NEWS ANALYSIS

FIRPTA and Feeder Funds In Opportunity Zones

by Marie Sapirie

Questions of how to deal with withholding on non-U.S. investors under the 1980 Foreign Investment in Real Property Tax Act and whether feeder funds are acceptable investment vehicles fall under the category of things Congress should have realized would need attention when it enacted the Opportunity Zone regime. But it didn't, or if it did, it failed to address them in the statute, so Treasury is stuck making more policy decisions than are ideal.

The text of section 1400Z-2 provides no guidance on what Congress intended regarding foreign investments in Opportunity Zones, and it doesn't seem to allow for the use of feeder funds. Congress unintentionally created a withholding snafu at the intersection of the Opportunity Zone regime and FIRPTA, with the potential for circumvention of the latter.

Lawmakers didn't change the text of FIRPTA itself in the Tax Cuts and Jobs Act, although evidently not because they were feeling uncharitable toward the real estate industry. The eventual FIRPTA rules will likely deal with the mechanics of how non-U.S. persons can obtain FIRPTA certificates and refunds. Feeders might be permitted, because retail investors would benefit from that expansion of the regime and it generally seems to be in line with what Congress intended.

FIRPTA Issues

The Opportunity Zone regime effectively repealed the FIRPTA tax for non-U.S. persons who invest capital gains that wouldn't have been taxed by the United States to begin with, said Eric Kodesch of Lane Powell PC. If non-U.S. persons have capital gain from the sale of stock that the United States doesn't tax, for example, and they invest that gain in a qualified opportunity fund, they aren't subject to tax on the appreciation if they hold the QOF investment for 10 years, even if the sole asset of the QOF is U.S. real estate. That effectively repeals the FIRPTA tax.

However, Kodesch said FIRPTA withholding is more complicated than that. Assuming that the

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interest in the QOF is a U.S. real property interest (USRPI), when the non-U.S. persons sell their QOF interest after the 10-year period, they must either get a FIRPTA certificate from the IRS or allow the withholding and file for a refund, Kodesch said.

Non-U.S. persons with effectively connected income resulting from the sale of a USRPI are eligible to use section 1400Z-2 to defer and partially avoid capital gains on amounts reinvested in QOFs, and to avoid tax on any appreciation of the investment in the QOF. Those benefits put them on equal footing with U.S. investors in QOFs. But unlike the rules for U.S. investors, FIRPTA requires withholding on non-U.S. persons selling real property in the United States, and things start to get dicey in the withholding area when USRPIs are sold and rolled over into QOF investments. Absent a fix, it's possible that some taxpayers could have trouble getting refunds or that FIRPTA taxes might not be paid. Preventive measures to keep taxpayers from using the Opportunity Zone regime to circumvent FIRPTA will probably be necessary in future guidance.

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Prop. reg. section 1400Z-2(a)-1(b)(5) says that when a taxpayer is required to include deferred gain in income under the Opportunity Zone regime, it retains its attributes as if it had never been deferred. Although the proposed regulations don't refer to FIRPTA in the list of examples of attributes, the list is capped off by a catchall that includes any other attributes taken into account by any other applicable code provisions, which means that FIRPTA gain remains FIRPTA gain. The amount of FIRPTA gain will be reduced by 10 percent and then 15 percent at the five- and seven-year marks, respectively, but it won't shed its character as FIRPTA gain under the proposed rules. The challenge for Treasury is to determine how best to ensure that the FIRPTA tax is eventually paid.

A withholding problem arises if a non-U.S. person uses the capital gain realized from the sale of a USRPI to invest in a QOF. The non-U.S. person should then be entitled to a refund of the FIRPTA withholding amount since the investment allows the taxpayer to defer recognition of the gain, but there are different options for the timing of the refund.

One possibility would be to allow the taxpayer to apply for a refund at the time of the reinvestment in the QOF. That would seem to follow directly from the statute. Taxpayers would generally prefer a refund upon reinvestment in a QOF, because then they have the withholding amount in cash to put into the QOF. But if Treasury goes with that option, there will have to be a mechanism to allow taxpayers to file their refund claims, and that will probably require amending the FIRPTA regulations, said Peter Connors of Orrick Herrington & Sutcliffe LLP.

Treasury could consider allowing taxpayers to self-certify that capital gains have been reinvested in a QOF and requiring them to pay the FIRPTA tax upon the disposition of the QOF investment if the 10-year holding period under section 1400Z-2(c) to avoid tax on the deferred gain isn't met, similar to the way a gain recognition agreement works, Connors suggested. Using gain recognition agreements as a model for the self-certification would mean that taxpayers would agree to keep the statute of limitations open and, if required by the IRS, furnish a security permitted under reg. section 1.367(a)-8(h). That could include an annual certification. Treasury could keep track of both the refunded amounts and the transferor under that approach.

Another possibility for refund timing is that the refund would become available after the investment had been held for 10 years. The problem with a later refund is that section 6511 allows a refund claim for only three years, but the QOF investments may be held for 10 years. It's unclear whether the IRS has the authority to extend the statute, and taxpayers are unlikely to embrace the idea of waiting on a refund.

One of the reasons for FIRPTA withholding was to ensure payment of U.S. tax on the sale of real estate given that the sold real estate might have been the non-U.S. person's only asset in the United States. The reinvestment requirement of

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the Opportunity Zone regime mitigates that problem, Kodesch noted. If non-U.S. persons sell U.S. real estate and reinvest the capital gains in a QOF, they have the usual FIRPTA withholding options of getting a withholding certificate or seeking a refund of the FIRPTA withholding amount. For 2026, they should file a tax return reporting 85 to 100 percent of the deferred gain and pay the tax then. If they don't, there's the QOF interest in the United States that the IRS can look to as protection for the fisc, he said.

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The Florida Bar pointed out that the usual wait time for getting a withholding certificate makes the requirement to invest in a QOF within 180 days of the sale or exchange in order to defer the gain even more difficult for non-U.S. persons, because FIRPTA withholding agents hold the tax in escrow until the non-U.S. person receives the certificate, which can take several months. The bar association requested an election for taxpayers to use either the date of the sale or the date of receipt of the reduced FIRPTA withholding certificate as the start of the 180-day period. Non-U.S. investors would also like Treasury to allow the inclusion of gains that aren't subject to U.S. federal income tax in the definition of eligible gains under the 10-year holding period rule. "This would attract non-U.S. investor capital to opportunity zones that would not otherwise have an incentive to be directed to investments in opportunity zones," the bar explained.

Feeder Funds

Fund managers would like to be allowed to aggregate investments into feeder funds and use that aggregator to invest in a QOF, while preserving the benefits of the Opportunity Zone regime for the investors in the aggregator. The Real Estate Roundtable advocated extending the regime to allow feeder funds because it would "provide scalability and allow fund managers to operate similar to a traditional real estate fund."

However, there's a hitch because the statute says that capital gains to be deferred should be "invested by the taxpayer" in the QOF. Allowing feeder funds to invest in QOFs would seem to require a departure from the statutory text, and it's unclear how far Treasury is willing to stretch to accommodate that request, which enjoys a decent amount of support. The comment letter from the Real Estate Roundtable pointed to reg. section 1.1045-1(a) as an example of regulations permitting an intermediate partnership in an analogous situation.

The New York State Bar Association said that allowing feeder funds would comport "with the general 'aggregate' partnership theory embodied in the Proposed Regulations," and that it would streamline getting investors into QOFs. However, NYSBA also pointed out that it could make the basis rules even more complex.

Guidance on FIRPTA withholding and feeder funds wasn't among the topics Treasury anticipated addressing in the preamble to the first set of proposed Opportunity Zone regulations, and a substantial list of open items remains for future regulations. But both questions are pressing, because taxpayers will need to know the procedure for obtaining a refund of withholding and whether they can get the benefits of the new regime by investing in a feeder fund. ■

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