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Proposed Tax Regulations Protect U.S. Tax Exemption for Sovereign Wealth Investors

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Proposed tax regulations issued on November 3 will make it easier for foreign governments, their instrumentalities and controlled entities – including sovereign wealth funds – to invest in U.S. private funds without losing the U.S. tax exemption provided under section 892[1] because of income from commercial activities. The proposed regulations limit the "all or nothing" approach of the current regulations (temporary regulations issued in 1988), under which a small amount of commercial activity income can cause an entity to lose the exemption with respect to all of its income. Taxpayers are permitted to rely on the proposed regulations until they are published in final form.

Background

Section 892 provides a U.S. tax exemption to foreign governments (as defined below) for certain types of U.S.-source investment income. Because all non-U.S. persons are exempt from U.S. tax on income from trading in stocks and securities for their own accounts, bank deposit interest, and (under the portfolio interest exemption) most U.S.-source interest, the main benefit of the section 892 exemption is for U.S.-source dividends (which would otherwise be subject to U.S. withholding tax at a rate of 30%, or a lower treaty rate, if available).

A "foreign government" means the integral parts or controlled entities of a foreign sovereign. An integral part of a foreign sovereign is any person or body, however designated, that constitutes a governing authority of a foreign country. A controlled entity is a separate entity from the foreign sovereign that is wholly owned and controlled by the foreign sovereign (directly or through one or more controlled entities), is organized under the laws of that foreign sovereign, whose net earnings accrue only to the benefit of the foreign sovereign and not to the benefit of any private person, and whose assets vest in the foreign sovereign upon dissolution. Sovereign wealth funds generally qualify as foreign governments under section 892, as do many foreign governmental pension plans.

The section 892 exemption does not apply to "commercial activity income" or to income received by, or from, a "controlled commercial entity." A controlled commercial entity is an entity owned by a foreign sovereign that meets certain ownership or control thresholds (generally, the foreign government must own a 50% or greater interest in the entity, by vote or value, or an interest providing the foreign government effective practical control over the entity) and that is engaged in commercial activities anywhere in the world.[2] The policy behind these exceptions is that foreign governments should not be allowed to use their exempt status to compete unfairly with for-profit businesses. The "all or nothing" application of these exceptions to controlled commercial entities, however, has been criticized. If a controlled entity engages in commercial activities anywhere in the world, it will be treated as a controlled commercial entity and will not qualify for the section 892 exemption with

[1] "Section" references are to the Internal Revenue Code of 1986, as amended.

[2] By contrast, outside of section 892, a non-U.S. person is subject to U.S. tax on a net basis only on income that is effectively connected with a trade or business in the United States.

respect to any of its income. Thus, all of a controlled entity's passive investment income can be "tainted" by $1 of commercial activity income. (By contrast, although an integral part of a foreign sovereign loses the section 892 exemption with respect to any commercial activity income, its other income is not tainted and thus remains eligible for the exemption.) Any distribution by the entity to the foreign sovereign will also not qualify for the section 892 exemption.

This "all or nothing" rule can be a trap for a controlled entity investing in private funds because a controlled entity is generally treated as being engaged in any commercial activity conducted by a partnership in which it is a partner. If a controlled entity invests in multiple private funds and one of those funds produces any commercial activity income, the controlled entity will become a controlled commercial entity and will lose the section 892 exemption not only with respect to income from that fund, but with respect to all of its other investments, even if those other investments conduct no commercial activities.

The proposed regulations attempt to deal with these issues by:

- providing special rules for limited partners in limited partnerships and for partners in trading partnerships,
- providing a *de minimis* exception,
- providing that a separate determination is made each year as to whether an entity is a controlled commercial entity, and
- clarifying the definition of commercial activity.

Exceptions for Limited Partners and Partners in Trading Partnerships

In general, commercial activities of a partnership are attributed to its partners. The proposed regulations provide a broad exception to this attribution rule that should protect sovereign wealth fund investors in private funds from being treated as engaged in commercial activities as a result of such an investment. Under the proposed regulations, 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.

The rule above appears intended to apply to investors in limited partnerships, limited liability companies, and non-U.S. entities treated as partnerships. The rule applies to any holder of an interest in an entity treated as a partnership for federal tax purposes if the holder does not have the right to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year under the law of the jurisdiction in which the partnership is organized or under the governing agreement. Although the proposed regulations provide that consent rights in the case of extraordinary events, such as dissolution of the partnership, do not constitute rights to participate in control, more extensive rights or service on an advisory committee should be examined carefully to make sure that the sovereign wealth fund investor does not fall outside the category of "limited partner" under this rule.

The proposed regulations also make clear that a foreign government will not be considered to be engaged in commercial activities solely because it is a member of a partnership (other than a dealer) that effects transactions in stocks, bonds, other securities, commodities, or financial instruments for the partnership's own account. This exception applies even if the limited partner exception, described above, is not available. This rule uses the definition of "financial instrument" contained in the

temporary regulations and does not clarify what derivative contracts (beyond those referencing currencies and precious metals) are included.

De Minimis Exception

An entity will not be considered to engage in commercial activity if it conducts only "inadvertent commercial activity," meaning that:

- the failure to avoid conducting the commercial activity is reasonable,
- the commercial activity is promptly cured, and
- certain record maintenance requirements are met.

A controlled entity will not be able to rely on the section 892 exemption with respect to income from an inadvertent commercial activity, but the exemption will be available with respect to the entity's other qualifying income.

A failure to avoid conducting commercial activity will not be considered reasonable unless adequate written policies and operational procedures are in place to monitor the entity's worldwide activities.

Provided that adequate written policies and operational procedures are maintained, the proposed regulations include a "5%" safe harbor, under which an entity's failure to avoid conducting commercial activity will be considered reasonable if:

- the value of the assets used in, or held for use in, the activity does not exceed 5% of the total value of the assets reflected on the entity's balance sheet for the taxable year, and
- the income earned by the entity from the commercial activity does not exceed 5% of the entity's gross income as reflected on its income statement for the taxable year.

Year-by-Year Determination

The proposed regulations provide that the determination of whether an entity is a controlled commercial entity is made on an annual basis. Thus, an entity will not be considered a controlled commercial entity in one year solely because it was a controlled commercial entity in an earlier year.

Definition of Commercial Activity

The proposed regulations make clear that investments in financial instruments will not be treated as commercial activities, whether or not the financial instruments are held in the execution of governmental financial or monetary policy. The section 892 exemption will only be available, however, for financial instruments that are so held. As noted above, the proposed regulations do not clarify which derivative contracts are included in the definition of "financial instruments."

The proposed regulations also clarify that, by itself, gain from the sale of a U.S. real property interest, and certain REIT distributions that are so treated, will not constitute the conduct of a commercial activity. This issue has not been clear because such gain is generally treated as income that is effectively connected with the conduct of a trade or business in the United States. Although this gain is not commercial activity income, and thus does not taint the foreign government's other income, this gain can in no event qualify for the section 892 exemption.

Foreign Account Tax Compliance Act

One looming issue for sovereign wealth funds is not addressed in the proposed regulations. Under U.S. legislation enacted on March 18, 2010, commonly referred to as the Foreign Account Taxpayer Compliance Act or "FATCA," starting in 2014, a 30% withholding tax will apply to certain payments made to foreign financial institutions that fail to collect and provide substantial information regarding their "United States accounts" to the IRS on an annual basis. For our recent alert on FATCA, please click here. Section 1471(f)(1) of the Code exempts from this withholding tax any payment to "any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one or more of the foregoing." The IRS has not yet issued guidance on the extent (if any) to which sovereign wealth funds will be able to rely on this exemption. The IRS expects to issue proposed regulations under FATCA by the end of 2011, although those regulations may not address this issue.

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