

## IRS Issues Proposed Regulations Clarifying What Foreign Pension Funds are Eligible for Tax Exemption on US Real Property Investments

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**AUTHORS:** David Powell

The IRS has recently issued long-awaited (but still only proposed) guidance on which foreign pension funds may be eligible for exemption on US taxes on foreign investment in real property under a law passed in 2015. 84 Fed. Reg. 26605 (June 7, 2019). Information on the passage of the original statutory exemption can be [found here](#). The new proposed regulations would clarify a number of important areas in the exemption.

Though only proposed, taxpayers may rely on the regulations in the interim, and one anti-abuse rule is effective immediately. Comments to the Treasury and IRS on the regulations are due by September 5, 2019.

### Background

The Foreign Investment in Real Property Tax Act ("FIRPTA") generally imposes US taxes on proceeds from foreign investment in US real property, including withholding, generally at a 15 percent rate. Importantly, though, in 2015, the Protecting Americans from Tax Hikes Act of 2015, (the "PATH Act") introduced an exemption for certain foreign pension funds investing in US real property under new section 897(l) of the US Internal Revenue Code (the "Code") and later modified by the Appropriations Act of 2018.

The key to this foreign pension fund exemption is to be a "qualified foreign pension fund" or "QFPF". Entities all of the interests of which are held by a qualified foreign pension fund ("qualified controlled entities" or "QCEs") are also treated as QFPFs.

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## What the Statute Required

The statute generally defines QFPF to generally means any trust, corporation, or other organization or arrangement—

- A. created or organized under the law of a country other than the US,
- B. established by such country (or its political subdivisions), or by 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 persons designated by such employees, as a result of services rendered by such employees to their employers,
- C. which does not have a single participant or beneficiary with a right to more than 5 percent of its assets or income,
- D. “which is subject to government regulation and with respect to which annual information about its beneficiaries is provided, or is otherwise available, to the relevant tax authorities in the country in which it is established or operates” (which had originally been more limited to require that the plan “provides annual information reporting about its beneficiaries to the relevant tax authorities”), and
- E. with respect to which, under the laws of the country in which it is established or operates—
  - a. contributions are deductible or excluded from the gross income or taxed at a reduced rate, or
  - b. investment income is deferred, or excluded from the gross income of such entity or is taxed at a reduced rate.

For some time, foreign pension funds have been looking for guidance on some these terms.

## Clarifications in the Proposed Guidance

The principal clarifications in the proposed regulation definitions of QFPF and QCE include:

- Indirect Ownership of Qualified Controlled Entities  
The proposed regulations provide that a QCE may be owned directly or indirectly through one or more QCEs.
- Multiple QFPF Owners  
The proposed regulations provide that the interests in a QCE may be held by one or more QFPFs directly or indirectly through one or more qualified controlled entities.
- Creditor Interests in a Qualified Controlled Entity

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A creditor's interest in an entity should not be taken into account for purposes of determining whether the entity is treated as a QCE if the interest does not share in the earnings or growth of the entity.

- De Minimis Ownership of a Qualified Controlled Entity by Non-QFPFs Not Allowed

The proposed regulations do not permit ownership of a QCE by any person other than a QFPF or another QCE.

- Anti-Avoidance Rule - Selling a Corporation Holding US Real Property to a QFPF or QCE

The preamble to the proposed regulations notes that there has been some concern about preventing QFPFs from indirectly acquiring US real property from a foreign corporation, which could permit the acquired corporation to avoid tax on gain that would otherwise be subject to tax under section 897. In an example given in the preamble, a foreign corporation (FP) that is not a QFPF or QCE owns 100 percent of the stock of FS, a foreign corporation, and that FS owns a US real property interest with a basis of \$80x and a fair market value of \$200x. FP sells the stock of FS to a QFPF. If FS were treated as a QCE and FS later sold the USRPI for \$200x, neither FP nor FS would be subject to tax under section 897 on the \$120x gain attributable to its investment in the US real property, even though the gain accrued while FS was owned by FP, which was not a QFPF or QCE. (Some might see some parallels in this issue to the recent tax controversies over dividend withholding refunds for stocks held for a short time by pension funds.)

In response to this, the proposed regulations provide that a qualified holder (a QFPF or QCE) does not include any entity or governmental unit that, at any time during the testing period, determined without regard to this limitation, was not a QFPF, a part of a QFPF, or a QCE. For this purpose, the testing period generally means the shortest of (i) the period beginning on the date that section 897(l) became effective (December 18, 2015), and ending on the date of a disposition described in section 897(a) or a distribution described in section 897(h), (ii) the ten-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 US real property interest as of the date it became a QCE, a QFPF, or part of a QFPF.

- Establishment to Provide Retirement or Pension Benefits

The proposed regulations state that the QFPF definition is not intended to exclude common foreign pension arrangements that provide a relatively small amount of ancillary benefits to participants and beneficiaries. The regulations would require that all of the benefits that an eligible fund provides are qualified benefits to qualified recipients, and that at least 85 percent of the present value of the qualified benefits that the eligible fund reasonably expects to provide in the future are retirement or pension benefits. Qualified benefits include retirement, pension,

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or ancillary benefits. Ancillary benefits are benefits payable upon the diagnosis of a terminal illness, death benefits, disability benefits, medical benefits, unemployment benefits, or similar benefits. The Treasury Department and the IRS request comments on whether the regulations should also define retirement or pension benefits (for example, with reference to whether there are penalties for early withdrawals).

The proposed regulations do not differentiate between plans that are primarily responsible for the provision of qualified benefits to qualified recipients, on the one hand, and plans that are secondarily responsible for the provision of qualified benefits to qualified recipients (i.e., governmental pension guaranty funds).

- Five Percent Limitation and Related Parties

The proposed regulations provide that, for purposes of applying the 5 percent limitation, an individual is considered to have a right to the assets and income of an eligible fund to which any person who would be aggregated with that person under the related party aggregation rules of US Code sections 267(b) or section 707(b).

- Annual Reporting Requirement

The proposed regulations provide that the information requirement that the eligible fund annually provides to the relevant tax authorities in the foreign country in which it is established or operates the amount of qualified benefits provided to each qualified recipient by the eligible fund will be treated as having been failed if the eligible fund is required only to provide information to the relevant tax authorities in a year in which no qualified benefits are provided to qualified recipients. This appears to mean, as some comments requested, that reporting need be done only on recipients who receive distributions in a year, but further clarification would be helpful. The regulations go on to request comments as to whether the final regulations should permit other types of information to satisfy the information requirement.

Further, the proposed regulations would interpret “relevant tax authority” to broadly include one or more governmental units of the foreign country in which the eligible fund is created or organized.

- Tax Deduction or Exemption Requirement

An eligible fund will be treated as satisfying the tax deduction or exemption requirement even if the eligible fund is established and operates in a foreign country that has no income tax.

The proposed regulations also provide that an eligible fund is treated as satisfying the requirement in a taxable year if, under the income tax laws of the foreign country in which the eligible fund is established or operates, at least 85 percent of the contributions to the eligible fund are deductible or excluded from gross income or taxed at a reduced rate, or tax on at least 85 percent of the investment income of the eligible fund is deferred or taxed at a reduced rate. The Treasury also asks for comments on this threshold.

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The proposed regulations provide that, for purposes of this requirement, references to a foreign country do not include references to a state, province, or political subdivision of a foreign country.

- No Safe Harbors

The Treasury opted not to include any safe harbors in the proposed regulations. Thus, a foreign pension fund that qualifies for other benefits under an income tax treaty (whether a corresponding plan or otherwise) or IGA must make a separate determination as to whether it is a QFPF.

## Effective Date, Reliance, Comments

Generally, the regulation will not be effective until the final regulation is published in the Federal Register. However, the anti-abuse rule described above on selling a corporation holding US real property to a QFPF or QCE has an immediate applicability date of June 6, 2019. Otherwise, a taxpayer may rely on the proposed regulations with respect to dispositions or distributions occurring on or after December 18, 2015, and prior to the applicability date of the final regulations, if the taxpayer consistently and accurately complies with the rules in the proposed regulations.

Comments and requests for a public hearing must be given to the IRS and Treasury by September 5, 2019.

## Summary

The proposed regulations address a number of questions that had been raised as to how the QFPF definition applied for the critical tax exemption for a foreign pension fund to invest effectively in US real property. If you have any questions or would like to file any comments with the IRS and Treasury on the proposed regulations, please contact David Powell or your regular Groom lawyer.

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