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BLOG POST

Foreign Pension Funds Potentially Exempt from FIRPTA

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On April 10th, the White House issued the Administration's Fiscal Year 2014 Revenue Proposals. Contained in the infrastructure section is a proposed exemption for foreign pension funds from the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), which is found in Sections 897 and 1445 of the Internal Revenue Code of 1986, as amended (the "Code").

FIRPTA is a withholding tax that applies to sales proceeds arising from a disposition of a U.S. real property interest by a non-U.S. owner. The buyer must withhold and deposit 10% of the gross proceeds paid to the non-U.S. seller unless an exemption applies. Due to the fact that the definition of a "U.S. real property interest" is very broad, the withholding tax applies to transfers, conveyances, exchanges, sales and other dispositions of real estate, mineral rights, stock in corporations that derive 50% or more of their value from U.S. real property, and other direct and indirect interests in real property. FIRPTA has limited exceptions for sales of publicly-traded stocks and minority positions in domestically-controlled REITs.

FIRPTA withholding is not a final tax. The foreign seller is required to file a U.S. income tax return, determine the appropriate amount of net income tax due on the gain, and then claim a credit for the FIRPTA tax withheld by the buyer. Foreign pension funds, which normally do not file U.S. tax returns, find the filing requirement burdensome.

In order to incentivize foreign pension funds to invest in U.S. infrastructure projects, including oil and gas fields, pipelines, real estate development, and toll roads, the Administration has proposed putting foreign pension funds on an equal footing with U.S. pension funds that are permitted to invest in certain real estate assets on a tax-exempt basis due to their preferred status under Sections 401 and 501(a) of the Code.

In order to qualify for the exemption, the foreign pension fund would have to meet certain requirements. For example, a foreign pension fund would have to be (i) organized to provide retirement benefits to its participants or beneficiaries and (ii) generally exempt from income tax in its home country.

The proposal, if enacted, would open up certain classes of investment assets effectively unavailable to foreign pension funds. Traditionally, foreign pension funds have restricted their investments in U.S. real estate in several ways.

For instance, foreign pension funds currently have the ability to lend money to a real estate project developer and take back a plain vanilla debt instrument. However, such debt does not allow the fund to share in the appreciation of the underlying property. With respect to oil and gas assets, they could invest in volumetric production payments ("VPPs"), generally treated as debt instruments under Code Section 636. However, for purposes of FIRPTA, VPPs are treated as U.S. real property interests. Accordingly, gain on the sale of a VPP would be subject to U.S. federal income tax.

Second, foreign pension funds could form a U.S. real property holding company to own the real estate. The sale of the shares would still be subject to FIRPTA withholding and the foreign seller would still have to file a tax return. In order to avoid FIRPTA withholding and filing the tax return, the domestic holding company could sell the real estate directly to the buyer. The sale would be exempt from FIRPTA, but the U.S. holding company would be subject to U.S. corporate income tax at the rate of 35% on any gain. The foreign pension fund could liquidate a U.S. holding company that had disposed of all of its U.S. real estate assets without any withholding or net income tax. However, if the holding company still owned other assets in the real estate portfolio, the distribution of a dividend would be subject to a 30% withholding tax on dividends, reduced or eliminated in some cases by tax treaty.

Unlike investments in stock of domestic corporations, foreign pension funds generally avoid investments in real estate assets through U.S. Master Limited Partnerships ("MLPs") because the business activity conducted and the income earned by the MLP would be attributed to the foreign fund, requiring the filing of a U.S. income tax return and the payment of net income tax. It is not clear whether this proposal would extend an exemption to foreign pension funds owning MLP interests, because such an exemption would require amendments to other sections of the Code in addition to FIRPTA.

Lastly, foreign pension funds could enter into swap contracts on real estate indices to gain exposure to a particular real estate market, or they could take minority positions in publicly-traded corporations or domestically-controlled REITs. The disposition of these positions would generally be entitled to an exemption from FIRPTA.

Most, if not all, foreign pension funds implement these types of self-imposed limitations on their U.S. real estate investments. Many direct investments in U.S. real estate are outside the scope of their investment guidelines. The proposed change in law is designed to allow them to pursue direct ownership interests in energy and infrastructure projects, including pipeline, rail and roads.

It remains to be seen whether Congress, if it enacts this proposal into law, will restrict foreign pension plans from operating the infrastructure assets they own, or whether they will be permitted to exert control over the assets. Conditions could be imposed on the tax-exemption which would limit its application to passive investments with the absence of commercial control. There has always been political concern with foreign investors owning and controlling U.S. infrastructure. The Committee on Foreign Investment in the U.S. ("CFIUS") and the U.S. Congress intervened in 2006 when a company from the United Arab Emirates, Dubai World, bought and took control of a British company that operated at least six large ports in the United States. Dubai World eventually sold the U.S. ports to the asset management division of AIG. More recently, political and national security concerns have been raised when Chinese investors attempt to buy U.S. infrastructure assets.

The exact language that would amend Sections 897 and 1445 of the Code is not yet clear. If enacted, the proposal would take effect in taxable years beginning after December 31, 2013. However, it is encouraging that the Administration recognizes the need to rebuild America's infrastructure and to offer a carrot to foreign sources of financing. This proposal deserves to be closely watched as the President's budget makes its way through Congress.