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Representing Sovereign Wealth Funds

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In this article, Kreisberg examines the federal income tax treatment of sovereign wealth funds, with and without the benefit of section 892, and highlights practical strategies for structuring their investments.

As the world battles the COVID-19 pandemic, businesses large and small are experiencing a liquidity crisis, despite the unprecedented easing measures taken by the Federal Reserve and similar non-U.S. bodies. In times of crisis, such as the Great Recession, when capital is scarce, sovereign wealth funds (SWFs) play an important role as a deep source of capital that can provide a lifeline to struggling businesses. This indeed is playing out in the current crisis, maybe more so than at any previous time in history, as the scope of SWF strategies and investments has never been so broad.

SWFs invest in almost every asset class — from blind pool funds to direct investments in landmark real estate and infrastructure projects to unicorn tech companies to entertainment and media. Chances are that if you walk into a famous building or use a billion-dollar app, one or more SWFs are behind it. As time goes on, these institutions are becoming more hands-on with their investments, driving terms. Blind pool funds are increasingly viewed as a vehicle to gain exposure to co-investment opportunities. Some SWFs are even beginning to sponsor their own funds, capitalizing on their relationships and industry expertise, a trend this author believes will only increase over time.

The United States and many other countries are keenly aware of the importance to their economies of encouraging SWF investment and, accordingly, offer material tax advantages to such investors. While the United States encourages offshore capital generally, including, for example, by sourcing capital gain based on the residence of the seller (subject to exceptions for investments in U.S. real property), section 892 provides additional benefits to SWFs that are not available to nongovernmental investors. This article addresses the U.S. federal income tax treatment of SWFs, with and without the benefit of section 892, and includes practical strategies for structuring their investments.

I. Foreign Governments, in General

Foreign governments are generally treated as foreign corporations for federal income tax purposes, with section 892 acting as an overlay to the rules applicable to nongovernmental entities. This is similar to the way in which real estate investment trusts are generally treated as corporations, with the REIT rules acting as an overlay. To the extent section 892 is not available for a particular investment, the foreign government will essentially be treated as any other non-U.S. corporate investor.

A. U.S. Trade or Business

The primary focus of non-U.S. investors, including foreign governments, is to avoid being engaged in a U.S. trade or business (USTB), as defined in section 864(b), as this triggers a U.S. tax return filing obligation and subjects the investor to the full investigatory authority of the IRS. This means that the IRS can subpoena documents, emails, minutes from board meetings, individual board members, and so forth, risking lasting

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reputational harm to the investing entity and the individuals who control it. In addition to the disclosure of potentially sensitive information, there is also the risk that an IRS audit could subject some or all of the investor's other investments to U.S. tax return filing and payment obligations. For this reason, investments with a high USTB risk should generally be held in special purpose vehicles to protect the investor's other investments.

Under section 875, if an entity treated as a partnership for federal income tax purposes is engaged in a USTB, then a non-U.S. investor that is a partner in that partnership will be treated as engaged in a USTB as well. Such investments by non-U.S. investors should generally be held through U.S. corporate blockers (including REITs, when appropriate), which can often be leveraged to reduce tax drag. However, the reinstatement of downward attribution under the Tax Cuts and Jobs Act has jeopardized the use of the portfolio interest exemption (PIE) in many instances in which the non-U.S. investor owns more than 50 percent of the vote or value of the U.S. blocker (a situation that would also preclude use of section 892 by an SWF), making the use of leveraged blockers more of a challenge. Nonetheless, there are still workarounds to downward attribution and, even in the absence of such workarounds, distributions that would otherwise constitute withholdable dividends can be made as tax-free principal repayments in the leveraged blocker structure.[1]

B. FIRPTA

Gain from the sale of a capital asset is generally sourced based on the residence of the seller.[2] As such, a non-U.S. investor can typically sell stock and securities tax free, unless those stocks or securities represent U.S. real property interests (USRPI), as defined in section 897(a). Section 861(a)(5) provides that gain from the sale of a USRPI is U.S. source, and section 897(a), promulgated under the 1980 Foreign Investment in Real Property Tax Act, provides that such gain will be treated as effectively connected with a U.S. trade or business, triggering withholding of 15 percent on the gross proceeds[3] and a U.S. tax return filing and payment obligation. Moreover, gain on sales of interests in a partnership with any underlying USRPIs triggers a U.S. tax return filing and payment obligation[4] and results in 15 percent withholding tax on the total amount realized unless the partnership satisfies the "50/90" test set forth in reg. section 1.1445-11T.[5]

A USRPI includes any interest in real property other than an interest solely as a creditor.[6] Stock in a corporation is treated as a USRPI to the extent the corporation is a U.S. real property holding corporation (USRPHC) at any point over the shorter of the investor's holding period and a five-year lookback period (the testing period). In general, a USRPHC is any U.S. corporation 50 percent or more of whose total real property (U.S. and non-U.S.) and trade or business assets constitute USRPIs,[7] measured by fair market value and applied by looking through 50 percent or more owned subsidiaries (by value).[8] Importantly for section 892 purposes, as discussed under Section II.F, stock and securities will be treated as used in an entity's trade or business, and thus included in the denominator, if the FMV of such assets equals or exceeds 90 percent of the FMV of the entity's real property and other trade or business assets (the investment company test).[9] Also significant is that, solely for purposes of determining USRPHC status, an interest in a foreign corporation is treated as a USRPI unless it is established that such foreign

[1] A Treasury official has commented that the effect of downward attribution on the portfolio interest exception was an unintended consequence, noting, however, Treasury's belief that it lacks regulatory authority to resolve the issue. Congress included a fix to this issue in the initial draft of the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136), but that fix was removed in subsequent drafts. The motive for removing the fix is unclear.

[2] Section 861.

[3] Section 1445.

[4] Section 897(g).

[5] Either 50 percent or more of the value of the gross assets of the partnership does not consist of USRPIs or 90 percent or more of the value of the gross assets of the partnership does not consist of USRPIs plus "cash or cash equivalents," within the meaning of reg. section 1.1445-11T(d)(1).

[6] Reg. section 1.897-1(d).

[7] Section 897(c)(2); and reg. section 1.897-2(b).

[8] Section 897(c)(5); and reg. section 1.897-2(e)(3).

[9] Reg. section 1.897-1(f)(iii).

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corporation is not a USRPHC, applying the rules described above as if it were a U.S. corporation.[10] Stock in a USRPHC will not be treated as a USRPI if it is of a class that is publicly traded, subject to specific ownership thresholds,[11] or if the USRPHC has qualified as a "domestically controlled qualified investment entity" (typically a domestically controlled REIT or "DREIT") over the shorter of the time in which the entity has been in existence or a five-year lookback period (the DREIT testing period).[12]

An interest other than solely as a creditor generally includes any right to share in the appreciation in value in, or gross or net proceeds from, real property, including stock, options, convertible instruments, stock appreciation rights, and the like.[13] Thus, a convertible debt interest is an interest other than solely as a creditor, and if the issuer is a USRPHC, such debt interest is a USRPI. This means that any gain on the sale of that debt instrument will be subject to FIRPTA, although payments of interest and principal and any gain realized on conversion will not.[14]

II. Section 892

A. Benefits

When section 892 applies, it exempts from federal income tax U.S.-source income on stocks, bonds, other domestic securities, and financial instruments held in the execution of governmental financial or monetary policy. Note that non-U.S. investors without section 892 status are generally exempt from U.S. tax on gain from sales of stock, absent FIRPTA, and on interest payments to the extent PIE or a treaty applies. As such, the main benefits of section 892 are for (1) withholding tax on dividends to the extent not otherwise reduced or eliminated by treaty, (2) withholding tax on interest to the extent not eliminated by PIE (such as for contingent interest) or by treaty, and (3) sales of minority-owned USRPHCs for which an exception to FIRPTA does not otherwise apply and for which reg. section 1.892-5T(b) does not apply (as discussed further under Section II.F).

Section 892 does not apply to royalties and, more importantly, it does not by its terms apply to gain from sales of partnership interests, regardless of the nature of the partnership's underlying assets. This is a curious result. One would think that the drafters would have chosen either (1) an entity approach, in which partnership interests are treated as a capital asset, eligible for the benefits of section 892 much like stock, possibly subject to specific exceptions in the nature of "hot assets," or (2) an aggregate approach, in which partnerships are looked through and section 892 is applied based on the nature of the underlying assets. Instead, section 892 gets "turned off" on such transactions (subject to a few daring practitioners and clients who think this result is too absurd and decide to turn it back on). Rather than expressing a specific viewpoint on the issue, it may be that Congress and Treasury were simply not prepared to resolve the tension between the aggregate theory and entity theory as it relates to section 892, as had been the case for so long concerning sales of partnership interests and effectively connected income. Maybe now, following the passage of section 864(c)(8), which applies a look-through approach on sales of partnership interests for determining effectively connected income, Congress or Treasury will decide to apply this approach to section 892 as well.

In practice, this means that in order for an SWF to take advantage of section 892 on an exit from a partnership investment, one of two things must happen: either (1) the partnership sells the underlying portfolio company and distributes out the proceeds, in which case the character of the sale will flow through to the SWF; or (2) the partnership distributes out the underlying portfolio company to the SWF and allows the SWF to effectuate the sale. Option (1) works well when the partnership as a whole has determined to exit the underlying investment, but it does not work as well when only the SWF wants to exit. In that case, the partnership could theoretically sell only a portion of the investment and make a special allocation of the income to the SWF, but

[10] Section 897(c)(4); and reg. section 1.897-2(e)(1).

[11] Section 897(c)(3), (h)(6).

[12] Section 897(h)(4)(E).

[13] Reg. section 1.897-1(d)(3).

[14] Reg. section 1.897-1(h), Example 2.

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one can expect lawyers for the other investors to express concern that such special allocation will not be respected, subjecting the other investors to unintended tax consequences. Option (2) is the preferred approach when the SWF wants to exit and the other partners want to continue with the underlying investment. SWFs can typically negotiate for option (2) as a special exit right in the partnership agreement or a side letter, although the general partner may insist on the right to require the purchaser of the SWF's allocable share of the underlying investment to recontribute the purchased interest to the partnership to achieve the same result as if the SWF had sold partnership interests. When drafting those arrangements, it is best for the general partner to have the option to require such recontribution rather than for it to be hard-wired to avoid the IRS recharacterizing the transaction as a sale of partnership interests.

B. Qualification

Only foreign governments can claim the benefits of section 892. A foreign government includes both integral parts and controlled entities. An integral part 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, with no portion of the net earnings of which inuring to the benefit of any private person.[15] A controlled entity is an entity that is separate in form from the foreign sovereign although organized in the same jurisdiction and that is wholly owned, directly or indirectly through one or more controlled entities, by the foreign sovereign.[16]

For section 892 to apply, the income must not be from commercial activities and must not be received by or from a controlled commercial entity (CCE).[17] A CCE is defined as any entity engaged in commercial activities, whether conducted within or outside the United States, if the foreign government "holds (directly or indirectly) any interest in such entity which (by value or voting power) is 50 percent or more of the total of such interests in such entity" or holds any other interest in such entity, by vote, value, or otherwise, which provides the foreign government with "effective practical control" of such entity.[18]

C. Controlled Commercial Entities

There are a few things to unpack from the definition of a CCE. For starters, commercial activities can take place anywhere in the world to satisfy the first prong of the definition, not just in the United States. This is similar to how unrelated business taxable income is measured for tax exempts, which can occur anywhere in the world, but unlike how ECI is measured for regular non-U.S. investors, which is limited to income effectively connected with a trade or business in the United States.

The "by or from" language means that the portfolio company generating the income ("from") must not be a CCE and that the governmental investing entity receiving the income ("by") must also not be a CCE. The portfolio company will of course be engaged in commercial activities, the first prong of the CCE test described earlier, so the key for such entities is making sure that the governmental investing entity does not own 50 percent or more of the vote or value or have effective practical control. The governmental investing entity, on the other hand, will by default be "controlled," as it must be 100 percent owned by the government to claim section 892 benefits, so the key for that entity is making sure it is not treated as engaged in commercial activities.

The ownership test is applied based on both direct and indirect ownership. There are no constructive ownership rules under section 892 — no references to section 318, 267(b), or 707(b) — but rather SWFs are left with the more vague "direct or indirect" standard. Practically speaking, this requires SWFs to assess all ownership in an underlying entity to determine its CCE status, on a governmentwide basis, regardless of each potential investor's percentage interest, type of intermediate entities, or branch of government. This can often be difficult to assess,

[15] Reg. section 1.892-2T(a)(2).

[16] Reg. section 1.892-2T(a)(3).

[17] Section 892(a)(2).

[18] Reg. section 1.892-5T(a).

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as many foreign governments have multiple arms through which they invest, and the different arms are often not coordinated, not to mention the trillions of dollars of investments, which can be difficult to keep track of. Blind pool investments make this even more difficult. In light of these difficulties, SWFs will often request that sponsors monitor the SWF's ownership interest in the underlying portfolio companies, arguing that the sponsor is in a better position to know who the investors are than the SWF. Of course, this often leads to difficult negotiations, as sponsors prefer to not be responsible for monitoring actions taken by the SWF's own affiliates.

One interesting point to consider in the definition of a CCE is the reference to owning "any interest" in an entity and whether "such interest" is 50 percent or more of the total of "such interests" in such entity. This may lead one to argue that the 50 percent ownership test should be applied class by class rather than in the aggregate. For example, if a corporation has an equal amount of common and preferred shares outstanding, and an SWF owns 80 percent of the common and 40 percent of the preferred, so that it owns 60 percent of the total equity, is it possible to claim section 892 benefits on dividends from the preferred shares (of which it only holds 40 percent)? Arguably the preferred constitutes "any interest" that is separate from the common, and the SWF owns less than 50 percent of the total of "such interests." While this approach has some intellectual appeal, ultimately it would be too easy an end run around the limitations of section 892, and any time the aggregate ownership exceeds 50 percent, one would have to address "effective practical control." The 50 percent test should therefore be applied on an aggregate basis.

A more fundamental issue in the definition of a CCE is determining what rights should be counted for purposes of measuring the 50 percent voting power test as well as "effective practical control." While there is no direct authority in the section 892 context, this issue comes up throughout the code any time the rules hinge on a voting power threshold, such as, for example, affiliation under section 1504, the portfolio interest exception, treatment as a U.S. shareholder for purposes of subpart F and global intangible low-taxed income, whether there has been a substantially disproportionate reduction under section 302, whether a REIT is internally managed, and so forth. Voting power is most clearly defined by the ability to appoint directors, which can be measured on a simple pro rata basis.[19] It gets complicated, however, when dealing with negative veto rights over an action, or when an action requires a supermajority vote, whereby an SWF can unilaterally block the action, thereby exerting greater than 50 percent control with respect thereto. The answer should generally be that those rights do not count for purposes of the voting power test or effective practical control to the extent they relate to fundamental matters necessary to protect the investment rather than everyday operational issues.

The landmark case addressing this issue is *Alumax*,[20] in which the court looked beyond the mere ability to appoint directors and instead considered the shareholders' ability to manage the business of a subsidiary for purposes of determining whether one of the shareholders held 80 percent of the voting power, which would allow the shareholder to include the subsidiary in its consolidated return. Those rights were implemented by issuing separate classes of stock, with the minority class being entitled to appoint directors who in turn had supermajority voting rights over a list of fundamental issues. The court held that these supermajority voting rights constituted voting power so that the holder of the majority class of stock did not meet the 80 percent voting power test and could not include the subsidiary in its consolidated return. The supermajority rights applied to mergers, purchases, or sales of assets worth more than 5 percent of Alumax's net worth; partial or complete liquidation of Alumax; any appropriation of capital in excess of $30 million; the appointment or dismissal of the CEO; and any loans to affiliated corporations not in the ordinary course of business. The court was particularly influenced by the power of the minority class to effectively veto the appointment or dismissal of the CEO, as hiring and firing of officers is one of the core functions traditionally allocated to the

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[19] Rev. Rul. 69-126, 1969-1 C.B. 218; and *Erie Lighting Co. v. Commissioner*, 93 F.2d 883 (1st Cir. 1937).

[20] *Alumax Inc. v. Commissioner*, 165 F.3d 822 (11th Cir. 1999).

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board. Another unique fact is that Alumax's certificate of incorporation required Alumax to distribute 35 percent of its annual net income as dividends, thereby taking away another core function of the board, determining the amount and timing of dividends. Although not necessarily conferring voting power on the minority shareholders, that provision did sufficiently weaken the authority of the board enough to call into question the propriety of relying on the traditional measure of voting power, the ability to appoint directors.

Alumax does not set forth a complete list of negative veto rights or supermajority voting rights that would be considered voting power, although it does stand for the proposition that those rights may indeed be relevant. While no such list exists, the guiding principle when measuring voting rights and effective practical control under section 892 should be that the SWF is entitled to those rights over material issues that will significantly affect the value of its investment but not to the extent those rights confer to the SWF the power to manage the day to day operations of the business.[21]

To be clear, effective practical control is not coterminous with 50 percent voting power. Effective practical control can result by holding a minority interest that is sufficiently large to achieve effective control when paired with other creditor, contractual, or regulatory relationships.[22]

D. Commercial Activities

As mentioned earlier, section 892 does not apply to income from commercial activities, which is relevant when investing from an integral part. Section 892 also does not apply to income received by CCEs, which are controlled entities engaged in commercial activities. Despite the significance of what constitutes commercial activities under section 892, the code and Treasury regulations provide only a vague definition and a list of activities that do not constitute commercial activities.

The regulations state, unhelpfully, that "all activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or other persons with a view towards the current or future production of income or gain are commercial activities."[23] Commercial activities do not, however, include investments in stocks, bonds, securities, net leases, land not producing income, sale of USRPIs (although the gain associated therewith is not generally eligible for the exemption, unless the USRPI is a minority interest in a USRPHC), trading, and investing in financial instruments "held in the execution of governmental financial or monetary policy."[24] The proposed regulations turn off the requirement that investments in financial instruments must be "held in the execution of governmental financial or monetary policy," presumably because no one knows what that means.[25]

The reference in the definition quoted above to activities ordinarily conducted by "other persons" implies that even if the SWF has no commercial motive for engaging in an activity, the fact that other persons ordinarily engage in such activity for profit is enough to cause the SWF to be treated as engaged in commercial activities. This is made explicit in the proposed regulations, which state, "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."[26] That said, it begs the question what is meant by the "nature of the activity" and whether that phrase can be interpreted to include the surrounding facts and circumstances, which may or may not bear on "purpose or motivation."

While the definition of commercial activities will naturally overlap with the definition of a USTB, there are key differences. As mentioned earlier, commercial activities can occur anywhere in the world, whereas a USTB requires a U.S. nexus. Moreover, reg. section 1.892-4T(b) specifies that an activity can be considered a commercial activity even if that activity does not constitute a USTB (or a trade or business under section 162),

[21] *See also Hermes Consolidated Inc. v. United States*, 14 Cl. Ct. 398 (1988).

[22] Reg. section 1.892-5T(c)(2).

[23] Reg. section 1.892-4T(b).

[24] Reg. section 1.892-4T(c).

[25] REG-146537-06.

[26] Prop. reg. section 1.892-4(d).

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suggesting that the definition of commercial activities is potentially broader than USTB, above and beyond the geographical difference.

Similar to how section 875 applies in the USTB context, reg. section 1.892-5T(d)(3) provides that the commercial activities of a partnership are attributable to its partners for purposes of section 892, although the section 892 proposed regulations provide a significant exception for which there is no USTB corollary. Prop. reg. section 1.892-5(d)(5)(iii) provides that an entity that is not otherwise engaged in commercial activities will not be attributed the commercial activities of the partnership in which it holds a limited partner interest. A limited partner interest is defined as one in which the SWF does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's tax year under the law of the jurisdiction in which the partnership is organized or under the governing agreement, although the SWF is entitled to consent rights over specific extraordinary events, including but not limited to admission or removal of a general or limited partner, amendment of the partnership agreement, dissolution of the partnership, disposition of all or substantially all the partnership's property outside the ordinary course of business, merger, or conversion.[27] Due to the factual nature of this inquiry, and the fact that the regulations are only in proposed form (despite taxpayers being allowed to rely on them currently), in practice SWFs will typically choose to rely on this exception only as a matter of last resort.

It is important to note the distinction between whether something constitutes a commercial activity, on one hand, and whether income therefrom is eligible for exemption under section 892, on the other hand. While there is significant overlap, there are distinctions as well, and the two concepts must be thought of separately. For example, while the "limited partner exception" in the proposed regulations, discussed earlier, will prevent commercial activities of a partnership from being attributed to an SWF limited partner, operating income from the partnership will not generally be eligible for the exemption under section 892 (and, as a side note, may also create a USTB). Similarly, the proposed regulations provide that a sale of a USRPI is not treated as commercial activity, but nonetheless gain therefrom is not exempt under section 892 (unless it is a minority interest in a USRPHC and reg. section 1.892-5T(b) does not apply, as discussed later). As one final quirk, the proposed regulations provide that investments in financial instruments need not be for the purpose of "governmental financial or monetary policy" to avoid commercial activity status, but they do need that purpose to be eligible for the exemption under section 892. What then is the purpose of avoiding commercial activity status if the income therefrom is not exempt? The answer is that it prevents controlled entities from becoming CCEs and losing the section 892 exemption on all the CCE's other investments.

E. Integral Parts Versus Controlled Entities

A key distinction between integral parts and controlled entities is that if an integral part is treated as engaged in commercial activities, it will only taint for section 892 purposes the income associated with those activities, whereas if a controlled entity is treated as engaged in commercial activities, it will become a CCE and lose its 892 status for all its income on all its investments. Before the 2011 proposed Treasury regulations, there was an open question as to the duration of the commercial activities taint. Was it "once a CCE, always a CCE," as in the passive foreign investment company rules? The proposed regulations provide relief on this point, specifying that when a 50 percent owned entity (or one in which the SWF has effective practical control) engages in commercial activities in a tax year, those commercial activities will taint the entity for that entire year, but the taint will not carry over to the succeeding tax year.[28] Thus, the determination is made annually. Query what happens if the entity is engaged in commercial activities throughout a tax year, but the SWF sells down its ownership interest so that it no longer owns 50

[27] Prop. reg. section 1.892-5(d)(5)(iii)(B). Note, this list may be indicative of what rights a shareholder can have without it constituting "voting power," as discussed earlier.

[28] Prop. reg. section 1.892-5(a)(3).

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percent nor has effective practical control over the entity in that year. Does the prior ownership interest (or effective practical control) taint the entity for that entire year or even subsequent years? The proposed regulations do not address this scenario, as they assume 50 percent ownership or effective practical control and thus only address the commercial activities prong. Nonetheless, once one falls below the ownership threshold (and there is no effective practical control), this should be an automatic kick-out from CCE status, effective immediately, as a basic, black-and-white requirement to be treated as a CCE is no longer present. This could be made clearer, although, if and when final regulations are issued.

While integral parts have the advantage of commercial activities only tainting the income generated therefrom, in practice SWFs investing through integral parts will still take great pains to avoid being treated as engaged in commercial activities in any scenario. This is true even for investments made outside the United States, in which the income generated would not be eligible for section 892 in any event (section 892 only applies to exempt U.S.-source income). Note also that while the commercial activities of a parent-controlled entity are attributed down to its subsidiaries (but not between brother/sister controlled entities),[29] the commercial activities of an integral part are not attributed down. While this approach of integral parts avoiding commercial activities in all scenarios may seem overly conservative and not grounded in the law, there are corollaries throughout the tax practice in which lawyers exercise an abundance of caution to sleep better at night. Think about protective check-the-box elections for non-U.S. entities whose default status matches the election made on the form, or section 83(b) elections filed for unvested profits interests despite Rev. Proc. 2001-43, 2001-2 C.B. 191, explicitly stating that this is not necessary. Those actions may not be strictly necessary, but they give peace of mind and protect against change in law risk.

[29]Reg. section 1.892-5T(d).

F. FIRPTA

One of the great advantages of section 892 is the ability to invest in U.S. real estate on a reduced or even tax-free basis. Gain from the sale of stock in a USRPHC is exempt from tax under section 892 provided two general requirements are satisfied: (a) the SWF owns less than 50 percent of the vote and value of the USRPHC and does not have effective practical control thereof so that the USRPHC is not a CCE (the "from" test); and (b) holding stock of the USRPHC does not make the purported 892-eligible investing entity a controlled commercial entity under reg. section 1.892-5T(b) (the "by" test).

A trap for the unwary, reg. section 1.892-5T(b) generally provides that an entity that would be treated as a USRPHC but for the fact that it is organized outside the United States shall be treated as engaged in commercial activities. In effect, this means that a section 892 "controlled entity" will be treated as a CCE if it holds even de minimis USRPIs unless (1) it holds sufficient non-U.S. real estate assets to "swamp" the USRPIs for purposes of the general USRPHC test or (2) it satisfies the investment company test. In practice, a controlled entity will most often apply the investment company test, as it can't hold regular trade or business assets for purposes of the general test, as those assets would generate commercial activities, and its ability to "swamp" USRPIs with non-U.S. real estate is typically limited. Under the investment company test, a controlled entity can generally hold USRPIs with an FMV equal to 10 percent of its total investments and maintain its section 892 status. And while inserting a non-U.S. corporation between the investing entity and the USRPHC is a customary approach for protecting against USTB risk, it will not help preserve section 892 status under reg. section 1.892-5T(b) in light of the rule discussed earlier which provides that, solely for purposes of determining USRPHC status, interests in a non-U.S. corporation are treated as a USRPI to the extent the non-U.S. corporation would be treated as a USRPHC but for the fact it is foreign.

It is important to note that reg. section 1.892-5T(b) applies only to SWFs that invest through controlled entities, not integral parts, yet another

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significant difference between these two methods of investing.

One way to get around reg. section 1.892-5T(b), other than swamping and the 10 percent investment company threshold, is to invest in a USRPHC that is not treated as a USRPI so that the 892 investing entity is not treated as a USRPHC. Examples include (1) stock in a USRPHC (other than a REIT) that is publicly traded in which the SWF owns 5 percent or less at all times over the testing period,[30] (2) stock in a REIT that is publicly traded in which the SWF owns 10 percent or less at all times over the testing period,[31] and (3) interests in a REIT that is 50 percent or more owned by U.S. persons (a domestically controlled qualified investment entity, commonly referred to as a DREIT) at all times over the DREIT testing period.[32] Minority investments by section 892 controlled entities in DREITs (or by integral parts in any type of REIT) are especially tax-efficient, as (1) the REIT is not generally subject to tax provided it distributes its earnings and profits out to its shareholders as dividends, (2) the SWF is not subject to withholding on those dividends under section 892, and (3) the SWF is not subject to tax on a sale of the REIT shares under section 892. In the event there is not sufficient domestic ownership to achieve DREIT status, there is at least one private letter ruling allowing non-U.S. persons to run a portion of their investment through a U.S. corporate blocker to qualify the underlying entity as a DREIT.[33] Many SWFs also qualify as, or are affiliated with, qualified foreign pension funds, which are treated as non-foreign persons for purposes of FIRPTA.[34] Practitioners have wondered whether this means a qualified foreign pension fund can be used to increase domestic ownership for purposes of qualifying an entity as a DREIT, although I am not aware of anyone having taken this position yet.

Suppose, however, that an SWF controlled entity owns interests in a portfolio company that is treated as a USRPHC so that the SWF controlled entity is treated as a CCE under reg. section 1.892-5T(b). Suppose further that the portfolio company cleanses its status as a USRPHC by virtue of changes to the relative value of its assets. In that case, the portfolio company will continue to be treated as a USRPHC for five years with respect to its current owners (the testing period). Query whether this means the SWF controlled entity would also continue to be treated as a USRPHC and thus a CCE for the entire five-year testing period under the FIRPTA rules, so that it must wait an additional five years to be eligible for section 892, or rather whether it can apply section 892 right away.

Reg. section 1.892-5T(b) provides that a controlled entity is treated as engaged in commercial activities and thus a CCE if it is treated as a USRPHC under section 897(c)(2) (but for the fact that it is organized outside the United States). Section 897(c)(2) provides the definition of a USRPHC but, importantly, does not provide for the lookback rule. The lookback rule is in section 897(c)(1) and is used for purposes of determining whether an interest in a USRPHC (as defined in section 897(c)(2)) is a USRPI, which is a different inquiry. The section 892 regulation only mentions section 897(c)(2), not section 897(c)(1), nor are there any authorities suggesting that the section 897(c)(1) lookback rule applies for purposes of section 892. Accordingly, the SWF controlled entity should be eligible for the benefits of section 892 in the tax year following the year in which it no longer satisfies the definition of a USRPHC and thus is no longer treated as engaged in commercial activities. This interpretation is consistent with the spirit of the section 892 proposed regulations, which provide that the taint of commercial activities applies only annually.

III. One Last Trap for the Unwary

Before closing any discussion about representing sovereign wealth funds, one must mention a seemingly random and significant trap for the unwary found in the entity classification regulations. Reg. section 301.7701-2(b)(6) provides that any business entity that is wholly owned by a foreign government or any other entity described in reg. section 1.892-2T (that is, integral parts and controlled entities) shall be

[30] Section 897(c)(3).

[31] Section 897(k)(1).

[32] Section 897(h)(2).

[33] LTR 200923001.

[34] Section 897(l); and T.D. 9751.

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treated as a per se corporation. This means that if, for example, a foreign government makes a minority investment in a U.S. portfolio company through a Delaware entity that is intended to be treated as a disregarded entity or a partnership, the Delaware entity will instead be treated as a corporation if it is treated as wholly owned by the SWF, subject to full U.S. corporate income tax. This situation might arise in a fund-of-one context when the SWF owns the Delaware entity alongside a sponsor, but the sponsor is not respected as a partner for tax purposes so that the entity is treated as wholly owned by the SWF. In those situations, SWFs should insist that the sponsor contribute sufficient capital to the Delaware entity to mitigate this risk. There is no clear authority addressing how much capital, if any, a person or entity must contribute to a partnership to be respected as a partner, and the issue is hotly contested in the market. Sponsors often want to limit their financial exposure, taking the position that, following the issuance of the check-the-box regulations and subsequent revenue procedures governing the issuance of profits interests for services, no capital is required when the sponsor acts as general partner or managing member of the entity. Nonetheless, there is guidance in old revenue procedures setting forth a sliding scale of capital required based on total capital of the vehicle.[35] Practitioners generally consider this to be the gold standard, though some advisers may get comfortable with less. Given the amount of tax potentially at stake, one is best advised to adhere as closely as possible to the revenue procedures.

Adding further complexity to the "wholly owned" issue is that there is no clear authority defining what it means for an entity to be "wholly owned," in particular whether it includes indirect ownership through entities that are not foreign governments or controlled entities. The preamble to reg. section 301.7701-2(b)(6) suggests that the intent was for the phrase "wholly owned" to include indirect ownership.[36] In particular, the preamble notes that a request was made by a commentator to specify that "wholly owned" only referred to direct ownership but that Treasury was refusing to make that change. The reason given was that the rules concerning foreign governments were intended to mirror existing rules that applied to U.S. state governments, and the rules for U.S. state governments were not limited to direct ownership. While the regulations as drafted do not refer to indirect ownership, and the general practice in the code and Treasury regulations is to specify if indirect ownership should be considered, the vagueness of the phrase "wholly owned" combined with the statement in the preamble about indirect ownership should lead one to exercise caution. ■

[35] Rev. Proc. 89-12, 1989-1 C.B. 798; Rev. Proc. 95-10, 1995-1 C.B. 501; each declared obsolete in Rev. Rul. 2003-99, 2003-34 IRB 388.

[36] T.D. 9012.

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