Executive summary

On 18 December 2015, President Obama signed the Consolidated Appropriations Act, 2016 (the Act), which amends the Foreign Investment in Real Property Tax Act (FIRPTA). The Act introduces several changes to the application of FIRPTA, some of which are discussed below.

For certain foreign pension funds, the Act provides that Section 897 shall not apply to any United States real property interest (USRPI) held directly (or indirectly through one or more partnerships) by a qualified foreign pension fund or any entity wholly owned by a qualified foreign pension fund. The exemption also applies to capital gain dividend distributions from real estate investment trusts (REITs).

These new provisions apply to dispositions and distributions after 18 December 2015, the date of enactment of the Act.

Detailed discussion

Legislation

The legislation under Section 323 of the Act creates a new exception to FIRPTA for interests held by qualified foreign pension funds under new Code Section 897(l). In particular, Section 897(l)(X1) exempts from the FIRPTA rules...
any USRPI held directly (or indirectly through one or more partnerships) by a qualified foreign pension fund or by any entity wholly owned by a qualified foreign pension fund. Section 323 of the Act also exempts capital gain dividend distributions from a REIT to a qualified foreign pension fund or any entity wholly owned by a qualified foreign pension fund that is attributable to gain the REIT derived from the sale of a USRPI.

Section 897(l)(2) defines the term “qualified foreign pension fund” as any trust, corporation, or other organization or arrangement:

- Created or organized under the law of a country other than the United States
- 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
- With no single participant or beneficiary with a right to more than 5% of its assets or income
- Subject to government regulation and providing annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates
- For which, under the laws of the country in which it is established or operates:
  - Contributions to the organization or arrangement that would otherwise be subject to tax under those laws are deductible or excluded from the entity’s gross income or taxed at a reduced rate or
  - Taxation of any investment income of the organization or arrangement is deferred or the income is taxed at a reduced rate

This provision also makes conforming changes to Section 1445(f)(3) to provide an exemption from withholding on dispositions by qualified foreign pension funds (and their wholly-owned foreign subsidiaries) of USRPIs, and authorizes regulations to be promulgated to implement these provisions.

For example, as noted earlier, Qualified Foreign Pension Fund is defined to mean “any trust, corporation, or other organization or arrangement” that meets certain criteria. This seems all encompassing and appears to include any type of business or governmental association or organization, provided that the other definitional requirements of Section 897(l)(2) are met.

The five requirements for a Qualified Foreign Pension Fund outlined in Section 897(l)(2) are relatively straightforward though there are certain ambiguities. Section 897(l)(2)(B) requires establishing the Qualified Foreign Pension Fund to provide retirement or pension benefits to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered. Several questions arise about this provision. For example, what does it mean to be a current or former employee of one or more employers? Would a pension fund for, or including, self-employed individuals qualify? Does a governmental social security-type fund providing benefits to unemployed persons qualify? The answers to these and other questions will determine how broadly this new FIRPTA exception applies.

Further, once a Qualified Foreign Pension Fund is determined to exist, there appear to be no restrictions or limitations on the type or purpose of entities that are wholly owned by such funds to take advantage of this new provision. For example, such wholly-owned entities seemingly may be for-profit enterprises conducting commercial activities. While Section 892 would not permit an income tax exemption for income derived from commercial activities, Section 897(l) may provide an exception from FIRPTA for a Qualified Foreign Pension Fund that indirectly conducts commercial activities through an entity that it wholly owns.

Some commentators have noted ambiguity regarding the obligation to report under Section 897(l)(2)(D) to the relevant tax authority in the country where the foreign pension fund is established or operates. When a foreign government otherwise meets the definitional requirements for a Qualified Foreign Pension Fund under Section 897(l) but may not have any reporting obligations given that it is a governmental entity itself, such pension fund may not come within Section 897(l). There is a further ambiguity when a foreign pension fund otherwise meeting the definitional requirements under Section 897(l) has reporting obligations to governmental authorities that are not typically thought of as tax authorities in that particular country.

Specific considerations relating to foreign pension funds

The provisions of the new foreign pension fund exception to FIRPTA appear to be broad, and open the door for increased foreign investment in US real estate, particularly for qualified foreign pension funds (Qualified Foreign Pension Funds).
New Section 897(l) and amended Section 1445(f)(3) apply to dispositions and distributions after 18 December 2015, the date of enactment of the Act.

Other FIRPTA changes

Under FIRPTA, gain that a nonresident alien or foreign corporation generally derives from the sale or other disposition of stock in a US real property holding corporation is taxable at ordinary or capital rates. Under present law, FIRPTA does not apply to stock sales in a United States real property holding corporation (USRPHC), when the shareholder owns shares of a class of stock that is regularly traded on an established securities market, provided that the shareholder holds (applying attribution rules) no more than 5% of that class of stock at any time during the testing period (the Portfolio Investor Exception).

Section 322 of the Act is among several other changes made with respect to FIRPTA and is discussed below. In particular, Section 322 increases the stock ownership threshold for exception from FIRPTA for portfolio investment in publicly traded stock of USRPHCs from 5% to 10%, but only for stock of a publicly traded REIT.

The provision also increases the ownership threshold for the exception to Section 897(h)(1) (distributions by a REIT attributable to gain the REIT derives from the sale of a USRPI) from 5% to 10% for distributions by a publicly traded REIT that are attributable to gain the REIT derives from the sale of USRPIs. Therefore, such distributions are subject to the rules otherwise applicable to distributions by US corporations and to the rules applicable to REIT capital gain dividends. Under prior law, such REIT distributions were treated as effectively connected income from the sale by the shareholder in the United States of USRPIs.

Finally, Section 322 also introduces new Section 897(k)(2), which provides an additional exception to FIRPTA for certain “qualified shareholders” in REITs. The exception generally applies to qualified shareholders in REITs, regardless of whether the REIT is publicly traded or domestically controlled.

This exemption does not, however, apply to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10% of a class of stock of the REIT (determined by application of the constructive ownership rules of Section 897(c)(6)(C)). Thus, so long as the “more-than-10%-rule” is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately-held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA.

A qualified shareholder includes certain foreign partnerships, certain publically traded residents of treaty countries and certain publically traded foreign limited partnerships. The definition of a “qualified shareholder,” however, is complex and will require careful consideration to determine whether a foreign person may meet this definition.

Implications

Although it is not entirely clear from the definitions which foreign pension funds qualify for the new FIRPTA exception, these provisions will tend to make foreign investment in the US real estate market more attractive. Additionally, foreign pension funds currently investing in USRPIs, including REIT stock, may want to re-evaluate compliance needs and restructuring possibilities. In addition, withholding agents may need to await guidance from the Internal Revenue Service and Treasury Department regarding requirements for documenting withholding obligations under the new rules. In the meantime, there are many ambiguities about the new law’s application that will require careful consideration to determine whether a foreign person may be within the scope of the new provisions.
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