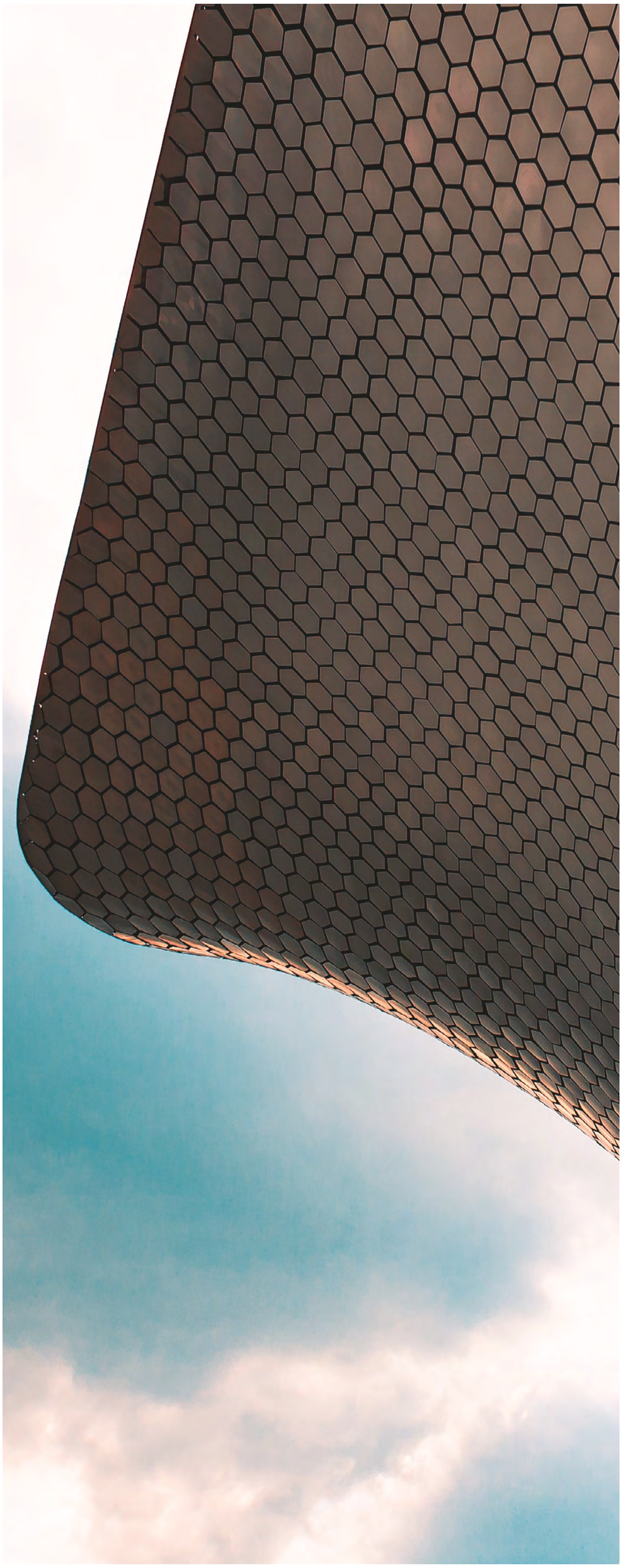
Real Estate Investment in the US

THE LEGAL PERSPECTIVE

DLA PIPER

Introduction



The US real estate market remains a preferred option for investors seeking diversification and stable yields in an uncertain economy, and recent surveys of commercial real estate executives show enthusiastic appraisals of the US market's prospects going forward. That should surprise nobody, given the steadily (if slowly) improving economy and the flood of capital pouring into property markets. Adding to the positive assessment is the near-unanimous expectation that interest rates will either remain where they are or increase only slightly.

DLA Piper's Real Estate group in the US is consistently recognized as the country's leading real estate practice. We offer a full range of services in areas including acquisitions and disposals, construction, financing, hospitality and leisure, land use, planning and development, leasing, environmental law, insurance and tax. We assist clients throughout the entire life cycle of their investments, and we understand the business of real estate.

This document is intended to serve as a comprehensive guide to the most relevant features of investing in US real estate, including the process of buying, selling, development, leasing, and financing real property in the US. This guide does not, however, aim to be exhaustive. The law applicable to real estate differs from state to state (and in some cases from city to city), so this guide should not be considered a substitute for the in-depth legal advice that only an attorney, qualified in the applicable state and well versed in the peculiarities of its legal system, can give to their client. If you have any further questions relating to the material in this overview, our experienced US Real Estate team will be happy to assist you.

Contents

1. Ownership of real estate

1.1 Fee ownership

Fee ownership is the highest category of ownership in the US, giving the owner rights to possess and dispose of land. Fee ownership includes ownership of all constituent parts of the property, buildings, and everything above and beneath the surface of the land such as underground structures, unless rights thereto have been granted to a third party.

1.2 Leasehold ownership

Ownership of a leasehold interest confers rights of exclusive possession and use of land for a limited period of time, subject to the terms of the lease. Most commercial transactions for acquisition of property involve fee interests, but transactions can also be structured as a long-term ground lease. In such case, at the end of the lease term ownership of improvements on the property would typically revert to the landlord. As noted below, consent of the landlord may be required for transfer of a leasehold interest in real property. Leases are discussed in section 6 below.

1.3 Condominium

Condominium ownership allows fee ownership of a self-contained unit within a building together with non-exclusive rights (with other condominium unit owners) to certain common areas of the property. Although most often used in the context of multi-unit residential properties, commercial condominiums are becoming more common. State laws regarding condominiums vary.

1.4 Easements

A real estate owner can also give non-exclusive rights, known as easements, to third parties to use the land, such as granting a right of way. Recorded easements are binding on any successors in title to the property. State laws regarding easements vary.

1.5 Restrictions on ownership by foreigners

There are no blanket prohibitions on foreign ownership of US real estate, but various US laws impose restrictions and requirements applicable to foreign investors in certain cases, including:

- **Foreign Assets Control Rules:** The federal government imposes economic sanctions against and prohibits certain deals with various countries, entities, individuals and organizations. The Office of Foreign Assets Control at the US Department of the Treasury (OFAC) administers and enforces these sanctions, and all US Persons (i.e., US citizens, permanent resident aliens, persons and entities within the US, and all US-incorporated entities and their foreign branches) are required to comply with the sanctions.

- **CFIUS:** The Committee on Foreign Investment in the US (CFIUS) oversees enforcement of laws that allow certain foreign investment transactions to be blocked where they might impact US national security, and can cause divestiture of completed investments in certain circumstances.

- **The Patriot Act:** Since September 2001, the federal government has regulated investment in the US through disclosure and other laws designed to identify terrorist organizations and individuals, under a statutory scheme known as the Patriot Act. Prospective buyers may be required to make certain disclosures under these laws.

- **BEA Reporting Requirements:** Foreign investment in a US business which results in a foreign person or entity owning 10% or more of the voting securities of a US business may be subject to reporting requirements administered by the Bureau of Economic Analysis (BEA) of the US Department of Commerce.

The foregoing are not the only US laws that impact ownership by foreigners. Non-US investors should also keep in mind: (i) the Foreign Investment in Real Property Tax Act (FIRPTA), discussed in section 7.9 below, (ii) regulations passed by the Department of Defense (e.g. International Traffic in Arms Regulations), (iii) the Agricultural Foreign Investment Disclosure Act of 1978, (iv) the Hart-Scott-Rodino Antitrust Improvement Act of 1976 and other antitrust and competition laws, (v) export control rules and regulations, (vi) US antidumping and countervailing duty laws, (vii) US immigration laws, (viii) tax laws, and (ix) state and local laws.

2. Acquisition of ownership

2.1 Formal requirements

Transfer of real property is typically accomplished pursuant to the terms of a purchase and sale contract that is negotiated and executed between parties after they have reached agreement on the purchase price and other fundamental terms of a transaction. The purchase and sale contract, to be enforceable, must be in writing, signed by the parties, and must identify the property to be sold and the material terms of the transaction. Applicable state law will mandate any further particular requirements for the contract, which may otherwise be negotiated freely between the parties.

There will usually be an interval between the date of the purchase and sale contract and the date when the title transfer takes place, which transfer is referred to as the closing. The actual conveyance of ownership at closing is usually completed simultaneously with payment of the purchase price, and is accomplished through execution and delivery of a notarized deed complying with the requirements of applicable state law.

There is not one single set of US laws governing the transfer of title to real property. Each state has its own law, consisting of case law and statutes, applicable to the acquisition of interests in land; local regulations are also applicable to aspects of property ownership, such as zoning compliance and building codes, and state laws may also be targeted at specific classes of property. For instance, special environmental disclosure laws apply in some states with respect to certain categories of industrial property and some states impose protections for the security deposits of residential tenants upon a transfer of title by their landlord. In addition, federal laws may be applicable.

2.2 Registration

As noted above, fee ownership is generally transferred by a deed complying with the requirements of applicable state law. The deed, in order to provide constructive notice to future prospective purchasers and other parties that title to the property has been transferred, must be recorded in the proper registry or recording office. There is no single property register or recording office for all properties in the US. Each county within each state maintains its own property records.

2.3 Asset deals

The most common form of real estate transaction is an asset deal in which the buyer acquires a fee simple ownership interest in a given parcel or parcels of real property. As noted above, asset transactions are typically completed pursuant to the terms of a purchase and sale contract that will describe terms of the transaction. These should include purchase price, any deposit, any due diligence period, a mechanism for the buyer to investigate title, the representations and warranties given regarding the property, the closing date, documents to be delivered at closing, the allocation of property costs and income at closing, and other matters such as the allocation of risk if the property is damaged prior to closing.

Generally, the rule of caveat emptor (i.e. buyer beware) applies to most real estate purchase and sale transactions, under which it is a buyer's responsibility to satisfy itself regarding property condition, title, and other matters. Seller's warranties are generally not provided under statute and the seller and buyer will negotiate the extent of any seller's representations and warranties when negotiating the purchase agreement. The agreement will also usually provide for the extent of remedies available to the buyer if the seller makes a misrepresentation. In most cases, the buyer's remedy will be limited to termination of the agreement and obtaining a refund of its deposit if the misrepresentation is discovered prior to closing and, if discovered after closing, to monetary damages which may be limited in amount and otherwise by the terms of the agreement. It is typical for any post-closing misrepresentation claims to be subject to a survival period, after which a buyer may have no remedies against a seller.

In many but not all localities in the US it is customary for a buyer to be entitled to an initial period after signing of the contract, known as a due diligence period, in which to conduct investigations of the property and during which the buyer may withdraw from the transaction and the buyer's deposit may be subject to refund. The contract should specify the length of any due diligence period (usually in the range of 30 to 90 days) and the scope of documents and information that must be provided by the seller to the buyer before or during this period. If the contract does not provide for a due diligence period, the buyer should conduct its due diligence investigations prior to signing the contract.

As part of its due diligence investigations, the buyer will (with the aid of its counsel) typically review a title report prepared by a title insurance company, underlying title documents, a survey, searches respecting the seller, certificates of occupancy and permits, any environmental reports and physical condition reports, contracts affecting the property, leases, any zoning reports, insurance certificates, appraisals, and financial documents. The deed may include representations by the seller concerning title, but such representations are often limited. Purchasers of fee ownership in land typically obtain an owner's title insurance policy effective at the closing that protects against undisclosed liens, encumbrances, and title defects. Terms of the coverage and endorsements to increase coverage may be negotiated in most jurisdictions.

In connection with a sale transaction, consent is typically required from anyone who has lent money to the seller and has a security interest in the property being sold, unless the mortgage is being paid off in full, in accordance with its terms, at the closing (which is, in fact, the most common scenario). The holders of any rights of first offer or first refusal affecting the property will have to waive or fail to exercise their rights. Consent may also be required from the landlord if the land interest being sold is a leasehold interest. State law will mandate whether any special consents are required from occupants of residential property that is being transferred.

Zoning, construction and environmental laws may all apply and should be investigated with the assistance of counsel. As part of its due diligence, the buyer will wish to confirm that the property is being used in compliance with any local permits and land use restrictions, including any certificate of occupancy issued by the applicable local governmental authority and that the property is not subject to any notices of violation issued by any such authority. The responsibility of property owners for prior environmental contamination is governed both by federal law and by the state law of the property in question, as discussed below.

In order to ascertain the permitted uses of a parcel of real estate under the applicable zoning or planning law, a buyer will typically request that the seller deliver a copy of the certificate of occupancy confirming the permitted use or the title insurer will obtain a copy of the certificate from the municipality. In some localities, certificates of occupancy are not issued. In either case, it is also common for a zoning report to be obtained to confirm the permitted use, and if the buyer is planning to change the use or to perform construction at the property, further investigation of the zoning regime applicable to the property should be undertaken as part of due diligence investigations.

Asset deals are subject to a range of taxes and other transaction costs, as discussed further in section 7 below. Depending on where the property is located and other factors, these can include city, county and state transfer taxes, mortgage recording taxes, sales taxes and brokerage fees. The types and rates of taxes vary depending on locality, property type and purchase price, and there may be city, county and state transfer taxes applicable to an asset sale, as well as separate mortgage recording taxes and in some cases other supplemental transfer-related taxes. However, in most other states no mortgage recording tax is payable, in many localities transfer taxes are low, and in some localities there are no transfer taxes.

Local customs for allocation of closing costs vary, including with respect to which party is generally responsible for escrow fees, title insurance and survey costs, recording charges, and city, county and state transfer taxes. Local custom can be modified by contract, and the purchase agreement should comprehensively describe how costs are to be allocated between the parties.

2.4 Share deals

Another way to acquire real estate is for a buyer to purchase the legal entity which owns the property, through a transfer of ownership interests in such entity rather than the sale of the assets owned by the entity. In the US, the legal entities that own real property come in various forms, but the most common are limited liability companies and limited partnerships.

When a transaction is structured as an entity or share deal (i.e. a transfer of entity ownership interests), different tax considerations may apply. The applicability of taxes and transaction costs to an entity or share deal, and local custom as to the allocation of those costs between the buyer and the seller, varies from state to state. State and other local laws of the property in question will determine whether transfer taxes and other taxes are payable in a share deal. In most instances, the applicable state, or the county in which the property is situated, has established customs for matters such as allocation of escrow fees, title insurance and survey costs, and city, county and state transfer taxes, but these customs can be varied by contract and the purchase agreement for the transaction should describe the allocation of those costs between the parties in detail.

The due diligence prior to closing of a share deal should, in addition to the due diligence referenced in paragraph 2.3 above concerning the underlying real property itself, cover the entity at issue, including with respect to:

(i) all legal aspects of the shares or other ownership interests in the entity owning the property such as whether there are any pre-emption rights, encumbrances, etc.;

(ii) whether the entity has (or has previously had) employees, and the liabilities in relation thereto; and

(iii) all other pre-existing assets and liabilities of the entity, including under any prior or existing contracts, and under any applicable laws.

2.5 Public auctions

For specialist investors, purchasing at a public auction can be considered. Properties for sale by auction are usually the subject of an enforced sale, such as a sale pursuant to a court order arising from a bankruptcy or foreclosure by a secured lender. The complexity of the auction procedure makes it advisable for a prospective buyer to work closely with legal advisors, including as applicable qualified bankruptcy specialists.

3. Construction

3.1 Contract pricing

Construction projects can be priced in a number of different ways to suit the individual needs of a particular project. Commonly used pricing arrangements include the following:

Lump Sum: under a lump sum agreement, the contractor agrees to perform the work for a fixed price. This arrangement is best suited for projects where the scope of work and schedule are detailed enough to allow the contractor to accurately estimate the cost of the project. Lump Sum projects give the owner the advantage of being able to limit exposure for cost overruns; however, the owner will not be able to capture savings, if the actual cost of the project is less than the lump sum price.

Cost Plus: under a cost plus contract, the owner pays the contractor the actual cost of the work plus a pre-negotiated fee. This is most common where the owner wants to include the contractor during pre-construction and there are uncertainties about the final scope of work. Cost plus contracts promote efficiency by involving the contractor in early stages of the project; however, financial considerations are a concern as contractors may not have an incentive to limit costs because they are not subject to a cap and will receive fee on additional costs.

Guaranteed Maximum Price: in a guaranteed maximum price contract, the owner pays the contractor the cost of the work plus a pre-negotiated fee up to a cap or GMP. Absent a formal change order, the contractor is liable for costs that exceed the GMP. When the actual cost of the project is less than the GMP, the owner and general contractor often share the savings. Guaranteed maximum price contracts are the most common pricing arrangement for large commercial projects and have the advantage of providing the owner with the assurance that will not be liable for cost overruns. However, it is common for there to be disagreements between owners and contractors about what is in the GMP and contractors may provide inflated estimates to limit their exposure for cost overruns.

Time and Materials: under a time and materials contract, the owner agrees to compensate the contractor for work based on a pre-negotiated unit price schedule. This arrangement is most appropriate where the owner can accurately identify the work that needs to be done but may be uncertain of the specific quantities. This arrangement is often used for repetitive, easily quantifiable tasks and is not typically used for complex construction projects.

3.2 Project delivery systems

There are a number of different methods for assigning responsibility for the design and construction of a project and the project delivery system should account for the specific budgetary, quality, and scheduling needs of each individual project.

Design/Bid/Build: this is the most traditional delivery method in US construction. Under this system, the owner contracts with the architect for the design and then uses that design to secure competitive bids and ultimately enter into an agreement with a contractor for the construction of the project. This method is easy to manage and provides a clear separation of design and construction responsibility. However, the rigid separation of these functions can result in inefficiencies and create an adversarial relationship between the contractor and the architect.

Design-Build: under a design-build contract, the owner contracts with a single entity for both the design and construction of the project. This method endeavors to create a streamlined process where the owner has a single point-of-contact and design and construction can be developed concurrently. However, having only one firm responsible for both functions can result in less owner control and the elimination of the checks and balances that exist in more-traditional delivery methods.

CM At-Risk: CM at-risk projects consist of a three-party team including the owner, architect, and a construction manager. Like other methods, the architect and construction manager are under separate contracts; however, here the construction manager is typically engaged during the design phase to consult during preconstruction. The construction manager is considered to be at risk because it operates as a general contractor and assumes scope and schedule responsibility for construction once the design is completed.

Integrated Project Delivery (IPD): this method has been developed in an attempt to respond to the complexities of modern construction by creating a team of project participants that is engaged early in the project to develop an approach that identifies and addresses potential project issues. IPD strives for the sharing of risk through the integration of resources, processes, and expertise; however, absent exceptional circumstances, it can be difficult to implement with actors that are accustomed to more traditional methods.

3.3 Risk allocation and dispute resolution

Risk Allocation: in addition to project delivery systems and pricing arrangements, construction risk can be managed through a number of different vehicles, including the use of specific contractual provisions, insurance, and bonds/guarantees. Common contractual clauses used to distribute risk include indemnification provisions, warranties, schedule-related requirements (including the imposition of liquidated damages), and the ability to withhold payment.

With respect to insurance, each party to a design or construction contract should always confer and obtain advice from its own risk manager or insurance agent regarding the types and limits of insurance that will best protect each project.

In addition, owners may seek additional security from a third-party surety or a guarantee from a contractor's parent company. Common forms of bonds that protect various parties to the construction process include performance bonds wherein the surety guarantees to the owner that the contractor will complete the construction work and payment bonds that guarantee to the owner that the contractor will pay its subcontractors and suppliers.

Dispute Resolution: construction disputes are generally heard in state and federal courts in the state where the project is located. In lieu of litigation, parties may mutually agree to arbitrate their dispute. Although not always the case, arbitration is intended to be an informal and more-efficient process than litigation. However, arbitrator decisions are final and are only subject to appeal under extremely narrow circumstances. There are many factors that determine whether a party should pursue litigation or arbitration and each matter should be considered on a case-by-case basis. In addition, parties often engage in mediation in an attempt to resolve the matter early on in the dispute. This is often non-binding and done at the agreement of the parties.

4. Zoning and planning law permits

Zoning and planning law permits in the US are governed primarily at the local level by municipal and county governments. Authority for such local governance is derived from and defined by applicable state law, and can vary significantly in both substance and procedure. Applicable laws are typically contained in local comprehensive planning documents and local zoning and subdivision ordinances.

Development must be in accordance with use restrictions and in most cases a use must be permitted in the district where the property is located or specific approval of the use must be obtained. Even if the use at issue is permitted, approval is sometimes required for a change of use.

Plans for new construction and most refurbishment must typically be reviewed and approved by local building department officials for compliance with local building standards and local zoning and subdivision ordinances. Consent from regional and state agencies may also be required. In some cases, design and appearance of new buildings also requires approval from local authorities.

Permitting approval timelines vary significantly, depending on various factors. New development approvals often require formal hearings at which members of the public can testify for or against a proposed project. Local reviewing bodies will often require extensive application materials, and will issue findings of fact respecting a proposal.

Depending on the proposal, final decisions may be made by planning staff, a local reviewing body, or elected officials. Appeals of adverse decisions may be submitted by the applicant (and, in some cases, by others) to a local appeals board or a court for resolution.

Depending on the proposed project, additional agreements with governmental authorities may also be needed. Types and forms of agreements depend upon particular local practice and applicable state law.

Violations of local zoning and planning requirements can result in governmental imposition of fines and/or injunctions requiring specific actions be taken. In some jurisdictions, third parties can seek to enforce zoning ordinances through legal action.

5. Environmental liability

There are a number of complex problems that can arise from the laws and policies governing environmental issues in real estate transactions, and non-compliance with regulatory requirements and the failure to address potential liabilities can carry significant financial risk.

The US Environmental Protection Agency (EPA) is charged with the protection of the environment and has promulgated many requirements and protections governing the allocation of responsibility for environmental issues. To name just a few, regulations include those that govern the discovery, handling, and remediation of hazardous materials at a site, the kinds of materials used in construction, pollution prevention, providing for storm water and drainage, and sustainability guidelines.

Under a wide range of federal, state, and local regulations, the owner of real property can be held liable for the entire cost of remediating environmental hazards on a property that it acquires, regardless of whether it contributed to the contamination or other environmental damage at the site. Although the owner may be able to pursue previous owners to recover costs incurred to remediate environmental issues at a project in most jurisdictions, adversarial proceedings are often uncertain and amounts recovered frequently fail to make the subsequent owner whole. Therefore, buyers often rely upon contractual protections (such as indemnification provisions) to provide certainty and redistribute environmental risk. However, in order to effectively allocate contractual liability, parties must obtain a thorough understanding of existing conditions at a site by conducting extensive environmental due diligence prior to acquiring any real property interest. Once existing risks are known, parties can negotiate for the appropriate contractual protections.

6. Leases

There are two main types of arrangements allowing a person, company or other organization to occupy real estate for a limited period of time without buying it outright.

The first is a lease, which grants the right of exclusive possession of the property for an agreed period of time. A lease confers on the tenant contractual rights and a proprietary interest in the property. There are different types of leases but commercial leases broadly fall into one of two categories: Gross Leases where the tenant's financial responsibility is primarily limited to the payment of rent and the landlord is fixed with the operating costs of the property; and net leases where, in their purest form, the tenant is also responsible for the cost of operating, insuring and paying taxes on the real property. A ground lease is a subspecies of net lease where the tenant is given rights to develop a parcel of land leased to it.

The second is a license, which grants permission to occupy or use the property. Unlike a lease, a license is a merely personal contractual arrangement between its original parties conferring no transferrable interest in the leased real estate and often not binding upon future owners of the land.

Real estate laws and regulations vary from state to state and advice from local counsel should be sought as to local laws. Residential tenants in particular are often accorded additional statutory rights.

6.1 Duration

The duration of commercial leases vary but, in many instances range from three to ten years. Leases of over 30 years tend only to be ground leases and net leases.

Generally, a tenant's right to occupy the leased premises ends when the lease term expires. However, under the common law holdover rule, a tenant remaining in possession after lease expiration without the landlord's agreement may be treated by the landlord either as a trespasser subject to eviction or as a tenant under a lease for a new term of up to one year. Most states have enacted legislation abolishing this rule – the terms of those statutes vary widely in how they govern the relationship between the landlord and the holdover tenant. Guidance with respect to the actions to be taken by a landlord to ensure timely vacation of the premises should be sought from a qualified local attorney.

6.2 Rent

Often, rent payments are due on a monthly basis and are paid in advance. Most leases provide for the first fixed rent payment to be made upon signing the lease, together with the delivery of any required security deposit.

Whether the rent will vary during the term is dependent upon the terms of the lease. If the lease provides for the rent to be changed or increased, it will either specify the amount of such change or increase or will provide a mechanism, such as a procedure for appraisal by an independent expert, for its determination.

6.3 Operating expenses

Leases of premises within multi-tenanted properties generally provide an operating expense clause detailing a mechanism for the tenants to proportionately share the cost of maintaining and operating the common facilities. Many leases require tenants only to pay increases above those operating expenses that the landlord incurred in a set Base Year.

Tenants of multi-tenanted properties will typically be charged for electricity either directly by the electricity provider or by the landlord based upon their proportionate share of the landlord's electricity bill. How water is paid for will generally depend upon how the water is to be used – in office and most retail leases, for instance, the landlord will often pay for the cost of water for drinking and lavatory purposes. In restaurant, industrial and other leases where there is more costly water usage, the tenant will often be responsible for its cost. Similarly, payment of heating and air conditioning charges depend upon the type of property. Tenants of retail leases will often be directly responsible for procuring heating and air conditioning service at their own expense. However, in the case of multi-tenanted office buildings, landlords will often pay for the heating and air conditioning of tenants' premises during regular business hours (subject to reimbursement through the shared operating expenses mechanism discussed above).

6.4 Maintenance and repair

In the typical commercial lease, a tenant will be directly responsible for maintaining and repairing the interior of the leased premises at its own cost and the landlord will be responsible for repairing and maintaining the exterior, structure and common areas of the property, subject to reimbursement by tenants through the shared operating expense mechanism whereby all of the tenants proportionately share the cost of maintaining and operating the common facilities. With ground leases and certain types of net lease, the tenant will be directly responsible for repairing and maintaining the entire leased premises at its own expense.

6.5 Assignments, subleases and mortgaging leasehold interests

A lease can prohibit the tenant from assigning its lease for the remainder of its term, subleasing all or a portion of its leased premises, mortgaging its leasehold interest or otherwise granting to a third party rights in the leased premises. Even if not absolutely prohibited, the tenant's ability to assign or sublet will usually be conditioned upon obtaining the landlord's prior consent in most cases. If the lease is silent as to whether transfers are prohibited, the law of most states will allow the tenant to transfer its lease.

6.6 Insurance

Except in the case of ground leases, it usually falls upon the landlord to insure the building against fire and other types of damage (subject to reimbursement of premiums through the shared operating expenses mechanism described in section 6.3 above). The tenant will be responsible for obtaining general liability insurance and property damage insurance with respect to the tenant's property. Tenants are often required to procure business interruption insurance and insurance covering injury to employees and workers. With ground leases and certain types of net lease, the tenant will be directly responsible for insuring the entire leased premises at its own expense. The precise events which are covered by the insurance in question, and the extent of any exclusions, vary according to the insurance market in which the property is located and the type and use of the property.

6.7 Termination

A well-drafted lease will always grant the landlord the right to recover possession of the premises if the tenant defaults under its material lease obligations. However, leases will generally grant the tenant a grace period in which to cure most instances of default before the lease can be terminated and possession recovered by the landlord. State law will govern the process for recovering possession and certain states grant tenants additional statutory rights. Please consult an attorney qualified in the state in question regarding the process in a particular locality.

In addition, sometimes leases grant the landlord a right to terminate the lease prior to expiration of the term. Such special termination rights are not common to any particular locality or property type – their inclusion is entirely dependent upon the deal negotiated between the parties.

6.8 Requirements for writing

A lease with a duration of more than one year must be in writing and signed by the party to be charged. Real estate laws and regulations vary from state to state and advice from local counsel should be sought as to local laws.

7. Tax

An individual, organization or company may invest in US real estate either directly in their own name or indirectly through any one of many different legal entities, including corporations, general and limited partnerships, limited liability companies, real estate investment trusts (REITs) and other types of trusts. The tax system in the US is a complex web of various taxes imposed by different governing authorities. The multi-layered tax system reflects the US constitutional structure of overlapping federal and state governments, with the result that taxes may be imposed at any one or more of the following three levels: (i) US federal taxes, (ii) state taxes, and (iii) local (city and county) taxes.

While US federal taxes apply uniformly throughout the country, state and local taxes vary widely from jurisdiction to jurisdiction and advice from local counsel should be sought as to local laws.

7.1 Real estate transfer tax

No US federal taxes are imposed on the purchase of real estate. Various states and localities (cities and counties) impose taxes on the transfer of interests in real property within that state such as when deeds (documents) which convey interests in real property are officially recorded (also known as documentary stamp taxes, documentary transfer taxes, or real estate transfer taxes). In some states (including local jurisdictions within such state), documentary transfer tax or real estate transfer tax is due on transfers of certain interests in legal entities that own real property real property within the respective state.

Also, various states impose taxes when mortgages or deeds of trust securing loans that are secured by interests in real estate are officially recorded.

7.2 Value added tax

Currently, there are no value added taxes imposed under the US federal tax system or the tax systems of any of the states.

7.3 Property taxes and other taxes

Most states and/or localities (cities and counties) impose some form of *ad valorem* property tax on the ownership of real property. These taxes typically are computed as a percentage of the assessed fair market value of the property, and generally are not subject to offset or reduction. Limitations on these taxes vary from jurisdiction to jurisdiction and advice from local counsel should be sought as to local laws.

The states and localities impose a variety of other taxes that may be relevant to the ownership and operation of real property, including sales and use taxes, transfer taxes and taxes on the lodging of official records, franchise taxes and gross receipts taxes.

7.4 Taxation of rental income from real estate

At the US federal tax level, taxable net income (i.e. the excess of income over deductions) derived from the ownership and operation of real property is treated as ordinary income and is subject to federal income tax at graduated rates. Effective January 2018, the maximum income tax rate on ordinary income has been reduced to 28% for corporations and 37% for individuals (note, however, the maximum income tax rate on ordinary income for individuals is set to sunset after 2025 and return to 39.6%) is 35% for corporations and 39.6% for individuals. As from 2013, the net investment income of US individuals is subject to an additional tax of 3.8%; foreign individuals, however, are not subject to this 3.8% net investment tax.

Disregarded entity

Generally, a limited liability company or other unincorporated business entity that has a single owner is disregarded for US tax purposes. The tax consequences of owning real property indirectly through a disregarded entity are substantially the same as if the property were held directly by the single owner of the disregarded entity.

Partnership

Real property that is owned by an entity that is classified as a partnership for US tax purposes generally is not subject to US federal income tax. Instead, the taxable income from the ownership and operation of the property flows through the partnership to the partners, who are subject to tax on the share of that income which is distributed to them.

Regular corporation

If real property is owned by an entity that is classified as a corporation for US tax purposes, net income from the ownership and operation of the property is subject to two levels of federal income tax. First, the corporation is subject to tax on any net income at regular tax rates applicable to US corporations. In addition, dividends paid by the corporation to its shareholders are subject to tax at the shareholder level.

Real estate investment trust (REIT)

A real estate investment trust, or REIT (as discussed in section 7.8 below), assuming that it complies with the various REIT requirements, will not be subject to US federal income tax.

Use of losses from other properties and activities

Generally, corporate taxpayers whose stock ownership is widely held can use taxable losses generated from the ownership and operation of the corporation's other properties and other business activities to offset current and future taxable net income derived from the ownership and operation of real property owned by the corporation up to 80% of such taxable income in a given year. The ability of an individual taxpayer to use taxable losses generated from the ownership and operation of other properties and other business activities to offset taxable net income derived from the ownership and operation of real property owned by the individual is much more restricted, in light of various complex limitations imposed by US federal income tax laws.

State and local taxes

Most (but not all) states impose income tax on the net income generated from the ownership and operation of real property owned and business activities conducted within that state. Income taxes may also be imposed at the local (city and county) level.

7.5 Taxation of distributions

US FEDERAL INCOME TAXES

Disregarded entity

Generally, a limited liability company or other unincorporated business entity that has a single owner is disregarded for US tax purposes. Accordingly, there should be no federal tax consequences to a single owner of a disregarded entity from cash distributions made to them by the disregarded entity.

Regular corporation

Dividends paid by a corporation to its shareholders are subject to tax at the shareholder level. Dividends paid by a US corporation to a shareholder that is itself a corporation will generally be eligible for a dividends received deduction (ranging from 50/70% to 100%. (Or simply 50-100%) depending on the percentage of stock ownership held by the distributee stockholder). In addition to regular corporate income tax, a foreign corporation that has a branch holding US real property in a US trade or business will potentially be subject to two branch level taxes.

Real estate investment trust (REIT)

Distributions made by a REIT to its shareholders will generally be taken into account as ordinary dividend income.

Partnership

Taxable income from the ownership and operation of real property owned by an entity that is classified as a partnership for US tax purposes flows through the partnership to the partners, who are subject to tax on their shares of that income, regardless of the amount of cash distributions actually made by the partnership to its partners. Any cash distributions to a partner that exceed the partner's adjusted tax basis in his or its partnership interest generate capital gain as if the partner had sold a portion of his or its partnership interest.

Income tax withholding for foreign investors

Where a foreign person invests in an entity taxed as a partnership, a 35% federal withholding tax generally is imposed on the foreign partner's distributive share of taxable income of the partnership that is effectively connected with a US trade or business (whether or not such income is distributed). In addition, to the extent a foreign person realizes any fixed, determinable, annual or periodical income (such as interest and dividend income) from a business entity that is not effectively connected with a US trade or business, such income generally is subject to a 30% federal withholding tax.

Withholding taxes may be reduced or eliminated with respect to certain types of income under applicable income tax treaties. Amounts paid as withholding taxes may be claimed by the foreign person as a credit against its US federal income tax liabilities.

State and local taxes

Most (but not all) states impose income tax on the net income generated from the ownership and operation of real property owned and business activities conducted within that state. Income taxes may also be imposed at the local (city and county) level.

7.6 Taxation of capital gains on real estate

US FEDERAL INCOME TAXES

Capital gains taxes

Gains from the disposition of real property that has been held by a non-corporate taxpayer for more than one year generally enjoy a reduced capital gains tax rate of 20%. However, if the real property includes building improvements that have been previously depreciated, gains up to the aggregate amount of prior depreciation deductions are taxed at a special rate of 25%. Real property that is held for less than a year or is held in the ordinary course of a trade or business is taxed at regular tax rates. Corporations do not enjoy the benefit of reduced capital gains tax rates applicable to individual taxpayers.

Disregarded entity

Generally, a limited liability company or other unincorporated business entity that has a single owner is disregarded for US tax purposes. Accordingly, any taxable gains from the sale or other disposition of real property is subject to tax by the single owner as if the single owner had directly owned the property.

Partnership

Taxable gains from the sale or disposition of real property owned by an entity that is classified as a partnership for US tax purposes flows through the partnership to the partners, who are subject to tax on their shares of that gain, regardless of the amount of cash distributions actually made by the partnership to its partners. The character of the gain (as ordinary income or capital gain) passes through the partnership to its partners.

Any cash distributions to a partner that exceed the partner's adjusted tax basis in their partnership interest generally result in capital gain as if the partner had sold a portion of their partnership interest.

Regular corporation

Gain from the sale or disposition of real property by a regular corporation is subject to two levels of income tax. First, the corporation is subject to tax on gain from the sale or disposition of the property at regular tax rates applicable to US corporations. In addition, dividends paid by the corporation to its shareholders are subject to tax at the shareholder level. If a corporation sells all of its US real property and then liquidates, the corporation is subject to income tax on gains from the sale of the property, but foreign stockholders will not be subject to tax on liquidating distributions from the corporation, and there is no Foreign Investment in Real Property Tax Act (FIRPTA) withholding (as discussed in section 7.9 below) required.

Real estate investment trust (REIT)

A REIT, assuming that it complies with the various REIT requirements, will not be subject to US federal income tax on gains realized from the sale or disposition of real property. A REIT may designate distributions to its shareholders as capital gain dividends, to the extent that they do not exceed the actual net capital gain of the REIT for the taxable year, in which case the distributions are taxable in the hands of stockholders as long-term capital gains.

State and local taxes

Most (but not all) states impose income tax on gains from the sale or other disposition of real property located within that state. Income taxes may also be imposed at the local (city and county) level. Various cities, counties and other local jurisdictions also require withholding against taxable gains from the sale or disposition of property in that local jurisdiction.

7.7 Taxation of gain on disposal of partnership interest in a partnership owning real estate

Taxable income from the ownership and operation of real property owned by an entity that is classified as a partnership for US tax purposes flows through the partnership to the partners, who are subject to tax on their shares of that income, regardless of the amount of cash distributions actually made by the partnership to its partners. Any cash distributions to a partner that exceed the partner's adjusted tax basis in their partnership interest generate capital gain as if the partner had sold a portion of their partnership interest.

7.8 Real estate investment trusts (REIT)

US tax law provides a tax-efficient treatment for a corporation (or trust) that qualifies for and elects to be taxed as a real estate investment trust, or REIT. To qualify as a REIT, a corporation (or trust) must principally own interests in real estate and satisfy other highly technical organizational, income and ownership requirements. The governance and tax treatment of such entity is very complex. A REIT, assuming that it complies with various REIT requirements, will not be subject to US federal income tax.

7.9 Foreign investment in real property tax act (FIRPTA)

The Foreign Investment in Real Property Tax Act (FIRPTA) provides special rules for gains from the disposition of a US real property interest (USRPI). Gains realized by a foreign investor from the sale of a USRPI are treated as effectively connected with a US trade or business carried on by the foreign investor. The term USRPI includes (i) direct ownership interests in US real estate, (ii) stock in a US corporation if, at any time during the prior five years, USRPIs represented at least 50% of all real property interests of the trade or business assets held by the corporation, and (iii) an interest in a partnership that principally holds USRPIs.

The liability of foreign investors for FIRPTA tax is enforced by a comprehensive withholding tax regime that applies to a disposition of a USRPI by any foreign person, under which the purchaser of a USRPI is required to withhold 15% (10% for closings prior to February 16, 2016) of the gross sales price and pay that amount over to the Internal Revenue Service. The amount withheld and paid over is not an additional tax, but is treated as a tax payment against the foreign investor's actual US income tax liability. No FIRPTA tax is imposed on a sale of REIT shares if (a) the REIT is publicly traded and the investor holds a 10% or less interest in the REIT, or (b) less than 50% of the REIT shares are or have been held directly or indirectly by foreign persons.

Investments in US real estate by non-US retirement and pension funds have historically been subject to FIRPTA. The Protecting Americans from Tax Hikes Act of 2015 (PATH Act), however, provides for an exemption from FIRPTA for non-US retirement and pension funds that dispose of (or that receive REIT distributions that are sourced from the disposition of) interests in US real estate, assuming the non-US retirement and pension funds satisfy several conditions. Significantly, the PATH Act does not exempt tax on operating income and/or dividends from REITs, and therefore significant tax planning is still required for such investors.

7.10 Tax benefits of owning real estate

Real estate investments enjoy a variety of benefits under US tax laws, some of which are identified below.

Deductions

In computing taxable income from the ownership and operation of real estate, the owner generally is entitled to deduct interest expense on borrowings to acquire, own and operate the property, which may be capped at 30% of adjusted taxable income of the applicable year, as well as the ordinary and necessary costs of owning and operating the property. An owner of buildings and other improvements to US real estate is also generally entitled to reduce taxable income by deductions for depreciation or cost recovery deductions.

No depreciation deductions may be claimed with respect to the cost of land. Under current law, the cost of building improvements is generally depreciated on a straight-line basis over 27.5 years for residential rental property, and 39 years for other types of commercial real property. Electing to extend the depreciation recovery period may result in a more beneficial interest expense deduction if the 30% cap applies.

Like-kind exchanges

A significant tax benefit to the ownership of US real estate is the ability of the owner to defer current income tax upon the disposition of the property through a like-kind exchange transaction. Gains realized from a like-kind exchange of US real property will not be recognized currently but will be deferred if the owner acquires property of a like kind and of equal value, and otherwise complies with complex timing, payment arrangements and other requirements applicable to exchange transactions.

8. Real estate finance

8.1 Forms of security

The mortgage and the deed of trust are the most common forms of security over real estate. The mortgage or deed of trust is usually recorded with the applicable county recorder where the property is located. The main difference between the mortgage and the deed of trust is the manner of enforcement following default.

A mortgage is a transfer of an interest in land to a lender as security for repayment of a loan or other obligation. The deed of trust is a particular kind of mortgage pursuant to which a borrower transfers an interest in real property to a trustee designated to hold title to the property for the benefit of the lender pending repayment of a loan or other obligation. With a deed of trust, if the borrower defaults on its obligation, the trustee may be compelled to sell the property and pay the lender from the sale proceeds or foreclose and transfer title to the lender.

8.2 Creating and perfecting security

The granting of a security interest in property requires the officers of a corporate entity to comply with its applicable articles of incorporation and by-laws, the applicable state and federal laws and regulations, and any contracts with other parties. A copy of a resolution of the board of directors authorizing the corporation to grant the security over its real estate assets should be obtained. In some states a foreign lender may need to obtain a license in order to lend and receive repayment due under the loan documents.

Recordation of a mortgage in the public records is generally a prerequisite to a validly perfected mortgage lien in real estate. However, failure to perfect the lien does not in fact make such lien invalid. The lien could be perfected at a later date subject to arguments that upon a bankruptcy filing of the mortgagor, the granting of such mortgage constituted a fraudulent conveyance. All documents intended to be recorded in the public records require the acknowledgment/notarization of the parties executing such document. The amount charged by notaries, in each case licensed by the applicable states, may vary. The amount of any required mortgage fees and taxes varies from state to state. Unlike notarial fees, mortgage recording taxes may amount to substantial sums.

8.3 Enforcement

Each state and local jurisdiction imposes different procedural hurdles before a security interest in real estate can be enforced. Some states require judicial intervention while others permit non-judicial remedies. In most cases, the borrower must be given notice of default and prescribed notice periods must be complied with before a lender can enforce a mortgage. Statutory notice periods vary in each jurisdiction but generally 30 days' notice will be required before a lender can enforce its remedies.

Lenders to troubled real estate owners may, to the extent the mortgage provides, appoint a receiver or agent to collect rents and manage the property so as to protect the relevant collateral. The receiver, though not actually an agent of the lender, will serve to preserve the asset while foreclosure proceedings may be pursued.

8.4 Borrower insolvency/priority of liens

The filing of any form of bankruptcy petition automatically stays foreclosure proceedings against the borrower. Nonetheless, courts may grant a lender relief from the automatic stay and the lender's security may be enforced pursuant to the general enforcement rules.

Creditors of a bankrupt borrower will be paid-off in the order of their lien priority. In general, the principle "prior in time, prior in right" determines the order of priority, unless a subsequent creditor fits within the protection of the local recording statute.
In a notice jurisdiction, a subsequent creditor has priority if it does not have notice of the prior interest. In a race jurisdiction, a subsequent creditor has priority if its lien has been recorded first. In a race-notice jurisdiction, a subsequent creditor has priority if its lien has been recorded first and such creditor has no notice of any prior interest.

Liens resulting from a property owner's failure to pay real estate taxes levied by local authorities or common area charges due under a condominium regime may have super-priority over liens for mortgage debt (irrespective of the time of filing). In addition, local laws vary as to the priority given to a mechanic's lien filed as a result of an owner's failure to pay contractors making improvements to a property. Finally, a creditor can agree to subordinate its security interest to that of another creditor by agreement.

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This guide was written predominantly by Angela Castro, Jarrod Matteson, John Ducat, Brian Hochleutner and David Berlyne.

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