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Memorandum

Updating the Sovereign Tax Exemption: The Proposed Regulations Under Section 892

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Over the last two decades, the importance of sovereign investment and the influence of sovereign investment funds have increased dramatically. The taxation of sovereign investment income has been governed by the double income tax treaties to which the United States is a party and §892 of the Code, which has also taken on increased significance given the prominence of sovereign investment funds. Uncertainties have been an important part of the legacy of §892. The history of §892, which dates to 1917, four years after the adoption of the income tax act, has been thoughtfully addressed elsewhere.[1]

This article will address recent developments in the area, the most important of which are proposed regulations that were issued on November 3, 2011 (the ''Proposed Regulations'').[2] The significance of the Proposed Regulations is heightened because many of the rules in this area are contained in the regulations, rather than in §892 itself, and, here, taxpayers may rely on the Proposed Regulations until final regulations are issued. Most recently, in connection with the issuance of proposed and temporary regulations under §871(m), a new proposed regulation was issued addressing the treatment of dividend equivalents for purposes of §892.[3]

BACKGROUND

Foreign persons receiving investment income that is not effectively connected with a U.S. trade or business may be subject to taxation under §§871 and 881 and subject to withholding taxation at the rate of 30% under §§1441 and 1442 However, many items of investment income are exempt from withholding under §§871 and 882. Section 892 sets forth exemption mechanisms for two types of taxpayers: foreign governments and international organizations. Under §892(a), the income of a foreign government received from investment in the United States in stocks, bonds, other domestic securities, financial instruments held in the execution of government financial or monetary policy, or interest on deposits in banks is not subject to taxation. As enacted by the Tax Reform Act of 1986, excluded from such exemption is income received, directly or indirectly, from commercial activities.[4] This includes income received directly or indirectly from a ''controlled commercial entity'' or from the disposition of any interest in a controlled commer-

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[1] *See* New York State Bar Association, ''Report on the Tax Exemption for Foreign Sovereigns Under Section 892 of the Internal Revenue Code'' (6/13/08), *available at* 2008 *TNT* 116-53 (the ''NYS Bar Report on Section 892''); Joint Committee on Taxation, ''Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States,'' JCX-49-08 (6/17/08), *available at* 2008 *TNT* 118-13 (the ''Joint Committee Report'').

[2] REG-146537-06, 76 Fed. Reg. 68119 (11/3/11).

[3] REG-120282-10, 77 Fed. Reg. 3202 (1/23/12).

[4] Prior to the Tax Reform Act of 1986, §892 provided:

cial entity.[5] Section 892 was again amended in 1988 to provide that foreign governments and noncommercial wholly owned governmental subsidiaries generally will be treated as corporate residents of their home country, for purposes of the Code, and that they generally will be so treated under an income tax treaty pursuant to which the United States receives reciprocal treatment.[6]

The §892 exemption also extends to ''international organizations.''[7] Under §892(b) an exemption is also available for the income of international operations, from income received from investments in the United States in stocks, bonds, other domestic securities owned by such international organizations, or from interest on deposits in banks in the United States of moneys belonging to such international organizations, or from any other source within the United States. Finally, §892(c) grants the Secretary power to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section. Closely related to §892 is §895, which exempts from U.S. tax income derived by a foreign central bank from U.S. government obligations or from interest on deposits with persons carrying on the banking business. An entity that qualifies for the §895 exemption from U.S. federal income tax might also qualify for the broader §892 exemption.

In the absence of §892, other Code sections would govern a sovereign's income. Many of these provisions exempt investment income that is not effectively connected income. For example, portfolio interest income is exempt under §881. Capital gains from investments that are not effectively connected with a U.S. trade or business are also exempt. However, gains on the disposition of a U.S. real property interest, including a U.S. real property holding corporation, are taxable and result in the effectively connected income status, with an exception for publicly traded stock where the holder does not own more than 5% of the shares).[8]

There are many instances, though, where investment income is taxable, even in the absence of a U.S. trade or business. For example, income from dividends is not exempt from taxation, but most treaties reduce the rate of taxation on portfolio dividends to 15%. In addition, contingent interest income does not qualify for the portfolio debt exemption.[9] Interest income from noncontrolled-but-related entities would also not be eligible for the portfolio debt exemption.[10] Under §892, each of these items of investment income is exempt from U.S. taxation.

TEMPORARY REGULATIONS UNDER SECTION 892

Proposed and temporary regulations were issued in 1988 under §892 that apply to income received by a foreign government on or after July 1, 1986.[11] The temporary regulations were issued after §892 had been substantially modified by the Tax Reform Act of 1986. Regs. §1.892-2T defines a foreign government. Regs. §1.892-3T describes the types of income that generally qualify for exemption and certain limitations on the exemption. Regs. §1.892-7T sets forth the relationship of §892 to other Code sections. No withholding is required under §§1441 and 1442 on income exempt from U.S. taxation under §892.

Earnings and profits attributable to income of a controlled entity of a foreign sovereign that is exempt from taxation under §892 are not subject to the branch profits tax imposed under §884(a). While not a matter addressed by §892, under §884(e), interest of international organizations is not subject to the branch interest rules.[12]

Regs. §1.892-4T provides rules concerning the characterization of activities as commercial activities. Regs. §1.892-5T defines a controlled commercial entity. The Proposed Regulations that were issued in November 2011 contain important updates to Regs. §§1.892-4T and -5T and are likely the most significant changes in the area since 1988.

What Is a Foreign Government?

Regs. §1.892-2T defines a foreign government. The term ''foreign government'' means only the ''integral parts'' or ''controlled entities'' of a foreign sover-

> The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

[5] §892(a)(2)(A).

[6] §892(a)(3).

[7] §892(b). *See also* §7701(a)(18).

[8] §897(c)(3). Of course, both U.S. and foreign corporations may be U.S. real property holding corporations when more than half of their value is from U.S. real property interests; however, only the sale of a U.S. corporation is subject to taxation. §897(c)(1)(A) and (2).

[9] §871(h)(4)(A).

[10] §871(h)(3).

[11] REG-209024-88; T.D. 8211.

[12] *See* PLR 8931038, updating PLR 8829089 (U.S. source interest of international development bank that is treated as an international organization is exempt from branch interest rules).

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eign.[13] An ''integral part'' of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country.[14] The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. An integral part does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity. Consideration of all the facts and circumstances will determine whether an individual is acting in a private or personal capacity.

The term ''controlled entity'' means an entity that is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity if it satisfies the following four requirements: (1) it is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities; (2) it is organized under the laws of the foreign sovereign by which it is owned; (3) its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and (4) its assets vest in the foreign sovereign upon dissolution.[15] A controlled entity does not include partnerships or any other entity owned and controlled by more than one foreign sovereign.[16] Pension trusts are controlled entities if (i) the trust is established exclusively for the benefit of (a) employees or former employees of a foreign government; or (b) employees or former employees of a foreign government and nongovernmental employees or former employees that perform or performed governmental or social services; (ii) the funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government; (iii) the trust forming a part of the pension plan provides for retirement, disability, or death benefits in consideration for prior services rendered; and (iv) income of the trust satisfies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.[17] Pension funds that are not controlled entities may be integral parts of a foreign government.[18] As described below, the distinction between an integral part and a controlled entity is very important. And to be distinguished from a controlled entity is a ''controlled commercial entity,'' which is not eligible for the §892 exemption.

[13] Regs. §1.892-2T(a)(1).

[14] Regs. §1.892-2T(a)(2).

[15] Regs. §1.892-2T(a)(3).

[16] *Id.*

[17] Regs. §1.892-2T(c)(1).

[18] Regs. §1.892-2T(c)(2), *Ex. 4(a)*.

What Income Is Exempt?

Regs. §1.892-3T describes the types of income derived by a foreign government that are exempt income. As set forth in §892(a)(1), this includes: (1) income from investments in the United States in stocks, bonds, or ''other securities''; (2) income from investments in the United States in financial instruments held in the execution of governmental financial or monetary policy; and (3) interest on deposits in banks in the United States of moneys belonging to such foreign government.

Income from investments in stocks, bonds, or ''other securities'' includes gain from their disposition and income earned from engaging in §1058 securities lending transactions.[19] This exemption also applies to gain from the disposition of U.S. real property holding corporations (except where the corporation is a controlled commercial entity).[20] However, neither income earned from a U.S. real property interest nor gain from the disposition of a U.S. real property interest is exempt.[21] The term ''other securities'' includes any note or other evidence of indebtedness.[22] Thus, an annuity contract, a mortgage, a banker's acceptance, or a loan is a security for purposes of this section.[23] However, the term ''other securities'' does not include partnership interests (with the exception of publicly traded partnerships within the meaning of §7704) or trust interests.[24] It is noteworthy that gain from the disposition of a U.S. real property holding corporation would generally pass through to a partner under §897. Thus, the exclusion of partnership interests from the definition of ''other securities'' effectively eliminates an exemption from taxation that would exist if the sale had been made directly by the foreign government.[25] The term ''other securities'' also does not include commodity forward or futures contracts and commodity options unless they constitute securities for purposes of §864(b)(2)(A).[26] There is also no exclusion under §892 for royalty income.

The term ''financial instrument'' includes any forward, futures, options contract, swap agreement, or similar instrument in a functional or nonfunctional currency or in precious metals when held by a foreign

[19] Regs. §1.892-3T(a)(2).

[20] Regs. §1.892-3T(b), *Ex. 1* (holding that gain from sale of a 12% interest in a USRPHC is exempt).

[21] Regs. §1.892-3T(a)(1) (flush language).

[22] Regs. §1.892-3T(a)(3).

[23] *Id.*

[24] *Id.*

[25] *See* NYS Bar Report on Section 892, footnote 91, and accompanying text.

[26] *Id.*

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government or central bank of issue.[27] Nonfunctional currency or gold is considered a ''financial instrument'' also when physically held by a central bank of issue.[28] A financial instrument is deemed held in the execution of governmental financial or monetary policy if the primary purpose for holding the instrument is to implement or effectuate such policy.[29]

Unlike the exemption that is available to tax-exempt organizations, the exemption provided to foreign governments under §892 is available without regard to whether it is derived from debt-financed property.[30]

What Is a Commercial Activity?

All activities (whether conducted within or outside the United States) that are ordinarily conducted by the taxpayer or by other persons with a view toward the current or future production of income or gain are commercial activities.[31] An activity may be considered a commercial activity even if such activity does not constitute the conduct of a trade or business in the United States under §864(b).[32] Regs. §1.892-4T(c)(1) specifically states that the following will not be considered commercial activities: (1) investments in stocks, bonds, and other securities; (2) loans; (3) investments in financial instruments held in the execution of governmental financial or monetary policy; (4) the holding of net leases on real property or land that is not producing income (other than on its sale or from an investment in net leases on real property); and (5) the holding of bank deposits in banks. Transferring securities under a loan agreement that meets the requirements of §1058 is an investment.[33] An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.[34]

While trading in stock is a trade or business under §162, trading in stocks, securities, or commodities for a foreign government's own account does not constitute a commercial activity regardless of whether such activities constitute a trade or business for purposes of §162 or a U.S. trade or business for purposes of §864.[35] Indeed, investments (including loans) made by a banking, financing, or similar business constitute commercial activities, even if the income derived from such investments is not considered to be income effectively connected to the active conduct of a banking, financing, or similar business in the United States by reason of the application of Regs. §1.864-4(c)(5).[36] The inclusion of loans in the exemption is interesting given that lending is often indicative of a trade or business. However, in fact, the loans contemplated by the commercial activity exclusion lack the financial motive of a trade or business.[37]

For example, in PLR 8604030, the IRS addressed the treatment of a loan by a central bank.[38] The government of the foreign country instructed its central bank to lend a U.S. foundation, which supported students of the foreign country in the United States, $42 million to retire existing debt on real estate and to construct a new building on property. The U.S. branch of a foreign bank controlled by the foreign country acted as an intermediary because the central bank was prohibited from making loans except to banks. The central bank made a loan to the other foreign bank, which in turn made a loan to the foundation on terms negotiated between the foundation and the central bank. There was a long and continuing history of default by the foundation and agreement by the central bank and foreign bank to various lengthy deferred payment arrangements extending well beyond the original term of the loan. The value of the loan was small in relation to the value of real estate. The central bank and foreign bank had consistently foregone the assertion of their rights as creditors. The IRS ruled that the interest income earned by the central bank and the other foreign bank was exempt from U.S. tax under §892 and was not subject to withholding under §1441 or §1442.

What Is a Controlled Commercial Entity?

The exemption, generally applicable to a foreign government and its controlled entities for income described in Regs. §1.892-3T, does not apply to income received by a controlled commercial entity or received (directly or indirectly) from a controlled com-

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[27] Regs. §1.892-3T(a)(4). Some people believe that the phrase ''in a functional or nonfunctional currency'' is unclear and could be read to refer to the underlying transaction, rather than how the contract is denominated. Adding the word ''denominated'' would clear up a lot of confusion.

[28] *Id.*

[29] Regs. §1.892-3T(a)(5)(i).

[30] §512(b)(4).

[31] Regs. §1.892-4T(b).

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] Regs. §1.892-4T(c)(1)(ii).

[36] Regs. §1.892-4T(c)(1)(iii).

[37] Regs. §1.892-4T(c)(i).

[38] PLR 8604030. *See also* PLR 9235061 (involving a loan by a foreign government's export credit agency where the loans are limited to transactions with selected U.S. persons that require and qualify for financing that are identified by the foreign government, where none of corporation's activities is conducted with a view toward the current or future production of income).

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mercial entity. In other words, the entity will not be exempt, nor will dividends and interest received from it or gain from the sale of the entity be exempt from tax under §892.[39] Importantly, wholly owned entities of foreign governments or any other entities described in Regs. §1.892-2T are *per se* corporations under the check-the-box rules, thereby broadening the scope of this provision.[40] Thus, a foreign entity similar to an LLC would be treated as a corporation (and must be tested under these provisions). In contrast, activities that are integral parts of a foreign government may be eligible for the exemption, notwithstanding the presence of some taxable commercial income. The *per se* entity rule broadens the impact of the all-or-nothing rule and has been subject to criticism.[41]

The temporary regulations thus adopt an all-or-nothing approach in determining whether a controlled commercial entity is eligible for the §892 exemption. Any entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government (i) holds (directly or indirectly) any interest in such entity that (by value or voting power) is 50% or more of the total of such interests or (ii) holds (directly or indirectly) a sufficient interest (by value or voting power) or any other interest in such entity that provides the foreign government with ''effective practical control'' of such entity.[42] Effective practical control may be achieved through a minority interest that is sufficiently large to achieve effective control, or through creditor, contractual, or regulatory relationships which, together with ownership interests held by the foreign government, achieve effective control.[43] The temporary regulations give an example of effective control where an entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government, in addition to holding a small minority interest (by value or voting power) is also a substantial creditor of the entity or controls a strategic natural resource that such entity uses in the conduct of its trade or business, giving the foreign government effective practical control over the entity.[44]

Except for partners of publicly traded partnerships, commercial activities of a partnership are attributable to its general and limited partners for purposes of §892.[45] The operation of this rule is illustrated in the ownership by K, a controlled entity of a foreign government, of a general partnership interest. The partnership owns investments in both various stocks and bonds and a New York City real estate office building. The controlled entity will be deemed to be engaged in commercial activity by being a general partner even if it does not actually make management decisions with regard to the partnership's commercial activity. Accordingly, its distributive share of partnership income (including income derived from stocks and bonds) will not be exempt from taxation under §892.[46] The controlled entity will be taxable even if an independent contractor is hired to lease offices and manage the building.[47] As noted in the Joint Committee Report, the attribution of activities from a partnership often results in the need to create special structures, such as noncontrolled blockers.[48]

The temporary regulations identify three entities which are treated as engaged in a commercial activity. These include: (1) U.S. real property holding corporations or foreign corporations that would be U.S. real property corporations if incorporated in the United States; (2) central banks, but only if engaged in commercial activities within the United States; and (3) pension trusts, which engage in commercial activity within or outside the United States.[49]

While the treatment of pension trusts is consistent with other aspects of the rules concerning controlled commercial entities, the treatment of foreign corporations that hold U.S. real estate seems unusually broad. While foreign corporations are taxed on the disposition of their interests in U.S. real estate, gains from the sale of foreign corporations holding U.S. real estate are not taxable under FIRPTA, nor are dividends or interest. Under the temporary regulations, however,

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[39] Regs. §1.892-5T(a).

[40] Regs. §301.7701-2(b)(6).

[41] The elimination of the *per se* rule was one of two principal recommendations of a New York State Bar Association Report issued in 2008. *See* NYS Bar Report on Section 892, footnote 75, and accompanying text.

[42] Regs. §1.892-5T(a)(1). Note that to be a controlled entity, and thus receive foreign government status, under Regs. §1.892-2T(a)(3), the entity must be wholly controlled.

[43] In PLR 9224034, the IRS addressed the treatment of a domestic corporation, Newco, that was established by several Swedish pension funds to hold an interest in a general partnership that would invest in U.S. real estate.

[44] Regs. §1.892-5T(c)(2).

[45] Regs. §1.892-5T(d)(3).

[46] Regs. §1.892-5T(d)(4), *Ex. 4(a)*.

[47] Regs. §1.892-5T(d)(4), *Ex. 4(b)*.

[48] Joint Committee Report, footnote 193, and accompanying text.

[49] Regs. §1.892-5T(b). A pension trust is not treated as a controlled commercial entity if the trust only earns income that would not be unrelated business taxable income if the trust were a qualified trust described in §401(a). However, only income that is described in Regs. §1.892-3T and which is not from commercial activities is exempt from taxation under §892. Regs. §1.892-5T(b)(3).

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dividends from such foreign corporations and gains from their sale will be taxable.[50]

THE PROPOSED REGULATIONS

The Proposed Regulations address two specific areas: What is a commercial activity, and what is a controlled commercial entity?

Modifications to the Commercial Activity Test

As they pertain to what is a commercial activity, the Proposed Regulations state that only the nature of the activity, not the purpose or motivation for conducting the activity, is determinative of whether the activity is commercial in character.[51] The Proposed Regulations further state that an activity may be considered a commercial activity even if such activity does not constitute a trade or business for purposes of §162 and even if it does not constitute (or would not constitute if undertaken in the United States) the conduct of a trade or business in the United States for purposes of §864(b).[52] The preamble to the Proposed Regulations states that comments requested further guidance on the duration of a determination that an entity is a controlled commercial entity.[53] In response to this comment, the Proposed Regulations provide 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.[54]

As noted above, the temporary regulations contain a specific exemption for specific types of income derived by a foreign government, including (i) income from investments in the United States in stocks, bonds, or other securities; (ii) income from investments in the United States in financial instruments held in the execution of governmental financial or monetary policy; and (iii) interest on deposits in banks in the United States of moneys belonging to such foreign government.[55] The exemption does not apply to income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity.

The Proposed Regulations make changes to what constitutes a commercial activity. They expand the exemption for activities not considered commercial to include financial instruments, so that it now applies without regard to whether such financial instruments are held in the execution of governmental financial or monetary policy.[56] The preamble to the Proposed Regulations states that the revision addresses only the definition of commercial activity for purposes of determining whether a government will be considered to derive income from the conduct of a commercial activity, or whether an entity will be considered to be engaged in commercial activities. It does not address whether income from activities that are not commercial activities will be exempt from tax under §892. In other words, for a central bank, financial instruments income will be exempt only if held in the execution of monetary policy.[57]

Questions had arisen concerning the impact of the disposition of a U.S. real property interest on the issue of whether an entity had conducted a commercial activity. This is because §897(a)(1) requires that a taxpayer take into account gain or loss from the disposition of a U.S. real property interest as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with that trade or business. To resolve uncertainty regarding the implication on commercial activity status, Prop. Regs. §1.892-4(e)(1)(iv) provides that a disposition of a U.S. real property interest does not constitute the conduct of a commercial activity.[58]

MODIFICATIONS TO THE DEFINITION OF A CONTROLLED COMMERCIAL ENTITY

The most significant changes relate to the definition of a controlled commercial entity. Prior to the Proposed Regulations, tax planning was complicated by the so-called ''all-or-nothing'' rule. If an entity is engaged in any commercial activity—anywhere in the world—it will be considered to be engaged in a commercial activity. The Proposed Regulations modify this concern by providing a mechanism for avoiding inadvertent commercial activities.[59] However, they make no change to the treatment of foreign corpora-

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[50] Possible rationales for the treatment of foreign corporations holding U.S. real estate as controlled commercial entities are described in Gregory May, ''The Foreign Sovereign Tax Exemption,'' 2009 *TNT* 12-60 at 18 (1/22/09).

[51] Prop. Regs. §1.892-4(d).

[52] *Id.*

[53] REG-146537-06.

[54] Prop. Regs. §1.892-5(a)(3).

[55] Regs. §1.892-3T(a)(1).

[56] Prop. Regs. §1.892-4(e)(1).

[57] Regs. §1.892-3T(a)(1)(ii).

[58] This also includes a deemed disposition under §897(h)(1) upon a distribution.

[59] Prop. Regs. §1.892-5(a)(2). The elimination of the all-or-nothing rule was one of two principal recommendations of a NYS Bar Association Report issued in 2008. *See* NYS Bar Report on Section 892, footnote 78, and accompanying text.

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tions holding U.S. real property interests. They continue to be treated as engaged in a commercial activity where they otherwise meet the U.S. real property holding corporation thresholds.

As an initial matter, the term ''entity'' is now defined under the Proposed Regulations, as a corporation, partnership, a trust (including a pension trust) and an estate.[60] Thus, a partnership can be a controlled commercial entity. However, for purposes of determining whether an entity is a controlled commercial activity, an entity that conducts only ''inadvertent commercial activity'' will not be considered to be engaged in commercial activities.[61] However, importantly, any income derived from such inadvertent commercial activity will not qualify for exemption from tax under §892.[62] Commercial activity of an entity will be treated as inadvertent commercial activity only if three requirements are met: (a) failure to avoid conducting the commercial activity is reasonable; (b) the commercial activity is promptly cured; and (c) the record maintenance requirements are met.[63]

Failure to Avoid Conducting the Commercial Activity Is Reasonable

Whether an entity's failure to prevent its worldwide activities from resulting in commercial activity is reasonable will be determined in light of all the facts and circumstances.[64] Due regard will be given to the number of commercial activities conducted during the taxable year and in prior taxable years, as well as the amount of income earned from, and assets used in, the conduct of the commercial activities in relationship to the entity's total income and assets, respectively. A failure to avoid commercial activity will not be considered reasonable unless there is continuing due diligence to prevent the entity from engaging in commercial activities within or outside the United States as evidenced by having adequate written policies and operational procedures in place to monitor the entity's worldwide activities. A failure to avoid commercial activity will not be considered reasonable if the management-level employees of the entity have not undertaken reasonable efforts to establish, follow, and enforce such written policies and operational procedures. [65]

Provided that adequate written policies and operational procedures are in place to monitor the entity's worldwide activities, the entity's failure to avoid commercial activity during the taxable year will be considered reasonable if: (1) the value of the assets used in, or held for use in, all commercial 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 (2) the income earned by the entity from 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.[66] One question that needs to be resolved is what types of financial accounting standards would be within the scope of this standard, as special rules apply for governmental entities.

The Commercial Activity Is Promptly Cured

The 5% test is not a *de minimis* test. Instead, it is necessary to cure the commercial activity. A timely cure shall be considered to have been made if the entity discontinues the conduct of the commercial activity within 120 days of discovering the commercial activity.[67] One question to be resolved is whose knowledge is relevant for purposes of the discovery standard? For instance, do both employees and agents count?

The Record Maintenance Requirements Are Met

Adequate records of each discovered commercial activity and the remedial action taken to cure that activity must be maintained. The records shall be retained so long as the contents thereof may become material in the administration of §892.[68]

Modifications to the Treatment of Partnerships

The Proposed Regulations also address the attribution of activities from partnerships, and, in doing so, limit the attribution where limited partnerships are involved. As in the temporary regulations, the commercial activities of an entity classified as a partnership for federal tax purposes (thus including, for example, an LLC treated as a partnership) will be attributable to its partners for purposes of §892.[69] For example, if an entity holds an interest as a general partner in a partnership that is engaged in commercial activities, the partnership's commercial activities will be attributed to that entity for purposes of determining if the entity is a controlled commercial entity.[70]

The preamble to the Proposed Regulations notes that comments stated that a disparity in tax treatment

[60] Prop. Regs. §1.892-5(a)(1).
[61] Prop. Regs. §1.892-5(a)(2)(i).
[62] *Id.*
[63] *Id.*
[64] Prop. Regs. §1.892-5(a)(2)(ii)(A).
[65] Prop. Regs. §1.892-5(a)(2)(ii)(B).
[66] Prop. Regs. §1.892-5(a)(2)(ii)(C).
[67] Prop. Regs. §1.892-5(a)(2)(iii).
[68] Prop. Regs. §1.892-5(a)(2)(iv).
[69] Prop. Regs. §1.892-5(d)(5)(i).
[70] *Id.*

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exists under the temporary regulations regarding a foreign government's trading activity because trading for a foreign government's own account does not constitute a commercial activity, but no similar rule applies in the case of trading done by a partnership of which a foreign government is a partner.[71] Under the Proposed Regulations, an entity not otherwise engaged in commercial activities will not be considered to be engaged in commercial activities solely because the entity is a member of a partnership (whether domestic or foreign) that effects transactions in stocks, bonds, other securities, commodities, or financial instruments for the partnership's own account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects such transactions for the account of the partnership. The exception does not apply if the partnership is a dealer in stocks, bonds, other securities, commodities, or financial instruments, as determined under the principles of Regs. §1.864-2(c)(2)(iv)(a).[72]

The Limited Partnership Exception

A new exception is made for ''limited partnership interests,'' as defined under the Proposed Regulations. A sovereign 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.[73] Nevertheless, a foreign government member's distributive share of partnership income will not be exempt from taxation under §892 to the extent that the partnership derived such income from the conduct of a commercial activity. An interest in an entity classified as a partnership for federal tax purposes (thereby potentially applying to limited liability companies) will be treated as a limited partner in a limited partnership if the holder of such interest does not have rights 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.[74] Rights to participate in the management and conduct of a partnership's business do not include consent rights in the case of extraordinary events such as 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.[75] The existing exception for publicly traded partnerships appears to be subsumed in the exemption for limited partnership interests.

An example illustrates the application of the limited partnership rule. In the example, K, a controlled entity of a foreign sovereign, has investments in various stocks and bonds of U.S. corporations and in a 20% interest in Opco, a limited liability company that is classified as a partnership for U.S. federal tax purposes. Under the governing agreement of Opco, K has the authority to participate in the management and conduct of Opco's business. Opco has investments in various stocks and bonds of U.S. corporations and also owns and manages an office building in New York City. Because K has authority to participate in ''the management and conduct'' of Opco's business, its interest in Opco is not a limited partner interest. Therefore, K will be deemed to be engaged in commercial activities because of attribution of Opco's commercial activity, even if K does not actually make management decisions with regard to Opco's commercial activity, the operation of the office building. Accordingly, K is a controlled commercial entity, and all of its income, including its distributive share of partnership income from its interest in Opco and its income from the stocks and bonds it owns directly, will not be exempt from tax under §892.[76] In a second example, Opco has hired a real estate management firm to lease offices and manage the office building. As under the temporary regulations, notwithstanding the fact that an independent contractor is performing the activities, Opco will still be deemed to be engaged in commercial activities.[77]

The Proposed Regulations are proposed to apply on the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. However, as noted at the outset, the Preamble states that taxpayers may rely on the Proposed Regulations until final regulations are issued.

The Proposed Regulations represent a significant relaxation in the rules applicable to the sovereign debt regime. While changes with respect to the taxation of foreign corporations holding U.S. real estate would also have been desirable, the changes to the all-or-nothing rule and the treatment of limited partnerships represent significant improvements. These changes are likely to minimize some of the special structuring

[71] REG-146537-06.

[72] Prop. Regs. §1.892-5(d)(5)(ii).

[73] Prop. Regs. §1.892-5(d)(5)(iii)(A). The Proposed Regulations do not address whether the disposition of a limited partnership interest will be considered to be a commercial activity.

[74] Prop. Regs. §1.892-5(d)(5)(iii)(B).

[75] *Id.*

[76] Prop. Regs. §1.892-5(d)(5)(iv), *Ex. 1.*

[77] Prop. Regs. §1.892-5(d)(5)(iv), *Ex. 2.*

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that sovereign investment funds have previously found necessary to make for U.S. investments. [78]

Treatment of Dividend Equivalents

Finally, proposed and temporary regulations were issued under §871(m) on January 23, 2012. This is a provision added by the HIRE Act[79] that treats as U.S. source income certain ''dividend equivalents'' effective for payments made on or after September 14, 2010. Section 871(m)(2) provides that the term ''dividend equivalent'' means ''(A) any substitute dividend made pursuant to a securities lending or sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, (B) any payment made pursuant to a specified notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States, and (C) any other payment determined by the Secretary to be substantially similar'' to one of the foregoing. The proposed regulations implement the latter authority.

Prop. Regs. §1.892-3(a)(6) specifies that income from investments in stocks includes the payment of a dividend equivalent described in §871(m) and Prop. Regs. §1.871-15. Thus, it is a taxpayer-favorable provision. Like the Proposed Regulations, this provision would apply to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. However, as with the Proposed Regulations, the preamble states that taxpayers may rely on this part of the proposed regulations until final regulations are issued.[80]

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[78] In response to the Proposed Regulations, thoughtful comments were submitted by the American Bar Association and New York State Bar Association. See ''Comments on Proposed Regulations Issued Under Section 892,'' *available at* 2012 *TNT* 20-10 (1/30/12) and ''Proposed Regulations Under Section 892, *available at* 2012 *TNT* 24-50 (2/2/12).

[79] P.L. 111-147.

[80] Prop. Regs. §1.871-15(f).

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