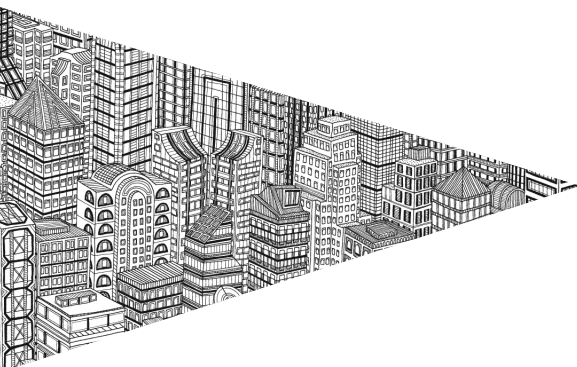


International Tax Alert



Treasury and IRS issue proposed regulations on the taxation of income of foreign governments under Section 892

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Executive summary

On 2 November 2011, the Internal Revenue Service and Treasury issued proposed regulations (REG-146537-06) (the proposed regulations) that provide guidance on the taxation of income of foreign governments from investments in the United States under Section 892 of the Internal Revenue Code. The proposed regulations modify in part the temporary and proposed regulations that were issued on 27 June 1988 (TD 8211, 53 FR 24060) (the 1988 temporary regulations).

The proposed regulations contain generally positive modifications to the current Section 892 rules, including:

- ▶ An exception to the “all or nothing” rule for inadvertent commercial activity
- ▶ Annual determination of controlled commercial entity status
- ▶ Guidance that commercial activities will *not* include:
 - Investing in financial instruments (including derivatives), regardless of whether they are held in the execution of governmental financial or monetary policy
 - Disposing of a US real property interest
 - Holding certain limited partnership interests or being a partner in a partnership that is engaged in trading activity for its own account

The preamble to the proposed regulations states that the regulations are not effective until they are published as final regulations in the Federal Register, but taxpayers may rely on the proposed regulations until final regulations are issued.

Detailed discussion

Background

Under Section 892, US source income (e.g., dividends, interest, capital gains) received by foreign governments (including their controlled entities) from investments in the United States in stock, bonds, or other domestic securities, or financial instruments held in the execution of governmental financial or monetary policy, is generally not subject to US federal tax.

This exemption for qualified investments under Section 892 does not apply, however, to income (1) derived from the conduct of any commercial activity; (2) received from or by a controlled commercial entity; or (3) derived from the disposition of any interest in a controlled commercial entity.

A “controlled commercial entity” means any entity that is at least 50 percent owned by the foreign government (measured by voting power or value), and that is engaged in commercial activities within or outside of the United States. The 1988 temporary regulations include rules for determining whether income-generating activities conducted by foreign governments or entities controlled by foreign governments are commercial

or noncommercial. In general, under the regulations, a foreign government or an integral part of it that derives income from qualified investments and from conducting commercial activity is eligible to claim a Section 892 exemption for income from qualified investments but not for commercial activity income. In contrast, these regulations provide that if a controlled entity earns any amount of income (even a *de minimis* amount) from commercial activity, then all of the income of the controlled entity—from both commercial and noncommercial activities—will be disqualified with respect to the Section 892 exemption (the all or nothing rule).

Treasury and the IRS received numerous comment letters from taxpayers focusing on the “all or nothing” rule and the burden it placed on foreign governments to ensure that their commercial entities did not inadvertently conduct even insignificant amounts of activity that could be considered commercial activity, especially as “commercial activity” was so broadly defined under the 1988 temporary regulations. According to the preamble, the proposed regulations have been issued expressly to address this and other issues raised in taxpayers’ comment letters.

Clarification of the Definition of Commercial Activity - Prop. Treas. Reg. Section 1.892-4

Prop. Treas. Reg. Section 1.892-4(d) adopts the general rule of the 1988 temporary regulations that, subject

to certain enumerated exceptions, all activities ordinarily conducted for the current or future production of income or gain are commercial activities. The proposed regulations clarify that “only the nature of the activity, not the purpose or motivation for conducting the activity, is determinative of whether the activity is commercial in character.” The proposed regulations also provide that an activity may be considered a commercial activity even if the activity does not constitute a trade or business for purposes of Section 162 or does not constitute (or would not constitute if undertaken in the United States) the conduct of a trade or business in the United States for purposes of Section 864(b).

Investing and Trading in Financial Instruments

Prop. Treas. Reg. Section 1.892-4(e)(ii) expands the commercial activities exception for trading in stocks, securities and commodities, by providing that investments in financial instruments (e.g., futures, forwards, options, derivatives) will not be considered commercial activities, irrespective of whether such financial instruments are held in the execution of governmental financial or monetary policy. The preamble clarifies that this rule only addresses the definition of commercial activity; it does not address whether income from activities that are not commercial activities will be exempt from tax under Section 892. Thus, pursuant to Treas. Reg. Section 1.892-3T(a), only income derived from investments in financial

instruments held in the execution of governmental financial or monetary policy will qualify for the Section 892 exemption.

Investments in US real property

Prop. Treas. Reg. Section 1.892-4(e)(iv) provides that the disposition (including a deemed disposition under Section 897(h)(1)) of a US real property interest does not constitute the conduct of a commercial activity. However, similar to the 1988 temporary regulations, the proposed regulations provide that income from the disposition of a US real property interest (other than an interest in a US real property holding company that is not a controlled entity) will not qualify for the Section 892 exemption from tax.

Controlled Entities - Inadvertent Commercial Activity Exception - Prop. Treas. Reg. Section 1.892-5

Prop. Treas. Reg. Section 1.892-5(a)(2) provides that an entity will not be considered engaged in commercial activities if it conducts only "inadvertent" commercial activity. Thus, the conduct of inadvertent commercial activity will not cause the entity to be a controlled commercial entity for purposes of Section 892, although any income from such inadvertent commercial activity will not qualify for the Section 892 exemption. A commercial activity will be treated as inadvertent only if:

- ▶ The failure to avoid conducting the commercial activity is reasonable under the specific facts and circumstances, considering the

number of commercial activities conducted during the year and in prior years, as well as the amount of income earned from (and assets used in) the conduct of the commercial activities relative to the entity's total income and assets;

- ▶ The commercial activity is promptly cured within 120 days of discovery; and
- ▶ Certain record maintenance requirements are met.

The proposed regulations introduce a safe harbor pursuant to which a failure to avoid conducting a commercial activity is deemed reasonable if (1) the value of the assets used in, or held for use in, all commercial activity is five percent or less of the entity's total asset value for the taxable year; and (2) the income from the commercial activity does not exceed five percent of the entity's gross income.

In addition, to qualify for the inadvertent commercial activity exception, the entity must keep records of each commercial activity it discovers and the curative action taken. Also, the entity must have adequate written policies and operational procedures in place to monitor its worldwide activities. The proposed regulations specify that a failure to avoid commercial activity will not be considered reasonable if management-level employees have not undertaken reasonable efforts to establish, follow and enforce such policies and procedures.

Prop. Treas. Reg. Section 1.892-5(a)(3) provides that the determination of whether an entity is a controlled commercial entity will be made on an annual basis. Thus, 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.

Treatment of Partnerships - Prop. Treas. Reg. Section 1.892-5(d)(5) *Partnerships engaged in trading activities*

Prop. Treas. Reg. Section 1.892-5(d)(5)(ii) provides that an entity will not be treated as engaged in commercial activities solely because it is a partner in a partnership that engages in trading activities for the partnership's own account in stocks, bonds, other securities, commodities, or financial instruments (or does so through a broker, commission agent, custodian, or other independent agent). Nonetheless, this exception does not apply in the case of a partnership that is a dealer in stocks, bonds, other securities, commodities, or financial instruments.

Limited partnership interests

The 1988 regulations provide a general rule that commercial activities of a partnership are attributable to its general and limited partners ("partnership attribution rule") and provide a limited exception to this rule for partners of publicly traded partnerships (PTPs). Under the proposed regulations, this attribution rule continues to apply to general

partners. However, Prop. Treas. Reg. Section 1.892-5(d)(5)(iii) provides that if an entity is not otherwise engaged in commercial activities, it will not be deemed engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership. However, even if the exception applies, the entity's distributive share of partnership income attributable to such commercial activity will not be exempt from taxation under Section 892. The proposed regulations define a limited partner interest as one in which the holder does not have rights to participate in the management and conduct of the partnership's business at any time during the taxable year under the law of the jurisdiction where the partnership is organized, or under the governing agreement.

Effective date

The preamble to the proposed regulations states that the regulations are not effective until they are published as final regulations in the Federal Register, but taxpayers may rely on the proposed regulations until final regulations are issued.

Implications

While the proposed regulations may not address all the concerns taxpayers have expressed about the 1988 temporary regulations during the past 20 years, they provide significant relief with respect to the "all or nothing" rule, which for many, especially for sovereign wealth funds, was the chief objection to the earlier guidance. The revised rules for attribution of partnership

activities are also welcome in that they will allow foreign government-controlled entities (particularly private equity funds and other investment partnerships) to participate in a broader range of investment vehicles with less risk of tainting the 892 status of the controlled entity.

The preamble notes that Treasury and the IRS will consider comments on the proposed regulations before adopting them as final regulations; no comment deadline was provided, and a public hearing on the proposed regulations has not yet been scheduled. Foreign governments and their controlled entities (including sovereign wealth funds) may want to consider suggesting further refinements to the proposed rules.

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