U.S. Income Taxation of Foreign Governments

IRS Issues Proposed Regulations on the U.S. Taxation of the U.S. Investment Income of Foreign Governments and Entities Wholly Owned by Foreign Governments

SUMMARY

Under Section 892 of the Internal Revenue Code, a foreign government is exempt from U.S. federal income taxation on certain investment income. Entities wholly owned by a foreign government – such as sovereign wealth funds and pension plans – that meet certain requirements are generally able to rely on the same exemption. If, however, a wholly owned entity engages in commercial activities anywhere in the world, the wholly owned entity is not eligible for this exemption.

Proposed regulations issued by the Internal Revenue Service on November 2, 2011 (the “Proposed Regulations”), if finalized, would modify, and generally limit, the circumstances in which a controlled entity would be considered to be engaged in commercial activity and therefore be ineligible for this exemption. If finalized, the Proposed Regulations would:

- make several clarifications to the definition of “commercial activity” including: (i) clarifying that only the nature of the activity, rather than its purpose, determines whether activity is commercial; (ii) providing that the definition of “commercial activity” is broader than the definition of “trade or business” under U.S. tax law; and (iii) clarifying that a sale of a U.S. real property interest, by itself, does not constitute commercial activity even if the gain from that sale would be subject to U.S. taxation;
- provide that a controlled entity is not considered to conduct commercial activity solely on account of (i) being a limited partner in a partnership that conducts commercial activity, so long as the controlled entity does not participate in the management of the partnership or the conduct of its business; and (ii) an ownership interest in a partnership that engages in the trading of stock, bonds, other securities, commodities or financial instruments if such trading is for the partnership’s own account;
- provide that inadvertent commercial activity of a controlled entity will not cause the entity to be treated as a controlled commercial entity, so long as certain requirements are met; and
clarify that status as a controlled commercial entity is tested annually.

Even though certain activities may not constitute "commercial activities" (for example, certain activities conducted through limited partnerships), a foreign government or controlled entity may nonetheless be subject to U.S. federal income tax on the income from such activities.

The Proposed Regulations would apply on and after the date the regulations are published as final in the Federal Register. Entities may, however, rely upon the Proposed Regulations until final regulations are issued. The Internal Revenue Service has requested comments on the clarity of the Proposed Regulations and how the Proposed Regulations could be made easier to understand.

DISCUSSION

Section 892 provides an exemption from U.S. taxation for certain investment income earned by a foreign government (including the integral parts of a foreign government and certain entities wholly owned and controlled by a foreign government).\(^1\) This exemption does not apply to income (1) earned from commercial activities, (2) received by, or from, a controlled commercial entity, or (3) earned on the sale of an interest in a controlled commercial entity.\(^2\) A “controlled commercial entity” is defined as any entity that (i) conducts (or is deemed to conduct) any level of commercial activity (whether or not in the United States) and (ii) is controlled by a foreign government.\(^3\)

The Proposed Regulations,\(^4\) if finalized, would modify, and generally limit, the circumstances in which a controlled entity would be considered to be engaged in commercial activity and therefore be ineligible for this exemption.

Definition of Commercial Activity

In many respects, the Proposed Regulations mirror the definition of “commercial activity” found in the current temporary regulations. The Proposed Regulations make a number of clarifications.

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\(^1\) All “Section” references are to the Internal Revenue Code of 1986, as amended (the “Code”). See Section 892(a); Temporary Treasury Regulations Section 1.892-2T(a)(1) (defining “foreign government”).

\(^2\) Section 892(a)(2). The absence of an exemption under Section 892 does not necessarily mean the income will be subject to U.S. taxation. For example, the sale of an interest in a U.S. corporation that is a controlled commercial entity may not be subject to U.S. taxation if the corporation does not have significant U.S. real estate holdings.

\(^3\) Section 892(a)(2)(B). For this purpose, “control” is determined by reference to both an objective test (vote or value) and subjective test (“effective control of such entity”). Id. In contrast, a “controlled entity” (i.e., an entity eligible for the benefits of Section 892) must, among other things, be wholly owned by a foreign government. Temporary Treasury Regulations Section 1.892-2T(a)(3).

\(^4\) REG-146537-06 (November 2, 2011).
First, the Proposed Regulations provide that only the nature of the activity, and not the purpose or motivation for conducting the activity, determines whether the activity is commercial.  

Second, the Proposed Regulations provide that commercial activity encompasses activity that would not be considered a trade or business for other purposes of the Code.

Third, the Proposed Regulations clarify that the sale of a U.S. real property interest does not, by itself, constitute the conduct of a commercial activity.  This was unclear under current guidance because gain from such a sale is generally deemed to be derived from the conduct of a trade or business within the United States.

**Attribution of Activities from a Partnership**

One of the most significant changes made by the Proposed Regulations is with respect to the attribution of activities from partnerships. Under current guidance, an entity is attributed the commercial activity conducted by any partnership (other than publicly traded partnerships) in which that entity invests.

Under the Proposed Regulations, an entity would not be considered engaged in commercial activity solely on account of an equity investment in a partnership that is a trader of stock, bonds, other securities, commodities or financial instruments if such trading is for the partnership’s own account and the partnership is not a dealer.

In addition, under the Proposed Regulations, an entity would not be considered engaged in a commercial activity solely on account of the entity being a limited partner in a partnership that conducts commercial

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5 Proposed Treasury Regulations Section 1.892-4(d).

6 Specifically, the Proposed Regulations provide that commercial activity does not need to constitute a trade or business for purposes of Section 162 (which permits deductions for ordinary and necessary expenses paid or incurred in carrying on a trade or business). Id. The Proposed Regulations also indicate that the activity need not constitute a “trade or business within the United States” (assuming the activity was conducted in the United States) under the definition relevant for determining whether a foreign person is subject to U.S. taxation on a net basis. Id. This is already part of the current temporary regulations. Temporary Treasury Regulations Section 1.892-4T(b).

7 Proposed Treasury Regulations Section 1.892-4(e)(1)(iv). The Proposed Regulations indicate (consistent with current temporary regulations) that the sale of interests in U.S. real property (other than a sale of a corporation holding U.S. real property) nonetheless would not be exempt from tax under Section 892. Id. Compare Temporary Treasury Regulations Section 1.892-3T(a)(1).

8 Section 897(a)(1).

9 Temporary Treasury Regulations Section 1.892-5T(d)(3) (“commercial activities of a partnership are attributable to its general and limited partners for purposes of [Section 892].”)

10 Proposed Treasury Regulations Section 1.892-5(d)(5)(ii). The inclusion of financial instruments reflects a change in the definition of what constitutes commercial activity. See Proposed Treasury Regulations Section 1.892-4(e)(1)(ii). According to the preamble to the Proposed Regulations, this change was not intended to change the scope of the Section 892 exemption for income derived from financial instruments. As a result, income from financial instruments (other than stock, bonds and other securities) will be exempt under Section 892 only if held in the execution of governmental financial or monetary policy. Temporary Treasury Regulations Section 1.892-3T(a)(1)(ii).
activity.\textsuperscript{11} For this purpose, a partner is not considered to be a limited partner if such partner has rights to participate in the management and conduct of the partnership’s business under the law of the jurisdiction of the partnership’s organization or under the governing agreement of the partnership.\textsuperscript{12} However, any income earned from the conduct of a commercial activity conducted by a partnership would not be exempt from U.S. taxation under Section 892.\textsuperscript{13} This change is significant in that it permits controlled entities of a foreign government to invest directly in partnerships that conduct commercial activities rather than through a corporate blocker, without becoming a controlled commercial entity solely by reason of such partnership interest.

**All or Nothing Rule**

Current temporary regulations suggest that any commercial activity conducted by a controlled entity could result in that controlled entity becoming a controlled commercial entity.\textsuperscript{14} If a controlled entity is a controlled commercial entity, none of its income (including its investment income) would be eligible for an exemption from U.S. taxation under Section 892.\textsuperscript{15}

Under the Proposed Regulations, inadvertent commercial activity would be disregarded in determining whether an entity conducts commercial activity.\textsuperscript{16} Activity would be treated as inadvertent if: (1) failure to avoid conducting the activity was reasonable; (2) the failure is promptly cured;\textsuperscript{17} and (3) certain record maintenance requirements are met.\textsuperscript{18}

Reasonableness would be determined in light of all facts and circumstances, and consideration would be given to the number of commercial activities conducted in current and previous years, the amount of income generated by the commercial activities relative to the entity’s total income, and the relative value

\textsuperscript{11} Proposed Treasury Regulations Section 1.892-5(d)(5)(iii)(A). This provision also applies to interests in limited liability companies treated as partnerships for U.S. federal income tax purposes. See Proposed Treasury Regulations Section 1.892-5(d)(5)(iv), Examples 1-3.

\textsuperscript{12} Proposed Treasury Regulations Section 1.892-5(d)(5)(iii)(B). Possession of consent rights in the case of certain extraordinary events would not cause a holder of such rights to be treated as other than a limited partner. Id.

\textsuperscript{13} Proposed Treasury Regulations Section 1.892-5(d)(5)(iii)(A).

\textsuperscript{14} Temporary Treasury Regulations Section 1.892-5T(a) (“means any entity engaged in commercial activities” that is controlled by a foreign government).

\textsuperscript{15} In contrast, a foreign government and an integral part of a foreign government would continue to be eligible for the Section 892 exemption for its other investment income.

\textsuperscript{16} Proposed Treasury Regulations Section 1.892-5(a)(2)(i). Income derived from the inadvertent commercial activity would not be eligible for Section 892 exemption. Id.

\textsuperscript{17} Proposed Treasury Regulations Section 1.892-5(a)(2)(i).

\textsuperscript{18} Discontinuing the activity within 120 days of discovery is considered timely. Proposed Treasury Regulations Section 1.892-5(a)(2)(iii).

\textsuperscript{19} In particular, the entity would have to maintain records related to each inadvertent commercial activity and the steps taken to cure that activity. Proposed Treasury Regulations Section 1.892-5(a)(2)(iv).
of the assets used in the conduct of the commercial activities. 20 Reasonableness would not be established if the entity does not conduct continuing due diligence to prevent commercial activity. 21 The Proposed Regulations require adequate written policies and operational procedures in place to monitor the entity’s activities as part of this continuing due diligence, as well as reasonable efforts by management-level employees of the entity to establish, follow and enforce such policies and procedures. 22 As a safe harbor, if the continuing due diligence requirements are met, the reasonableness standard is satisfied if (i) the value of assets used in all commercial activities does not exceed five percent of all the entity’s assets and (ii) the income earned from commercial activity does not exceed five percent of the entity’s gross income, in each case, as reflected on the entity’s financial statements as prepared for financial accounting purposes. 23

**Determination of Status**

Under the Proposed Regulations, a controlled entity is considered a controlled commercial entity for the entire tax year in which it engages in commercial activity. 24 However, such an entity will not be considered a controlled commercial activity in a subsequent tax year unless it conducts commercial activity in that tax year as well. 25

**Effective Date and Request for Comments**

The Proposed Regulations would apply on and after the date the regulations are published as final in the Federal Register. 26 Entities may, however, rely upon the Proposed Regulations until final regulations are issued. The Internal Revenue Service has requested comments on the clarity of the Proposed Regulations and how the Proposed Regulations could be made easier to understand.

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22 Id.
24 Proposed Treasury Regulations Section 1.892-5(a)(3).
25 Id.
26 Proposed Treasury Regulations Sections 1.892-4(f), 1.892-5(e).
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