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## Will Canadian Pension Plans Feast on U.S. Infrastructure (Without FIRPTA)?

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This column considers whether changes to U.S. tax law made by the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”) are likely to increase investment by Canadian pension plans in U.S. infrastructure. After all, that was the Obama Administration’s objective in proposing to remove the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) as an impediment to investment in U.S. real property by qualified foreign pension plans and their wholly owned subsidiaries. We begin with a description of how such plans previously invested into the United States and then consider how the new law will influence those structures. We conclude that while these changes are likely to increase investment by Canadian pension plans in U.S. real estate and infrastructure, the legal structures used for these investments before the PATH Act will continue to be relevant.

### INVESTMENT CYCLE: FOUR STAGES

In our experience, foreign pension plans generally follow a typical program of investing in U.S. real property and infrastructure, such as roads, bridges, and energy assets. The investment cycle consists of four stages, starting with investments in public companies, followed by private equity and hedge fund investments, co-investments and joint ventures, and ultimately controlled structures.

The U.S. income tax considerations relevant to each stage are as follows.

**Stage I.** The first stage consists of investments in publicly traded debt and equity of infrastructure projects. Dividends and interest from these investments are generally not subject to U.S. income tax when made by Canadian pension funds under Article XXI of the U.S.-Canada Income Tax Treaty (the “Tax Treaty”), and gains on the sale of such investments are generally not subject to U.S. income tax when realized by a foreign person.

As described in more detail below, investments in public Real Estate Investment Trusts (REITs) by foreign pension funds are generally not subject to FIRPTA unless the pension fund owns more than a threshold amount of the public REIT’s stock.

Because of the wide range of exemptions available for Canadian pension plans investing in publicly traded debt and equity of infrastructure projects, these investments can often be undertaken with minimal U.S. federal tax planning.

**Stage II.** The second stage involves indirect investment in infrastructure projects through private equity and hedge funds. These kinds of investments can usually be structured so that they do not subject the foreign pension fund to U.S. income tax.

A foreign person such as a pension fund can be subject to U.S. income tax in only two ways. First, foreign persons must pay tax on income that is effectively connected with a trade or business in the United States (such income, “ECI”). Second, U.S. tax must be withheld from certain types of payments of U.S.-source income, such as interest and dividends (but not gains from the sale of property), to foreign persons. Under FIRPTA, income and gains from investments in U.S. real property are treated as ECI.

Generally, foreign pension plans that seek to invest in U.S. infrastructure through private equity and hedge funds enjoy tax benefits similar to those available with respect to Stage I investments in public equity and debt. Investment funds that lend to U.S. borrowers can usually take advantage of the exception from withholding tax for portfolio debt, and tax treaties often reduce the rate of withholding on dividends received by the investment fund. In addition, Article XXI of the Tax Treaty may wholly exempt payments of interest and dividends that are allocable to Canadian pension funds from U.S. withholding tax.

Investments that give rise to ECI, including FIRPTA investments, require more sophisticated tax planning in Stage II. Generally the investment fund or the foreign pension fund will use a blocker corporation to shelter the foreign pension fund investor from ECI. In a case where the amount of U.S. real property held directly or indirectly through the blocker corporation exceeds 50%, however, a disposition of shares of the blocker, if organized as a U.S. corporation, could be subject to FIRPTA (as described more fully in the discussion of USRPHCs, below).

In the case of private equity investments, however, the underlying portfolio companies are normally subject to U.S. income tax. In addition, a portfolio company that holds more than a threshold amount of U.S. real property may cause a foreign pension fund to be subject to U.S. tax under FIRPTA.

If a portfolio company or blocker corporation would cause a foreign pension fund to be subject to FIRPTA, then by becoming a REIT, the portfolio company or blocker corporation sometimes can at least avoid corporate taxes.

**Stage III.** The third stage of infrastructure investments consists of direct co-investments or joint ventures.

Similar to Stage II investments, co-investments and joint ventures can often be structured so that payments of dividends, interest, and trading income qualify for a reduced or zero rate of U.S. income tax withholding under an applicable tax treaty.

If the foreign pension fund invests alongside a U.S. person, projects with a large amount of U.S. real property can often be structured as a REIT that is domestically controlled (“DC REIT”) and is therefore eligible for more favorable treatment under FIRPTA. Alternatively, a leveraged blocker may be able to avoid tax under FIRPTA or tax on other ECI.

**Stage IV.** Finally, in the last stage of the investment cycle, foreign pension funds take control positions directly in infrastructure projects.

When a foreign pension fund takes a control position, certain exemptions that reduce U.S. tax for the previous stages are no longer available. For instance, the portfolio interest exception is available only for investors who own less than 10% of the equity of the issuer of the portfolio debt. In the case of Canadian pension funds, the exception under Article XXI of the Tax Treaty is not available for dividends and interest paid by a related person. A payor and payee would generally be considered related if the payee participates in the management and control of the payor.<sup>1</sup> Other tax treaty provisions may provide a reduced rate of withholding on dividends or interest, although the benefit of these provisions may also be lost if the foreign pension fund has a permanent establishment in the United States.

Investments that give rise to ECI may be more problematic in a Stage IV investment than in the previous stages. A blocker structure may be able to protect a foreign pension fund from tax on ECI in gen-

eral, but if the blocker is organized as a U.S. corporation, investors should take care to ensure that the blocker itself is not a FIRPTA asset (see discussion of USRPHCs, below). Controlled structures that are subject to FIRPTA generally present a challenge to foreign pension funds and their U.S. tax advisors.

The remainder of this article examines the effects of the PATH Act on tax structuring in each of these stages.

## COMPARING U.S. TAXATION OF REAL ESTATE AND INFRASTRUCTURE INVESTMENTS

### Application of FIRPTA to Pension Plans Before the PATH Act

Generally, gains on the sale of property are not subject to U.S. income tax when realized by a foreign person. FIRPTA provides a major exception to this rule by treating gains from the disposition of U.S. real property interests (“USRPIs”) as ECI subject to a special withholding tax regime under §897 of the Code.<sup>2</sup> FIRPTA withholding is required even if a tax treaty would otherwise provide a more favorable rule.

Central to this rule is the definition of a USRPI. Generally, USRPIs include direct interests in real property located in the United States, associated personal property, and contracts under which a person shares in the appreciation in real property.<sup>3</sup>

In addition, a USRPI includes an interest in a United States real property holding corporation (“USRPHC”). A corporation is a USRPHC if 50% or more of its assets are USRPIs. To determine whether a corporation’s assets meet the 50% threshold, a corporation counts only its U.S. and foreign real property and any other assets used in its trade or business (i.e., not including non-real-estate passive assets).<sup>4</sup> In addition, applicable regulations provide a look-through rule for the corporation’s interests in partnerships and controlled corporations.<sup>5</sup>

Under the “FIRPTA Cleansing Rule,” if a USRPHC sells all of the USRPIs it has held in the previous five years in fully taxable transactions, the corporation is generally no longer a USRPHC and a disposition of the stock of that corporation is no longer subject to FIRPTA.<sup>6</sup>

If a partnership (or other entity classified as a partnership for U.S. tax purposes) holds USRPIs, then gain from the disposition of an interest in that partner-

<sup>2</sup> All section (“§”) references are to the U.S. Internal Revenue Code, as amended (“the Code”), or the Treasury regulations thereunder, unless otherwise indicated.

<sup>3</sup> Reg. §1.897-1(d).

<sup>4</sup> Reg. §1.897-2(b)(1).

<sup>5</sup> §897(c)(4) and §897(c)(5).

<sup>6</sup> §897(c)(1)(B).

<sup>1</sup> Tax Treaty, art. IX(2).

ship is subject to tax under FIRPTA to the extent that such gain is attributable to USRPIs.<sup>7</sup>

If a foreign person made a direct or indirect disposition of a USRPI (including an interest in a USRPHC) before the PATH Act was enacted, the purchaser of the USRPI was obligated to withhold 10% of the amount realized on the disposition under §1445. In certain situations, the rate of FIRPTA withholding was increased to 35%, for example, in the case of a distribution of a USRPI by a foreign corporation.<sup>8</sup>

## FIRPTA Exemptions Before the PATH Act

Several tax law exemptions enabled foreign persons to invest in USRPIs before the PATH Act was enacted, notwithstanding the general provisions of FIRPTA.

One widely used FIRPTA exemption was available to foreign investors in publicly traded corporations holding USRPIs, such as REITs. If the stock of a corporation that would otherwise be a USRPHC was regularly traded on an established securities market, that corporation would generally not be a USRPI unless the stockholder owned more than 5% of the corporation's stock at any time in the five years ending on the date of the disposition of the stock.<sup>9</sup> Constructive ownership rules were applied in determining whether a foreign person met the 5% ownership threshold.<sup>10</sup>

Another popular exemption was available with respect to a REIT if a majority of the REIT's stock was owned by U.S. persons. An interest in such a REIT, known as a DC REIT, is not considered a USRPI.<sup>11</sup> For the purpose of this exemption, a REIT is a DC REIT if less than 50% of the value of the REIT's stock is held by foreign persons during the five years ending on the date of disposition.

Special rules applied with respect to a REIT that distributed the proceeds of a disposition of USRPIs.<sup>12</sup> The resulting capital gains distribution would be subject to FIRPTA — a condition known as “USRPI taint”—despite the general rule that capital gains are not taxable to foreign persons. A capital gains distribution subject to a USRPI taint would be recharacterized as ECI to the foreign pension fund and would be subject to FIRPTA withholding.

However, a distribution that would otherwise suffer from the USRPI taint would be cured if the REIT stock was regularly traded on an established securities market located in the United States and the recipient of the distribution held less than 5% of the REIT's stock during the one-year period preceding the distri-

bution.<sup>13</sup> In such a case, the distribution would be treated as an ordinary REIT dividend, which could be eligible for a reduced rate of withholding under a tax treaty.

Generally, ordinary REIT dividends are subject to U.S. income tax withholding at a rate of 30% under §1441 and §1442. Tax treaties sometimes reduce the applicable rate of withholding to 15%, but typically only for shareholders who hold less than 10% of the REIT's stock. A small number of tax treaties provide special provisions for pension funds and other tax-exempt entities that may provide even greater relief.

In Notice 2007-55, the IRS announced regulations that would spread the USRPI taint beyond capital gain dividends by recharacterizing distributions on a REIT's liquidation and distributions in redemption of REIT stock as FIRPTA gain. Although these regulations have not been issued, practitioners have questioned how they should apply in cases where a foreign person has a high outside basis in the REIT shares, i.e., if the FIRPTA gain resulting from the REIT's disposition of USRPIs exceeds the foreign shareholder's gain in the REIT shares, will the foreign shareholder have to recognize all of the FIRPTA gain?

## Canadian Pension Funds Before the PATH Act

In addition to the exemptions from FIRPTA described above, foreign governmental pension funds are eligible for a special exemption from U.S. income tax for foreign governments and their wholly owned subsidiaries.<sup>14</sup> This exemption is generally available even with respect to FIRPTA assets, provided that the income derived therefrom is not the result of commercial activities or received by a controlled commercial entity, both within the meaning of §892.

Even if a Canadian pension fund cannot benefit from §892, it can still use a leveraged blocker to avoid taxation under FIRPTA. Alternatively, the pension fund can make debt investments in a FIRPTA asset, although it may be difficult for the pension fund to enjoy the full return on its investment, as earnings stripping limitations impose a ceiling on the amount of interest that may be paid with respect to the asset.

## CHANGES TO FIRPTA FOR REITS UNDER THE PATH ACT

As noted above, the PATH Act introduced a number of significant taxpayer-friendly changes to the FIRPTA provisions of the Code.

### Threshold for Regularly Traded REITs Increased to 10%

As described above, §897(h)(1) allowed foreign persons to escape the USRPI taint on dividends and

<sup>7</sup> §897(g).

<sup>8</sup> §897(d) and §1445(e).

<sup>9</sup> §897(c)(3).

<sup>10</sup> §897(c)(6)(C).

<sup>11</sup> §897(h)(2).

<sup>12</sup> §897(h)(1).

<sup>13</sup> *Id.*

<sup>14</sup> §892.

FIRPTA gain with respect to dispositions of regularly traded REIT stock, so long as their holding was less than 5% of that stock. This limitation has been increased from 5% to 10%.<sup>15</sup>

## Qualified Shareholders Exempt from FIRPTA

REIT stock held by certain “qualified shareholders” is now exempt from FIRPTA entirely. Gains from the sale of REIT stock are exempt from U.S. income tax under FIRPTA, and any related capital gain distributions are recharacterized as ordinary REIT dividends. Similar rules apply for redemptions and §301(c)(3) gain.

For the purposes of this exception, a qualified shareholder is a publicly listed foreign entity that meets three conditions: First, the foreign entity must qualify for treaty benefits (or be a foreign partnership with a class of units that are regularly traded on an established securities market in the United States); second, the foreign entity must be a qualified collective investment vehicle (a “QCIV”); and third, the foreign entity must maintain records of the identity of each person who owns more than 5% of the foreign entity’s publicly traded equity.<sup>16</sup> For the purpose of this definition, a QCIV is a foreign person that meets one of the following tests: It is eligible for a reduced rate of withholding on dividends under a tax treaty even if the foreign person owns more than 10% of the REIT stock; it is a publicly traded withholding foreign partnership that, if it were a corporation, would have been a USRPHC at some time during the previous five years; or it is designated as a QCIV by the Treasury Department and is either fiscally transparent or entitled to a tax deduction for distributions to its equity owners.<sup>17</sup>

The new exemption for the stock of REITs held by a qualified shareholder is not available to the extent that another person that is not a qualified shareholder holds more than 10% of the stock of the REIT either indirectly through the qualified shareholder or otherwise.<sup>18</sup>

## New Rules to Determine When a REIT Is Domestically Controlled

As described above, a DC REIT is not treated as a USRPI for the purposes of FIRPTA. The PATH Act added several new rules to make it easier for REITs to qualify as DC REITs.

First, the PATH Act created a presumption that any stockholder holding less than 5% of a U.S.-listed REIT’s stock is not a foreign person for the purposes of

determining whether the REIT is a DC REIT.<sup>19</sup> However, if the REIT has actual knowledge that the stockholder is a foreign person, then the REIT cannot rely on this presumption.

Second, any shareholder of a lower-tier REIT that is itself a RIC or REIT and is regularly traded on an established securities market (or issues redeemable securities) is presumed to be a foreign person for the purposes of determining whether the lower-tier REIT is a DC REIT.<sup>20</sup> However, if the upper-tier RIC or REIT is itself domestically controlled, then it is treated as a U.S. person for the purposes of determining whether the lower-tier REIT is a DC REIT.

Third, if a RIC or REIT that is not regularly traded on an established securities market (and does not issue redeemable securities) holds stock of a lower-tier REIT, then the lower-tier REIT must look through to the U.S. stockholders of the upper-tier RIC or REIT to determine whether the lower-tier REIT is a DC REIT.<sup>21</sup>

## FIRPTA Cleansing Rule No Longer Applies to REITs

The PATH Act amended the definition of a USRPHC so that the FIRPTA Cleansing Rule no longer applies to an interest in a corporation that was a RIC or a REIT in the five years preceding a disposition of that interest in the corporation.<sup>22</sup>

## Foreign Pension Plans Exempt from FIRPTA

Possibly the most significant change to U.S. tax law in the PATH Act is the complete exemption from FIRPTA for qualified foreign pension funds (“QFPFs”) and entities wholly owned by QFPFs.<sup>23</sup>

The exemption for QFPFs is significantly broader than the exemptions relied on by foreign pension funds before the PATH Act. For instance, in the case of a publicly traded USRPHC, a QFPF is exempt from FIRPTA even if it holds more than 10% of the USRPHC’s stock. Also, if a QFPF holds stock of a REIT that realizes a gain on the disposition of a USRPI, the related distribution will not suffer from the USRPI taint that would normally recharacterize a capital gain dividend as an ordinary REIT dividend.

In order to qualify as a QFPF, a pension fund must: (1) be created or organized in a foreign country; (2) be established to provide retirement or pension benefits to employees in consideration of services rendered; (3) not have any single participant or beneficiary with a right to more than 5% of the fund’s assets or income; (4) be subject to government regulation and provide annual information reporting about its

<sup>15</sup> §897(k)(1).

<sup>16</sup> §897(k)(3).

<sup>17</sup> §897(k)(4).

<sup>18</sup> §897(k)(2).

<sup>19</sup> §897(h)(4)(E)(i).

<sup>20</sup> §897(h)(4)(E)(ii).

<sup>21</sup> §897(h)(4)(E)(iii).

<sup>22</sup> §897(c)(1)(B)(iii).

<sup>23</sup> §897(l).

beneficiaries to the tax authorities in the country where it is established or operates; and (5) be entitled to a reduced or zero rate of tax on contributions or investment income under the laws of the country where it is established or operates.<sup>24</sup>

The PATH Act promises to increase investment by foreign pension funds in U.S. real property. Several barriers to investment remain, however. For instance, the PATH Act has not expanded the exemption for foreign governments and governmental plans under §892. Moreover, although the PATH Act has exempted QFPFs from being treated as having ECI under FIRPTA, it has done nothing with respect to ECI that arises from a trade or business within the United States and not from investments that are USRPIs.

### **Increase in Rate of FIRPTA Withholding**

Although the PATH Act included many taxpayer-favorable amendments to FIRPTA, one change that is adverse to taxpayers is *the increase in the withholding rate under FIRPTA from 10% to 15%*.<sup>25</sup> This change became effective on February 17, 2016.

### **OPEN QUESTIONS FOR PENSION FUNDS UNDER THE PATH ACT**

Although the PATH Act unquestionably benefits foreign pension plans, many questions remain regarding the implementation of the new provisions.

The new rules do not specify how many tiers of entities can be between a QFPF and its investment. It may be desirable to include language such as Article XXI(3) of the Tax Treaty, which provides that the treaty's exemption for income of pension funds is available for an entity that is operated exclusively to earn income for the benefit of a pension fund covered by Article XXI(2) of the Tax Treaty.

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<sup>24</sup> §897(l)(2).

<sup>25</sup> §1445(a).

As described above, one of the requirements for a fund to be a QFPF is that it provides tax authorities annual information reporting about its beneficiaries. No details are provided, however, regarding the scope and content of the required reports.

The exemption for QFPFs also applies to wholly owned subsidiaries of the QFPF. Arguably, entities that are not technically owned by QFPFs but are owned for the benefit of a QFPF should be included.

Although the PATH Act's new provisions provide welcome tax relief for foreign pension funds that invest in FIRPTA assets, including REITs, most types of infrastructure do not qualify for ownership by a REIT. Are legal structures for tax-favored investment in these kinds of assets forthcoming?

### **CONCLUSION**

The main policy justification for liberalizing FIRPTA under the PATH Act is to encourage foreign investment in U.S. infrastructure. As noted above, however, the FIRPTA exemption for QFPFs does not extend to ECI investments in general. Although many infrastructure investments result in ECI for foreign investors, such ECI is not generally the kind that results from FIRPTA investments.

Similarly, the PATH Act significantly improves the U.S. income tax rules applicable to REITs. But again, infrastructure investments are rarely suitable to be held in a REIT.

Ironically, tax structuring to avoid ECI, such as through leveraged blockers or compliance with §892, remain as critical as ever for reducing U.S. income tax on foreign pension funds' investments in U.S. infrastructure. In the case of Canadian pension funds, the provisions of the Tax Treaty remain crucial.

Although the revised law should certainly open the gates for more investing in U.S. real property, there are no incentives for investing in other kinds of infrastructure assets. Accordingly, the anticipated increase in foreign cash available to build roads, bridges, and power plants in the United States may not be as substantial as Congress had hoped when it passed the PATH Act.