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Tax Group Client Alert

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IRS ISSUES PROPOSED REGULATIONS REGARDING EXEMPTION OF FOREIGN GOVERNMENTS FROM U.S. INCOME TAX

The Internal Revenue Service (IRS) has proposed regulations (the "**Proposed Regulations**") under section 892 of the Internal Revenue Code of 1986, as amended (the "**Code**"), that provide guidance relating to the taxation of foreign governments and international organizations that derive income from sources within the United States. Code section 892 exempts from U.S. income taxation certain qualified U.S. source investment income derived by foreign governments, government instrumentalities and certain entities controlled by foreign governments. The section 892 exemption does not apply, however, to income that is: (1) derived from the conduct of a commercial activity, (2) received by or from (either directly or indirectly) a controlled entity that engages in commercial activities (a "controlled commercial entity"), or (3) derived from the disposition of any interest in a controlled commercial entity. The Proposed Regulations provide additional guidance and some relief in respect of: (1) what constitutes a commercial activity, (2) when a controlled entity will be treated as engaging in a commercial activity, and (3) the treatment of foreign governments and controlled entities that are members of partnerships. Taxpayers may rely on these Proposed Regulations until final regulations are issued.

I. Commercial Activity

Although the Proposed Regulations are substantially similar to previously issued temporary regulations under Code section 892 (the "**Prior Regulations**"), the Proposed Regulations make some notable changes. The Prior Regulations identified certain activities that would not be treated as commercial activities. These included investing in stocks, bonds and other securities, trading in securities for the government's own account and making loans (other than in the course of conducting a banking, financing or similar business). Also included was investing in "financial instruments" (such as derivatives) provided that the financial instruments were "held in the execution of governmental or monetary policy." The Proposed Regulations modify the requirement relating to financial instruments by specifying that investing in financial instruments is not a commercial activity, without regard to whether the financial instruments were held in the execution of government financial or monetary policy.

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Prior to the Proposed Regulations, there was some uncertainty as to whether investing in U.S. real estate constituted commercial activity. Code section 897(a)(1) (frequently referred to as "FIRPTA") requires that a nonresident alien or foreign corporation take into account gain or loss from the disposition of a U.S. real property interest as if the taxpayer were engaged in trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with that trade or business. The Proposed Regulations provide that a disposition of a U.S. real property interest does not, by itself, constitute commercial activity. Nevertheless, gain derived from such a disposition will not qualify for exemption under section 892 and will continue to be subject to U.S. taxation under the normal FIRPTA rules.

Although implicit under the Prior Regulations and other applicable law, the Proposed Regulations make explicit that an activity may be a commercial activity for purposes of Code section 892 even if the activity does not constitute a trade or business for other federal income tax purposes.

II. Controlled Commercial Entity

If an entity is deemed a controlled commercial entity, none of its income nor any income derived from it (e.g., dividends) by the foreign government qualifies for exemption, even to the extent a portion of the income of the controlled commercial entity may be from otherwise qualified investments. In response to taxpayer concern that this "all or nothing" rule is a trap for controlled entities of foreign governments that inadvertently conduct a small level of commercial activity, the Proposed Regulations carve out from the definition of controlled commercial entity any entity that conducts only "inadvertent" commercial activity. Commercial activity is inadvertent if: (1) the failure to avoid conducting the commercial activity is reasonable, (2) the commercial activity is promptly discontinued, and (3) certain record maintenance requirements are met. Although entities that conduct inadvertent commercial activity are not deemed controlled commercial entities, the income derived from such inadvertent commercial activity will not qualify for exemption from tax under section 892.

In determining whether an entity's failure to avoid conducting a particular commercial activity is reasonable, the Proposed Regulations state that due regard will be given to the number of commercial activities conducted during the taxable year as well as the amount of income earned from, and assets used in, the conduct of the commercial activity in relation to the entity's total income and assets. If there are adequate written policies and operational procedures in place to monitor the entity's worldwide activities, the Proposed Regulations specify that the controlled entity's failure to avoid the conduct of commercial activity will be considered reasonable if: (1) the value of the assets used in, or held for use in, the activity does not exceed five percent of the total value of the assets reflected on the entity's balance sheet for the taxable year and (2) the income earned by the entity from the commercial activity does not exceed five percent of the entity's gross income as reflected on its income statement for the taxable year.

The Proposed Regulations also clarify that the determination of whether an entity is a controlled commercial entity will be made on an annual basis. Consequently, the conduct of commercial activity in one year will not cause a controlled entity to be treated as a controlled commercial entity in subsequent years.

III. Partnerships

The Prior Regulations generally provided that the commercial activities of a partnership are attributable to its general and limited partners, so that by reason of holding an interest in a partnership that was engaged in a commercial activity, the controlled entity would be deemed a controlled commercial entity. An exception to this rule existed for interests in publicly traded partnerships. The Proposed Regulations expand the existing exception to cover all "limited partnership interests" held by a controlled entity. Under this expanded and revised exception, a controlled entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because

it holds a limited partnership interest in an entity that is treated as a partnership for U.S. income tax purposes and is engaged in commercial activities. Note, however, that the controlled entity's distributive share of partnership income attributable to such commercial activity will still be considered to be derived from the conduct of commercial activity, and therefore will not be exempt from taxation under section 892. Moreover, if the partnership is itself a controlled commercial entity, this exception will not apply and no part of the foreign sovereign partner's distributive share of partnership income will qualify for exemption from tax under section 892.

The Proposed Regulations define "limited partnership interest" for this purpose as an interest in an entity characterized for federal income tax purposes as a partnership, provided that the holder of such interest does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year. Whether such a right exists will be based on the law of the jurisdiction in which the entity is organized and under the entity's governing agreement.

Lastly, the Proposed Regulations provide a trading activity exception for partners. Under this exception, a controlled entity not otherwise engaged in commercial activities will not be considered to be engaged in commercial activities solely because the entity is a member of a partnership that engages in trading activity for the partnership's own account. This exception does not apply in the instance that the partnership is a dealer in stocks and securities under Code section 864.

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