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The new FIRPTA exemption for foreign pension funds

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Babak Nikravesh, partner at Hogan Lovells, unpicks the new FIRPTA exemption for foreign pension funds.

The FIRPTA related provisions of the PATH Act can be viewed as a marriage of the Obama and Congressional proposals put forward in recent years

In perhaps the most significant reform of the US tax regime governing foreign investment in US real estate since the 1980 enactment of the Foreign Investment in Real Property Tax Act (FIRPTA), President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) on December 18 2015. The PATH Act contains two particularly noteworthy provisions applicable to foreign investors in US real estate. The first is designed to spur foreign investment in real estate investment trusts (REITs) by, among other things, expanding existing tax exceptions for interests in publicly-traded REITs and creating a new exception for REIT interests held by certain publicly-traded shareholders and collective investment vehicles (CIVs). The second creates a new, wholesale exemption from FIRPTA for eligible foreign pension funds and entities wholly owned by such pension funds.

Birth of FIRPTA

Congress enacted FIRPTA in 1980 in response to concerns around a perceived advantage that foreign investors enjoyed over US investors when investing in US real estate. Before 1980, a foreign investor could arrange its investments so as to avoid US income tax on gains from the disposition of US real estate investments. With the enactment of FIRPTA, foreign investors became subject to tax on income and gain from most investments in US real property, including investments in the equity of corporations holding predominantly US real property interests.

"The new FIRPTA exemption dramatically expands the means by which an eligible foreign pension fund can invest in US real estate without being subject to FIRPTA"

FIRPTA has been sharply criticised over the years as a barrier to foreign investment. Legislation has been periodically introduced that would abolish or significantly curtail the effects of FIRPTA but, until the PATH Act, such attempts at legislative change have been unsuccessful. In 2013, for instance, the Obama Administration announced its intention to sponsor legislation that would increase foreign investment in US infrastructure by exempting investment gains of foreign pension funds from US tax. Competing Congressional proposals promoting REIT investments have also been put forward since 2010. The FIRPTA related provisions of the PATH Act may therefore be viewed as a marriage of the Obama and Congressional proposals that have been put forward in recent years.

The legislation

Effective from December 19 2015, the PATH Act provisions aimed at promoting foreign investment in US real estate fall into two general categories.

REIT provisions

The PATH Act seeks to spur foreign investment in REITs by, among other things,

- increasing the ownership ceiling for the existing FIRPTA exception for interests held by foreign investors in publicly-traded REITs from 5% to 10%;
- creating a new FIRPTA exception for any amount of REIT stock (whether or not publicly-traded) held by certain publicly-traded entities and collective investment vehicles; and
- reversing part of IRS Notice 2007-55 (the Notice) such that liquidating distributions from a REIT to certain foreign investors are tax-free.

The Notice was issued by the US Internal Revenue Service (IRS) in 2007 and contained two rulings relating to foreign investment in REITs. The second of these provided that liquidating distributions paid by a REIT should be treated as a sale of a REIT's underlying real estate rather than a sale of stock. The PATH Act reverses this second portion of the Notice in the case of certain publicly-traded entities and collective investment vehicles and, in so doing, harmonises the tax treatment of REIT stock sales and liquidating distributions for such investors.

Foreign retirement and pension fund provisions

The PATH Act creates a broad exemption from FIRPTA for interests held by foreign retirement or pension funds. The new exemption applies to any US real property interest held directly or indirectly (through one or more partnerships) by a 'qualified foreign pension fund' (QFPF) or by an entity wholly-owned by a QFPF. The legislation also makes conforming changes to the applicable withholding rules by causing QFPFs and entities wholly-owned by QFPFs not to be treated as 'foreign persons' for FIRPTA purposes.

A QFPF means any trust, corporation or other organisation or arrangement:

- which is created or organised under the law of a country other than the US;
- which 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;
- which does not have a single participant or beneficiary with a right to more than 5% of its assets or income;
- which 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
- with respect to which, under the laws of the country in which it is established or operates, (i) contributions to such trust, corporation, organisation 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, organisation or arrangement is deferred or such income is taxed at a reduced rate.

Foreign investors should expect the US Department of Treasury to issue regulatory guidance that will no doubt elaborate upon the application of these new rules, including details on the eligibility requirements for QFPFs and notice requirements necessary for transferees of real property to avoid withholding. Revised IRS Form W-8s designed to address foreign pension fund eligibility may also follow.

Observations

There are several notable aspects of the PATH Act's foreign pension fund provisions:

Expanded investment opportunities

Before the PATH Act, a foreign pension fund hoping to avoid FIRPTA could (i) take a minority position in a domestically controlled private REIT; (ii) obtain a less-than-5% position in a publicly-traded REIT; or (iii) in the case of a foreign pension fund treated as a 'foreign government' under Section 892 of the Internal Revenue Code, take minority, non-controlling positions in a REIT. The new FIRPTA exemption dramatically expands the means by which an eligible foreign pension fund can invest in US real estate without being subject to FIRPTA.

Does not protect against non-FIRPTA ECI or withholding tax

While the PATH Act offers an avenue for eligible foreign pension funds to avoid FIRPTA gains, it is not a shield from 'effectively connected income' (ECI). For example, while gain from the disposition of US real estate with respect to a QFPF may avoid FIRPTA, income earned on the real estate investment may potentially cause the investor to (i) be treated as engaged in a trade or business within the US; (ii) have ECI; and (iii) become exposed to branch profits tax in the case of investors treated as corporations for US tax purposes. Moreover, distributions or

payments from an underlying investment that are not treated as ECI may nonetheless be subject to withholding tax under US tax rules. Finally, gain from the disposition of a real estate asset used in a US trade or business may be taxable as ECI notwithstanding the FIRPTA exemption. Thus, while the PATH Act offers a very important benefit, it does not completely eliminate the need for proper planning when structuring investments into US real estate.

State income taxes may still apply

The FIRPTA exemption for eligible foreign pension funds is a federal exemption; it does not exempt gain from state-level taxes. While many states generally conform to the federal rules, whether by calculating state level income taxes by reference to federal concepts such as ECI (like New York) or by passing conforming legislation of their own (like California), it would be unwise to assume that a federal exemption from FIRPTA would necessarily mean an exemption from state taxes as well. As such, QFPFs should weigh the potential impact of state level taxes when evaluating real estate investment opportunities.

Coverage extends to subsidiaries of eligible pension funds

The terms of the PATH Act extend to subsidiaries that are wholly-owned by QFPFs. The statute does not restrict the extension of the benefit to a particular type of subsidiary – whether a corporation, partnership or trust – and does not preclude its application to entities formed in a jurisdiction other than that of the foreign pension fund. A strict reading of the statute leaves open the question, however, of whether subsidiaries that are not directly owned by a QFPF are eligible. Treasury guidance may clarify the extent to which indirect subsidiaries are eligible for preferential treatment.

Exemption not limited to non-foreign governmental pension funds

On the face of it, the special exemption afforded to QFPFs under the PATH Act is also potentially available to pension funds eligible for benefits under Section 892, the limited exemption from US source income available to foreign government affiliated investors, including governmental pension funds. Baring any regulatory curtailment, governmental pension funds may therefore find themselves eligible for Section 892 as well as this new exemption from FIRPTA.

Continuing utility of Section 892 for eligible pension funds

The principal benefit of Section 892 is an exemption from US federal income tax on dividends, interest and gains from the disposition of non-controlled corporations that predominantly hold US real estate. For foreign pension funds that meet the definition of a QFPF and which are fully exempt from US withholding tax on dividends and interest under an applicable income tax treaty, Section 892 may offer limited additional utility. As such, some QFPFs may consider whether the effort and expense of continued vigilance to preserve the benefits of Section 892 – such as by avoiding 'commercial activity' in the case of controlled entities and also 'unrelated business taxable income' (UBTI) in the case of pension trusts of foreign sovereigns – is warranted.

Competitive advantage

The Obama Administration first put forward the idea of a FIRPTA exemption for foreign pension funds in 2013 for two reasons. First, as a means to spur investment in US infrastructure. Second, as a way to put foreign pension funds on approximately equal footing with domestic pension funds. However, by enacting legislation that, in its genesis, purported to level the playing field

vis à vis domestic pension funds, the PATH Act has now created a competitive advantage for eligible foreign pension funds *vis à vis* foreign governmental investors like sovereign wealth funds. For instance, while sovereign wealth funds eligible for the Section 892 exemption are permitted to exit non-controlling stakes in corporations that primarily hold US real estate tax-free, QFPFs may enjoy a tax preferred exit even in the case of controlling positions. Moreover, the tax benefits afforded to QFPFs may even surpass, to some extent, the benefits available to domestic pension funds and university endowments that remain subject to detailed UBTI rules. One may therefore expect interest groups from these constituencies to object to these PATH Act changes, likely arguing for additional benefits of their own.

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