

The IRS Releases Proposed Regulations Regarding Taxation of Investments by Foreign Governments

On November 2, 2011, the Internal Revenue Service ("IRS") released a set of proposed regulations (the "Regulations") under Section 892 of the Internal Revenue Code ("Section 892"), which exempts certain investment income earned by foreign governments from U.S. taxation. The Regulations limit the extent to which entities controlled by foreign governments will be treated as engaged in "commercial activity," a characterization which disqualifies such entities' entire income from exemption under Section 892. With the implementation and expansion of safe harbors for certain direct and indirect investment activities, the Regulations create new opportunities for sovereign investors in funds and U.S. real property.

Summary of Section 892

Section 892 exempts from U.S. taxation certain qualified investment income derived by foreign governments, including income from investments in U.S. stocks, bonds, and domestic securities, and interest on U.S. bank deposits. There are two principal restrictions on the exemption in Section 892: first, Section 892 does not exempt any income that is derived from the conduct of "commercial activity," which is broadly defined to include any activity that seeks to produce income; second, a "controlled commercial entity" (defined below) is not eligible

under Section 892, nor is any income received from a controlled commercial entity or derived from the disposition of an interest in such an entity exempt under Section 892.

A "controlled commercial entity" is an entity conducting commercial activity in which a foreign government owns either (a) 50 percent (by vote or value) of the shares or interests in the entity, or (b) an interest that permits the foreign government to exercise effective control over the entity. Because any amount of commercial activity will taint all income received from a controlled commercial entity for purposes of Section 892, sovereign investors have typically been averse to investing directly or indirectly (through

a controlled entity) in partnerships that conduct any amount of commercial activity.

The exemption in Section 892 also does not cover income derived from United States real property or gain from the sale of a U.S. real property interest ("USRPI"). However, gain on the sale of stock of a non-controlled corporation is typically exempt under Section 892, even if such corporation holds U.S. real property. Any entity that is treated as a United States real property holding corporation (a "USRPHC") or that would be treated as a USRPHC if it were a U.S. corporation, is deemed to be engaged in a commercial activity, and therefore will be a controlled commercial entity if it is controlled by a

foreign government in the manner described above.

Overview of the New Regulations

The Regulations do not change the first restriction under Section 892; thus, any income derived from commercial activity (even de minimis commercial activity) or gain from the sale of a USRPI (other than gain on the sale of stock of a non-controlled corporation) is not exempt under Section 892 and remains subject to tax. Instead, the Regulations tailor the second restriction to allow entities controlled by foreign governments to engage in certain investment activities without being automatically characterized as controlled commercial entities.

De Minimis Rule for Commercial Activity

In determining whether a controlled entity is a controlled commercial entity, the Regulations provide a new exception for de minimis inadvertent commercial activity if (i) the failure to avoid conducting the commercial activity is "reasonable" (generally determined by the facts and circumstances, but a new safe harbor test is available, described below), (ii) the commercial activity is promptly cured, and (iii) certain record maintenance requirements are met. The safe harbor test for "reasonable" avoidance of commercial activity requires that (i) the entity establish written policies and operational procedures to monitor the entity's worldwide activities, and undertake reasonable efforts to follow and enforce

those policies and operational procedures; and (ii) for any taxable year, (a) the value of the entity's assets associated with the commercial activity does not exceed 5 percent of its total assets, and (b) the income from the commercial activity does not exceed 5 percent of the entity's total gross income.

Limited Partner Exception for Commercial Activity

The Regulations provide a new exception whereby a controlled entity, which is not otherwise engaged in commercial activities, will not be treated as a controlled commercial entity solely because it holds a limited partner interest in a partnership that conducts commercial activities. A "limited partner interest" is one in which the holder does not have rights (regardless of exercise) 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 of the partnership. For purposes of the Regulations, rights to participate in the management and conduct of the partnership's business do not include consent rights in the case of certain extraordinary events, including 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.

If a foreign government controls an investment partnership, the partnership will be a controlled commercial entity, and no portion of the income received from it will be exempt from tax under Section 892. Furthermore, as discussed above, the Regulations do not affect the rule that a limited partner's allocable share of income derived from a partnership's commercial activity is not exempt under Section 892 and remains subject to tax.

The limited partnership exemption is unlikely to provide considerable comfort to foreign government investors in investment funds and real estate investment vehicles because of the narrow list of limited partner rights that are not considered participation in the management and conduct of a partnership's business. Typically, foreign government investors in investment funds and real estate investment vehicles will have a variety of rights beyond those listed in the examples to protect their interests by limiting the activities of the investment manager and addressing rights in certain scenarios such as a loss of key persons.

Dispositions of U.S. Real Property Interests

The Regulations clarify that a disposition of a USRPI (including a deemed disposition through a real estate investment trust or regulated investment company under Section 897(h)(1) of the Internal Revenue Code) does not, in itself, constitute the conduct of a commercial activity. As such, entities controlled by sovereign investors will likely have more flexibility to invest in funds that hold United

States real property and USRPIs without being characterized as controlled commercial entities, although any income from United States real property or gain on the sale of a USRPI (other than gain on the sale of stock of a non-controlled corporation) remains subject to tax.

The regulations do not address the rule under which a controlled entity that is a USRPHC, or that would be treated as a USRPHC if it were a U.S. corporation, is deemed to be engaged in a commercial activity and thus is automatically characterized as a controlled commercial entity. This rule discourages foreign government investors from investing in U.S. real property because in certain cases even small indirect investments in U.S. real property can cause a controlled entity to be treated as a USRPHC.

Other Exceptions from Commercial Activity

The Regulations expand the "own-account trading" safe harbor under Section 892 to exclude own-account trading in financial instruments, including derivatives, forwards, futures, and options, by a non-dealer from the definition of commercial activity. In addition, a controlled entity will not be considered to be engaged in commercial activity solely because it is a member of a partnership that engages in own-account trading activity,

so long as such partnership is not a dealer for U.S. tax purposes.

Treatment of Financial Instruments

The Regulations eliminate the rule that financial instruments may only be held in the execution of government financial or monetary policy. Thus, a controlled entity will not be treated as engaged in commercial activity solely because it holds financial instruments, although income from financial instruments remains subject to tax, unless the financial instruments are held in the execution of government financial or monetary policy.

Annual Determination

The Regulations provide that the determination of whether an entity is a controlled commercial entity will be made on an annual basis. Thus, a controlled entity will not be considered a controlled commercial entity for a taxable year solely because the entity engaged in commercial activity in a prior taxable year.

Effective Date

The Preamble to the Regulations provides that, effective from November 2, 2011, taxpayers may rely on the proposed regulations until final regulations are issued. The Regulations will be effective once they are published as final regulations.

The foregoing is not intended or written to be used, and cannot be used by any person, for the purposes of avoiding U.S. federal income tax penalties.

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