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IRS Proposes Regulations Under Section 892 Regarding Taxation Of Foreign Government Entities

**Patrick B. Fenn,
Stephen M. Jordan,
Stuart E. Leblang and
Robert Rothman**

**AKIN GUMP STRAUSS HAUER &
FELD LLP**

The Internal Revenue Service (IRS) has issued proposed regulations under Section 892 of the Internal Revenue Code (available at http://www.irs.gov/irb/2011-48_IRB/ar14.html#d0e2387) that generally provide favorable clarifications and modifications of the rules

Patrick B. Fenn is Co-head of the tax practice group in the New York office and was one of the founding partners of that office in April 1993. Mr. Fenn focuses on providing taxation advice to domestic and offshore investment funds and to fund managers. In addition, he has extensive experience in the area of international taxation and has been involved in the structuring of major inbound and outbound multijurisdictional mergers and acquisitions.

Stephen M. Jordan, a Partner in the New York office, focuses on the tax-efficient structuring of domestic and cross-border debt and equity investments. Mr. Jordan regularly advises investment funds, high-net-worth individuals and multinational corporations, including financial institutions, on the tax implications of international private equity investments; financial products; and domestic and cross-border mergers, acquisitions and restructurings.



**Patrick B.
Fenn**



**Stephen M.
Jordan**



**Stuart E.
Leblang**



**Robert
Rothman**

governing eligibility for the Section 892 tax exemption of a controlled entity of a foreign sovereign that is not an integral part of such foreign sovereign ("controlled entity"), such as many sovereign wealth funds. Specifically, under the pro-

Stuart E. Leblang, a Partner, is the Co-head of Akin Gump's tax practice. Mr. Leblang also serves on the firmwide management committee. Mr. Leblang's practice includes planning and negotiation of domestic and international business transactions, corporate and financial tax counseling, and representation of clients on tax legislative and policy issues before the U.S. Congress, the U.S. Department of Treasury and other federal agencies. He also focuses on various investment-fund-related matters.

Robert P. Rothman, Senior Counsel, advises clients on the tax aspects of a wide range of business transactions. He is particularly experienced in corporate mergers, acquisitions, leveraged buy-outs, organizations, reorganizations, spin-offs, recapitalizations, redemptions, distributions, liquidations and other transactions involving both publicly and privately owned corporations.

posed regulations, a controlled entity will not be subject to the so-called "all or nothing" rule that would cause it to forfeit its eligibility for the Section 892 tax exemption solely as a result of inadvertent commercial activity, investments in partnerships as a limited partner, investments in partnerships engaged in certain trading activities and no other commercial activities, investments in financial instruments, or dispositions of U.S. real property interests ("USRPIs"). Pursuant to the Preamble, taxpayers may rely on these proposed regulations until final regulations are issued.

Background

Section 892 exempts from U.S. income taxation certain investment income from stocks, bonds and other securities derived by a foreign government, where a "foreign government" is defined as an integral part of a foreign sovereign, or a controlled entity. Sovereign wealth funds often constitute controlled entities, or they make investments through special purpose vehicles that constitute controlled entities. However, the Section 892 exemption does not apply to income derived from the conduct of commercial activity or derived from or

*Please email the authors at pfenn@akingump.com,
sjordan@akingump.com, sleblang@akingump.com or
rrothman@akingump.com with questions about this article.*

AKIN GUMP
STRAUSS HAUER & FELD LLP

by a controlled commercial entity (“controlled commercial entity”).

Under rules in the current regulations in effect since 1988, a controlled commercial entity is a controlled entity engaged in commercial activities anywhere in the world, directly or indirectly through a partnership. Accordingly, under the so-called “all or nothing” rule, none of the income derived by or from a controlled entity engaged in any commercial activity anywhere in the world (i.e., a controlled commercial entity) is eligible for the Section 892 exemption. This rule has been roundly criticized as a trap for the unwary who inadvertently conduct small levels of commercial activity as well as an unnecessary administrative and operational burden for foreign governments.

Highlights Of The Proposed Regulations

The proposed regulations clarify and modify the determination of whether a controlled entity is engaged in commercial activities anywhere in the world and is, therefore, a controlled commercial entity. As mentioned above, taxpayers may rely on these proposed regulations until final regulations are issued. Highlights include the following:

- *Inadvertent Commercial Activity.*

A controlled entity will not be treated as a controlled commercial entity solely because it conducts inadvertent commercial activity, although any income derived from such activity will not qualify for the Section 892 exemption. Under the current regulations, there is no exception for inadvertent commercial activity. Under the proposed regulations, commercial activity will be treated as inadvertent if (i) such commercial activity is discontinued within 120 days of its discovery by the controlled entity, (ii) certain record maintenance requirements are met regarding the discovery and cure of such commercial activity and (iii) the failure to avoid such commercial activity is reasonable. Under a safe harbor, such failure will be considered reasonable if (i) adequate written policies and operational procedures are in place to monitor the controlled entity’s worldwide activi-

ties, (ii) the value of the assets used in, or held for use in, the commercial activity does not exceed five percent of the total value of the assets on the balance sheet of the controlled entity for the taxable year for financial accounting purposes and (iii) the controlled entity’s income from the commercial activity does not exceed five percent of the controlled entity’s gross income on its income statement for the taxable year for financial accounting purposes. Otherwise, whether a failure to avoid commercial activity is reasonable generally will be determined in light of all the facts and circumstances, provided that the adequate written policies and operational procedures described above must be in place.

- *Investments in Partnerships.*

A controlled 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 an entity classified as a partnership for U.S. federal income tax purposes (“limited partner interest”) that conducts commercial activity, although the controlled entity’s distributive share of income attributable to such commercial activity will not be exempt under Section 892. Under the current regulations, the commercial activities of a partnership other than a “publicly traded partnership” are attributable to both general and limited partners. Under the proposed regulations, to qualify as a limited partner interest, the controlled entity must 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 governing agreement. Such rights will not include consent rights with respect to 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, merger or conversion.

In addition, the proposed regulations

clarify that a controlled entity will not be treated as engaged in commercial activities solely because it holds an interest as a (general or limited) partner of an entity classified as a partnership for U.S. federal income tax purposes that effects transactions in stocks, bonds, other securities, commodities or financial instruments for the partnership’s own account and is not a dealer. Under the current regulations, it is unclear whether such activity results in the attribution of commercial activity to controlled entity partners.

- *Investments in Financial Instruments.*

Investments in financial instruments, including derivatives, will not be commercial activities for Section 892 purposes, although any income derived from such financial instruments will not qualify for the Section 892 exemption unless such financial instruments are held in the execution of governmental financial or monetary policy. Accordingly, a controlled entity will not be treated as a controlled commercial entity solely because it invests in financial instruments, directly or indirectly, through a partnership. Under the current regulations, it is unclear whether the exception for financial instrument transactions applies only if the financial instruments are held in the execution of governmental financial or monetary policy.

- *Dispositions of USRPIs.*

Dispositions of USRPIs will not be commercial activities for Section 892 purposes. Accordingly, a controlled entity will not be treated as a controlled commercial entity solely because it disposes of a USRPI. However, gain derived from a disposition of USRPIs will not qualify for the Section 892 exemption.

- *Annual Determination of Controlled Commercial Entity Status.*

The determination that a controlled entity is a controlled commercial entity will be made on an annual basis. If a controlled entity is determined to be a controlled commercial entity for a given taxable year, such controlled entity will not be treated as a controlled commercial entity for any subsequent taxable year in which it is not engaged in a commercial activity.