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# Calling All Foreign Pension Funds: Congress Enacts Important Exclusion from "FIRPTA"

*By: Ezra Dyckman and Daniel W. Stahl*

While taxpayers may be accustomed to law changes bringing bad news, the Protecting Americans From Tax Hikes Act of 2015 (the "PATH Act") had some important taxpayer-friendly provisions. With respect to the taxation of foreigners, the PATH Act created and expanded a number of exceptions to the "FIRPTA" rules that generally govern the taxation of foreign persons selling interests in real estate located in the United States. One such provision may encourage a significant increase in the investments of foreign pension funds in U.S. real state through real estate investment trusts ("REITs").

**Background**

In general, foreign persons (i.e., nonresident alien individuals and foreign corporations) can be subject to U.S. tax under two separate schemes. First, a foreign person is subject to U.S. tax on taxable income that is "effectively connected" with a trade or business in the United States ("effectively connected income" or "ECI"). This tax is generally imposed on net income at the same rates as for a U.S. person (which can include capital gain rates if applicable). Second, if a foreign person receives income that is not ECI, the foreign person is generally subject to tax with respect to certain specific categories of income. These categories include interest, dividends, rents, and royalties from sources within the U.S. ("fixed or determinable, annual or periodical" income, or "FDAP" income). FDAP income is generally subject to a 30% withholding tax on the gross amounts.

Prior to the enactment of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), a foreign person that was not engaged in the conduct of a trade or business in the U.S. was generally not subject to U.S. tax upon the disposition of real estate located in the U.S. However, the FIRPTA rules generally treat a foreign person's gain or loss from the disposition of a U.S. real property interest (a "USRPI") as ECI. As a result, any gain that a foreign person has from the disposition of a USRPI is taxable under the rules that govern ECI.

An interest in a domestic corporation that owns U.S. real estate is generally treated as a USRPI. However, a corporation that is a domestically controlled REIT (i.e., with less than 50% of its stock owned by foreign persons) is excluded from the definition of USRPI. Therefore, a foreign person is not subject to U.S. tax upon the sale of stock of a domestically controlled REIT. Still, if a REIT (even one that is domestically controlled) makes a distribution to a foreign shareholder, any portion of the distribution that is attributable to gain from sales or exchanges of USRPIs is generally taxable for the foreign shareholder as gain from the sale of a USRPI (the "FIRPTA pass-through rule"). The IRS has issued a notice which states that the FIRPTA pass-through rule applies even to a distribution made to a foreign shareholder pursuant to liquidation of a REIT (even if the liquidating distribution would generally be treated under the Internal Revenue Code as sale proceeds for REIT shares).

**New Provision for Foreign Pension Funds**

The PATH Act enacted new Internal Revenue Code section 897(l), which exempts foreign retirement or pension funds that satisfy certain requirements (referred to herein as "foreign pension funds") from the provisions of FIRPTA. As a result, a foreign pension fund that is not engaged in a trade or business in the U.S. is now exempt from U.S. tax upon the sale of a USRPI (i.e., gain from any such sale would not be treated as ECI under FIRPTA, and therefore is not taxable in the U.S. since it is not FDAP income).

However, if a foreign pension fund actually has ECI as a result of being engaged in a trade or business in the United States, it would still be taxed under the normal rules for ECI. As a result, the new FIRPTA rule for foreign pension funds may turn out not to be as helpful as it would initially appear to be in many cases, since a foreign pension fund that owns U.S. real estate would often be

***Ezra Dyckman** is a partner in, and **Daniel W. Stahl** is an associate of, the law firm of Roberts & Holland LLP.*

considered to be engaged in a trade or business in the U.S. In addition, even if a foreign pension fund that owns U.S. real estate is not engaged in a trade or business, other limitations would likely prevent it as a practical matter from taking advantage of the new FIRPTA rule to sell its real estate tax-free.

If a foreign pension fund invests in U.S. real estate through a REIT, though, it can take advantage of the change in law without being subject to a 30% tax on gross rents. Under a REIT structure, the foreign pension fund would be subject to the 30% U.S. tax on its ordinary dividends, but, under the new rule, the foreign pension fund would not be subject to U.S. tax upon the disposition of its stock in the REIT (regardless of whether the REIT is domestically controlled). Also, since the new rule exempts foreign pension funds from the FIRPTA pass-through rule, the foreign pension fund would avoid being subject to U.S. tax even if the REIT first sells its real estate and then liquidates. Moreover, if the foreign pension fund were structured so as to also qualify as a sovereign under section 892 (which provides certain exemptions for sovereigns), then (by investing through a REIT in which it owns an interest of less than 50%) it could get the "grand slam" tax result of (i) being exempt from U.S. tax upon receipt of ordinary dividends from the REIT as a result of qualifying as a sovereign and (ii) being exempt from U.S. tax upon disposition of the real estate by the REIT under the new rule.

**Conclusion**

Any foreign person that owns an interest in U.S. real estate through a domestically controlled REIT can potentially achieve a tax-free exit from the investment by selling shares of the REIT. However, there are limitations which can limit the practicality of this approach. First, the foreign person must invest in a REIT that is owned more than 50% by U.S. persons, which means that it has to find a U.S. person that is willing to invest through a REIT. More generally, though, it may not be easy to find a buyer that is willing to purchase stock of the domestically controlled REIT, as opposed to buying the underlying real estate.

The new Code section 897(l), enacted by the PATH Act, solves both of these problems for foreign pension funds. A foreign pension fund can now set up its own REIT to acquire real estate located in the U.S., without having to invest together with U.S. persons to have a domestically controlled REIT. Subsequently, the foreign pension fund can now exit from its investment by causing the REIT to sell the underlying real estate tax free and liquidate without incurring any U.S. tax liability. Therefore, the foreign pension fund would not need to structure its exit as a sale of REIT shares in order to avoid FIRPTA.

It will be interesting to see whether there is a significant increase in the amount of investments in U.S. real estate made by foreign pension funds through REITs. In fact, it would be no surprise if foreign companies and governments set up pension funds specifically to comply with the new rule.