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Key Contacts



Alexander Anderson
New York
D: +1-212-326-2177



New Guidance on FIRPTA's Application to REITs, RICs, Foreign Governments, and Foreign Pension Funds

December 29, 2022

The Treasury Department has released new guidance on the application of the rules relating to the ownership and disposition of interests in US real property by foreign persons, commonly known as "FIRPTA". That guidance includes both proposed regulations that apply to "real estate investment trusts" ("REITs"), regulated investment companies ("RICs"), and foreign governments eligible for Section 892 and final regulations that apply to certain foreign pension funds. These rules both provide helpful clarifications where previous guidance had been unclear and in some cases liberalize the application of FIRPTA exceptions in order to exempt a broader range of foreign persons from its tax and withholding requirements. Below is a summary of some of the key provisions from these new proposed and final regulations.

General Rules of FIRPTA

While investors that are foreign persons are generally not subject to US federal income tax on capital gain, FIRPTA is an exception to that rule and applies to gain realized by foreign persons¹ on the disposition of US real property and stock of domestic "United States real property holding corporations" ("USRPHCs"). A corporation is generally a USRPHC if the fair market value of its interests in US real estate or stock in other USRPHCs is equal to 50% or more of the sum of the fair market value of such assets, the corporation's interests in foreign real property and any other assets used in a trade or business.²

FIRPTA and REITs and RICs

Current Law. Special rules apply to "qualified investment entities" ("QIEs"), which include REITs and RICs. FIRPTA tax does not apply to sales by a foreign person of an interest in a QIE that is "domestically controlled" (i.e., generally a QIE, less than 50% of the value of whose interests are owned, directly or indirectly, by foreign persons during the applicable testing period). In addition, the relevant rules provide that foreign persons are required to look through any distribution by a QIE (other than a publicly traded QIE in which the foreign person is less than a 5% shareholder during the applicable testing period) to determine if the underlying income would be subject to tax under FIRPTA.

Proposed Regulations. The proposed regulations clarify how to determine whether a QIE is domestically controlled. In particular, the proposed regulations would apply a look-through rule to certain direct or indirect holders of QIE interests that are defined as "look-through



Will S. Becker
Dallas
D: +1-972-360-1906



Jan Birtwell
London
D: +44-20-7558-4874



Luc Moritz
Los Angeles
D: +1-213-430-6672



Billy Abbott
Silicon Valley
D: +1-650-473-2614



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persons.” A look-through person is any holder other than an individual, a non-public domestic C-corporation if foreign persons hold directly or indirectly less than 25% or more of the fair market value of its stock, a tax-exempt entity, a foreign corporation, a publicly traded partnership, an estate, an international organization, a qualified foreign pension fund (“QFPF”) and a qualified controlled entity (“QCE”).³ If an interest in a QIE is owned by a look-through person, it is the look-through person’s owners that are relevant for determining whether the QIE is domestically controlled.

The proposed regulations also clarify that QFPFs and QCEs are to be treated as foreign persons for purposes of determining whether a QIE is domestically controlled.

Finally, the proposed regulations include rules specifying that with respect to a QIE that is publicly traded on an established securities market in the United States, a person holding less than 5% of its stock may be treated as both a US person and as a non-look-through person unless the QIE has actual knowledge to the contrary.

The foregoing proposed regulations will be effective with respect to transactions occurring on or after the date the regulations are finalized, but the IRS may, nevertheless, still challenge any position taken contrary to the foregoing prior to the effective date. REITs and RICs that intend to maintain domestic control in order to benefit non-US investors should consider updating any associated transfer restrictions and/or investor representations in their organizational documents to ensure consistency with these proposed regulations.

FIRPTA and Foreign Governments

Current Law. Foreign governments, their “integral parts” and certain “controlled entities”⁴ of foreign governments (collectively, “Section 892 Entities”) benefit from a partial exemption from US federal income tax under Section 892 of the Internal Revenue Code, but “controlled commercial entities” (“CCEs”) are not eligible for Section 892, nor are other Section 892 Entities eligible for the exemption under Section 892 with respect to income received from CCEs (e.g., dividends paid by a CCE or otherwise taxable gain from the sale of interests in a CCE). A CCE is an entity engaged in “commercial activities” in which a Section 892 Entity owns 50% or more of the total interests (by value or vote) or over which the Section 892 Entity exercises effective control.

In addition, a USRPHC (whether domestic or foreign) that is a controlled entity with respect to a Section 892 Entity will automatically be classified as a CCE whether or not that USRPHC is actually engaged in commercial activities. A significant risk of the foregoing rules arises for controlled entities that have subsidiaries that are USRPHCs—if the value of the parent’s subsidiary USRPHC stock is sufficient to cause the parent to become a USRPHC, the CCE taint can carry up the chain to threaten the availability of the Section 892 exemption for more entities than just the lower tier USRPHC.

Proposed Regulations. The proposed regulations provide a new exception to the rule that USRPHCs controlled by Section 892 Entities are automatically CCEs; namely, the rule will not apply to controlled entities that are USRPHCs solely by reason of direct or indirect ownership of non-controlling interests in other corporations. This rule will come as welcome guidance in particular to controlled entities acquiring interests in investment funds through such funds’ foreign corporate blockers given the difficulty such controlled entities typically have in monitoring the fund’s US real estate assets to determine whether they may be or become USRPHCs. Under the proposed rules, as long as the controlled entity does not control the blocker (or the blocker does not have controlling interests in any of its portfolio companies), the US real estate assets of the fund will not cause the controlled entity to become a CCE, thereby limiting the risk of losing the benefit of Section 892 to that controlled entity as well as its parent-controlled entities.

These proposed regulations will be effective for taxable years ending on or after their finalization, but taxpayers may rely upon them until finalized.

FIRPTA and Qualified Foreign Pension Funds

Current Law. A QFPF is a trust, corporation or other organization established by the government of a foreign jurisdiction or one or more employers to provide retirement or pension benefits to employees if the fund meets certain other requirements. Entities or arrangements that are QFPFs during the applicable testing period are generally exempt from tax under FIRPTA. Furthermore, under proposed regulations issued in 2019, certain foreign trusts or corporations that are wholly-owned, directly or indirectly, by QFPFs are also eligible for the exemption.

Final Regulations. The final regulations largely adopt the 2019 proposed regulations. However, they make several clarifying changes to the requirements that foreign pension funds must meet in order to be QFPFs, including by liberalizing them somewhat in a number of areas. Foreign pension funds, particularly those that may not have clearly been QFPFs under the 2019 proposed regulations, should re evaluate whether they meet the QFPF requirements as set forth in the final regulations.

The final regulations also make modifications to the contents of the certificates required to demonstrate an exemption from FIRPTA withholding and require QFPFs to maintain records establishing an exemption under Section 897(l). QFPFs and purchasers of US real property interests from QFPFs should review these requirements carefully to ensure that they maintain the appropriate documentation in the event of review by the IRS.

As noted above, the foregoing is a summary of just some of the key provisions from these proposed and final regulations; other provisions may be relevant to you as well. O'Melveny will be closely monitoring further developments in this area and can assist clients with analyzing and complying with the proposed and final regulations and any future guidance related to FIRPTA and US real property investors. Please contact the attorneys listed on this Client Alert or your O'Melveny counsel for questions regarding the information discussed herein.

¹ Foreign persons for this purpose include individual non-resident aliens, foreign corporations, foreign partnerships, foreign trusts and foreign estates.

² Note that because a foreign person is subject to tax under FIRPTA only with respect to dispositions of domestic USRPHCs, a foreign corporation's status as a USRPHC is generally only relevant for purposes of determining whether any other corporate shareholder in that foreign corporation is itself a USRPHC.

³ See further discussion of QFPFs and QCEs below.

⁴ A controlled entity is an entity that (a) is wholly-owned by a foreign sovereign, directly or indirectly through other controlled entities; (b) is organized under the laws of the foreign sovereign; (c) will credit all earnings to its own account or those of the foreign sovereign; and (d) will vest its assets in the foreign assets upon dissolution.

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