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New §897(l) Exempts Qualified Foreign Pension Funds from FIRPTA

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Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), gain or loss from the disposition of a U.S. real property interest (a USRPI) by a foreign person is subject to U.S. tax as if it were income effectively connected with a U.S. trade or business (ECI). Upon the disposition of a USRPI, the foreign person must pay tax on any net gain at the same rates applicable to U.S. persons. The collection of tax under FIRPTA is administered through withholding.

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act (the ''PATH Act''). The PATH Act includes several amendments to the FIRPTA rules under §897. Among those changes was the addition of a new §897(l), which provides that FIRPTA shall not apply to any USRPI held by, or to any distribution received from a REIT by, a qualified foreign pension fund (QFPF). The FIRPTA exemption under §897(l) extends to an entity all of the interests of which are held by a QFPF.

The genesis for this welcome change to U.S. tax law was likely a remark made by President Obama in 2013, while in Miami promoting investment in U.S. infrastructure.[1] According to reports, when the President learned that ''foreign pension funds'' would invest in U.S. infrastructure but for the FIRPTA tax,[2] he suggested that foreign pension funds should be exempt from U.S. tax to the same extent that U.S. pension funds are. If this indeed was the motivation for the repeal of FIRPTA for this class of investors, it is a great irony since, as explained below, the repeal will not result in the direct exemption from U.S. tax on infrastructure projects.

The Scope of the Exemption

New §897(l) makes FIRPTA inapplicable to QFPFs. However, it does not change the ECI provisions of the Code. If a QFPF invests in an active USRPI, such as a development or infrastructure project, its gain on the sale of that USRPI will be subject to tax under the usual ECI provisions of §864. The U.S. tax on exit would not apply if the USRPI is not used in a business, such as a triple net lease on an office building, but in that case there would be a 30% U.S. withholding tax on the rental income. If the ''net election'' under §882(d) is made to treat the building as used in a business, the withholding tax will be avoided but the gain on sale would be subject to tax in the same way under §864.[3]

[1] *Obama Pushes Plan to Build Roads and Bridges*, New York Times (Mar. 29, 2013).

[2] Although the contours of the definition remain unclear, most infrastructure assets likely qualify as USRPIs. *See* Announcement 2008-115, 2008-48 I.R.B. 1228.

[3] A few U.S. treaties provide for an annual net election, which could enable a practice commonly employed before the enactment of FIRPTA. The practice was to make the net election for each year in which the passively held USRPI was generating periodic income, but not in the year of its sale. Most foreign investors took advantage of the annual net election in the U.S.-Netherlands Antilles Income Tax Treaty, long since terminated. The few remain-

Given this dilemma, the significance of the §897(l) exemption will generally be limited to investment in the stock of a "United States real property holding corporation," a "USRPHC." If a QFPF invests in the stock of a USRPHC that is a regular "C" corporation, it will be exempt from tax on any gain realized when it sells such stock; no FIRPTA or ECI tax will apply. However, many buyers of USRPIs will not wish to purchase stock of a U.S. corporation with built-in gain at the corporate level, and if they agree to do so will ordinarily extract a significant discount. A better option would be to invest through a REIT, which generally pays no U.S. tax at the corporate level. The QFPF can sell REIT stock free of U.S. tax, and the buyer of the shares may be willing to purchase such stock given that the REIT itself is not a taxpayer.

Even better, a REIT can sell the underlying USRPI without payment of a corporate-level tax and then distribute the proceeds to its shareholders, including a QFPF. Section 897(l) exempts the distribution from FIRPTA tax under §897(h), effectively overriding Notice 2007-55[4] for this class of investors. But most types of infrastructure assets cannot be held by a REIT in any economically useful way. That is because a REIT cannot own actively managed assets. The best the REIT could do would be to hold the underlying real property and lease it to an operating company. But because rents received from a related person do not qualify as good REIT income,[5] this means that large shareholders of the REIT would not be able to participate in the operating income generated by the property.

The bottom line is that new §897(l) will be of use to QFPFs primarily to invest in traditional "REIT-able" assets and to a lesser extent to invest in the stock of regular "C" corporations where a stock sale can be accomplished. Where infrastructure is concerned, only the latter option would seem to hold any promise.

The Definition of a QFPF

Section 897(l)(2) defines a QFPF as "any trust, corporation, or other organization or arrangement" which:

A. Is created or organized under the law of a country other than the United States;

B. Is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered;

C. Does not have a single participant or beneficiary with a right to more than 5% of its assets or income;

D. Is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates; and

E. With respect to which, under the laws of the country in which it is established or operates — (i) contributions to such trust, corporation, organization, or arrangement which would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate; or (ii) taxation of any investment income of such trust, corporation, organization or arrangement is deferred or such income is taxed at a reduced rate."

The foregoing definition presents some interpretative issues. For example, the definition requires the pension arrangement to be formed under the law of a "foreign country." Many foreign pension arrangements, including both private and governmental plans, are formed under the law of a political subdivision of a foreign country, such as a state or province. Presumably this is not a serious hurdle, given that all U.S. pension funds are formed under state law.

A somewhat more perplexing aspect of the definition is that it applies only to a "trust, corporation, or other organization or arrangement" established to provide retirement or pension benefits. Many foreign countries do not recognize trusts, so it is helpful that the definition picks up other entities and "arrangements." Foreign pension arrangements may take the form of a separate corporation to hold and manage the assets of the plan. In some cases, the corporation itself does not "provide" benefits; instead, benefits are "provided" only by the plan (which may or may not be a separate entity). Presumably, either the income of the corporation or the plan, depending on how the arrangement is organized, would be exempt under §897(l) because it is all part of a single "arrangement."

The QFPF definition requires that the fund be subject to government regulation, and that it provide annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates. It is unclear to me what type of government regulation the drafter had in mind, and indeed what the purpose of this requirement is; probably it was intended to grant benefits only to recognized pension funds that do not result in private in-

ing treaty elections are in treaties that for various reasons would not be as attractive to use today. *See, e.g.,* the U.S.-Greece Income Tax Treaty at Article VIII.

[4] 2007-27 I.R.B. 13.

[5] §856(d)(2).

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urement. Foreign pension arrangements might not be expected to be subject to regulation in exactly the same way that U.S. ones would be, but in most cases they will be subject to some regulation. And most report tax information concerning their beneficiaries, at least through service providers.

The last prong of the QFPF definition appears to be garbled. It requires that contributions to the arrangement ‘‘which would otherwise be subject to tax under such laws are deductible or excluded from the gross income *of such entity* or taxed at a reduced rate’’ (emphasis supplied). This makes no sense; a contribution to a fund cannot be deductible by the fund itself. The language makes sense only if interpreted to refer to the *employee's* tax treatment, rather than to the fund's tax treatment.

Some of these definitional hurdles may be slightly more difficult to apply to a class of investors that President Obama should have had in mind if his intention was to open up the field of investment to well-endowed ‘‘foreign pension funds.’’ Many foreign investors that have the capacity and the appetite to invest in USRPIs are foreign government pension arrangements which separately qualify for exemption on certain income by reason of §892. It will be important to confirm that such arrangements qualify as QFPFs for at least two reasons. First, the §892 exemption applies only to sales of stock of less-than-50%-owned USRPHCs, whereas the QFPF exemption is not so limited. Second, the QFPF exemption extends to REIT distributions, whereas the IRS has taken the position in Notice 2007-55, that §892 does not.

Wholly Owned Entities

Section 897(l) extends to ‘‘any entity all of the interests of which are held by a qualified foreign pension fund.’’ Presumably this language was added in recognition of the fact that a QFPF might not invest directly, but through a wholly owned subsidiary. It is unfortunate that the language does not make clear whether the subsidiary must be directly wholly owned, or only indirectly wholly owned. This could matter where a QFPF owns USRPIs through a tiered structure (which could include one or more corporations or trusts), or through a ‘‘diamond’’ structure (where the investing entity is held by two or more different subsidiaries of the QFPF).

Somewhat similar and imprecise language is used in Reg. §301.7701-2(b)(6), which refers to ‘‘a business entity wholly owned by’’ a government. Although the precise meaning of that language remains unclear, the Preamble to that regulation stated that it was ‘‘not limited to those entities directly owned’’ by a foreign government.[6] Hopefully, the same was intended here.

The Way Forward

Section 897(l) will be very important to both QFPFs and to the REITs and other entities through which they invest in USRPIs. While the PATH Act exempts FIRPTA gains of QFPFs from withholding tax, withholding agents will no doubt need some comfort that a particular arrangement is in fact a QFPF. It will likely be quite a while until the IRS issues any guidance helping to define that term. Perhaps the IRS will be willing to issue private rulings in the meantime. But more likely, QFPFs and their withholding agents will rely on representations and on opinions of counsel that the investor qualifies as a QFPF.

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[6] T.D. 9012, 67 Fed. Reg. 49,862 (Aug. 1, 2002).

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