IRS Releases Proposed Regulations; Resolve Many Outstanding Issues for Qualified Foreign Pension Funds

On June 6, 2019, the IRS released proposed regulations which provide significant clarification regarding the scope of the exemption for qualified foreign pension funds ("QFPFs") from the Foreign Investment in Real Property Tax Act ("FIRPTA").

Under FIRPTA, non-U.S. persons are generally subject to tax when they dispose of U.S. real property interests ("USRPIs") including stock in U.S. corporations 50% of more of the value of whose assets consists of USRPIs. In order to encourage foreign investment in U.S. real estate and infrastructure projects, Congress, in December 2015, enacted Section 897(l) which provides that QFPFs will not be treated as nonresident alien individuals or foreign corporations for purposes of FIRPTA – effectively exempting QFPFs from tax under Section 897.

Following the enactment of Section 897(l), and subsequent clarifying amendments in 2018, a substantial amount of uncertainty remained regarding whether various foreign pension funds met the definition of a QFPF. The U.S. Treasury Department received extensive comments from taxpayers on the new rules and the proposed regulations accommodate many of those comments in a manner that should be welcomed by many taxpayers.

The proposed regulations, which generally may be relied upon effective immediately, remove much of the uncertainty surrounding Section 897(l) and adopt a broad interpretation of the term "QFPF".

Background

A QFPF is any trust, corporation, or other organization or arrangement:

1. which is created or organized under the law of a foreign country;

2. which is established by a foreign country (or political subdivision thereof) or one or more employers to provide retirement or pensions benefits to participants that are current or former employees (including self-employed individuals) or persons designated by such employees in consideration for services rendered by such employees to such employers;

3. which does not have a single participant or beneficiary with a right to more than 5% of its assets or income;

4. 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; and

5. with respect to which, under the laws of the country in which it is established or operates, (a) contributions to such entity or arrangement which would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or arrangement or taxed at a reduced rate; or (b) taxation of any investment income of such entity or arrangement is deferred, or such income is excluded from the gross income of such entity or arrangement or is taxed at a reduced rate.

In addition, a corporation or trust all of the interests of which are held, directly or indirectly, by a QFPF (a "qualified controlled entity") is treated as a QFPF.

Proposed Regulations

The proposed regulations generally adopt a broad interpretation of the term "QFPF" and permit significant flexibility in qualifying for the exemption. The following are some of the more important highlights of the proposed regulations:

1. *Organization or Arrangement*

   In general, the proposed regulations clarify that a QFPF need not be a separate legal entity but may comprise an overall "arrangement" that satisfies the statutory requirements outlined above. The preamble to the proposed regulations explains that Congress intended "arrangement" to be a flexible term that accommodates a broad range of structures including structures comprised of multiple separate entities and structures that do not utilize any separate legal entity.

   Further, the proposed regulations provide that the mere segregation of funds in a separate account maintained by the employer may qualify as a QFPF provided the other statutory requirements are satisfied. The proposed regulations include an example which illustrates that a QFPF may exist even in the absence of a separate legal entity. That example provides that a retirement plan which consists of an asset pool (i.e., accounts maintained on a balance sheet) and an agency which administers the retirement plan qualifies as a QFPF.

2. *Multi-Employer and Government-Sponsored Pension Funds and Pension Funds Organized by Trade Unions and Professional Associations*

   The proposed regulations clarify that the requirement that a fund be established by a foreign government or employer can be satisfied by a

single- or multi-employer pension fund, a government-sponsored pension fund, or a pension fund organized by a trade union, professional association, or similar group. In addition, the proposed regulations clarify that for purposes of this requirement a self-employed individual is treated as both an employer and an employee.

Furthermore, the proposed regulations provide that a foreign entity can be owned by multiple QFPFs and still be considered a "qualified controlled entity" provided that it has no non-QFPF owners. This represents a significant expansion of Section 897(l) which, by its terms, only applied to entities that were wholly owned by a single QFPF.

3. *Pension Funds that Provide Benefits Other Than Retirement or Pension Benefits*

Many foreign pension funds provide a limited amount of other benefits, including death, disability, survivor, medical or other similar benefits ("ancillary benefits"). The preamble to the proposed regulations provides that Section 897(l) was not intended to exclude common foreign pension arrangements that provide a relatively small amount of ancillary benefits. Accordingly, the proposed regulations permit up to 15% of the benefits provided by a QFPF to consist of ancillary benefits.

4. *Regulatory and Information Reporting Requirements*

The proposed regulations significantly relax the requirement that a QFPF be subject to government regulation and tax information reporting requirements in two respects. First, the proposed regulations provide that when a government administers a pension or retirement plan itself, the regulatory and information reporting requirements will automatically be deemed satisfied. Second, the proposed regulations provide that the tax information reporting requirements will be satisfied where a pension fund is required to provide the requisite beneficiary information, or such information is otherwise available, to one or more government units of the foreign country even if it is not required to provide such information directly to the foreign country's tax authority.

5. *Foreign Tax Treatment*

With respect to the requirement that the laws of the country in which the fund is organized or operated provide for tax-advantaged treatment of the fund and its income, the proposed regulations clarify that a fund can qualify as a QFPF if it is organized operated in a country that does not impose an income tax.

The proposed regulations further clarify that funds organized in countries that impose current tax on certain types of income received by pension funds may be treated as QFPFs if, under the income tax laws of such foreign country, at least 85% of the contributions to the fund are deductible or excluded from the fund's gross income or taxed at a reduced rate, or if tax on at least 85% of the investment income of the fund is deferred or imposed at a reduced rate.

In addition, a potential QFPF that does not meet the specific requirements of the statute may nevertheless qualify if it can establish that it is subject to preferential tax treatment that has substantially similar effect as the statutory requirements.

6. *Anti-Avoidance Rule*

The proposed regulations include an anti-abuse rule intended to curb a potential end-run around the FIRPTA rules created by the enactment of Section 897(l). Specifically, the proposed regulations contemplate a scenario where a foreign company that seeks to dispose of an appreciated USRPI is acquired by a QFPF thereby becoming a "qualified controlled entity" which would enable the foreign company to dispose of the appreciated USRPI without being subject to U.S. taxation under FIRPTA.

The proposed regulations seek to combat this potential abuse by limiting the QFPF exemption to "qualified holders". Under these rules, an entity will not be treated as a "qualified holder" if it was not a QFPF, a part of a QFPF, or a qualified controlled entity at any time during the shortest of: (1) the period beginning on December 18, 2015 and ending on the date of disposition; (2) the ten-year period ending on the date of the disposition; or (3) the period during which the entity (or its predecessor) was in existence. However, this anti-avoidance rule will not apply to an entity that did not own any USRPIs when it became qualified a controlled entity or a QFPF.

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Please feel free to contact any of the persons listed below if you have any questions on this important development:

Marco Blanco
Co-Chair, Partner
Tax Practice
mblanco@curtis.com
Paris: +33 1 42 68 72 00
Geneva: +41 22 718 3518
New York: +1 212 696 6128

Klas Holm
Co-Chair, Partner
Tax Practice
kholm@curtis.com
New York: +1 212 696 8800

Eduardo Cukier
Partner
Tax Practice
ecukier@curtis.com
New York: +1 212 696 6107

Olga Beloded
Counsel
Tax Practice
obeloded@curtis.com
New York: +1 212 696 6124

Thomas Reilly
Associate
Tax Practice
treilly@curtis.com
New York: +1 212 696 8800

Esther Zuckerman
Associate
Tax Practice
ezuckerman@curtis.com
New York: +1 212 696 8862