

## Publications

# Recent IRS Guidance Focuses on Rules for Qualified Foreign Pension Funds

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At the end of 2022, the Department of the Treasury and the Internal Revenue Service (together, the “IRS”) issued [two sets of guidance](#) – a final rule and a proposed rule – addressing the application of certain provisions of the Internal Revenue Code of 1986 (“Code”) to qualified foreign pension funds (“QFPFs”).

Historically, foreign pension funds have been major investors in property located in the United States. Congress has responded to efforts to allow QFPFs to invest in the US on a nontaxable basis by enacting the provisions discussed below. The IRS has finally addressed these provisions in its regulations.

Below is an overview of the guidance and notable takeaways for QFPFs and other stakeholders, including financial institutions that deal with QFPFs.

## A. Final Rule on Exception for Interests Held by Foreign Pension Funds

The Final Rule builds on an extensive and highly technical set of Code requirements regarding the tax treatment of QFPFs and their wholly owned entities, known as qualified controlled entities (“QCEs”), with respect to certain transactions involving interests in United States real property as defined in the Code (“USRPI”). 87 Fed. Reg. 80042 (Dec. 29, 2022).

As background, Code section 897 generally considers certain gains or losses by a nonresident foreign individual or a foreign corporation in connection with a USRPI to be “effectively connected with [a] trade or business” engaged in by such individual or corporation, subjecting them to US tax. In 2015, the Code was amended to add section 897(l) which provides an exemption from this rule for QFPFs and QCEs. Thus, QFPFs and QCEs are generally exempt from certain otherwise taxable transactions involving USRPIs.

The Final Rule comes nearly four years after the IRS issued its proposed rule regarding the availability and application of the Code section 897(l) exemption. Substantively, the Final Rule retains much of the 2019 proposed rule. However, there are some notable changes and clarifications, as summarized below.

## 1. QFPF Eligibility

Beyond the statutory requirements contained in Code section 897(l)(2), the Final Rule clarifies a number of conditions for a pension fund to constitute a QFPF. A number of these conditions are reminiscent of the basic IRS qualification rules for U.S. pension plans, but a few would never be permitted for US plans.

- **QFPF Administration.** The Final Rule confirms a pension fund may be a QFPF even if the fund (1) is administered by “one or more persons that are not the foreign jurisdiction or employer,” and (2) is established by “or at the direction of” a foreign jurisdiction to be a government-established fund. Thus, a QFPF may exist even if “private investment managers hold and invest contributions” for a pension fund created by foreign government mandate.
- **85% Test.** The Final Rule retains the requirement that at least 85% of the present value of qualified benefits that a pension fund “reasonably expects to provide in the future are retirement or pension benefits.” With respect to making this determination, the Final Rule clarifies that a fund “must measure the present value of benefits to be provided during the entire period” of the fund’s expected existence, and that this valuation must be made at least annually. Helpfully, the Final Rule also provides that a pension fund may “utilize any reasonable method for determining present value.”
- **Alternative to 85% Test.** In recognition of the possibility that “unanticipated events may cause a fund to fail the 85 percent threshold in any one year,” the Final Rule provides an alternative 48-month average test under which a fund will continue to be considered a QFPF “if it shows that it has consistently qualified as such over an extended period.”
- **“Qualified Benefits.”** The Final Rule expands on the meaning of “qualified benefits,” which is broadly defined to refer to retirement, pension, or ancillary benefits. The Final Rule defines retirement and pension benefits as benefits payable “after reaching retirement age under the terms of the eligible fund” or after an event resulting in an individual being “permanently unable to work.” The Final Rule also defines ancillary benefits to include various medical, unemployment, life insurance, short-disability, and incidental death benefits.
- **“Qualified Recipient.”** The Final Rule expands the definition of “qualified recipient” to include spouses of covered employees, as well as to “allow individuals who were never employees to constitute up to five percent of participants in plans established by employers.”
- **5% Limit on “Other Benefits.”** The Final Rule permits the provision of “a limited amount of benefits that are outside the scope of retirement and pension benefits and ancillary benefits.” Such benefits are broadly defined as “any benefits provided by the eligible fund as permitted or required under the laws of the foreign jurisdiction in which the fund is established or operates that do not otherwise fall within the definition of retirement and pension benefits or ancillary benefits.” However, the Final Rule limits the provision of such benefits to no more than 5% of the present value of qualified benefits reasonably expected to be provided during the fund’s entire existence.

## 2. Scope of QCE Exemption

- **QCE Ownership.** The Final Rule confirms that there is no de minimis or other exception to the requirement that a QCE be wholly owned by a QFPF.
- **Qualified Holder Rule.** Although the Final Rule retains the “qualified holder rule” to determine QFPF/QCE eligibility for the exemption, IRS provides for two alternative tests (based on USRPI ownership at the time of the relevant transaction) for meeting the requirement.
- **Qualified Segregated Accounts.** The Final Rule confirms that the exemption is only available with respect to gains/losses related to “qualified segregated accounts,” which are generally defined as a pool of assets maintained for the “sole purpose” of funding retirement, pension, or ancillary benefits for qualified recipients. The Final Rule clarifies that the “sole purpose” requirement is met even if “funds may revert (such as upon dissolution or the benefits failing to vest) to the governmental unit or employer in accordance with applicable foreign law,” as long as funding of contributions is “not more than what is reasonably necessary” for funding qualified benefits.

The Final Rule includes a number of other provisions, including rules relating to the treatment of distributions and early withdrawals (including rollovers), as well as various other requirements regarding withholding, documentation, and other administrative aspects of plan operation.

The Final Rule became effective on December 29, 2022, although certain provisions are effective earlier.

## B. Proposed Rule on Foreign Government Exemption

On the same day that it issued the Final Rule, the IRS released a proposed rule (“Proposed Rule”) regarding the tax exemption for foreign governments under Code section 892(a)(1). 87 Fed. Reg. 80097 (Dec. 29, 2022). Among other things, the Proposed Rule is intended to address a perceived incongruity in tax regulations as it relates to the application of exemptions for foreign governments to QFPFs and QCEs in connection with U.S. real property holding corporations (“USRPHC”).

As background, the exemption in Code section 892 generally does not extend to income derived from a commercial activity or received directly or indirectly from a “controlled commercial entity.” Currently, Treas. Reg. §1.892-5T treats a USRPHC as being engaged in a commercial activity, and further treats a USRPHC controlled by a foreign government to be a “controlled commercial entity.” As a result, with respect to a QFPF that qualifies as a USRPHC, the IRS notes that “none of the income, including, for example, from investments in the United States in stocks or securities, received by the foreign government from that QFPF would be eligible for the section 892 exemption.”

To address this ostensibly unintended consequence as applied to foreign pension funds, the Proposed Rule would amend the existing tax regulations to clarify that QFPFs and QCEs that qualify as a USRPHC but otherwise meet the conditions for exemption under Code section 897(l) are not treated as “controlled commercial entities” pursuant to Code section 892.