Final regulations on exception for U.S. real property interests held by foreign pension funds

Initial impressions and observations

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Contents

The U.S. Treasury Department and IRS on December 28, 2022, released final regulations (T.D. 9971) (the "final regulations") under section 897(l), which generally provide qualified foreign pension funds (QFPFs) and their wholly owned subsidiaries with a complete exemption from section 897 on gain from the disposition of a U.S. real property interest (USRPI) and provide an exemption for the receipt of certain distributions described in section 897(h). The final regulations were published in the Federal Register on December 29, 2022. The final regulations finalize guidance provided in proposed regulations (REG-109826-17) released June 6, 2019 (the "proposed regulations").

This report provides initial impressions and observations regarding the final regulations.

Treasury and the IRS also released proposed regulations on December 28, 2022 (REG-100442-22) providing rules for determining whether a "qualified investment entity" (i.e., a REIT or certain regulated investment companies) is a domestically controlled qualified investment entity for purposes of section 897. The proposed regulations also provide guidance regarding the rule in the section 892 regulations that generally treats a U.S. real property holding corporation as a "controlled commercial entity" for purposes of section 892. Those proposed regulations will be discussed in a separate KPMG report.

Background

Section 897(a) (commonly referred to as FIRPTA) treats gain or loss of a foreign person attributable to the disposition of a USRPI as gain or loss that is effectively connected with the conduct of a trade or business in the United States. Section 897(h)(1) provides special rules for certain distributions from qualified investment entities. Section 1445(a) generally requires the transferee of a USRPI from a foreign person to deduct and withhold 15% of the amount realized by the transferor. The 2015 PATH Act added section 897(l) to the Code, which provides a complete exemption from FIRPTA for QFPFs and their subsidiaries. The 2015 PATH Act also amended section 1445 generally to exempt QFPFs and their subsidiaries from withholding tax on USRPI gains.

The proposed regulations provided that gain or loss of a "qualified holder" from the disposition of a USRPI (and the receipt of section 897(h) distributions) was not subject to section 897 to the extent the gain or loss is attributable to one or more "qualified segregated accounts" maintained by the qualified holder. A qualified holder generally is a QFPF or a "qualified controlled entity" (QCE). A QCE is a foreign trust or corporation all of the interests of which are held by one or more QFPFs directly or indirectly through one or more QCEs or partnerships.

The final regulations retain the basic approach and structure of the proposed regulations but include several modifications and clarifications in response to comments.

Applicability dates and reliance on the final regulations

The final regulations generally apply with respect to dispositions of USRPIs and distributions described in section 897(h) occurring on or after December 29, 2022 (the date the final regulations were filed with the Federal Register). The rules exempting USRPI gain of a qualified holder from section 897(a), the new "qualified holder requirement", and the definitions of governmental unit and QCE all apply with respect to dispositions of USRPIs and relevant distributions occurring on or after June 6, 2019 (the date the proposed regulations were released).

An eligible fund may apply the final regulations with respect to dispositions and distributions occurring on or after December 18, 2015 (the date of the PATH Act), and before the applicability date of the final regulations, if the eligible fund and all related persons consistently apply the rules in the final regulations in their entirety for all relevant years. An eligible fund that chooses to apply the final regulations before their applicability date must apply a reasonable approach to any valuation requirements with respect to dates going back to December 18, 2015.

Qualification as a QFPF

QFPF may be any foreign trust, corporation, or other organization or "arrangement" that meets the five requirements in section 897(l)(2). Generally, a fund qualifies as a QFPF if it: (1) is an eligible fund; (2) is organized under foreign law; (3) is established to provide retirement or pension benefits to employees; (4) does not have large beneficiaries; (5) is subject government regulation and reporting; and (6) is entitled to favorable foreign tax treatment. The proposed regulations provided rules addressing each of these requirements. The final regulations generally follow the proposed regulations but make important changes to the rules for determining whether a pension fund meets the third requirement. The final regulations also include a more limited modification to the sixth requirement.

Established to provide retirement or pension benefits to employees

An eligible fund must be established either: (1) by a foreign country (or one or more political subdivisions thereof) to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (including self-employed individuals) or persons designated by such employees, as a result of services rendered by such employees to their employers (a "government-established fund"), or (2) by one or more employers to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (including self-employed individuals) or persons designated by such employees in consideration for services rendered by such employees to such employers (an "employer fund").

"Established by" requirement

Comments asserted that a pension fund should be treated as "established by" a foreign government when the national pension system of a foreign country is managed by private administrators and individual employees are required by law to establish a pension account maintained by a private administrator. The final regulations clarify that a government-established fund may be established by, or at the direction of, a foreign jurisdiction. If, however, an eligible fund is established at the direction of a foreign jurisdiction to provide benefits to the entity's employees in consideration for services, the fund will be considered an employer fund and not a government-established fund. The regulations further clarify that an eligible fund is treated as being established by a foreign jurisdiction or an employer even if persons other than the foreign jurisdiction or employer (e.g., private administrators) manage the eligible fund.

KPMG observation

There was some uncertainty under the proposed regulations whether a pension fund that was established at the direction of a foreign government could qualify as a QFPF if a private entity manages the fund's investments and maintains control of the fund's assets. The final regulations eliminate this uncertainty and make clear that an arrangement created pursuant to a foreign governmental mandate where private investment managers hold and invest contributions related to plans of other employers is eligible to be treated as a government-established fund.

The new rule designating certain funds as employer funds and not a government fund is consequential. As discussed below regarding the definition of a "qualified recipient," there are generally no concerns over the requirement that the benefits be paid to qualified recipients in the case of a government-established fund (i.e., there is no limitation on the number of non-employees in a government-established fund provided the fund meets the applicable threshold for retirement and pension benefits). By contrast, there are restrictions on payments of benefits to qualified recipients in the case of an employer fund that require most of the payments to be made to a current or former employee (or a spouse of a current or former employee), even though under the final regulations, up to 5% of the participants in an employer plan may be non-employees. Accordingly, the treatment of a fund that is established at the direction of a foreign jurisdiction to provide benefits to employees in consideration for services as an employer-fund rather than government-established fund therefore may be unfavorable for certain funds.

There is some uncertainty regarding the application of employer fund definition to some government-established funds. A foreign pension fund established by a foreign government for the benefit of the general populace necessarily will extend benefits to its own government's employees, creating a potential overlap in the two categories. To avoid this interpretative overlap, the better interpretation of the regulation is that a government-established fund is an employer fund only if it is established by a foreign government especially for its own employees in its capacity as an employer (e.g., a fund set up specifically for police and firefighters as opposed to a fund established for the general populace that also could include police and firefighters). Funds established by the government that do not meet this limited standard are government-established funds.

Scope of qualified benefits

The proposed regulations required that all benefits provided by an eligible fund be qualified benefits that are provided to qualified recipients (the "100% threshold"), and that at least 85% of the present value of the qualified benefits expected to be provided by the fund are retirement or pension benefits (the "85% threshold"). Qualified benefits were defined as retirement and pension or "ancillary benefits." If a fund provided benefits that did not meet either definition, then the fund could not qualify as a good QFPF.

The final regulations retain the 100% threshold and 85% threshold but provide several helpful modifications to the rules for determining the scope of qualified benefits, including liberally defining pension and retirement benefits, expanding the scope of ancillary benefits, and allowing QFPFs to provide a limited amount of "non-ancillary" benefits. The final regulations also provide helpful rules for valuing a fund's benefits and determining qualified recipients.

Retirement and pension benefits

The proposed regulations did not define retirement and pension benefits. In response to comments, the final regulations broadly define retirement and pension benefits to mean benefits payable to (1) qualified recipients after reaching the retirement age determined under or in accordance with local foreign law (including benefits paid to a qualified recipient who retires on or after a stated early retirement age), (2) qualified recipients or after an event that renders a qualified recipient permanently unable to work, and (3) distributions made to a surviving beneficiary of a qualified recipient. Additionally, to help taxpayers distinguish between retirement and pension benefits and ancillary benefits, the final regulations clarify that retirement and pension benefits generally are based on one or more of the following factors: contributions, investment performance, years of service with an employer, or compensation received by the qualified recipient.

KPMG observation

Under the proposed regulations there was some uncertainty regarding whether permanent disability benefits and survivor benefits constituted ancillary benefits or retirement and pension benefits. To be safe, many pension funds treated these benefits as ancillary benefits. The preamble notes that the IRS and Treasury included permanent disability and survivor benefits in the definition of retirement and pension benefits to eliminate this uncertainty and to clarify that such benefits are not ancillary benefits. The treatment of permanent disability and survivor benefits as retirement and pension benefits is a helpful modification that will allow many pension funds to "free up" additional capacity for ancillary and non-ancillary benefits (discussed below). These changes may enable pension funds that did not qualify as QFPFs under the proposed regulations to qualify for benefits under the final regulations.

Ancillary and non-ancillary benefits

The proposed regulations defined ancillary benefits as benefits payable upon the diagnosis of a terminal illness, death benefits, disability benefits, medical benefits, unemployment benefits, or "similar" benefits. In response to numerous comments requesting additional guidance regarding the scope of ancillary benefits, the final regulations make several modifications to the definition of ancillary benefits and include a new rule that allows a QFPF to provide a certain amount of benefits (referred to as "non-ancillary benefits") that are neither retirement and pension benefits nor ancillary benefits.

The final regulations define ancillary benefits as: (1) benefits payable upon the diagnosis of a terminal illness, incidental death benefits (e.g., funeral expenses), short-term disability benefits, life insurance benefits, and medical benefits; (2) unemployment, shutdown, or layoff benefits that do not continue past retirement age and do not affect the payment of accrued retirement and pension benefits; and (3) other health-related or unemployment benefits that are similar to the benefits described in the first two categories. Further, to resolve any potential overlap between retirement and pension benefits and ancillary benefits, the final regulations provide that ancillary benefits do not include any benefits that could also be defined as retirement and pension benefits within the meaning of the final regulations. Unemployment, shutdown, or layoff benefits that continue past retirement age or that affect the payment of accrued retirement and pension benefits will themselves be considered retirement and pension benefits.

The final regulations also include a taxpayer favorable rule that allows an eligible fund to provide non-ancillary benefits to qualified recipients in an amount up to 5% of the present value the qualified benefits the fund reasonably expects to provide in the future. Non-ancillary benefits are defined as benefits that are permitted or required under the laws of the foreign jurisdiction in which the fund is established or operates and do not otherwise fall within the definition of retirement and pension or ancillary benefits.

KPMG observation

The preamble to the final regulations acknowledges that many foreign pension funds are allowed or required to provide certain benefits that are neither retirement and pension nor ancillary benefits, such as withdrawals to fund a first home. Under the proposed regulations, providing any amount of such benefits arguably would disqualify an otherwise eligible fund from qualifying as a QFPF. The allowance for non-ancillary benefits will provide helpful relief to many pension funds that were not able to qualify as QFPFs under the proposed regulations.

The allowance for non-ancillary benefits does not impact the 85% threshold for retirement and pension benefits. Accordingly, each dollar of non-ancillary benefits that a fund provides reduces the amount of ancillary benefits the fund may provide.

There was some uncertainty whether life insurance benefits, incidental death benefits, and shutdown or layoff benefits qualified as ancillary benefits under the proposed regulations. While the allowance for non-ancillary benefits takes some pressure off of the classification of certain benefits as ancillary benefits or non-ancillary benefits, because non-ancillary benefits may not exceed 5% of the present value of the future benefits a fund expects to provide, it will be beneficial for many funds to classify more benefits as ancillary benefits rather than non-ancillary benefits.

Other distributions and early withdrawals

The proposed regulations did not address how early withdrawals from a QFPF should be treated for purposes of determining the amount of pension or retirement benefits provided by the fund. In particular, the proposed regulations did not address early withdrawals from one retirement plan that are rolled over into a different retirement plan, loans made by an eligible fund, or early withdrawals permitted by a fund in accordance with the local foreign law. The preamble to the final regulations states that Treasury and the IRS believe that these types of withdrawals should not be considered when calculating the 100% threshold, the 85% threshold, or the limitation on non-ancillary benefits. Accordingly, the final regulations add three categories of distributions that are excluded in calculating these thresholds.

The first category is loans made to qualified recipients pursuant to terms set by the eligible fund. The preamble notes that such loans should not be included when making threshold benefit determinations because there is an expectation that the loan will be repaid. However, any loan that a qualified recipient is not required to repay upon default is excluded from this category, unless the default results in a tax and penalty assessment in the foreign jurisdiction. The second category is distributions permitted under local foreign law that are made before the participant or beneficiary reaches the applicable retirement age, provided the participant contributes the funds to another qualified holder or to another retirement or pension arrangement that is subject to similar distribution or tax rules under the laws of the foreign jurisdiction. The third category is withdrawals of funds before the participant or beneficiary reaches retirement age to satisfy a financial need under principles similar to the U.S. hardship distribution rules and permitted under local foreign law, provided that any such withdrawal (or at least the portion of the withdrawal exceeding basis) is subject to tax and penalty in the relevant foreign jurisdiction.

KPMG observation

There was some uncertainty under the proposed regulations whether voluntary loans or early withdrawals were impermissible benefits that prevented a fund from qualifying as a QFPF. The final regulations provide helpful guidance that not only eliminates this uncertainty, but also makes clear that the three categories of permissible distributions do not adversely impact a fund’s calculation of retirement and pension benefits. In the case of early withdrawals, the determination of whether foreign law has principles similar to the U.S. hardship distribution rules may require some qualitative analysis, but a foreign rule that imposes a monetary penalty for early distributions should be considered analogous.

Calculation of present value of qualified benefits

The proposed regulations do not include rules for determining the present value of the qualified benefits that an eligible fund reasonably expects to provide in the future as retirement or pension benefits or as ancillary benefits, including rules addressing the appropriate frequency of the computation and the valuation methodology for the calculation. The final regulations clarify that an eligible fund must measure the present value of benefits to be provided during the entire period during which the fund is expected to be in existence. The final regulation further clarify that an eligible fund may use any reasonable valuation method to calculate the present value of benefits. However, the Commissioner may determine that the present valuation requirement is not satisfied if the relevant facts and circumstances indicate that the valuation method used was unreasonable.

The final regulations generally require a fund to calculate the present value of its future benefits at least once a year. As noted above, the final regulations include a taxpayer favorable “48-month alternative calculation” that allows a fund that flunks the 85% threshold or the 5% limitation on non-ancillary benefits for a particular year to qualify as a QFPF it satisfies the applicable thresholds over an extended period of time. Specifically, this test is met if the average of the present values of the future qualified benefits the eligible fund reasonably expected to provide, as determined by the valuations performed during the 48-month period preceding (and including) the most recent valuation determination, satisfies the 85% threshold or 5% limitation on non-ancillary benefits, as applicable. The average is determined by using the values (not percentages) of the qualified benefits the fund is reasonably expected to provide. The calculation is performed using a weighted average method where, if necessary, the values are adjusted when the length of valuation periods differs. However, the Commissioner may determine that the 48-month alternative calculation is not satisfied if the relevant facts and circumstances show that the method used to calculate the present value was unreasonable.

KPMG observation

Under the anti-abuse rule in the proposed regulations (the "qualified holder rule") discussed below, if an otherwise eligible fund flunked the 85% threshold in a particular year (e.g., because the present value of its future ancillary benefits during that year exceeded the 15% allowance), the fund would be ineligible for QFPF benefits for at least 10 years. As discussed further below, while the final regulations retain the qualified holder rule, the 48-month calculation will provide relief to funds that generally satisfy the 85% threshold and 5% limitation on non-ancillary benefits but happen to have excess ancillary or non-ancillary benefits in a particular year.

Qualified recipients

Under the proposed regulations, an eligible fund was required to provide qualified benefits solely to qualified recipients. Qualified recipients of government-established funds included any person eligible to be treated as a participant or beneficiary of such fund (or their designees), regardless whether the person was a current or former employee. Qualified recipients of an employer fund, on the other hand, were limited to current or former employees (or their designees) and self-employed persons. In response to comments, the proposed regulations permit individuals who were never employees to constitute up to 5% of participants in employer plans. The final regulations also modify the definition of qualified recipients to expressly include spouses of current or former employees.

KPMG observation

Certain countries or jurisdictions allow individuals to participate in employer-sponsored funds even if the individual was not a current or former employee of the employer. While such persons generally represent a small portion of fund participants, the inclusion of *any* non-employees prevented an employer fund from qualifying for benefits under the proposed regulations. The final regulations provide helpful modifications that may allow otherwise eligible employer funds to provide benefits to a limited number of non-employees and still qualify for QFPF benefits.

Favored tax treatment under foreign law

Pursuant to section 897(l)(2)(E), a pension fund will qualify as a QFPF only if the beneficiaries and/or the fund receive preferential tax treatment under local foreign law for contributions made to the fund or income received by or from the fund. The proposed regulations provide that an eligible fund is treated as satisfying this requirement for a tax year if: (1) under the income tax laws of the foreign country in which the eligible fund is established or operates, at least 85% of the contributions to the eligible fund are deductible or excluded from the gross income of the eligible fund or taxed at a reduced rate, or (2) at least 85% of the investment income of the eligible fund is deferred or excluded from the gross income of the eligible fund or is taxed at a reduced rate.

The proposed regulations allowed a fund that does not otherwise satisfy the aforementioned requirements to satisfy the requirements of section 897(l)(2)(E) if: (1) the fund is subject to a preferential tax regime due to its status as a retirement or pension fund, and (2) the preferential tax regime has a substantially similar effect as the tax treatment described in section 897(l)(2)(E). This rule applied only if the pension fund is subject to a preferential tax regime at the national level; a pension fund did not satisfy this requirement if the fund is subject to a preferential tax regime only at a subnational level (e.g., at the level of a state, province, or political subdivision of a foreign country).

The final regulations modify the rule in the proposed regulations to provide that a preferential subnational tax regime may satisfy the requirement of section 897(l)(2)(E) if the subnational tax law is covered by an income tax treaty between the foreign jurisdiction and the United States.

Qualified holder rule

General rule

The proposed regulations provided an anti-avoidance rule that denied the benefits of section 897(l) to any entity or governmental unit that, at any time during the testing period, was not a QFPF, a part of a QFPF, or a QCE (the "qualified holder rule"). For this purpose, the testing period was the shortest of: (1) the period beginning on the date that section 897(l) became effective (December 18, 2015) and ending on the date of a disposition of USRPI or relevant distribution; (2) the 10-year period ending on the date of the disposition or the distribution; or (3) the period during which the entity (or its predecessor) was in existence. Under the proposed regulations, the qualified holder rule did not apply to an entity or governmental unit that did not own a USRPI as of the date it became a QCE, a QFPF, or part of a QFPF.

The final regulations adopt the substantive rule of the proposed regulations but identify the qualified holder rule as a separate requirement to qualify for the benefits of section 897(l), rather than as part of the definition of a qualified holder. The final regulations also provide two transition rules, discussed below. To satisfy the qualified holder rule, a QFPF or a QCE must satisfy one of two tests at the time of the disposition of a USRPI or receipt of a relevant. Under the first test, a QFPF or a QCE is a qualified holder if it owned no USRPIs as of the earliest date during an uninterrupted period ending on the date of the disposition or distribution during which it qualified as a QFPF or a QCE. In other words, an eligible entity will satisfy the first requirement if it was a QFPF or QCE at all times between the date it first acquired a USRPI and the date of the disposition or distribution, regardless whether it was a QFPF or QCE during the period before it acquired a USRPI. Under the second test, a QPFP or QCE will satisfy the qualified holder rule only if the entity was a QFPF or QCE at all times during the relevant testing period described above.

KPMG observation

The first test likely will have limited application and generally will be relevant only to recently formed funds. The second test has broad application and generally will be the relevant test for established funds. Under both the proposed and final regulations, an entity that fails to qualify as a QFPF or QCE at any time during the testing period will be "tainted" for at least 10 years. If a pension fund fails to qualify as a QFPF at any time during the testing period both the pension fund itself and all of its wholly owned entities will be ineligible for the benefits of section 897(l) until 10 years from the date the pension fund reestablishes and continuously maintains QFPF status.

The preamble to the proposed regulations explained that the qualified holder rule was necessary to prevent the inappropriate avoidance of section 897(a) through QFPFs indirectly acquiring USRPIs held by taxable foreign corporations, but the qualified holder rule is incredibly broad and can apply to many situations that arguably do not raise the same concerns (e.g., a pension fund has too many ancillary benefits for a particular year due to circumstances beyond its control). The preamble to the final regulations notes that Treasury and the IRS recognize that the application of the qualified holder rule to an inadvertent failure to qualify as a QFPF could produce inappropriate results, particularly where a fund unexpectedly fails to meet the 85% threshold, but Treasury and the IRS rejected requests to narrow or modify the qualified holder in light of the favorable changes to the QFPF requirements. Specifically, the preamble explains that the 48-month alternative calculation, the new definitions of retirement and pension benefits and ancillary benefits, and the allowance for non-ancillary benefits provide sufficient relief to pension funds that might inadvertently fail to qualify as a QFPF in a particular year.

Transition rules

The first transition rule generally treats a QFPF or QCE as satisfying the qualified holder rule for periods before the final regulations are effective if the QFPF or QCE reasonably applied the statutory requirements of section 897(l)(2) to determine their status during such periods.

Specifically, with respect to any period from December 18, 2015, to the date when the requirements of the final regulations first apply to a QFPF or QCE, as applicable (but in any event no later than December 29, 2022, in the case of a QFPF, and no later than June 6, 2019, in the case of a QCE), the QFPF or QCE is deemed to satisfy the requirements of the final regulations for purposes of the qualified holder rule if the QFPF or QCE satisfies the requirements of section 897(l)(2) based on a reasonable interpretation of those requirements (including determining any applicable valuations using a consistent method).

KPMG observation

As discussed earlier, a QFPF or QCE may retroactively apply the final regulations to all periods since December 18, 2015. This transition rule provides relief to entities that currently qualify as QFPFs or QCEs under the final regulations but did not satisfy the requirements of the final regulations at some point during the testing period.

Under the second transition rule, for purposes of the qualified holder rule, in determining whether a trust or corporation is a QCE, the entity may disregard an interest held directly or indirectly by any person that provides services to the entity between December 18, 2015 and February 27, 2023 (the “transition period”), provided such interests in the aggregate represent no more than 5% (by vote or value) of the interests in the entity.

KPMG observation

The proposed regulations allowed a QCE to be owned by one or more qualified holders, but the proposed regulations did not allow any amount of ownership by non-qualified holders. The preamble to the proposed regulations states that the government received comments requesting that de minimis ownership of a QCE by non-qualified holders be disregarded under certain circumstances. The preamble further states that Treasury and the IRS determined that permitting a person other than a qualified holder to own an interest in a QCE would impermissibly expand the scope of the section 897(l) exemption. Despite numerous comments in response to the proposed regulations similarly requesting an exception for de minimis ownership by non-qualified holders, the final regulations follow the approach of the proposed regulations. Thus, subject to the second transition rule, if an entity has any non-qualified holder ownership during the relevant testing period the entity will be tainted for at least 10 years from the date the entity eliminates the non-qualified holder owner.

This second transition rule is intended to provide relief in situations where a trust or corporation failed to qualify as a QCE during the transition period solely because of a de minimis interest owned by a person that provided services to the entity, such as an asset manager or director. If an entity eliminates the service provider’s ownership interest within the transition period, the entity’s status as a non-QCE will be “cleansed” and the entity will be eligible for the benefits of section 897(l) with respect to future dispositions and distributions, provided it maintains its QCE status at all times going forward. The entity may not, however, claim a refund for taxes that it paid with respect to prior dispositions and distributions when it did not qualify as a QCE because of the service provider’s ownership.

Qualified segregated accounts

The proposed regulations provided that a qualified holder is exempt from section 897(a) only with respect to gain or loss attributable to one or more qualified segregated accounts maintained by the qualified holder. A qualified segregated account was defined as an identifiable pool of assets maintained for the sole purpose of funding qualified benefits to qualified recipients. The proposed regulations provided separate standards for determining whether an identifiable pool of assets constituted a qualified segregated account, depending on whether the pool of assets is maintained by a QFPF or QCE. In general, the assets in a qualified segregated account must be used exclusively to fund the provision of qualified benefits to qualified recipients or to satisfy necessary reasonable expenses of the eligible fund or QCE.

The final regulations retain the general rule of the proposed regulations, but modify the definition of a qualified segregated account to clarify that a pool of assets may be treated as held for the sole purpose of funding qualified benefits to qualified recipients, notwithstanding that in certain situations the funds may revert to the governmental unit or employer in accordance with applicable foreign law (e.g., upon dissolution or the benefits failing to vest), so long as contributions to the plan are not more than what is reasonably necessary to fund the qualified benefits to be provided to qualified recipients.

Modifications to withholding rules

Certification of qualified holder status

The proposed regulations allowed a qualified holder to certify that it is exempt from withholding under section 1445 (and in some cases section 1446(a)) by providing a certification that it is not a foreign person for purposes of section 1445. The proposed regulations also stated that the IRS intended to revise Form W-8EXP, *Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting*, to permit qualified holders to certify their section 897(l) status for purposes of section 1445. The final regulations follow the approach of the proposed regulations and allow a “withholding qualified holder” to certify its section 897(l) status on either a white-paper non-foreign certification or, once revised, a Form W-8EXP. The final regulations also clarify that a qualified holder that does not have a U.S. taxpayer identification number may instead provide its foreign taxpayer identification numbers.

KPMG observation

Fund sponsors and REITs that obtained statements from foreign investors certifying their qualified holder status under the proposed regulations or QFPF status under the statute should consider obtaining new certifications confirming that the foreign investors qualify for section 897(l) benefits under the final regulations.

Dispositions of USRPIs by foreign partnerships with QFPF partners

Foreign partnerships generally are subject to section 1445(a) withholding on dispositions of USRPIs because foreign partnerships are foreign persons for purposes of section 1445. Under the proposed regulations, a partnership could not be a qualified controlled entity and, therefore, there was no mechanism for a foreign partnership with all qualified holder partners to certify that it is not a foreign person for purposes of section 1445(a) withholding. As a result, the foreign partnership had to apply for a withholding certificate from the IRS to eliminate section 1445(a) withholding on a disposition of a USRPI. The final regulations allow a foreign partnership with all qualified holder partners to certify that it is a withholding qualified holder and, therefore, not a foreign person for purposes of section 1445. A foreign partnership with one or more non-qualified holder partners must continue to apply for a withholding certificate to reduce section 1445(a) withholding to the amount of the non-qualified holders' tax liability on the USRPI gain.

Coordination with section 1441 and 1442 withholding

Regulation § 1.1441-3(c)(4) generally provides special coordination rules for section 301 distributions from a U.S. real property holding corporation to a foreign shareholder. The final regulations modify the section 1441 regulations to address distributions to qualified holders. The final regulations also make other clarifying changes not related to qualified holders.

KPMG observation

There was some uncertainty whether the proposed regulations would have required a REIT to withhold under section 1441 or 1442 on a capital gain dividend to a qualified holder that was exempt from withholding under section 1445. The final regulations eliminate this uncertainty and confirm that a qualified holder is not subject to withholding under section 1441/1442 or section 1445 on a capital gain dividend from a REIT.

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