REAL ESTATE TAX

Foreign Pension Funds: Eyes on Proposed Tax Changes

TAXAND

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The Biden Administration and Senate Democrats recently released more details on proposed tax law changes. Not surprisingly, they involve tax increases. Which raises the question: how might foreign pension funds investing in the U.S. be affected? It is too early to say for sure – but in some scenarios, the tax increase could be very material and warrant a re-thinking of investment structures.

Individual Tax Increases – Why Should a Foreign Pension Fund Care?

During his 2020 presidential campaign, Biden proposed tax increases targeting high-income individuals. They include:

- Returning the top individual tax rate on ordinary income to 39.6%.
- Raising the long-term capital gains rate from 20% to 39.6% on taxpayers with income over $1 million.

Many, if not most, foreign pension funds are classified as "complex trusts." This means they are generally taxed like individuals. Pension funds that invest directly into U.S. real estate, infrastructure, or other assets that constitute a U.S. trade or business (USTB) may experience a dramatic increase in their tax rate where the investment return is geared toward long-term capital growth and exit gain. This may include investments in pass-through (not blocked) fund structures. The possibility of a near doubling of the tax rate should be carefully monitored. Blocker structures may become more attractive and some pension funds may consider moving unblocked investments into blockers.

Corporate Tax Increases – Impact on Blockers?

Within the past two weeks, both the Biden Administration and leading Senate Democrats have provided details on proposed increases to corporate taxation. The Biden Administration is looking for corporations to foot much of the bill for his massive $2.25 trillion infrastructure plan.

Potential changes include:

- Raising the federal tax rate from 21% to 28%.
- Denying deductions on payments to foreign related parties that are subject to a low effective tax rate. This could be of concern to leveraged blockers making payments of interest to their pension fund shareholders. It is not clear who would be included as related parties, whether there is a minimum income threshold, or whether pension funds that are tax-exempt in their country would be included.

There is thus far no indication that the favorable qualified foreign pension fund (QFPF) regime (which generally exempts a pension fund from FIRPTA) will be altered nor the taxation of REITs, other than the tax rate changes to certain shareholders.

It is anticipated that the road to passing major U.S. tax reform will be rocky due to the political divide in Washington. It is nonetheless conceivable that some degree of reform could take place as early as the fall of this year. Our initial impression is that leveraged blockers (or REITs where applicable) will continue to be a vehicle of choice for foreign pension funds investing in real estate, infrastructure, or other sectors involving a USTB.

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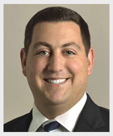

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