RCG

# FIRPTA Reform: Key to Reviving Commercial Real Estate

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# Executive Summary

## The Commercial Real Estate Problem

The U.S. economy remains fragile after losing 8.4 million jobs and $12.6 trillion in household net worth since 2007. Many government programs that have stimulated the economy during the nascent recovery period will be phased out through the next year. The commercial real estate industry, which employed 4.9 million workers before the recession in 2007, has been particularly impacted by falling demand from office, retail, industrial and hotel space users and a dearth of investment capital associated with the Great Recession and financial crisis. These impacts have been intensified by the punitive and arcane tax law Foreign Investment in Real Property Tax Act (FIRPTA).

In its current form, FIRPTA penalizes foreign investors in U.S. real estate equity by levying a 35% tax on realized gains. As a result, U.S. real estate is at a prohibitive disadvantage compared with other asset classes and real estate in other countries when competing for foreign investment capital. The U.S. commercial real estate investment market remains impaired, with $1.4 trillion in debt obligations maturing in the next five years. Without attracting foreign capital, continued volatility in market fundamentals will delay the stabilization and recovery within commercial real estate.

## The Benefits of FIRPTA Reform

The Real Estate Roundtable retained Rosen Consulting Group to evaluate the benefits of a reformed FIRPTA tax regime in increasing capital flows in the commercial real estate market, encouraging hiring in many sectors of the economy and stabilizing asset values. Dr. Kenneth T. Rosen is Chairman of Rosen Consulting Group. Dr. Rosen is the leading expert on real estate economics and also Chair of the Fisher Center for Real Estate and Urban Economics at the Haas School of Business at the University of California, Berkeley. The research team reached the following conclusions:

1. An estimated $2.8 trillion of global capital is available for U.S. real estate investment. Putting foreign investment in real estate equity on an equal tax footing with other asset classes will immediately unlock billions of dollars in investible capital into the commercial real estate market. International capital is vital to recapitalizing the $1.4 trillion of mortgage maturities.
2. With more capital available and less burdensome tax liabilities, the resulting increased investment activity would provide support to asset values, reducing the risk of billions of dollars in additional losses.
3. With 14.9 million Americans still unemployed, FIRPTA reform will stimulate hiring in the wide variety of industries connected with commercial real estate, including sales, financing, operations, construction, and even the public sector.
4. Increased capital flows and enhanced liquidity will stem the erosion in commercial real estate asset values. Stabilizing these assets greatly reduces the risk of both government and taxpayer loss as well as the risk of bank failures.
5. Several hundred billion dollars worth of souring commercial real estate loans are on the books of smaller regional and community banks. Improving capital flows and stabilizing these assets would shore up these institutions, which are the primary source of funding for small business activity. Small businesses expand payrolls before large companies during economic recovery periods.

## Conclusions

FIRPTA hurts the millions of Americans whose livelihoods depend on the health of the commercial real estate market. By constraining the inflow of foreign capital, FIRPTA is not only costing jobs and undermining the commercial real estate markets but is also reducing local and federal government tax revenue. In order to assist in job creation and stimulate the recovery of the U.S. economy, FIRPTA should be reformed immediately.

## Introduction

The U.S. economy remains fragile, despite the statistical recovery that has become apparent since 2009. The consumer sector, which accounts for approximately 70% of the U.S. economy, is still suffering from millions of lost jobs, depressed home values, income pressures and the erosion of $12.6 trillion in household net worth. In addition, the commercial real estate industry in particular, which directly employed 4.9 million workers in the United States before the recession in 2007, has been impacted by the Great Recession and tumultuous financial markets through deep asset value declines and a damaging contraction in overall demand. These negative effects have been intensified by the punitive and arcane Foreign Investment in Real Property Tax Act (FIRPTA) by discouraging foreign investment in domestic real estate.

Enacting FIRPTA reform would positively impact the U.S. economy almost immediately and strengthen the nascent recovery by encouraging the flow of investment dollars to the capital-starved commercial property market. Lawmakers have the ability to level the playing field through equitable tax treatment of foreign investment into commercial real estate, potentially turning the trickle of foreign capital into a flood of potentially hundreds of billions of new investment dollars in a relatively short period of time. Rosen Consulting Group estimates the magnitude of capital available for U.S. real estate investment ranges near $2.8 trillion globally, a significant portion of which is currently waiting on the sidelines for stabilized markets and attractive investments. Should Congress choose to reform FIRPTA, investors around the world would receive the clear, unified signal that the U.S. government seeks to encourage inward foreign investment, rather than restrict it, as FIRPTA effectively does in its current form.

While there has been international interest in U.S. real estate assets for many years, FIRPTA discourages international investors from placing capital in U.S. real estate by levying additional taxes on equity investment that do not apply to other asset classes. With the less prohibitive tax burden and simpler regulatory obligations that would follow FIRPTA reform, foreign investors would be more inclined to invest in U.S. real estate assets. Moreover, switching to a capital gains tax regime for real estate equity transfers would bring with it the dual benefit of both tax savings and a downward adjustment in investors' required rates of return for suitable transactions. Proceeds from these tax savings would likely be reinvested in U.S. real estate, and the depth and breadth of properties within the required returns threshold would expand greatly.

At present, the investment market for commercial properties is still highly illiquid in the aftermath of the recent financial crisis. Total commercial property investment volume dropped to $51.8 billion in 2009, from $520.5 billion in 2007. As market fundamentals begin to stabilize, attracting outside investment capital will be instrumental in returning to a functioning property market. The growth in capital available for U.S. real estate investment would fuel an increase in transactions, particularly now that assets may be priced at a relative discount compared with recent years when valuations swelled alongside unrealistic expectations. Of the several benefits that increased transactions will bring, liquidity will be restored in the market and asset values should stabilize and begin to recover.

The jobs market would also benefit from FIRPTA reform. In addition to increasing property transactions, improved capital flows would stimulate the many sectors of the economy associated with the commercial real estate industry, including construction, sales, and building operations, as well as the indirect jobs supported by the spending of related wages. Furthermore, a rise in capital flows would mitigate any negative effects of the impending capital gap in the commercial real estate debt market, as $1.4 trillion of commercial mortgages mature by 2014. Addressing the capital gap would have a disproportionate benefit on local and regional banks, which hold a majority of the souring commercial mortgages. These financial institutions are primary sources of funding for small businesses, a sector of the economy that has yet to benefit appreciably from thawing capital markets. Small businesses, moreover, have traditionally been the source of job creation during economic recovery periods in the past. Ensuring stability among small banks is a timely and efficient policy response to supporting and growing the jobs market, which, given the depth of the Great Recession and the 8.4 million jobs lost since the onset of the downturn, is of utmost importance in the current environment.

## FIRPTA Discourages Foreign Investment into U.S. Real Estate

Whereas profits realized by foreign investors from securities and personal property transactions are typically not taxed by the United States, gains from real property transactions are taxed at the same rate that applies to domestic tax payers. Profits from foreign investment in domestic real estate are also usually subject to Effectively Connected Income (ECI) taxes in the United States as well as taxes in the investor's home country, resulting in an effective tax rate that frequently reaches as high as 54.5%.

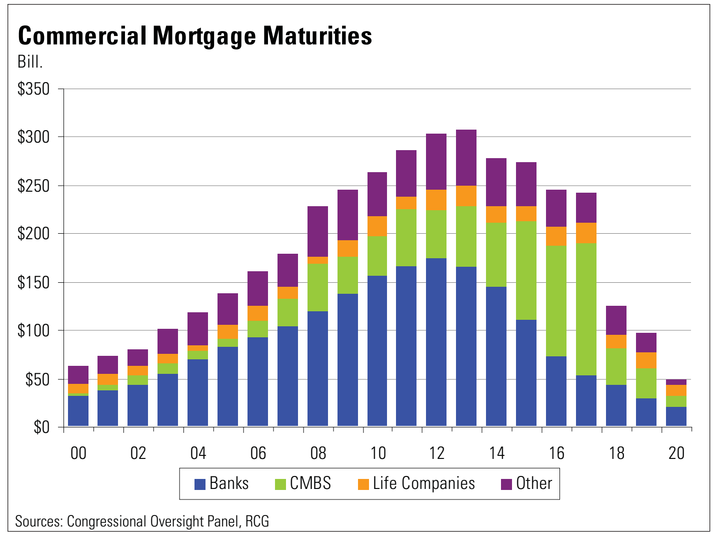
In addition to higher taxes, FIRPTA's complex rules generate additional costs for non-U.S. investors by requiring thorough, recurring analyses to determine applicability. Additionally, retroactive rules could in some cases cause the application of FIRPTA taxation even in the absence of a current real property interest in a real property holding corporation. Furthermore, FIRPTA rules pertain only to capital gains and do not allow for capital losses, while the IRS does not impose this penalty on other U.S. asset classes. The net effect of FIRPTA is to place U.S. real estate at a prohibitive disadvantage when competing for foreign investment capital.

FIRPTA reform would raise the overall attractiveness of U.S. real estate investment at a time when capital is desperately needed. While there is strong foreign interest in U.S. real estate assets, particularly for portfolio diversification and stability reasons, many foreign investors cite the increased tax burden and red tape as deterrents to investment. Addressing these deterrents would correct the inequitable tax treatment of foreign equity investment in U.S. real estate and encourage the flow of additional capital to domestic assets. Under a relaxed or repealed FIRPTA regime, the magnitude of capital that would be made available for U.S. real estate investment would grow immensely.

### *Commercial real estate investment activity has dried up*

The withdrawal of available capital and weakening market fundamentals sent commercial real estate transaction activity down dramatically starting in 2008. Market volatility and valuation uncertainty has continued to discourage sellers of non-distressed properties from risking to sell at a potential loss, while buyers were focused on investing in opportunistic distressed properties through 2009. At the same time, the increasing prevalence of distressed properties reflects the extent of falling values and weakened fundamentals. The total volume of U.S. commercial property transactions peaked in 2007 at $520.5 billion before tumbling to $132.7 billion 2008, according to Real Capital Analytics. In 2009, just $51.8 billion of properties were sold.

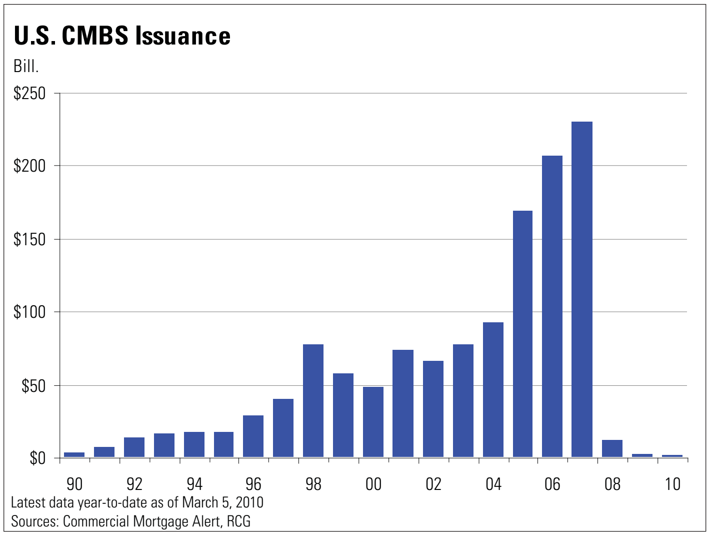
Despite the widespread turmoil in U.S. commercial real estate during the past two years, international buyers have proven somewhat resilient, by certain measures relative to domestic investors, potentially indicating their preference for the long-term strength and stability of U.S. real estate assets. Cross-border investors comprised $4.0 billion of acquisitions in 2009 or 8.1% of total investment, up from 7.5% in 2008 and 6.0% in 2007. Nevertheless, total investment volume was much less in 2009 than in recent years, and the near-term outlook for cross-border investment flows remains unclear. Many domestic investors are sidelined while market fundamentals remain volatile and distressed properties are worked through the system. Foreign investors are following a similar pattern with one key difference. While the barriers to entry for domestic investment capital remain on risk associated with market fundamentals, foreign investors have the additional burden of FIRPTA tax penalties impacting investment flows.

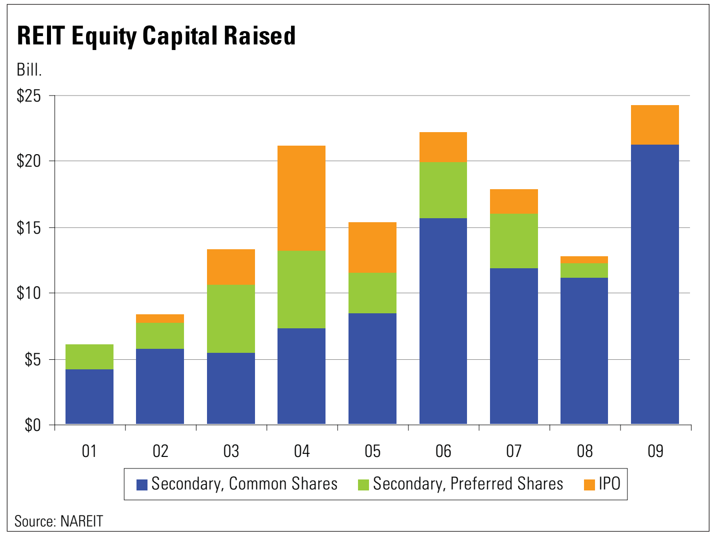



### *Existing sources of capital are not adequate to meet growing refinancing demand*

Deteriorating fundamentals and tight credit conditions in the U.S. commercial real estate market have created a seemingly insurmountable gap in refinancing loans on billions of dollars in assets. With values depressed and limitations on allowable leverage, refinancing commercial mortgage debts will be challenging in the next several years. An estimated $1.4 trillion of commercial mortgages will mature before 2014, according to the Congressional Oversight Panel, a significant portion of the $3.4 trillion in total outstanding debt. Fresh capital investment is needed in the short-term to avert the severe repercussions on the stability of the commercial real estate industry should these mortgage defaults continue to rise. Existing sources of capital, however, including the secondary mortgage market, banks, REITs, institutional funds and GSEs, will prove inadequate compared with the massive refinancing demand that will arise in the near future. A failure to meet this refinancing demand spells rising mortgage default rates, heavy credit losses at small- and medium-sized banks and continued constraints on lending activity by financial institutions across the country. The risk of spiraling commercial mortgage defaults threatens the U.S. economy on many fronts.

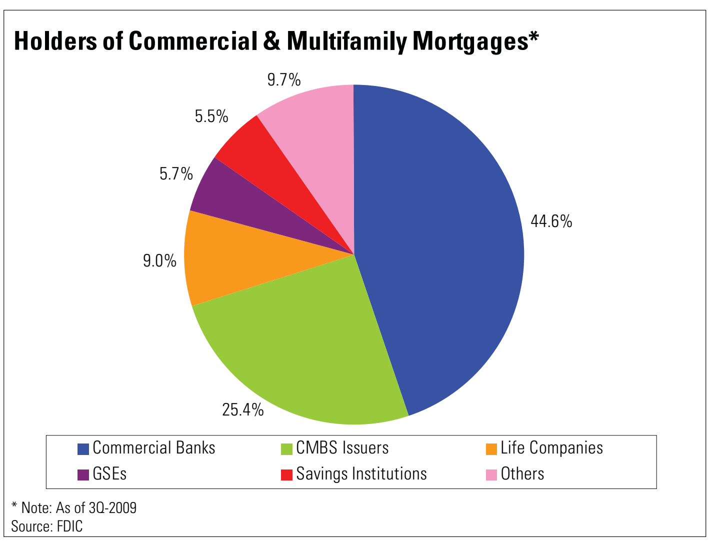
Before the financial crisis, the commercial mortgage-backed securities (CMBS) market had been a primary source for liquidity in the commercial mortgage market by giving mortgage issuers access to fresh capital on a continual basis and from a wider variety of sources, including smaller investors. An average of $202.2 billion in new CMBS were issued annually between 2005 and 2007, the peak years of issuance. Annual issuance fell to $12.1 billion in 2008 and $3.0 billion in 2009. Despite government stimulus in the form of the Term Asset-Backed Lending Facility (TALF) and thawing credit markets, securitization activity is not likely to ramp up to levels seen during the boom period because underwriting should remain relatively cautious through the next several years. Furthermore, the TALF CMBS program has had only a minimal impact on commercial real estate so far, with operations totaling just $17.4 billion in 2009. Nearly all




of the loans secured through the program were for legacy CMBS. The only new issuance was $72.2 million requested in the November facility as part of Developers Diversified Realty Corporation's $400 million new issue. The TALF program is scheduled to end on March 31st for legacy CMBS and on June 30, 2010 for newly issued CMBS, and given the low volume so far, it is unlikely to have a significant impact on the CMBS market by its conclusion.

Commercial banks and savings institutions represent another significant source of capital in the commercial mortgage market. Collectively, FDIC-insured commercial banks and savings institutions held more than $1.8 trillion in commercial real estate loans on their books as of the fourth quarter of 2009, compared with total assets of $13.1 trillion. The Pension Real Estate Association's (PREA) tally places the total commercial and multifamily mortgages held by commercial banks and savings institutions at more than $1.7 trillion. Given that many commercial banks, particularly those with a regional focus and a relatively small asset base, are heavily exposed to souring commercial real estate loans, capital contributions from this sector should shrink during the coming years.




Real Estate Investment Trusts (REITs) provide an additional source of capital in the commercial real estate market. According to the National Association of Real Estate Investment Trusts (NAREIT), the public REIT sector attracted more than $24 billion in equity capital in 2009, much of which was committed to deleveraging REITs' portfolios. Secondary offerings accounted for the lion's share of equity raised in 2009. The $21.2 billion in total secondary equity raised, including both common and preferred shares, is the largest annual total since NAREIT began tracking data in 2001. Many in the REIT industry point to this reopening of the capital markets as a key development in ensuring the survival of public REITs in general.

In addition, there is some indication of investor demand for troubled commercial real estate debt. During the summer months of 2009, more than a dozen mortgage REITs (i.e., REITs focused on investments in mortgage loans and/or securities backed by mortgage loans) and mortgage-focused investment partnerships sought to go public, representing a proposed total amount of capital to be raised at $5.8 billion. Given that many of the offerings were only completed after cutting the total amount of shares by drastic amounts and that share prices are generally down relative to their IPO pricing, investor appetite in these risky ventures appears to be limited.

Life insurers, pension funds, endowment funds and other institutional investors are significant investors in commercial real estate debt as well. According to the latest available data from PREA, life companies held $310.1 billion in commercial and multifamily mortgage loans as of the third quarter of 2009. These investors typically have a lower risk appetite than other private investors and generally hold mortgages to maturity, setting them apart from others in terms of underwriting practices and investment horizons. Unlocking additional capital from institutional investors will be difficult in the current environment. Fund-specific asset allocation requirements dictate how much capital a particular investment fund can contribute to a particular class of assets. The drop in value of institutional equity and bond holdings from 2007 to 2009 forced the sell-off of a portion of institutional investors' real estate portfolios in order to comply with these requirements, a phenomenon dubbed the "denominator effect." The subsequent rise in share prices after March of 2009 means institutional investors may draw back current offerings or acquire some assets, though any net increase in overall liquidity will not be significant.

The Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA) comprise a relatively small yet important source of capital for commercial real estate. The two former-government sponsored entities held $197.4 billion in commercial and multifamily mortgage loans as of the third quarter of 2009, according to PREA. However, their commercial real estate investment activities are generally isolated to the multifamily property mortgage market, and thus their lending is of little direct consequence to other commercial real estate asset classes, which are most in need of liquidity. Nevertheless, growth of their mortgage portfolios have outpaced all other investor classes since 2006, providing much-needed liquidity to the multifamily market at a time when other lenders became increasingly unwilling to participate in the secondary mortgage market.

Although these domestic commercial real estate investors currently hold a significant portfolio of equity and debt instruments, they are reigning in exposure to real estate. New commercial mortgage issuance already fell, a point illustrated by the Mortgage Bankers Association (MBA) Originations Index. The base index value of 100 is the average of the four quarters of 2001, prior to the start of the commercial real estate boom. After peaking at more than 350 in the second quarter of 2007, the index plunged, hitting a low of 40 in the first quarter of 2009 and increasing only slightly during the next two quarters. The index underscores that origination activity has fallen not just from liquidity-fueled peak levels during the middle of the decade, but from lower levels in 2001 prior to the run-up in transaction volume and prices.

## *FIRPTA reform will improve capital flows to U.S. real estate*

The universe of funds available for U.S. real estate investment is immense, though a significant portion has not been available for placement in the United States because of FIRPTA's heavy tax burden and complex applicability rules. Including non-U.S. pension funds, sovereign wealth funds, high net worth investors, private equity real estate funds and REITs, there is a cumulative nearly $7.1 trillion available for real estate investment based on current funds earmarked for this use and a 10% allocation for sovereign wealth funds, based on the similar long-term strategies of pension funds. This is a rather conservative estimate, since it does not take into account several potential sources of global real estate capital, including international insurance companies and banks, for which there is little available data. Assuming that non-U.S. investors desire to have at least 40% of allocated real estate funds invested in the United States, foreign capital for U.S. real estate investment would total more than $2.8 trillion. Again, this estimate is conservative as Association of Foreign Investors in Real Estate (AFIRE) members indicated they have 48% of assets invested in the United States already and wish to acquire more U.S. properties in the future.

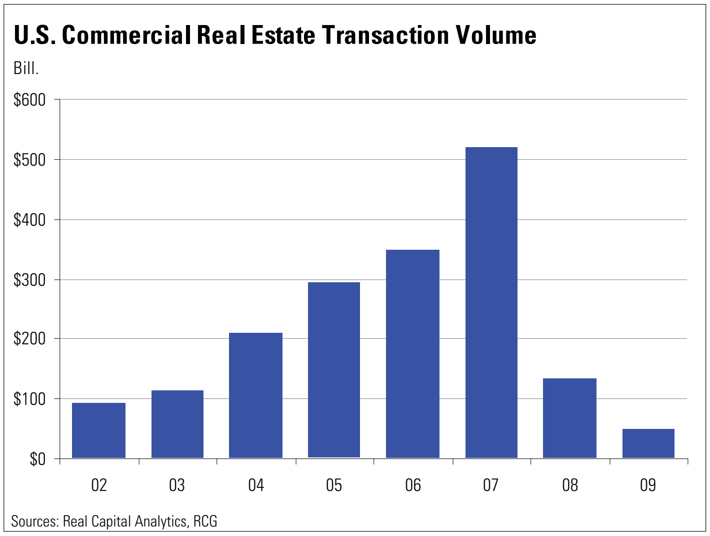
A reformed FIRPTA regime would increase capital flows into U.S. real estate on two fronts: reinvested tax savings and a fundamental shift in foreign investors' allocation of global real estate capital. The first relies upon a shift to withholding tax on real estate equity transactions according to a structure analogous to capital gains, away from the multiple layers of tax liabilities within FIRPTA's current regime. Because most investors typically allocate capital to certain asset classes based on a preset structure, the savings realized on a shift to a 15% capital gains tax from the 35% FIRPTA tax would be reinvested into U.S. real estate, increasing overall capital flows in the market. For example, a foreign investor that wishes to liquidate a U.S. real estate portfolio and realize gross gains of $100 million would theoretically set aside 35%, or $35 million, for the FIRPTA tax liability alone. With a 15% capital gains tax, on the other hand, the investor would set aside only $15 million for tax purposes, thereby freeing up another $20 million for immediate direct investment into the market.

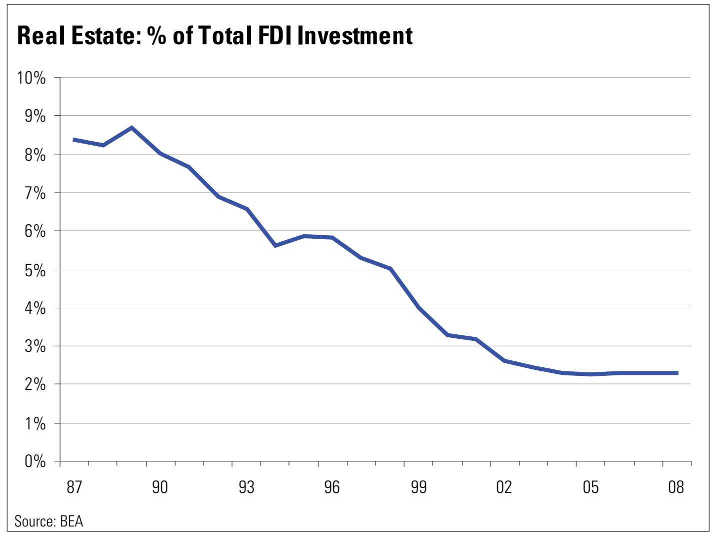
FIRPTA reform would also send a resounding and unified signal to global investors that the U.S. government is encouraging inward foreign investment into commercial real estate, after implicitly discouraging it for 30 years. Removing the punitive tax burden imposed by FIRPTA, on one hand, would increase foreign equity investment in U.S. real estate by encouraging investors to allocate additional portions of investible funds into U.S. real estate. On the other, FIRPTA reform could attract new investors to the market that had previously been discouraged by the United States' heavy tax burdens. We expect that the importance and impact of such a shift would be difficult to overstate.

## *Commercial property transactions will increase with FIRPTA reform*

Rising capital flows realized from FIRPTA reform would increase the amount of commercial property transactions in the market. Strong demand already exists for investible U.S. real estate assets for their relatively stable risk-adjusted returns in the long run and for portfolio diversification benefits. All other factors equal, a lighter tax burden would encourage additional investment in U.S. real estate. The lower required rate of return resulting from a decreased marginal tax rate would grant investors a wider selection of properties that qualify as suitable investments.

Reforming FIRPTA is a timely policy response to the current turmoil facing the commercial real estate market. The recent freefall in U.S. commercial real estate property values and continued rise in




distressed commercial assets provide international investors with a growing number of opportunities to enter the market at a relative discount. Global investors still perceive the United States as a haven for stability, and in fact, falling prices of commercial real estate during the past two years have made high quality properties in core markets attractive acquisition targets at favorable pricing. With additional capital for investment unlocked by FIRPTA reform, investors would be able to pursue such investment opportunities with greater frequency.

A larger base of potential buyers, moreover, would encourage owners to offer properties for sale. Without a compelling financial reason to sell (e.g., imminent default), owners are simply holding their properties off the market, since they were unwilling to sell at the prevailing price levels that were heavily skewed down from the many sales of distressed properties. Even though market fundamentals should stabilize through the next several years, it is unclear when investors will return in the market to a level that supports favorable pricing. Promoting inward foreign investment and unlocking additional capital from global real estate funds would accelerate this process by attracting international investors to the commercial real estate investment market.

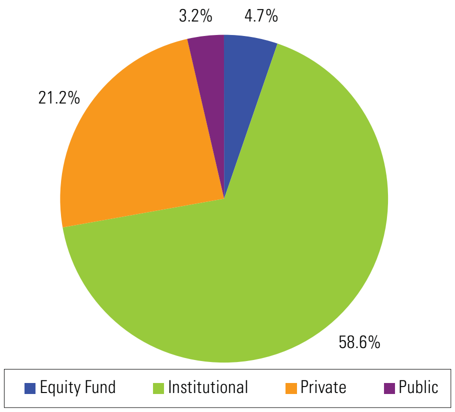
## *FIRPTA reform would encourage investment from many international players*

The resulting rise in U.S. real estate investment transactions would provide additional sources of capital to existing equity and debt holders, improving the market's liquidity and stability, as well as allowing some owners to avoid foreclosure. Equity positions in REITs, joint ventures, or direct real estate acquisitions would directly benefit from a reduction in the tax burden placed on international investors by FIRPTA, while all stakeholders in U.S. commercial real estate would benefit from the market's increased liquidity and stability.

Foreign direct investment (FDI) position in the United States for all countries, which includes both equity positions and outstanding debt, totaled $2.3 trillion in 2008 and $2.1 trillion at year-end 2007 on a historical cost basis, according to the Bureau of Economic Analysis. Non-U.S. investments in real estate and rental and leasing-related assets totaled $52.0 billion in 2008 and $48.5 billion in 2007 or approximately 2.2% of total foreign direct investment in both years. In comparison to recent decades, the share of real estate-related investments as a percentage of total foreign investment positions has slipped during this time, from 5.0% of all investment positions in 1998, and 8.2% in 1988. At its most recent peak, the inflow of foreign direct investment in the form of equity capital to assets in real estate-related industries reached $6.3 billion or 2.3% of FDI equity capital inflows in 2007. Approximately $3.7 billion or more than 50% of this amount originated from Asian investors.

Reforming FIRPTA would unlock vast amounts of capital from a variety of sources, leading to a net increase in FDI. Cross-border investment has been dominated by institutional investors, such as sovereign wealth funds (SWFs), pension funds, insurance companies, and foreign banks. In 2009, institutional investors accounted for $2.4 billion or 58.6% of total cross-border U.S. commercial real estate acquisitions, according to Real Capital Analytics. Private investors accounted for the second-largest amount invested during 2009, with $859 million or 21.2% of total cross-border investments. Private buyers include high-net worth individuals and families, as well as non-traded REITs. Non-institutional private equity firms purchased only $192 million worth of U.S. properties or 4.7% of total cross-border acquisitions. Equity funds recorded the greatest decline in transaction volume, as nearly $1.9 billion were purchased in 2008. Foreign public buyers, such as REITs and listed funds, purchased $129 million worth of U.S. commercial real estate in 2009 for 3.2% of total cross-border acquisitions. Public buyers also sharply curtailed purchases during 2009. Owner-users and unknown purchasers accounted for the rest of cross-border transaction activity. The reform of FIRPTA will stimulate the amount of deployable capital for U.S. commercial real estate across foreign capital sources, many of which are rapidly growing in new geographies.

**Cross-Border Transactions by Investor Type- 2009**




Sources: Real Capital Analytics, RCG

**Foreign Investment in U.S. Real Estate (in billions)**

| Buyer Origin | 2007 | 2008 | 2009 |
|---|---|---|---|
| Australia | $10.4 | $0.2 | $0.0 |
| Germany | $2.6 | $1.7 | $0.9 |
| Canada | $6.9 | $0.6 | $0.1 |
| United Kingdom | $3.1 | $0.4 | $0.2 |
| Israel | $2.6 | $0.6 | $0.0 |
| Japan | $0.9 | $0.8 | $0.0 |
| Hong Kong | $0.1 | $0.0 | $0.1 |
| Asia | $0.6 | $0.2 | $0.3 |
| Europe | $2.5 | $1.3 | $0.2 |
| MidEast | $2.9 | $5.9 | $0.1 |
| Americas | $0.0 | $0.1 | $0.0 |
| Ireland | $0.9 | $0.5 | $0.0 |

Source: AFIRE

The source of foreign investment capital evolved in recent years with the entrance of new countries and institutions. A greater proportion of investment in U.S. real estate has come from Asia, with buyers from Hong Kong, Singapore, Korea, and China making major purchases in recent quarters. In contrast with most other countries and continents, Asian investors (excluding Japan) increased their investment in U.S. real estate from 2008 to 2009, as reflected by the table below. This shift reflects a growing pool of potential investors interested in purchasing U.S. real property, who could be further inclined to do so after FIRPTA reform. In addition to geographical differences, the types of buyers have also changed, with a rising share of real estate transactions involving high-net worth, entrepreneurial investors in addition to traditional players in the market. Sovereign wealth funds (SWF) and private equity real estate funds have also been rapidly growing, and constitute a major source of future growth for the U.S. commercial real estate market.

### *Global institutional investors dominate real estate investment market*

Despite the rise in proportion of private investors, foreign institutional funds remain a dominant global player in the U.S. real estate investment market. Global pension funds already hold a significant amount of commercial property in their portfolios and real estate allocations are growing. According to a study by PREA based on Organisation for Economic Co-operation and Development (OECD) data, pension funds outside of the United States held nearly $516 billion of global commercial real estate assets as of 2009, including holdings in their home countries. Average real estate allocations ranged from less than 1% (e.g., Belgium, Hungary) to 15% (e.g., Switzerland). Of the countries that allocated some portion of their pension funds for commercial real estate, their average current allocation was 6.9% in 2008. Many pension funds have target allocations of more than this level, representing untapped funds which could be invested in U.S. real estate, particularly if the FIRPTA tax burden was removed. In the United States, PREA members had an average of 9.6% of their portfolios invested in real estate in 2009, for example. One of the largest pension funds in the country, CalPERS, had $13.8 billion, or approximately 6.7% of its total fund, invested in real estate. Its target allocation to real estate, defined in June 2009, was 10%. We expect allocations to real estate to increase worldwide, as pension funds seek to diversify their portfolios both by asset class and by geography. The reform or repeal of FIRPTA would increase the use of U.S. real estate assets for this purpose, thereby expanding on a large source of global capital. Similar logic follows for insurance companies and other established institutional players. Many foreign institutional investors have indicated a desire to increase U.S. real estate investment volume; however, the tax burden, the related cost of compliance and the inability to offset losses provide ample barriers to entry in many cases.

In addition to increasing real estate allocations for traditional institutional investors, sovereigns, particularly in emerging economies, will be a source of dramatic growth for the U.S. commercial real estate market if FIRPTA is reformed. The BRIC nations (Brazil, Russia, India and China) have seen their respective trade surpluses grow sharply in recent years and have formed SWFs to manage this excess capital, except for India, which has an SWF in the planning stages. With an estimated $3.8 trillion in assets under management as of December 2009, according to the Sovereign Wealth Fund Institute, SWFs are currently smaller in comparison to some other institutional players; however, they are growing quickly. This rapid growth will lead these institutions to play a more prominent role in the global investment market going forward. Moreover, greater asset allocations to U.S. real estate by SWFs, as would occur with the reform of FIRPTA, would provide a new, and much needed, source of liquidity to the U.S. real estate market. Since 2006, 14 new SWFs were established with estimated holdings of more than $608 billion as of December 2009. One specific example of the rapid growth and impact of SWFs on U.S. real estate, the $300 billion China Investment Corporation plans to increase its investment in U.S. real estate, particularly distressed assets. This SWF is also reported to potentially receive another $200 billion in funds from the country's foreign reserves.

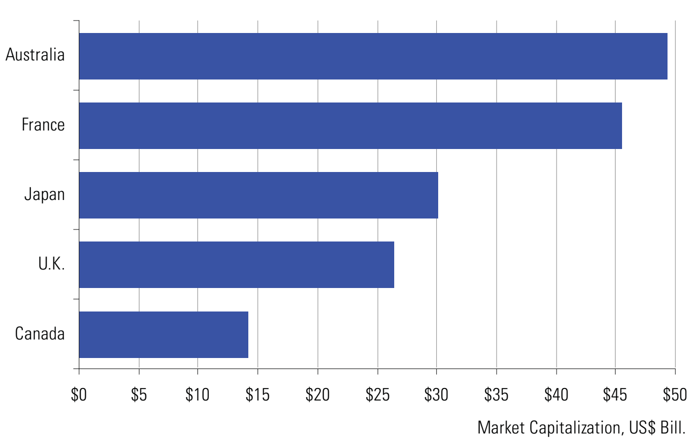
This growing interest in U.S. commercial real estate, coupled with the rapid growth of SWF assets, indicates massive potential growth in the universe of funds for U.S. real property investment, which would grow even larger with the reform of FIRPTA.

Looking forward, the strong growth in emerging economies following the global recession will surely expand deployable capital for many SWFs and other non-U.S. investment funds. In fact, many emerging economies have already started to recover ahead of the United States, and FIRPTA reform could encourage greater capital inflows from these nations when the U.S. commercial real estate market needs it most. And, as other developing nations continue to build wealth in the coming decade, we expect both the number of funds, as well as the volume of deployable capital, to increase.

### *High net worth investors are attracted to U.S. real estate*

Private buyers, such as high net-worth families and individuals, have traditionally been active buyers of real estate assets, which are viewed as stable, tangible investments, particularly when located in the United States. A 2009 report by Merrill Lynch and Capgemini indicated that global real estate assets held by high net-worth investors grew to $5.9 trillion in 2008 from $2.9 trillion in 2003. This increase in the volume of real estate holdings corresponded with higher real estate allocations, which grew from 17% of holdings in 2003 to 18% of holdings in 2008. According to a survey performed by the Wharton Global Family Alliance, which tracks investment trends among high net-worth family investment offices, the average real estate allocation for wealthy families in North and South America grew from approximately 4% in 2007 to approximately 7% in 2009. European family investment offices reported higher real estate allocations, with approximately 13% in 2007 and 17% in 2009. Additionally, anecdotal evidence from a major private bank indicated that high net-worth clients held approximately 7% of assets in real estate; however, their target allocation is in the range of 10% to 15%, with a goal of approximately half of all real estate assets located in the United States should the tax environment be relaxed.

**Largest Foreign REIT Markets**




Sources: EPRA, RCG

Although the diversification and stability benefits of U.S. commercial real estate are in demand, the punitive tax burden and other restrictions placed on foreign investors by FIRPTA discourages potential investors so that real demand for these assets is never realized. Private buyers will continue to be a strong source of investment in commercial real estate and the reform of FIRPTA would lead to a higher proportion of real estate funds invested in the United States. According to some industry participants, the repeal or reform of FIRPTA could result in investment increasing by two- or three-fold compared with what is planned in the current tax environment.

### *Private equity real estate funds are a growing source of capital*

Private equity real estate funds have also been on the rise throughout the world. According to London-based research firm Preqin Ltd., in October of 2009, there were 363 funds worldwide with an aggregate target allocation of $178 billion. In 2009, private equity real estate funds garnered $40.6 billion in fundraising, with $21.4 billion allocated primarily toward investment in North America. In aggregate, real estate funds based in North America claimed 53% of aggregate private equity funds in 2009, although this high proportion is less than the 54% recorded in 2008. Additionally, private equity real estate investors indicated a rising preference for debt investments, with 36% interested in the debt market in the fourth quarter of 2009, up from 14% at year-end 2008. With more than $83 billion in private equity capital deployed elsewhere in the world and more capital raised regularly, the expanding universe of global private equity real estate funds should be a growing source of potential future investment in U.S. real property, signaling the potential for FIRPTA reform to open up more equity investment. However, as it stands, the costs unfairly levied on foreign investors are discouraging many new funds from entering the domestic market.

### *International REITs may be an untapped capital resource*

Foreign-based REITs represent a potentially large, and in some cases, untapped source of direct capital investment in U.S. commercial real estate. Investment in U.S. commercial real estate assets offers non-U.S. REITs the important strategic benefit of geographic and asset class diversification. In the case of investing in U.S. REITs, this can be done with a single security. In addition, shares of a REIT are much easier to transfer than real property assets, minimizing liquidity risk. FIRPTA's cumbersome tax liability on foreign REITs represents a significant barrier to entry for a massive base of investment capital into U.S. commercial real estate assets.

The European Public Real Estate Association (ERPA) estimated that non-U.S. REITs worldwide were worth $214.5 billion as of mid-2009, based on total market capitalization. Most countries with tax structures similar to U.S. REITs allow foreign investment into U.S. real estate in some form, and most allow unrestricted investment into real property, U.S.-based REITs, and various other forms of real estate-backed securities. However, some countries place restrictions on the proportional allocation of foreign investment and also the investment classes allowed. Nonetheless, we estimate that approximately 99.7% of the non-U.S. REIT capital is legally investable into U.S. real estate assets.

The U.S. commercial real estate market, and indeed the country as a whole, stands to strongly gain from FIRPTA reform at the present time. Several of the largest national economies in the world have either recently implemented new laws allowing REIT-like entities to exist and/or have relaxed regulations to promote cross-border investment. Japan is a prime example. Japan's REIT market was valued at $30.1 billion in mid-2009 — the fourth largest in the world behind the United States, Australia and France. In May 2008, Japanese REITs (J-REITs) were granted the ability to directly invest in foreign real estate assets. Even though investment activity has been slow since these regulations were amended due to the global recession, the improving market conditions in the United States and around the world in the coming years mean portfolio managers of J-REITs will be looking overseas for new investment opportunities. In addition to attracting capital from J-REITs, alleviating FIRPTA requirements will attract investment capital from REITs in other major countries including Germany, Spain, Philippines and Dubai, among others.

Many global REITs are reluctant to invest outside their home country despite the strategic advantages of doing so. Ernst & Young estimated that just 27.1% of the REITs around the world were engaged in some degree of offshore investment activity in 2008. Restrictive legislation governing outside foreign investment (e.g., FIRPTA) is one of the major factors that prevent robust cross-board capital flows. The cost of compliance and elevated tax liability causes many REIT funds to eschew U.S. real estate investment in spite of its benefits. Being that REIT structures attract investors sensitive to tax liabilities, relaxing FIRTPA regulations would break down this major roadblock to foreign investment into U.S. commercial real estate.

Currently, non-U.S. investment funds face the same issues as domestic investment funds: falling asset values and commodity prices, resulting in smaller amounts of deployable capital. With foreign investors' appetite for stabilized properties in established markets, the demand for access to U.S. real property will remain robust despite current turmoil and rising opportunities in international office markets. From 2005 to 2009, AFIRE members showed a sustained confidence in the United States as the country that provides the most stable and secure real estate investment by a wide margin. This confidence in the U.S. real estate market will likely continue into the future, guaranteeing the position of U.S. commercial real estate as a premier asset class.

### *Influx of new capital brings positive impacts*

FIRPTA reform will increase the universe of potential capital for U.S. real estate investment. With trillions of dollars in real estate-allocated capital cumulatively, global funds will be much more likely to enter or expand in the U.S. real property market once the playing field is leveled with respect to tax liability for international investors.

Global financial markets are still working through the aftereffects of the recession and investors remain cautious with their capital, particularly when dealing with real estate assets. International investors are attracted by the safe haven provided by U.S. real estate and take advantage of low pricing following the steep decline in values during the last two years; however, the additional financial and compliance burdens placed on equity investments by FIRPTA results in fewer attractive acquisition targets, particularly given the currently cautious attitude toward underwriting standards and revenue projections. Reform of FIRPTA would open the U.S. real estate market to an increasingly large pool of global capital, driven by rapid growth of sovereign wealth funds, private equity real estate funds and international REITs. This new capital would increase liquidity, stabilize market conditions and bolster confidence in the commercial real estate market.

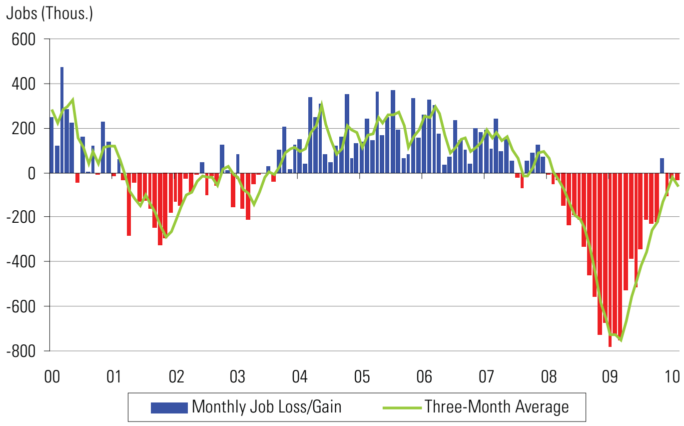
## Positive Impact on Jobs

The benefits of FIRPTA reform extend beyond the resulting increase in capital flows. The commercial real estate market will improve as investment activity picks up, in turn stimulating the job market. Given the intense current need for hiring in the U.S. economy, the effect that increased capital flows would have on the job market is one of the most important reasons that FIRPTA should be reformed immediately.

### *FIRPTA reform will generate much-needed jobs*

The reform of FIRPTA will create jobs at a time when a record number of Americans are unemployed and the country is desperately in need of payroll expansion. In 2009, 4.7 million jobs were cut. In February, total non-farm payrolls declined by 2.5% year-over-year, reflecting the loss of 36,000 jobs during the month, , down from a peak of 779,000 jobs eliminated in January of 2009. Although layoffs are beginning to ease, little job creation is occurring, signaling a slow national recovery in the absence of major engines of employment growth. In total, 8.4 million jobs were cut from the peak in December 2007 to the most recent trough in February 2010, leaving a huge gap in employment without job creation. Accordingly, measures to protect and create jobs are of particular importance in the current economic environment. Reforming FIRPTA will accomplish this goal by stimulating hiring in the wide variety of industries connected with commercial real estate transactions, operations and construction.

**U.S. Employment Growth**




Note: Latest data through Feb-10
Sources: BLS, RCG

Even with fewer job losses anticipated in the coming months, unemployment will remain high. In order for the economy to fully recover, strong job creation across multiple sectors is critical. Whereas the clean tech, biotech, and high-technology industries will lead the recovery in hiring, the worst-hit segments of the economy, such as those related to residential and commercial real estate, will be the slowest to turn around. According to the most recent available data from the National Association of Industrial and Office Properties (NAIOP), the overall commercial real estate industry employed the equivalent of 4.9 million full-time workers in 2007, contributing to $170.1 billion in personal income. Since then, payrolls contracted, creating a void in employment that could be at least partially filled by stimulating investment activity. However, it is difficult to ascertain exactly how many jobs were lost as a result of the downturn in commercial real estate because related sector employment overlaps with other industries. Even as other segments of the economy begin to recover, in the absence of investment activity, commercial real estate-related employment will continue to contract through the short term, as the number of distressed properties grows and market fundamentals remain weak. Although some of these jobs will come back as the market stabilizes through the medium term, it is uncertain how many will be created, especially in the absence of external catalysts to stimulate investment activity.

During previous recessions, the drop-off in commercial real estate investment corresponded with job losses as well. Real estate rental and leasing employment, which is a subset of the financial activities sector and a proxy for overall commercial real estate-related employment, fell during the last major real estate recession in the early 1990s. From the peak in real estate rental and leasing employment in May 1990 to the trough in September 1991, payrolls declined by 1.9%, reflecting the loss of 30,500 jobs. In the current downturn, losses were more severe, with sector employment falling 10.2% from the peak in June 2006 to the most recent trough in February 2010, shedding 223,000 jobs. As this sector is just one component of commercial real estate-related employment, total losses have been much higher. In the non-residential construction sector, for

**U.S. Non-Farm Payroll Employment**

*Feb/Feb (Thousands, SA)

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Non-Farm | 130,532 | 132,485 | 130,723 | 130,183 | 130,270 | 132,317 | 134,813 | 136,873 | 137,951 | 134,328 | 129,547 | 129,526 |
| *% Change* | *2.5%* | *1.5%* | *-1.3%* | *-0.4%* | *0.1%* | *1.6%* | *1.9%* | *1.5%* | *0.8%* | *-2.6%* | *-3.6%* | *-2.5%* |
| Mining | 512 | 525 | 524 | 504 | 504 | 533 | 585 | 639 | 678 | 713 | 630 | 625 |
| *% Change* | *-6.1%* | *2.5%* | *-0.1%* | *-3.9%* | *0.1%* | *5.7%* | *9.6%* | *9.3%* | *6.1%* | *5.2%* | *-11.7%* | *-8.0%* |
| Construction | 6,709 | 6,792 | 6,785 | 6,700 | 6,827 | 7,117 | 7,533 | 7,689 | 7,491 | 6,704 | 5,700 | 5,555 |
| *% Change* | *5.2%* | *1.2%* | *-0.1%* | *-1.3%* | *1.9%* | *4.2%* | *5.8%* | *2.1%* | *-2.6%* | *-10.5%* | *-15.0%* | *-13.7%* |
| Manufacturing | 17,277 | 17,178 | 15,710 | 14,910 | 14,300 | 14,285 | 14,189 | 14,001 | 13,726 | 12,822 | 11,529 | 11,555 |
| *% Change* | *-1.0%* | *-0.6%* | *-8.5%* | *-5.1%* | *-4.1%* | *-0.1%* | *-0.7%* | *-1.3%* | *-2.0%* | *-6.6%* | *-10.1%* | *-6.6%* |
| Trade, Trans. & Util. | 26,065 | 26,339 | 25,625 | 25,435 | 25,279 | 25,692 | 26,118 | 26,432 | 26,709 | 25,619 | 24,627 | 24,623 |
| *% Change* | *2.5%* | *1.1%* | *-2.7%* | *-0.7%* | *-0.6%* | *1.6%* | *1.7%* | *1.2%* | *1.0%* | *-4.1%* | *-3.9%* | *-2.8%* |
| Information Services | 3,537 | 3,716 | 3,532 | 3,302 | 3,165 | 3,091 | 3,065 | 3,047 | 3,039 | 2,923 | 2,763 | 2,717 |
| *% Change* | *7.4%* | *5.1%* | *-5.0%* | *-6.5%* | *-4.1%* | *-2.3%* | *-0.8%* | *-0.6%* | *-0.3%* | *-3.8%* | *-5.5%* | *-5.2%* |
| Financial Activities | 7,667 | 7,734 | 7,827 | 7,900 | 7,980 | 8,073 | 8,240 | 8,353 | 8,232 | 8,007 | 7,669 | 7,594 |
| *% Change* | *1.3%* | *0.9%* | *1.2%* | *0.9%* | *1.0%* | *1.2%* | *2.1%* | *1.4%* | *-1.4%* | *-2.7%* | *-4.2%* | *-3.3%* |
| Prof. & Business Svcs. | 16,361 | 16,837 | 16,079 | 15,877 | 16,137 | 16,594 | 17,256 | 17,774 | 18,051 | 17,220 | 16,486 | 16,569 |
| *% Change* | *5.5%* | *2.9%* | *-4.5%* | *-1.3%* | *1.6%* | *2.8%* | *4.0%* | *3.0%* | *1.6%* | *-4.6%* | *-4.3%* | *-2.1%* |
| Educ. & Health Svcs. | 14,936 | 15,313 | 15,915 | 16,392 | 16,750 | 17,147 | 17,574 | 18,042 | 18,559 | 19,033 | 19,339 | 19,405 |
| *% Change* | *2.1%* | *2.5%* | *3.9%* | *3.0%* | *2.2%* | *2.4%* | *2.5%* | *2.7%* | *2.9%* | *2.6%* | *1.6%* | *1.7%* |
| Leisure & Hospitality | 11,706 | 11,976 | 11,967 | 12,112 | 12,320 | 12,630 | 12,905 | 13,294 | 13,535 | 13,248 | 12,983 | 12,998 |
| *% Change* | *2.9%* | *2.3%* | *-0.1%* | *1.2%* | *1.7%* | *2.5%* | *2.2%* | *3.0%* | *1.8%* | *-2.1%* | *-2.0%* | *-1.4%* |
| Other Services | 5,138 | 5,196 | 5,333 | 5,399 | 5,402 | 5,396 | 5,405 | 5,466 | 5,514 | 5,445 | 5,314 | 5,308 |
| *% Change* | *2.2%* | *1.1%* | *2.6%* | *1.2%* | *0.1%* | *-0.1%* | *0.2%* | *1.1%* | *0.9%* | *-1.3%* | *-2.4%* | *-1.9%* |
| Government | 20,540 | 20,804 | 21,355 | 21,588 | 21,546 | 21,693 | 21,879 | 22,088 | 22,377 | 22,561 | 22,480 | 22,470 |
| *% Change* | *2.3%* | *1.3%* | *2.6%* | *1.1%* | *-0.2%* | *0.7%* | *0.9%* | *1.0%* | *1.3%* | *0.8%* | *-0.4%* | *-0.4%* |

Sources: BLS, RCG

example, 184,000 jobs were cut from the peak in employment in March 2008 to the most recent trough in February 2010, reflecting a 21.8% decline. Although hard to measure, related job losses in other sectors have been high as well. Consequently, actions to bolster real estate-related investment and employment are particularly important in light of the current challenges facing related sectors. By taking measures to stabilize the weakest segments of the economy, future job growth will be more diverse and sustainable.

### *Why does more need to be done to protect and create jobs?*

Stimulus measures passed during recent months recognized the importance of job creation for the recovery of the economy. Nonetheless, many of the actions taken to stimulate job growth during the past year had minimal positive effect on unemployment, signaling the need for alternative strategies with longer-term goals. According to analysis completed by the Associated Press, the more than $20 billion allocated to transportation improvements did not benefit the unemployment situation. The study compared counties that received stimulus money with counties that did not and found no difference in unemployment trends. Other measures have similarly failed to achieve adequate job creation to offset the sharp employment losses that have plagued the country. Given the importance of job creation in the recovery of all aspects of the economy, additional action should be taken to put Americans back to work through the reform of FIRPTA.

Despite the challenges facing many of the stimulus measures, successes are also evident. Even if the number of jobs created has been too low to fully counteract the large number of jobs cut, putting people to work, no matter how many, prevents an even steeper rise in unemployment and has a positive effect on the local economy. The tax credit offered to homebuyers provides an excellent example of how measures not directly targeted at job creation can still successfully support employment. By jump starting the for-sale housing market with increased sales activity, the tax credit prevented many additional job losses in the residential real estate industry, and created jobs in areas of the country where sales picked up the most. Increased home sales have directly supported jobs at mortgage, sales, appraisal, and title firms, while also indirectly stimulating the economy with the spending of incomes generated by these positions.

Similarly to the homebuyers tax credit, FIRPTA reform will increase commercial real estate sales transactions, in turn spurring related employment. Commercial transactions directly support appraisal, mortgage, underwriting, legal, and sales positions, in addition to indirectly sustaining jobs in the overall economy. Construction employment is also directly bolstered by commercial sales, as new owners often opt to improve or repair buildings upon transfer. Given the generally high dollar value of commercial assets, a single transaction can sustain related incomes for months at a time, signaling the importance of every individual sale in boosting the local economy. Accordingly, stimulating commercial real estate sales transactions fuels employment, illustrating that FIRPTA reform will support jobs with each additional commercial property sold.

### *What role will foreign investment in commercial real estate play in job creation?*

Foreign investment is already an important source of economic growth nationally, directly supporting approximately 5.3 million jobs at the U.S. affiliates of foreign-owned companies. These jobs account for roughly 4.6% of total private employment throughout the country, and do not include the millions of positions indirectly supported by the spending of wages generated by these jobs. Foreign investment in U.S. assets has been on the rise in recent months in response to the discounts created by the recession for well-capitalized buyers. As reported by the Bureau of Economic Analysis, during the third quarter of 2009, foreign-owned U.S. assets increased by $332.4 billion, compared with an increase of just $14.6 billion during the second quarter. With FIRPTA reform, commercial real estate in the United States will benefit from this increasing investment interest by becoming more attractive as an asset class for foreign investors, resulting in job creation and preservation.

#### *FIRPTA reform will directly support investment-related jobs*

Opening up foreign investment in commercial real estate will help to stabilize demand, in turn preventing additional job cuts and promoting hiring at investment-related firms. For example, increased opportunities for foreign investment will encourage sovereign wealth funds to expand their U.S. real estate portfolios, fueling domestic job gains related to the operation of these funds. As noted earlier, we expect FIRPTA reform to produce a larger amount of investment activity, and SWFs will need to expand domestic offices in order to operate these assets, as well as employ legal counsel, appraisers and other service providers to facilitate acquisitions. Similar job growth will occur at other investment-related entities as well, such as pension funds and REITs. CalPERS, for example, is the largest pension fund in the country and employed 2,315 people in July 2009, all of which are currently on furlough three days a month with the current economic crisis. The lost wages of these furloughed employees are in turn affecting spending in the local economy, further deepening the recession. Layoffs at CalPERS and other pension funds are increasingly likely if the investment market does not stabilize. Market stability produced by increased foreign investment in commercial real estate will not only help to limit real estate job losses throughout the country, but will spur new hiring.

Increased investment will also benefit private equity firms with operations in the United States. Even with the global economic downturn, private equity firms are still expanding on a worldwide level, demonstrating the demand for these investment vehicles, especially among global investors. Through October of 2009, 412 new private equity firms were started around the world, bringing the overall number of actively managed firms to 4,270, according to Preqin. This estimate does not include companies that manage corporate, personal, or third-party capital that is not pooled into investment vehicles, resulting in an even higher number if these firms were included. Among the 4,270 companies tracked by Preqin, approximately 69,100 people are employed and nearly 56% work in the United States. Changes to FIRPTA will directly support domestic hiring as more foreign private equity firms invest in U.S. real estate, particularly given the view among foreign investors that the United States is the best opportunity for capital appreciation.

Another benefit will be the stimulating effect on jobs from commercial real estate asset stabilization. Increased demand for properties will help to stabilize the commercial market, in turn limiting the number of distressed assets and related job cuts. General building operations support maintenance, repair, custodial, utilities and management jobs. Property management jobs include a wide variety of functions, ranging from security to marketing, leasing, accounting, finance and building engineering services. When properties are distressed or landlords realize decreasing operating revenues, building operations staff is often trimmed, resulting in job losses. The cuts stemming from building defaults, as with any layoffs, have a multiplier effect in the overall economy, with income losses affecting spending and, consequently, jobs in other industries as well. By keeping properties out of foreclosure, fewer jobs are eliminated, benefiting the overall economy.

*FIRPTA reform will stimulate hiring on Main Street*

FIRPTA reform, and the corresponding stabilization of assets, will protect jobs associated with smaller regional banks, which have far-reaching effects on the overall economy. For smaller banks in weaker areas of the country, increasing commercial defaults translate to a larger degree of instability and corresponding job losses, as many of these banks keep high concentrations of local commercial mortgages on their books. As the Congressional Oversight Panel recently reported, regional and community banks will experience a disproportionate share of commercial real estate defaults due to their high concentration of commercial real estate and construction loans. If these banks are weakened by defaults, small business lending in turn dries up, impeding the recovery of local economies by contributing to further job losses and preventing payroll growth among small businesses unable to acquire financing. The widespread failure of small banks would prove disastrous for the fledgling stabilization of the economy. In previous recessions, small businesses were the key to the recovery of the economy, adding jobs before their larger counterparts, as cited by the Small Business Administration. Coming out of the recession in 2002, firms with less than 20 employees added 29,000 jobs during the year, whereas companies with 20 to 499 employees cut 127,000 positions, and firms with 500 or more employees eliminated 129,000 jobs for the year. Consequently, protecting the stability of smaller banks is important to future job creation and the stability of the overall economy. Moreover, without small banks to support business expansion, commercial vacancy rates will rise even higher, further weakening commercial real estate fundamentals and contributing to additional job losses.

In addition to stimulating job growth associated with the sale of existing properties and stabilization of the commercial real estate market, FIRPTA reform will fuel hiring in the battered construction sector by funding projects as market fundamentals improve in the coming years. Construction activity is a major component of economic growth when investment dollars are available and market conditions are strong enough for building to occur. According to a study by NAIOP, nearly $1.16 trillion was spent on total construction in 2007, directly and indirectly sustaining 33.2 million jobs throughout the country and contributing $1.23 trillion in personal income. On non-government office, industrial and retail space alone, construction spending totaled $89.2 billion, providing 2.5 million year-round, full-time equivalent jobs and fueling $85.5 billion in personal income. This spending contributed $283.7 billion to GDP through both direct and indirect means. In order to measure the total impact of commercial construction, NAIOP looked at the costs of the entire development process, encompassing everything from architecture and engineering to legal services, marketing, management, landscaping, interior design and actual construction. In addition to the jobs created during the construction process, the study emphasized the importance of ongoing employment associated with building operations in providing and sustaining jobs in the local economy. Although many construction jobs have been eliminated since 2007, increased investment and the stabilization of the economy will result in more sustainable construction job creation in the coming years.

Many commercial construction projects throughout the country are currently on hold because of weak market conditions, and the rising number of distressed construction projects is amplified by the lack of investors willing or able to take on these incomplete efforts. Given the limited access to capital and tighter lending standards, many of these projects will continue to face prohibitively high pre-sale or pre-leasing thresholds to gain funding even when market conditions begin to improve. However, with increased foreign investment, troubled projects could be purchased at a discount and finally completed once market conditions begin to stabilize by bringing in new sources of funding. Because market fundamentals are currently weak, it is highly unlikely that these projects will be completed during the short term, relieving the potential for overbuilding. Nonetheless, the transfer of ownership of existing buildings will immediately fuel construction hiring through the tenant improvements and renovations that are common under new ownership, supporting jobs in the fragile sector. As the overall economy improves, FIRPTA reform will also lead to more construction projects started by foreign owners, further fueling job growth in construction as well as in other related sectors.

*Spillover effects will permeate other sectors of the Economy*

The spillover effects of construction activity on the overall economy are significant, emphasizing the impact that increased foreign investment will have on job creation. According to a study commissioned by the Associated General Contractors of America (AGC), during times of limited capital availability, such as with the current economic environment, every $1 billion invested in commercial construction sustains 28,500 jobs. One-third of these jobs are direct in on-site construction positions, one-sixth are jobs with suppliers, and half are jobs created by the spending of income from these employees. Moreover, an estimated $3.4 billion in gross domestic product (GDP) results from each $1 billion invested in commercial construction. Of this contribution to GDP, personal income accounts for approximately one-third. Consequently, increased foreign investment in commercial construction will translate into more jobs and positive economic activity.

Presently, limited investment in commercial real estate and weak market conditions are resulting in widespread job cuts in the public sector, caused by the decline in tax revenue from the commercial real estate industry. Commercial real estate activity supports property, transfer, payroll and income tax revenue throughout the country. According to a report from the State University of New York, state tax revenues throughout the country are down the most in at least 46 years, resulting in large budget gaps. California, Arizona, and Illinois face budget gaps larger than 40% of planned General Fund Spending, according to the Pew Research Center. Alaska, Nevada, New Jersey and New York face shortfalls of 30% or more, with many other states not far behind. In New York, as with the rest of the country, real estate transfer taxes for commercial and residential properties plummeted. During 2009, real estate transfer taxes totaled $456 million, down by 44.2% from 2008 and 56.7% from 2007. Between 2008 and 2009, revenue from real estate transfers decreased by nearly $365 million. Similarly, in the state of Washington, real estate excise taxes were down by 63.3% in fiscal year 2009 from the peak in fiscal year 2005, reflecting a decline of nearly $734 million in revenue to $426 million in 2009. In response to such huge shortfalls, many states are raising taxes and cutting services, with additional job cuts looming if shortfalls cannot be bridged. Increased investment in commercial real estate will help to stabilize falling tax revenues, in turn benefiting both the state and federal governments, and preventing public sector job cuts or furloughs.

In both the construction and post-construction phases, investment in commercial real estate supports millions of jobs throughout the country through real estate transactions, operations, construction and related tax revenue. In the current financial environment, commercial real estate transactions have plummeted and few construction projects are still under way, resulting in widespread job losses throughout the related industries. Even though the number of jobs cut in response to the downturn is unknown, it is clear that the effects are widespread. As with the residential real estate market, weakness in related employment spills over to other segments of the economy as well, underlining the importance of the commercial real estate market to the health of the overall economy. Whereas some of these jobs will come back in the coming years, investment activity must be stimulated to ensure hiring. The reform of FIRPTA will open commercial real estate to more foreign investment, helping to stabilize demand for properties, which will in turn protect existing jobs and aid in payroll expansion. Given the absence of job creation in the current economy, the ability of FIRPTA reform to generate employment underscores the importance of opening up foreign investment in commercial real estate.

## Asset Stabilization

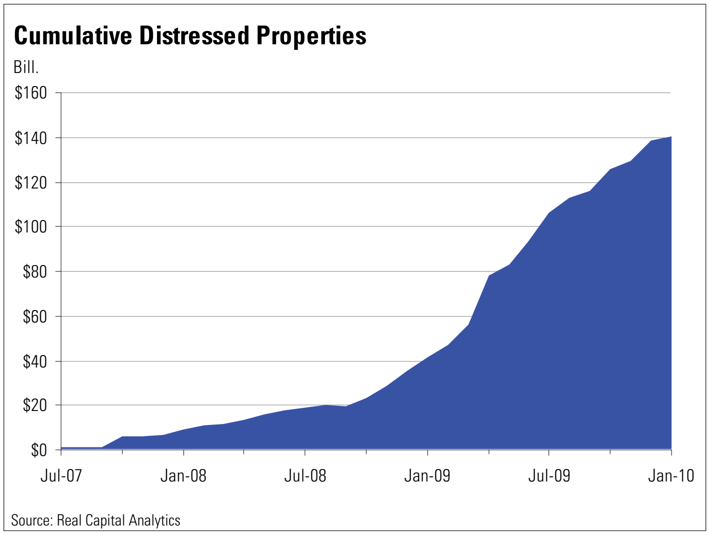
***Equitable tax treatment under FIRPTA will help to stabilize asset values***

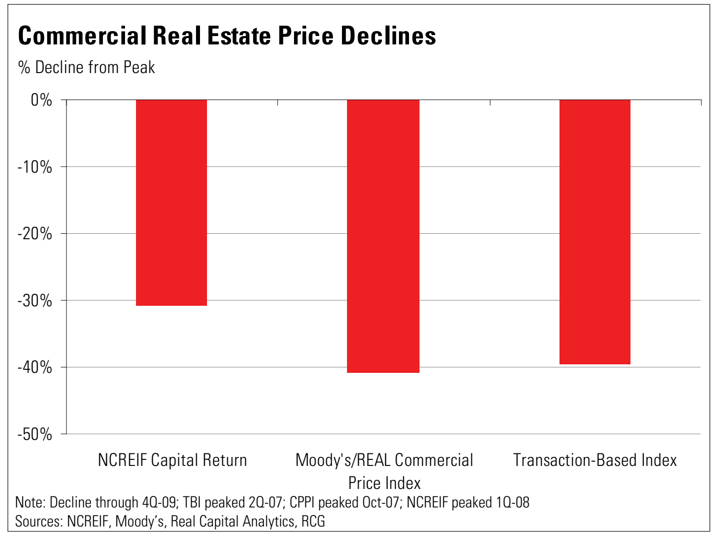
The commercial real estate market is currently under considerable stress, primarily from constraints on investment capital and deteriorating operating fundamentals. In addition to rising vacancies and falling rents, evaporating liquidity has undermined the values of property assets at a rapid rate since 2007. Amending FIRPTA to allow equitable tax treatment for foreign real estate investors would expand the pool of capital available for investment in U.S. commercial real estate. This enhanced liquidity will promote proper price discovery in the current environment where the dearth of transactions has clouded traditional valuation measures. In the continued absence of liquidity, investment losses will further constrain capital flows and refinancing will be become even more difficult, locking prices in a downward spiral and ensuring massive losses across virtually all sectors of the economy.

*Why are values falling?*

A number of factors are pressuring commercial real estate values downward. On the income side, demand for commercial real estate contracted commensurate with the job market's descent into its worst state since the Great Depression, with approximately 8.4 million jobs lost. Rising vacancy rates and declining rents through the past year in a great majority of metropolitan areas contributed to a drop in NOI across the board, while expectations for lofty rent growth in the near future have disappeared.

A lack of liquidity in the commercial real estate capital markets, however, is arguably the most significant factor in the precipitous decline in commercial real estate values. Liquidity in the real estate




capital markets is essential to the normal functions of the commercial real estate industry, including the acquisition and disposal of properties, the construction of new buildings, and structural and environmental upgrades that stave off obsolescence.

Current market conditions, despite recent gains in global financial markets, do not provide the adequate flow of investment capital needed for these activities. In the wake of the financial crisis and the subsequent period of uncertainty, underwriting on commercial mortgages has become much more conservative, reflecting a pendulum-like shift in lenders' appetite for risk. With credit severely constrained and operating fundamentals likely to deteriorate further, values have dropped, but the magnitude is uncertain because few properties traded hands since 2008.

This uncertainty feeds into a negative feedback loop. As a result of uncertain values and poor fundamentals, financiers command higher risk premiums, which raise cap rates and diminish property values. Whereas an 80% or higher loan-to-value ratio (LTV) commercial mortgage with full or partial interest-only terms may have been typical in 2006, a deal underwritten today is likely to have an LTV between 40% and 60%. In that environment, well-capitalized owners will delay selling properties in order to avoid capital losses. The very few transactions that close are forced sales and not reflective of an underlying asset's true value in relatively normal credit conditions. Without comparable sales transactions, valuation certainty will continue to elude market participants. The drop in overall transaction volume to very low levels in 2009 and the rapid accumulation of distressed properties since 2007 are evidence that this situation describes the current state of the U.S. commercial real estate market: intervention is desperately needed to ensure long-term stability.

### *How much have values fallen?*

It is now certain that commercial real estate assets have experienced a substantial decline in value and will remain under considerable stress in 2010. The extent to which values have fallen is difficult to ascertain: building owners not in financial trouble choose not to sell at discounted prices, meaning comparable transactions are sparse in today's marketplace, and transactions from the 2005 to 2007 timeframe are not valid for comparison because underwriting practices have shifted so drastically. Nevertheless, several price indices can offer some context to the drop in values. Two national commercial property asset price indices, Moody's/REAL Commercial Property Index (CPPI) and the Transaction-Based Price Index (TBI), suggest a value decline of all U.S. commercial real estate assets of 40.8% and 39.5%, respectively, since mid- to late 2007, according to the latest data, though considerable variation exists across property type and geographic location. The National Council of Real Estate Investment Fiduciaries' (NCREIF) capital return index, which measures the change in market value of a large sample of commercial properties of all types, peaked in the first quarter of 2008 and has declined 30.9% in the seven subsequent quarters. By comparison, the capital return index contracted by 32.3% across 24 quarters following the savings and loan debacle in the early 1990s. The current value decline has been more swift and will likely end up more severe than the last serious real estate crash.

Without a large sample of transactions, unfortunately, these measurements are rough estimates at best. Values have likely fallen more in those markets where commercial real estate was overbuilt and/or where the main economic drivers have contracted the most during the recession. It is safe to say, however, that reforming FIRPTA and increasing liquidity will be a key factor in stabilizing values of commercial real estate assets. Without adequate capital for refinancing, $1.4 trillion in maturing commercial mortgage debt between 2010 and 2014 will weigh heavily on asset values going forward.

### *What can be done to stem the erosion in values?*

Exogenous factors are absolutely essential to break the cycle of falling values. By amending or repealing FIRPTA regulations, the enhanced liquidity that follows the expansion of foreign investment capital will help to return the commercial property markets to a more normal state where credit is available to worthy borrowers and risk is priced accordingly. With the return of a more liquid market, financiers will no longer be stricken by a prohibitively low tolerance for risk. In fact, an analogous situation would be the astounding rebound in the stock markets since March 2009, which has been fueled, at least in part, by a return of confidence in the long-term stability of the U.S. economy and movement away from the safe haven offered by U.S. Treasuries. Favorable lending standards to worthy borrowers will encourage the trading of properties at appropriate pricing levels. The rise in transaction volume of non-troubled assets will make valuation more accurate and efficient by providing comparable transactions.

*What are the consequences of continued destabilized assets?*

Stabilizing asset values will have numerous positive impacts to the benefit of the commercial real estate industry, the U.S. economy as a whole, and the citizens of the United States. If the commercial real estate market remains starved for liquidity and values remain destabilized, however, the consequences would be dire and far-reaching. The commercial real estate market needs adequate liquidity to effectively price assets and rollover debt obligations

If borrowers are unable to refinance debt obligations, the resulting wave of commercial mortgage defaults will inflict financial losses across many sectors of the economy, most notably for the debtors that hold these mortgages, as well as the government and taxpayers. Widespread losses in banks' mortgage portfolios decrease core capital ratios and potentially force banks to either raise new capital or declare insolvency. The resulting bank failures from souring commercial real estate loans would ultimately delay or even reverse the still-fragile economic recovery. At the very least, banks have tightened lending standards to preserve capital reserves and protect against future losses, cutting off funding that credit-worthy businesses need to grow and hire. In fact, massive losses going forward could plausibly send the credit markets into Credit Crisis 2.0.

### ***FIRPTA reform will reduce the risk of government and taxpayer Loss***

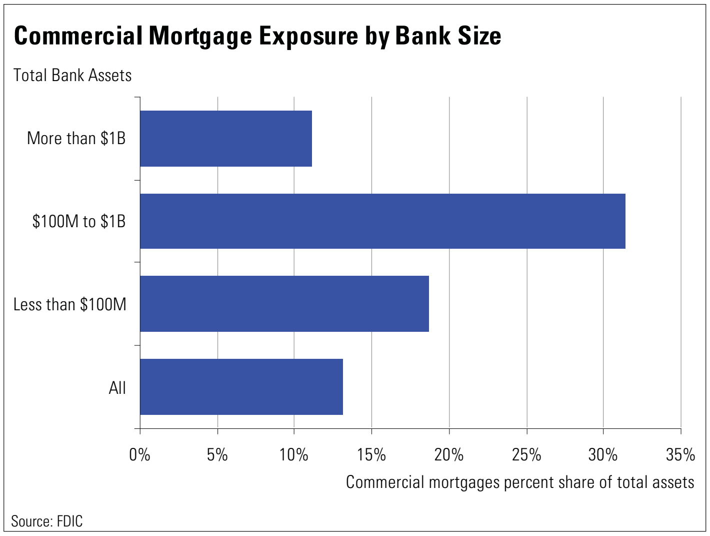
A destabilized commercial real estate market places the government and taxpayers at risk of financial losses from souring investments going forward. With the passage of the Emergency Economic Stabilization Act of 2008 (EESA) in October 2008 and the implementation of the Troubled Asset Relief Program (TARP), the federal government became an integral player in the commercial real estate market — first by directly investing in troubled commercial real estate assets held by financial institutions, then indirectly by injecting capital into the financial institutions themselves. Although $700 billion had been allocated for TARP, the Treasury Department is not likely to disburse the total amount.

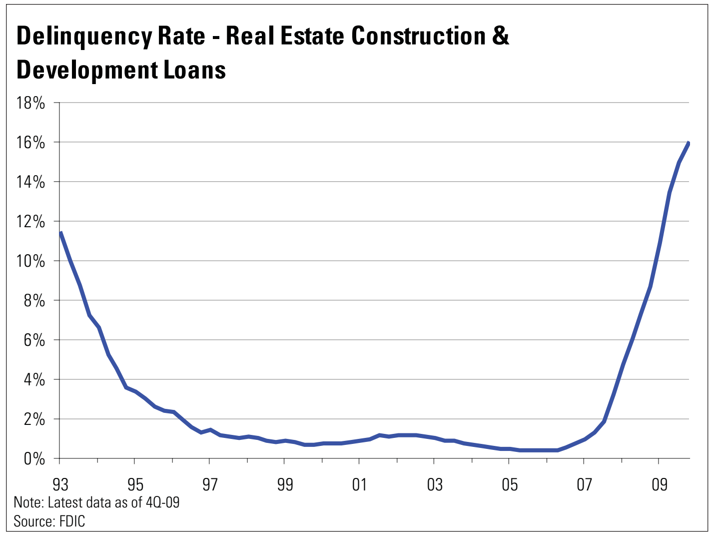
While it is true the most recent cost estimates for TARP are much less than the original $700 billion allotted, further disbursements of sizable amounts are expected in the near future. In particular, much of the $30 billion of investments and loans under the Public-Private Investment Program (PPIP) are expected to be recorded in 2010. Through PPIP, the Treasury will use TARP funds to match private investment in securities backed by CMBS, among other types of collateral. By partnering with private investors in the CMBS market, the interests of the federal government (and the taxpayers) are now directly in line with the performance of the securities and the value of their underlying assets. Stabilizing these assets through enhanced liquidity greatly reduces the risk that the government (and taxpayers) will lose on this initial investment.

A change in the tax revenue structure does raise a concern. With the U.S. fiscal deficit expected to approach a post-war high of 11% of GDP in 2010, any action that removes a source of tax revenue must be done thoughtfully, as the risks associated with an unsustainable fiscal deficit are significant. However, the cost of maintaining the current FIRPTA regime, in terms of constraining the inflow of foreign capital, far exceeds direct loss of tax revenues generated by the Act. In fact, this direct loss in revenue is miniscule when compared with the size of the entire U.S. fiscal budget: the Joint Committee on Taxation recently estimated that repealing FIRPTA would lower total tax receipts by approximately $8.3 billion over a ten year period. On the other hand, FIRPTA repeal would unlock many billions of dollars in additional foreign capital as discussed previously in this report. The capital gains taxes levied on this additional investment, in addition to rising property and transfer tax receipts and the associated corporate and payroll tax revenues from increased foreign investment and local hiring, could far exceed the lost $8.3 billion depending on the degree of investment activity and how quickly foreign investors ramped up acquisitions. In the end, by constraining the inflow of foreign capital, FIRPTA is not only costing jobs and undermining the commercial real estate markets, but is also reducing local and federal government tax revenue.

### ***FIRPTA reform may reduce the risk of bank failures***

Destabilized commercial real estate assets present a significant risk to the health of banks around the United States. Commercial banks are heavily invested in commercial real estate loans: they account for nearly one-quarter of all loans and leases on their books, for a total of more than $1.6 trillion as of the fourth quarter of 2009. For many banks, particular small- to medium-sized institutions, capital reserves are insufficient to protect against a wave of commercial mortgage losses. In fact, in recent Congressional testimony, Sheila Bair, head of the FDIC, called commercial real estate lending "the most prominent area of risk for rising credit losses at FDIC-insured institutions during the next several quarters."




The risk of massive defaults in banks' commercial mortgage portfolios threatens the delicate state of the credit markets, as well as the economy as a whole. Lending standards, in their pro-cyclical nature, are still very conservative compared with those seen during the previous expansion period, and are constraining many types of business activity. If loan losses grow worse, banks will tighten lending standards even further. Given that credit markets are still in a fragile stage, any large credit loss events could send financiers into panic mode once again, virtually ensuring another credit crisis and another recession. Worse yet, since government finances and political will are already stressed, any new market intervention by the federal government is not likely to be as effective as the measures implemented in late 2008 and 2009.

### *Stabilized assets will support small banks in particular*

Small banks in particular are highly vulnerable to falling commercial real estate asset values, more so than larger banks. Small and medium-sized banks greatly increased their lending to commercial developers in recent years as larger institutions dominated the market for home mortgages and consumer credit. According to FDIC data, commercial real estate loans account for 31.4% of total assets among commercial banks with assets between $100 million and $1 billion compared with just 11.1% for commercial banks with assets greater than $1 billion. Weighing commercial real estate loans against Tier I capital, the key measure of a bank's capital adequacy, the picture becomes clearer. Among banks with assets between $100 million and $10 billion, commercial real estate loans outweigh the Tier 1 capital base by nearly three and a half to one. Furthermore, smaller banks typically have a regional focus, and their loan portfolios are highly concentrated in their home geographic area. This concentration exposes the bank to economic events that may be isolated to their region. At present, regional banks in the South and West that capitalized on rapid development during the boom years are in much worse health than their Northeastern or Midwestern counterparts. Larger banks, on the other hand, have the benefit of access to wider geographic market coverage. In this way, larger banks are less exposed to economic troubles that may be isolated to one particular region.

Smaller regional and community banks are a key source of credit for small business activity around the country. Given troubles with their commercial real estate portfolios and the expectation of future credit losses, many small businesses are not able to get the credit they need to expand and increase hiring. This creates an unnecessary bottleneck in the recovery of the overall labor market, even when there is demand for more hires. The Federal Reserve's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices quantifies bank lending standards for small firms that apply for commercial and industrial (C&I) loans. The latest survey from January 2010 shows banks are still tightening overall lending standards for small businesses. Small businesses account for a larger share of job creation during recovery periods, and thus disproportionately contribute to economic recovery compared with large and medium-sized firms. FIRPTA reform's effect on stabilizing commercial real estate values will shore up the balance sheets of small banks and encourage lending to small businesses, thus supporting hiring activity at those companies that will drive the economic recovery.

As of March 10, 194 banks failed across the United States since 2007. The upward trend in delinquency rates and low prospects for refinancing indicate more trouble is on the way. As of the fourth quarter of 2009, the delinquency rate on real estate construction and development loans reached 16.0%, up from 0.4% in 2005. According to the FDIC, 702 banks were on the so-called "Watch List" as of February 24, 2010, meaning they are at risk of failing. Since this list is not publicly available, however, tracking the status of individual institutions is not possible. As discussed earlier, refinancing maturing debts will be difficult given weakened fundamentals and lower liquidity in credit markets. The impacts of bank failures on the overall economy are, again, far-reaching. FIRPTA reform, however, will help to reverse the course of failing banks, particularly at the local and regional levels.

### *FIRPTA reform will benefit Main Street and support public REIT markets*

In addition to preventing direct losses to the government, taxpayers, banks and other debt holders, several other ancillary benefits would result from relaxing restrictions on foreign investment in U.S. commercial real estate. Stabilizing asset values will mitigate the losses posted by pension funds, endowment funds and other institutional investors, which will have a direct positive impact on the general public. For example, CalPERS, the pension fund and health benefits administrator for more than 1.6 million California public employees, retirees and their families reported a 47.5% loss on its real estate holdings in 2009. Furthermore, institutional investors have been forced to sell off portions of their real estate holdings recently in order to comply with asset allocation requirements. The timing of these asset sales is extremely disadvantageous to these investment funds since they are capturing much of the loss in value that occurred since 2007. Capital losses inflicted on these funds affect an enormous swath of the U.S. population, from retirees to college students and others.

Reforming or repealing FIRPTA rules may also support public REIT valuation by better attracting capital from foreign sources. FIRPTA currently places a 5% cap on foreign ownership of a public REIT before taxing under statutory guidelines. Lifting or removing this disincentive on foreign investment would funnel additional capital into the public REIT sector. A diverse array of capital sources minimizes the risk of liquidity shocks in the market. A highly liquid public REIT market better supports values of its underlying property assets than one that is capital constrained.

In response to the meteoric rise in REIT price indices since March 2009, some market participants expressed concerns regarding overvaluation. As seen in the accompanying chart, the overall public REIT market is now priced higher relative to underlying asset values than at any other time since at least 1990, at 23%, according to Green Street Advisors. This phenomenon can be explained partly by the expectation that real estate values will rise from current levels. Otherwise, the premium share pricing seems unrealistic given deteriorating operating fundamentals in most markets and across most property types, leaving the public market exposed to a correction in the near future. This contrarian analysis, however, assumes that currently depressed property valuations are here to stay. On the other hand, we have shown that the increase in liquidity brought on by reforming FIRPTA has the potential to stabilize these falling asset values. By setting the stage for capital appreciation, FIRPTA reform supports the recent gains in public REIT market share prices.

Furthermore, some property owners have reportedly been negatively affected by the sometimes-onerous capital requirements of leasing property. Lease concessions, like generous tenant improvements and free rent, are often necessary in the current environment. As a result, those owners without access to adequate capital to fund

**REIT Valuation to Net Asset Value**


Note: Latest data as of March 2010
Source: Green Street Advisors

these concessions are left unable to attract tenants, to the detriment of operating fundamentals. An influx of foreign investment may help alleviate these capital constraints to leasing, which would have a net positive effect on operating fundamentals.

## FIRPTA reform will help millions of Americans

As it stands, FIRPTA not only penalizes foreign investors who wish to take advantage of the stability and diversification benefits of investment in U.S. real property, but also hurts the millions of Americans whose livelihoods depend on the health of the commercial real estate market. Despite any good intentions behind FIRPTA's passage, this outdated U.S. tax law has had numerous unintentional negative impacts over the years. The primary among those has been to divert capital inflows away from the United States, which results in lower transaction volume, fewer jobs and instability of commercial real estate assets. The consequences of these effects are particularly far-reaching given the current economic climate in the United States, which has seen 8.4 million jobs lost in the past two years. Furthermore, the upcoming shortfall of capital for the refinancing of commercial real estate assets will send many property owners into foreclosure, exacerbating the problems associated with unemployment, credit losses, and valuation uncertainty that face this crucial industry and further delaying real economic recovery.

In order to assist in job creation and stimulate the recovery of the U.S. economy, FIRPTA should be reformed. By lowering this tax barrier, foreign capital inflows to commercial real estate would increase dramatically. This increase would have a significant impact on real estate capital markets, which have been slow to return to normal market conditions. A growing pool of real estate capital would allow many owners to avert foreclosure and the negative effects thereof. The additional liquidity and the resulting rise in commercial property transactions would lend to stability in asset values, the lack of which has been deterring many real estate players, both foreign and domestic, from pursuing their normal lines of business. Rising

U.S. real estate investment activity will stimulate hiring to handle acquisitions, asset management and other aspects of commercial property operations. Additionally, increased capital inflows and asset stability will save a number of financial institutions, primarily small to mid-sized banks, from bankruptcy, further preserving jobs and improving the health of the U.S. financial markets and economy. By stimulating foreign capital investment in real estate, FIRPTA reform would contribute to the loosening of domestic capital markets, the stability of commercial property values, and job creation in a number of related sectors, ultimately contributing to a vigorous and sustainable economic recovery in the United States.