Client Alert

Tax

November 2011

New Proposed Regulations Provide Helpful Guidance for Investments by Sovereign Wealth Funds and Foreign Sovereigns

On November 3, 2011, the IRS published proposed regulations under Section 892 of the Code[1] that provide helpful guidance, and answer several questions, regarding the extent to which a foreign sovereign, a sovereign wealth fund or other controlled entities will be exempt from US tax under Section 892 of the Code on their investments into the United States. The proposed regulations have significant implications, particularly for sovereign wealth funds, in how they structure their investments into the United States. Pending finalization, the IRS has indicated that taxpayers may rely on the proposed regulations.

Key Points

Principally, the proposed regulations provide that:

- Limited partnerships' commercial activities will not be attributed to certain limited partners.
- Commercial activities do not include certain dispositions of US real property interests and investments in financial instruments.
- Testing of an entity's status as a controlled commercial entity is done on an annual basis and is subject to a "de minimis" exception.
- Solely being a partner in a partnership conducting trading activity for its own account (and not otherwise engaged in commercial activities) will not cause such partner to be engaged in commercial activities.

Background

Section 892 of the Code generally exempts from US tax the income of foreign sovereigns and their subsidiaries from investments in stocks, bonds and other securities (including gains from the sale of shares in REITs), except that any such income derived from a commercial activity or derived by a "controlled commercial entity" is not eligible for the exemption. Under existing regulations, a controlled commercial entity is an entity that is controlled by a foreign government and is engaged in commercial activities anywhere in the world.

1 References to the Code are to the Internal Revenue Code of 1986, as amended.

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

Because current regulations would provide that a controlled commercial entity is ineligible for the exemption under Section 892 of the Code for *all* of its income, foreign sovereign investors investing into the United States through controlled entities have had to expend significant time and expense to carefully construct and implement detailed structures in order to isolate or avoid any investments with the potential for commercial activities.

Under current regulations it is uncertain whether various transactions give rise to commercial activities, and whether a controlled entity that has engaged in commercial activity can cure such "taint". In addition, in light of the administrative and operational burdens necessary to structure investments to minimize commercial activity risk, practitioners and investors have long requested that a "de minimis" exception apply for entities inadvertently conducting a small degree of commercial activity.

The proposed regulations broadly address some of these issues and provide helpful guidance on the rules relating to commercial activities and the exemption under Section 892 of the Code. The proposed regulations do not, however, expand the availability of the tax exemption under Section 892 of the Code. Thus, transactions that were not exempt from tax under Section 892 of the Code continue not to be exempt. The proposed regulations do, however, provide foreign sovereigns some "peace of mind" that inadvertent commercial activity will not have catastrophic results, such as resulting in a loss of the exemption under Section 892 of the Code for a sovereign wealth fund's entire investment portfolio in the United States.

Clarification of Certain Non-Commercial Activities

Commercial activities are defined broadly under current law and the proposed regulations to include "all activities (whether conducted within or outside the United States) which are ordinarily conducted for the current or future production of income or gain," except for those activities specifically enumerated in such regulations. Such exclusions include investments in stocks, bonds and other securities, loans, and financial instruments. The proposed regulations provide two further clarifications of the meaning of commercial activities.

Dispositions of US Real Property Interests

A disposition (deemed or actual) of a "US real property interest" (as defined in Section 897(c) of the Code) will not constitute the conduct of a commercial activity. US real property interests generally include most non-creditor direct interests in US real estate and shares in US real property holding corporations, including most equity REITs. Under Section 897(h) of the Code, REIT distributions, to the extent attributable to gain from sales or exchanges by such REIT of US real property interests, are "deemed" dispositions of US real property interests.

The practical effect of the proposed regulation is to confirm that a foreign sovereign that has invested in a US real property holding corporation (including a REIT) will not have commercial activities either upon the sovereign's disposal of shares in the corporation, or upon the REIT disposing of a US real property interest and distributing the proceeds to the sovereign investor. The IRS currently takes the position that income derived from such deemed dispositions of US real property interests by a REIT are not eligible for the exemption under Section 892 of the Code.[2] The proposed regulations do not alter this position.

> The following example illustrates the application of the new proposed regulation:
>
> Subsidiary (S) of Foreign Government X owns shares in a REIT. The REIT sells a parcel of US real estate and distributes the proceeds. Under current law, there has been at least a theoretical question that such indirect disposition of US real estate resulted in S engaging in commercial activity (as a direct disposition of a US real property interest might). Under the proposed regulations, this theoretical question is resolved in the negative; however, under the IRS's current view, S will nonetheless be subject to US federal income taxation on proceeds from the sale and be required to file a US federal income tax return.

2 *See* IRS Notice 2007 – 55.

Investments in Certain Financial Instruments

The proposed regulations provide that investments in certain financial instruments will not be considered to be commercial activities, irrespective of whether or not such instruments are held in the execution of governmental financial or monetary policy (which is what current regulations require). We note that the proposed regulations do not exempt income from investments in financial instruments from tax under Section 892 of the Code.

Treatment of Controlled Entities

Annual Testing

The proposed regulations provide that the determination of whether an entity is a controlled commercial entity is made on an annual basis. Thus, the fact that an entity may engage in commercial activities in a particular year will not cause it to lose the exemption under Section 892 of the Code for subsequent years.

Inadvertent Commercial Activity

The IRS will not consider a controlled entity conducting only "inadvertent commercial activity" to be engaged in commercial activities. This de minimis exception will apply if an entity's failure to avoid conducting the commercial activity is "reasonable," the commercial activity is "promptly cured," and the entity meets certain "record maintenance" requirements.

Reasonableness is determined on a facts and circumstances basis. The IRS will consider the number of commercial activities conducted in the current and previous taxable years, as well as the amount of income earned from, and assets used in the conduct of the commercial activities in relationship to an entity's total income and assets, respectively. In addition, reasonableness is satisfied only if an ongoing diligence process is in place (and followed and enforced) whereby adequate written policies and operational procedures are used to monitor the entity's worldwide activities.

In lieu of the facts and circumstances test, the proposed regulations offer a safe harbor under which, provided the diligence requirements noted above and certain recordkeeping requirements are met, the failure to avoid conducting commercial activity will be deemed to be reasonable. To qualify, an entity's assets attributable to, and income from, such commercial activity cannot exceed five percent of the total balance sheet assets and income statement gross income, respectively, of the entity for financial accounting purposes.

The "cure" requirement of the de minimis test requires that an entity must discontinue the conduct of the commercial activity within 120 days of discovery of such activity. The proposed regulations do not specify how such activity must be discontinued, but divestiture of an offending asset and discontinuation of the offensive action are suggested as examples.

The last requirement of the de minimis test requires an entity to maintain and retain "adequate records" of each discovered and subsequently purged commercial activity, and the means whereby it was purged, for as long as such documentation may become material with regard to the exemption under Section 892 of the Code.

We note, however, that notwithstanding of the protection afforded by the de minimis exception, none of the income derived from commercial activity, whether or not de minimis, will qualify for the exemption under Section 892 of the Code. The following example illustrates the application of the new proposed regulation:

> Subsidiary (S) of Foreign Government X has significant investments in US securities for which it claims the exemption under Section 892 of the Code. S has compliance procedures in place in accordance with the proposed regulations to monitor its investments to determine whether it ever conducts commercial activity. S makes one investment outside the United States for which it obtains assurances that such investment does not give rise to commercial activities. Notwithstanding such assurances, the investment gives rise to commercial activities. Under the current regulations, S would lose the benefit of the exemption under Section 892 of the Code for all of its US securities investments, perhaps indefinitely. Under the proposed regulations, assuming the amount of income is within the 5 percent safe harbor, such commercial activity would be "inadvertent" (so long as S timely cures and retains adequate records) and S would not be deprived of its exemption under Section 892 of the Code.

No Attribution of Partnership's Commercial Activities to Limited Partners

The proposed regulations create a broad exemption from commercial activities for passive limited partners in entities treated as partnerships for United States federal income tax purposes. The proposed regulations will not attribute the commercial activity of a partnership to a limited partner if certain requirements are met.

To qualify for this exemption, an entity holding a partnership interest cannot have the right to participate in the management or conduct of the partnership's business at any time during the partnership's taxable year, other than certain rights in the case of extraordinary events such as dissolution, admission/expulsion of a partner, certain major asset dispositions and related events. Participation in management is determined under local law. It is unclear whether the entirety of rights in agreements among partners would be taken into account.

We note that a foreign sovereign partner's distributive share of partnership income attributable to commercial activity will not be exempt from taxation under Section 892 of the Code. The following example illustrates the application of the proposed regulation:

> Subsidiary (S) of Foreign Government X is a limited partner in a real estate fund that makes investments in REITs. The provisions of the fund's limited partnership agreement are carefully drafted to ensure that fund does not engage in commercial activities. Notwithstanding this, the fund makes an investment that results in commercial activities. Under the current regulations, such commercial activities may be attributed to S and cause it to lose the exemption under Section 892 of the Code, perhaps permanently. Under the proposed regulations, S, assuming it is considered a limited partner under the proposed regulations, would not be deemed engaged in commercial activities solely because of fund's activities and will not lose its exemption under Section 892 of the Code. S's distributive share of income from the fund will be subject to tax to the extent of S's proportionate share of income attributable to the commercial activities.

Participating in Trading Partnerships

The proposed regulations provide that a foreign sovereign will not be treated as engaged in commercial activity solely as a result of holding an interest in a partnership that trades in stocks, bonds, certain other securities, commodities or financial instruments. This rule applies whether or not the foreign sovereign qualifies for the limited partner exception noted elsewhere in this alert.

> The following example illustrates the application of the proposed regulation:
>
> Subsidiary (S) of Foreign Government X is a member in an LLC treated as a partnership for US federal income tax purposes. S has the right to participate in the management and conduct of the LLC's business and so does not qualify for the new "limited partner" exception from commercial activities with respect to its interest in the LLC. The LLC trades in stocks, securities and foreign currency derivatives. Under the proposed regulations, S is not deemed engaged in commercial activities as a result of the LLC's trading activities.

Unresolved Issues and Action Items

The proposed regulations leave open several unresolved issues relevant to foreign sovereigns and their investments into the United States:

- The proposed regulations do not change the current rule that causes a controlled entity of a foreign sovereign to be treated as a controlled commercial entity where greater than 50 percent of the controlled entity's assets are US real property interests. Thus, significant planning is still required for sovereign wealth funds making investments into US real estate.
- It remains unclear the extent to which the making of loans results in commercial activities.
- It is unclear whether the limited partner exception would apply if a limited partner participated on an advisory committee to a partnership or the extent to which contractual arrangements among partners providing additional rights to a limited partner would be taken into account under the exception.

- Further guidance on the monitoring and compliance requirements in the de minimis exception will be needed.

The proposed regulations also present planning opportunities for foreign sovereign investors:

- Foreign sovereign investors may consider requesting covenants in fund agreements addressing the requirements of the limited partner exception (e.g., requiring the general partner of the fund to conduct due diligence on investments to ascertain commercial activities risk, to provide notice of commercial activities and the ability to cure, including the ability to transfer its partnership interest in the event commercial activities are discovered).
- Foreign sovereign investors may consider investing through partnerships to take advantage of the limited partner exception rather than investing through managed accounts that would not appear to provide the same protection from commercial activities (e.g., lending activity conducted by a partnership may not result in commercial activities to a foreign sovereign investor while lending done on the investor's behalf by a third-party investment manager may result in commercial activities to the sovereign investor).

Conclusion

The proposed regulations represent a major step forward in the clarification of an admittedly complex set of rules. Although the proposed regulations answer many of the questions posed with regard to the current regulations, several important questions remain outstanding and the proposed regulations raise many new questions themselves. The comment period with respect to these regulations is open until February 1, 2012, and we would expect that some of the unresolved issues would be raised in comments to the IRS. In the meantime, the Preamble to the proposed regulations allows taxpayers to rely on the proposed regulations until the final regulations are issued.

This Client Alert is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This Client Alert should not be acted upon in any specific situation without appropriate legal advice and it may include links to websites other than the White & Case website.

White & Case has no responsibility for any websites other than its own and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.

This Client Alert is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.

In this publication, White & Case means the international legal practice comprising White & Case LLP, a New York State registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law and all other affiliated partnerships, companies and entities.
NY/1111/TAX/A/06597_4