

Date: July 23, 2019

To: **Roland Kriemler**

From: **Maher Haddad**

Re: **Application of Proposed Treasury Regulation Section 1.897(l)-1 (Exception for Interests Held by Foreign Pension Funds) to Swiss Tax-Exempt Investment Foundations**

This memorandum analyzes whether recently-issued proposed regulations extend the exemption from the tax imposed on non-U.S. persons on gains from the sale of U.S. real property assets under the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) to a Swiss tax-exempt investment foundation all of the beneficial interests in which are held by pension plan investors each of whom is a “qualified foreign pension fund” (a “QFPF”).

Pursuant to FIRPTA, a the gain or loss recognized by a non-U.S. person on the sale or disposition of a “U.S. real property interest” is subject to U.S. federal income tax as if it were income effectively connected with a trade or business carried on in the U.S., even if the property sold or disposed of is a wholly passive investment of the non-U.S. seller.¹

Section 897(l)(1) of the Internal Revenue Code (the “Code”) provides relief to QFPFs from the tax imposed by FIRPTA. It generally exempts the gain realized by a QFPF or any entity “all the interests of which are held by” a QFPF from sale of a “U.S. real property interest” from being treated as taxable income under FIRPTA.

Proposed regulations were recently issued in order to clarify which entities qualify for the exemption from FIRPTA tax provided by Section 897(l) of the Code. Under these proposed regulations, a Swiss tax-exempt investment foundation, all of the beneficial interests in which are held by one or multiple pension funds likely qualifies for the exemption, assuming each of the pension funds that is a beneficial owner of such investment foundation itself qualifies as a QFPF in if the foregoing is true at all times during an applicable “testing period.”

Pursuant to the proposed regulations, gain or loss from the disposition of a “U.S. real property interest” by a “qualified holder” is not subject to tax under FIRPTA.² For this purpose, a “qualified holder” can be a QFPF or a “qualified controlled entity” that has at all times met the requirements for being treated as a “qualified controlled entity” during the entirety of an applicable “testing period.”³

A “Qualified controlled entity” is a trust or corporation organized under the laws of a non-U.S. jurisdiction, all of the interests of which are held by one or more QFPFs, directly or indirectly through one or more qualified controlled entities or partnerships.⁴

¹ I.R.C. § 897(a)(1).

² Prop. Treas. Reg. § 1.897(l)-1(b)(1).

³ Prop. Treas. Reg. § 1.897(l)-1(d)(11).

⁴ Prop. Treas. Reg. § 1.897(l)-1(d)(9).

Swiss tax-exempt investment foundations are established under Swiss law. If all of the beneficial interests in any such investment foundations are directly or indirectly owned by multiple pension plans each of which is a QFPF, that Swiss investment foundation should be treated as a “qualified controlled entity,” and therefore a “qualified holder” that qualified for the exemption from FIRPTA tax if all of the beneficial interests in that Swiss investment foundations have been directly or indirectly only held by QFPFs for the entire duration of the applicable “testing period.”

This “testing period” is the shorter of (1) the period beginning on December 18, 2015 and ending on the date of disposition of the applicable “U.S. real property interest” by the foundation; (2) the ten-year period ending on the date of disposition of the applicable “U.S. real property interest” by the foundation; and (3) the period during which the foundation (or its predecessor) has been in existence.⁵

In addition, the proposed regulations provide that the exemption from FIRPTA tax available to “qualified holders” applies only to gain or loss attributable to “qualified segregated accounts” maintained by such “qualified holders.”⁶ A “qualified segregated account” is an identifiable pool of assets maintained solely for funding qualified benefits to qualified recipients.⁷ Assets of a “qualified controlled entity” are treated as an identifiable pool of assets maintained solely for funding qualified benefits to qualified recipients only if:

- 1) All net earnings of the qualified controlled entity are credited to its own account or to the “qualified segregated account” of a QFPF or other “qualified controlled entity” with no portion of its income inuring to the benefit of a person other than a qualified recipient; and
- 2) All assets of the “qualified controlled entity,” after satisfaction of liabilities to persons having interests in the entity solely as creditors, vest in a “qualified segregated account” of a QFPF or another “qualified controlled entity” upon dissolution.⁸

What the above essentially means is that, in order for a Swiss investment foundation to be treated as a “qualified controlled entity” that is exempt from FIRPTA tax with respect to an investment account maintained by it, now of the ultimate direct or indirect beneficial owners of the investment returns generated by such an account can be any person or entity other than a QFPF. Therefore, a non-QFPF cannot have a beneficial interest in the profits generated by such an investment account (for example, under a promote arrangement) if taxable gain from the sale or disposition of a “U.S. real property interest” by such an investment account is to be exempt from FIRPTA tax. Note, however, that asset management fees and similar fees should not affect the exemption from FIRPTA tax if they are not based on the profits generated by the investment account.

⁵ Prop. Treas. Reg. § 1.897(l)-1(d)(14).

⁶ Prop. Treas. Reg. § 1.897(l)-1(b)(2).

⁷ Prop. Treas. Reg. § 1.897(l)-1(d)(13)(i).

⁸ Prop. Treas. Reg. § 1.897(l)-1(d)(13)(iii).