

US Taxation of Foreign Pension Funds

Qualified Foreign Pension Fund Final Regulations

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Final QFPF Regulations - Background

- On December 28, 2022, the Treasury Department and IRS released long-awaited final regulations (the "**Final Regulations**") governing qualified foreign pension funds ("**QFPF**"s). Pursuant to legislation adopted in December 2015, QFPFs are generally exempt from taxation under the Foreign Investment in Real Property Tax Act ("**FIRPTA**"), which taxes a foreign person on gain from the direct or indirect disposition of a US real property interest ("**USRPI**"). The QFPF regime was generally intended to put qualifying foreign retirement arrangements on similar footing with those in the US on certain dispositions of USRPIs and thereby encourage investment into the US.
- Proposed regulations (the "**Proposed Regulations**") were issued in 2019 and provided more specific guidance as to the scope of the exemption and what foreign arrangements are treated as QFPFs. Regulatory guidance is greatly needed since the 2015 statute (as amended) is very brief and open to varying interpretations. Also, retirement arrangements can vary greatly country-by-country.

Final QFPF Regulations - Background

- The Final Regulations largely comport with, and also favorably clarify and enhance, the provisions of the Proposed Regulations. The Final Regulations are effective December 29, 2022, with certain rules retroactive to June 6, 2019.
- It is expected that many pension funds that had been uncertain as to their QFPF status under the statute and Proposed Regulations will achieve a greater level of comfort under the Final Regulations.



QFPF Statutory Definition

A QFPF is any trust, corporation, or other organization or arrangement:

- which is created or organized under the law of a foreign country,
- which is established by such country (or subdivision thereof) or 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, as a result of (or in the case of an employer pension fund) in consideration of services rendered by such employees to their employers,
- which does not have a single participant or beneficiary with a right to more than 5% of its assets or income,
- which is subject to government regulation and with respect to which annual information about its beneficiaries is provided, or is otherwise available, to the relevant tax authorities in the country in which it is established or operates, and
- with respect to which, under the laws of the country in which it is established or operates either: (i) contributions to such trust, corporation, organization, or arrangement which would otherwise be subject to tax are deductible or excluded from the gross income of such entity or arrangement or taxed at a reduced rate, or (ii) taxation of any investment income of such trust, corporation, organization or arrangement is deferred, or such income is excluded from the gross income of such entity or arrangement or is taxed at a reduced rate.

Regulatory Framework for FIRPTA Exemption

- As tax regulations are prone to do, the Proposed and Final Regulations created many new concepts and definitions that seek to clarify the requirements for the FIRPTA exemption.
- Both the Proposed and Final Regulations provide that the FIRPTA exemption applies to: (i) gain or loss of a "**Qualified Holder**;" (ii) from the disposition of a USRPI (including REIT capital gain dividends); provided (iii) the gain or loss is attributable to a "**Qualified Segregated Account**" maintained by a Qualified Holder.
- A Qualified Holder is a QFPF or "**Qualified Controlled Entity**" ("**QCE**") that satisfies certain other requirements.
- A QCE is a trust or corporation created or organized under the laws of a foreign jurisdiction all of the interests of which are held by one or more QFPFs directly or indirectly through one or more QCEs.



New Testing Period

- The Final Regulations provide for two alternative timing tests that must be satisfied at the time of the disposition of a USRPI. A QFPF or QCE is a Qualified Holder only if: (i) 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, or (ii) it satisfies the applicable testing period requirement.
- The testing period is the shortest of: (i) the period beginning December 18, 2015, and ending on the date of the disposition or distribution; (ii) the ten-year period ending on the date of the disposition or distribution; or (iii) the period during which the entity was in existence.



Qualified Segregated Accounts

- Like the Proposed Regulations, the Final Regulations define a Qualified Segregated Account as an identifiable pool of assets maintained for the sole purpose of funding "**Qualified Benefits**" to "**Qualified Recipients**".
- The Final Regulations clarify that in the case of assets held by an eligible fund, the Qualified Segregated Account requirement is fulfilled provided contributions are not more than what is reasonably necessary to fund the Qualified Benefits to be later provided to Qualified Recipients, even if the contributed funds revert back to the employer or government under foreign law.
- This is especially helpful in jurisdictions that allow for a reversion of funds to the employer or government in the case of overfunding.



QFPF – Basic Definition under the Regulations

- The Final Regulations (slightly modified from the Proposed Regulations) provide that a pension fund is considered a QFPF if it is established:
  - by or at the direction of the foreign country in which it is created or organized to provide "**Retirement and Pension Benefits**" to participants or beneficiaries that are current or former employees (or their designees) as a result of services rendered to employers; or
  - by one or more employers to provide Retirement and Pension Benefits to participants or beneficiaries that are current or former employees (or their designees) in consideration for services rendered to such employers.
- The Final Regulations also: (i) provide relief for an eligible fund that inadvertently fails to qualify as a QFPF; and (ii) permit third party service providers to administer or otherwise provide services to the eligible fund (including holding assets in a Qualified Segregated Account as part of or on behalf of the eligible fund).

Established to provide Retirement and Pension Benefits

- Under the Final Regulations, an eligible fund is established to provide Retirement and Pension Benefits if:
  1. All of the benefits that an eligible fund provides are Qualified Benefits provided to Qualified Recipients;
  2. At least 85% of the present value of the Qualified Benefits that the eligible fund reasonably expects to provide to Qualified Recipients in the future are Retirement and Pension Benefits; and
  3. No more than 5 % of the present value of the Qualified Benefits the eligible fund reasonably expects to provide to qualified recipients in the future are "**Non-ancillary Benefits**." This third requirement was added in the Final Regulations to allow a *de minimis* amount of benefits to be neither Retirement and Pension Benefits nor Ancillary Benefits.

Qualified Benefits

- Qualified Benefits are now defined as: (i) Retirement and Pension Benefits; (ii) Ancillary Benefits; and (iii) Non-ancillary Benefits.
- As noted, at least 85% of the benefits (by value) must constitute Retirement and Pension Benefits and no more than 5% may constitute Non-ancillary Benefits.
- The Final Regulations also provide a new definition of Retirement and Pension Benefits, where none existed before. They also provide an enhanced definition of Ancillary Benefits.

Retirement and Pension Benefits

- The Final Regulations define Retirement and Pension Benefits as distributions to Qualified Recipients made after the Qualified Recipient reaches retirement age (determined under foreign law), or after a specified event that results in a Qualified Recipient being permanently unable to work. This includes distributions to a surviving beneficiary.
- Retirement and Pension Benefits can be 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.



Ancillary Benefits

- The Final Regulations provide a more detailed list of the specific types of benefits that are treated as Ancillary Benefits. They consist of: (a) benefits payable upon the diagnosis of a terminal illness, incidental death benefits (for example, funeral expenses), short-term disability benefits, life insurance benefits, and medical benefits; (b) 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 (c) other health-related or unemployment benefits that are similar to (a) and (b).
- Benefits that would qualify as both Ancillary Benefits and Retirement and Pension Benefits are not treated as Ancillary Benefits.
- Non-ancillary Benefits means benefits that are neither Ancillary Benefits nor Retirement and Pension Benefits and that are provided as permitted or required under foreign law.



Valuation Requirements

- The Final Regulations adopted new valuation requirements for purposes of determining whether a fund meets the 85% test and does not exceed the 5% limit on Non-ancillary Benefits. The fund must determine, on at least an annual basis, the present value of the Qualified Benefits that the eligible fund reasonably expects to provide to Qualified Recipients during the entire period during which the eligible fund is expected to be in existence. An eligible fund may utilize any reasonable method for performing the present valuation.
- There is also a new recordkeeping rule which requires an eligible fund to maintain records sufficient to establish that it satisfies the value requirements.



Qualified Recipients – 5% Relief

- The Final Regulations provide that, with respect to employer funds, individuals who were never employees (or their spouses or designees) but that are otherwise eligible under the plan may constitute Qualified Recipients provided such persons do not exceed 5% of the overall eligible recipients and do not have a right to more than 5% of the fund's assets or income.
- The Final Regulations also include spouses of current or former employees in the definition of Qualified Recipients.



Withholding – Treatment of Foreign Partnerships

- The Final Regulations provide that a foreign partnership that is wholly owned by Qualified Holders is not subject to FIRPTA withholding. A Qualified Holder, as well as a foreign partnership all of the interests of which are held by qualified holders (including through partnerships) may certify their status as a "W**ithholding Qualified Holder**," which is not treated as a foreign person for purposes of the FIRPTA withholding rules.
- There is no withholding exception for a foreign partnership that has non-qualified holders. However, Qualified Holders investing through a foreign partnership are still eligible for the exemption on their share of FIRPTA gains derived through the foreign partnership.



Withholding - Documentation

- The Final Regulations provide that a Withholding Qualified Holder may submit a certification of non-foreign status to avoid FIRPTA withholding. Generally, a transferee of a USRPI is required to withhold 15% of the gross proceeds unless the transferor furnishes the transferee with a certification stating that the transferor is not a foreign person.
- Alternatively, a Withholding Qualified Holder may provide a Form W-8EXP to certify its deemed non-foreign status once the form has been revised by the IRS to address the QFPF rules.
- The Final Regulations also clarify that a Withholding Qualified Holder may provide its foreign taxpayer identification number if it does not have a US taxpayer identification number – which is a welcome change that streamlines the certification process.



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