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Proposed Regulations Provide Clarity for Qualified Foreign Pension Fund Exception

Tax Talks on **July 3, 2019**

On June 7, 2019, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") released proposed Treasury regulations under Sections 897, 1445 and 1446 (the "Proposed Regulations") regarding the exception for qualified foreign pension funds ("QFPFs") from taxation under the Foreign Investment in Real Property Tax Act ("FIRPTA") provisions of the Internal Revenue Code of 1986, as amended (the "Code").[1] This exception was added to the Code pursuant to the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act").

The Proposed Regulations are taxpayer favorable because they broadly construe which entities may constitute QFPFs and the requirements that must be met under Section 897(l) in an effort to include a wide range of plans that are in substance foreign pension funds but that might not qualify under a strict interpretation of the statute. The Proposed Regulations should encourage further investment in U.S. real property by foreign pension plans by providing greater clarity regarding whether a plan meets the requirements to be treated as a QFPF. Rules for certifying an exemption from FIRPTA withholding and plans to revise IRS Form W-8EXP are also provided in the Proposed Regulations.

Background

In general, in the case of a nonresident alien individual or a foreign corporation, Section 897(a)(1) provides that any gain or loss arising from the disposition of a U.S. real property interest ("USRPI") is taxed as if such gain or loss is effectively connected with the conduct of a U.S. trade or business (commonly referred to as effectively connected income, or "ECI") by the nonresident alien individual or foreign corporation. Furthermore, under Section 897(h), any distribution from a qualified investment entity ("QIE"), which includes any real estate investment trust ("REIT") and certain regulated investment companies ("RICs"), to a nonresident alien individual, foreign corporation, or other QIE is treated as gain recognized from the sale or exchange of a USRPI to the extent such gain is attributable to sales or exchanges of USRPIs by the distributing QIE. However, the PATH Act added Section 897(l) to provide an exception for QFPFs by not treating them as nonresident alien individuals or foreign corporations for the purposes of Section 897 (referred to herein as the "Section 897 exception" or the "exception"). Please see our blog post and client alert relating to the enactment of the PATH Act for a more detailed background discussion.

Scope of the Exception

Qualified Segregated Accounts

The Proposed Regulations limit the scope of the Section 897 exception to gain or loss attributable to one or more qualified segregated accounts maintained by the QFPF (together with qualified controlled entity, defined below, is referred to as a "qualified holder" in the Proposed Regulations). A qualified segregated account is defined to be an identifiable pool of assets maintained for the sole purpose of funding qualified benefits (generally, retirement, pension and certain ancillary benefits) to qualified recipients (generally, plan participants and beneficiaries). Whether each requirement under Section 897(l)(2) is satisfied is determined solely with respect to the income and assets held by an eligible fund in one or more qualified segregated accounts, including the qualified benefits funded by such accounts, the qualified recipients whose benefits are funded by such accounts, and the information reporting and regulation related to such accounts.

Qualified Controlled Entity

Under Section 897(l)(1), a QFPF is defined to include any entity all the interests of which are held by a QFPF (a "qualified controlled entity").[2] It was unclear whether this meant that such an entity must be directly owned by the QFPF, rather than owned through a series of entities, or whether it could be owned by multiple QFPFs. The Proposed Regulations clarify that a qualified controlled entity may be owned directly or indirectly by one or more QFPFs through one or more qualified controlled entities. In addition, only corporations and trusts may be treated as qualified controlled entities. The Treasury and the IRS determined it is unnecessary to allow partnerships to be treated as qualified controlled entities because indirect ownership is permitted.

In order to determine the status of an entity as a qualified controlled entity, the Proposed Regulations exclude any interest solely as a creditor and ignore the more limited definition of controlled entity under Treasury regulation section 1.892-2T(a)(3) (relating to entities controlled by a foreign sovereign).[3] To prevent avoidance of tax by taxpayers other than QFPFs, *de minimis* ownership by a taxpayer other than a QFPF is explicitly prohibited, and an anti-abuse rule prohibits any entity or governmental unit that was not (or was not part of) a QFPF or a qualified controlled entity at any time during a specific testing period from qualifying for the exception under the Proposed Regulations.

Eligible Fund

The Treasury and the IRS, stating their intent to be consistent with congressional intent, provided for a broad range of structures (referred to as "eligible funds") that may be treated as a QFPF under the Proposed Regulations. Section 897(l)(2) states that "any trust, corporation or other organization or arrangement" may be an eligible fund. One of the big questions about this language was how to interpret "organization or arrangement." The Proposed Regulations specify that an "organization or arrangement" means one or more trusts, corporations, employers or governmental units. Furthermore, a "governmental unit" means any foreign government, or part thereof, and includes any person, body, group of persons, organization, agency, bureau, fund, instrumentality, however designated, of a foreign government.

The Proposed Regulations, through the use of the terms “eligible fund,” “qualified controlled entity” and “qualified segregated accounts,” clarify that various types of pension plans can be QFPFs including: foreign private and government-sponsored public pension plans, multi-employer plans and pension plans of trade unions or professional associations. Furthermore, a plan may be structured as one or more segregated pools of assets.

Qualified Foreign Pension Fund Requirements

The additional five requirements under Section 897(l)(2) that must be met in order for an eligible fund to be treated as a QFPF are clarified and generally expanded by the Proposed Regulations as follows:

A. Created or organized under the law of a country other than the United States

Recognizing that it is common for pension plans to be organized or governed by local laws (*e.g.*, provincial law in Canada), the Proposed Regulations provide that the reference to “country” may include states, provinces, or political subdivisions of a foreign country.

B. Established to provide retirement or pension benefits

Because foreign pension plans often provide some ancillary benefits, the Proposed Regulations permit a QFPF to provide some benefits other than retirement benefits and pension benefits. Certain “ancillary benefits” are treated as “qualified benefits” under the Proposed Regulations, including benefits payable upon the diagnosis of a terminal illness, death benefits, disability benefits, medical benefits, unemployment benefits, or similar benefits. However, no more than 15% of the present value of the qualified benefits that an eligible fund reasonably expects to provide in the future can be from ancillary benefits.

C. 5% limitation on right to assets or income

Section 897(l) contains no rule regarding constructive ownership. However, the Proposed Regulations apply the attribution rules under Section 267(b) or Section 707(b) to determine whether an individual has a right to more than 5% of a QFPF’s assets or income under Section 897(l)(2)(C). No specific computation rules are provided, and the Proposed Regulations instead require a facts and circumstance determination for calculating the 5% limitation.

D. Subject to governmental regulations and information reporting

A QFPF must be subject to government regulation and must provide or otherwise make available annual information about its beneficiaries to the relevant tax authorities in the country in which it is established or operates. The Proposed Regulations provide useful clarifications:

- The Proposed Regulations require such information to include the amount of qualified benefits provided to each qualified recipient, but also provide that an eligible fund will not fail the information requirement if it is not required to provide information in a year in which no qualified benefits are provided to qualified recipients.
- A government-sponsored pension plan that is administered by one or more governmental units, other than in its capacity as an employer, will automatically satisfy the regulation and information requirements under the Proposed Regulations.
- Private foreign pension plans may be required to provide information to one or more governmental bodies responsible for regulating pensions in the relevant country. Those governmental bodies may be separate and distinct from the tax authorities. Accordingly, the Proposed Regulations provide that an eligible fund will satisfy the information requirement if, pursuant to the applicable foreign laws, it provides the required information, or makes it available, to one or more governmental bodies.

E. Preferential tax treatment in the foreign country in which it is established or operates

The laws of the foreign country in which an eligible fund is established or operates must provide either that (1) contributions to the eligible fund which would otherwise be subject to tax under such laws are deductible or excluded from gross income of such eligible fund or taxed at a reduced rate, or (2) any investment income of the eligible fund is deferred, excluded from gross income of the eligible entity or is taxed at a reduced rate. The Proposed Regulations relax this requirement and provide exceptions in cases where (i) the foreign country does not have an income tax, (ii) where at least 85% of the contributions or investment income is subject to the required tax treatment, and (iii) where the eligible fund is subject to a preferential tax regime that has a substantially similar effect as the required tax treatment under this provision. For purposes of this requirement, the Proposed Regulations specify that it is determined with respect to the national laws of a foreign country. It is important to note that although an eligible fund may be created or organized under the laws of states, provinces, or political subdivisions of a foreign country, it must receive preferential tax treatment on a national level (*e.g.*, for a pension fund established under the laws of a Canadian province, the preferential tax treatment under Canadian federal tax rules is relevant, not a preference under provincial tax rules).

Withholding

The IRS intends to revise Form W-8EXP to be used by qualified holders to certify their status as non-foreign for withholding tax purposes. In the interim, a certificate of non-foreign status may be used. It is also intended that withholding agents and partnerships may rely on the revised Form W-8EXP.

Note that withholding taxes other than FIRPTA, such as those imposed on payments to non-U.S. persons generally under Sections 1441 and 1442, and on certain allocations of ECI to foreign partners under Section 1446 may still be imposed.

Observations

The rules regarding QFPFs apply specifically for purposes of the FIRPTA rules. These rules do not impact the definition of “pension plan” under any income tax treaties between the United States and another country or under the Foreign Account Tax Compliance Act (“FATCA”). Accordingly, a pension plan may be a QFPF under the FIRPTA rules but may not be a pension plan under an applicable income tax treaty or FATCA.

REIT Related Observations

Publicly-Traded Exemption. The Section 897 exception allows a QFPF to own more than 10% of a publicly traded REIT and not be subject to FIRPTA. Foreign investors in publicly traded REITs generally are exempt from ECI treatment under Section 897 on capital gain dividends attributable to gain from the sale of a USRPI by the REIT (pursuant to Section 897(h)(1)), and on gain from the sale of REIT stock (pursuant to Section 897(c)(3)), if the foreign investor owns no more than 10% of the REIT.[4] However, a QFPF could rely on the Section 897 exception to be exempt from ECI treatment under Section 897 even if it owns more than 10% of a REIT. In practice, REITs typically limit ownership of their shares to 9.8% or less of any class or series of shares unless the investor receives a waiver of the limitation. Accordingly, a QFPF would need to obtain a waiver of the ownership limit in order to own more than 10% of a REIT. Any REIT considering waiving its ownership limit for a QFPF should be careful that a large ownership position by the QFPF does not raise any related party rent issues if the QFPF owns a large interest in any of the REIT's tenants.

Domestically-Controlled Exemption. A QFPF may be able to own 50% or more of a private REIT (through a joint venture or other fund structure) and exit the investment through the sale of the underlying real property and liquidation of the REIT, rather than by selling REIT stock. Foreign investors in U.S. real property typically desire to structure their investment in U.S. real property through a domestically-controlled REIT[5] so that they can exit the investment through a sale of the REIT stock. Section 897(h)(2) exempts gain from the sale of stock of a domestically-controlled REIT from being treated as ECI under the FIRPTA rules. The alternative generally would be for the REIT to sell its assets and redeem the foreign investor's shares in liquidation of the REIT. Shareholders generally are treated as recognizing capital gain or loss with respect to their stock in the complete liquidation of a REIT;[6] however, the IRS takes the view that liquidating distributions made by REITs to foreign investors are taxed under Section 897(h)(1) as ECI to the extent attributable to gain from the sale of a USRPI by the REIT. The Section 897 exception exempts QFPFs from tax on liquidating distributions under Section 897(h)(1) regardless of whether the REIT is domestically-controlled.

It is unclear what the impact of the Section 897 exception is on determining whether a REIT is domestically controlled. Section 897(l)(1) states that for purposes of the FIRPTA rules, a QFPF "shall not be treated as a nonresident alien individual or a foreign corporation," but it does not go so far as to say that a QFPF is treated as a domestic entity. This creates an inherent tension between QFPFs that may not need to rely on the domestically-controlled exemption to avoid ECI, and other foreign investors that need to rely on this exemption. Guidance from the IRS would be welcome on this point.

Pension-Held REIT. It is understood that the intention behind the Section 897 exception was to put QFPFs on a similar footing as domestic pension funds with respect to the taxation of their investment in U.S. real property. Whether a REIT acts as an effective blocker of unrelated business taxable income ("UBTI") for domestic tax exempt entities depends on the REIT not being treated as a pension-held REIT. A REIT is treated as pension-held if its ownership is concentrated in trusts "described in Section 401(a) and exempt from tax under Section 501(a)."[7] A QFPF is not defined by reference to these Code Sections. Accordingly, absent further guidance to the contrary, it may be reasonable to assume that a QFPF could own more than 25% of a REIT and not cause the REIT to be treated as a pension-held REIT.

Effective Dates

The Proposed Regulations generally will apply to dispositions and distributions occurring on or after the date of the adoption of the rules as final Treasury regulations. However, certain provisions of the Proposed Regulations containing the general rule for the exception and several definitions are proposed to apply to dispositions and distributions occurring on or after June 6, 2019.[8] Taxpayers may rely on the Proposed Regulations with respect to dispositions or distributions occurring on or after December 18, 2015 and prior to the applicability date of the final Treasury regulations.

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[1] References to "Section" are to the Code.

[2] Section 897(l)(1) provides that "an entity all the interests of which are held by a qualified foreign pension fund shall be treated as such a fund."

[3] In order for an entity to be treated as a controlled entity under Treas. Reg. section 1.892-2T(a)(3), the entity must be organized in the same jurisdiction as its foreign sovereign owner, and may not be owned by more than one foreign sovereign.

[4] The exception is specific to the class of stock of the REIT owned by the foreign investor. The particular class of stock must be regularly traded and the foreign investor cannot own more than 10% of such class of stock, determined by applying certain constructive ownership rules.

[5] A REIT is domestically-controlled if 50% or more of the value of its stock is owned, directly or indirectly, by U.S. persons at all times during a testing period.

[6] Section 331 treats liquidating distributions as payment in exchange for the stock held by a shareholder.

[7] *See* Section 856(h)(3)(E).

[8] *See* Prop. Treas. Reg. sections 1.897(l)-1(b)(1) (containing the general rule that gain or loss of a qualified holder from the disposition of USRPI, including gain from a distribution described in Section 897(h), is not subject to tax under Section 897(a)), 1.897(l)-1(d)(5) (definition of "governmental unit"), 1.897(l)-1(d)(7) (containing the definition of "qualification date"), 1.897(l)-1(d)(9) (containing the definition of "qualified controlled entity"), 1.897(l)-1(d)(11) (containing the definition of "qualified holder"), 1.897(l)-1(d)(14) (containing the definition of "testing period").

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