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Qualified Non-US Pension Funds Now Exempt from US "FIRPTA" Taxation

On December 18, 2015, Congress passed, and the President signed into law, The Protecting Americans From Tax Hikes Act of 2015 (the "Act"). Among other things, the Act makes significant changes to the rules enacted by the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") that will be relevant to certain non-US pension funds investing in US real estate, and funds established to make such investments.[1]

Under the Act, a "qualified foreign pension fund", or any non-US taxable entity that is wholly owned by a qualified foreign pension fund (either, a "QFPF"), will no longer be subject to US federal income tax under FIRPTA in respect of gain from the disposition of a "United States real property interest" (a "USRPI"). Subject to the discussion below, such exemption applies to gain realized directly by a QFPF, gain realized through an entity treated as a partnership for US federal income tax purposes, and distributions from a REIT that are attributable to gain from the disposition of a USRPI.

The Act also provides QFPFs with an exemption from the withholding imposed under FIRPTA on proceeds from the disposition of a USRPI, and on certain distributions from REITs and other entities.[2]

The Act does not, however, provide an exemption to a QFPF in respect of gains that are treated as effectively connected with the conduct of a United States trade or business ("effectively connected income" or "ECI"). Likewise, it does not provide an exemption to a QFPF in respect of withholding of US federal income by a partnership in respect of ECI.

In most cases, gains that are derived from the disposition of US real estate that is held by a QFPF directly or through an entity that is treated as a partnership for US federal income tax purposes, will be treated as ECI, and accordingly such gains normally remain subject to US federal income tax in the hands of a QFPF notwithstanding the exemption established by the Act. On the other hand, distributions from a REIT that are attributable to gain from the disposition of a USRPI normally are not treated as ECI, and can qualify for exemption under the Act.

Accordingly, the exemption provided under the Act is most likely to provide a benefit in respect of US real estate interests held through a REIT.[3] A REIT is required to satisfy various detailed requirements relating to its income, assets, ownership and

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1 The Act makes various other changes to FIRPTA and to the taxation of "real estate investment trusts" ("REITs") that are discussed in the December 2015 briefing, "Re: The Protecting Americans From Tax Hikes Act of 2015".

2 In general, FIRPTA imposes withholding at a 15% rate on proceeds realized by a non-US person from the disposition of a USRPI, and imposes withholding at rates of 35%, 25% and 20% in respect of certain distributions by REITs and other entities that are attributable to the disposition of a USRPI. The FIRPTA withholding serves s a collection mechanism to ensure the payment of US federal income tax that is imposed under FIRPTA on gain from the disposition of a USRPI.

3 A QFPF may hold an interest in US real estate through other structures, such as a US "C" corporation. However, the exemption under the Act is unlikely to have a meaningful effect on the US federal income tax treatment of such structures. For example, the Act would exempt gain realized by a QFPF on the disposition of stock of a US "C" corporation that is a current or former "United States real property holding corporation". However, the Act would not affect the US federal income tax that is imposed on the US "C" corporation in respect of operating

distributions. Those requirements have the effect of limiting the types of US real estate investments that may be held through a REIT, the manner in which the REIT manages its US real estate investments, and other aspects of the structure and operations of a REIT. For example, those requirements effectively limit a REIT to holding real estate for long-term rental, as opposed to holding real estate for development and sale.

The Act defines a qualified foreign pension fund as a trust, corporation, or other organization or arrangement that satisfies the following requirements:

- It is created or organized under the law of a country other than the United States;
- It 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;
- It does not have a single participant or beneficiary with a right to more than 5% of its assets or income;
- It 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
- It is subject to a preferential tax regime under the laws of the country in which it is established or operates.[4]

There are a number of open questions as to how the foregoing requirements will apply to different non-US pension schemes and arrangements. For example, it is not clear whether a pension fund will fail to qualify because (i) it permits participation by persons who are not employed (e.g., self-employed or unemployed persons); (ii) it provides benefits other than retirement or pension benefits; or (iii) it is established in a country that does not impose an income tax. Accordingly, non-US pension funds should consider carefully the extent to which they satisfy the foregoing requirements.

More generally, non-US pension funds, and managers of investment funds having non-US pension funds as investors, should consider whether the structures through which they hold investments in US real estate will accommodate the new exemption.

income and gains it derives from the disposition of a USRPI.

4 The preferential tax regime may take one of two forms. Either (i) contributions to such trust, corporation, organization, or arrangement that otherwise would be subject to tax under the laws of the country in which it is established or operates are deductible or excluded from the gross income of such entity, or are 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.

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