THE FOREIGN INVESTOR'S GUIDE TO U.S. REAL ESTATE

JEREMY D. SMITH

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By
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1990

OCEANA PUBLICATIONS, INC.
NEW YORK • LONDON • ROME

ABOUT THE AUTHOR

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ISBN: 0-379-20107-0

Manufactured in the United States of America

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ACKNOWLEDGMENTS

The variety of ways in which the practical and legal problems of investing in U.S. real estate are dealt with by foreign investors and their advisors is almost as varied as the number of investors themselves. I am therefore extremely grateful to numerous others who were willing to share with me the benefit of their own experiences in working with foreign investors. Their contributions have undoubtedly made this a better and more useful book. In each instance assistance and advice was readily given and I am indebted to all for their generosity. In particular, I wish to give special thanks to Daniel B. Zanini, Esq. of Parker, Duryee, Rosoff & Haft, New York, N.Y. who reviewed the entire text more than once and provided always useful advice . I also wish to give special thanks to Jim Yager of KPMG Peat, Marwick & Main in Hong Kong for his invaluable input in preparing the tax and financing chapters. Sandi DiMola, Esq., a New York attorney specializing in immigration law provided similar assistance with respect to the immigration discussion in chapter eight. I am also especially grateful to Mr. Harry Francis of Barclay's Bank in New York for both his patience in teaching me some of the fundamentals of currency trading as well taking the time to critique that portion of chapter eight dealing with exchange risks. My thanks also to Roderick Richards of the Bank of East Asia in New York, Rita Daniel of Fairfield Communities, Inc. in Little Rock, Arkansas and Professor Paul Lapides of New York University for their assistance. Many thanks also to Iris Block of Precise/Ceres Abstract Co. in Ardsley, N.Y. who provided frequent and generous assistance. The assistance of Ed Feldman, Esq. and Bob Gilmore, Esq. both of Snow, Becker, Krauss P.C. in New York City, Cary Lapidus, Esq. of Lapidus & Reiff in San Francisco and Gary P. Miller, Esq. of Pritchard, Englefield & Tobin of London is also gratefully acknowledged.

Special thanks is due to Ken Miller of the Miller Marketing Network in New York and London whose friendship and generosity have in very substantial ways made publication of this book possible.

My thanks also to Jefri Ruchti, my editor at Oceana Publications and to Philip Cohen and Ed Newman, all of whom made the process of bringing this book to fruition not just painless but pleasurable.

There are a host of additional names which could also be included here, all of whom in one way or another contributed to the preparation of this book. The omission of their names does not diminish the value of their contributions. I cannot, however, fail to mention my wife Susan, or my children, Kim and Jason, each of whom also contributed in their own special way to the completion of this book.

While all of the help provided by my friends and colleagues has undoubtedly made this a better book, errors of both commission and omission are exclusively mine.

November 22, 1989 Jeremy D. Smith
Englewood, New Jersey

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A FRAMEWORK FOR INVESTORS

Real estate investment today has become a global activity. For a variety of reasons investors are no longer content to restrict their investment activities to home. As a result, a tremendous amount of investment capital has found its way into the international marketplace. More and more, foreign investors are seeking opportunities in the United States. While there has been a significant level of foreign investment in U.S. real estate since the 1950's, the situation today differs in several ways.

Following World War II there were few foreign corporations or individuals either capable or interested in U.S. real estate investment. As the shattered economies of Europe and Asia slowly recovered the level of investment gradually increased. Initially, such investments came primarily from large corporations and pension funds. In some cases the need to do so was dictated by local circumstance. As Dutch pension funds grew, for example, they were compelled to seek investments abroad since so few opportunities existed at home. The political stability and economic strength of the U.S. made it an attractive place in which to invest. Similarly, insurance companies and large corporations also began to feel the need to seek out opportunities abroad. And sometimes the investment in real estate would merely be incidental to the establishment of manufacturing or distribution facilities.

Some of these trends have continued and are self-evident today. Japanese auto manufacturers have established factories in a number of states. European pension funds still consider it an essential of prudent portfolio management to maintain at least 5-10% of their investments in U.S. real estate.

But circumstances of late have conspired to change dramatically both the type of foreign investor and the type of investment sought by him. In the late 1970's and early 1980's the U.S. began to attract more and more individual investors interested in single family homes, luxury condominiums, small office buildings and occasionally small shopping centers. Frequently these investors were seeking a safe haven for their money - away from the ravages of inflation, the uncertainty of political upheaval, or both. This trend has continued to expand and current events have today made U.S. real estate a genuine bargain for many of these investors. Since 1986 the U.S. dollar has declined substantially against other major world currencies making investment opportunities for German, English, Japanese and Taiwanese investors in particular all the more attractive.

Domestic events too have in some cases given added impetus to investors to seek out opportunities abroad. The Taiwanese government in 1987 removed virtually all remaining foreign exchange restrictions which had been in effect for over forty years, making it possible for the first time for it's citizens to invest overseas legally. Indeed, in an effort to help reduce it's huge U.S. trade surplus, estimated at $68 billion in 1986, the Taiwanese government has recently been quietly encouraging investment in U.S. realty.

Recent regulatory changes in South Korea now make it possible for Korean investors to invest freely in overseas property. Prior to 1989 South Koreans were limited to purchasing foreign real estate only in conjunction with overseas business activities. In 1989 the government removed this limitation, as well as others relating to reporting overseas investments to government agencies. As a result, industry analysts estimate that South Korean investment in US real estate may reach as high as $1 billion by the end of 1989.

In Japan, the government in 1988 imposed an income tax of 20% on interest earned on savings. It is estimated that as much as US$2.3 trillion in savings accounts have been affected by this new tax. As a result, analysts believe that a significant portion of this previously untapped fund will find its way into the international real estate market. And this was in addition to the already strong incentives that the Japanese had to invest in the U.S.. Since 1986 the exchange rate has gone from 240 to as low as 125 yen per dollar. Real estate prices are exorbitant in Japan and returns are very low. The Japanese investor interested in real estate must therefore of necessity look abroad. In 1986, prior to the new tax laws in Japan, Japanese investment in U.S. real estate was estimated at U.S.$600 million. In 1988 Japanese investment in U.S. real estate was, according to the U.S. government, estimated at over $10 billion. Private estimates have ranged as high as $16 billion. The difference is largely attributable to the fact that the government estimate excludes investments of less than $1 million and purchases of residences for personal use regardless of price. Indeed, it has been reported that Japanese investors now own in excess of 40% of all commercial real estate in Los Angeles, a favorite city for Japanese investors. While much of this investment has been by large cash-rich corporations, more and more small corporate and individual investors have also entered the fray. As more and more individual foreign investors have purchased U.S. realty, the types of investment properties being sought have also changed.

Many individual investors have sought out luxury condominiums, single family homes or small commercial properties in major U.S. cities. As these investors have become more familiar with the U.S. they have begun to expand their geographic boundaries and are now finding investment grade properties in other cities as well. While foreign investment has been and continues to be strong in such cities as Boston, New York, Los Angeles, San Francisco, Chicago and Washington, D.C., there has been growing interest in other locations such as Florida, Connecticut, New Jersey and regions in California away from it's major cities.

While the transnational flow of real estate investment capital is a world-wide phenomenon, the successful investor must always remember that real estate *practice* is always a *local* practice. The ability to financially analyze a property is a skill easily transported across international borders, but that is not enough. An intimate knowledge of the local real estate market is vital to the success of any investment. Many of the assumptions upon which the necessary financial projections are based are in turn based upon assumptions about trends in the local marketplace. The kind of intimate knowledge and understanding necessary to make intelligent and meaningful assumptions can only come from someone who deals in that marketplace regularly.

This presents a major problem for the foreign investor. How does he identify sources of such information? Once identified, how does he establish working relationships with these advisors? What should he expect from them? What should he not expect from them? And what will they expect from him? How are they paid? For a first time investor the experience of operating in an alien culture and legal environment can be intimidating at best. The small foreign investor, whether an individual or a small corporation, can take some comfort from the fact that the high level of foreign investment taking place in the United States today is evidence that the complexities of U.S. real estate investment can indeed be mastered.

The purpose of this book is to help both the individual and corporate foreign investor identify sources of local information, understand their working relationship with these local advisors, and understand the basic legal and tax considerations involved in acquiring real property in the United States. This book will not tell you how to analyze a proposed investment or how to tell a good deal from a bad one. Ultimately, such decisions must rest with the investor. The true measure of a knowledgeable investor is not how many answers he has but rather his ability to ask informed questions. This book is intended to give you that ability.

Whenever a real estate investor considers a particular investment abroad there are a number of factors which he must first consider which will determine the feasibility of the proposed investment. This initial determination is usually made without reference to the financial aspects of the transaction itself. If the investor cannot satisfy himself with respect to these threshold issues the investment ordinarily will not be made.

The most obvious of these threshold issues is political stability. Does the country in question have a tradition of free elections of civilian rulers or is it ruled by a military regime? Can one reasonably expect a continuation of the laws, policies and practices regarding foreign ownership of real estate as government administrations change over time? Or is there a danger of expropriation if a rival political party comes to power? The answers to these questions will affect each investor differently. A U.S. investor considering an investment in the Philippines may consider the risk of expropriation too high. However, if he can insure against this risk through OPIC insurance (Overseas Private Investment Corporation, a quasi-governmental agency) he may still consider the transaction viable. A Hong Kong investor, for whom such insurance is not available, would likely find the risk unacceptable. Similarly, a Hong Kong investor may find acceptable an investment opportunity in mainland China, even in the absence of insurance against expropriation. The American investor may consider the risks unacceptable, even with insurance. In each instance each investor must consider carefully these and other complex factors within the context of his own resources, investment objectives and capacity and willingness to take risks.

Except for the issue of political stability all of the other feasibility factors are in most cases determined by local law. These factors can generally be divided into three broad and somewhat overlapping categories:

> **general feasibility factors:** those factors which will determine whether or not an investment will be made regardless of the terms of the transaction itself;
>
> **transactional feasibility factors:** those factors which directly affect some particular aspect of the investment under consideration;
>
> **deal neutral factors:** those factors which create affirmative obligations or duties due to status as a foreign investor but which do not directly affect the evaluation of the proposal.

This analytical framework can be utilized in any country. It is a very subjective framework and how one may classify a particular factor will very often depend on the subjective criteria the investor has established for himself. Before discussing specific factors as they currently exist in the United States it is necessary to review briefly the political organization of the U.S..

The U.S. is a republic composed of fifty sovereign states. The federal government is a government of limited powers granted to it in the U.S. constitution. The constitution specifically reserves to the states those powers not granted to the federal government.

The constitution also grants certain rights and protections to all citizens regardless of the state in which they reside. Each state, within the limits prescribed by the constitution, is free to enact such laws as it may see fit. In most cases the state legislature has delegated a significant portion of it's powers to political subdivisions within the state. As a result, a complete review of legal factors which may affect a particular transaction, whether real estate or any other type of business activity, must always consider the impact of federal, state and local laws.

Many countries have laws which either restrict or prohibit the right of foreigners to own real property. Such laws are particularly common in developing countries. In the United States however, at the federal level, the government maintains an open door policy. Those restrictions which do exist are relatively narrow and do not ordinarily affect the types of investments sought by the majority of foreign real estate investors. Restrictions primarily exist with respect to the sale or leasing of public lands, that is, lands owned by the United States government. Such lands can ordinarily be sold only to U.S. citizens, aliens who have declared their intention of becoming a U.S. citizen and corporations organized under the laws of the United States or of any state or territory. This last exception makes it possible for a foreign investor to acquire public lands through a U.S. corporation, even if no shareholder is a U.S. citizen. A citizen of a foreign country which does not grant reciprocal rights to U.S. citizens however, can be prohibited from acquiring any direct or indirect interest in public lands. In addition, citizens of certain countries deemed to be enemies of the United States under the Trading with The Enemy Act are expressly prohibited from owning real property. At this writing there are only four countries on this list: North Korea, Cuba, Vietnam and Cambodia. Regulations issued under the International Emergency Economic Powers Act apply similar prohibitions to citizens of Libya.

The story is much different however at the state level. At present over thirty states regulate foreign ownership in some manner. There is a great deal of similarity among the states in how they have sought to impose restrictions. In general, the restrictions limit either the size, type or duration of ownership or some combination of these three factors. No state simply prohibits ownership by foreigners.

California law authorizes every person, whether a citizen or alien, to own real property within the state. Illinois, by contrast, provides that alien owners must dispose of their real property interests no later than six years after acquisition. The state may force the sale of property held beyond this period with the proceeds going to the state by a legal process known as "escheat". Illinois also prohibits alien landlords of farmland from passing on to their tenants, either directly or indirectly, the payment of taxes. In Wisconsin, an alien not resident in some state or territory of the U.S. cannot acquire or hold more than 640 acres, except by devise, inheritance or the collection of debt.

Additional restrictions may exist at the corporate level. Wisconsin, a primary dairy and farm state, prohibits any corporation in which more than 20% of it's stock is owned by a non-resident alien or aliens, from owning more than 640 acres unless acquired by the good faith collection of debt through the judicial process. In addition, corporations and trusts are generally prohibited from owning Wisconsin lands for the purpose of farming. Appendix 1 contains a list of restrictions in each state. While these laws are infrequently amended, it is essential to check that they have remained unchanged when dealing in a specific state.

A number of farm states adopted new laws in the late 1970's which imposed disclosure requirements on foreign owners of agricultural lands. These laws were in response to the widespread belief that foreign investors were buying up vast quantities of prime farmland. While most states affected took the measured response of imposing disclosure requirements so that the problem could be quantified, Wisconsin chose to go further. This is an excellent example of how different states may deal differently with the same issue. It is noteworthy that a private study released in July of 1989 estimated that as of 1989 only approximately 12.5 million acres in forty-nine states or 1% of all U.S. farmlands were owned by foreign investors.

The majority of states which do regulate foreign corporate ownership are less restrictive than Wisconsin. In U.S. legal parlance, a "foreign corporation" is a corporation formed under the laws of some state other than the