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Proposed Regulations for Qualified Foreign Pension Funds that are Exempt from U.S. Tax on Disposition of U.S. Real Property Interests

Background

The Foreign Investment in Real Property Tax Act of 1980, as amended (FIRPTA), imposes tax on gain realized on disposition by nonresident alien individuals or foreign corporations (non-U.S. persons) of a U.S. real property interests (USRPI) by treating such gain as effectively connected with the conduct of a U.S. trade or business by such non-U.S. persons (effectively connected income, or ECI). The FIRPTA tax is enforced by requiring the purchaser (or other transferees) of a USRPI from a foreign person to withhold an applicable percentage (generally 15%) of the gross proceeds and pay over to the Internal Revenue Service (IRS). On June 7, 2019, the IRS and the Treasury Department issued **proposed regulations** (the Proposed Regulations) on Section 897(l) of the Internal Revenue Code (the Code) that provides an exemption from the FIRPTA tax for qualified foreign pension funds (QFPF) on gains or losses attributable to dispositions of USRPI. The Proposed Regulations provide rules for determining the qualification for the exemption under Section 897(l), including certain organizational structures that are eligible for such exemption. The Proposed Regulations also clarify certification and documentation requirements with respect to withholding obligations under Sections 1445 and 1446. In addition, the Proposed Regulations provide certain anti-avoidance rules by imposing conditions on the sale of certain investment vehicles wholly owned by a QFPF.

General Code Provisions Relevant to the Proposed Regulations

Section 897(h)(1) of the Code provides that any distribution by a qualified investment entity (QIE) to a nonresident alien individual, a foreign corporation, or any other QIE is generally treated as gain from the sale or exchange of a USRPI to the extent such distribution amount is attributable to gain from sales or exchanges by the QIE of USRPIs. A QIE includes any real estate investment trust (REIT) and certain regulated investment companies (RIC).

Under Section 897(l) of the Code, a QFPF is not treated as a nonresident alien individual or foreign corporation for purposes of the FIRPTA tax. For purposes of the exemption under Section 897(l), a QFPF includes an entity all the interests of which are held by a QFPF (Qualified Controlled Entity) (each a QFPF and Qualified Controlled Entity is a Qualified Holder). A QFPF is generally defined as any trust, corporation or other organization or arrangement that meets the following requirements:

- It is created or organized under the laws of a foreign country;
- It is established (by such foreign country or one or more employers) to provide retirement or pension benefits to participants or beneficiaries that are current or former employees, including self-employed individuals (or their designees) of one or more employers for services rendered;
- It does not have a single participant or beneficiary with a right to more than 5% of its assets or income (the 5% limitation);
- It is subject to government regulation and with respect to which annual information about its beneficiaries is provided, or otherwise available, to the relevant tax authorities in the country in which it is established or operates (the information reporting requirement); and
- Under the laws of the country in which it is established and operates, (i) contributions to it that would otherwise be subject to tax under such laws are deductible or excluded from gross income or taxed at a reduced rate, or (ii) taxation of its investment income (if any) is deferred or subject to a reduced rate (the foreign tax treatment).

Under Section 1445(e)(6) of the Code, a QIE is required to deduct and withhold the FIRPTA tax on any portion of a distribution from the QIE to a nonresident alien individual or a foreign corporation that is attributable to gain from the sale or exchange of a USRPI by the QIE. However, a QIE is not required to withhold if a QFPF or a Qualified Controlled Entity that holds interest in the QIE provides the QIE a certification that the interest holder is not a foreign person.

Further, under Section 1446 of the Code, a partnership is generally required to deduct and withhold on ECI, which includes any partnership income treated as ECI pursuant to Section 897, that is allocable to a foreign partner. A foreign partner's allocable share of partnership ECI excludes income or gain exempt from U.S. tax by reason of a provision of the Code or by operation of any tax treaty (or reciprocal agreement) with the United States. A U.S. partnership required to withhold under both Sections 1445 and 1446 with respect to income treated as ECI pursuant to section 897 is deemed to satisfy the withholding requirements of Section 1445 if it complies with the requirements of Section 1446.

General Rules Under the Proposed Regulations

Determination of Qualified Controlled Entities

The proposed regulations define a Qualified Controlled Entity as a trust or corporation organized under the laws of a foreign country, all of the interests of which (other than an interest solely as a creditor) are

held directly by one or more QFPFs or indirectly through one or more Qualified Controlled Entities or partnerships. Thus, the proposed regulations clarify that a Qualified Controlled Entity may be owned directly or indirectly through one or more Qualified Controlled Entities; e.g., if a QFPF owned all of the interests of Entity A, and Entity A owned all of the interests of Entity B, then Entity B should be eligible to be treated as a Qualified Controlled Entity. The proposed regulations also provide that an entity whose interests are owned by multiple QFPFs will also be treated as a Qualified Controlled Entity.

However, the Proposed Regulations treat the inclusion of partnerships as Qualified Controlled Entities as unnecessary because under the Proposed Regulations the exemption from the FIRPTA tax applies to gain or loss earned indirectly through one or more partnerships. Thus, only corporations and trusts may be treated as Qualified Controlled Entities for purposes of these regulations.

Anti-Avoidance Rule

To prevent the inappropriate avoidance of the FIRPTA tax, the Proposed Regulations provide that a Qualified Holder does not include any entity or governmental unit that at any time during the “testing period” was not a QFPF, a part of QFPF, or a Qualified Controlled Entity. The testing period generally means the shortest of (i) the period beginning on Dec. 18, 2015 (i.e., the date section 897(l) became effective), and ending on the date of a disposition of FIRPTA asset or a distribution described in section 897(h), or (ii) the 10-year period ending on the date of the disposition or the distribution, or (iii) the period during which the entity (or its predecessor) was in existence. This limitation does not apply to an entity or governmental unit that did not own a USRPI as of the date it became a Qualified Controlled Entity, a QFPF, or part of a QFPF.

Determination of QFPFs

The Proposed Regulations have expanded the definition of QFPFs. Generally, under the Proposed Regulations, multi-employer pension funds and government-sponsored public pension funds are also considered QFPFs. Further, the Proposed Regulations say a retirement or pension fund organized by a trade union, professional association, or similar group may be treated as a QFPF by providing that an eligible fund is treated as established by any employer that funds, in whole or in part, the eligible fund. The Proposed Regulations further clarify that the determination whether a plan is established to provide qualified benefits to qualified recipients should be made without regard to whether such plan has primary responsibility to provide qualified benefits to certain qualified recipients or rather is established to provide the qualified benefits to qualified recipients only in the event of the default of one or more other plans.

However, with respect to the 5% limitation, the Proposed Regulations apply certain attribution rules described in Section 267(b) or Sections 707(b) of the Code to determine whether an individual is considered to have a right to more than 5% of the assets and income of an eligible fund.

Information Reporting Requirement

The Proposed Regulations provide that an eligible fund is treated as satisfying the information requirement, as described above, only if it annually provides to the relevant tax authorities (or one or more governmental units) in its country of establishment or operations the amount of qualified benefits provided to each qualified recipient by the eligible fund (if any), or such information is otherwise available to those authorities. However, an eligible fund will not be treated as failing to satisfy the information reporting requirement if the eligible fund is not required to provide information to the relevant tax authorities in a year in which no qualified benefits are provided to qualified recipients. Further, a

government-administered pension or retirement plan will be automatically deemed to satisfy the information reporting requirement.

The Foreign Tax Treatment

The Proposed Regulations provide that an eligible fund is treated as satisfying the foreign tax treatment requirement, as described above, if the eligible fund is established and operates in a foreign country that has no income tax. Further, the Proposed Regulations provide that an eligible fund that does not specifically receive the foreign tax treatment, as described above, would be deemed to satisfy the requirement if the eligible fund establishes it is subject to a preferential tax regime due to its status as a retirement or pension fund, and the preferential tax regime has a substantially similar effect as the foreign tax treatment requirement. The Proposed Regulations do not provide any guidance on what is considered “substantially similar” for purposes of this rule. However, the Proposed Regulations make it clear that the foreign tax treatment requirement applies at the national income tax level, and for purposes of the foreign tax treatment requirements, references to a foreign country do not include references to a state, province, or political subdivision of a foreign country.

Coordination with Income Tax Treaties

The Proposed Regulations clarify that the definitions of pension fund under a U.S. income tax treaty or an intergovernmental agreement (IGA) were designed with policy goals unrelated to the FIRPTA tax. Pension funds as defined in those agreements with the United States are not necessarily the types of entities for which an exemption from the FIRPTA tax is appropriate. Thus, a foreign pension fund that qualifies for the benefits under an applicable agreement with the United States must separately determine whether it is a QFPF under Section 897(l) of the Code.

Withholding Tax and Certification Rules

The Proposed Regulations provide that the IRS Form W-8EXP will be amended to permit Qualified Holders to certify their status under Section 897(l) of the Code. Prior to the release of revised Form W-8EXP, Qualified Holders can provide a certificate of non-foreign status described in Treas. Reg. §1.1445-5(b)(3) for purposes of both Sections 1445 and 1446 of the Code. The Proposed Regulations also provide the transferee an option to request the certification of non-foreign status or IRS Form W-8EXP.

Further, a certification of non-foreign status or a revised IRS Form W-8EXP can also be provided by a Qualified Holder with respect to certain distributions and other transactions involving domestic or foreign corporations, partnerships, trusts, and estates that can otherwise give rise to a withholding requirement under Section 1445(e) of the Code. However, although such certification or IRS Form W-8EXP will relieve the withholding agent from withholding obligations under Section 1445(e) of the Code, any otherwise applicable reporting requirements (for example, reporting required on Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding) remain applicable.

With respect to the partnership withholding under Section 1446(a) of the Code, the Proposed Regulations provide that any gain from the disposition of a USRPI or distribution received from a QIE that is not otherwise treated as ECI because of exemption under Section 897(l), will not be treated as ECI subject to section 1446 withholding to the extent allocable to a Qualified Holder. For this purpose, a partnership may rely on an updated IRS Form W-8EXP both to determine a partner's foreign status and to exclude any gain from the disposition of a USRPI, including any distribution treated as gain from the disposition of a USRPI under Section 897(h), from the determination of such partner's allocable share of ECI. Alternatively, a partnership may also rely on a certificate of non-foreign status to treat a partner as a

Qualified Holder. Other general reporting requirements applicable to partnerships with respect to its partners will continue to apply.

Effective Date

The Proposed Regulations are generally proposed to apply to distributions under Section 897(h) and dispositions of USRPI occurring on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. The anti-avoidance rule (discussed above) are proposed to apply to dispositions of USRPIs and Section 897(h) distributions occurring on or after June 7, 2019 (i.e., the date when the Proposed Regulations were filed for public inspection with the Federal Register).

Taxpayers may rely on the Proposed Regulations with respect to dispositions or distributions occurring on or after Dec. 18, 2015, and prior to the effective date of the final regulations, if the taxpayer consistently and accurately complies with the rules in the Proposed Regulations.

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