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IRS and Treasury Department Finalize Qualified Foreign Pension Funds Regulations

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 interest (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 transferee) of a USRPI from a foreign person to withhold an applicable percentage (generally 15%) of the gross proceeds and pay such proceeds to the Internal Revenue Service (IRS).

In 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 provide an exemption from the FIRPTA tax for qualified foreign pension funds (QFPF) on gains or losses attributable to dispositions of USRPI.

On Dec. 29, 2022, the IRS and the Treasury Department finalized the Proposed Regulations and retained the general approach and structure of the Proposed Regulations (the "Final Regulations"). The Final 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 Final Regulations also clarify certification and documentation requirements with respect to withholding obligations under Sections 1445 and 1446.

General Code Provisions Relevant to the Final 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). A REIT is often the preferred form of investment for QFPFs, considering that they enjoy an exemption from FIRPTA both with respect to the sale of REIT shares, and the sale of assets of the REIT.

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 or "QCE") (each a QFPF and QCE 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 USPRI by the QIE. However, a QIE is not required to withhold if a QFPF or a QCE that holds interest in the QIE provides the QIE a certification that the interest holder is not a foreign person. As mentioned above, a QFPF is not treated as a nonresident alien individual or a foreign corporation under the FIRPTA rules.

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 generally 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 Final Regulations

Determination of Qualified Controlled Entities

The Final Regulations define a QCE 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 QCEs or partnerships. As in the Proposed Regulations, the Final Regulations provide that a QCE may be owned directly or indirectly through one or more QCEs; e.g., if a QFPF owned all of the interests of Corporation A, and Corporation A owned all of the interests of Corporation B, then Corporation B should be eligible to be treated as a QCE. Further, an entity whose interests are owned by multiple QFPFs will also be treated as a QCE.

Some commentators suggested that a *de minimis* ownership of certain entities by non-QFPFs (such as managers and directors, which may be required by the local law) should be introduced to allow such entities to qualify as QCEs. The Treasury Department and the IRS rejected the comment stating that a *de minimis* exception would be an impermissible expansion of the scope of Section 897(l).

The Final Regulations donot explicitly provided guidance on whether non-economic ownership by a non-QFPF entity (*e.g.*, non-economic ownership by a general partner in a foreign partnership classified as a corporation for U.S. tax purposes) in another entity should be ignored for purposes of determining whether such other entity is a QCE. However, the preamble to the Final Regulations states that any additional guidance related to non-economic ownership is unnecessary as general tax principles should be considered to determine whether an interest in an entity should be disregarded for purposes of determining whether that entity is a QCE.

Further, the Final Regulations are silent on whether partnerships should be specifically included as QCEs. However, any specific guidance on this issue would be unnecessary (as previously discussed in the Proposed Regulations) because under the exemption from the FIRPTA tax applies to gain or loss earned indirectly through one or more partnerships. This allows a QFPF to invest with a non-QFPF through a partnership and qualify for the Section 897(l) exemption on a flow-through basis. Technically, only corporations and trusts may be treated as QCEs for purposes of these regulations. It should be noted that certain entities that are otherwise classified as partnerships are deemed to be per se corporations if they are wholly owned by section 892 investors (which can include a governmental pension fund).

Qualified Holder Rule (Anti-Avoidance Rule)

To prevent the inappropriate avoidance of the FIRPTA tax, the Proposed Regulations provided 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 QCE. 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 QCE, a QFPF, or part of a QFPF.

The Final Regulations generally adopt this approach but clarify that the Qualified Holder Rule is a separate requirement to qualify for the Section 897(l) exemption and it is not part of the definitions. Specifically, the Final Regulations provide that at the time of the disposition of USRPI or distributions by a qualified investment entity under Section 897(h), a Qualified Holder must meet one of the following two tests: (i) it owned no USRPIs as of the earliest date it became a QFPF or a QCE and remained qualified as

a QFPF or a QCE thereafter, or (ii) it satisfies the applicable testing period requirement as described in the Proposed Regulations (mentioned above).

The Final Regulations also include the following two provisional safe harbor rules to determine whether an entity is a qualified holder. First, for a period from Dec. 18, 2015, to Dec. 29, 2022 (for QFPFs), or June 6, 2019 (for QCEs), an entity will be a qualified holder if meets the definition of a QFPF described in Section 897(l)(2) (as discussed above) based on a reasonable interpretation of those requirements. Second, from Dec. 18, 2015, to Feb. 27, 2023, a QCE can disregard a *de minimis* interest of up to 5% owned by any person that provides services to the QCE. However, the second safe harbor does not apply for purposes of determining whether an entity is a QCE at the time of any disposition or distribution of a USRPI. Instead, this safe harbor is limited to cases where an entity fails to qualify as a QCE (and, thus a qualified holder) for purposes of determining whether a QCE is a qualified holder, solely because a service provider holds a 5% or less in the entity during the transition period. This safe harbor would prevent the restarting of the 10-year testing period on the date the service provider's interest is disposed of. However, the Section 897(l) exception would not apply even during the safe harbor period if a service provider holds an interest in the QCE at the time of any disposition of USRPI.

Clarification Regarding Qualified Segregated Accounts:

The Proposed Regulations provided that a Qualified Holder is exempt from FIRPTA tax to the extent any gain or loss is attributable to one or more qualified segregated accounts, which was defined to include any pool of assets maintained for the purpose of funding qualified benefits (retirement, pension, etc.) to qualified participants (plan participants and beneficiaries) (the "Qualified Segregated Accounts Requirement"). The Final Regulations clarify that the Qualified Segregated Accounts Requirement will be satisfied regardless of whether funds may revert (e.g., upon dissolution or the benefits failing to vest) to a governmental unit or employer in accordance with an applicable foreign law, provided that such governmental unit or employer does not overfund the plan in excess of what is reasonably necessary.

Determination of QFPFs

The Proposed Regulations have expanded the definition of QFPFs. Generally, under the Proposed Regulations, multi-employer pension funds (i.e., employer-established funds) and government-sponsored public pension funds (i.e., government-established 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 provided 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.

With respect to government-established funds, the Final Regulations clarify that an eligible fund may be established "at the direction of" a foreign jurisdiction to provide benefits to the establishing entity's employees, which will be considered an employer fund. Further, the Final Regulations allow a non-employer or a non-foreign jurisdiction person (e.g., a private investment manager) to administer, hold and invest contributions. In addition, an eligible fund can be established by a governmental unit acting in its capacity as an employer.

The Final regulations retain the approach with respect to the 5% limitation (as described above) such that certain attribution rules described in Section 267(b) or Sections 707(b) of the Code will apply to determine whether an individual is considered to have a right to more than 5% of the assets and income of an eligible fund.

Purpose and Valuation of Eligible Fund

The Proposed Regulations provided that an eligible fund will be treated as a QFPF if: (i) all the benefits provided by the entity are qualified benefits to qualified recipients (the "100% threshold") and (ii) at least 85% of the present value of the qualified benefits that the entity reasonably expects to provide in the future are retirement or pension benefits (the "85% threshold").

The Proposed Regulations required that the calculation of the 85% threshold would be made on an annual basis without specifically identifying a period for making this determination. The Final Regulations add the 48-month alternative calculation such that a fund can qualify as a QFPF if it shows that the average of the present values of the retirement and pension benefits the eligible fund reasonably expected to provide over its life, as determined by the valuations performed over the 48 months preceding (and including) the most recent present valuation, satisfies the 85% threshold. This is a welcome change for funds that may fail the 85% threshold in any one year due to certain unanticipated events.

Information Reporting Requirement

The Final Regulations clarify 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 Final Regulations further retain the approach that an eligible fund is treated as satisfying the foreign tax treatment requirement, as described above under "General Code Provisions Relevant to the Final Regulations," if the eligible fund is established and operates in a foreign country that has no income tax. Further, the Final 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 Final Regulations do not provide any guidance on what is considered "substantially similar" for purposes of this rule.

Further, the Proposed Regulations provided 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. However, the Final Regulations clarified that such subnational tax requirement should satisfy the foreign tax requirements if they are covered under an income tax treaty with the United States.

Coordination with Income Tax Treaties

The Final Regulations do not explicitly provide any guidance on coordination with income tax treaty, however, the preamble to the Proposed Regulations clarified 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 Final Regulations clarify that a foreign partnership that is owned entirely by Qualified Holders should not be subject to withholding under Section 1445 due to the complete exemption from FIRPTA tax for such Qualified Holders. Accordingly, such partnership may certify its status as a "withholding qualified holder" (as further discussed below) that is not treated as a foreign person. If non-Qualified Holders hold interest in a partnership together with Qualified Holders, the partnership will not qualify as a withholding qualified holder. Instead, Qualified Holders who hold interest in such a partnership may be required to obtain a withholding certificate from the IRS to lower the withholding at the partnership level.

The Final 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, withholding Qualified Holders can provide a certificate of non-foreign status described in Treas. Reg. §1.1445-2(b)(2)(i) for purposes of Section 1445(a) withholding. Specifically, the regulations are modified to require the transferor to state that it is not treated as a foreign person because it is a withholding qualified holder. Further, the withholding Qualified Holder is permitted to provide its foreign taxpayer identification number if it does not have a U.S. taxpayer identification number. Similar changes are introduced with respect to Section 1445(e) withholding requirements. Further, the Final Regulations do not permit a transferor to submit a Form W–9 because a transferor cannot represent its status as a withholding qualified holder on the certification of non-foreign status on Form W-9, which the transferor is otherwise required to represent under the regulations.

With respect to the partnership withholding under Section 1446(a) of the Code, the Final 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 Final Regulations will apply on or after Dec. 29, 2022, for dispositions of USRPIs and distributions described in Section 897(h). The Qualified Holder Rule would apply with respect to dispositions of USRPIs and distributions described in section 897(h) occurring on or after June 6, 2019. However, an eligible fund, and all persons bearing a relationship to the eligible fund described in section 267(b) or

707(b), may choose to apply the final regulations with respect to dispositions and distributions occurring on or after Dec. 18, 2015, and before the applicability date of the final regulations, if applied consistently.

Authors

This GT Alert was prepared by:

- Pallav Raghuvanshi | +1 212.801.2151 | raghuvanship@gtlaw.com
- Robert D. Simon ‡ | +1 703.903.7581 | simonr@gtlaw.com

‡ *Admitted in Colorado, New Jersey, New York, and the District of Columbia. Not admitted in Virginia. Practice limited to federal tax practice.*