To Our Clients and Friends:

On November 3, 2011, the IRS published new proposed Treasury Regulations providing guidance relating to the taxation of income of foreign governments from investments in the United States under Section 892 of the Internal Revenue Code of 1986, as amended (the "Code"). The proposals update regulations that were first issued in 1988, and are welcome additions to an area of U.S. tax law that has grown in importance with the emergence of government investment funds, sometimes referred to as "sovereign wealth funds," controlling in the aggregate trillions of dollars of investment assets. Although the proposals provide useful immediate guidance to foreign governments, taking advantage of these beneficial rules will require foreign governments in many instances to introduce new written policies and operational procedures. Foreign government investors are advised to review carefully their investment structures in light of these new rules and, where appropriate, seek advice from experienced counsel.

Background

Section 892 of the Code exempts certain types of qualified investment income derived by a "foreign government" in the United States from U.S. income tax, including (i) income from stocks, bonds, and other domestic securities, (ii) income from financial instruments held in the execution of governmental financial or monetary policy, and (iii) interest on deposits in U.S. banks.

A "foreign government" is defined as including only the "integral parts" and "controlled entities" of a foreign sovereign. An "integral part" is defined as "any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country." A "controlled entity" is generally defined as a separate juridical entity wholly owned by the foreign sovereign and organized in the jurisdiction of the foreign sovereign, the income and assets of which inure to the foreign sovereign.

Section 892 provides certain exceptions to the general rule of tax exemption. In particular, Section 892 does not exempt any income (i) derived from the conduct of any "commercial activity," (ii) received by or from a "controlled commercial entity," or (iii) derived from the disposition of any interest in a "controlled commercial entity." A "controlled commercial entity" is an entity owned by a foreign government that meets certain ownership or control thresholds and that is engaged in "commercial activities" anywhere in the world. "Commercial activities" are generally defined as all activities ordinarily conducted for the current or future production of income, with certain specified exceptions.

Under the current rules, the two types of foreign government investors are treated differently. An "integral part" of a foreign sovereign that derives income from qualified investments and from commercial activity can claim the Section 892 exemption with respect to the income from the qualified investments, even though it is engaged in commercial activities. However, if a "controlled entity"
engages in commercial activities anywhere in the world, the controlled entity is transformed into a controlled commercial entity and loses all tax benefits under Section 892 with respect to any of its income (including income from investments otherwise qualifying under Section 892 that are not commercial activities).

The newly proposed regulations address this harsh "all or nothing" rule for controlled entities by generally restricting what constitutes "commercial activities" and when a controlled entity will be considered a "controlled commercial entity."

**Proposed Regulations**

1. **Summary of Changes**

   The proposed regulations make the following important changes to the Section 892 regime:

   - The regulations prevent treatment of a controlled entity as a controlled commercial entity as a result of only inadvertent commercial activity;[1]
   - The regulations provide that the determination of whether an entity is a controlled commercial entity will be made on an annual basis;[2]
   - The regulations limit the situations in which investments in financial instruments will be considered commercial activities;[3]
   - The regulations provide that the disposition of a United States real property interest does not, by itself, constitute commercial activity;[4]
   - The regulations provide that the commercial activities of a partnership will not be attributed to a foreign government that is a limited partner without management rights;[5] and
   - The regulations clarify that trading stocks, securities or commodities by a partnership of which a foreign government is a partner does not constitute commercial activity by the foreign government.[6]

   Each of these changes is discussed in more detail below.

2. **Inadvertent Commercial Activity**

   The proposed regulations recognize the harsh results if a controlled entity inadvertently earns a small amount of commercial activity income. Under the proposed regulations, a controlled entity would not be considered a controlled commercial entity (and thereby would still be eligible for exemption on income from its qualified investments that are not commercial activities) if it conducts only inadvertent commercial activity. Commercial activity will be treated as inadvertent commercial activity only if (i) the failure to avoid conducting the commercial activity is reasonable; (ii) the commercial activity is promptly cured; and (iii) certain record maintenance requirements are met. However, none of the
income derived from such inadvertent commercial activity will qualify for exemption under Section 892.

Showing that the failure to avoid commercial activity was reasonable will necessarily depend on the surrounding facts and circumstances, including the number of commercial activities conducted during the taxable year as well as the amount of income earned from, and assets used in, the commercial activity relative to the entity's total income and assets. A failure to avoid commercial activity will not be considered reasonable unless adequate written policies and operational procedures are in place to monitor the entity's worldwide activities. As long as such written policies and operational procedures are in place, the proposed regulations provide a safe harbor under which the failure to avoid commercial activity will be considered reasonable if (i) the value of the assets used in, or held for use in, the activity does not exceed 5% of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes, and (ii) the income earned by the entity from the commercial activity does not exceed 5% of the entity's gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes.

3. **Once a Controlled Commercial Entity, Not Always a Controlled Commercial Entity**

Under current law, it has not been clear whether a controlled entity, if it engages in commercial activity, would forever be tainted as a controlled commercial entity. The proposed regulations resolve this uncertainty, providing that the determination of whether an entity is a controlled commercial entity will be made on an annual basis. Accordingly, an entity will not be considered a controlled commercial entity for a taxable year solely because the entity engaged in commercial activities in a prior taxable year.

4. **Financial Instruments**

Under current law, investments in "financial instruments" are not considered commercial activities if held in the execution of governmental financial or monetary policy. The proposed regulations remove the requirement that such instruments be held in the execution of governmental financial or monetary policy to avoid treatment as commercial activities. In addition, the proposed regulations expand the existing exception to the definition of commercial activity for trading of stocks, securities, and commodities to include financial instruments, without regard to whether such financial instruments are held in the execution of governmental financial or monetary policy.

Note, however, these changes only affect whether such investments will constitute commercial activities. They do not affect whether income from those investments will be exempt under Section 892, as Section 892 requires that financial instruments be held in the execution of governmental financial or monetary policy in order for the income to be eligible for the exemption. The primary impact of these changes is to reduce the likelihood that a controlled entity will be deemed a controlled commercial entity and thereby lose the Section 892 exemption on all of its U.S. source income.

5. **United States Real Property Interests**

For foreign investors, the disposition of a U.S. real property interest ("US RPI") is treated as income effectively connected with the conduct of a United States trade or business. The proposed regulations
clarify that the disposition of a US RPI, including the receipt of a REIT capital gain dividend that constitutes a deemed disposition of a US RPI, may constitute income from a trade or business and therefore not be exempt from tax under Section 892, but does not by itself constitute the conduct of a commercial activity for a foreign government.

6. Partnerships

Under current law, the commercial activities of a partnership are attributable to its general and limited partners, with a limited exception for partners of publicly traded partnerships ("PTPs"). The proposed regulations expand the existing exception for PTP interests by providing a more general exception for limited partnership interests. Under the revised exception, an entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership, including a PTP that qualifies as a limited partnership. To qualify as a limited partner for the purposes of this exception, the holder of the interest must not have rights to participate in the management and conduct of the partnership's business under the law of the jurisdiction in which the partnership is organized or under the governing agreement. A controlled entity that meets this exception will not be deemed to be engaged in commercial activities by virtue of the activities of the partnership. However, its distributive share of partnership income attributable to such commercial activities will still be considered derived from the conduct of commercial activity and therefore not exempt from tax under Section 892. In addition, if the partnership itself is a controlled commercial entity, no part of the foreign government partner's distributive share will qualify for exemption.

Also under current law, trading stocks, securities or commodities by a foreign government for its own account does not constitute commercial activity. However, no similar rule applies in the case of trading done by a partnership of which a foreign government is a partner. The proposed regulations eliminate this disparity by providing that an entity not otherwise engaged in commercial activities will not be considered to be engaged in commercial activities solely because it is a member of a partnership that effects transactions in stocks, bonds, other securities, commodities, or financial instruments for the partnership's own account. However, this exception does not apply in the case of a partnership that is a dealer in such instruments.

7. Effective Date

The proposed regulations will become effective on the date they are finalized; however, the proposed regulations permit foreign governments to rely immediately on the proposed regulations.

[2] Id. at -5(a)(3)
[3] Id. at -4(e)(1)(i) and (ii)
[4] Id. at -4(e)(1)(iv)
Gibson, Dunn & Crutcher lawyers actively represent a number of foreign governments in their investments and were instrumental in the drafting of the Generally Accepted Principles and Practices (GAPP)--Santiago Principles by the International Working Group of Sovereign Wealth Funds. Our lawyers are available to assist in addressing any questions you may have regarding these developments. If you have any questions, please contact the Gibson, Dunn & Crutcher attorney with whom you work or any of the attorneys listed below.

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