IRS Issues Proposed Regulations Addressing Income Earned by Sovereign Wealth Funds and Other Foreign Governmental Entities

On November 2, 2011, the US Treasury Department released proposed regulations (the Proposed Regulations) under Section 892 of the Internal Revenue Code of 1986, as amended (the Code) that should facilitate the investment in private equity funds by sovereign wealth funds and other entities controlled by foreign governments. The Proposed Regulations clarify some previously unanswered questions, and liberalize the existing rules in several respects, eliminating some “traps for the unwary.” The Proposed Regulations are welcome news to private equity funds and to sovereign wealth funds.

Background

Foreign governments and entities wholly owned by a foreign government may qualify under Section 892 of the Code for a special exemption from certain US federal income taxes not enjoyed by other non-US persons. The most significant benefits afforded by Section 892 are an exemption from (i) withholding taxes on US source dividends (which are generally subject to withholding at a 30 percent rate, unless reduced by a tax treaty), (ii) interest (which, if it does not qualify for the “portfolio interest exemption,” is subject to withholding at a 30 percent rate, unless reduced by a tax treaty), and (iii) gain on the sale of stock of a US real property holding corporation (which is generally subject to a 35 percent tax, and is typically not reduced by tax treaties).

The benefits of Section 892 extend not only to foreign governments themselves, but also to entities that are wholly-owned by foreign governments and that meet certain conditions. Importantly, the Section 892 exemption does not apply to income received by or from a so-called “controlled commercial entity.” A controlled entity of a foreign government is a “controlled commercial entity” if it engages in “commercial activities.” The exclusion of controlled commercial entities is intended to exclude from the benefits of Section 892 government-owned businesses, such as national airlines. Most sovereign wealth funds, and many foreign pension funds that are established to provide benefits to government employees, are controlled entities of foreign governments, and many have a significant amount of investment capital and are frequent investors in private equity funds and related co-investment transactions.
Problems Under Temporary Treasury Regulations

There are a number of issues and uncertainties that existed under the Temporary Treasury Regulations promulgated under Section 892 of the Code (the Temporary Regulations) that have been addressed in a favorable way under the Proposed Regulations. The issues and uncertainties include the following:

1. Potentially Permanent Taint. While it was not entirely clear how long an entity remained a “controlled commercial entity” after engaging in commercial activity, under a restrictive reading of the Temporary Regulations, once a controlled entity of a foreign government became a controlled commercial entity, the benefits of Section 892 were permanently unavailable to it and all of its subsidiaries.

2. No De-minimis Rule. Under the Temporary Regulations, earning one dollar of “commercial activity income” could permanently exclude a controlled entity of a foreign government from the benefits of Section 892. In addition, mere ownership of an interest in a partnership that had commercial activity income could cause the controlled entity to be a controlled commercial entity, potentially permanently excluding such entity from the benefits of Section 892.

3. Traps for the Unwary. Many types of income that the United States does not tax in the hands of non-US persons could be commercial activity income, the receipt of which would cause a controlled entity of a foreign government to be a controlled commercial entity. Those types of income included:


      Commercial activity income is not limited to US-source income. Thus, a controlled entity of a foreign government could receive commercial activity income, or engage in a commercial activity, long before it had any reason to be aware of, or concerned about, US tax rules governing such income, and as a result, could potentially be permanently excluded from the benefits of Section 892.

b. Certain kinds of investment income. Under the Temporary Regulations, “commercial activities” are defined as all activities ordinarily conducted for the current or future production of income or gain with exceptions for investments in stocks, bonds and other securities. As a result, there was a question of whether income from currency hedging and sales of interests in partnerships that held only stocks, bonds and other securities gave rise to commercial activity income, even though this type of income is not normally subject to tax by the US in the hands of a non-US person.

4. Investing in Limited Partnerships. Under the Temporary Regulations. All the activities of a partnership are attributed to its partners and a controlled entity of a foreign government becomes a controlled commercial entity if a partnership in which it invests engages in any commercial activity, even if such income is not allocated to the controlled entity. As a result of this rule and because a controlled commercial entity is not entitled to the benefits of Section 892 on any of its income, sovereign wealth funds and other controlled entities of foreign governments generally require limitations on the activities that can be undertaken by partnerships in which they invest to prevent the partnership from being engaged in any commercial activity.

Changes Made By the Proposed Regulations

The Proposed Regulations mitigate the problems discussed above and make it
much easier for a controlled entity of a foreign government to invest in a limited partnership.

1. The Proposed Regulations Broaden the Exceptions for Commercial Activity Income. Under the Proposed Regulations, income from “financial instruments” is excluded from commercial activity income. This includes income from forward contracts, futures, options, swaps or similar instruments. Thus, for example, income from currency hedging with respect to investments made by a private equity fund in assets denominated in currencies other than its functional currency is no longer a concern under the Proposed Regulations. In addition, gain from the disposition of an interest in US real property is not treated as commercial activity income (although it is still not exempt from tax under Section 892 other than as noted above with respect to certain interests in US real property holding corporations).

2. The Proposed Regulations add an Inadvertent Commercial Activity Exception. The Proposed Regulations provide that a controlled entity of a foreign government that conducts only inadvertent commercial activity will not be considered to be a controlled commercial entity (although the income from such activities will not be exempt from tax under Section 892). In order to qualify for this exception, the failure to avoid the commercial activity must be reasonable, the commercial activity must be promptly cured, and certain record-maintenance rules must be complied with.

3. The Proposed Regulations Clarify that there is no Permanent Taint and add an Annual Test. The Proposed Regulations provide that status as a controlled commercial entity is determined annually, and a controlled entity of a foreign government that does not engage in any commercial activities for a taxable year is not a controlled commercial entity in such taxable year, even if it engaged in commercial activities in a prior year. This is particularly useful in the case of controlled entities of a foreign government that were in existence for some time prior to investing in the US, which otherwise may have difficulty determining whether they had commercial activity income in the past, and which prior to the publication of the Proposed Regulations, could have resulted in their permanent exclusion from the benefits of Section 892, along with all of their direct and indirect subsidiaries.

4. The Proposed Regulations make it Easier for Controlled Entities to Invest in Limited Partnerships. The Proposed Regulations substantially modify the treatment of the ownership of an interest in a limited partnership in two important respects:

   a. First, the Proposed Regulations provide that ownership of an interest in a partnership that is not a dealer and that trades for its own account in stocks, bonds, other securities, commodities or financial instruments, will not cause a controlled entity to be a controlled commercial entity.

   b. Second, in what may be the most useful change for purposes of investment by controlled entities in private equity funds, under the Proposed Regulations, a controlled entity not otherwise engaged in commercial activities will not be deemed to be engaged in a commercial activity solely because it holds a minority interest as a limited partner in a limited partnership (or an equivalent non-managing interest in another type of entity that is classified as a partnership for US federal income tax purposes), even if that partnership is engaged in a commercial activity. An interest in an entity classified as a partnership for US federal income tax purposes...
is treated as an interest as a limited partner in a limited partnership as long as the holder of the interest does not have rights to participate in the management and conduct of the partnership's business. Because investments in private equity funds by sovereign wealth funds and other controlled entities nearly always take the form of an interest that would be treated as a limited partnership interest under the Proposed Regulations, this provision effectively eliminates any concern that a typical investment in a private equity fund could cause a controlled entity to be a controlled commercial entity and lose the benefits of Section 892 on all of its income. The Proposed Regulations do not modify the rule that commercial activity income allocated from a partnership to a controlled entity is not exempt from tax under Section 892, and a controlled entity would still be required to pay US federal income tax on commercial activity income derived from an interest in a partnership if the income would otherwise be subject to tax by the US in the hands of a non-US person.

Effective Date and Reliance

The Proposed Regulations will be effective on the date they are published as final regulations in the Federal Register. However, the Preamble to the Proposed Regulations states that taxpayers may rely on the Proposed Regulations until final regulations are issued. This is welcome news as the changes make it easier for controlled entities of foreign governments to obtain the benefits of Section 892 and remove concerns that previously had to be addressed when controlled entities of foreign governments invested in private equity funds.

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