November 9, 2011

# IRS Proposes Favorable Changes to Sovereign Wealth Funds' U.S. Tax Exemption

The IRS issued proposed regulations last week that will make it easier for sovereign wealth funds and other entities controlled by foreign governments to invest in private funds without jeopardizing their exemption from U.S. federal income taxation under Section 892 of the Code. Importantly, taxpayers may rely on the proposed regulations until final regulations are issued.

As discussed in greater detail below, the proposed regulations provide that, solely for purposes of determining status as a controlled commercial entity (which is ineligible for exemption from U.S. taxation under Section 892), (i) an entity controlled by a foreign government will not be treated as engaging in commercial activities solely by reason of its status as a limited partner in a partnership that engages in commercial activities, and (ii) "inadvertent" commercial activity is disregarded. In addition, the proposed regulations clarify that the disposition of a U.S. real property interest and the ownership of an interest in a partnership that trades investment assets for its own account do not constitute commercial activities. These changes do not, however, exempt any commercial activity income of a foreign government, or its controlled entities, from being subject to U.S. taxation.

**Background**

Section 892 of the Code provides foreign governments and their controlled entities a narrow, but important, exemption from U.S. federal income taxation on certain types of investment income on which other non-U.S. investors generally are subject to tax (most notably, dividends, non-portfolio interest and gains from sale of non-controlled U.S. real property holding corporations). This exemption is, however, unavailable to income received by or from a controlled commercial entity. Under the rules in effect prior to these new proposals, an entity that is majority owned or controlled by a foreign government would be treated as a "controlled commercial entity" if, among other things, such entity engaged in *any* commercial activities whether within or outside the United States (sometimes called the "all-or-nothing rule").

"Commercial activities" are those ordinarily engaged in for the current or future production of income or gain, whether or not rising to the level of a "trade or business." Current regulations provide that certain investment and trading activities, as well as the holding of net-leased or non-income-producing real property, are not commercial activities.

Importantly, current regulations also provide that the commercial activities of a partnership (other than a publicly traded partnership) are attributable to its partners, including limited partners. Thus, a sovereign wealth fund entity that invests in a partnership engaged in commercial activities could lose its U.S. tax exemption on all of its income, whether generated through that partnership or otherwise. To avoid this result, sovereign wealth funds have typically invested in private funds through "blocker" entities or required private funds to make investments that could give rise to a commercial activity through AIVs.

**Changes to the All-or-Nothing Rule**

*No Partnership Attribution to "Limited Partners."* Under the proposed regulations, solely for purposes of determining status as a controlled commercial entity, a limited partner is not treated as engaging in the commercial activities of the partnership if it does not have the right to participate in the management and conduct of the partnership's business, and would therefore not be treated as a controlled commercial entity solely as a result of holding such a partnership interest. The same rule would apply to a member of a limited liability company.

Consent rights with respect to extraordinary events (such as the admission or expulsion of a partner, the amendment of the partnership agreement, the dissolution of the partnership, the disposition of substantially all of the partnership's property and the merger or conversion of the partnership) are not considered management participation rights for these purposes. However, the proposed regulations do not address ongoing, but limited rights such as representation on a private fund's advisory board. In the absence of further guidance, such arrangements should be evaluated on a case-by-case basis.

This exception means that a private fund's commercial activities will generally not cause a sovereign wealth fund that invests in the private fund to lose its tax exemption; however, the sovereign wealth fund will still be taxed on its share of the U.S. income of the private fund attributable to commercial activities, and may have to file a U.S. tax return reporting such income. In addition, if a sovereign wealth fund owns more than 50% of a private fund or otherwise has effective control over the private fund, and the private fund engages in some commercial activity, the private fund itself would be treated as a controlled commercial entity, and the sovereign wealth fund's entire share of the income of the private fund (whether or not such income was from a commercial activity) would be ineligible for the benefits of Section 892.

*Investing and Trading in Financial Instruments.* Solely for purposes of determining status as a controlled commercial entity, investing and trading in financial instruments will not be considered a commercial activity, regardless of whether such financial instruments are held in the execution of governmental financial or monetary policy. However, a foreign government will continue to be ineligible for the benefits of Section 892 with respect to income from financial instruments (which is defined to exclude stocks, securities, loans and commodities) unless held in the execution of governmental financial or monetary policy.

*Inadvertent Commercial Activity.* Solely for purposes of determining status as a controlled commercial entity, inadvertent commercial activity is disregarded. An entity's commercial activity is "inadvertent" if (i) adequate written policies and procedures are in place to monitor the entity's worldwide activities, (ii) not more than 5% of the entity's assets were used in

commercial activities, (iii) not more than 5% of the entity's income was derived from commercial activities, (iv) the commercial activity is discontinued within 120 days of discovery, and (v) adequate records of each discovered commercial activity and remedial action are retained. A foreign government will nonetheless continue to be subject to U.S. tax on income from inadvertent commercial activities.

**Changes to "Commercial Activity" Rules**

*Partnership Trading Activities.* Current law provides that trading for one's own account does not constitute a commercial activity. The proposed regulations clarify that a partner in a partnership that trades for its own account (regardless of the partner's participation in the management and conduct of the partnership's business) will not be treated as engaged in a commercial activity solely because of its interest in the partnership. This exception does not apply if the partnership is a "dealer" in stocks, bonds, other securities, commodities or financial instruments. The same rule would apply to a member of a limited liability company.

*Disposition of U.S. Real Property Interests.* Pursuant to the new proposals, the disposition of a U.S. real property interest will not be considered a commercial activity. A "U.S. real property interest" generally includes any non-creditor interest in U.S. real property and stock of a U.S. real property holding corporation (generally, a U.S. corporation that holds substantial U.S. real property interests). However, a foreign government will continue to be subject to U.S. tax on the gain from the disposition of a U.S. real property interest (other than stock of a U.S. real property holding corporation), including its share of such gain recognized by a partnership in which it invests. As under prior law, income from net leases (even though not considered a commercial activity) is not exempt from U.S. tax under Section 892.

**Annual Testing**

Under prior law, it was not clear whether an entity that engaged in commercial activities could regain eligibility for Section 892 once it ceased to engage in those activities. The proposed regulations provide that the determination of controlled commercial entity status will be made for each taxable year. As a result, a controlled entity will not be "tainted" by commercial activity from a prior year.

**No Change in Scope of Section 892 Exemption**

As noted above, although these proposed rules significantly narrow the impact of the all-or-nothing rule that can disqualify a controlled entity from receiving the benefits of Section 892 exemption, it does not expand the categories of income eligible for that exemption. Accordingly, like other foreign investors, a foreign governmental entity may still prefer to use "blocker" and AIV structures to avoid the need to file U.S. tax returns even if its Section 892 exemption is not at risk.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Richard J. Bronstein
(212) 373-3744
rbronstein@paulweiss.com

David W. Mayo
(212) 373-3324
dmayo@paulweiss.com

Brad R. Okun
(212) 373-3727
bokun@paulweiss.com

Peter J. Rothenberg
(212) 373-3154
prothenberg@paulweiss.com

Jeffrey B. Samuels
(212) 373-3112
jsamuels@paulweiss.com

David R. Sicular
(212) 373-3082
dsicular@paulweiss.com

*Colin S. Kelly contributed to this client alert.*

**NEW YORK**
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

**BEIJING**
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

**HONG KONG**
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

**LONDON**
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

**TOKYO**
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

**TORONTO**
Toronto-Dominion Centre
77 King Street West, Suite 3100
P.O. Box 226
Toronto, ON M5K 1J3
Canada
+416-504-0520

**WASHINGTON, D.C.**
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

**WILMINGTON**
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410