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# IRS Takes View That FIRPTA Exemption for Publicly Traded Stock Must Be Tested at Partnership Level

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## Key Points

- Internal IRS correspondence in the fovrm of a recent Chief Counsel Memorandum concludes that funds structured as partnerships (e.g., master funds in a standard master-feeder structure) must determine the availability of the 5% and 10% ownership thresholds for the publicly traded stock exemption from FIRPTA tax based on *the partnership's* ownership of the stock, as opposed to the offshore feeder's (or non-U.S. investors') relative ownership upstream. Investment funds could have U.S. withholding tax exposure under this approach, whether any trades are entered into directly or via swap.
- Prior to the release of the Memorandum, there was significant uncertainty regarding the appropriate level at which to test the relevant ownership thresholds. The Memorandum is not official guidance and, therefore, is not binding on taxpayers. However, it may be indicative of how the IRS will approach the issue on audit, and could have significant financial accounting implications (e.g., under FIN 48).
- Investment funds and their non-U.S. investors may wish to consider whether planning is available to enhance the likelihood of the FIRPTA exemption applying. For instance, subject to compliance with ERISA, fund sponsors could consider holding relevant trades in parallel with or above the level of the master fund. Fund sponsors should also consider potential side letter exposure (e.g., in case of notice, tax efficiency or refund assistance requirements) associated with the IRS position.
- Non-U.S. investors that are eligible for an investor-level FIRPTA exemption (e.g., QFPF or Section 892 status) are recommended to diligence their investee positions to ensure that the FIRPTA exemption continues to apply.

## The Memorandum

In a Chief Counsel Memorandum released May 19, 2023 (the Memorandum), the Internal Revenue Service (IRS) asserted that partnerships must determine the availability of the 5% and 10% ownership thresholds for purposes of the Publicly Traded Stock Exception (defined below) under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) based on the partnership's ownership of the stock, as opposed to each partner's pro rata ownership of such stock through the partnership.

The Memorandum is of particular significance to investment funds and their non-U.S. investors that invest in U.S. real estate-related listed stocks or other securities (e.g., convertible/exchangeable or profit participating securities, and certain master limited partnership (MLP) interests).

Under the approach set forth in the Memorandum, investment funds operating in a typical master-feeder structure are required to test whether the aggregate ownership interest in publicly traded stock positions held at the master fund level is at or below the 5% statutory threshold (10% in case of real estate investment trusts

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(REITs)) by reference to public float, even if non-U.S. investors' (including any non-U.S. feeder funds) indirect ownership of the relevant position is below the threshold.

The Memorandum is not official guidance. Rather, it is internal advice rendered by IRS chief counsel attorneys to field agents. It is not binding on taxpayers, but may be indicative of how the IRS will approach the issue on audit, and could potentially make it more difficult for fund sponsors to take the position for financial accounting purposes (e.g., under FIN 48) that testing should be conducted at the feeder fund level. This may have financial statement implications both for current and prior positions held by investment funds and could potentially result in withholding tax exposure.s

## The Publicly Traded Stock Exception

In general, gain realized by non-U.S. investors from the sale or exchange of stock in a U.S. corporation that is held as a capital asset is not subject to U.S. federal income tax or filing obligations, unless the gain is treated as "effectively connected" with the conduct of a U.S. trade or business (ECI).

Under FIRPTA, however, gain or loss realized by non-U.S. investors on the sale or exchange of a U.S. real property interest (USRPI) is deemed to be ECI. A USRPI includes an investment in stock issued by a U.S. corporation or a U.S. REIT with significant U.S. real property-related assets (i.e., a U.S. real property holding corporation, or USRPHC).

For non-U.S. corporate investors, the FIRPTA tax is generally 21%. For non-U.S. individuals, trusts and estates, the tax may range from 20% to 37% depending on the holding period in the stock.

Perhaps more significantly, a non-U.S. investor that is engaged in a U.S. trade or business (including as a result of the FIRPTA rules) must file a U.S. tax return and may also have associated state and local tax return filing obligations. U.S. tax treaties typically do not provide relief from FIRPTA tax, but certain non-U.S. sovereign investors (i.e., Section 892 investors) and qualified foreign pension fund (QFPF) investors may benefit from a specific statutory exemption.

Under Section 897(c)(3) of the Internal Revenue Code of 1986, as amended, an exemption from FIRPTA is available in case of the sale or exchange of stock in a USRPHC if any class of stock in the USRPHC is "regularly traded" on an established securities market and the relevant non-U.S. investor held 5% (10% in the case of a REIT) or less of such class of stock during the relevant testing period (the Publicly Traded Stock Exception).

The testing period is the five-year period ending on the date of the sale or exchange or, if shorter, the investor's holding period in the stock. The Treasury regulations expand this exemption to include a variety of stock and non-stock interests (both regularly traded and non-regularly traded) in USRPHCs that have at least one class of regularly traded stock.

Thus, the exemption is of significant importance to non-U.S. investors in virtually any investment fund that holds material positions in regularly traded USRPHCs and other similar entities, including many MLPs.

## Potential Financial Reporting Impacts

In general, Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Tax Positions – An Interpretation of FASB Statement No. 109* (FIN 48), requires an entity to impose a financial statement reserve in respect of tax positions (including with respect to withholding tax) that do not meet a more likely than not standard.

Prior to the release of the Memorandum, the treatment of regularly traded interests held by partnerships was uncertain absent specific statutory or regulatory guidance on point, and some tax advisors expressed the view

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that testing the 5% Publicly Traded Stock Exception at the partner level was a reasonable position, in light of the purpose and history of the FIRPTA rules.

Because the Memorandum does not address many of the arguments that have been made in support of testing at the partner level,[1] it is unclear whether the release of the Memorandum renders it infeasible for funds to continue applying a look-through approach on a go-forward basis.

In this regard, we also note that the Memorandum appears to cut against a current trend of regulatory guidance that seeks to treat partnerships as "aggregates" for income inclusion purposes, such as the recently finalized regulations under the controlled foreign corporation regime, and recently proposed regulations under the passive foreign investment company regime.

Additionally, in the context of the "portfolio interest exemption" from U.S. taxation, the U.S. Treasury has explicitly provided in final regulations that the ownership test for purposes of determining whether a non-U.S. investor is a "10-percent shareholder" must be applied at the partner level (and ***not*** the partnership level).

Notwithstanding the foregoing, the Memorandum purports to "clarify" existing law, so funds should be aware that the Memorandum could potentially impact financial accounting positions they have taken with respect to this issue (e.g., for FIN 48 purposes) and should consult their advisers in this regard.

Finally, the Memorandum generally does not affect the position of prime brokers and other paying agents in their capacity as U.S. withholding agents, as FIRPTA withholding is generally not required upon sale of an interest in a U.S. corporation if any class of its stock is regularly traded on an established securities market.

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[1] See, e.g., the New York City Bar Association Report Requesting Guidance on Application of the FIRPTA Exception for Publicly Traded Stock in the Partnership Context (June 5, 2016), available at: **https://www2.nycbar.org/pdf/report/uploads/20073029-LettertoIRSreFIRPTAwithArticleTAXBUS2.8.16.pdf**.

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