FRIED FRANK

To Our Clients and Friends Memorandum

friedfrank.com

Treasury and IRS Provide Greater Certainty on Qualified Foreign Pension Fund Rules

Although foreign persons are generally subject to U.S. federal income tax on their gains from U.S. real property, "qualified foreign pension funds" have been exempt from tax on this gain since late 2015. However, many foreign pension funds have not been certain as to whether they qualify for this exemption, which has led to uncertainty on the part of both the pension funds and their counterparties who would be withholding agents. On June 6, 2019, the U.S. Treasury Department ("Treasury") and Internal Revenue Service ("IRS") issued proposed regulations that broadly interpret the qualified foreign pension fund exemption, which should create more certainty in the market.

Background

Since the early 1980s, the Foreign Investment in Real Property Tax Act ("FIRPTA") has generally imposed U.S. federal income tax on any foreign individual or corporation that recognizes gain from the sale of U.S. real estate or from certain interests in domestic corporations that own substantial U.S. real estate ("U.S. real property holding corporations"). In 2015, Congress created a new FIRPTA exemption for qualified foreign pension funds ("QFPFs") in the Protecting Americans from Tax Hikes Act of 2015 ("PATH Act") with the enactment of Section 897(*l*).

Section 897(*l*) provides that a QFPF is not subject to FIRPTA taxation or FIRPTA withholding. Notably, however, a QFPF continues to be taxable under the provisions of the Code generally applicable to foreign investors, such as U.S. tax on a QFPF's income or gain that is effectively connected with a U.S. trade or business (i.e., ECI) and ordinary dividend income from REITs and other corporations. Accordingly, most QFPFs invest in U.S. real property through U.S. corporate blockers (including REITs, which are popular blockers for real property investments that meet REIT eligibility requirements). For example, a QFPF's gain from the sale or other taxable disposition of U.S. real property that is not held in a trade or business would be tax-free under Section 897(*l*). The exemption also generally applies to a QFPF's REIT capital gain dividends, REIT liquidating distributions, and gain from the sale of stock in a U.S. real property holding corporation (including a REIT that is not otherwise exempt as a domestically controlled REIT).

A QFPF is exempt from FIRPTA withholding tax, which is otherwise 15% of the gross proceeds received in the transaction. The withholding regulations were revised in early 2016 to exempt a QFPF from FIRPTA withholding under Section 1445 if the QFPF provides a FIRPTA certificate of non-foreign status. The preamble to the current proposed regulations announces that the IRS will revise Form W-8EXP, which is typically used by foreign governments and international organizations to claim exemption from withholding tax, so that it can also be used by QFPFs for the Section 897(*l*) exemption. In addition, the proposed regulations contain new rules for exempting QFPFs from FIRPTA withholding under Section 1446 for partnership distributions and in other contexts.

Some states, but not all, conform to the federal QFPF exemption for purposes of state and local income taxes. California, for example, has not conformed to the PATH Act.

Qualified Foreign Pension Fund Qualification

A QFPF is a trust, corporation, or other organization or arrangement that meets all of five statutory requirements, which are summarized below with additional guidance in the proposed regulations.

1. The QFPF is created or organized under the law of a foreign country.

   - The proposed regulations provide that a QFPF may be structured in a variety of ways. For example, a QFPF does not have to be a separate legal entity and may consist of a group of accounts maintained on the balance sheet of a foreign government. The proposed regulations also provide that a QFPF can be created or organized under the laws of a foreign country's political subdivision.

2. The QFPF is established by the foreign country (or its political subdivisions), or by one or more employers, to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or their designees), including self-employed individuals, as a result of services rendered by such employees to their employers.

   - The proposed regulations clarify that this requirement can be met by multi-employer pension funds and government-sponsored public pension funds, as well as a pension fund organized by a trade union that is funded by the union members' employer. The proposed regulations also provide that the QFPF may generally have up to 15% of its benefits consist of "ancillary" benefits, such as benefits payable upon the diagnosis of a terminal illness, death benefits, disability benefits, medical benefits, unemployment benefits, and similar benefits.

3. The QFPF does not have a single participant or beneficiary with a right to more than 5% of the QFPF's assets or income.

   - The proposed regulations provide attribution rules to include the interests of a spouse, siblings, ancestors, lineal descendants, and certain related entities. Treasury declined to provide rules on how to actually calculate the percentage, due to the complexity of the issue and the relatively few cases to which the 5% limitation would be expected to apply.

4. The QFPF is subject to government regulation, and annual information about the QFPF's beneficiaries is provided or available to the relevant tax authorities of the QFPF's country.

   - The proposed regulations allow the QFPF to provide the annual information to another governmental body instead of the relevant tax authority. The QFPF does not have to provide any information in a year in which it does not provide any benefits to participants or beneficiaries. The proposed regulations also waive the information requirement when the QFPF is run by a foreign government, so that the government does not have to provide annual information to itself.

5. Under the laws of the foreign country in which the QFPF is established or operates, either (i) contributions to the QFPF are deductible, excluded from the QFPF's gross income, or taxed at a reduced rate, or (ii) the QFPF's investment income is tax-deferred, excluded from its gross income, or taxed at a reduced rate.

- The proposed regulations contain a de minimis exception, which allows up to 15% of the contributions to be non-deductible, or up to 15% of the QFPF's investment income to be subject to regular income taxation, without failing this requirement. The proposed regulations also confirm that this requirement is automatically met if the foreign country has no income tax. However, a deduction or exemption for provincial or other sub-national taxes does not meet this requirement.

It should be noted that an entity may oscillate between QFPF status and non-QFPF status on a year-to-year basis. For example, its ancillary benefits may exceed 15% in some years but not in other years.

Qualified Controlled Entities

Code Section 897(*l*) provides that an entity all the interests of which are held by a QFPF is treated as a QFPF, so that the entity's gain from the disposition of U.S. real property is also exempt from FIRPTA taxation. The proposed regulations refer to such an entity as a "qualified controlled entity" and provide several favorable interpretative rules.

In particular, in response to concerns over the literal wording of the statute, the proposed regulations confirm that a qualified controlled entity does not have to be directly wholly owned by a single QFPF, and therefore that it may be wholly owned, directly or indirectly, by one or more QFPFs. This is helpful for cases where multiple related QFPFs invest through a single aggregating investment vehicle, but may potentially also have broader applications. For instance, two unrelated QFPFs from the same country may jointly own a same country corporation that could also qualify. The proposed regulations do not prohibit QFPFs formed under different countries from using an investment vehicle in a third party country, provided that all of the other requirements for eligibility are met. However, no other (non-QFPF) person may own even a de minimis equity interest in the qualified controlled entity (although non-QFPF persons may own an interest in the qualified controlled entity solely as a creditor (i.e., a non-convertible loan), which is consistent with similar concepts in the FIRPTA rules).

A partnership (as classified for U.S. federal income tax purposes) cannot be a qualified controlled entity, but generally does not need to so qualify because the QFPF exemption applies on a pass-through basis to the partnership's partners. It should be noted that a partnership or other entity that is wholly owned, directly or indirectly, by a governmental QFPF is taxed as a corporation under the "per se" corporation rules, in which case that entity may be a qualified controlled entity and eligible to claim the QFPF exemption.

Treasury was concerned that qualified controlled entities may be used for "inappropriate avoidance" of FIRPTA taxation. For example, a foreign individual may own all of the stock of a foreign corporation that owns non-business U.S. real property, which would give rise to combined U.S. federal income tax and branch profits tax of up to 44.7% on a sale. Instead, the foreign individual could sell all of the foreign corporation's stock to a QFPF without triggering FIRPTA tax. The QFPF could then treat its newly acquired foreign corporation as a qualified controlled entity that can sell its U.S. real property without any U.S. tax under the QFPF exemption. This example, and similar transactions, are addressed by an anti-abuse rule that requires a QFPF or a qualified controlled entity to always have that status during a testing period of generally ten years before the disposition or distribution that would otherwise result in FIRPTA taxation, though the testing period is reduced for some newly formed entities and in certain cases involving periods before December 18, 2015 (when the QFPF exemption became effective). Accordingly, the QFPF in the above example may be required to own the stock of its newly acquired foreign corporation for ten years (and be a QFPF for the entire period) in order for the corporation to be able to sell its U.S. real property without FIRPTA taxation.

Effective Date

The proposed regulations generally apply to transactions occurring after the regulations are finalized. However, the anti-abuse rules apply to transactions occurring on or after June 6, 2019. A taxpayer may rely on the proposed regulations before finalization, as long as the regulations are applied consistently and accurately.

Structuring Considerations for QFPFs' Investments through REITs

As noted above, a foreign person is subject to U.S. federal income taxation on its gain from the disposition of a U.S. real property interest that is used in a U.S. trade or business, including a rental trade or business. This taxation is not imposed under the FIRPTA rules and, accordingly, is not eliminated by the QFPF exemption.

By contrast, if a QFPF invests in the stock of a REIT that owns U.S. real property, the REIT's gain from the disposition of the U.S. real property may be distributed to the QFPF as a REIT capital gain dividend. Although such a dividend is generally taxed under FIRPTA for a REIT's foreign shareholders,[1] the QFPF rules exempt a REIT's QFPF shareholder from U.S. federal income tax on the capital gain dividends. A similar tax-free result can occur with a REIT's liquidating distributions and sales of REIT stock. Accordingly, REITs will continue to be used by QFPFs for tax efficient planning with respect to U.S. real estate that may be owned by a REIT and where trade or business income is expected.

It should be noted that a foreign shareholder's REIT ordinary dividends, attributable to the REIT's operating income, are generally subject to a 30% U.S. dividend withholding tax. The QFPF exemption does not provide any relief for this withholding tax. However, the withholding tax may be eliminated under Section 892 for foreign government-owned QFPFs, and the tax may be reduced or eliminated by U.S. income tax treaties with select foreign countries.[2]

Conclusion

The proposed regulations provide helpful rules that interpret the QFPF provisions broadly and with greater certainty. The proposed regulations should provide QFPFs with substantial flexibility in making their desired U.S. real estate investments, as long as they avoid a targeted anti-abuse rule that prevents certain controlled entities from engaging in future transactions that inappropriately avoid tax. From a structuring perspective, REITs will likely continue to be the investment vehicle of choice, with the QFPF's form of ownership of the REIT driven by the withholding tax considerations on ordinary dividends. However, QFPFs will continue to be subject to ECI taxation in other contexts, including from real estate related activities not held through REITs or other U.S. corporations, and state tax considerations may also apply to planning choices.

---

[1] An exception applies to capital gain dividends and liquidating distributions from publicly traded REITs to their not greater than 10% shareholders, which is subject to U.S. dividend withholding tax instead of FIRPTA taxation.

[2] Many tax treaties exempt dividends received by pension funds, although the treaty definitions of pension funds may not correspond precisely to the definition of a QFPF or qualified controlled entity.

*   *   *

Primary Authors:

Libin Zhang

Cameron N. Cosby

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

Michael J. Alter	+1.202.639.7094	michael.alter@friedfrank.com
Robert Cassanos	+1.212.859.8278	robert.cassanos@friedfrank.com
Cameron N. Cosby	+1.202.639.7490	cameron.cosby@friedfrank.com
Joseph E. Fox	+1.212.859.8853	joseph.fox@friedfrank.com
Katrin Gänsler	+49.69.870.030.777	katrin.gaensler@friedfrank.com
Michelle B. Gold	+1.202.639.7243	michelle.gold@friedfrank.com
Alan S. Kaden	+1.202.639.7073	alan.kaden@friedfrank.com
Colin S. Kelly	+1.212.859.8895	colin.kelly@friedfrank.com
Christopher Roman	+1.212.859.8985	christopher.roman@friedfrank.com
Kenneth Rosenfeld	+1.212.859.8034	kenneth.rosenfeld@friedfrank.com
David I. Shapiro	+1.212.859.8039	david.shapiro@friedfrank.com
Nick Thornton	+44.20.7972.9220	nick.thornton@friedfrank.com
Eli Weiss	+1.212.859.8855	eli.weiss@friedfrank.com
Richard A. Wolfe	+1.212.859.8922	richard.wolfe@friedfrank.com
Libin Zhang	+1 212.859.8983	libin.zhang@friedfrank.com