IRS Issues Proposed Section 892 Regulations

The IRS has issued proposed guidance relating to the taxation of the income of foreign governments from investments in the United States. This guidance affects foreign governmental entities that derive income from sources within the United States, and generally liberalizes certain of the rules impacting the existing limited exemption from U.S. federal income tax applicable to such income.

Earlier this week, the IRS issued proposed Treasury Regulations (the "Proposed Regulations") that provide guidance relating to the taxation of the income of foreign governments from investments in the United States under Section 892 of the U.S. Internal Revenue Code of 1986, as amended. The Proposed Regulations will affect foreign governmental entities that derive income from sources within the United States.

Section 892 In General

In general, Section 892 exempts from U.S. income taxation certain qualified investment income (*e.g.*, income from certain investments in stocks, bonds and other securities) derived by a "foreign government." The term "foreign government" means only the "integral parts"[1] or "controlled entities"[2] of a foreign sovereign. The exemption from U.S. income tax under Section 892 does not apply to income (1) derived from the conduct of any "commercial activity" (defined below), (2) received *by* a "controlled commercial entity" or received (directly or indirectly) *from* a "controlled commercial entity," or (3) derived from the disposition of any interest in a "controlled commercial entity." The term "controlled commercial entity" is defined as any entity owned by the foreign government that meets certain ownership or control thresholds and that is engaged in commercial activities anywhere in the world.

An *integral part* of a foreign sovereign that derives income from both qualified investments and from the conduct of commercial activity is eligible to claim the Section 892 exemption with respect to the income from qualified investments, although not with respect to the income derived from the conduct of commercial activity. By contrast, if a *controlled entity* of the foreign government

[1] In general, an "integral part" of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality or other body, however designated, that constitutes a governing authority of a foreign country.

[2] The term "controlled entity" generally means an entity that is separated in form from a foreign sovereign, is wholly owned and controlled by the foreign sovereign (directly or indirectly), is organized under the laws of the foreign sovereign, the net earnings of which are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person, and the assets of which vest in the foreign sovereign upon dissolution.

engages in commercial activities anywhere in the world, it is treated as a controlled commercial entity, and **none** of its income (including income from otherwise qualified investments) qualifies for exemption under Section 892. In addition, none of the income derived from the controlled entity (*e.g.*, dividends), including the portion attributable to qualified investments of the controlled entity, will be eligible for the Section 892 exemption in such case. This "all or nothing" approach has represented a significant administrative and operational burden for foreign governments and a trap for unwary foreign governments that inadvertently conduct even a small level of commercial activity.

Exception for Inadvertent Commercial Activity

To address this issue, the Proposed Regulations provide that an entity will not be considered to engage in commercial activities if it conducts only "inadvertent commercial activity." 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 met. **If commercial activity is treated as inadvertent, the income derived from such inadvertent commercial activity will not itself qualify for the exemption under Section 892, but the entity will not lose its entitlement to the Section 892 exemption entirely (*i.e.*, the entity will remain eligible for the exemption under Section 892 on qualified (non-commercial activity) investment income).**

In determining whether an entity's failure to avoid conducting a particular commercial activity is "reasonable," the Proposed Regulations provide that due regard will be given to the number of commercial activities conducted during the taxable year, as well as the amount of income earned from, and assets used in, the conduct of the commercial activity in relationship to the entity's total income and assets. 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. **As such, controlled entities of foreign governments are well advised to adopt such policies and procedures as soon as possible.**

The Proposed Regulations include a safe harbor under which, **provided that 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" if: (1) the value of the assets used in, or held for use in, the activity does not exceed five percent (5%) 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 (2) the income earned by the entity from the commercial activity does not exceed five percent (5%) of the entity's gross income as reflected on its income statement for the taxable year as prepared for such purposes.

Annual Determination of Controlled Commercial Entity Status

The Proposed Regulations provide that the determination of whether an entity is a "controlled commercial entity" will be made on an annual basis. **Accordingly, an entity will not be considered a controlled commercial entity for a taxable year solely because the entity engaged in commercial activities in a prior taxable year.** Although this was generally considered by tax practitioners to be the rule prior to issuance of the Proposed Regulations, this is a helpful clarification.

Definition of Commercial Activity — In General

The existing Treasury Regulations under Section 892 provide rules for determining whether income is derived from the conduct of a "commercial activity," and specifically identify certain activities that are not commercial, including certain investments, trading activities, cultural events, non-profit activities and governmental functions. The Proposed Regulations clarify that only the nature of an activity, not the purpose or motivation for conducting the activity, is determinative of whether the activity is a commercial activity. Furthermore, the Proposed Regulations clarify that an activity may be considered a commercial activity even if the activity does not constitute a trade or business for other U.S. federal income tax purposes.

Definition of Commercial Activity — Financial Instruments

The existing Treasury Regulations under Section 892, provide that investments in financial instruments (generally defined to include any forward, futures or options contract, swap agreement or similar instrument in a functional or nonfunctional currency or in precious metals), are not treated as "commercial activities" if held in the execution of governmental financial or monetary policy. The Proposed Regulations modify this rule by providing that investments in financial instruments will not be treated as commercial activities irrespective of whether such financial instruments are held in the execution of governmental financial or monetary policy. Similarly, the Proposed Regulations expand the existing exception from commercial activity for trading of stocks, securities, and commodities to include financial instruments, without regard to whether such financial instruments are held in the execution of governmental financial or monetary policy.

The foregoing modifications address **only** the definition of commercial activity for purposes of determining whether a government will be considered to derive income from the conduct of a commercial activity, or whether a controlled entity will be considered to be engaged in commercial activities. They do not address whether income from activities that are not commercial activities will be exempt from U.S. tax under Section 892. As such, the Proposed Regulations do not change the existing rule that only income derived from investments in financial instruments held in the execution of governmental financial or monetary policy qualifies for the exemption under Section 892.

Definition of Commercial Activity —U.S. Real Property Interests

In general, a nonresident alien or foreign corporation is required to take into account gain or loss from the disposition of a U.S. real property interest (a "USRPI") as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with that trade or business. **The Proposed Regulations provide that a disposition (including a deemed disposition by way of "capital gain" dividends from a real estate investment trust or certain regulated investment companies) of a USRPI, by itself, does not constitute the conduct of a commercial activity. However, the Proposed Regulations do not change the existing rule that the income derived from the disposition of a USRPI (other than a non-controlling interest in a so-called "U.S. real property holding corporation") does not qualify for the exemption under Section 892.**

Investments in Partnerships

In general, commercial activities of a partnership are attributable to its general and limited partners (the "partnership attribution rule"), subject to a limited exception for partners of publicly traded partnerships ("PTPs"). The Proposed Regulations provide a more general exception for limited partnership interests. Under this 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," including a PTP that qualifies as a limited partnership.

For this purpose only, an interest as a limited partner in a limited partnership is defined as an interest in any entity classified as a partnership for U.S. federal tax purposes if the holder of the 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 under the law of the jurisdiction in which the partnership is organized or under the entity's governing agreement.

Notwithstanding the above, a limited partner's distributive share of partnership income attributable to commercial activity will be considered to be derived from the conduct of commercial activity, and therefore will not be exempt under Section 892. Furthermore, in the case of a partnership that itself is a controlled commercial entity, no part of the foreign government partner's distributive share of income from such partnership will qualify for the exemption under Section 892.

The expanded exception under the Proposed Regulations for commercial activities derived through a partnership may impact the fashion in which private equity funds and hedge funds structure investment vehicles for foreign government investors, and may avoid the need for certain parallel investment structures in order to avoid a commercial activity issue. However, it is unclear whether a foreign government that is a partner in a partnership and that is not allocated any commercial activity income would nonetheless still be required to file a U.S. tax return.

In general, trading for a foreign government's own account does not constitute a commercial activity. The Proposed Regulations clarify that an entity that is 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. However, this exception does not apply in the case of a partnership that is a dealer in stocks, bonds, other securities, commodities or financial instruments.

Effective Date

The Proposed Regulations are proposed to apply on the date they are published as final Treasury Regulations. However, taxpayers are permitted to rely on the Proposed Regulations immediately and until they are modified, revoked or finalized.

Some Things Not Addressed

Although, in general, the proposed regulations are helpful in clarifying and easing certain of the Section 892 rules, they fail to deal with certain issues that foreign governments and their U.S. tax advisors have long wrestled with. These include, for example, (1) no relaxation of the rule making

a controlled entity ineligible for exemption if such entity would qualify as a "U.S. real property holding corporation" were it formed under U.S. law and (2) maintenance of the rule requiring taxation of REIT liquidating distributions and REIT capital gain dividends even if the REIT is a non-controlled entity or a "domestically controlled" REIT, gain on sale of which would not be taxable. Hopefully, these two issues will be addressed in the near future.

Please feel free to contact any of these Kaye Scholer attorneys if you have questions about this Client Alert.

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