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Treasury Issues Proposed Regulations with Safe Harbor for Sovereign Wealth Funds

On November 2, Treasury proposed regulations (the "Proposed Regulations") under section 892 of the Internal Revenue Code (the "Code") that eliminate the "all or nothing" rule that previously applied for determining whether an entity is a "controlled commercial entity." The Proposed Regulations also made several other changes regarding the treatment of commercial activities, several of which are described below. Although the Proposed Regulations technically do not become binding until they are finalized, taxpayers are permitted to rely on the Proposed Regulations until final regulations are issued.

Section 892 of the Code provides a partial exemption from U.S. federal income tax for foreign governments and certain "controlled entities" of foreign governments. Sovereign wealth funds typically meet the definition of a controlled entity and are able in appropriate circumstances to take advantage of the section 892 exemption. Private equity and hedge funds seeking investment from sovereign wealth investors often structure their funds to provide sovereign wealth investors with income that is exempt under section 892 of the Code. Accordingly, the Proposed Regulations could have a material impact on investment funds with sovereign wealth investors.

Inadvertent Commercial Activity

Before the Proposed Regulations, if an entity controlled by a foreign government derived any income from a commercial activity, it would be treated as a "controlled commercial entity," and would not be eligible for the exemption from tax under section 892 of the Code. As a result, none of the investment income received by the controlled entity would be exempt under section 892 of the Code, nor would any of the income received by the foreign government from the controlled entity (e.g., interest and dividends). Under the Proposed Regulations, an entity that conducts only "inadvertent commercial activity" is not considered a controlled commercial entity. Any income from the inadvertent commercial activity is not exempt under section 892 of the Code, but the activity does not taint the status or the other income of the entity.

A commercial activity is an "inadvertent commercial activity" if:

- the failure to avoid conducting the commercial activity is reasonable;
- the entity stops conducting the commercial activity within 120 days of discovery; and
- the entity maintains adequate records of each discovered commercial activity and the remedial action taken.

Failure to avoid conducting a commercial activity is deemed to be reasonable if:

- the entity has adequate written policies and operational procedures in place to monitor the entity's worldwide activities and management level employees of the entity have undertaken reasonable efforts to establish, follow, and enforce such written policies and operational procedures;
- the value of the assets used in all commercial activity is 5% or less of the total value of all assets on the entity's balance sheet (prepared for financial accounting purposes); and

- the income earned from commercial activity is 5% or less of the entity's gross income on the entity's income statement (prepared for financial accounting purposes).

If the entity does not satisfy the safe harbor described above, whether the failure to avoid conducting the commercial activity is reasonable will be determined in light of all of the facts and circumstances. The Proposed Regulations also indicate that the determination as to whether an entity is a controlled commercial entity is made on an annual basis, so that being treated as a controlled commercial entity in a prior year does not taint the current year.

Other Changes

The Proposed Regulations provide that investing in financial instruments (forwards, futures, options and swaps) is not treated as a commercial activity regardless of whether the instruments are held in the execution of governmental financial or monetary policy. As a result, such activities do not taint a controlled entity. However, income from financial instruments continues to be exempt under section 892 of the Code only if the instruments are held in the execution of governmental financial or monetary policy.

The Proposed Regulations also expand the exception for trading activities for the foreign government's own account. Before the Proposed Regulations, effecting non-dealer transactions in stocks, securities, or commodities for a foreign government's own account did not constitute a commercial activity. Under the Proposed Regulations, this exception is expanded to include effecting non-dealer transactions in financial instruments for the foreign government's own account.

The Proposed Regulations limit the attribution of commercial activities to limited partners. An entity that is not otherwise engaged in commercial activities will not be deemed to be engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership or as a non-managing member of a limited liability company. However, the limited partner or member's distributive share of income derived from the partnership or limited liability company's commercial activity will not be exempt under section 892 of the Code.

The Proposed Regulations provide that a disposition (including a deemed disposition) of a U.S. real property interest does not give rise to a commercial activity, although the income from such a disposition is not exempt under section 892 of the Code.

If you would like more information about the Proposed Regulations, please contact one of the lawyers listed below.

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