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**New York State Bar Association**

**Tax Section**

# Report on the Changes to FIRPTA under the Protecting Americans from Tax Hikes Act of 2015

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## Contents

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# Report on the Changes to FIRPTA under the Protecting Americans from Tax Hikes Act of 2015

This report[1] provides comments on certain provisions of the Protecting Americans from Tax Hikes Act of 2015 (the "**PATH Act**"), enacted on December 18, 2015,[2] that affect taxation under the Foreign Investment in Real Property Tax Act of 1980 (as amended, "**FIRPTA**"), and related changes to the taxation of real estate investment trusts ("**REITs**").

This report is divided into four parts. Part I contains a general summary of our recommendations. Part II includes a brief summary of the statutory framework of the taxation of non-U.S. investors in real estate under Section 897 of the Internal Revenue Code of 1986, as amended (the "**Code**"),[3] and Part III includes a summary of certain changes made to the FIRPTA provisions pursuant to the PATH Act. Part IV sets forth our comments and recommendations with respect to these changes.

## I. SUMMARY OF RECOMMENDATIONS

### A. Definition of Qualified Foreign Pension

1. In the requirement that a QFPF be organized under the law of a country other than the United States, the relevant "law" should include laws of the country's political subdivisions.

[1] The principal author of this report is Marcy Geller, with substantial assistance from William Smolinski, Kimberly Blanchard, Stephen Land and Willard Taylor. Helpful comments were received from Robert Cassanos, Peter Connors, John Hart, Michael Hirschfeld, Richard Nugent, Amanda Nussbaum and Michael Schler. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] The PATH Act is Division Q of the Consolidated Appropriations Act, 2016, Pub. L. 114-113, 129 Stat. 2242 (2015).

[3] Unless otherwise indicated, all "Section" references are to the Code and all "Treas. Reg. §" references are to the Treasury regulations promulgated thereunder.

2. Guidance should confirm that each entity that may form part of an "arrangement" for a foreign pension plan (including the entities that collect contributions, hold the invested assets, manage the investments and provide the ultimate benefits to the participants) is eligible for exemption under Section 897(l) as a QFPF.

3. Guidance should confirm that national government-sponsored pension plans, as well as industry group plans to cover self-employed professionals, qualify for the exemption under Section 897(l).

4. Regulations should clarify that the provision of benefits to a pension beneficiary's spouse, children, family or other dependents (*i.e.*, survivorship beneficiaries) of a given beneficiary qualify as benefits to a current or former employee to the extent the beneficiary was a current or former employee.

5. Guidance should permit a QFPF to engage in other activities to a limited extent, such as providing benefits other than pension and retirement benefits.

6. Consideration should be given to requiring QFPFs to be broadly based in ways that go beyond the 5-percent limitation on any single beneficiary.

7. Regulations should be issued clarifying the possible methods by which a QFPF may satisfy the annual information reporting and government regulatory requirements, especially for plans sponsored by a foreign government.

8. Guidance should be issued clarifying the language requiring contributions to an entity be deductible or excludible by the pension plan or that the tax imposed on the entity be deferred or reduced.

## B. Structuring Issues for QFPFs

1. Guidance should provide that indirect ownership through a partnership is permitted for the REIT capital gain dividend exemption.

2. Guidance should clarify whether indirect wholly-owned entities can qualify for exemption as QFPFs.

3. Guidance should clarify that an entity may still be considered "wholly-owned" for purposes of Section 897(l) if persons other than the foreign pension fund own no more than *de minimis* amounts or if such ownership is required by local law.

4. Guidance should clarify that in interpreting the definition of "an entity all of the interests of which are held by a QFPF," only equity interests should be taken into account, or interests other than solely as a creditor.

5. Guidance should confirm that a "wholly-owned" subsidiary should not be barred from the exception under Section 897(l), even if the subsidiary is engaged in activities other than merely owning real property.

6. Guidance should indicate whether subsidiaries of QFPFs, otherwise qualifying under Section 897(l), need to be organized in the same jurisdiction as the QFPF.

7. Guidance should indicate that the QFPF exemption extends to entities owned exclusively by multiple QFPFs, and should describe the mechanics by which QFPFs may pool their assets to invest in those entities.

## C. Publicly Traded and Domestically Controlled FIRPTA Provisions

1. Guidance should be issued on whether a "person" for purposes of the "publicly traded" exception and "domestically controlled" test should be determined at the partner or partnership level.

2. Clarification should be provided as to whether the new 10-percent threshold for the "publicly traded" exception applies for periods before the effective date of the PATH ACT, in cases where the relevant disposition or distribution occurs after that date.

3. Guidance should be issued clarifying that ownership of REITs should be determined on a look-through basis for partnerships holding REIT shares, but not corporations holding REIT shares, in determining whether the REITs qualify as "domestically controlled" REITs.

## D. Collective Investment Vehicles

1. Regulations under Section 897(k) should appropriately extend this new exemption to other entities that meet the same characteristics as LAPTs and *beleggingsinstellingen* to which the PATH Act currently applies (possibly including an angels list of qualifying entities).

2. Regulations under Section 897(k) should clarify whether a publicly traded partnership would need to qualify as a USRPHC if treated as a domestic corporation, rather than just a real estate holding corporation.

## E. Withholding Tax Forms

1. The IRS should issue a new Form W-8 specific for QFPFs, a form of certificate in the regulations under 897 allowing QFPFs to claim exemption from FIRPTA, or a

modification to the existing Form W-8EXP to permit QFPFs to use this form for claiming exemption from FIRPTA.

2. A new or modified Form W-8 should also be issued to enable withholding agents to determine the status of a REIT shareholder as a qualified shareholder under Section 897(k).

## II. TAXATION OF NON-U.S. INVESTORS IN U.S. REAL ESTATE GENERALLY

Foreign corporations and nonresident alien individuals ("**Non-U.S. persons**") are subject to U.S. federal income tax only in limited circumstances. Specifically, Non-U.S. persons are generally taxed only on income that is U.S. source fixed or determinable annual or periodic ("**FDAP**" income) or is effectively connected with a U.S. trade or business ("**ECI**").[4] Typically, taxation of capital gains earned by Non-U.S. persons is limited in scope: capital gains are generally sourced according to the residence of the seller, so most capital gains earned by Non-U.S. persons are foreign source income, and therefore not subject to U.S. tax unless effectively connected to a U.S. trade or business.[5]

Subject to certain exceptions, Non-U.S. persons are subject to tax on the disposition of real property interests (as described more fully below) under FIRPTA, as enacted in Sections 897 and 1445 of the Code.[6] Even in the absence of FIRPTA, income from U.S. real property, and gains from its disposition, can be subject to U.S. tax as ECI if the investment itself is a U.S. trade or business under the general ECI rules. As an example, while a passive net lease would ordinarily not be considered a trade or business, in certain cases an owner's activity "in connection with domestic real estate that is beyond the mere receipt of income from rented property, and the payment of expenses incidental to the collection thereof, places the owner in a trade or business within the United States, provided that such activity is considerable, continuous, and regular."[7] Such a determination may be uncertain in many circumstances; moreover, in the absence of a U.S. trade or business an owner of U.S. real property will be subject to 30 percent withholding tax on the gross rent from the property, without reduction for depreciation, interest, or operating expenses. Because of this uncertainty, and the potentially severe consequences of being unexpectedly taxed on a gross basis, Sections 871(d) and 882(d) permit a foreign investor to elect to

[4] *See* Sections 871(a)(1) and (b)(1).

[5] *See* Sections 864(c)(2), 865(a)(2), and 871(a)(2).

[6] FEDERAL TAX—HISTORICAL LEGISLATIVE DOCUMENTS (1954-2002), Pub. L. No. 96-499, § 1122(a) (1980).

[7] Rev. Rul. 73-522, 1973-2 C.B. 226. *See also* De Amodio v. Comm'r, 34 T.C. 894, 906 (1960) *aff'd*, 299 F.2d 623 (3rd Cir. 1962); Lewenhaupt v. Comm'r, 20 T.C. at 163 (1953); Pinchot v. Comm'r, 113 F.2d 718, 719 (2d Cir. 1940).

be treat income from U.S. real estate as effectively connected with a U.S. trade or business, regardless of the determination that might be made under the general rules. Such an election, however, applies to all U.S. real property of the investor, and cannot be revoked without the consent of the IRS.[8] Before the enactment of FIRPTA and certain changes to the above election rules, Non-U.S. investors would elect out of gross basis taxation in the years of operation, but not with respect to the year of sale. In effect, those investors would escape gross basis taxation on rental income, as well as tax on gain on sale as the sale of real property was not ECI prior to FIRPTA. With the enactment of FIRPTA, which in part was targeted to tax such passively held real estate that escaped both tax on its rental income stream and gain on sale, the Non-U.S. investor would now be subject to tax on the gain regardless whether the gain would have otherwise been ECI.

### A. FIRPTA in Brief

As a general matter, FIRPTA taxes Non-U.S. persons on the disposition of United States real property interests (each, a "**USRPI**"). USRPIs include not only interests (held directly or indirectly through certain look-through vehicles) in real property, but interests in certain corporations (and to a certain extent, partnerships) that hold a substantial amount of U.S real property. The FIRPTA rules also provide for look-through rules with respect to sales of real estate by certain pass-through entities.[9]

In addition, the FIRPTA provides rules relating to distributions attributable to USPRIs. For example, Section 897(d) of the Code provides that gain shall be recognized by a foreign corporation on a distribution (including a liquidating or redeeming distribution) of a USRPI in an amount equal to the excess of the fair market value of the interest (as of the time of the distribution) over its adjusted basis.[10] Section 897(h) of the Code generally provides a look-through rule which subjects to FIRPTA taxation distributions by a "qualified investment entity" (defined as a REIT or regulated investment company (a "**RIC**"))[11] to Non-U.S. investors to the extent that the distributions are attributable to gain from the sale or exchange of a USRPI.[12]

[8] A handful of older treaties allow this election to be made annually. *See*, *e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Feb. 20, 1950, U.S.–Greece, art. VIII, 5 U.S.T. 891, 1958-2 C.B. 1054.

[9] Section 897(g); Treas. Reg. § 1.897-7T.

[10] This rule does not apply to the extent that the distributee would be subject to taxation upon a subsequent disposition of the distributed property. Section 897(d)(2)(A).

[11] Section 897(h)(4)(A).

[12] Section 897(h)(1).

FIRPTA generally requires a Non-U.S. person to treat any gain or loss on the disposition of a USRPI as ECI,[13] and can apply to dispositions that are not sales. The payor of proceeds of the sale of a USRPI to a Non-U.S. person is generally required to withhold 15 percent of the sales price,[14] and a domestic USRPHC is required to withhold 15 percent of the value of any distributions to foreign shareholders that are treated as a sale or exchange of their shares.[15] In addition, a domestic partnership, trust or estate that disposes of a USRPI is generally required to deduct and withhold at the highest applicable marginal rate, to the extent that any gain from the disposition is allocable to a foreign partner or beneficiaries.[16]

## B. Exceptions to FIRPTA

Adding to the complexity of the FIRPTA regime is a series of exceptions (subject to various limitations) to the general rules. These exceptions represent carveouts from the otherwise broad definitions of USRPIs and USRPHCs. A few of those exceptions are specifically addressed below.

### 1. Publicly Traded Exception

Section 897(c)(3) provides that if any class of stock of a USRPHC is regularly traded on an established securities market, stock of that class shall be treated as a USRPI only in the case of a person who, at some time during the shorter of that person's holding period of the interest or the 5-year period ending on the date of the disposition of the interest, held more than 5 percent of that class of stock. In determining whether a person has satisfied the 5-percent threshold, the constructive ownership rules of Section 318(a) apply.[17] This exception looks to the "person" who has held the stock. However, neither the statute nor the regulations have specified whether, in the case of a partnership (which is included in the Section 7701(a)(1) definition of "person"), the 5-percent threshold should be tested at the level of a partnership that owns the stock or the partners of the partnership.[18] The publicly traded exception also modifies the general look-through rule for distributions by a qualified investment entity under Section 897(h)(1), by providing that FIRPTA will not apply to any amounts distributed by such an entity on a class of stock to a

[13] Section 897(a).

[14] Section 1445(a).

[15] Section 1445(e)(3).

[16] Section 1445(e)(1).

[17] Section 897(c)(6)(C). To the extent that the Section 7704 rules do not otherwise apply, this exception also applies to any class of interests in a partnership or trust (for partnerships or trusts that would qualify as USRPHCs if these partnerships or trusts were corporations) which are regularly traded on an established securities market. Treas. Reg. § 1.897-1(c)(2)(iv).

[18] *See* notes 92–93 and accompanying text.

shareholder who has owned no more than 5 percent of that class during the one-year period ending on the date of the distribution.[19]

### 2. Domestically Controlled Qualified Investment Entity Exception

Shares of REITs and RICs (to the extent they qualify as USRPHCs) are generally included in the definition of a USRPI, so any gain from the sale or exchange of these shares will be subject to taxation under FIRPTA. These REITs and RICs are defined as "qualified investment entities" under Section 897 of the Code.[20] The Code provides a limited exception to this rule in the case of "domestically controlled" qualified investment entities. A qualified investment entity is "domestically controlled" within the meaning of Section 897 of the Code if less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the shorter of (1) the 5-year period ending on the date of the disposition or (2) the period during which the qualified investment entity was in existence.[21] The stock of such a domestically controlled qualified investment entity is not a USRPI under Section 897 of the Code: a foreign shareholder may therefore sell the stock of such an entity without being subject to tax under FIRPTA, even if the entity is a USRPHC.[22]

### 3. Section 892 Investors

As a general matter, income earned by a foreign government (together with its controlled entities, a "**Section 892 Investor**") from investments in the U.S. in stocks, bonds, or other domestic securities or in certain financial instruments is generally exempt from taxation, including, in some circumstances, taxation under FIRPTA.[23] This exemption does not apply to income earned from "commercial activities" (as defined under Section 892), or income received by or from a "controlled commercial entity."[24] A controlled commercial entity is any entity engaged in commercial activities (whether within or outside the United States) if the government either (1) holds (directly or indirectly) any interest in the entity which (by value or voting interest) is 50 percent or more of the total of that entity's interests, or (2) holds (directly or indirectly) any other interest in the entity which provides the foreign government with effective control of that entity.[25] Thus, minority investments (in which the Section 892 Investor does not possess effec-

[19] Section 897(h)(1).

[20] Section 897(h)(4)(A).

[21] Sections 897(h)(4)(B) and (D).

[22] Section 897(h)(2); Treas. Reg. § 1.897-1(c)(2)(i).

[23] Section 892(a)(1).

[24] Section 892(a)(2).

[25] Section 892(a)(2)(B).

tive control) in USRPHCs fall within this exemption, so a disposition of shares in such a USRPHC is not subject to taxation under FIRPTA. However, this exemption is limited: income derived from USRPIs that are not stock or securities, as well as any gain derived from the disposition of those USRPIs, does not qualify for exemption under Section 892.[26]

## III. THE PATH ACT

The PATH Act contains a number of changes to the FIRPTA regime. Those FIRPTA changes include some modifications to existing law as well a new FIRPTA exception for qualified foreign pension funds.

### A. Qualified Foreign Pension Funds

New Section 897(l) of the Code provides an exemption from the FIRPTA rules for a "qualified foreign pension fund" (a "**QFPF**") or an entity wholly-owned by a QFPF, which applies to any gain from a USRPI held directly (or indirectly through one or more partnerships) by the QFPF, or to any distribution that it receives from a REIT.[27] A QFPF is defined as any trust, corporation or other organization or "arrangement"[28] that satisfies each of the following criteria:

1. It is created or organized under the law of a country other than the United States;
2. 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;
3. It does not have a single participant or beneficiary with a right to more than 5 percent of its assets or income;
4. 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
5. Under the laws of the country in which it is established or operates, (i) contributions to the organization or arrangement that would otherwise be subject to tax under those laws are deductible or excluded from its gross income or taxed at a

[26] Treas. Reg. § 1.892-3T(a)(1).

[27] Section 897(l)(1), *added by* PATH Act § 323(a), 129 Stat. 2242, 3102 (2015).

[28] As pointed out by the staff of the Joint Committee on Taxation, "Foreign pension funds may be structured in a variety of ways, and may comprise one or more separate entities. The word 'arrangement' encompasses such alternative structures." STAFF OF THE JOINT COMM. ON TAX'N, *General Explanation of Tax Legislation Enacted in 2015* (JCS–1–16) 283, n. 967 (2016) (the "**General Explanation**").

> reduced rate, or (ii) taxation of any investment income of the organization or arrangement is deferred or the income is taxed at a reduced rate.[29]

The PATH Act also makes conforming changes to Section 1445 of the Code to eliminate withholding on sales by QFPFs (and their wholly-owned foreign subsidiaries) of USRPIs.[30] The changes to Section 897(l) and Section 1445(f)(3) are effective on the date of enactment (December 18, 2015).[31]

## B. Publicly Traded Exception for REIT Stock

The PATH Act modified the exception from FIRPTA for both dispositions of publicly traded REITs, and for distributions from publicly traded REITs that are attributable to gain from the disposition of USRPIs, by increasing the threshold for the exception from 5 percent to 10 percent.[32]

## C. Domestically Controlled Qualified Investment Entity Exception

The PATH Act modified and clarified the definition of a "domestically controlled qualified investment entity" to provide a number of new rules and presumptions relating to whether such an entity is domestically controlled within the meaning of the Code.[33] Previously, neither the Code nor the regulations provided a mechanism by which a publicly traded REIT could determine whether 50 percent or more of the fair market value of its outstanding stock was owned by U.S. persons. Under the revised FIRPTA rules, a qualified investment entity is permitted to presume that holders of less than 5 percent of a class of stock regularly traded on an established securities market in the United States are U.S. persons throughout the relevant testing period, except to the extent that the qualified investment entity has actual knowledge that they are not U.S. persons.[34] In addition, if a publicly traded REIT is a domestically controlled REIT, it will be treated as a U.S. person for purposes of determining the status of any REIT in which it owns shares.[35] If a non-publicly traded REIT owns stock in another REIT, the stock owned by the first REIT is deemed to be owned by a U.S. person in the same proportion as the first REIT is itself

[29] Section 897(l)(2)(A)–(E); PATH Act § 323(a), 129 Stat. 2242, 3102 (2015).

[30] Section 1445(f)(3)(B); Treas. Reg. § 1.1445-2(b)(2); PATH Act § 323(b), 129 Stat. 2242, 3103 (2015).

[31] Path Act § 323(c), 129 Stat. 3103 (2015).

[32] Section 897(k)(1); PATH Act § 322(a)(1), 129 Stat. 2242, 3098 (2015)

[33] General Explanation, at 282.

[34] Section 897(h)(4)(E)(i); PATH Act § 322(b)(1)(A), 129 Stat. 2242, 3101 (2015); General Explanation, at 282.

[35] Section 897(h)(4)(E)(ii); PATH Act § 322(b)(1)(A), 129 Stat. 2242, 3101 (2015).

owned by U.S. persons for purposes of determining whether the second REIT is domestically controlled regardless of whether the upper-tier REIT is itself a domestically controlled REIT.[36]

## D. Collective Investment Vehicles

The PATH act also added Section 897(k)(2) of the Code, which provides a new exception for "qualified shareholders": qualified collective investment vehicles ("**QCIVs**") that meet certain requirements enumerated in the statute and hold stock of a REIT.[37] The exemption provides that any REIT stock which is held directly (or indirectly through one or more partnerships) by such a "qualified shareholder" shall not be treated as a USRPI, and any distribution to the qualified shareholder on the REIT stock shall not be treated as gain recognized from the sale or exchange of a USRPI.[38] However, unlike the exemption for QFPFs, such a distribution is not entirely exempt from tax; instead, it is treated as an ordinary dividend for tax purposes.[39]

The term "qualified shareholder" is defined as a foreign entity which means the following requirements:

1. Either (i) the entity is eligible for treaty benefits under a U.S. income tax treaty that includes a comprehensive exchange of tax information program and the principal class of interests in the entity is listed and regularly traded on one or more recognized stock exchanges (as defined in that treaty) or (ii) is a foreign limited partnership created under foreign law in a jurisdiction that has an agreement for exchange of information with the United States and has a class of units representing more than 50 percent of its total outstanding limited partnership units which is regularly traded on the New York Stock Exchange or the NASDAQ;

2. The entity is a QCIV; and

3. The entity maintains records on the identity of its 5-percent owners.[40]

A QCIV is a foreign person who meets one of the following tests:

1. It is eligible under a tax treaty for a reduced rate of withholding with respect to REIT dividends even if it holds more than 10 percent of the stock of a REIT;

[36] Section 897(h)(4)(E)(iii); PATH Act § 322(b)(1)(A), 129 Stat. 2242, 3101 (2015); General Explanation, at 283.

[37] PATH Act § 322(a), 129 Stat. 2242, 3098–3101 (2015).

[38] Section 897(k)(2)(A)(i)–(ii).

[39] Section 857(b)(3)(F).

[40] Section 897(k)(3)(A)(i)–(iii).

2. It is a foreign partnership that (i) is a publicly traded partnership (within the meaning of Section 7704(b) of the Code) that is not treated as a corporation under Section 7704(a) of the Code (by meeting the 90-percent qualifying income exception), (ii) is a withholding foreign partnership and (iii) would be treated as a USRPHC if it were a U.S. corporation at any time during the five preceding years; or

3. It is designated as a QCIV by the Secretary of the Treasury and is either (i) fiscally transparent within the meaning of Section 894 of the Code or (ii) is required to include dividends in its gross income, but is entitled to a deduction for distributions to its unitholders.[41]

The 897(k) exception for qualified shareholders, much like the now-revised publicly traded exceptions, contemplates a 10-percent ownership limitation. However, that limitation is applied at the level of the unitholders of the qualified shareholder. If a person owns more than a 10 percent in a U.S. REIT (either solely by indirect ownership through the qualified shareholder or together with other indirect and direct ownership interests in the REIT), then a proportionate amount of its interest in the U.S. REIT is not eligible for the Section 897(k) exceptions.[42]

Qualification under the REIT treaty rule requires that the QCIV be eligible for a reduced rate of withholding on REIT dividends even when the QCIV owns more than 10 percent of the REIT. Many U.S. treaties limit treaty benefits on REIT dividends to shareholders who own 10 percent of less of the REIT's stock, consistent with the current U.S. model treaty.[43] The General Explanation identifies two treaties that allow, in limited circumstances, treaty benefits for REIT dividends paid to shareholders that own more than 10 percent of the REIT's stock.[44]

The first such treaty is the treaty with Australia, which provides for a maximum U.S. withholding tax of 15 percent on REIT dividends paid to a listed Australia property trust (a "**LAPT**"), regardless of the percentage of the REIT owned by the LAPT.[45] However, if the re-

[41] Section 897(k)(3)(B)(i)–(iii). As a matter of sentence construction, the three clauses in Section 897(k)(3)(B)(ii) lack a logical "and" or "or" connector, although we believe that "and" is intended, and the General Explanation, at 282, takes this view.

[42] Section 897(k)(2)(B).

[43] U.S. 2016 Model Income Tax Treaty, art. 10(4)(a).

[44] *See* General Explanation, at 282 n. 966.

[45] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Aug. 6, 1982, U.S.–Austl., art. 10(4)(d), 35 U.S.T. 1999, 1986-2 C.B. 220, *as amended by* Protocol, Sept. 27, 2001, art. 6, T.I.A.S. 13,164. To qualify for this rule, the LAPT must be an Australian unit trust registered as a "Managed Investment Scheme" under the Australian Corporations Act, in which the principal class of units is listed on a recognized stock exchange in Australia and regularly traded on one or more recognized stock exchanges in the United States or Australia.

sponsible entity for the LAPT knows that any LAPT shareholder owns more than 5 percent of the LAPT, then that shareholder is deemed to own its proportionate share of the LAPT's interest in the REIT, and is subject to the normal limitations that apply. For example, if the LAPT owns 50 percent of the REIT and an Australian individual owns 50 percent of the LAPT, then that individual would be treated as owning 25 percent of the REIT, which is in excess of the 10-percent limitation on individual REIT shareholdings, and hence in such a case no withholding tax relief would be available under the treaty for that portion of the dividends received by the LAPT.

The second such treaty is the treaty with the Netherlands, which provides for a maximum U.S. withholding tax of 15 percent on REIT dividends paid to a *beleggingsinstelling*, regardless of the percentage of the REIT owned by the *beleggingsinstelling*.[46] The treaty does not provide for a look-through analogous to the rule described above with respect to LAPTs. To our knowledge, there are no other treaties that identify specific types of entities as eligible for a reduced rate of withholding on dividends from REITs in which the entity has a greater than 10-percent interest.[47]

## IV. RECOMMENDATIONS

### A. General Comments

The additional exceptions added by the PATH Act, while beneficial to QFPFs and QCIVs, add further layers of exceptions to the FIRPTA rules, which raise issues of interpretation that are discussed below. As the FIRPTA rules have been enacted over time in piecemeal legislation, it is difficult to form a coherent policy justification for the many exemptions offered by the FIRPTA rules. Sometimes the policy reasons for the rules and related exemptions are not clear or known since, in certain cases, the only legislative history consists of materials prepared by the staff of the Joint Committee on Taxation which explain the rules but not the reasons for adopting them.[48] In developing guidance that addresses these issues, we recommend that the IRS and Treasury consider the policies behind these rules new rules and FIRPTA taken as a whole.

[46] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992, U.S.–Neth., art. 10(4)(c)(iv), Hein's No. KAV 3507, *as amended by* Protocol, Mar. 8, 2004, art. 3, Hein's No. KAV 6475. A *beleggingsinstelling* (literally, an "investment institution") is described under Dutch law in Article 28 of the Netherlands Corporation Tax Act (*Wet op de vennootschapsbelasting* 1969).

[47] *But see* note 101 *infra* and accompanying text (identifying treaties with a 25 percent threshold).

[48] *See* General Explanation, at 277–84; *see also* STAFF OF THE JOINT COMM. ON TAX'N, *Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40)*, (JCS–144–15) 184–91 (2015).

As a result of the ECI and FIRPTA rules and specific exceptions, today, most U.S. real estate investment by foreign investors is made through a U.S. corporation to avoid the filing of U.S. tax returns, potential branch profits tax on ECI, and gross taxation on non-ECI from this real property. Typically, the investment is disposed of by way of a sale of the real estate itself, followed by a liquidation of the U.S. corporation; in such a case, the buyer gets a cost basis in the real estate and no exposure to liabilities of the selling corporation, while the investor avoids FIRPTA gain on the liquidation itself under the "cleansing" rule of Section 897(c)(1)(B), which permits a corporation to be free of USRPHC status once it has sold all of its U.S. real property.[49] Thus, when the U.S. corporation is not a REIT, FIRPTA can be avoided, but at a cost of the tax paid by the U.S. corporation itself.

One consequence of the way in which the FIRPTA rules have evolved is to make REITs a preferred vehicle for foreign investment in U.S. real estate. If the property is of a type that constitutes qualifying real property under the REIT rules, then the U.S. corporation itself can make a REIT election, thereby avoiding tax at that level. While the foreign investor in the REIT is subject to withholding tax on the REIT dividends, that withholding tax, even at the 30 percent statutory rate, is less than the avoided 35 percent corporate level tax, and in some cases can be reduced by treaty, or eliminated altogether in the case of a Section 892 Investor that does not control the REIT. While the IRS has broadly asserted a taxing right under FIRPTA in relation to distributions by the REIT that are attributable to gain from U.S. real property,[50] foreign investors can avoid FIRPTA on a sale of shares of the REIT, if the REIT domestically controlled; and if the investor is a small public shareholder it can avoid FIRPTA on both share sales and distributions attributable to U.S. real property gain.

The PATH Act amplifies the appeal of REITs to foreign investors. As noted above, it raised the maximum permitted ownership for investors in publicly traded REITs from 5 percent to 10 percent, and added a favorable presumption for small shareholders in determining whether a REIT is domestically controlled. It added a new exemption for QCIVs that invest in REITs. And while the QFPF exemption is not expressly limited to REITs, most QFPFs will want to invest through a REIT whenever possible, in order to avoid entity level tax (if that investment were owned by a U.S. corporation) and the filing of U.S. tax returns and tax on gain on sale upon exit (if that investment were owned transparently and gave rise to ECI).

The REIT rules were originally enacted as a way to permit U.S. individuals to pool their investments in real estate in a corporate vehicle without incurring a layer of corporate tax.[51]

[49] The PATH Act repealed this cleansing rule for REITs and RICs. *See* Section 897(c)(1)(B)(iii), *added by* PATH Act § 325(a), 129 Stat. 3103 (2015). However, this repeal may provide a benefit to non-U.S. investors in the context of REIT liquidations where such an investor has high-basis stock.

[50] *See* Notice 2007-55, 2007-27 I.R.B. 13.

[51] *See* H.R. Rep. No. 86-2020, pt. II (1960).

However, the interaction of the REIT rules with favorable exemptions from FIRPTA and Section 892 has permitted investments to be made in a way that enables gain from the sale of the investment, and sometimes the ongoing income before sale, to escape U.S. taxation completely. The PATH Act provides a new classes of investors with incentives to use REITs as well for their investment vehicles. We believe similarly-situated investors should be treated similarly, and, to some extent, the piecemeal exemptions that have been enacted over time provide inconsistent tax results. For example, the taxation of real estate by Section 892 Investors is different from the tax imposed on QFPFs; Section 892 Investors are subject to tax on capital gain distributions attributable to the sale of USRPIs, whereas QFPFs are not. There may be policy reasons for these differences; but to the extent possible, we believe that the IRS and Treasury should use a more systematic approach in treating similarly situated investor under the FIRPTA rules.[52]

Further, the exemption that the PATH Act provides for QFPFs would be more effective if QFPFs have clearer guidance on when gain from a direct investment in U.S. real estate (*i.e.*, not through a REIT) will avoid taxation as ECI as well as being exempt from FIRPTA. Congress stated that the new exemption for QFPFs was intended to place foreign pension funds on equal footing with U.S. pension funds. However, those classes of investors are subject to very different sets of rules with respect to varying types of income. In general, the rules for "unrelated business taxable income ("**UBTI**") that apply to U.S. pension funds have significant differences from the ECI and FIRPTA rules that apply to foreign pension funds. For example, U.S. pension funds are generally exempt from tax with respect to passive income, including rents from real property that may not be qualifying REIT assets, unless the income is debt-financed.[53] In addition, there are special exceptions to such debt-financed rules for certain qualifying real estate investments (*e.g.*, the fractions rule). Foreign pension funds, however, are not able to avoid tax on operating assets placed outside of a REIT, regardless of whether those assets themselves are debt-financed. Thus, certain classes of assets that may be "real estate" in the colloquial sense, such as infrastructure assets, will generate ECI for foreign investors in the case of direct investments. As Section 897(l) is currently drafted, QFPFs would still be subject to taxation on this ECI, but whether U.S. pension funds may or may not be exempt from tax on such income is independent of whether this income is ECI. It is unclear whether Congress intended the exemption to stop short in this fashion, to the extent its intent was to encourage foreign investment in real estate and place foreign pension plans on equal footing with U.S. pension plans.[54]

[52] Certain investors will not pay tax on ongoing income either, but others will pay tax on this income at a 30 percent rate.

[53] Sections 511 and 514.

[54] In certain ways, this is consistent with an intent to put foreign pension funds on the same footing as U.S. pension funds. If a U.S. pension fund with sensitivity to UBTI within the meaning of Section 511 of the Code wants to avoid the incurrence of UBTI in connection with investment in an asset that cannot be placed

The recommendations discussed below deal with some specific and technical issues relating to some of the exemptions from FIRPTA contained in the PATH Act.[55]

## B. Definition of a QFPF

As currently drafted, there is some uncertainty regarding aspects of the definition of QFPFs. As one of the apparent purposes of the PATH Act was to increase foreign pension fund investment in U.S. real estate and to put foreign pension funds on a closer footing with their U.S. peers,[56] we request that the IRS and Treasury work expeditiously to address some of the concerns contained in this draft so that pension funds, their beneficiaries, and their legal counsel may find greater clarity in these rules.

Foreign pension plans may differ significantly from their counterparts in the United States, and consideration should be given to these differences in determining when these plans should qualify under Section 897(l). These plans may be governed and regulated under different authorities, may be subject to different tax regimes and may be formed as different types of entities or with different ownership structures from their U.S. counterparts. The Joint Committee acknowledged that there are many ways in which a foreign pension fund may be formed.[57] As discussed in detail below, we recommend that Treasury and the IRS promulgate regulations that address these differences and provide guidance as to the sorts of differences that nonetheless comport with Congress's intent of alleviating the tax burden of foreign pension funds' investments in U.S. real property. Accordingly, we recommend that regulations provide clarifying language for each of the five components of the QFPF definition in light of these structural and governance differences.

into a REIT structure, it would likely hold such an investment through a blocker entity treated as a corporation for U.S. federal income tax purposes. QFPFs may now do the same thing with respect to ECI investments which cannot be placed into a REIT structure. However, various important differences between UBTI and ECI (*e.g.*, the lack of a "debt-financed UBTI" analog in the ECI rules) start to strain this comparison.

[55] In particular, this report responds to comments requested by Treasury and the IRS on what regulations, if any, should be issued pursuant to Section 897(l)(3). T.D. 9751, 81 Fed. Reg. 8398–99 (Feb. 19, 2016).

[56] *See* STAFF OF THE JOINT COMM. ON TAX'N, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal,* (JCS-4-13), December 20, 2013, at 95 ("The stated rationale for the proposal is to treat foreign pension plans that may wish to invest in U.S. real property comparably with U.S. pension funds that are exempt from tax.").

[57] *See* note 28 *supra.*

### 1. Applicable Foreign Law

A QFPF must be a trust, corporation or other organization or arrangement "created or organized under the law of a country other than the United States."[58] It is common for these entities to be organized or otherwise governed by the laws of the political subdivisions of a given tax domicile. For example, pension funds are organized under provincial law in Canada,[59] just as U.S. pension funds are often created and governed by the laws of individual states, as opposed to federal law. We recommend that regulations confirm that the definition of "law" of a given country includes laws of political subdivisions of that country.

### 2. Type of Entity

The statute provides that a QFPF means any trust, corporation, or other organization or arrangement. While "arrangement" is not defined in the statute, the General Explanation provides that "foreign pension funds may be structured in a variety of ways, and may comprise one or more separate entities…the word 'arrangement' encompasses such alternative structures."[60] Although Congress' intent is to put foreign pension plans on equal footing with U.S. pension plans, Congress recognized that foreign organizations are formed and operated differently from their U.S. counterparts. Congress did this in part by including broad language such as "arrangement" in its definition. In furtherance of that intention, any regulations promulgated by Treasury should contemplate that foreign pension funds may comprise separate legal entities acting together to perform the various functions of a pension fund. As one example, the functions of (i) collecting contributions from employers, (ii) holding invested assets, (iii) managing fund investments and (iv) providing benefits to participants might each be conducted by separate entities.[61] So long as such arrangement has a unified framework with an identifiable pool of assets that can together be recognized as a pension fund within the meaning of Section 897(l), each of the constituent entities within such an arrangement should be entitled to the benefits of 897(l), to the extent each entity is acting as part of such an arrangement. We recommend that Treasury and the IRS provide guidance which reflects the principle that any structure comprising various components, accounts or entities which serve the broader purpose of providing pension or retirement benefits is an "arrangement" within the meaning of Section 897(l)(2), and each component of such an arrangement (regardless of whether it is the entity that was formed to provide benefits to its participants) should be eligible for the QFPF exemption.

[58] Section 897(l)(2)(A).

[59] The Constitution Act, 1897, 30 & 31 Vict, c 3, s 94A.

[60] *See* note 28 *supra*.

[61] *See* CPP Investment Board, *Comment Letter Submitted Pursuant to Treasury Decision 9751 on Section 897(l)(3)*, at 2–3 (May 20, 2016).

### 3. Benefits for Services Rendered

#### *a. Employer Requirement*

A QFPF must provide retirement or pension benefits to participants or beneficiaries who are current or former employees of one or more employers "in consideration for services rendered."[62] Although the statute does not seem to require a direct relationship between the employer and employees—it just requires that the participants are currently or have been previously employed—the wording of the statute is not clear.[63] The General Explanation noted that "[m]ulti-employer and government-sponsored public pension funds that provide pension and pension-related benefits may still satisfy this prong of the definition. For example, such pension funds be established for one or more companies or professions, or for the general working public of a foreign country."[64] Given the fact that pension funds may provide benefits to self-employed persons and persons that may not be considered "employees" under U.S. common law definitions, we also recommend that regulations focus on whether a pension fund covers working people, and should not focus on whether there is an identifiable employer to match up with each employee. Although the General Explanation is helpful in clarifying that the sponsor of the plan does not need to be the employer of the participants, we recommend that regulations confirm that Section 897(l)(2) extends to pension funds that cover single employers, multiple employers, groups of employees (such as unions), and employers that are covered based on their nationality, location, industry, profession or other common features.[65]

In addition, the above statement seems to make it clear that Section 897(l) should apply to government-sponsored public pension funds. However, it remains unclear whether a foreign sovereign pension fund—for example, one created in the context of a sovereign social security system (perhaps analogous to Social Security in the United States)—is left out of this definition. We therefore recommend that regulations make explicit that government-sponsored pension funds established to provide pension and pension-related benefits to the general working public of a foreign country can satisfy the requirements of Section 897(l)(2)(B).

[62] Section 897(l)(2)(B).

[63] The requirements under Section 897(l) are fairly consistent with the definition of "foreign retirement fund" under Treas. Reg. § 1.1471-6(f)(2) which provides that a "broad participation retirement fund" is a fund established to provide "retirement, disability or death benefits" to beneficiaries that are current or former employees of "one or more employers in consideration for services rendered." Some of the other definitional requirements in Section 897(l)(2)—specifically, Section 897(l)(2)(C) and Section 897(l)(2)(D)—mirror the requirements contained in this section of the FATCA regulations.

[64] General Explanation at 283, n. 968.

[65] *See* CPP Investment Board, *supra* note 60, at 4.

*b. Current or Former Employees Requirement*

The statute provides that the pension plan must provide benefits to current or former employees. However, we recommend that regulations should contemplate the provision of benefits to a beneficiary's spouse, children, family members or other dependents that may be survivorship beneficiaries of a given "current or former employee" beneficiary. Such a concept certainly exists in the U.S. context,[66] and should be extended to analogous situations in foreign countries.

*c. Types of Benefits Rendered*

In addition, foreign retirement plans may provide other benefits, such as payments on death or disability, or for medical expenses.[67] The requirement that a QFPF be "established to provide retirement or pension benefits" does not specify that the QFPF be established *exclusively* for those purposes. At the same time, it does not appear to us that the QFPF exemption was intended to provide relief for funds that primarily serve purposes other than retirement or pension benefits.

Some sensible line drawing is called for here. Imposing a requirement that the plan provide *no* benefits other than retirement or pension benefits is likely to eliminate the benefits of the exemption for many foreign plans, even in cases where substantially all of the assets of those plans are maintained for those benefits. On the other hand, allowing the exemption to extend to plans whose assets are, to a substantial degree, used for other purposes would allow the exemption to apply more broadly than it was presumably intended.

A similar issue arises in the treaty context, where the current U.S. negotiating position is to allow a treaty exemption for dividends received by a fund that is "operated exclusively *or almost exclusively*…to administer or provide pension or retirement benefits" [emphasis added].[68] Likewise, the definition of a retirement fund under FATCA includes a fund that is generally eligible for tax benefits under a tax treaty, and "is operated principally to administer or provide pension or retirement benefits."[69] We believe that the approach taken by these rules is generally

[66] For example, U.S. qualified pension plans must provide benefits to the surviving spouse of a "vested participant" (unless waived by the surviving spouse). *See* Sections 401(a)(11), 417(a).

[67] *See* Caisse de dépôt et placement du Québec, *Comments on New Section 897(l)* (July 15, 2016); CPP Investment Board, *supra* note 60, at 4-5.

[68] U.S 2016 Model Income Tax Treaty, arts. 1(k), 10(3)(a).

[69] Treas. Reg. § 1.1471-6(f)(1). Other types of funds that may qualify for exemption from FATCA include "broad participation retirement funds" (as described by § 1.1471-6(f)(2)), "narrow participation retirement funds" (as described by § 1.1471-6(f)(3)), investment vehicles exclusively for retirement funds (as described by § 1.1471-6T(f)(5)) and pension funds of an exempt beneficial owner (as described by § 1.1471-6T(f)(6)).

appropriate, but greater clarity would result if any guidance on the QFPF exemption were to specify the percentage of its assets that can be devoted to benefits other than pension or retirement benefits, without causing the QFPF to lose the protection of this exemption. One standard that the IRS and Treasury might consider as a test would be to require "substantially all" of the benefits provided be pension and retirement benefits, because we believe it would be reasonable for a QFPF to be able to provide more than a *de minimis* amount of benefits other than pension and retirement. Any standard that is adopted should clearly specify what amounts would satisfy this criteria.[70]

Also, the nature of these other benefits could be relevant. The FATCA definition of broad-based retirement plans includes a fund established to provide retirement, disability or death benefits, without any limitation on the extent to which the plan provides disability or death benefits as opposed to retirement benefits.[71] Thus, any guidance under the QFPF exemption might be more liberal in permitting the QFPF to have roles other than providing pension or retirement benefits, if those other roles were only to provide related employee benefits such as those for death or disability. If so permitted, any guidance should also specify whether these related activities are combined with other non-pension activities in determining the standard articulated above.

#### 4. 5-Percent Participants or Beneficiaries

The QFPF must not have a "single participant or beneficiary with a right to more than 5 percent of its assets or income."[72] The statute does not require the application of any statutory attribution rules in reaching that threshold. However, some form of attribution may be appropriate in certain situations, such as a sovereign pension fund whose beneficiaries are members of a single extended family group.

Apart from this 5-percent limitation, there is no express requirement that the QFPF be broadly based. It is therefore possible that a pension fund benefitting only a limited group of senior executives could meet the literal terms of the definition of a QFPF, if no single executive had a right to more than 5 percent of its assets or income. On the other hand, a plan benefitting a broad spectrum of employees could fail to satisfy this test if there were a single employee with a greater than 5 percent interest, which could plausibly happen with plans for smaller businesses.

The definition of a QFPF in Section 897(l) bears a close resemblance to the definition of a broad-based retirement fund under the FATCA regulations. In particular, the FATCA regulations also require that no single beneficiary have a right to more than 5 percent of the fund's

[70] *See* Caisse de dépôt et placement du Québec, *supra* note 60, at 3–9.

[71] Treas. Reg. § 1.1471-6(f)(2).

[72] Section 897(l)(2)(C).

assets, which matches the corresponding QFPF rule.[73] This approach to determining when a pension fund is broad based makes sense in the FATCA context, where the objective is identifying overseas assets of U.S. persons, and the concern is that one or a small group of U.S. persons may be hiding assets in what is ostensibly a foreign retirement plan. By contrast, the QFPF exemption offers an overt tax break, and the other aspects of the QFPF definition, such as the requirements that it be subject to regulation and reporting, and be eligible for tax-favored treatment of its contributions or earnings, suggest that the exemption is intended for foreign plans that are in some way analogous to U.S. qualified retirement plans. If that is the case, a technical amendment may be needed to impose more stringent requirements that ensure broader coverage than is implied by just the 5-percent limitation itself.

### 5. Annual Reporting and Government Regulation

The QFPF must also be subject to government regulation and provide "annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates."[74] It would be helpful if guidance were provided as to the intention behind this requirement. Given that a foreign government may regulate pension funds in ways that differ from U.S. regulation, such an indication of intent could provide clarity for pension funds as to whether its local jurisdiction's regulations and reporting requirements are sufficient in the eyes of the Treasury. We would also recommend that any guidance from Treasury or the IRS not require any particular form of government regulation.

In some contexts, the reporting and regulatory requirement appears too restrictive. For example, a number of foreign pension funds, including most if not all foreign sovereign pension funds, are created by the government itself. As a practical matter, these entities do not "report to" or "regulate" themselves. As a result, regulations should also provide that "government regulation" under Section 897(l)(2)(D) can take any form endorsed by the government (and, perhaps more importantly, is not required to be uniform across all pension funds in a country).

The "relevant taxing authority" may itself be unduly restrictive, as there may be otherwise eligible entities that report to a governmental authority or department that is not a taxing authority. Furthermore, within a given arrangement, it is possible that a separate entity is responsible for any information reporting to the relevant governmental authority. In light of those facts, we recommend that any guidance clarify that "taxing authority" can mean whichever governmental authority receives the required information to be reported by the pension fund, and should recognize that the entity actually receiving the Section 897(l) exemption from taxation under FIRPTA may not be the same entity responsible for this information reporting.

[73] Treas. Reg. § 1.1471-6(f)(2)(i).

[74] Section 897(l)(2)(D).

### 6. Tax Treatment of Contributions and Earnings

For a QFPF, either (i) contributions to the organization or arrangement that would otherwise be subject to tax must be deductible or excluded from the gross income of the entity or taxed at a reduced rate, or (ii) taxation of any investment income of the organization or arrangement must be deferred or taxed at a reduced rate. These determinations are to be made "under the laws of the country in which it is established or operates."[75] While we have no specific recommendations on this criteria for a QFPF, we discuss the lack of clarify as to how these provisions are to be applied. We recommend that the IRS and Treasury provide guidance regarding this requirement, including whether the test applies to the pension plan itself or to its participants.

*First prong:* The first prong relates to contributions to the plan entity, and by its terms can be satisfied if the contribution is (i) deductible or (ii) excluded from the gross income of the entity or (iii) taxed at a reduced rate. The first component requires deductibility, but it does not unambiguously say by whom. The clause itself only references the plan entity rather than the plan sponsor or its participants, so it might be read to refer to a deduction by the entity. Under this view, the first and second components would be read together, so that the phrase "from the gross income of the entity" applies to both "deductible" and "excluded", the deduction being from the gross income of the entity.

The idea of deducting an amount received, rather than an amount paid, is used elsewhere in the tax law, such as the dividends received deduction.[76] In such a context, a deduction serves a function similar to an exclusion from gross income, so this component may be intended to deal with situations in which a plan entity is required to include contributions in gross income but can then claim an offsetting deduction. Also, the statutory language refers to contributions "which would otherwise be subject to tax," which further supports the view that it is the taxation of the entity that is addressed here.

On the other hand, it would be natural to think of the requirement as applying to the person *paying* the contribution, presumably either the plan sponsor or participant. This approach would mirror the deductibility of contributions to qualified retirement plans in the United States.[77]

The third component, which requires taxation at a "reduced rate," does not say what the rate is reduced from, but presumably this means relative to some "normal" rate that applies to income generally. Nor is there any threshold for how meaningful the reduction must be in order to count.

[75] Section 897(l)(2)(E).

[76] Section 243(a).

[77] Section 404(a).

*Second prong:* The second prong relates to investment income of the entity, and can be satisfied in the taxation of that income is (i) deferred or (ii) taxed at a reduced rate. The statute does not say *whose* taxation is deferred: it could be the entity itself, or else the participant or beneficiary. But that ambiguity may well have been deliberate, since the statute appears to focus on the tax burden on the income itself rather than with who is paying the tax. Again, there is no threshold on how meaningful the deferral or reduction in rate must be in order to count. Curiously, this prong mentions taxation at a reduced rate but does not mention exemption from tax altogether.

These two prongs may have been intended to permit foreign arrangements that are broadly similar to traditional and Roth qualified plan and Individual Retirement Account ("**IRA**") arrangements in the United States. Traditional qualified plans and IRAs generally receive pre-tax, and tax-deductible, contributions; any growth within the plan or account is generally tax-free, but withdrawals are taxed at the account holder's marginal rates at the time of those withdrawals.[78] By contrast, Roth accounts in qualified plans and Roth IRAs generally receive post-tax contributions, and any growth or later withdrawals will generally be exempt from taxation.[79]

Overall, it appears that the requirements for a QFPF are intended to apply to plans that enjoy some kind of favored tax treatment in their home country. However, the terms of the statute could cover a plan that enjoyed no tax advantages at all. Consider, for example, a rabbi trust that is set up to provide benefits to a group of executives (with no individual having a greater than 5 percent interest). The contributions to such an arrangement would not be deductible by the employer under U.S. tax law, but neither would those contributions be includible in the gross income of the trust. Accordingly, such a trust organized in a country with similar rules would literally satisfy this requirement, even though the tax treatment of the trust is no more favorable than, for example, the U.S. tax treatment of an unfunded deferred compensation arrangement.

## C. QFPFs: Structuring Issues

### 1. Indirect Ownership

Section 897(l) exempts from FIRPTA any USRPI "held directly (or indirectly through 1 or more partnerships) by, or to any distribution received from a real estate investment trust by" a QFPF or its wholly-owned subsidiary. The phrase "directly or indirectly" is used in connection with the *holding* of a USRPI, but not in connection with the *distribution* from a REIT. We believe however, that it makes sense for the exemption for REIT distributions to apply also to those distributions even if received through partnerships rather than directly. Otherwise, gain from the disposition of REIT shares held through a partnership would be covered by the exemption, but

[78] *See generally* Section 408.

[79] *See generally* Section 408A.

distributions from the REIT would not. Although Section 897 draws distinctions between REIT share dispositions and REIT distributions in other contexts,[80] we doubt that such a distinction was intended here,[81] and it would be helpful if regulations could confirm this point.

Also, the exemption applies to a QFPF "or any entity all of the interests of which are held by a QFPF." The statute is not clear whether this exemption extends to lower-tier wholly-owned corporate subsidiaries of the QFPF. The legislative history is silent on this point: the General Explanation recites the operative language added by the PATH Act, and notes that regulations may be promulgated to give effect the purposes of the statutory language.[82] As noted just above, Section 897(l) uses the phrase "directly or indirectly" in applying the exemption to USRPIs held through partnerships; the failure to use this phrase for wholly-owned entities suggests that only a direct wholly-owned subsidiary of a QFPF may qualify. However, there may be legal, economic or other non-tax reasons for a QFPF to structure a real estate investment through a chain of wholly-owned subsidiaries (which may be corporations or partnerships for U.S. tax purposes). Limiting the exemption to direct ownership does not appear to us to serve any apparent purpose, and we therefore recommend that the Treasury provide guidance that confirms that a subsidiary of a QFPF that is wholly-owned through a multi-tiered holding structure can qualify for the FIRPTA exemption. Such an approach would be consistent with the rule that treats entities wholly owned by a state or foreign government as *per se* corporations under the check the box regulations; the preamble to those regulations makes clear that indirect ownership is taken into account for this purpose.[83]

### 2. Wholly-Owned Entities

The QFPF exception applies to entities "all the interests of which are held" by QFPFs.[84] Referring to "all of the interests of which are held" rather than "wholly owned" raises the question whether interests other than ownership interests, such as creditor interests, are also required to be held by the parent QFPF. We do not believe that it is appropriate to require creditor interests to be held by the parent QFPF, since that would rule out external leverage by a wholly owned subsidiary, even though there is no such restriction on borrowings by the parent QFPF.

[80] For example, the exception for domestically controlled REITs applies to share sales but not REIT distributions. Section 897(h)(1) and (2).

[81] Jason Yen, attorney-adviser with the Treasury Office of International Tax Counsel, recently stated that Treasury does not think there was "any intent to create a negative inference," and that it was the position of Treasury that the exception would "apply to distributions through partnerships." *See* Amy S. Elliot, *First PATH Act Technical Correction Expected "Very Soon,"* TAX NOTES (Mar. 16, 2016), at 3.

[82] General Explanation, at 283.

[83] Treas. Reg. § 301.7701-2(b)(6); T.D. 9012, 67 Fed. Reg. 49862–63 (Aug. 1, 2002).

[84] Section 897(l)(1)(B).

However, it would seem reasonable to limit the permitted creditor interests to those solely as a creditor, so that a subsidiary with external equity-flavored debt would not be viewed as wholly owned by its parent. We ask that guidance be issued to confirm this view.

Moreover, in certain circumstances, subsidiaries of QFPFs may not be wholly-owned. Certain jurisdictions might require ownership by directors or managers of the employer, or, may require nominal ownership by another entity. We ask that the IRS and Treasury provide that such subsidiaries may be considered "wholly-owned" notwithstanding *de minimis* ownership by parties other than the pension plan if required under the law of the country in which the pension plan or subsidiary is organized.

Further, as drafted, the exemption for wholly-owned entities by its terms covers operating subsidiaries as well as investment holding vehicles. While this is certainly a beneficial result for the QFPF (and the operating subsidiary), we question whether Congress intended foreign operating companies to be able to avoid FIRPTA even if wholly owned by a QFPF. For example, if wholly-owned subsidiary owned both a USRPHC as well as an operating business, should wholly-owned subsidiary be eligible for the exemption under Section 897(l)? Further, should it matter whether the subsidiary is fiscally transparent under local law? The statute provides no limitation on the types of activities such wholly-owned subsidiary may engaged in. In contrast, Section 892 does provide limitations regarding commercial activity in order for a wholly-owned subsidiary of a foreign government to take advantage of the Section 892 exemption.[85] The lack of a similar standard here suggests that Congress did not intend to impose such standard. Given that the ultimate beneficiaries of the investment in the real estate are the participants in the pension plan and Congress intended them to be exempt from FIRPTA, we think it would be appropriate to permit these wholly-owned entities to engage in activities that might otherwise be subject to tax in the U.S. without tainting this FIRPTA exemption. We request guidance confirming that a wholly-owned subsidiary of a QFPF may participate in other activities unrelated to the FIRPTA investment.

Lastly, the statutory language is silent as to whether the entity (or any intermediate entities, as discussed in the preceding Part) must be organized or resident in the same tax jurisdiction as the parent QFPF. Depending on the investment strategy of a given QFPF, it may be investing in U.S. real estate through an entity whose jurisdiction of organization or residency does not match that of the QFPF. There does not seem to be a policy reason for the exemption to be denied on account of the mismatch. Accordingly, we recommend clarifying that the QFPF and its wholly owned entities do not need to be organized or resident in the same tax jurisdiction.

We recognize that allowing wholly owned entities to be organized or resident in a different jurisdiction would be inconsistent with the approach taken by the regulations under Section

[85] *See*, generally, Treas. Reg. §§ 1.892-4T, 1.892-5T.

892, which extend the Section 892 exemption to entities wholly owned by a foreign sovereign only if the entity is organized in the jurisdiction of the foreign sovereign itself.[86] However, that limitation appears to be more appropriate in the Section 892 context, because a wholly owned entity formed under the laws of the foreign sovereign can be more readily seen as an alter ego of the sovereign itself. This consideration, however, is not relevant for determining eligibility for the QFPF exemption, which should permit QFPFs to operate as permitted under the laws of the governmental body under which the QFPF was organized, provided it meets the other requirements.

### 3. Entities Owned by Multiple QFPFs

The exception for entities wholly owned by a QFPF appears to exclude an entity treated as a corporation for U.S. federal income tax purposes that is owned by *multiple* QFPFs rather than a single QFPF. There seems to be no policy reason to exclude a pooling vehicle in which each owner is a QFPF (or wholly-owned subsidiary) that qualifies for the exemption under Section 897(l).

The statute permits a QFPF to avoid FIRPTA if it invests in real property through a partnership vehicle with other investors (regardless of their QFPF status). We question why a corporate entity, where all owners themselves would be eligible for exemption from FIRPTA, should not itself qualify for this exemption as a pooling vehicle.

In other contexts, the tax law extends favorable tax treatment of pension funds to pooling vehicles owned by a group of them. For example, Section 501(c)(25) accords tax-exempt status to a corporation formed to hold real estate that is owned by up to 35 pension funds, charities, or governmental units. And in the treaty context, the IRS has ruled that a pooled investment trust fund for the benefit of a group of employee benefit trusts can qualify for benefits under the Canadian treaty as an organization "operated exclusively to earn income for the benefit of" an employee benefit trust, even though the fund described in the ruling earns income for the benefit of multiple employee benefit trusts, not just one.[87] Also, Rev. Rul. 81-100[88] provides that certain qualified retirement plans and IRAs are permitted to pool their assets for investment purposes in an "81-100" group trust if certain specified requirements are satisfied.[89]

[86] Treas. Reg. § 1.892-2T(a)(3)(ii).

[87] PLR 200035027 (Sept. 15, 2000). *See* Convention with Respect to Taxes on Income and on Capital, Sept. 26, 1980, U.S.–Can., art. 21(2), T.I.A.S. 11,087, 1986-2 C.B. 258.

[88] 1981-1 C.B. 326.

[89] These requirements include restrictions on transferability of equity interests in the group trust and restriction of membership of the group trust to certain qualifying plans. Rev. Rul. 2011-1, 2011-2 I.R.B. 251, *as modified by* Notice 2012-6, 2012-3 I.R.B. 293.

We recommend a similar approach here, with regulations that extend the Section 897(l) exemption to entities owned exclusively by multiple QFPFs, and describe the mechanics by which QFPFs may pool their assets to invest in these entities.

## D. The Publicly Traded Exception

### 1. Definition of Person

As noted earlier, newly-added Section 897(k)(1) of the Code increases from 5 percent to 10 percent the maximum stock ownership that a shareholder may have held, during the relevant testing period, in a class of REIT stock that is publicly traded, to avoid having that stock treated as a USRPI upon disposition by the shareholder, or to have capital gains distributions subject to tax under FIRPTA. For publicly traded shares of USRPHCs that are not REITs, the maximum remains at 5 percent.

The statutory language provides that this exception will apply to any "person" who has held no more than 5 percent of any class of stock of a publicly traded USRPHC (10 percent for REITs).[90] A "person" includes a partnership for U.S. federal income tax purposes.[91] However, the regulations provide that the exception applies to a person who "beneficially owned" no more than 5 percent of that class of stock.[92] While not explicitly addressed by the FIRPTA rules, in other contexts partners are treated as the beneficial owners of partnership income and property.[93] As a result, practitioners remain unclear as to whether the ownership threshold for this exception is tested at the partner or partnership level. This issue is not new to the PATH Act, which simply increased the maximum percentage for REITs, but because of this increase it will apply more broadly.

Other FIRPTA rules contemplate look through treatment for partnerships,[94] and we believe there is no policy consideration for a different result in the context of the publicly traded exception. Thus, we recommend that regulations confirm look-through treatment of partnerships in this context.

90 Sections 897(c)(3) and (k)(1)(A).

91 Section 7701(a)(1).

92 Treas. Reg. § 1.897-1(c)(2)(iii).

93 *See, e.g.*, Treas. Reg. § 1.1441-1(c)(6)(ii)(B) (providing that partners of a foreign partnership are the beneficial owners of income paid to the foreign partnership).

94 PLR 200923001 (Feb. 26, 2009) suggests that partnerships should be looked-through for purposes of determining whether a qualified investment entity is domestically controlled under section 897(h)(4)(B). Also, Section 897(c)(4)(B) provides that a corporate partner looks through to a proportionate share of a partnership's assets in determining whether the partner is a USRPHC.

### 2. 10-Percent Threshold Testing Period

In increasing the publicly traded exception threshold from 5 percent to 10 percent for dispositions of REIT shares and for distributions by REITs, the new statutory language merely substitutes "5 percent" for "10 percent" in those relevant provisions. These increases are effective for any disposition on or after the date of enactment of the PATH Act, or any distribution by a REIT on or after that date (unless deducted by the REIT in a year ending on or before that date).[95]

We believe that this effective date rule is properly read to apply the higher 10-percent threshold for the entire testing period, even if the testing period extends back to periods before the date of enactment of the PATH Act. For example, if a Non-U.S. person sells shares of a REIT on December 1, 2016 and acquired those shares in 2010, it should be sufficient that the shareholder held no more than 10 percent during the 5-year period ending on the date of sale, even if that shareholder owned more than 5 percent during the pre-enactment portion of that period. We recommend that this point be clarified in regulations.

## E. Look-Through Rules for the Domestically Controlled REIT Test

Like the test discussed above under the definition of person for the publicly traded exception, the test for whether a REIT is domestically controlled, and therefore the sale of its shares is not subject to FIRPTA, looks to whether less than 50 percent of the REIT has been held "directly or indirectly by foreign persons" during the applicable testing period. The statute provides no guidance on whether reference to a "foreign person" is to the actual owner of the shares in the REIT or to the beneficial owners, such as partners in a partnership. It is also unclear whether "indirectly" refers to ownership by attribution or merely ownership held through a nominee. Section 897(a) specifically lists a "non-resident alien individual or foreign corporation" as subject to FIRPTA taxation (rather than a "foreign person"). Further, Treas. Reg. § 1.897-1(c)(2)(i) provides that for purposes of making the determination as to whether a REIT is domestically controlled, the actual owners of stock, as determined under Treas. Reg. § 1.857-8 must be taken into account. That regulation states that "an actual owner of stock of a [REIT] is the person who is required to include in gross income in his return the dividends received on the stock . . .[g]enerally, such person is the shareholder of record of the [REIT]."[96] The IRS has ruled privately that a REIT would not look through C corporations in determining domestically controlled REIT status, noting that C corporations are the entities which include in income in their returns and actually pay U.S. tax on distributions from REITs and citing Treas. Reg. § 1.857-8.[97]

[95] PATH Act § 322(c)(1), 129 Stat. 3102 (2015).

[96] Treas. Reg. § 1.857-8(b).

[97] PLR 200923001 (Feb. 29, 2009).

The language in the regulation implies that, in determining domestically controlled REIT status, the REIT should look through partnerships because its partners include the REIT dividends in their gross incomes (although technically the partnership does so as well). If this were not the case, merely forming a U.S. partnership rather than a foreign partnership to hold shares of the REIT could cause the REIT to be domestically controlled. Because of the conflicting language in the statute and regulations, we recommend that Treasury and the IRS issue guidance clarifying that for purposes of determining domestically controlled REIT status, the REIT would look through partnerships. In contrast, because Section 897(a) applies to foreign corporations and those entities are "actual" owners of stock, we further recommend that Treasury and the IRS confirm its private ruling position by providing public guidance that REITs would not look through corporations in making this determination.

## F. The Qualified Shareholder Exception

The new exception under Section 897(k) for qualified shareholders can apply in three different ways, depending on how the relevant QCIV obtains its status as such: under the REIT treaty rule, the publicly traded partnership rule, or special designation by the IRS. Each of these rules seek to expand the publicly traded exception on a look-through basis to entities more like real estate investment trusts that are formed to be widely held by passive investors in real estate holdings. However, as noted earlier, only Australian LAPTs and Dutch *beleggingsinstellingen* appear to be covered by the REIT treaty rule, if that rule is limited to specified entities that are eligible for treaty benefits for dividends from REITs in which they hold a greater than 10 percent interest.[98] However, the statutory language could be read more broadly. There are number of older treaties that have no special rules at all for REIT dividends, so that a REIT shareholder that qualifies for benefits under one of those treaties can obtain a reduced rate of withholding even if the shareholder owns more than 10 percent of the REIT.[99] The General Explanation disavows such a broad view, stating that the QCIV "must be eligible for a reduced rate of withholding under a provision in the dividends article of the relevant treaty dealing specifically with dividends paid by REITs."[100] If this was intended, this narrower interpretation of the statutory language should be reflected in the form of regulations.

Even if the scope of the REIT treaty rule is limited in this fashion, it could apply outside the context of the Australia and Netherlands treaties. The treaties with Portugal, Thailand, and Tunisia all provide for a reduced rate of withholding on REIT dividends in cases where the

98 *See* Part III.D *supra.*

99 *See, e.g.,* Agreement with Protocol and Exchange of Notes for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, Apr. 30, 1984, U.S.-China, art. 9(2), T.I.A.S. No. 12065, 1988-1 C.B. 414

100 General Explanation at 282, n. 966.

shareholder owns less than 25 percent of the REIT.[101] Since shareholders owning more than 10 percent but less than 25 percent can qualify for a reduced rate of withholding under these treaties, those shareholders are literally covered by the REIT treaty rule, even if it is limited to treaties dealing specifically with REIT dividends. We doubt that this result was intended, but in any case guidance under the REIT treaty rule should make the matter clear.

In addition, the publicly traded partnership rule is very narrowly focused, since it applies only to publicly traded partnerships that would be USRPHCs if they were treated as United States corporations. As a drafting point, it is puzzling that the test refers to USRPHCs,[102] because at least half of an entity's assets must be USRPIs to be a USRPHC. In contrast, the Australian trusts and Dutch vehicles noted above are not required to own half of their assets in United States real estate.[103] Quite possibly, some confusion arose in the drafting because an interest in a USRPHC is generally treated as a USRPI only if the USRPHC is domestic.[104] The test therefore excludes publicly traded partnerships that invest primarily or even wholly in real estate, but in a broad range of locations rather than with a focus on the United States. It is not clear to us that such a narrow focus was intended.[105]

Moreover, the General Explanation does not provide a specific policy reason for the requirement that the foreign partnership be a withholding foreign partnership under 897(k)(3)(B)(ii), and we are not clear as to why such a requirement would be necessary for entities to qualify as "qualified shareholders." No similar withholding requirement or other information reporting requirement appears to apply to entities contemplated by Section 897(k)(3)(B)(i). Accordingly, unless there a specific policy reason, we recommend that this requirement not be applied in designating foreign entities that qualify as QCIVs pursuant to Section 897(k)(3)(B)(iii), or in the course of articulating an "angels list" of foreign entities that by definition qualify as QCIVs, each as more fully discussed below. Lastly, the Treasury is given

[101] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Sept. 6, 1994, U.S.–Port., art. 10(4); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Nov. 26, 1996, U.S.-Thai., art. 10(3), Hein's No. KAV 4911; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, June 17, 1985, U.S.–Tun., art. 10(3).

[102] Section 897(c)(2).

[103] *Id.*

[104] Section 897(c)(1)(A)(ii). However, even foreign USRPHCs are treated as USRPIs for purposes of determining whether its shareholders are USRPHCs. Section 897(c)(4)(A).

[105] A prior version of this legislation in 2013 would not have required the publicly traded partnership to have a U.S. focus. *See* H.R. 2870 § 2(a)(3), which would have allowed QCIV status to "a corporation (other than a corporation that is entitled to a deduction or exclusion for dividends paid to its shareholders or subject to a requirement to distribute any portion of its taxable income annually) engaged primarily in the trade or business of operating or managing real estate entities or assets."

authority to designate other types of foreign entities as QCIVs, provided that the entity is either fiscally transparent or entitled to a dividends-paid deduction for distributions to persons holding interests (other than interests solely as a creditor) in that entity. The carve-out of interests solely as a creditor is puzzling, since payments of interest would presumably be also deductible by any entity that was allowed a dividends-paid deduction. Payments of principal might not be deductible, but the dividends-paid deduction, in the U.S. sense, applies only to distributions paid out of earnings and profits, and not to return-of-capital distributions.[106]

More fundamentally, neither the statute nor the General Explanation indicates *whose* tax law determines whether the entity is fiscally transparent or entitled to a dividends paid deduction. The statute does state that fiscal transparency is within the meaning of Section 894, but the regulations under Section 894 address fiscal transparency of an entity both in the United States, the jurisdiction of residence, and the jurisdiction of residence of the entity's owners.[107] The generic reference to a dividends-paid deduction, rather than to the specific rules under the Code, suggest that the tax law of some foreign jurisdiction is relevant. We believe that the most likely intended answer is that both fiscal transparency and the dividends-paid deduction are to be determined under the laws of the jurisdiction where the foreign entity is resident, and it would be helpful if the regulations could clarify this point.

This power to designate other types of foreign entities as QCIVs can be usefully applied to broaden the scope of the REIT treaty rule and the publicly traded partnership rule in ways that are considered to be consistent with the purposes of those rules. For example, other entities that have the relevant characteristics of LAPTs and *beleggingsinstellingen* could be designated as QCIVs, even if they are resident in countries that do not have a tax treaty that provides reduced withholding tax rates on REIT dividends paid to those entities when they exceed 10 percent ownership of the REIT. Also, the Treasury could designate as QCIVs publicly traded partnerships that invest primarily in real estate, even if they do not invest primarily U.S real estate and therefore would not be USRPHCs if they were corporations. There may be other circumstances in which it is appropriate to designate foreign entities as QCIVs, since Congress left to Treasury the discretion to designate which foreign entities will qualify as QCIVs. It would be helpful for the Treasury and the IRS to publish an "angels list" of legal entities in specific jurisdictions that will by definition qualify as a QCIV, similar to the list of *per se* corporations provided under Treas. Reg. § 301.7701-2(b)(8). Also, fairness would dictate that all entities that meet the criteria specified by the IRS and Treasury should similarly qualify for this exemption. We recommend that the IRS and Treasury also provide a list of criteria for vehicles to avail themselves of this exemption, even if not specified on the angels list.

[106] Section 562(a).

[107] Treas. Reg. § 1.894-1(d).

## G. Revisions to Forms W-8

Currently, there is no specific IRS W-8 form available for a QFPF to submit to claim its exemption from FIRPTA under the new PATH provisions. Although Treasury and the IRS provided amendments to the regulations under Section 1445 specifying that a QFPF is a non-foreign person for purposes of withholding, the QFPF has no form available to claim its exemption. Such a form may be needed to the extent the QFPF is a partner in a partnership and the partnership makes a distribution attributable to gain from the sale of USRPIs. We recommend that the IRS issue a new form that QFPFs may submit to claim exemption under Section 897(l), or possibly amend W-8EXP to include a box for QFPFs to claim that exemption.

Similarly, withholding agents that pay REIT dividends will need to collect information that will enable them to determine whether the beneficial owner of the dividend is a qualified shareholder, and we expect that Form W-8BEN will need to be modified for this purpose. The information will need to include the percentage of the dividend that is ineligible for the qualified shareholder exemption by reason of a unitholder of the qualified shareholder having an indirect ownership interest of 10 percent or more of the REIT.