

September 14, 2016

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**Re: New Zealand Superannuation Fund Comments Addressing Section 897(l) Qualified Foreign Pension Fund Requirements**

Dear Sirs:

The Protecting Americans From Tax Hikes Act (“PATH Act”), enacted on December 18, 2015, provides a new exemption from the application of IRC section 897 (“FIRPTA”) for qualified foreign pension funds (“QFPFs”).<sup>1</sup> We would like to take this opportunity to provide written comments regarding the requirements set forth to meet the definition of a QFPF and we respectfully request that Treasury consider the following comments and proposed recommendations before issuing regulations under section 897(l).

Our comment letter addresses the new statutory rules and provide an overview of the position of the New Zealand Superannuation Fund (“NZSF”). We then present analysis to support our proposal that Treasury provide regulations that expand the definition of a QFPF to include entities that qualify as pension funds under definitions set forth in applicable United States income tax treaties. Entities that would qualify as a pension fund under a treaty should also be deemed to qualify as a QFPF under section 897(l)(2). Further, we also present reasoning to suggest that regulations be issued which clarify the employer/employee definition as set forth in section 897(l)(2)(B), particularly with respect to government sponsored public pension funds, as well as regulations which define the term “arrangement” in relation to section 897(l).

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<sup>1</sup> P.L. 114-113.

## I. General Overview of Statutory Rules

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) established Section 897 of the Internal Revenue Code (“Code”).<sup>2</sup> Under IRC Section 897(a)(1), any gain derived by a nonresident individual or corporation from the disposition of a U.S. real property interest (“USRPI”) shall be taken into account as income that is effectively connected (“ECI”) with a trade or business in the U.S. (“USTB”) and subject to U.S. federal taxation. Broadly, a USRPI is defined under IRC Section 897(c)(1) as an interest in real property located in the U.S., or any interest in a U.S. real property holding corporation (“USRPHC”). Generally speaking, a USRPHC is defined under IRC Section 897(c)(2) as any corporation where the fair market value of its USRPI equals or exceeds 50% of the fair market value of its total assets.

Under the PATH Act, new section 897(l) provides for an exemption from tax under FIRPTA where a USRPI is held by a QFPF directly, or indirectly through one or more partnerships, or to any distribution received by a QFPF from a real estate investment trust (“REIT”). Section 897(l) also applies to any entity where all of the interests of which are held by a QFPF.<sup>3</sup> This means that QFPFs generally will be exempt from U.S. federal income tax on gains derived from the disposition of a USRPHC, distributions from a USRPHC that are characterized as capital gains under section 301(c)(3), and capital gain REIT distributions. QFPFs may also be exempt from U.S. federal income tax on sales of direct interests in U.S. real property as long as such holdings are not actually used in the conduct of a U.S. trade or business.

A QFPF is defined as any trust, corporation, or other organization or arrangement that meets each of the following five requirements<sup>4</sup>:

- (A) It is created or organized under the law of a country other than the U.S.;
- (B) It is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees, or persons designated by such employees, of one or more employers in consideration for services rendered; (the “Employee/Employer Requirement”)
- (C) It does not have a single participant or beneficiary with a right to more than five percent of its assets or income;
- (D) It is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or organized; and
- (E) 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 under such laws are deductible or excluded from the gross income of such entity 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 taxed at a reduced rate.

The PATH Act, and subsequent amendments to existing regulations, also provide that QFPFs are not subject to the FIRPTA withholding rules under section 1445<sup>5</sup>.

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<sup>2</sup> The Internal Revenue Code of 1986, as amended.

<sup>3</sup> See JCX-144-15, Technical Explanation Of The Protecting Americans From Tax Hikes Act Of 2015, House Amendment #2 To The Senate Amendment To H.R. 2029 (Rules Committee Print 114-40).

<sup>4</sup> Section 897(l)(2)(A)-(E).

Additionally, the Joint Committee on Taxation (“JCT”), in its general explanation of tax legislation in 2015 (“the JCT Bluebook”) included a footnote clarifying and expanding the term “arrangement” under section 897(l). The footnote states:

*Foreign pension funds may be structured in a variety of ways and may comprise one or more separate entities. The word “arrangement” encompasses such alternative structures.<sup>6</sup>*

Finally, the JCT Bluebook also includes a footnote referring to the Employee/Employer Requirement, noted above, which suggests that such requirement ought to be interpreted broadly and government-backed public/social pension funds may satisfy it:

*Multi-employer and government-sponsored public pension funds that provide pension-related benefits may satisfy this prong of the definition. For example, such pension funds may be established for one or more companies or professions, or for the general working public of a foreign country.<sup>7</sup>*

## **II. General Overview of New Zealand Superannuation Fund**

The New Zealand Superannuation and Retirement Income Act 2001 established the NZSF, a long-term, growth-oriented, global investment fund. The NZSF is funded by the government of New Zealand, which has contributed over \$10.8 billion to the fund thus far. The purpose of NZSF is to provide for the future funding of retirement benefits paid by the government of New Zealand which are guaranteed to all New Zealanders aged 65 and older.

The organizational form of NZSF is not an entity which is a trust, corporation, or organization, but rather it is a collection of assets wholly owned by the New Zealand government. The NZSF holds a pool of assets on the government’s balance sheet and is managed by a government entity, the Guardians of New Zealand Superannuation (“GNZS”). The GNZS operates by investing government contributions made to NZSF, as well as the returns generated from the investments, in New Zealand and internationally. The goal is to grow the size of NZSF to help pay for future New Zealand Superannuation payments.

Further background information on NZSF is contained on our website [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz).

Currently NZSF is invested in diversified assets throughout the world, a significant number of which include U.S. investments, including U.S. real estate assets. In light of its commitment to continue considering investing in the U.S., including in U.S. infrastructure and real estate projects, NZSF agrees with and welcomes the introduction of the QFPF exemption enacted under section 897(l) as it demonstrates the United States policy commitment towards encouraging investment in U.S. real property by foreign pension funds. However, we are concerned that the requirements set forth in section 897(l), as enacted, can be narrowly

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<sup>5</sup> See section 1445(f)(3)(B). The JCT Report explains the changes made to section 1445 are “conforming changes” which eliminate withholding on sales by qualified foreign pension funds as well as their wholly-owned foreign subsidiaries of USRPIs. See JCX-144-15.

<sup>6</sup> See Joint Committee on Taxation’s general explanation of tax legislation enacted in 2015, released on March 14, 2016. Footnote 967.

<sup>7</sup> See Joint Committee on Taxation’s general explanation of tax legislation enacted in 2015, released on March 14, 2016. Footnote 968.

interpreted to define a QFPF in terms that preclude many foreign pension funds from accessing the exemption from FIRPTA, which visibly goes against the broader policy intent behind the section's enactment.

In order to ensure that section 897(l) supports the underlying policy objective of encouraging foreign pension fund investment in U.S. real estate, NZSF submits that Treasury should promulgate regulations clarifying the definition of a QFPF. It is NZSF's view that such regulations should broaden the scope of the definition of a QFPF, to ensure that foreign pension funds that exhibit characteristics that fall within the spirit of the exemption for QFPFs, but that may not fall strictly within all limbs of the statutory definition of section 897(l), are included.

### **III. Comments and Proposed Recommendations**

- A. Entities meeting the definition of a "Pension Fund" under a U.S. tax treaty should be considered a QFPF for the purpose of section 897(l).

Section 897(l) defines a QFPF in terms that materially differ from those used to define pension funds in existing U.S. treaties. There are situations, such as that of NZSF, where an entity can qualify as a pension fund under an existing U.S. tax treaty, however there may be a level of uncertainty as to whether it meets the QFPF statutory definition despite it clearly falling within section 897(l)'s intended policy. Accordingly, if a foreign trust, corporation, or other organization or arrangement is resident in a country that has an income tax treaty with the U.S., and it qualifies for the benefits of such income tax treaty under treaty provisions specifically applicable to pension funds, then it is our view that such organization or arrangement should also be deemed to qualify as a QFPF.

A rule noting that an entity which qualifies as a pension fund under an existing tax treaty makes sense because it simplifies the determination process while furthering already established U.S. interests that were previously negotiated in a treaty and implements section 897's policy intent. Additionally, it would be extremely difficult to issue regulations that are both sufficiently inclusive of valid pension funds and not so voluminous that the rules become difficult to interpret. The clear benefit of referencing specific pension fund provisions in income tax treaties is that they are already negotiated and the types of recognized pension fund structures are also identified by both parties. Moreover, in many cases, pension funds in treaty countries will already have made determinations as to their status under the treaty, thus this rule would simplify the process of determining whether they are also QFPFs.

For example, under the U.S. – New Zealand Tax Treaty, the term "pension fund" includes (paraphrased here for ease of reference):

Any person established in a Contracting State that is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements and in the case of the U.S. is generally exempt from income taxation. In the case of New Zealand, the term refers to a superannuation scheme registered under the Superannuation Schemes Act 1989, a KiwiSaver Scheme registered under the KiwiSaver Act 2006, the New Zealand Superannuation Fund, or the Government Superannuation Fund.<sup>8</sup>

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<sup>8</sup> Protocol amending the U.S. – New Zealand Treaty, Paragraph 6, Subparagraph (l).

Clearly, NZSF is specifically defined as a pension fund in the tax treaty and thus will qualify for all benefits applicable to pension funds under the treaty. It would seem contrary for U.S. tax policy to include NZSF as a pension fund under the U.S. – New Zealand treaty, but then to potentially deny QFPF treatment to NZSF under domestic law.

Similarly, Treasury and the IRS used a broad approach in implementing the Foreign Account Tax Compliance Act (“FATCA”), which generally requires foreign financial institutions to register with the IRS, perform due diligence to determine which of their accounts are held by certain U.S. persons, and report annually to the IRS information about such accounts. FATCA is intended to prevent U.S. persons from evading U.S. taxes by hiding assets offshore. However, entities that were unlikely to evade taxes were being burdened with additional compliance requirements. In response, Treasury and the IRS issued regulations that created certain categories of “exempt beneficial owners,” - entities that generally have few FATCA-related obligations.

We also note for completeness that the United States and New Zealand FATCA Inter-Government Agreement (effective 1 July 2014) specifically lists NZSF as a Government Entity, non-reporting New Zealand Financial Institution and Exempt Beneficial Owner.

Recognizing the potential that the general definitions could not be expected to cover all retirement fund structures that present a low risk of use for tax evasion, Treasury and the IRS provided that treaty-qualified retirement funds would be treated as exempt beneficial owners. The regulations define a “treaty-qualified retirement fund” as:

*A fund established in a country with which the United States has an income tax treaty in force, provided that the fund is entitled to benefits under such treaty on income that it derives from sources within the United States (or would be entitled to such benefits if it derived any such income) as a resident of the other country that satisfies any applicable limitation on benefits requirement, and is operated principally to administer or provide pension or retirement benefits.<sup>9</sup>*

In summary, we are aware that:

- the U.S. is trying to foster investment from foreign pension funds;
- that it is generally accepted that foreign pension funds are not likely to intentionally seek to evade their U.S. tax obligations; and
- the IRS has previously taken steps to alleviate the compliance burden for foreign pension funds under other regimes.

Therefore, where such funds are already granted tax benefits under an existing tax treaty, it seems logical to follow the same approach with respect to the granting of benefits under section 897(l).

*Recommendation:*

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<sup>9</sup> Treas. Reg. § 1.1471-6(f)(1).

We recommend that if a foreign entity or arrangement satisfies the requirements to be treated as a pension fund for the purpose of a tax treaty with the U.S, or if the foreign entity or arrangement is specifically named as a pension fund in any such treaty, the entity should qualify as a QFPF for purposes of Section 897(1)(2).

- B. Treasury and the IRS should release regulations which clarify the employer/employee definition as set forth in section 897(1)(2)(B).

Section 897(1)(2)(B) states that a QFPF must be established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees of one or more employers for consideration for services rendered. One reading of this requirement may be that it defines a narrow scope of pension funds which are funded solely for current and former employees and only paid out to such current and former employees who worked for the employer. Reading the statute in this manner would have the effect of excluding foreign government-sponsored pension funds that are set up for the purpose of providing retirement benefits to citizens of such foreign country, such as NZSF. Reading the scope this narrowly would preclude such funds, which are indeed a form of pension fund, from enjoying the tax exemption from FIRPTA provided to QFPFs.

Further, JCT Bluebook footnote 968 suggests that it is indeed the intent of U.S. tax policy makers to include government-sponsored public pension funds within the definition of a QFPF. Specifically, footnote 968 mentions that such foreign government-sponsored pension funds that are established for the general working public of a foreign country should be included within the definition of a QFPF. This language appears to be more in line with the overall policy intent of encouraging foreign pension funds to invest in U.S. real property interests. Further, the footnote provides insight into the fact that the QFPF exemption appears to have been intended to benefit a much larger population of investment entities than section 897(1) may apply to (in the absence of the clarification we seek in future regulations).

*Recommendation:*

We recommend that regulations be released that include the intent expressed in JCT Bluebook footnote 968. Such regulations should provide that a foreign government, and by extension a government-sponsored public pension fund, should meet the definition of an employer under section 897(1)(2)(B). Further, the regulations should provide that the general public, which is entitled to retirement benefits under the law of the foreign country, should meet the definition of an employee under section 897(1)(2)(B).

- C. Treasury and the IRS should release regulations which define the term “arrangement” in relation to section 897(1).

The flush language of section 897(1) defines the organizational form of a QFPF to be any trust, corporation, or other organization or arrangement. This definition, while sufficiently broad to encompass many types of foreign pension funds, does not provide adequate certainty surrounding the qualification process. For example, a pension fund such as NZSF does not have a specific legal form and is constituted via government legislation. In reading section 897(1), one is left to determine whether such a legal form

meets the definition of “arrangement” when considering the potential application of the exemption from FIPRTA for QFPFs. The lack of clarity around the definition of “arrangement” provides uncertainty, which in turn could have a chilling effect with respect to foreign pension fund investment in U.S. real property assets.

It appears as though the intent of the policy behind section 897(l) was to allow for flexibility in the definition of arrangement. This flexibility can be seen in JCT Bluebook Footnote 967, which states that foreign pension funds may be structured in a variety of ways and that the word “arrangement” encompasses alternative structures. Seeing that the intended usage of the word “arrangement” appears to countenance flexibility based on JCT Bluebook Footnote 967, it would be beneficial for foreign pension funds, as well as for the U.S. policy makers, to either codify the definition of “arrangement” in order to provide greater clarity and certainty to potential foreign pension fund investors or to provide an expanded list of illustrative circumstances which would qualify.

#### *Recommendation*

We recommend that regulations be released that define the term “arrangement” for the purposes of section 897(l). A definition for “arrangement” should account for the fact that a foreign pension fund can be constituted via local country legislation without there being a defined legal form, and such legislation should be respected as an “arrangement” for purposes of qualifying as a QFPF under section 897(l).

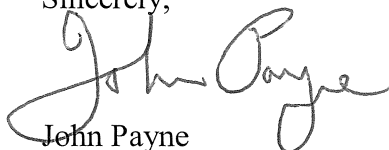
#### **IV. Conclusion**

The Secretary has authority to consider our comments and proposed recommendations based on the broad regulatory power granted under section 897(l)(3) to issue such regulations as may be necessary or appropriate to carry out the purpose of section 897(l)(2).

As of the date of this comment letter, no final, temporary, or proposed regulations have been issued under section 897(l). We believe that our preceding comments are in line with carrying out the purpose and intention of section 897(l) and request that these comments, and our proposed recommendations, be part of the consideration for the contents of future regulations.

We appreciate the Treasury’s and Service’s efforts to issue any future guidance with respect to section 897(l). We would be happy to discuss these comments at your convenience. Thank you again for your time to consider these matters. Please feel free to contact us with any questions.

Sincerely,



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