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TAX UPDATE

Proposed IRS Regulations Would Clarify Existing U.S. Federal Income Tax Rules Applicable to Foreign Governments' Investment into the United States

In a Notice of Proposed Rulemaking issued on November 2, 2011 (http://www.ofr.gov/OFRUpload/OFRData/2011-28531_PI.pdf), the Internal Revenue Service released proposed regulations (the "Proposed Regulations") that would modify the existing U.S. federal income tax rules applicable to investments made by foreign governments, their agencies, instrumentalities and "controlled entities". While the Proposed Regulations will technically only apply after they are published as final, the Notice's preamble states that taxpayers may rely on them until final regulations are issued.

Background

Section 892 of the U.S. Internal Revenue Code generally excludes certain types of income derived by foreign governments from gross income for U.S. federal income tax purposes. In particular, this exclusion applies to income derived from investments in U.S. stocks, bonds, or other securities (including, in general, any gain recognized on their disposition). However, the Section 892 exclusion does not apply to income (1) derived by a foreign government from the conduct of any "commercial activity", (2) received by a "controlled commercial entity" of a foreign government or received (directly or indirectly) by a foreign government from a "controlled commercial entity" or (3) derived by a foreign government from the disposition of any interest in a "controlled commercial entity". A "controlled commercial entity" is an entity owned by the foreign government that meets certain ownership or control thresholds and that is engaged in "commercial activities" anywhere in the world.

The Proposed Regulations modify the current rules in several favorable respects by (1) providing a new exception to the attribution of "commercial activities" from certain partnerships to a partner, (2) adding exceptions to the list of activities not treated as "commercial activity", (3) allowing a controlled entity not to become a "controlled commercial entity" as a result of "inadvertent commercial activities" and (4) clarifying or modifying certain other miscellaneous provisions in generally favorable ways. In other ways, however, the Proposed Regulations are disappointing in that they leave in place certain peculiar traps for the unwary foreign sovereign investor that are in the existing regulations under Section 892. Perhaps comments, which are due by February 1, 2012, will address some of these unchanged items.

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Limited Partner Exception

Under the current regulations, if an entity controlled by a foreign government engages in even a *de minimis* amount of "commercial activity" anywhere in the world, it will be a "controlled commercial entity" not entitled to the benefits of Section 892 with respect to any of its income (the "all or nothing"–rule).[1] In addition, for this purpose, (1) the activities of a parent "controlled commercial entity" are attributed to its subsidiary controlled entities and (2) the activities of a partnership are attributed to its general and limited partners. Because foreign governments often use controlled entities for non–tax reasons when making investments, rather than making the investments directly, these rules have made foreign governments very sensitive to the possibility that investment in a partnership that might conduct any "commercial activity" (even activity in violation of covenants to the contrary by the partnership and its manager) could taint all the income of the entity making that investment. Consequently, this has led foreign governments to use an increasing number of special purpose companies to isolate the risk of any such negative effect to just the special purpose company making each specific partnership investment.

The Proposed Regulations will likely alleviate some of that concern by providing a new exception to the rule that otherwise attributes partnership activity to its partners for purposes of Section 892. Under this exception, an entity that is not otherwise engaged in "commercial activities" will not be treated as so engaged solely because it holds an interest as a limited partner in a limited partnership (including a publicly traded limited partnership that qualifies as a partnership for tax purposes), provided the limited partner does not (under the law of the jurisdiction in which the partnership is organized or under the governing agreement) have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year. For this purpose, disqualifying management rights do not include consent rights in case of extraordinary events (such as admission or expulsion of a general or limited partner, amendment of the partnership agreement, dissolution of the partnership, disposition of all or substantially all of the partnership's property outside of the ordinary course of the partnership's activities, the merger of the partnership, or its conversion). Controlled entities often enter into side letter agreements when making investments in private equity and hedge funds, or otherwise have certain consent or veto rights under the fund documents, including the right to designate a member of a limited partner advisory committee that has such rights. While the Proposed Regulations appear to intend that such typical consent and veto rights generally should not be treated as disqualifying management rights, further clarification of which customary consent or veto rights are included in this exception would be helpful.

The exception would not change the tax treatment of the controlled entity's distributive share of partnership income attributable to "commercial activity", which would continue to be treated as derived from the conduct of "commercial activity" and ineligible for the Section 892 exclusion. Rather, the exception prevents this income from tainting the controlled entity's other income, which would remain eligible for Section 892 exclusion.

"Inadvertent Commercial Activities" Will Not Result in Controlled Entities Losing the Benefit of Section 892

The Proposed Regulations would change the "all or nothing rule" of Section 892 and provide that a controlled entity will not be considered to be engaged in "commercial activities" if it conducts only "inadvertent commercial activities". However, any income derived from such an "inadvertent commercial activity" will remain ineligible for exclusion under Section 892.

"Commercial activities" of an entity 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

[1] This is not the case with respect to an "integral part" of a foreign government, which, while still subject to tax with respect to income derived from "commercial activities", may continue to claim the benefits of Section 892 with respect to other income.

3. Certain record maintenance requirements are met.

Reasonableness of Failure. Whether an entity's failure to prevent its worldwide activities from resulting in "commercial activity" is reasonable will be determined based on all the facts and circumstances. The Proposed Regulations provide that due regard will be given to the number of "commercial activities" conducted during the taxable year and in prior taxable years, as well as the amount of income earned from, and assets used in, the conduct of the "commercial activities" in relationship to the entity's total income and assets, respectively. Moreover, a failure to avoid "commercial activity" will not be considered reasonable unless there is continuing due diligence to prevent the entity from engaging in "commercial activities" within or outside the United States as evidenced by (1) the adoption of adequate written policies and operational procedures that are intended to monitor the entity's worldwide activities and (2) management level–employees having undertaken efforts to establish, follow and enforce such written policies.

The Proposed Regulations provide a safe harbor, pursuant to which an entity's failure to avoid "commercial activity" during the taxable year will be considered reasonable if

1. adequate written policies and operational procedures are in place to monitor the entity's worldwide activities (as described in the immediately preceding paragraph),
2. the value of the assets used in, or held for use in, all "commercial activities" does not exceed 5% percent of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes, and
3. the income earned by the entity from "commercial activity" does not exceed 5% percent of the entity's gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes. For purposes of determining whether an entity that is a limited partner in a partnership engaged in commercial activities meets this safe harbor, assets used in the conduct of, and income derived from, "commercial activities" by such partnership will only be taken into account if the entity does not meet the limited partner exception described above with respect to such limited partnership interest.

Cure Requirement. A timely cure will be considered to have been made if the entity discontinues the conduct of the "commercial activity" within 120 days of discovery. For example, if an entity that holds an interest as a general partner in a partnership discovers that the partnership is conducting "commercial activity", the entity will satisfy the cure requirement if, within 120 days of discovering the "commercial activity", the entity discontinues the conduct of the activity by divesting itself of its interest in the partnership (including by transferring its interest in the partnership to a related entity), or the partnership discontinues its conduct of "commercial activity".

Record Maintenance. Adequate records of each discovered "commercial activity" and the remedial action taken to cure that activity must be maintained.

Expansion and Clarification of Investment Activities not Constituting "Commercial Activity"

The Proposed Regulations restate the general rule of the existing regulations that, subject to certain exceptions, all activities ordinarily conducted for the current or future production of income or gain are "commercial activities". The Proposed Regulations go on to expand the exceptions for certain investment and trading activities, by providing that investments in not only stocks and debt instruments, but also other "financial instruments"[2], will not be treated as "commercial activities". The treatment to date has been that only financial instruments held in the execution of governmental financial or monetary policy are covered by Section 892, a condition removed by the Proposed Regulations.

[2] A "financial instrument" generally includes any forward, futures, options contract, swap agreement or similar instrument in a currency or in precious metals.

In addition, in what most practitioners would regard as a clarification rather than an expansion, the Proposed Regulations provide that an entity will not be treated as engaged in "commercial activities" solely by reason of a disposition of a "U.S. real property interest" (a "USRPI").[3] Neither of the foregoing changes, however, affect the treatment of the income derived by a foreign government from such financial instruments or the disposition of any such USRPI – such income would remain ineligible for the Section 892 exclusion unless, in the case of financial instruments, such financial instruments are held in the execution of governmental financial or monetary policy or, in the case of a USRPI, such income is not derived from the disposition of a direct interest in U.S. real property (as opposed to the shares of a United States real property holding corporation). The Proposed Regulations, however, do not change the rule that a non-U.S. entity, 50% or more of the assets of which consist of USRPIs, is a controlled commercial entity ineligible for the benefits of Section 892.

Finally, the Proposed Regulations provide that an entity not otherwise engaged in "commercial activities" will not be considered to be engaged in "commercial activities" solely because it is a member of a partnership that effects transactions in stocks, bonds, other securities, commodities, or financial instruments for the partnership's own account, unless the partnership is a dealer.

Annual Determination of Controlled Commercial Entity Status

The Proposed Regulations provide clarification that the determination of whether a controlled entity engages in "commercial activities" will be made on an annual basis. Accordingly, if a controlled entity engages in "commercial activities" at any time during a taxable year, the entity will be considered a controlled commercial entity for the entire taxable year. However, an entity not otherwise engaged in "commercial activities" during a taxable year will not be considered a controlled commercial entity for that taxable year even if the entity engaged in "commercial activities" in a prior taxable year.

Effective Date and Reliance by Taxpayers

As noted in the introduction. while the Proposed Regulations are applicable only upon publication of final regulations in the Federal Register, taxpayers may rely on the Proposed Regulations in the interim period.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work or one of the following Sidley lawyers:

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[3] A USRPI is generally an interest (other than solely as a creditor) in (i) U.S. real estate or (ii) a "U.S. real estate holding corporation" (a "USRPHC"). A USRPHC is generally a corporation, 50% or more of its trade or business assets consist of interests (other than solely as a creditor) in (i) U.S. real property or (ii) other USRPHCs.

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