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Proposed Guidance Under Section 892 Regarding Taxation of Foreign Governments on US Investment Income

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On November 2, 2011, the Internal Revenue Service issued long-awaited guidance concerning the taxation of certain income of foreign governments from investments in the United States under Section 892 of the Internal Revenue Code. This guidance takes the form of proposed regulations that modify and expand existing temporary regulations issued in 1988. The 1988 temporary regulations were widely criticized as unduly restrictive. Ultimately the criticisms culminated in the issuance of these proposed regulations. Given the significantly increased investing activities of foreign governments (including sovereign wealth funds) that are eligible for Section 892 tax benefits as compared to 23 years ago, the proposed regulations are a welcomed step in the right direction. However, as discussed below, the proposed regulations fail to provide guidance on a number of critical issues.

Importantly, the preamble to the proposed regulations indicates that taxpayers may rely on the proposed regulations until final regulations are issued. This is an unusual provision to be found in proposed regulations. While the provision is welcome, it would be useful for the IRS to make clear that these proposals may be relied upon by a Section 892 investor that invests in a blind pool for all investments made by that pool, even if some investments are made after any changes that might be made to these proposals in final regulations.

Inadvertent Commercial Activity Exception

A controlled entity will not be disqualified entirely from the benefits of Section 892 as a result of certain inadvertent commercial activity.

Generally, Section 892 exempts from US federal income taxation income from investments in US stocks or securities, including interest income, dividend income and gains on the sale of domestic securities, earned by a foreign government. The term "foreign government" is defined by the 1988 temporary regulations, and in these proposed regulations, as including both the "integral parts" or "controlled entities" of a foreign sovereign. The distinction drawn between "integral parts" and "controlled entities" has been used to rationalize an "all or nothing" rule that disqualifies a controlled entity of a foreign sovereign from the benefits of Section 892 if it engages in any level of commercial activity (no matter how trivial) anywhere in the world. In contrast, an "integral part" of a foreign sovereign engaged in commercial activity loses the benefits of Section 892 only with respect to the income from commercial activities, and retains the benefits of Section 892 for any other qualifying investment income.

Section 892 does not exempt any income derived from the conduct of any commercial activity. More important, the exemption does not extend to any income received by or from a controlled commercial entity ("CCE") or derived from the disposition of any interest in a CCE. For these purposes,

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an entity will be treated as a CCE if it is engaged in commercial activities (whether within or outside the United States) and the foreign government directly or indirectly owns at least 50% of the economic or voting interests in, or otherwise exercises effective practical control over, the entity.

In an effort to ameliorate the harsh application of the "all or nothing" rule, the proposed regulations create an exception under which a controlled entity will not be treated as a CCE, and, as such, will not be disqualified from the benefits of Section 892, as a result of certain inadvertent commercial activity. Specifically, the proposed regulations provide that commercial activity will be treated as inadvertent commercial activity only if: (1) the failure to avoid conducting the commercial activity is reasonable; (2) the commercial activity is promptly cured; and (3) certain record maintenance requirements are satisfied. The proposed regulations include a safe harbor under which, provided there are adequate written policies and operational procedures in place to monitor the entity's worldwide activities, the controlled entity's failure to avoid the conduct of commercial activity during a taxable year will be considered reasonable.

The new inadvertent commercial activity rule is not a de minimis rule; rather, it is a narrow exception for foot faults. Controlled entities will therefore still be required to structure their investments within and without the United States to ensure that a commercial activity engaged in by one entity does not taint the Section 892 status of another. Moreover, the proposed regulations did not change, as many had hoped, a provision under the 1988 temporary regulations[1] treating a controlled entity that meets the definition of a "US real property holding corporation" as a CCE, even if that entity owns only stock of noncontrolled corporations owning US real property. This rule also requires foreign governments to structure their worldwide portfolios with great care to where in the worldwide group certain real property-related investment are held.

The proposed regulations helpfully clarify that the determination of whether an entity constitutes a CCE will be made on an annual basis. As such, an entity will not be considered a CCE for a taxable year solely because the entity engaged in commercial activities for a prior taxable year.

Partnership Attribution Rules

The proposed regulations modify the partnership attribution rules to provide that an entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership.

As noted above, an entity will be treated as a CCE if it is engaged in commercial activities (whether within or outside the United States) and the foreign government directly or indirectly owns at least 50% of the economic or voting interests in, or otherwise controls, the entity. The 1988 temporary regulations provide

attribution rules for activities of related controlled entities. One such attribution rule provides that activities of a partnership are attributed to its general and limited partners, subject to an exception for partners of publicly traded partnerships. Once again, disparate treatment results under this attribution rule depending on whether the foreign government constitutes an "integral part" or a "controlled entity." Where the foreign government constitutes an "integral part" and it invests directly in a partnership, any income such integral part derives from the commercial activities of the partnership will not qualify for exemption under Section 892 exemption; however, the income such integral part derives from qualifying investments will still qualify for exemption under Section 892. In contrast, where a controlled entity of a foreign sovereign invests in a partnership engaged in commercial activities, the partnership's commercial activities are attributed to its partners; accordingly, the controlled entity becomes a CCE, causing all of its income to become ineligible for the Section 892 exemption.

The proposed regulations turn off the attribution of commercial activity from a partnership to a limited partner. Under the revised exception, an entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership. Although the commercial activity of the limited partnership will not cause a controlled entity of a foreign sovereign to be deemed engaged in commercial activities, the limited partner's distributive share of partnership income attributable to such commercial activity will be considered to be derived from the conduct of commercial activity and, therefore, will not be exempt from taxation under Section 892.2

For this purpose, a limited partner interest in a limited partnership is defined as an interest in an entity classified as a partnership for US federal income tax purposes where the holder of such interest does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year. It is unclear whether this definition imports a new facts and circumstances test for determining whether a particular partnership interest constitutes a "limited partner" interest for these purposes, or if this definition is meant to address limited partner equivalents in limited liability companies or other entities treated as partnerships for US tax purposes.

The "all or nothing" rule, combined with the partnership attribution rules under the 1988 temporary regulations created unnecessary foot faults that could easily result in a controlled entity being completely denied of the benefits of Section 892. The proposed regulations essentially eliminate the need to create separate corporate "blockers" solely for Section 892 purposes, for example where a foreign government invests as a limited partner in a partnership that conducts activities wholly outside the United States. The proposed regulations may also eliminate the need for US fund sponsors to create parallel funds for their foreign government investors, although blockers will still be necessary when investing in the United States, given that active business income derived through an operating entity would be subject to US tax.

Definition of Commercial Activity

The proposed regulations expand the trading exception to include financial instruments.

The proposed regulations, like the statute, fail to define the term "commercial activities." Instead, the 1988 temporary regulations and the proposed regulations define "commercial activities" in the negative. They describe certain activities that do not constitute "commercial activities," and at several points state that the test for what constitutes a commercial activity is not the same as the tests used for other purposes of the Code. Although commentators have suggested that the Section 864(b)(2) trade or business standard be adopted for purposes of testing commercial activity under Section 892, the proposed regulations failed to adopt such approach. The proposed regulations do add a helpful new rule that treats investing in financial instruments in a manner similar to investing in stocks and securities, such that such investing is not treated as a commercial activity.

It should be noted that the revisions made to the treatment of financial instruments address only the definition of commercial activity, and do not address whether the income derived from such activities will be exempt under Section 892. That is, the regulations do not make clear on their face whether income from

investing in financial instruments is included within Section 892's exemption for income from stocks and securities. For example, the term "financial instrument" likely encompasses equity swaps described in Section 871(m) of the Code, which treats a "dividend equivalent" as a dividend for purposes of the provisions subjecting foreign persons to US tax under the Code and the corresponding withholding provisions. The proposed regulations, however, do not explicitly address the treatment of dividend equivalent payments. It would be unfortunate if dividend equivalent payments received by foreign governments were not exempt from tax under Section 892 where such payments would have been exempt if the underlying stock had been held directly by the foreign government.

The disposition of a US real property interest does not, by itself, constitute the conduct of a commercial activity.

The proposed regulations clarify that the disposition of a United States real property interest, including a deemed disposition under Section 897(h)(1), does not, by itself, constitute the conduct of a commercial activity. However, the income derived on the disposition of such interest, other than gain from the sale of stock of a noncontrolled US real property holding company, will not qualify for exemption under Section 892.

Issues Not Covered

The proposed regulations, while helpful in some respects, fail to address a variety of important interpretive issues arising under Section 892. Among these, some of the most important are:

- Section 892 treats an entity as a controlled entity if the foreign government has "effective practical control" over the entity. The 1988 temporary regulations and the proposed regulations do not define "effective practical control" and provide no examples illustrating the meaning of "effective practical control." As such, uncertainty still exists in many situations as to whether a foreign government has acquired "effective practical control" over an entity. This determination is particularly difficult to make, given that Section 892 employs a "50% or more" test rather than a "more than 50%" test for control.
- The proposed regulations fail to refine the distinction between "integral part" and "controlled entities." The definitions in the 1988 temporary regulations create uncertainty and produce materially different tax results based on what are often purely formalistic distinctions.
- The proposed regulations neglect to define the term "commercial activity" in any useful way.

1 Treas. Reg. § 1.892-5T(b).

2 Additionally, the proposed regulations provide that an entity not otherwise engaged in commercial activities will not be considered to be so engaged solely because it is a partner in a partnership that effects transactions in stocks, bonds, other securities, commodities or financial instruments for the partnership's own account. This exception, however, does not apply in the case of a partnership that is a dealer in stocks, bonds, other securities, commodities or financial instruments.

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