MORRISON | FOERSTER

Client Alert.

November 7, 2011

New Proposed Regulations Clarify Scope of Section 892 and Create *De Minimis* Exception for Inadvertent Commercial Activity

By Robert A.N. Cudd, Stephen L. Feldman, Michelle M. Jewett and Maureen E. Linch

On November 2, 2011, the Internal Revenue Service (the "IRS") and the Treasury Department issued proposed Treasury Regulations (the "Proposed Regulations")[1] which modify and clarify the temporary Treasury Regulations promulgated in 1988 (the "Temporary Regulations") under Section 892 of the Internal Revenue Code of 1986, as amended (the "Code").[2] In general, Section 892 exempts from U.S. federal income taxation qualified investment income received by foreign governments as long as the foreign government or an entity controlled by the foreign government does not engage in commercial activity. While clarifying that all revenue from an entity controlled by a foreign government will not qualify for Section 892's exemption if the entity is engaged in commercial activity, the Proposed Regulations create a safe harbor for entities controlled by foreign governments that "inadvertently" engage in commercial activities. This is a welcome development, particularly for sovereign wealth funds, which may be considered separate, controlled entities under Section 892.

BACKGROUND

Income received by a foreign government generally will be exempt from U.S. federal income taxation under Section 892 unless the income is derived from a commercial activity, a controlled commercial entity, or the sale of an interest in a controlled commercial entity.[3]

Under the Temporary Regulations, a foreign government is limited to its integral parts and its controlled entities.[4] If an integral part of a foreign government receives income from both qualified investments and commercial activities, the qualified investments will be eligible for the Section 892 exemption, but the income from commercial activities will be subject to U.S. federal income taxation. However, if a controlled entity engages in any commercial activity anywhere in the world, none of the U.S. income of the controlled entity will be eligible for the Section 892 exemption, even if some of the income would otherwise qualify as noncommercial income. For purposes of these rules, a corporation is deemed to be engaged in commercial activities if it is a U.S. real property holding corporation ("USRPHC") or would be but for the fact that it is a foreign corporation.

The definition of commercial activity in the Temporary Regulations is extremely broad. The Temporary Regulations first define commercial activity inclusively, as all activity ordinarily conducted for the current or future production of income or

[1] REG-146537-06.

[2] T.D. 8211. All Section references herein are to the Code and the Treasury Regulations promulgated thereunder.

[3] Sections 892(a)(1) and (2).

[4] Treasury Regulations Section 1.892-2T(a).

gain, but then enumerate a list of exceptions, including investments, cultural events, nonprofit activities, and governmental functions.[5]

The rules in the Temporary Regulations with respect to attribution of the commercial activities of a partnership to its partners are also extremely far-reaching. Both general and limited partners are treated as engaging in any commercial activities which are undertaken by their partnerships.[6] The only relief from this attribution regime is a limited exception for publicly traded partnerships.

PROPOSED TREASURY REGULATIONS

In response to comments that the Temporary Regulations offered too narrow an exemption under Section 892 and posed administrative and operational burdens on foreign governments, the Proposed Regulations generally expand the availability of the exemption under Section 892. First, the Proposed Regulations restrict the definition of controlled commercial entity by adding a *de minimis* exception for inadvertent commercial activity and by delineating the testing period for determining whether a controlled entity is commercial. Second, the Proposed Regulations confine the definition of commercial activities by modifying and clarifying the definition in the Temporary Regulations. Finally, the Proposed Regulations limit the attribution of the commercial activities from partnerships to partners by creating a new exception for limited partners.

Restricting the Definition of Controlled Commercial Entity

The Proposed Regulations contain a new *de minimis* exception for inadvertent commercial activity by controlled entities of foreign governments which should provide a reasonable safe harbor for controlled entities to make investments. A controlled entity can avoid being classified as a controlled commercial entity if it engages in only inadvertent commercial activity. A controlled entity will qualify for the exception if three requirements are met: (i) the failure to avoid commercial activity is reasonable; (ii) the controlled entity promptly stops engaging in the commercial activity after becoming aware of the activity; and (iii) the controlled entity maintains records according to certain standards. In order to meet the first requirement (that the failure to avoid commercial activity was reasonable) the foreign government must implement written policies and operational procedures to monitor the controlled entity's worldwide activities. The reasonableness requirement also contains a safe harbor. The failure to avoid commercial activity will be considered reasonable if the value of the assets held for use in the commercial activity is no more than 5 percent of the total value of all of the controlled entity's assets, and the income earned from the commercial activity is no more than 5 percent of the entity's gross income. Even if the controlled entity meets all of the requirements of the *de minimis* exception, however, all income derived from the inadvertent commercial activity will be subject to U.S. federal income taxation but will not taint income from noncommercial activity.

The Proposed Regulations also specify that the determination of whether a controlled entity is a controlled commercial entity is made on an annual basis. A determination in one year that an entity is a controlled commercial entity will not cause the entity to be a controlled commercial entity in another year.

[5] Treasury Regulations Section 1.892-4T(b).

[6] Treasury Regulations Section 1.892-5T(d)(3).

Confining the Definition of Commercial Activity

Although the Proposed Regulations maintain that an activity may be commercial even if it would not constitute a business activity for other purposes of the Code, the Proposed Regulations limit the definition of commercial activity in several ways. They provide that the determination of whether an activity is commercial hinges on the nature of the activity, rather than the purpose for conducting the activity.[7] The Proposed Regulations further provide that investments in financial instruments will not be treated as commercial activities, even if they are not held in connection with the execution of governmental monetary or financial policy, as required by Section 892(a)(1)(A)(ii) and the Temporary Regulations.

The Proposed Regulations also provide that the mere disposition, or deemed disposition, of a U.S. real property interest will not rise to the level of a commercial activity, absent other commercial activities. This clarification should prevent foreign governments investing in U.S. real estate through a blocker corporation that is not a USRPHC from being subject to tax on distributions made by the blocker. In addition, controlled entities investing in real estate that are not USRPHCs should not be subject to tax on income from other investments even though any income from the disposition of the U.S. real property interest will not be exempt from U.S. tax under Section 892.

Limiting the Attribution of Commercial Activities to Limited Partners

Under the Proposed Regulations, an entity which is not otherwise engaged in commercial activity will not be treated as engaged in commercial activity merely because it holds a limited partner interest in a limited partnership. This new exception applies only if the limited partner has no rights to participate in the management and conduct of the partnership's business at all times during the partnership's taxable year. However, any income received by a limited partner attributable to commercial activity of the partnership will not qualify for the Section 892 exemption. In addition, if an integral part of a foreign government receives income from a partnership that is a controlled commercial entity, none of the income will qualify for the Section 892 exemption, but the income will not taint the limited partner's other income. This clarification should allow controlled entities such as sovereign wealth funds to invest as limited partners in U.S. or non-U.S investment partnerships without the risk of becoming controlled commercial entities.

The Proposed Regulations also provide that an entity which is not otherwise engaged in commercial activities will not be deemed to be engaged in commercial activities solely because it is a partner in a partnership that transacts in securities, commodities, or financial instruments for its own account. This exception does not apply if the partnership is a dealer in securities, commodities, or financial instruments.

Contact:

Robert A.N. Cudd
(415) 268-6904
rcudd@mofo.com

Stephen L. Feldman
(212) 336-8470
sfeldman@mofo.com

Michelle M. Jewett
(415) 268-6553
mjewett@mofo.com

Maureen E. Linch
(415) 268-6015
mlinch@mofo.com

[7] Proposed Treasury Regulations Section 1.892-4(d).

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for eight straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.