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TREASURY ISSUES PROPOSED REGULATIONS FOR FOREIGN SOVEREIGN INVESTORS UNDER SECTION 892

This White Paper analyzes the proposed regulations (the "Proposed Regulations") recently issued by the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") under §892 of the Internal Revenue Code ("Code"),[1] the provision of the Code that exempts from federal income tax certain investment income of "foreign governments." Although not yet effective, the preamble to the Proposed Regulations states that taxpayers may rely upon the Proposed Regulations until final regulations are issued.[2]

Published in the Federal Register on November 3, 2011, the Proposed Regulations represent the most significant regulatory development under §892 since the bulk of the current regulations were issued in temporary form in 1988 (the "Temporary Regulations"). Advisors to foreign governments have long expressed frustration with the Temporary Regulations and have sought their revision since the Temporary Regulations were first issued in proposed form. Yet it was not until so-called "sovereign wealth funds" ("SWFs")—many of which are eligible for the benefits of §892—entered the public consciousness that calls for clarification and revision to the Temporary Regulations were heeded.[3]

The Proposed Regulations do not address all of the deficiencies of the Temporary Regulations, and perhaps raise as many questions as they answer. Nevertheless, their publication is welcome and represents what we hope is the first of a series of much-needed guidance under §892. Treasury has invited public comment on the Proposed Regulations by February 1, 2012, and may revise the Proposed Regulations further in light of such comments.

EXECUTIVE SUMMARY

The Proposed Regulations do two principal things: (i) elaborate on whether, and when, a foreign government is engaged in commercial activities, and (ii) limit the circumstances in which an entity may become

a controlled commercial entity ("CCE"). Thus, in brief, the Proposed Regulations:

- Elaborate on the meaning of "commercial activity."
- Clarify and expand the scope of the §892 investing and trading exceptions.
- Confirm that the disposition of a United States real property interest (a "USRPI") is not, by itself, a commercial activity.[4]
- Provide that an entity that engages only in "inadvertent commercial activity" will not be a CCE.
- Provide that the commercial activities of a limited partnership will not be attributed to the partnership's limited partners.
- Clarify that an entity must reassess whether it is a CCE annually, and that the taint of being a CCE lasts for the entirety of the entity's taxable year.

ANALYSIS

THE MEANING OF COMMERCIAL ACTIVITY

Background. A foreign government is exempt under §892 from federal income tax on certain types of U.S. source passive income, including dividend income, interest income, and gain from the disposition of a noncontrolled U.S. real property holding corporation.[5] A foreign government under §892 consists of a foreign sovereign's "integral parts" and "controlled entities."[6]

The §892 exemption does not extend to income derived from the conduct of commercial activity, to income received by or from a CCE, or to gain from the disposition of an interest in a CCE.[7] A CCE is an entity that is engaged in commercial activity in which the foreign government holds 50 percent or more of the interests (measured by vote or value) or over which the foreign government possesses effective control.[8]

Although the negative consequences of commercial activity are far-reaching, the Code does not define commercial activity. Only three sentences of the Temporary Regulations state what a commercial activity is:

- All activities that are ordinarily conducted with a view toward the current or future production of income or gain are commercial activities, regardless of whether those activities are conducted within or without the U.S.[9]
- An activity may be considered a commercial activity even though it may not be a U.S. trade or business under §864.[10]
- Investments (including loans) made by a banking, financing, or similar business are commercial activities, even if the income derived from such investments is not considered to be income effectively connected to the active conduct of a banking, financing, or similar business in the U.S.[11]

The remainder of the Temporary Regulations on commercial activity identify those activities that are *not* commercial. This angel list of protected activities excepts from commercial activity:

- Making and holding certain investments, including stocks, bonds, other securities, and financial instruments held in the execution of governmental financial or monetary policy;[12]
- Trading in stocks, securities or commodities for a foreign government's own account; [13]
- Cultural events;[14]
- Nonprofit activities;[15]
- Governmental functions;[16] and
- Purchasing activities.[17]

Summary of Proposed Regulations. The Proposed Regulations provide that the determination of whether a particular activity is a commercial activity turns on "the nature of the activity," not the purpose or motivation for conducting it.[18]

The Proposed Regulations further provide that an activity may be considered a commercial activity even though it does not constitute a trade or business under §162 or does not constitute (or would not constitute if undertaken in the U.S.) the conduct of a U.S. trade or business under §864.[19] The reference to §162, which allows deductions for ordinary and necessary expenses paid or incurred for carrying on a trade or business, is new and clarifies that a commercial activity may exist even if the activity in question is not a trade or business for either §864 or §162 purposes.[20]

Commentary. The Temporary Regulations are inadequate to help foreign governments determine whether they are

engaged in commercial activity, even though that determination is crucial to the application of §892. The Proposed Regulations now stress that intent is irrelevant for assessing commercial activity, and that the "nature" of the activity, in the abstract and without reference to a foreign government's purpose or motivation for conducting it, is determinative. Unfortunately, this addition to the definition of commercial activity by the Proposed Regulations, without further elaboration, is likely to confuse further rather than illuminate, and it may in fact make foreign governments more fearful that they may be engaged in commercial activity.

The Temporary Regulations start with the broad proposition that all activities that are ordinarily conducted with a view toward the current or future production of income or gain are commercial activities. They then add that an activity could be a commercial activity even if it does not constitute a trade or business within the U.S. under §864(b). Although the intersection of trade or business activities and commercial activities is not well understood, many foreign governments and their advisors came to believe that the determination of commercial activity followed largely that of a U.S. trade or business, aside from the fact that any measure of activity could be commercial (unlike trade or business activity, which requires the activity to be regular, substantial, and continuous), and that activities conducted anywhere could be commercial (unlike trade or business activities, which must be conducted within the U.S.).

The Proposed Regulations further dispel that notion, confirming that the standards for analyzing commercial activity differ from those for analyzing a trade or business. The increasingly clear divorce between commercial activity and trade or business principles, coupled with Treasury's preference for advising foreign governments as to what a commercial activity is not, rather than what it is, means that foreign governments that wish to engage in activities that fall outside the angel list of noncommercial activities should do so with caution.

The Proposed Regulations make the further point that the nature of the activity alone and not the purpose or motivation for conducting it is also determinative of whether an activity is a "nonprofit activity" or a "governmental function," both of which are on the list of protected activities. This addition likely circumscribes the types of activities that may qualify under those exceptions, and foreign governments seeking to rely on those exceptions should consider carefully the effect of the proposed changes.

THE INVESTING EXCEPTION

Background. Among the exceptions to commercial activity in the Temporary Regulations is the "Investing Exception."[21] This exception provides that certain investment activity will not be treated as a commercial activity, regardless of the volume of transactions of that activity or because of other unrelated activities. Among the investments identified in the Investing Exception are investments in stocks, bonds, and "other securities," as well as investments in "financial instruments held in the execution of governmental financial or monetary policy." A financial instrument is deemed held in the execution of governmental financial or monetary policy if the primary purpose for holding the instrument is to implement or effectuate such policy.[22] Also included is the holding of "net leases on real property or land which is not producing income (other than on its sale or from an investment in net leases on real property)." [23]

Proposed Regulations. The Proposed Regulations clarify that the terms "other securities" and "financial instruments" have those meanings specified elsewhere in the Temporary Regulations.[24] The Proposed Regulations also eliminate the requirement that, for an investment in a financial instrument to be a noncommercial activity, the financial instrument must be held in the execution of governmental financial or monetary policy. However, the preamble to the Proposed Regulations stresses that while the holding of any financial instrument is not commercial, to be exempt under §892, the financial instrument must continue to be held in the execution of governmental financial or monetary policy.

The Proposed Regulations now clearly provide that the holding of "real property" (in addition to net leases on real property or land) that is not producing income (other than on its sale or from an investment in a net lease on real property) is not a commercial activity.

Commentary. The clarification of the Investment Exception is welcome. The elimination of the requirement that financial instruments be held specifically in the execution of governmental financial or monetary policy to be noncommercial is a positive development, since it reduces some uncertainty that foreign government had over whether their investments in certain derivatives and other financial products may have been commercial. Treasury's unwillingness to expand the scope of the regulatory exemption to cover even those financial instruments that are not held in the execution of governmental financial or monetary policy is unsurprising, given the clear requirements of the statute. Nevertheless, foreign governments should not assume that such investment income would be taxable since income from, for example, financial instruments might still avoid net basis taxation under the §864(b) Trading Safe Harbor and gross basis taxation by reason of the source of income rules (under, for instance, Treas. Reg. §1.863-7) or through the application of an income tax treaty.

The addition of a specific exception for holding "real property" is also a positive development because it eliminates the concern that holding direct interests in realty that does not produce income may be a commercial activity. "Real property" as used in §892 is undefined, although presumably it refers to the definition found in the regulations under §897, which includes land and unsevered natural products of land, improvements, and personal property associated with the use of real property.[25] As under the Temporary Regulations, if the real property produces income (other than from its sale or a net lease),[26] the act of holding that real property will be a commercial activity. Thus, simply holding land that does not produce income will not be a commercial activity,[27] but holding a building for the production of rental income (from other than passive, net leases) will be a commercial activity. A foreign government desiring to hold rental-producing real property without the negative consequences of commercial activity would be well advised to consider pursuing such an investment through a limited partnership that qualifies for the Limited Partner Exception, discussed below.

Strangely absent from the Proposed Regulations' clarification to the Investing Exception is any reference to commodities. Its continued absence from the Investing Exception is strange, given that the Trading Exception, discussed below, excepts trading in commodities from commercial activity. That trading in commodities is not commercial but investing could be is nonsensical and likely an oversight by Treasury that hopefully will be clarified in the final regulations.

THE TRADING EXCEPTION

Background. Among the exceptions to commercial activity in the Temporary Regulations is the "Trading Exception."[28] This §892 Trading Exception provides that "trading," or effecting transactions in stocks, securities, or commodities for a foreign government's own account, will not constitute a commercial activity regardless of whether such activities constitute a trade or business for purposes of §162 or a U.S. trade or business for purposes of §864. Trading differs from investing in that investing involves the purchase of securities for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market.[29] Trading, by contrast, involves the purchase and sale of securities with reasonable frequency so as to catch the swings in the daily market movements and profit thereby on a short-term basis.[30] Unlike investing, trading is viewed as creating a trade or business, and but for the Trading Safe Harbor of §864,[31] a foreign person that engages in securities trading would be treated as engaged in a U.S. trade or business and thereby subject to net basis taxation.

The §892 Trading Exception applies regardless of whether the foreign government effects the transactions through its employees or through a broker, commission agent, custodian, or other independent agent, and regardless of whether any such employee or agent has discretionary authority to make decisions in effecting the transactions. The Trading Exception does not apply if such transactions are undertaken as a "dealer,"[32] defined as a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom.[33]

Proposed Regulations. The Proposed Regulations clarify and expand the Trading Exception in several ways. First, as with the revisions to the Investment Exception, the

Proposed Regulations clarify that the terms "other securities" and "financial instruments" have those meanings specified elsewhere in the Temporary Regulations.[34] Second, the Proposed Regulations add that trading in "bonds" and "financial instruments" (without regard to whether those financial instruments are held in the execution of governmental financial or monetary policy) is not a commercial activity.[35]

Commentary. The clarification and expansion of the Trading Exception is a welcome development, although unlikely to satisfy fully the concerns of foreign governments. As investment in bonds is exempt under §892 and a noncommercial activity under the Investment Exception, the addition of bonds to the Trading Exception is an appropriate (but not unexpected) addition that lends a measure of symmetry to the rules. More notable is the inclusion of financial instruments in the Trading Exception.

Since the Temporary Regulations were issued, sovereign investors have increasingly looked to invest in diverse asset classes such as derivative instruments. To promote such investment from foreign persons generally, Treasury has proposed rules providing that trading in derivatives does not create a U.S. trade or business and that income attributable to certain "notional principal contracts" is foreign-source income.[36] The evolution of the rules for foreign government investors lagged well behind these general developments.

Thus, foreign governments and their advisors have long been concerned that the Trading Safe Harbor of §864 was on its face broader than the Trading Exception of §892, without any real policy basis to account for that difference. For example, in 1998, Treasury issued proposed regulations under §864 providing that foreign persons who enter into derivative transactions for their own accounts and who are not dealers with respect to any derivative transactions (and who are not otherwise dealers in stocks, securities, or commodities) will not be engaged in a U.S. trade or business solely by reason of those transactions.[37] Yet no similar rule was proposed under §892 with respect to commercial activities. Similarly, the §864 Trading Safe Harbor applied whether the foreign persons traded directly or indirectly through a partnership,[38] but the §892 Trading Exception contained no analogue.

These omissions were particularly anomalous when one considers that investments in financial instruments held in the execution of governmental financial or monetary policy, regardless of the volume of such investments, would not be a commercial activity, yet trading in such financial instruments did not expressly enjoy any measure of protection. Particularly for foreign governments participating in investment partnerships such as hedge funds that engage in trading activities (often involving derivatives), the relative weakness of the §892 Trading Exception vis à vis the §864 Trading Safe Harbor was a point of concern.

The Proposed Regulations now provide that the Trading Exception encompasses trading by foreign governments directly or through partnerships,[39] bringing the §892 Trading Exception more closely in line with the §864 Trading Safe Harbor. A point of concern, however, is that whereas the Proposed Regulations under the §892 Trading Exception speak of "financial instruments" and "other securities," the proposed regulations under the §864 Trading Safe Harbor speak of "derivatives."[40] The terms are not synonymous, and foreign governments seeking to rely upon the Trading Exception on the assumption that all derivative investments are covered are mistaken. Foreign governments should consider carefully whether their intended derivative transactions fall within the scope of the exception.

For instance, a derivative covered by the §864 Trading Safe Harbor includes notional principal contracts ("NPCs"),[41] but only certain NPCs, such as swap agreements in functional or nonfunctional currency, are treated as "financial instruments" under the §892 Trading Exception.[42] Moreover, equity derivatives are not only not protected by the Trading Exception, but payments on such derivatives would be subject to federal income tax withholding to the extent that they are determined by reference to dividends from U.S. corporations.[43]

The addition of the Limited Partner Exception, described below, makes the expansion of the Trading Exception (and the differences between the Trading Exception and the Trading Safe Harbor) perhaps less significant for those foreign governments that conduct their potential trading activities entirely through partnership vehicles such as most hedge funds.

DISPOSITIONS OF USRPIs

Background. Gain or loss of a foreign government from the disposition of a USRPI is treated as gain or loss effectively connected with a U.S. trade or business.[44] Some feared that this rule meant that a foreign government disposing of a USRPI could be deemed to be engaged in commercial activity for purposes of §892.

Proposed Regulations. The Proposed Regulations confirm that the disposition of a USRPI, including a deemed disposition of a USRPI under the rules applicable to real estate investment trusts and certain regulated investment companies, is not, by itself, a commercial activity.[45]

Commentary. The Proposed Regulations only confirm what most already believed to be true. If the disposition of a USRPI were a commercial activity, then the exemption under §892 with respect to gain from the disposition of a noncontrolled U.S. real property holding corporation ("USRPHC")[46]—itself a USRPI—would be nonsensical.

Moreover, in the preamble, Treasury observed that it and the IRS believe that "an entity that only holds passive investments and is not otherwise engaged in commercial activities should not be deemed to be engaged in commercial activities solely by reason of the operation of section 897(a)(1)." This view is welcome because it does two important things. First, it supports the view that the list of investments in the Investing Exception is illustrative, not exhaustive, of noncommercial activities. While income therefrom may not necessarily be exempt under §892, the holding of any passive investment, including a USRPI, should not be viewed as a commercial activity. Second, it supports the elimination of what many observers believe to be the most inequitable aspect of the Temporary Regulations: the USRPHC rule contained in Treas. Reg. §1.892-5T(b). Under this rule, if a controlled entity holds a single passive asset—a USRPI—then that controlled entity will be deemed engaged in commercial activity and become a CCE. If Treasury and the IRS truly believe that merely holding a passive investment is not a commercial activity, then the USRPHC rule should be eliminated.

INADVERTENT COMMERCIAL ACTIVITY EXCEPTION FROM CCE STATUS

Background. As noted, the negative consequences of commercial activity are significant. An entity in which the foreign government holds 50 percent or more of the interests, or over which the foreign government possesses effective control,[47] that conducts commercial activity anywhere becomes a CCE with three principal effects:

- All income received *from* a CCE is ineligible for §892.
- Where the CCE is a controlled entity, all income received *by* the CCE is ineligible for §892.
- All income derived from the disposition of an interest in a CCE is ineligible for §892.[48]

As suggested by the second bullet point above, the perils of commercial activity are particularly acute for controlled entities. Unlike integral parts, which are governing authorities of a foreign sovereign,[49] a controlled entity is at risk of commercial activity "tainting."[50] For instance, an integral part that conducts commercial activity will be ineligible for the §892 exemption on income derived from that commercial activity, but it will remain eligible for §892 with respect to other, noncommercial income.[51] By contrast, a controlled entity that conducts (or is deemed to conduct) commercial activity of any quantum anywhere in the world will become a CCE such that it will not be entitled to the §892 exemption for *any* of its income, even income that is not commercial and would otherwise qualify under §892.[52]

Proposed Regulations. The Proposed Regulations create an exception from CCE treatment for entities that conduct only "inadvertent commercial activity." Under this rule, an entity that conducts only inadvertent commercial activity will not be treated as engaged in commercial activity for purposes of determining whether that entity is a CCE, provided each of the following requirements is satisfied:

- The failure to avoid conducting the commercial activity is "reasonable."
- The commercial activity is promptly "cured."
- The specified "record maintenance requirements" are met.[53]

Notably, even if an entity qualifies for the "inadvertent commercial activity" exception, none of the income associated with that commercial activity will be eligible for exemption under §892.

Reasonable Failure and "Safe Harbor."[54] Determining whether the failure to avoid commercial activity is reasonable is a facts and circumstances test. The Proposed Regulations make clear that this determination should take into account the number of commercial activities conducted in the current and prior taxable years, and it should compare the total income earned from and assets used in commercial activity against the entity's total income and assets. Where the commercial activities of a partnership are attributed to its partners, under a look-through rule, the assets used in the conduct of the commercial activity by the partnership are treated as assets used in the conduct of commercial activity by the entity, and the entity's distributive share of partnership income from the conduct of commercial activity by the partnership shall be treated as income earned by the entity from commercial activity. Moreover, for any failure to avoid commercial activity to be considered reasonable, an entity must engage in ongoing due diligence to avoid engaging in commercial activities anywhere in the world, as evidenced by having written policies and operational procedures in place to monitor the entity's activities.[55] The Proposed Regulations stress that a failure to avoid commercial activity will not be considered reasonable unless the entity's management-level employees have undertaken reasonable efforts to establish, follow, and enforce such written policies and operational procedures.

Significantly, the Proposed Regulations provide a safe harbor to establish that the failure to conduct commercial activity was reasonable.[56] Provided that the adequate written policies and operational procedures are in place as noted above, an entity's failure to avoid commercial activity will be considered reasonable if:

- The value of the assets used in (or held for use in) all commercial activity is ≤5 percent of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes;[57] and
- The income earned by the entity from commercial activity is ≤5 percent of the entity's gross income as reflected on the entity's income statement for the taxable year as prepared for financial accounting purposes.[58]

Prompt Cure.[59] An entity will be considered to have timely cured the commercial activity if it discontinues the conduct of the commercial activity within 120 days of discovery. Timely divestment or transfer to a related entity of an interest in a general partnership conducting commercial activity, or timely discontinuance by the general partnership of the commercial activity, will satisfy this requirement.

Record Maintenance.[60] An entity must maintain adequate records of each discovered commercial activity as well as the remedial actions taken to cure the activity. The Proposed Regulations require that such records be retained for as long as the contents of such records "may become material in the administration of section 892."

Commentary. Critics of the Temporary Regulations called for some *de minimis* exception to the CCE rules, and the Inadvertent Commercial Activity Exception represents Treasury's attempt to satisfy that request. While any effort to limit the negative effects of CCE status is to be applauded, and while the underlying purpose of this inadvertent commercial activity rule is sound, the rules as written leave many questions unanswered and may, for some foreign governments, have limited utility. The exception is available only where the entity in question (i) adequately protects itself against the conduct of commercial activity; (ii) where it does conduct commercial activity, does not conduct a lot of it, and promptly seeks to discontinue the activity; and (iii) maintains sufficient records to document its discoveries and corrective action. If any of these requirements is not met in the manner described in the Proposed Regulations, the Inadvertent Commercial Activity Exception will not apply.

To satisfy the cure requirement, a controlled entity must discontinue the commercial activity within 120 days of discovery. Where the controlled entity is a minority member of a general partnership and the general partnership is conducting the activity, the controlled entity could satisfy the cure requirement by divesting itself of the general partnership interest or transferring it to an affiliate. "Warehousing" the investment in an affiliate would permit a rapid resolution of the commercial activity issue, perhaps allowing the

controlled entity transferor additional time to find a purchaser of its general partnership interest. Likewise, should the controlled entity wish to retain the investment indefinitely without the negative consequences associated with commercial activity tainting, it could do so through an affiliated company. While the affiliate would itself be deemed engaged in commercial activity, the negative consequences of commercial activity tainting could be isolated in that affiliate where, for instance, the affiliate was specially formed to house that general partnership interest.

Some of the questions raised by the Proposed Regulations include the following:

- The Reasonable Failure requirement states that due regard will be given to the "number" of commercial activities conducted in the current and prior taxable years. How are commercial activities counted? If, for instance, a foreign government engages in trading activity not covered by the Trading Exception, is each such trade a commercial activity?
- The Reasonable Failure requirement provides that for purposes of considering the number of commercial activities conducted and the income/assets associated with commercial activity, the commercial activities of a partnership are attributed to its partners where the attribution rules of (d)(5)(i) apply. Since part of this analysis requires comparing income and assets associated with commercial activity with the income and assets of the entity in total, would an entity be able to look through to the income and assets of partnerships that do not conduct commercial activities as well?
- The Reasonable Failure requirement directs a foreign government to compare commercial income and activities against total income and activities. Aside from the safe harbor, which specifies an acceptable ratio of 5 percent, how is a foreign government to know whether it has achieved a satisfactory comparison?
- Can the Reasonable Failure requirement be satisfied if the foreign government undertook a particular activity deliberately on the belief that it was not commercial but later determined that it was?
- What sort of policies and procedures would be sufficient to satisfy the Reasonable Failure due diligence requirement?
- Many foreign governments make their U.S. investments through special purpose vehicles created specifically for a particular investment or series of investments. Often, these special purpose vehicles do not have employees. Can a controlled entity without employees satisfy the Reasonable Failure due diligence requirement, or the safe harbor?
- The Reasonable Failure safe harbor refers to assets and income reflected on an entity's balance sheet and income statement prepared "for financial accounting purposes." Since a controlled entity must be formed under the laws of the jurisdiction of the foreign sovereign by which it is owned, can the balance sheet and income statement be prepared (and the data therein analyzed) using local and not U.S. financial accounting standards?
- Does the Record Maintenance requirement stipulate that records be kept until the expiration of the applicable statute of limitations, or does the administration of §892 require some other retention time?

LIMITED PARTNER EXCEPTION FROM CCE STATUS

Background. The Temporary Regulations contain various commercial activity attribution rules, including a rule that attributes the commercial activities of partnerships (other than publicly traded partnerships) to their partners.[61] Under this rule, even minority limited partners of partnerships that engage in commercial activities will be treated as engaging in commercial activities as well.

Proposed Regulations. The Proposed Regulations create an exception to the partnership attribution rule of the Temporary Regulations.[62] An entity that holds "an interest as a limited partner in a limited partnership" will not be treated as engaged in commercial activities solely because the limited partnership is engaged in commercial activities.[63]

To qualify for this exception, an entity must hold an interest in an entity classified as a partnership for federal tax purposes.[64] Such interest will be treated as an "interest as a limited partner in a limited partnership" if the holder of the interest does not possess any 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.[65] Rights to participate in the management and conduct of the partnership's business do not include consent rights in the case of "extraordinary events" such as:

- Admission or expulsion of a general or limited partner;
- Amendment of the partnership agreement;
- Disposition of all or substantially all of the partnership's property outside the ordinary course of the partnership's activities;
- A merger of the partnership; or
- A conversion of the partnership.[66]

Commentary. The creation of a Limited Partner Exception to the attribution of commercial activity is the most useful aspect of the Proposed Regulations. Foreign governments are significant investors in various real estate, private equity, and hedge funds, and they have gone to extraordinary lengths to insulate themselves from the potential taint of even the most minor commercial activity of their investment partnerships. The Limited Partner Exception should simplify much of the tax structuring that foreign governments and the sponsors of investment funds seeking foreign government participation had to pursue in order to facilitate such investments.

A point of caution is warranted. Although taxpayers may rely upon the Proposed Regulations until final regulations are issued, taxpayers should be prepared for the possibility that the final regulations may abandon or circumscribe the Limited Partner Exception. However, in the unlikely event that happens and a foreign government has relied upon the Proposed Regulations to structure its investments, the foreign government may need to restructure its investment holdings accordingly.

Notably, the Limited Partner Exception does not apply if a limited partner has the right to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year. As the examples supplied in the Proposed Regulations indicate, it is the possession rather than the actual exercise of such rights that is the relevant inquiry. Moreover, a limited partner must consider whether those rights are conferred under both the constitutive documents of the partnership as well as the law of the jurisdiction under which the partnership was organized.

The Proposed Regulations do not indicate what sorts of rights represent the right to participate in the management and conduct of the partnership's business. They do provide that consent rights in the case of "extraordinary events" such as (but likely not limited to) those indicated above do not confer that power. Unstated is whether other rights, such as the right to sit on the advisory board or advisory committee of a partnership, would be deemed a right to "participate" in partnership management or business.

Interestingly, the Proposed Regulations do not limit application of this rule to minority positions in partnerships. Thus, a controlled entity could take a controlling limited partner position in a limited partnership, and although that partnership would become a CCE in that event, the commercial activities of the partnership would still not be attributed to the controlled entity partner (although, of course, any income from the CCE would be ineligible for §892).

Finally, it bears noting that the Limited Partner Exception does not protect against the general attribution rule that causes partners of partnerships that are engaged in a U.S. trade or business to be deemed engaged in that U.S. trade or business as well.[67] A foreign government that is deemed engaged in a U.S. trade or business will have an obligation to file a federal income tax return and will be subject to net basis taxation at the corporate rate of 35 percent on income effectively connected with that trade or business ("ECI") plus the branch profits tax at the statutory rate of 30 percent (subject to treaty reduction) on that income.[68] Therefore, where possible, foreign governments should continue to insist upon robust covenants in limited partnership agreements or side letters thereto against ECI.

DURATION OF CCE STATUS

Background. Although the negative consequences of commercial activity are considerable, neither the Code nor the Temporary Regulations indicate when the commercial activity "taint" causing an entity to become a CCE begins or for how long it endures. The absence of any guidance in this area has led to differing, largely speculative, interpretations by advisors to foreign governments.

Proposed Regulations. The Proposed Regulations provide that the determination of whether an entity is a CCE is conducted annually in accordance with the entity's taxable year.[69] Thus, an entity that is engaged in commercial activities at any time during the taxable year in which the foreign government holds 50 percent or more of the interests or over which the foreign government possesses effective control will begin to be treated as a CCE as of the start of the year and will continue to be a CCE until the end of the year. Moreover, the commercial activities of a prior taxable year will have no bearing on whether an entity is a CCE in any future taxable year.[70]

Commentary. Causing CCE status to be retroactive to the first day of the taxable year is an aggressive and inequitable interpretation of the duration of the commercial activity taint. It is aggressive in that nothing in the legislative history of §892 suggests that income earned by a controlled entity during a period prior to the actual conduct of commercial activity should be treated as income of a CCE. A more reasonable approach would be to treat the commercial taint as commencing on the day when the commercial activity itself commenced. It is also inequitable in that it will force foreign governments earning U.S. source income that was, at the time earned or paid, free of any commercial activity taint to remit monies to the IRS to satisfy the uncollected withholding tax obligation. The Proposed Regulations give no indication of how or when that is to be done, although presumably it would accompany the filing of a federal income tax return.

A controlled entity that is a CCE will also need to notify its withholding agents of its change in circumstances within 30 days of the change to the effect that any IRS Form W-8EXP delivered is no longer valid (at least for the balance of the controlled entity's taxable year), as the certification concerning commercial activities in the form will no longer be accurate.[71] If possible, the foreign government should deliver alternative forms to withholding agents, such as IRS Form W-8BEN, for the taxable year, and if the commercial activity has ceased prior to the beginning of the following taxable year, a new IRS Form W-8EXP for the following taxable year to reestablish eligibility for §892. Provided a withholding agent does not have actual knowledge or reason to know otherwise, the retroactive effect of a foreign government's commercial taint should not cause a withholding agent to incur any liability for failing to withhold on payments to a foreign government if, prior to the payment, the withholding agent can reliably associate the payment with appropriate documentation establishing an exemption from withholding.[72]

Causing CCE status to endure until the last day of an entity's taxable year is a sensible interpretation of the duration of the commercial activity taint. The alternatives would have been to have the commercial taint lapse once the commercial activity was discontinued or to have the commercial taint endure permanently for the remainder of the entity's existence. The former alternative would have been difficult to administer, and the latter alternative would have been unduly harsh, particularly without any mechanism by which an entity could purge that taint.

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ENDNOTES

1 All "section" or "§" references are to the Code or the Treasury Regulations ("Treas. Reg.") promulgated thereunder, as appropriate.

2 That the Proposed Regulations are not effective until finalized but that taxpayers "may" rely upon them until then suggests that foreign governments may treat the Proposed Regulations as optional.

3 Growing public awareness of SWFs was sparked by several high-profile cases, commencing perhaps with the 2006 attempt by DP World, a company owned by the government of Dubai, to acquire the port management business of several major United States seaports. At the time, some observers asked whether SWFs were using their financial resources to make investments for strategic reasons, and some speculated that favorable federal income tax rules might be subsidizing this activity. In March, 2008, U.S. Senators Max Baucus and Chuck Grassley requested the nonpartisan Joint Committee on Taxation (the "JCT") to review the history, rules, and policy underpinnings of the U.S. tax regime for sovereign investment. The JCT, as well as the New York State Bar Association (the "NYSBA") and the American Bar Association (the "ABA"), each produced a report in June 2008. Thus, it was likely the criticisms and recommendations of the NYSBA and the ABA, and the many letters to Treasury over time from concerned foreign governments and their advisors, that finally spurred Treasury to act.

4 A USRPI is any interest, other than an interest solely as a creditor, in either (i) real property located in the United States or Virgin Islands, or (ii) a domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation during the five-year period ending on the date of disposition of such interest. Treas. Reg. §1.897-1(b)(1). A USRPI does not include an interest in a domestically controlled real estate investment trust, or a class of stock of a domestic corporation whose shares are regularly traded on a established securities market, but only if held by a person who, during the applicable testing period, did not own more than 5 percent of that class of stock. Treas. Reg. §1.897-1(c)(1); Section 897(c)(3); Treas. Reg. §1.897-1(c)(2)(iii).

5 Section 892(a)(1); Treas. Reg. §1.892-3T(a)(1), (b).

6 Treas. Reg. §1.892-2T(a)(1).

7 Section 892(a)(2)(A).

8 Section 892(a)(2)(B).

9 Treas. Reg. §1.892-4T(b).

10 *Id.*

11 Treas. Reg. §1.892-4T(c)(1)(iii).

12 Treas. Reg. §1.892-4T(c)(1)(i).

13 Treas. Reg. §1.892-4T(c)(1)(ii).

14 Treas. Reg. §1.892-4T(c)(2).

15 Treas. Reg. §1.892-4T(c)(3).

16 Treas. Reg. §1.892-4T(c)(4).

17 Treas. Reg. §1.892-4T(c)(5).

18 Prop. Treas. Reg. §1.892-4(d).

19 *Id.*

20 The amendment also adds a measure of symmetry to the regulations as the §892 Trading Exception referenced both §162 and §864, but the general definition of commercial activity cross-referenced only §864.

21 Treas. Reg. §1.892-4T(c)(1)(i).

22 Treas. Reg. §1.892-3T(5)(i).

23 Treas. Reg. §1.892-4T(c)(1)(i).

24 Prop. Treas. Reg. §1.892-4(e)(1)(i).

25 Treas. Reg. §1.897-1(b).

26 The Proposed Regulations do not clarify when a lease will be considered a "net lease."

27 Moreover, the sale of such real property, by itself, should not be a commercial activity, although gain from such sale (if of a USRPI) would be deemed to be income effectively connected with a U.S. trade or business and taxable to the foreign government. Section 897(a)(1).

28 Treas. Reg. §1.892-4T(c)(1)(ii).

29 *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976). *See also Higgins v. Commissioner*, 312 U.S. 212 (1941).

30 *Id.*

31 Treas. Reg. §1.864-2(c).

32 Treas. Reg. §1.892-4T(c)(1)(ii).

33 Treas. Reg. §1.864-2(c)(2)(iv)(a).

34 Prop. Treas. Reg. §1.892-4(e)(1)(ii).

35 *Id.*

36 Prop. Treas. Reg. §1.864(b)-1; Treas. Reg. §1.863-7.

37 Prop. Treas. Reg. §1.864(b)-1.

38 Treas. Reg. §1.864-2(c)(2)(ii).

39 Prop. Treas. Reg. §1.892-5(d)(5)(ii).

40 Prop. Treas. Reg. §1.864(b)-1(a).

41 Prop. Treas. Reg. §1.864(b)-1(b)(2)(i).

42 Treas. Reg. §1.892-3T(a)(4).

43 Section 871(m).

44 Section 897(a)(1).

45 Prop. Treas. Reg. §1.892-4(e)(iv).

46 A USRPHC is a domestic corporation that holds predominantly USRPIs. Section 897(c)(2).

47 Section 892(a)(2)(B).

48 Section 892(a)(2)(A).

49 Treas. Reg. §1.892-2T(a)(2).

50 The Temporary Regulations do not clearly differentiate integral parts from controlled entities, creating considerable consternation among foreign governments that believe they may qualify for such treatment but nevertheless are not certain. Foreign governments that believe they may qualify for integral part status must therefore take into consideration the possible application of the less favorable controlled entity rules. *See* Treas. Reg. §1.892-2T(a).

51 Treas. Reg. §1.892-5T(d)(4) (Example 1(a)).

52 Treas. Reg. §1.892-5T(d)(4) (Example 1(c)).

53 Prop. Treas. Reg. §1.892-5(a)(2).

54 Prop. Treas. Reg. §1.892-5(a)(2)(ii)(A).

55 Prop. Treas. Reg. §1.892-5(a)(2)(ii)(B).

56 Prop. Treas. Reg. §1.892-5(a)(2)(ii)(C).

57 Prop. Treas. Reg. §1.892-5(a)(2)(ii)(C)(1).

58 Prop. Treas. Reg. §1.892-5(a)(2)(ii)(C)(2).

59 Prop. Treas. Reg. §1.892-5(a)(2)(iii).

60 Prop. Treas. Reg. §1.892-5(a)(2)(iv).

61 Treas. Reg. §1.892-5T(d)(3).

62 Prop. Treas. Reg. §1.892-5(d)(5)(i).

63 Prop. Treas. Reg. §1.892-5(d)(5)(iii)(A).

64 Prop. Treas. Reg. §1.892-5(d)(5)(iii)(B).

65 *Id.*

66 *Id.*

67 Section 875(1).

68 Treas. Reg. §1.6012-1(g)(1)(i); Section 882(a); Section 892(a)(3); Section 884(a); Treas. Reg. §1.884-0(a).

69 Prop. Treas. Reg. §1.892-5(a)(3).

70 *Id.*

71 Treas. Reg. §1.1441-1(e)(4)(ii)(D).

72 Treas. Reg. §1.1441-8(b).