-US Investor.

There is no "silver bullet" that resolves all of the issues FIRPTA presents to Non-US Investors. Yet, some recent innovations that mitigate the impact of those tax and tax reporting obstacles have begun to open the flow of new non-US capital to US real estate funds and assets. Customized solutions are necessary, but the structures are becoming more common place and the economic benefits are readily quantifiable.

In many cases an approach may solve one problem (the filing requirement) but not address the other (the tax paying obligation). In addition, the up-front costs of tailoring a tax-effective strategy for an individual investor or private equity fund can be high. Conversely, a structure, once chosen, is generally scaleable for additional investments or can help to accommodate additional investors. Given the right circumstances and mix of investors, Non-US Investors with sufficient resources have the ability to work with private equity fund sponsors to utilize creative solutions available today to help address their needs and enable them to invest on a less frictional basis in the multitude of opportunities available in the US real estate markets.

One promising structure, in spite of its complexities, stands head and shoulders above the rest in terms of absolute tax savings to Non-US Investors and alleviating US tax filing requirements — the "Leveraged Blocker." When compared to the other commonly utilized alternative structures available — the private REIT and the more typical "standard" blocker structure — the tax savings a leveraged blocker structure potentially provides outweighs the additional cost and complexities, as illustrated in Table 1:

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1 *As described in the December 2006 / January 2007 issue (Volume 2, Issue 10) of Private Equity Real Estate. Includes US funds and US-based multi-region funds with significant allocations to US real estate.*

2 *A general description of the FIRPTA rules is attached as Appendix A to this paper.*

**Table 1. Comparison of Costs and Benefits of Various FIRPTA-related Structures**

| Structure/ Considerations | Effective US Tax Rate on Distributions[3] | Non-US Investor Tax Filing Obligation? | Barriers to Formation | Expected Costs |
|---|---|---|---|---|
| Leveraged Blocker (and alternatives) | Can be between 20% and 35% | No - Blocker files | High | Medium - High |
| Private REIT | Can be between 30% and 54.5%[4] | Yes, but only in certain cases[5] | Medium - High | Medium - High |
| Standard Blocker | Up to 40% - 54.5%[6] | No - Blocker files | Low | Low - Medium |
| Direct Investment | Up to 54.5% | Yes - Direct | None | Low |

As Table 1 illustrates, the Standard Blocker solves the tax filing problem without solving the tax payment problem, while the Private REIT may solve both or solve neither, depending on the circumstances. Only the Leveraged Blocker structure can provide relief for Non-US Investors by potentially reducing their US tax obligation by 40-65% while also eliminating the US tax return filing requirement.

## LEVERAGED BLOCKERS

The "Leveraged Blocker" is a Delaware (or other US) corporation that is capitalized with a mix of loans and equity from its investors. The goal of this structure is to shield Non-US Investors from the US-tax filing requirement that FIRPTA imposes, while at the same time reducing the effective rate of US tax Non-US Investors will bear on their investment.

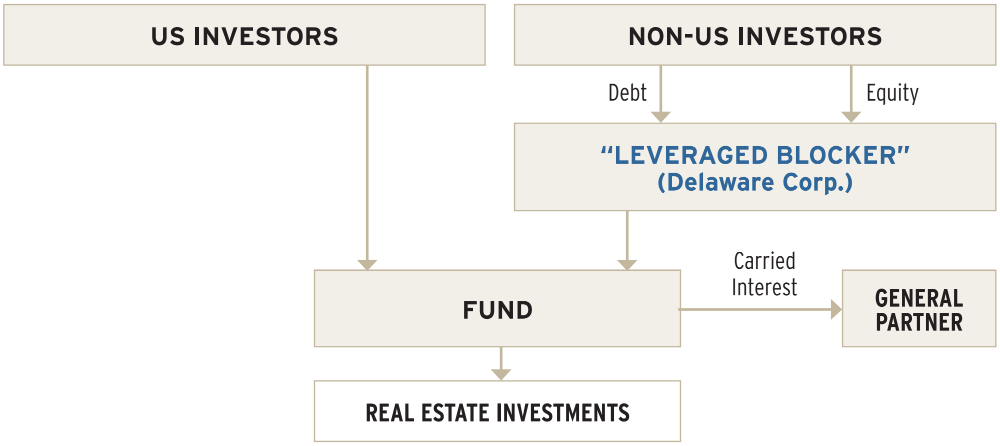
3 *The ranges of effective tax rates provided in Table 1 are illustrative and depend on a number of factors including (but not limited to) the exit strategy for the particular investment, the type of income generated (gains vs. current income), the ability to effectively use leverage, interest rates on debt, the application of a tax treaty in the investor's home jurisdiction and the number of investors participating in a given investment structure. Each investment is unique, but generally these structures will reduce US tax rates applicable to Non-US Investors in US real estate.*

4 *A zero rate of US tax could apply if a Non-US Investor is able to sell shares of a private "domestically controlled" REIT. Otherwise, effective US tax rates are dependent on the type of investment the REIT makes and domicile of Non-US Investors, as more fully described in footnote 5. REIT disposals of US real property trigger tax to Non-US Investors upon distribution at rates up to 35%. A second withholding tax applies upon distribution, which may be limited by treaty.*

5 *In general a Non-US Investor will incur a US tax filing obligation in a private REIT investment where the REIT is not "domestically controlled", or where the REIT disposes of US real property interests and distributes the proceeds to the Non-US Investor.*

6 *Reduced to the lower end of the cost range if blocker resides in a treaty jurisdiction; however, most blocker entities reside in low-tax jurisdictions to avoid the imposition of local taxes on the blocker's profits.*

### Leveraged Blocker Structure




- Leveraged Blocker pays US tax on realized gains at effective tax rates that can be between 30% and the 54.5% effective rate applicable to Standard Blockers
- Non-US Investors capitalize blocker with debt and equity — a 3 to 1 ratio is common
- Interest rate on debt determined by, among other things, creditworthiness of underlying assets and type of investment (i.e., development, income-producing property, etc.)
- Interest repayment on debt reduces net taxable income of blocker
- If structured properly, interest payment will be free of withholding tax and dividend payment on profit will have low withholding tax

Whether the Leveraged Blocker meets the goal of reducing a Non-US Investor's effective rate of US tax on a US real estate investment depends on a number of factors, each of which is specific to a particular investment. Appendix B to this paper details mechanically how the Leveraged Blocker structure is intended to work, but the main structuring component is the interest deduction associated with a leveraged investment that the Leveraged Blocker uses to reduce the amount of the Leveraged Blocker's income that is subject to US tax.

While each investment is unique, it is safe to say that a favorable Leveraged Blocker structure would likely have some or all of the following features, each of which should be thoroughly vetted with counsel:

- Non-US Investors holding less than 50% of the Leveraged Blocker's capital (to help ensure interest deductibility) — thus, a minimum of three investors is mandatory;

- A mix of investors that will minimize the amount of withholding on interest payments the Leveraged Blocker makes. Examples of such a mix of investors include:

  - At least three Non-US Investors, none of which hold 50% or more of the Leveraged Blocker's capital and all of which are either residents of a jurisdiction that has a tax treaty with the US which provides for a zero percent withholding on interest,[7] or are non-US governments;

  - Non-US Investors that are not resident of a jurisdiction that has a tax treaty with the US, each of whom holds less than 10% of the Leveraged Blocker; or

  - A combination of the above;

- A market-based debt to equity ratio sufficient to maximize the effectiveness of the leverage (perhaps 60%-80% leverage);

- The maximum reasonable interest rate on the debt that takes into account (among other things) creditworthiness and type of underlying real estate assets; and

- Non-US Investors who reside in a jurisdiction that has a tax treaty with the US to take advantage of reduced withholding rates applicable to dividends.

Appendix C provides an example, purely for illustrative purposes, of the tax efficiencies that can potentially be obtained on the right set of facts; however, as stated previously, each investment is unique and will provide its own range of potential tax savings. A key factor in the potential tax savings is the length of time the leverage will be outstanding – the longer the leverage is outstanding, the greater the tax savings. Thus, a Leveraged Blocker structure, although tax efficient, may not be the best structure for a "quick flip" investment.

It should be noted that the Leveraged Blocker can be an expensive and complex structure to establish and organize; however, most of the expense and time is usually attributable to negotiations with potential investors. One way to minimize costs would be for a group of aligned investors to present a fund sponsor with a requested Leveraged Blocker structure.

The Leveraged Blocker is a viable structure to tax-effectively invest in US real estate, particularly for larger, scaleable, Non-US Investors. Despite the careful tax planning, complexities and costs necessary to ensure the effectiveness of the Leveraged Blocker structure, Non-US Investors will find the tax savings to be significant.

7 *For example, residents of Austria, Belgium, Denmark, France, Germany, Luxembourg, the Netherlands, Norway, Switzerland and the U.K. are eligible for a zero percent withholding rate on interest paid by US obligors.*

## ALTERNATIVE STRUCTURES FOR NON-US INVESTORS IN US REAL ESTATE

The following structures, noted briefly in Table 1 above, are alternatives to the Leveraged Blocker structure and include Private REITs and the more typical Standard Blocker as well as a variation on the Leveraged Blocker.

There is no "one-size fits all" structure to address tax issues. Non-US Investors may prefer the Private REIT and Standard Blocker structures over the Leveraged Blocker structure for their simplicity, because they are more common in the market, "user-tested," and in the case of the Standard Blocker, for its relatively low cost.

In the case of the variation on the Leveraged Bocker structure detailed below, Non-US Investors and fund sponsors may decide to investigate this strategy for its flexibility. Potential tax savings exceeding those of the Leveraged Blocker may justify the costs of additional complexity, expense, and risk inherent with a relatively untested strategy, not yet approved by the US taxing authorities.

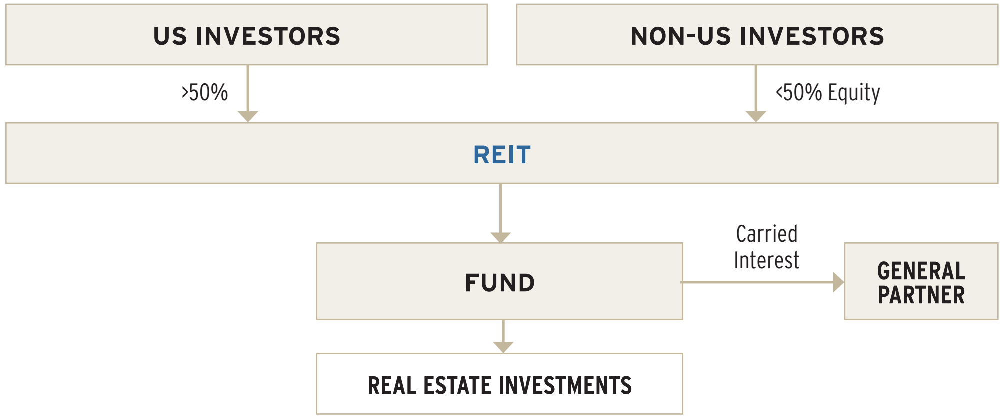
### Private REITs

Created by statute, a real estate investment trust (REIT) is a unique, tax-efficient type of holding vehicle that is created to invest in real property assets. By effectively eliminating net tax at the corporate level, a REIT passes pre-tax income through to investors when they receive distributions and thus subjects investors to only one level of tax (as opposed to the general "double-tax" US tax regime that applies to corporations and their shareholders).

REITs that invest in the US usually are composed primarily of investments in US real estate. As a result, distributions from REITs to Non-US Investors, or gains those investors realize from the sale or exchange of REIT shares are normally subject to FIRPTA tax. There is an exception from this rule, however, for "domestically-controlled" REITs.

A disposal of shares in a domestically-controlled REIT does not trigger FIRPTA tax or filing obligations. These REITs, however, must be structured in a particular way to demonstrate domestic control – specifically, US investors must hold more than 50% of the capital of the REIT. This structure has been relatively common for Non-US Investors to utilize for US real estate investment, particularly in so-called "club" deals or deals where the Non-US Investor can exercise a significant amount of control on the structure and exit of the investment.

**Domestically Controlled REIT Structure**




- REIT must be more than 50% held by US persons to be "domestically controlled"
- Sales of underlying real estate can still trigger FIRPTA tax and filing requirement to Non-US Investors
- Benefit to Non-US Investors may therefore be limited to reduced withholding rates on dividends paid by REIT (as compared to Standard Blocker), or for funds that invest in non-capital gains producing assets, or public or other domestically-controlled REITs

A private equity real estate fund could also utilize a domestically-controlled REIT to moderate tax liability by forming a fund comprising US and Non-US Investors. The fund holds shares in a REIT (or potentially in multiple REITs), each of which in turn owns U.S. real property. If the fund is able to exit its investment through a sale of its REIT shares, or if instead the REIT is the investor in the fund and the Non-US Investor is able to exit its investment through a sale of REIT shares, Non-US Investors can avoid US tax as such a share sale would not be subject to FIRPTA or other US taxes.

However, in the private equity fund context, this is probably an unlikely exit strategy. More typically, for a private equity fund using a private REIT structure, a Non-US Investor will not achieve expected tax efficiencies. One reason is that the FIRPTA tax and corresponding tax return filing requirement still attaches if the REIT disposes of US real estate and distributes the capital gains from the sale to its Non-US Investors. A possible way to avoid this downside is to hold each real estate asset in a separate REIT and dispose of the shares of each REIT discretely (not up through the holding entity), if this is a reasonable arrangement from a business perspective.

This amount of structuring to accommodate Non-US Investors can be prohibitive for a fund sponsor. First, the fund must organize the REIT — an often time-consuming and expensive proposition. Then, to try to maximize the potential for US tax savings, the sponsor must attempt to hold each individual real property asset in a separate REIT or subsidiary that itself is exempt from the FIRPTA rules. Finally, the sponsor needs to attempt to exit the investment through a sale of the shares of the subsidiary REIT which can result in a lower purchase price than a sale of the underlying assets would produce.

Even if a fund sponsor does not or cannot implement this additional level of structuring, a private REIT structure can still produce a better after-tax result than the Standard Blocker structure detailed below. This is because the withholding tax that applies to dividend distributions from a REIT may be reduced from the standard 30% rate if the Non-US Investor resides in a jurisdiction with a favorable tax treaty with the US, such as France, Germany, the Netherlands and the U.K. The result could be the reduction of the 54.5% effective rate detailed in Table 1 to something in the area of 40-45%. It should be noted, however, that utilizing the REIT structure still leaves open the possibility that the Non-US Investor will have a US tax filing obligation.

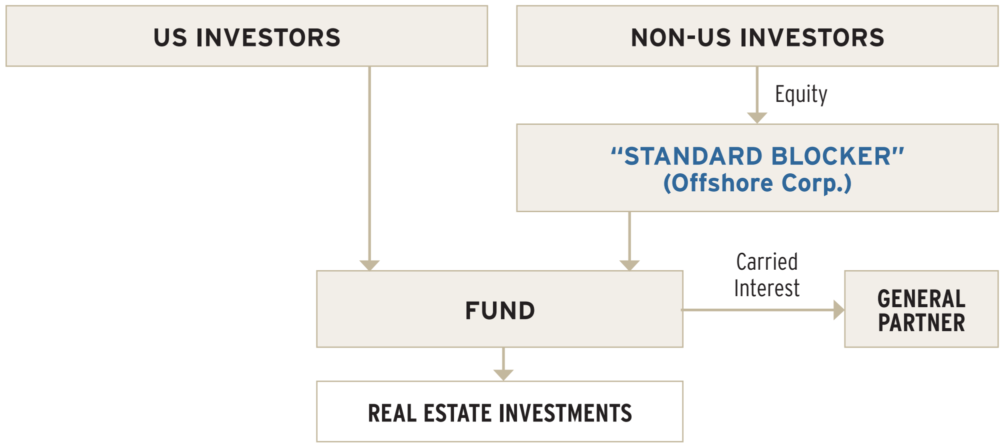
Notwithstanding the above, for certain types of funds for which capital gains from direct investments in real estate are not the primary expected source of income (e.g., so-called "mortgage REITs", or REITs that themselves invest in publicly-traded REITs), the domestically-controlled private REIT can avoid the application of the FIRPTA tax rules and result in tax efficiencies to Non-US Investors. Additionally, smaller "club deals", where Non-US Investors would be able to ensure exiting the investment through a sale of REIT shares, would have the same result.

However, for the more typical private equity real estate fund, the costs of establishing and operating the REIT structure may outweigh the limited tax benefit the structure provides to Non-US Investors.

### The Standard Blocker Structure

Non-US investors who do not wish to accommodate the complexities and costs of the Leveraged Blocker structure, and who are more concerned with US tax filings than bearing US tax costs, have the option to invest in a typical "standard" blocker structure. This investment is generally made through an offshore company, such as a Cayman Islands company, that holds an interest in a private equity real estate fund.

### Standard Blocker Structure




- Standard blocker pays effective rate of tax at 54.5% (up to 35% on realized gains and a second "branch profits" tax ), unless the blocker resides within a treaty jurisdiction
- Standard blocker files US income tax return – not Non-US Investors. Non-US Investors are thus not subject to investigatory and subpoena powers of the IRS
- Structure cheaper & less complex than leveraged blocker structure, but less tax efficient
- Blocker corporation can be formed in the Cayman Islands or other low-tax offshore jurisdiction.

Using this structure, the blocker functions as the taxpayer, paying FIRPTA taxes and filing any required tax returns while the individual shareholders (i.e., the Non-US Investors) are shielded from tax filing requirements. However, this approach is not tax-efficient as the blocker entity still pays the full 35% FIRPTA tax on its share of the fund's gains from disposals of US real estate investments.

In addition, the blocker entity also pays a second "branch profits" tax, resulting in an effective tax rate of 54.5% on the Non-US Investor's share of the fund's real estate profits, unless the blocker resides within a jurisdiction with a favorable tax treaty with the US. In this case, the effective US tax rate may be reduced to a rate ranging from 40% to 54.5%; however, any such jurisdiction would likely impose local taxes on the profits of the blocker, utilizing most, if not all, of the US benefit.

### Variations on Leveraged Blocking Entities

**Parallel Funds.** The Leveraged Blocker structure detailed above can be beneficial for real estate funds dedicated to US real estate. At the same time, it can be detrimental for real estate funds with a global focus by subjecting income from non-US investments to US tax (because all of the fund's income would pass through the US blocking entity).

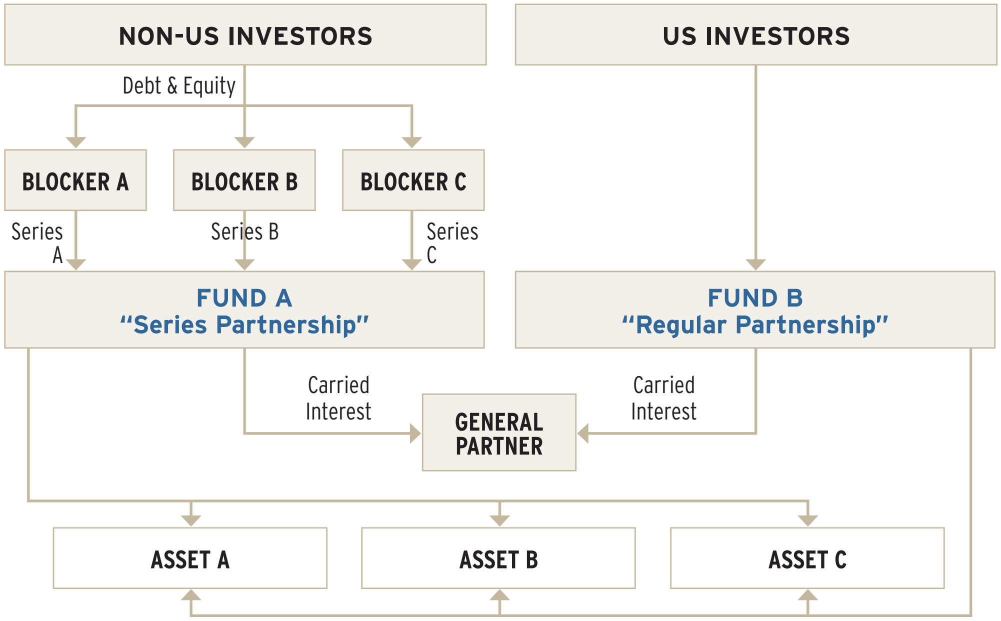
For real estate funds that will make investments outside of the US, a variation on the leveraged blocking structure is required. For example, a fund sponsor could establish parallel funds — one for US investments and one for non-US investments. Non-US Investors would invest directly into the fund dedicated to non-US investments with no corresponding US tax liability or reporting requirements, and invest through a blocking entity into the fund dedicated to US investments.

**Series Partnerships.** In an effort to seek greater tax efficiencies, Non-US Investors could work with fund sponsors to explore further variations and enhancements on the blocking entity approach. For example, liquidating distributions from a corporation to a non-US shareholder are not subject to the same withholding tax as dividends paid to the same shareholder. In fact, they are not subject to US tax at all so long as any real estate that corporation held — directly or indirectly — has been disposed of in a taxable transaction prior to the liquidation. Thus, a structure that features an exit of a liquidating distribution rather than a dividend is an attractive structure to Non-US Investors in US real estate.

It is generally difficult under US tax rules to establish this type of enhanced leveraged blocker structure within the traditional private equity real estate fund context. Investors' interests in a private equity fund are part of a pooled approach, and not generally made on an investment-by-investment basis, at least vis-à-vis other investors. However, it may be possible, depending on the level of US tax risk an investor is willing to bear, to achieve the tax goals of this approach by using a special kind of partnership called a "series partnership."

A series partnership is a unique kind of partnership authorized by Delaware law in which each investment made by the partnership can be contained in a separate "series," distinct and separate from the other series and investments in the partnership.

### Series Partnership Structure with Leveraged Blockers




- Fund A has separate "series" for each investment
- Similarly, separate leveraged blockers for each series, tied to each investment
- Funds flow through repayment of blocker debt and liquidating distribution – potentially more tax efficient than stand alone leveraged blocker, but costly and complex to implement
- IRS has not ruled on the use of a series partnership; therefore this structure carries risk of IRS challenge

Under this structure, Non-US Investors would invest in a fund through separate blocker entities that are established for each underlying investment. The separate blocking entities each hold a separate series in the series partnership. When the fund disposes of a real estate investment, it distributes the proceeds to the holder of the series to which that investment relates. The Non-US Investors are repaid on their investment through debt repayment — like the leveraged blocking structures previously discussed — and through a liquidating distribution of the relevant blocking entity.

Because the blocking entity at that time only holds cash from disposal of the real estate investment to which it relates and not an interest in the other real estate investments held by the partnership (on the theory that each series is truly separate and distinct), the liquidating distribution theoretically would trigger no US tax. Thus, if the structure is respected by the IRS, Non-US Investors will have escaped withholding tax on the liquidating distributions and reduced their effective tax rate even further than the tax efficiencies the Leveraged Blocker structure is intended to provide.

The series partnership structure is not common. In addition, the IRS has not yet ruled on whether each series in a series partnership is respected as a separate entity for US tax purposes. Therefore, this structure, if implemented, would carry tax risk. If each series is not a separate entity for tax purposes, then the liquidating distribution of a blocking entity would give rise to FIRPTA tax — the blocking entity would be treated as holding an interest in the fund which at that time would continue to hold real estate investments.

If this were the case, the series partnership structure would generally give rise to no more actual tax than the potential 20% to 35% range noted in Table 1 for the Leveraged Blocker structure. Such a result would require the filing of amended returns and the potential for penalties and interest. Thus, despite its potential attractive tax savings, many Non-US Investors may find it too risky to use this structure at this time, but should carefully observe the movement of the IRS as it relates to series partnerships in hopes the structure gains support. It should be noted that as of this date the series partnership structure has been minimally utilized.

The series partnership, Leveraged Blocker, and other variations are not cost-effective solutions for smaller investors, since the start-up fixed costs involved with creating the structures are significant. More negotiations between affected parties are involved in setting up multiple blocking corporations with multiple investors, and more documents are obviously required for complex investment mixes of debt and equity. Still, for scale Non-US Investors in scale funds, investigating these alternatives in detail is a worthwhile undertaking. Once the documents are negotiated and vetted, the tax efficiencies gained and the elimination of reporting requirements should easily justify the up front costs of time and money.

## CONCLUSION

FIRPTA tax and associated filing obligations need no longer be barriers to non-US investment in US real estate. Through creative structuring approaches tailored to the various needs of different types of Non-US Investors, their locations, and anticipated investments, fund sponsors and their advisors are now able to structure solutions to minimize FIRPTA's effects and create a win-win situation for all involved.

## Appendix A. FIRPTA in a Nutshell

Non-US persons generally do not pay US tax on disposals of securities or personal property located in the US. In this regard, the United States is something of a tax haven for Non-US Investors. Since 1980, though, this beneficial tax treatment has not extended to disposals of real estate situated in the US.

Enacted partly to prevent Non-US Investors from acquiring landmark US properties, FIRPTA imposes a tax on gains realized from the disposition of a US real property interest, an interest in real property located in the US that includes a "fee" interest in real estate and also includes one or more of the following:

- An interest in a partnership or other "flow-through" entity that holds US real estate
- An interest in a corporation at least half the value of the assets of which are in US real estate (subject to certain exceptions), referred to as a "US real property holding corporation"
- Any direct or indirect right to share in the proceeds, appreciation or profits of US real estate

In general, FIRPTA imposes a tax on gains from a sale of a US real property interest by a non-US person at US tax rates that generally apply to US taxpayers (i.e., at rates up to 35%). This tax is collected partially through a withholding mechanism whereby the seller of the real property interest is obligated to withhold ten percent of the sale's gross proceeds at the time of sale.

These gains are also treated as income that is "effectively connected with" the conduct of a US trade or business, or Effectively Connected Income ("ECI"). A non-US person that receives this type of income incurs a corresponding US federal income tax filing obligation and consequently becomes subject to the subpoena powers of the IRS with respect to all of its US investments.

Finally, if a non-US person receiving ECI from an investment in US real estate is organized as a corporation, a second, entity-level tax applies to distributions by that corporation. This so-called "branch profits" tax—levied at a 30% rate on the after-tax proceeds of an ECI investment—is intended to mirror the tax that US taxpayers pay on dividends received from US corporations.

Thus, the end result of an investment in US real estate by a non-US person can be an effective tax rate as high as 54.5% — that is, an initial 35% tax on the gains from the real estate investment plus an additional 30% tax on the after-tax proceeds (30% of the remaining 65% equals 19.5% of the total gains). Clearly, this tax rate compared to much more favorable rates in other jurisdictions, or on other asset classes in the US, makes real estate a less favored asset class absent some relief of this relatively high tax structure.

## FIRPTA IN THE PRIVATE INVESTMENT FUND CONTEXT

Private equity funds that invest in US real estate are generally organized as partnerships (or other pass through entities) with a general partner responsible for fund management and limited partners who invest capital passively in the fund. When a real estate fund disposes of a US real property interest, FIRPTA applies on an indirect basis to tax non-US partners on their share of the partnership's profits from the sale. This rule applies to any disposal of a real estate interest by a real estate fund. Interposing a partnership between a non-US limited partner and an underlying US real estate investment does not prevent FIRPTA's application.

For example, Non-US Investors in a US real estate fund are generally subject to FIRPTA if any of the following occur:

- The fund disposes of shares in a US real property holding corporation
- The fund disposes of a US LLC or other flow-through entity that holds real estate assets
- An LLC or other flow-through entity owned by the fund disposes of US real property and distributes profits up to the fund
- The fund sells real estate assets it owns directly

This raises two major impediments to fundraising from Non-US Investors who have not implemented any customized tax mitigation structures:

**Significant Taxes.** In the typical fund context, a fund's disposal of a US real property interest results in FIRPTA tax to non-US limited partners, based on their pro-rata share of the fund's gains from the disposal. The tax is imposed at rates up to 35% — a significant dilution to the gross profits generated by the general partner. The tax bite is particularly severe compared with results from other US investment opportunities unencumbered by comparable taxes (such as debt and equity securities). The tax impediment is particularly harsh in light of the reality that even the best performing real estate funds typically do not generate returns that equal those from venture capital, or more recently from the largest buy out funds.

**IRS Investigatory Powers.** Compounding the problem of having a tax liability on real estate investment proceeds, a Non-US Investor subject to FIRPTA must also file US federal income tax returns. A time-consuming, costly burden, federal tax filings can also entail corresponding US state income tax filings in jurisdictions where the fund invests or operates. In addition, Non-US Investors who file US federal income tax returns thereby give the IRS the authority to examine all information pertaining to their US investments. Thus, the IRS may issue subpoenas for documents.

## Appendix B. Mechanics of the Leveraged Broker Structure

Briefly, the Leveraged Blocker structure is intended to work as follows:

- Non-US Investors form a Delaware (or other US) corporation and capitalize it with a mix of debt and equity. The proper ratio of debt to equity will depend on the facts of the particular investment. A ratio of approximately three to one is not uncommon.

- A private equity real estate fund disposes of a real estate asset and distributes the proceeds to its investors, including the Leveraged Blocker.

- The Leveraged Blocker pays out the proceeds from its investment in the fund to its owners as a mix of debt repayment, dividends and return of capital.

- The Leveraged Blocker is taxed on its share of the fund's income at regular US tax rates applicable to corporations (up to 35%) and files a US income tax return (the Non-US Investors in the Leveraged Blocker are thus shielded from the US tax filing requirement). The portion of the distributed proceeds that are attributable to repayment of interest on the Leveraged Blocker's debt should be deductible by the Leveraged Blocker and reduce the effective tax rate it must pay on its income.

- Return of capital (principal on debt and equity invested) is distributed tax-free.

- Dividend payments the Leveraged Blocker makes to the Non-US Investors attract a 30% withholding tax that may be reduced under a tax treaty (for example, 15% under each of the income tax treaties the US has with France, Germany, the Netherlands and the UK, among others).

Impediments to the most favorable tax treatment include the inability to secure the right mix or number of investors to ensure that the Leveraged Blocker can deduct against its income interest paid to the Non-US Investors or the unwillingness of investors to share the potentially high upfront costs in establishing the structure.

## Appendix C. Illustrative Leveraged Blocker Example

This example is purely for illustrative purposes and should not be construed as a promise of expected tax benefits. It is provided to illustrate how, on the proper set of circumstances, Non-US Investors can substantially reduce their US tax on in investment in US real estate through a Leveraged Blocker. Each assumed fact is purely hypothetical and not based on any actual fund or investment.

### FACTS

- Leveraged Blocker established with a debt to equity ratio of 3:1
- Non-US Investors comprised of three institutional investors from the U.K., Germany and France, each of whom will hold one-third of the Leveraged Blocker
- Each Non-US Investor invests $100 million in the Leveraged Blocker — $75 million as debt with an interest rate of 15%[8] and $25 million as equity.
- Leveraged Blocker contributes the $100 million to a real estate private equity fund for an investment in the fund — the fund invests the full $100 million in one US real estate asset.
- The fund holds the investment for two years and disposes of the investment for $160 million with $148 million being distributed to investors after a promote to the General Partner of $12 million (20% of the $60 million profit).

### RESULTS

- The Fund distributes $148 million to the Leveraged Blocker — $100 million as return of capital and $48 million as profit.
- The Leveraged Blocker's net taxable income is $25.5 million ($48 million profit from the investment less $22.5 million of accrued interest).
- Thus, the Leveraged Blocker's US corporate income tax is approximately $8.9 million (35% corporate income tax rate applied to the $25.5 million net profit).
- Leveraged Blocker has approximately $139.1 million to distribute to the Non-US Investors ($148 million proceeds from the investment less the $8.9 million tax).
- The Leveraged Blocker distributes $75 million as debt repayment, $25 million as return of equity and $22.5 million as interest.

8 *This interest rate will be determined by reference to a number of criteria, including expected creditworthiness and type of the underlying assets and what an arms'-length lender would expect to receive on a loan to an entity holding those assets.*

- The remaining approximately $16.6 million to distribute is a dividend which attracts a 15% withholding tax, assuming each Non-US Investor is a resident of a country with a tax treaty with the US that provides for a 15% withholding rate on dividends (absent a treaty, the rate would be 30%). The Leveraged Blocker withholds approximately $2.5 million in tax.

- Thus, the Non-US Investors receive approximately $136.6 million in net proceeds out of the $148 million gross proceeds the Leveraged Blocker received from the fund ($148 million less $8.9 million less $2.5 million).

- The effective US tax rate on the Non-US Investors' investment is approximately 23.8% ($11.4 million in tax paid, divided by the $48 million profit on the investment), a substantial savings over the 54.5% rate that would have applied using a standard Cayman Islands blocker.

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