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GLOBAL FUNDS TAX ADVISORY – REAL ESTATE

Final regulations under sections 897(l), 1441, 1445, and 1446 relating to qualified foreign pension funds

Tax Alert

Overview

On December 29, 2022, the IRS and the Department of the Treasury published final regulations under sections 897(l), 1441, 1445, and 1446 (the "Final Regulations") regarding gain or loss of a qualified foreign pension fund (QFPF) attributable to certain interests in US real property, and the applicable withholding provisions. The Final Regulations, which mostly adopt the 2019 proposed regulations (the "Proposed Regulations"), are effective as of December 29, 2022 (the date of their publication in the Federal Register).

Final regulations under section 897(l)

Section 897(l) provides an exemption to the application of section 897(a) on gain or loss on certain dispositions of, and distributions with respect to, United States real property interests (USRPI(s)) for certain foreign pension funds and their subsidiaries. The Proposed Regulations contained rules relating to the qualification for the exemption under section 897(l), as well as rules addressing related withholding requirements.

The Final Regulations largely retain the structure and content of the Proposed Regulations, with a few changes, additions, and clarifications. As in the Proposed Regulations, the Final Regulations do not provide any relief in the case of "de minimis" non-QFPF ownership in a qualified controlled entity (QCE). The Final Regulations also do not provide additional guidance on what constitutes an "interest" in a QCE; rather, the preamble states that such a determination is made based on the definition of "interest in" provided by the section 897 regulations, facts, and taking into account general US tax principles. As many QFPFs often invest through collective investment vehicles that can require the sponsor or manager to hold an interest in the vehicle, the lack of guidance for this issue will likely continue to create uncertainty for taxpayers.

The Final Regulations provide welcome relief by including a rule that a QFPF may provide limited amounts of non-ancillary benefits and non-retirement and

pension benefits, a concession that was not allowed under the Proposed Regulations. In addition, a definition of "retirement and pension benefits" was added and the definition of "ancillary benefits" was revised. The definitions in the Final Regulations should lessen the concern that providing ancillary benefits (such as death benefits, disability benefits, medical benefits or certain other benefits) will jeopardize qualification as a QFPF. To address concerns over "inadvertent failures" to qualify as a QFPF due to the application of the annual "85-percent threshold" requirement, the Final Regulations provide a new alternative 48-month average calculation to satisfy this requirement. Additionally, while the "qualified holder" rules, including the ownership requirements, from the Proposed Regulations are retained, two new transition rules are provided.

The Final Regulations also clarify certain elements of the Proposed Regulations, including that an arrangement formed pursuant to a foreign government mandate in which a private investment manager holds and invests contributions on behalf of the foreign government is nevertheless treated as "established by" the foreign government. Other clarifications include the scope of ancillary benefits, treatment of certain distributions such as rollovers and early withdrawals, situations in which funds may revert back to a plan sponsor from a qualified segregated account, and the scope of qualified beneficiaries.

Final regulations under sections 1445 and 1446

With respect to withholding, the Final Regulations add a new definition for a "withholding qualified holder." In addition to a "qualified holder," which includes a QFPF and a QCE, a withholding qualified holder includes a foreign partnership that is wholly owned by qualified holders. This is welcome relief as many QFPFs jointly invest through entities treated as foreign partnerships that were subject to section 1445 withholding despite all of the partners qualifying for the QFPF exemption from FIRPTA. However, as with QCE qualification, it may be problematic to make use of this relief where an interest is held by a sponsor or manager interest in a foreign partnership.

Additionally, when providing a certification of non-foreign status for withholding under sections 1445 and 1446, the Final Regulations now permit the use of a foreign taxpayer identification number if the withholding qualified holder does not have a US taxpayer identification number. The Final Regulations also clarify that a Form W-8EXP is a type of certification of non-foreign status, and a withholding qualified holder may use it to certify its non-foreign status once the IRS revises Form W-8EXP to take into account the Final Regulations.

Final regulations under section 1441

The Final Regulations provide additional relief by amending the existing coordination rule for sections 1441 and 1445. The amendments provide that withholding qualified holders are not subject to section 1445 withholding on distributions from real estate investment trusts (REITs) or other entities that are qualified investment entities (QIE(s)) that are capital gain dividends treated as gain attributable to the sale of US real property. This is a departure from the approach taken by the Proposed Regulations, which may have led to section 1441 withholding on capital gain dividends treated as gain attributable to the sale of US real property to QFPFs.

The Final Regulations also clarify which coordination rules a United State real property holding corporation that is a QIE or non-QIE can follow to satisfy obligations under sections 1441 and 1445. In addition, the Final Regulations clarify that dividends that are not capital gain dividends paid from REITs or other QIEs to a withholding qualified holder continue to be subject to withholding tax under section 1441. Finally, the Final Regulations also clarify that if withholding is not required under section 1445 on a REIT's capital gain

dividend because it is made with respect to stock that is regularly traded on an established market in the US to a 5%-or-less holder, withholding will apply under section 1441 even if the distribution is to a withholding qualified holder.

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