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A TAX-EFFICIENT WAY TO ATTRACT MORE NON-PROFIT AND FOREIGN INVESTMENTS

BY PERRY LERNER

As real estate funds in the U.S. face increasingly steep competition for investors, the ability to attract endowments and foreign investors requires much more than gross investment performance.

In my own experience as a board member of two colleges and a cancer research center, the challenge is to address investment returns, volatility, simplicity and risk — investment risk, tax risk and reputation risk. A dollar is a dollar. For endowments, prudent management in terms of net returns determines whether an institution can execute its operational plan — such as the number of financial aid students that a college can serve. Predictability and a preference for smoothing volatility means investing in alternatives, including real estate, which often means exposure to UBIT (Unrelated Business Income Tax).

Insurance dedicated funds and managed accounts (IDFs) — real estate investment funds held in insurance company separate accounts — are emerging as a significantly more cost- and tax-efficient means of investing in U.S. real estate for endowments and foreign investors. They're also easier to administer than corporate blocker structures for the real estate fund.

Take a $120 million RE investment firm looking to raise $5 million to $20 million per investor. Over the last 20 years, the firm used a corporate blocker structure to reduce tax liabilities for endowments and foreign investors under the IRS provisions for UBIT and FIRPTA (Foreign Investment in Real Property), respectively. The most common blocker is a U.S. corporate entity capitalized with equity and debt, which reduces the tax burden by the interest paid or accrued on debt.

But corporate blocker structures can be costly to establish and maintain. Moreover, recent tax legislation limits the deductibility of interest. These structures have always involved a high level of complexity that the new rules will only increase. Also, as certain universities and colleges experienced following the release of the Paradise Papers, these corporate blockers — typically set up in offshore tax havens — create reputation risk.

For the $120 million fund, an insurance solution may be the better option, both in terms of simplicity and tax efficiency. A blocker would likely be around 50% tax efficient, while an IDF could be 100% tax efficient, though would require paying about 40 basis points in fees.

IDFs allow foreign investors and endowments to access U.S. real estate investments without owning them under current Federal and state tax laws. Instead, the group annuity contract investing in the IDF is treated as the owner, and any income and gains are chargeable to the insurance carrier. The carrier can offset any tax liabilities with reserve charges equal to its obligations under the group annuity contract. This generally results in no taxes at the insurance company level. Income and gains can then be reinvested in additional properties without the drag of current taxation.

The main drawback of an IDF is the lack of control — an investor can't tell the fund manager to buy/sell an individual property. For someone who wants to pick up the phone and yell at the fund manager, that could be a deal-breaker, but at least for endowments, it's a straw-man argument. Very few endowments have the internal expertise to make buy/sell decisions in real estate; even Harvard Endowment outsourced its direct RE investments to Bain Capital. And investors can always receive current information on the fund's operations and attend investor meetings.

There's also a diversification requirement for IDFs, but most real estate funds over $75 million will be investing in more real estate parcels than the minimum IDF requirement of five.

The bigger issue preventing greater use of IDFs is that they're perceived as new and different — despite the fact that insurance companies like Prudential have marketed RE funds using this structure for decades. Further the IRS approved of the insurance structure, and has reaffirmed through private letter rulings since the mid-1990s.

Still, because they will seem new and different to most prospective investors, representatives of the real estate fund will have to take the time to make a persuasive case for the structure's benefits to decision makers and other gatekeepers. It could mean a longer selling process, but a senior marketing expert and in-house tax lawyer can work together to educate endowments and foreign investors about IDFs, and create a marketing advantage by offering a simple, tax-efficient solution to real estate investments. In turn, the fund will benefit from a lower administrative burden relative to corporate blocker structures, while still minimizing tax risk.

Simplicity is another priority for these investors. Conventional blocker structures now have to deal with new tax rules, but nothing has changed for IDFs. Endowments and foreign investors are looking for new opportunities to generate returns, and shouldn't turn away from real estate due to tax reasons. The use of group annuity solutions will continue to grow with the demand for efficient investment vehicles for U.S. real estate investments.

Perry Lerner is the co-founder of Crown Global and is focused on the company's strategic planning, product development and institutional relationships.