

TAX SECTION

New York State Bar Association

Report on Temporary and Proposed
Regulations Under Section 892 of the Code

by

The Committee on U.S. Activities
of Foreign Taxpayers

October 14, 1988

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TAX SECTION

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October 14, 1988

Section 892 Regulations

Dear Larry:

I enclose our report concerning the temporary and proposed regulations under-code section 892, prepared by members of the Committee on U.S. Activities of Foreign Taxpayers. The report was prepared by a task force consisting of Barry Michael Cass (Chairman), L. Anthony Joseph, Jr., Solomon Packer and Richard E. Andersen. Messrs. Andersen and Cass were the principal draftsmen of the report. Helpful comments were received from numerous sources, including William L. Burke, John A. Corry, James S. Eustice, Arthur A. Feder, Stephen A. Fiamma, Kenneth Kral, Charles M. Morgan III, Leslie B. Samuels, Willard B. Taylor, Harry E. White, Jr. and Ralph O. Winger.

The section 892 regulations generally represent a fair and workable set of rules governing the availability and scope of the tax exemption provided by that section for certain types of income earned by foreign governments. We believe, however, that a number of technical and non-technical changes and additions to the temporary and proposed regulations would be desirable in order to further certain policy objectives, render the rules generally consistent with other applicable patterns of U.S. federal income taxation, and ease the burdens associated with the administration of, and compliance with, the statute.

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Among the areas highlighted in the report are the proper scope of the exemption, with particular reference to the treatment of instruments of foreign persons that nevertheless produce U.S.-source income; the relationship between the "controlled entity" and "integral part" elements of a foreign government, particularly where they may overlap in respect of a single organ or entity; the proper treatment of public and private pension funds and social security arrangements; the interplay of the publicly traded partnership rules of Code section 7704 and the partnership provisions of the temporary and proposed regulations; the effect of the section 892 exemption on the branch profits and alternative minimum tax rules; the proper application of the UBTI standard to establish the existence of commercial activities by pension plans; and the certification requirements for avoiding withholding on exempt income. Several technical comments are also contained in the report.

If and at such time as a public hearing is held on the subject of the temporary and proposed regulations under Code section 892, we would appreciate an opportunity to testify.

The Tax Section of the New York State Bar Association is hopeful that this report will be useful to you in the process of preparing final regulations on this subject.

Sincerely,

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Tax Report #589

NEW YORK STATE BAR ASSOCIATION
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On June 24, 1988, the Internal Revenue Service issued temporary (T.D. 8211, INTL-959-86) and proposed (INTL-285-88) regulations (collectively, "proposed regulations" or "Prop. Reg.") under section 892 of the Internal Revenue Code of 1986 ("Code"), which excludes from gross income and exempts from U.S. federal income tax certain types of income earned by foreign governments and international organizations. The proposed regulations supersede the existing regulations under section 892 of the Code and interpret that section in light of the amendments made by section 1247 of the Tax Reform Act of 1986 ("Act"). This report¹ examines the proposed regulations and makes recommendations to clarify certain of their provisions.

¹ This report was prepared by a subcommittee of the NYSBA Tax Section Committee on U.S. Activities of Foreign Taxpayers. The subcommittee consisted of Barry Michael Cass (Chairman), L. Anthony Joseph, Jr., Solomon Packer and Richard E. Andersen. Messrs. Andersen and Cass were the principal draftsmen of the report. Helpful comments were received from William L. Burke, Herbert L. Camp, John A. Corry, James S. Eustice, Arthur A. Feder, Stephen A. Fiamma, Kenneth Krai, Charles M. Morgan III, Leslie B. Samuels, Willard B. Taylor, Harry E. White, Jr. and Ralph O. Winger.

SUMMARY AND GENERAL RECOMMENDATIONS

The proposed regulations generally present a fair and workable set of rules governing the availability and scope of the exemption provided by section 892 of the Code as amended by the Act. However, the proposed regulations need to be clarified or modified in certain respects. The comments set forth below identify areas which, it is submitted, should be changed and offer suggestions for those changes.

BACKGROUND

An exemption from U.S. federal income tax for certain income earned by foreign governments has been part of the federal income tax laws since 1916; a similar exemption for certain classes of income earned by qualifying international organizations was added in 1945. Until 1978, the Internal Revenue Service generally interpreted the exemption to apply to all U.S. income of foreign governments (other than certain of their wholly-owned entities). Regulations were proposed in 1978 and made final in 1980 ("1980 Regulations") that generally removed income derived from the conduct of a commercial activity, even when earned by an integral part of a foreign sovereign, from the scope of the exemption.

The Act significantly altered the approach taken in the 1980 Regulations by narrowing the scope of the section 892 exemption. As amended by the Act, section 892 exempts only income from (a) investments in stocks, bonds, or other domestic securities, (b) financial instruments held in the execution of governmental financial or monetary policy and (c) bank deposits in the United States. New Code section 892(a)(2) expressly states that the exemption is not available for income derived from commercial activities or received from or by a "controlled commercial entity". An entity is deemed to be a "controlled commercial entity" if (i) a foreign government holds, directly or in-directly, 50 percent or more (by value or by vote) of all the interests in the entity, or otherwise exercises effective practical control over the entity, and (ii) the entity engages in commercial activities.

COMMENTS ON THE PROPOSED REGULATIONS

1. Assumptions

This report makes two assumptions in connection with the effect of S. 2238, the Technical Corrections Bill of 1988 (reported to the U.S. Senate by the Senate Finance Committee on August 3, 1988), on the rules set forth in the proposed regulations under section 892. First, it is assumed that the clarifications to section 892 of the Code contained in the Technical Corrections Bill will be enacted into law. Second, all

provisions of the Technical Corrections Bill that relate to the subject of this report are assumed to be in force retroactively to the effective date of the corresponding portions of the Act.

2. Timing of Corrections to the Regulations

The suggestions and corrections to the proposed regulations contained in these comments should be reflected in the final regulations. However, since the regulations were issued in temporary as well as proposed form, we recommend that certain of our comments, which will or could have an immediate impact on numerous foreign governments, be reflected immediately through the publication of a notice or announcement by the Internal Revenue Service. We make specific reference below to those issues that we believe require immediate guidance.

3. General Style Comments

The portions of the proposed regulations that repeat, implement, or expand upon provisions set forth in the statute should provide citations to the specific statutory provisions to which they relate. Absent such a specific statutory reference, a reader of the regulations might assume that the proposed regulations were promulgated as legislative regulations under authority of section 892(c), even where the proposed regulations are merely interpretive of the statutory rules.

4. Substantive Comments

The following are non-technical comments relating to specific provisions of the proposed regulations under section 892.

a. Scope of Exempt Income. Despite generally tightening the section 892 exemption in the Act, Congress continued to use the loose phraseology of "investments in the United States" as the threshold for two of the three categories of potentially exempt income. Ever since a 1918 amendment to the predecessor of Code section 892, the meaning of the phrase "investments in the United States" has been uncertain. We suggest that the phrase must be interpreted to include all investments producing U.S.-source income. Indeed, the first sentence of Prop. Reg. § 1.892-1T(a), carrying over language from the first sentence of section 1.892-1(a)(1) of the 1980 Regulations, specifically refers to U.S.-source income, although no further such reference is made in either the proposed regulations or the 1980 Regulations.

Such an interpretation would be generally consistent with the general U.S. taxing pattern for foreign persons. Income that is not effectively connected with a U.S. trade or business is taxed to a foreign person only if it is from U.S. sources. The

narrow classes of effectively connected income that are taxable even if sourced outside the United States (see section 864(c)(4)) would almost certainly be viewed as either a category of income outside the permissible types of investments set forth in section 892(a)(1)(A) or (B), or as derived from commercial activities (except, perhaps, activities falling within the last clause of section 864(c)(4)(B)(ii)) and therefore ineligible for the section 892 exemption in any event under section 892(a)(2)(A)(i).

A clear statement² in the proposed regulations that the phrase "investments in the United States" includes all investments of the appropriate type that generate U.S.-source income would prevent certain untoward, and presumably unintended, results. For instance, if the exemption were read to apply only to stock or obligations of U.S. corporations³, interest paid by the U.S. branch of a foreign corporation would be ineligible for the section 892 exemption, even though that interest is from U.S. sources (and therefore, absent the application of section 892, taxable and subject to withholding) by virtue of section

² Since the first sentence of Prop. Reg. § 1.892-1T(a) continues the reference to U.S.-source income found in section 1.892-1(a)(1) of the 1980 Regulations, it seems that the position espoused herein has already been "re-adopted" in the proposed regulations.

³ Section 7701(a)(4) of the Code supports the view that the terra "domestic securities" includes securities issued by U.S. issuers, but it does not appear that the phrase excludes other securities producing U.S.-source income.

884(f)(1)(A) of the Code. That result was not intended by Congress, as is suggested by section 892(a)(1)(B), which grants an exemption for interest earned by foreign governments on deposits "in banks in the United States", i.e.. seemingly including deposits in U.S. branches of foreign banks, which pay U.S. source interest under Code section 884(f)(1)(A).

Perhaps a loan to the U.S. branch of a foreign corporation would be viewed as an "investment in the United States" so that the current statutory and proposed regulation language would yield the correct result even without the expansion we propose. However, since foreign corporations can pay U.S.-source dividends pursuant to section 861(a)(2)(B), absent the clarification we advocate the section 892 exemption seemingly would not apply to a U.S.-source dividend paid by a foreign corporation. Thus, in order to avoid adverse and unexpected results that, were not intended by Congress when it amended section 892 of the Code in 1986, we recommend that Prop. Reg. § 1.892-3T(a)(1) be amended to clarify that the income that qualifies for the exemption under section 892(a)(1) of the Code includes all U.S.-source income from investments in stocks, bonds, or other securities. The term "domestic securities" as used in the statute is properly read to refer to either the domestic status of the issuer or the U.S. source of the income from that security; it should be noted that the word "domestic" does not appear in Prop. Reg. § 1.892-3T(a)(1)(i) to modify the word "securities" used in that provision.

b. Elements of a Foreign Government

Prop. Reg. § 1.892-2T(a) carries over without significant change the distinction made in section 1.892-1(b)(1) of the 1980 Regulations between an integral part and a controlled entity of a foreign sovereign, both of which qualify as a "foreign government" for purposes of the section 892 exemption. The definition of "integral part" in Prop. Reg. § 1.892-2T(a)(2) is sufficiently broad to include a governing authority organized as a corporation. However, such an incorporated authority could also fall within the definition of a "controlled entity" in Prop. Reg. § 1.892-2T(a)(3).

The proposed regulations also have carried over unchanged from the 1980 Regulations the notion that the status of a foreign governmental unit as an integral part of the foreign sovereign is determined on the basis of a functional analysis that looks to the existence of governing authority rather than to the form of organization, and the list of bodies that qualify as integral parts under, both Prop. Reg. § 1.892-2T(a)(2) and section 1.892-1(b)(2) of the 1980 Regulations bears out this approach. Therefore, the fact that a governing authority is incorporated should be irrelevant to its status as an integral part of a foreign sovereign, and a sentence should be added to Prop. Reg. § 1.892-2T(a)(1) to provide that a governing authority that qualifies as both an integral part and a controlled entity

of a foreign sovereign shall be treated exclusively as an integral part of the sovereign for all purposes of section 892 of the Code and the regulations thereunder.

The importance of this position becomes clear if one postulates the receipt of income exempt under section 892 by a controlled entity that is a governing authority in its home country (and therefore an integral part of the foreign sovereign) and is also engaged in commercial activities. If treated as a controlled entity, such an authority would fit the definition of a controlled commercial entity, with the result that its otherwise exempt income loses the benefit of the section 892 exemption. If the same authority were not in corporate form, only income derived from the commercial activities would be tainted for section 892 purposes, and the otherwise exempt income would not be adversely affected. See Rev. Rul. 87-6, 1987-1 C.B. 179, Situation 3, and Prop. Reg. § 1.892-5T(d)(4), Example 1. These differing results would exalt form over substance in a manner not contemplated by section 892.

c. Pension Arrangements

i. Social Security Funds. Prop. Reg. § 1.892-2T(c) discusses the treatment of pension trusts and funds that are established for the benefit of certain governmental and quasigovernmental employees. The proposals do not address the

status of pension programs of general applicability, such as social security funds. Indeed, it is not possible for a social security trust to qualify under the pension trust rule of Prop. Reg. § 1.892-2T(c), because the beneficiaries of such trusts include, in contravention of Prop. Reg. § 1.892-2T(c)(1)(i), persons who are not present or former governmental or quasi-governmental employees.

There appears to be no sound policy reason to deny the section 892 exemption to the otherwise eligible income of social security pension funds, whether or not trusteeed. (In fact, the Internal Revenue Service so ruled in Rev. Rul. 73-46, 1973-1 C.B. 342, concerning the Social Security Fund of the Trust Territory of the Pacific Islands.) It seems that a bona fide social security program that is primarily designed to provide retirement, disability and survivors' benefits for a broad cross-section of the citizens and residents of a foreign country is quintessentially part of the legitimate governmental functions of a sovereign. Furthermore, the possibilities for abuse and for prohibited channeling of commercial activities through such bona fide social security programs seem remote. Therefore, no justification appears for denying the section 892 exemption to the appropriate classes of income of social security programs

While it is true that a non-trusted social security fund might be fit into the "integral part" category under the proposed regulations as currently drafted, trusted plans would not benefit from such categorization under the present rules. See paragraph 4.c.ii below. Given the inherently governmental nature of social security programs, Prop. Reg. § 1.892-2T(a)(2) or Prop. Reg. § 1.892-2T(c) should provide that all bona fide social security funds, whether or not trusted, shall be treated as integral parts of a foreign government for purposes of Code section 892. The suggestion made in this paragraph 4.c.i, if adopted, should be the subject of a prompt I.R.S. notice or announcement to provide taxpayers with immediate guidance.

ii. Distinction Between Trusts and Funds. Prop. Reg. § 1.892-2T(c) draws a distinction between a separately organized pension trust, which qualifies as a controlled entity if certain requirements are satisfied, and non-trusted pension funds, which qualify as integral parts of a foreign sovereign. As a result, a trusted plan that carries on even a de minimis amount of commercial activity loses its ability to earn exempt investment income, whereas the assets of a non-trusted plan can earn income free of U.S. tax even if the integral part of the foreign sovereign that established the plan is engaged in numerous commercial activities. We submit that such a distinction is overly formalistic in that it disregards the functions of pension arrangements sponsored by foreign governments and penalizes common-law nations, which are more likely to establish

separate pension trusts than are civil-law jurisdictions to which the trust is an unfamiliar concept. Since both the trustee and non-trustee plans may benefit the same governmental and quasi-governmental employees, there is no sound policy reason for treating a pension arrangement more harshly simply because it is structured as a separate trust rather than as a separate fund. Therefore, for reasons similar to those set forth in paragraph 4.b.i above, Prop. Reg. § 1.892-2T(c) should be amended to grant integral part status to pension trusts that satisfy the requirements set forth in Prop. Reg. § 1.892-2T(c)(1)(i). iii. Employee Contributions. A clarification is required in Example (3) of Prop. Reg. § 1.892-2T(c)(2), which is unclear as to why the employee contributions in that fact pattern render the plan an investment conduit. In the example, it is unclear whether it is the fact that the contributions are unlimited or the fact that they are voluntary that categorizes the plan as an investment conduit that evidences the prohibited inurement for the benefit of private persons.

We believe that neither voluntary nor compulsory employee contributions should, in and of themselves, render a pension plan ineligible for foreign government status, as long as such contributions are appropriately limited by law or the plan document so as to avoid constituting an investment conduit.

Indeed, most countries that have tax-favored retirement plans for private persons (whether at the individual or corporate levels), including the United States, have made a policy decision that the tax benefits of such savings are appropriate as long as excessive amounts of otherwise taxable income are not sheltered by them. Assuming the applicable limits are not exceeded, these programs qualify for the relevant tax benefits regardless of whether employee participation is mandatory or voluntary.

Therefore, Prop. Reg. § 1.892-2T(c)(1) should be amended to state the rule that an otherwise qualifying pension arrangement will not fail to be treated as a controlled entity or an integral part of a foreign sovereign, as the case may be, merely because it provides for either (A) mandatory employee contributions, or (B) voluntary employee contributions that are reasonably limited in amount. In addition, example (3) of Prop. Reg. § 1.892-2T(c)(2) should be amended to reflect that it is the unlimited nature of the contributions, rather than the fact that they are voluntary, that results in the income of the trust being deemed to inure to the benefit of private persons.

d. Partnerships

i. Partnership Interests as Securities. Prop. Reg. § 1.892-3T(a)(3) states that partnership interests, with the exception of publicly traded partnerships within the meaning of Code section 7704, are not "securities" for purposes of the section 892 exemption. By negative implication, therefore, all interests in publicly traded partnerships (within the meaning of section 7704) are securities for purposes of the section 892 exemption. The provision should be rephrased as suggested below to make that result clear.

In addition, it is not clear whether the regulation intends interests in all such partnerships to be "securities", or only interests in those partnerships that are treated as corporations under section 7704(a). The reference in the regulation being to section 7704, not section 7704(a), the former could well be the interpretation. Thus, interests in a passive-income publicly traded partnership described in section 7704(c), though such a partnership is not treated as a corporation under section 7704, would, under this reading, nevertheless be "other securities" for section 892 purposes.

It is possible that the failure to refer to section 7704(a) of the Code is a technical error which warrants correction, so that only publicly traded partnerships that are taxable as corporations could qualify for the special rule of Prop. Reg. §1.892-3T(a)(3). If the omission of such reference is

intentional, however, we submit that the rule as set forth in the proposed regulations is incorrect. In order to preserve the general principle that true partnerships are "flow-through" entities for purposes of determining the tax treatment of their partners, a more rational rule would be to treat all partnerships (other than publicly traded partnerships taxable as corporations under section 7704(b) of the Code) as "flow-through" entities for section 892 purposes under a strict aggregate theory of partnership taxation.⁴ Thus, commercial activities and the source and character of exempt and non-exempt income of the partnership would be attributed directly to its partners, and gain from the sale of an interest in such a partnership by a foreign government partner would be pro-rated between exempt and non-exempt gain in accordance with the nature of the partnership's income (possibly over an appropriate testing period, such as a three-year period similar to the one contained in section 861(a)(2)(b) of the Code).

If the foregoing suggestion is not adopted, the rule of Prop. Reg. § 1.892-3T(a)(3) as applied to passive-income publicly traded partnerships described in Code section 7704(c) should

⁴ Thus, publicly traded partnerships exempt from section 7704 treatment under the effective date provisions (see section 10211(c)(1)(B) and (2) of the Revenue Act of 1987) would be treated under the partnership rules for purposes of section 892.

logically be extended to all widely-held limited partnerships.

The premise of such a rule would presumably be that foreign governments should not be taxable on income from their portfolio investments, as distinguished from income derived from their conduct of commercial activities, and that it is appropriate to view income from publicly traded partnerships as being derived from a portfolio-type investment rather than from the conduct of a commercial activity, and therefore eligible for the section 892 exemption, because of the lack of investor control over the business of the enterprise, as evidenced both by the restrictions on investor power under the Uniform Limited Partnership Act and by the effective lack of control caused by the wide dispersion of interests in the entity. It would seem anomalous, accepting the foregoing premise, to deny "other security" status to limited partnership interests in widely-held, though not publicly traded, partnerships.

As a corollary to the changes suggested above and in paragraph 4.e below, the last sentence in Prop. Reg. § 1.892-3T(a)(2) should be deleted as misleading in light of what follows. Furthermore, a statement should be added to that provision to clarify that any interest in an entity treated as an association taxable as a corporation under section 7701 of the Code and the regulations thereunder shall be treated as stock for purposes of the section 892 exemption. Although primarily applicable to interests in nominal partnerships, the same rule should also apply to entities that purport to be trusts but

qualify for association status, such as real estate investment trusts and certain investment trusts.

ii. Attribution of Commercial Activities. Prop. Reg. § 1.892-5T(d)(3) provides that commercial activities of a publicly traded partnership are not attributed to its partners. To be consistent with the suggestion made in paragraph 4.d.i above, the exemption for publicly traded partnerships from the activity attribution rule should be clarified to either refer only to those taxed as corporations under section 7704(a) of the Code or, less preferably, broadened to include widely held, but not publicly traded, limited partnerships.

Furthermore, the proposed regulations should be clarified to provide explicitly that income earned by a foreign government from a transaction described in section 707(a) of the Code between the foreign government, e.g., as lender, and a partnership in which it is a partner is not tainted merely because the partnership is engaged in commercial activities.

Finally, it should be made clear in Prop. Reg. §§ 1.892-3T(a)(2) and 1.892-5T(d)(3) that, as suggested in paragraph 4.d.i above, the character of the income earned by a partnership (other than a publicly traded partnership taxable as a corporation) flows through to its foreign government partner. Thus, where the

partnership earns dividends and gain from the sale of stock traded for its own account, such income is potentially eligible for the section 892 exemption (provided that the partnership is not a dealer in securities). If the partnership instead, or in addition, earns, for example, rental income from the active operation of a commercial office building, the foreign government partner's share of such rental income is not eligible for the section 892 exemption. It follows, therefore, that the example given in Prop. Reg. § 1.892-5T(d)(3) must be clarified to indicate that the reason none of the controlled entity's distributive share of partnership income is exempt under section 892 is that the commercial activities of the partnership make the controlled entity a controlled commercial entity, and no income of a controlled commercial entity is eligible for the section 892 exemption, and that a different result could obtain if the partner were instead, an integral part of a foreign sovereign. See example (1)(c) of Prop. Reg. § 1.892-5T(d)(4). A similar explanatory sentence should be inserted before the last sentence of each of Examples (4)(a), (4)(b) and (4)(c) of Prop. Reg. § 1.892-5T(d)(4).

e. Trusts

i. Trusts Taxable as Associations. Prop. Reg. § 1.892-3T(a) provides that stock in a corporation is an investment producing income that qualifies for the section 892 exemption.

That rule would apply to real estate investment trusts ("REITs") that are organized as corporations. However, REITs can also be created as trusts, as can other business and investment entities. To avoid uncertainty and to conform to the general Code rules, the proposed regulations should be amended to clarify that interests in trusts that are taxable as associations are treated as stock for section 892 purposes. The corollary rule, that certain trusts, such as fixed-investment trusts, are flow-through entities for tax purposes, should also be reflected in the proposed regulations by treating them explicitly in the manner suggested in paragraph 4.d above in respect of partnerships that are not taxable as corporations under section 7704(a). Of course, the same concepts apply to partnerships: see paragraph 4.d.i above.

ii. FIRPTA Consideration for REITs. Section 897(h)(1) of the Code provides that distributions by REITs to foreign holders, to the extent allocable to sales of U.S. real property interests by the REIT, will themselves be treated as gain from the disposition of a U.S. real property interest and thus subject to tax under section 897. The proposed regulations already take the position that stock in a U.S. real property holding corporation is "stock" and not an interest in the underlying U.S. real property interests. There is no sound policy reason for treating interests in REITs more harshly than stock in U.S. real property holding corporations for purposes of section 892 of the Code.

Therefore, a provision should be added to Prop. Reg. § 1.892-3T(a) to clarify that distributions described in section 897(h) (1) of the Code will be exempt from tax under section 892, unless the foreign government owns 50 percent or more of the REIT. In such a case the REIT will be a controlled commercial entity and distributions from it (as well as gain on the disposition of its shares) will not be exempt under section 892 of the Code.

f. Controlled Commercial Entities

i. Definition. As a corollary to the analysis set out in paragraphs 4.b and 4.c above, relating to the treatment of foreign governmental units qualifying as both integral parts and controlled entities of a foreign sovereign, a provision should be added to Prop. Reg. § 1.892-5T(a) to clarify that an integral part of a foreign sovereign will never be treated as a controlled commercial entity for purposes of section 892 of the Code regardless of whether it has been separately incorporated. Thus, an integral part of a foreign sovereign may earn income that is not exempt under section 892 without tainting its exempt income. This is the result reached in Example (1) of Prop. Reg. § 1.892-5T(d)(4), but we believe that the principle should be stated in the text of the proposed regulation and should not have to be inferred from the example.

ii. Determination of Commercial Activity. The proposed regulations are silent as to the time at which the existence of a commercial activity is to be determined. There is some indication from the statutory language that the test should be applied annually for each year in which income from a controlled entity (in the sense of Code section 892(a)(2), not Prop. Reg. § 1.892-2T(a)(3)) is received, since the test is cast in the present tense. This result is consonant with sound policy, since it seems unfair for commercial activities last engaged in during 1988 to taint income received in 1992 (aside from receipt of tainted earnings described in Prop. Reg. § 1.892-5T(d)(2)(i): see paragraph 4.f.iii below). We suggest that this rule be made explicit in the proposed regulations.

iii. Effect of Controlled Commercial Entity Status. Section 1.892-5T(d)(2)(i) of the proposed regulations states the general rule that commercial activities of a subsidiary are not attributed to its parent. That provision states, however, that dividends or other payments received by the parent from the subsidiary are not exempt under section 892, and that dividends paid in turn by the parent are "tainted" to the extent attributable to the dividends received by the parent from the subsidiary. It appears that this rule can apply only where the two corporations are both domestic, since dividends paid by a foreign parent not engaged in a U.S. trade or business would not be taxable by the United States in any event. Assuming that the

situation is so limited, a question arises as to the effect of consolidation, particularly whether the intercompany dividend elimination purges the section 892 taint at the parent level. It is submitted that such elimination should not purge the taint, since the alternative would be to make this rule largely elective by foreign governments; however, as to these types of issues, an example would be helpful to determine the scope of the provision.

Furthermore, Prop. Reg. § 1.892-5T(d)(2)(i) appears to require a "first-in, first-out" rule for attributing the taint to dividends paid by the parent; however, the provision does not set out in detail how the tainted portion of the dividends paid by the parent is to be accounted for. The proposed regulations should be expanded to clarify that tainted earnings and profits must be accounted for separately from other earnings and profits of the parent in a multi-year pool.

iv. Definition of Control. Under Code section 892(a)(2)(B)(i) and Prop. Reg. § 1.892-5T(a)(1), a foreign government is deemed to control an entity if it holds at least 50 percent (by value or vote) of the interests in that entity. The application of the definition is unclear, however, when the entity has two or more classes of equity interests outstanding. The provision should be amended to clarify that all classes of interest are taken into account in determining the percentage

ownership of the entity by the foreign government. See, e.g., section 957(a)(1) of the Code.

Furthermore, the proposed regulations should make clear that the interests examined for purposes of determining the presence or absence of control under Prop. Reg. § 1.892-5T (excluding the factors, other than ownership, that are taken into account in determining effective practical control) must qualify as equity interests. In addition, it should be clarified that options to acquire equity interests shall be treated as exercised, as long as the right of exercise is not contingent upon the happening of an event outside the optionee's control, regardless of whether the option is "in the money" at the time of determination. More-over, the general rules for characterizing convertible instruments as debt or equity should be expressly made to apply.

In addition, with respect to the definition of effective practical control appearing in Prop. Reg. § 1.892-5T(c)(2), it should be clarified that normal creditor status -- even if the size of the indebtedness is considerable in relation to the equity accounts of the borrower and if commercially reasonable negative covenants are imposed on the borrower -- does not, without more, rise to the level of effective practical control. Compare Treas. Reg. § 1.897-1(d) (describing interests that are and are not interests "solely as a creditor" for FIRPTA purposes). In this regard, consideration should be given to specifying a minimum equity interest that must be present before

effective practical control will be found.

g. Certification Requirements

Section 1.1441-8T(a) of the proposed regulations provides that withholding is not required under Treas. Reg. § 1.1441-1 with respect to any item of income exempt from taxation under section 892. Prop. Reg. § 1.1441-8T(b) currently provides that a foreign government seeking the benefit of the section 892 exemption on certain items of income must certify to each withholding agent that the exemption is available and must supply certain information, including the items and amount of income to which the exemption applies. The certification (for which it is understood a form is in preparation) must be filed annually, in duplicate, under penalties of perjury, and in advance of payment of the income to which it relates.

Several of these requirements are onerous or impractical and should be modified* First, the requirement that the certificate be filed with the withholding agent in advance of payment of the items to which it relates should be modified. Treas. Reg. § 1.1441-6(c)(2) requires that a Form 1001, used to claim reduced income tax treaty rates of withholding tax for items of income other than dividends, be filed with the withholding agent "as soon as practicable". We see no policy reason to subject foreign governments to a more

burdensome time requirement. We therefore recommend that the "as soon as practicable" time limit be adopted in Prop. Reg. § 1.1441-8T(b).

Second, the requirement that the certification set forth the amount of the affected payment should be deleted, since that amount may not always be determinable at the time the certificate is filed. In similar withholding circumstances, no such advance specification is required. See, e.g., Treas. Reg. § 1.1441-4(i)(1), the exemption from withholding for income earned by foreign central banks of issue to which section 895 applies; Form 1001; and Treas. Reg. § 1.1441-4(a)(2), regarding the exemption from withholding for effectively connected income.

Third, there appears to be no reason for the certification to be made under penalties of perjury, where the other forms and statements required by the regulations under section 1441 of the Code are not subject to this requirement. See Treas. Reg. §§ 1.1441-4(a)(2), 1.1441-4(i)(1), and 1.1441-6(c).

Fourth, the requirement that the certification be filed with the withholding agent annually should be replaced by a three-year rule that conforms to the provisions governing the filing of Form 1001. See Treas. Reg. § 1.1441-6(c)(2). In addition, since the proposed regulations do not require that the certification be filed with the Internal Revenue Service (consistent with the procedural rules concerning Form 1001), the

requirement that the certification be submitted to the withholding agent in duplicate should be deleted. In its place, a requirement should be added that a withholding agent must retain the certification for at least four years after the end of the last calendar year in which income subject to the certification is paid. Compare Treas. Reg. § 1.1441-6(c)(2).

Finally, in order to permit withholding agents to set up systems and procedures to implement the certification requirements, we suggest that Prop. Reg. § 1.1441-8T be amended to provide a separate effective date, such as 180 days after publication of the proposed and temporary regulations in the Federal Register.

On a related point, the proposed regulations make no mention of the availability of an exemption procedure for FIRPTA withholding (a sale of a minority interest in a U.S. real property holding corporation generates exempt income under Prop. Reg. § 1.892-3T). This issue should be addressed in the final regulations under section 892.

The suggestions made in this paragraph 4.g, if adopted, should be the subject of a prompt I.R.S. notice or announcement to provide taxpayers with immediate guidance.

h. Relationship To Other Code Section

i. Branch Profits Tax. Prop. Reg. § 1.982-7T(d) provides that earnings and profits of a controlled entity attributable to income exempt under section 892 of the Code are exempt from the application of the branch profits tax imposed by section 884 of the Code. The apparent theory behind this position is that exempt income would not give rise to a non-exempt dividend under Prop. Reg. § 1.892-5T(d)(2) if earned by a U.S. subsidiary rather than by a branch of the foreign government, and that the theory of branch-subsidiary parity sought to be furthered by the branch profits tax requires that the same results apply to both types of structure.

On this theory, the provision should be broadened to apply to all items of income of a branch (whether or not exempt under section 892) which are not derived from the conduct of a commercial activity. If a U.S. subsidiary of a foreign government that is not engaged in any commercial activity earns income not described in section 892(a)(1) and remits it after the payment of relevant income taxes to the foreign government, the dividends would be exempt from withholding tax under Prop. Reg. § 1.1441-8T(a) (since the payor would not be a controlled commercial entity). In order to achieve subsidiary-branch tax parity, such income when earned by a branch should also be excluded from the computation of effectively connected earnings and profits for

purposes of Code section 884, and a provision should be added to Prop. Reg. § 1.892-7T(d) clarifying that rule.

It is interesting to note in this regard that the Internal Revenue Service has ruled that international organizations would not be subject to the branch level interest tax. Ltr. Rul. 8828064; Ltr. Rul. 8829020; Ltr. Rul. 8829089.

The suggestions made in this paragraph 4.h.i, if adopted, should be the subject of a prompt I.R.S. notice or announcement to provide taxpayers with immediate guidance.

i. Alternative Minimum Tax. Section 56 of the Code is not among the provisions for which coordination rules are provided under Prop. Reg. § 1.892-7T. For the reasons expressed in paragraph 4.h.i above, no income (whether or not exempt under section 892) derived by a foreign government and not attributable to commercial activities should be taken into account for purposes of the alternative minimum tax imposed by section 56. A paragraph should be added to Prop. Reg. § 1.892-7T so providing.

The suggestions made in this paragraph 4.h.ii, if adopted, should be the subject of a prompt I.R.S. notice or announcement to provide taxpayers with immediate guidance.

ii. Withholding on Partnership Distributions. In view of the special rules available for publicly traded partnerships, a provision should be added to Prop. Reg. § 1.892-7T to the effect that no withholding under section 1446 of the Code shall be required with respect to either (a) any distributions to foreign governmental partners from publicly traded partnerships, or (b) that portion of distributions made to foreign governmental partners that is attributable to items of partnership income that, if earned directly by the foreign government, would be exempt income. This exemption from section 1446 withholding could be conditioned upon receipt of certification from the foreign government partner that it is entitled to the section 892 exemption. A mathematical test should be adopted to determine the appropriate portion of distributions made by partnerships other than publicly traded partnerships that is exempt from withholding under this suggestion, in order to avoid cumbersome and unnecessary tracing rules. Similar principles should govern the interplay of section 892 with section 1446 as it would be amended by the Technical Corrections Bill.

The suggestions made in this paragraph 4.h.iii, if adopted, should be the subject of a prompt I.R.S. notice or announcement to provide taxpayers with immediate guidance.

iv. Unrelated Business Taxable Income. To provide a framework for a functional analysis of commercial activities in

the context of pension trusts, Prop. Reg. § 1.892-5T(b)(3) adopts the rules of section 512 of the Code (relating to the unrelated business taxable income ("UBTI") of certain tax-exempt organizations).⁵ The proposed regulations indicate that a pension fund that is a controlled entity will not be considered to be a controlled commercial entity if the pension fund does not earn any UBTI. This rule should be viewed strictly as a safe harbor, and the controlled commercial entity classification should ultimately depend on whether or not the entity in fact engages in commercial activities. Thus, a pension fund that earns UBTI should not automatically be treated as a controlled commercial entity; rather, that determination should ultimately be made on the basis of the activities of the fund. In this connection, examples (2)(a) and (2)(b) in Prop. Reg. § 1.892-5T(d)(4) should be modified to make it clear that earning UBTI will not necessarily result in classification as a controlled commercial entity.

The application of the UBTI rule in the context of section 892 should also be relaxed in certain situations. Section 514 requires that income from debt-financed property be taken into account in determining UBTI. However, in the context of

⁵ If the suggestion contained in paragraph 4.c.ii above i.e., that governmental and quasi-governmental pension trusts should be treated as integral parts of a foreign sovereign) is adopted, the UBTI standard should be eliminated from the regulations as superfluous. If the purpose of importing the section 512 rules is to define a controlled commercial entity (or, as suggested below, to provide a safe harbor for such a definition), it can have no application to a pension trust that is treated as an integral part, and not a controlled entity, of the foreign sovereign.

section 892, UBTI should be computed without taking into account income from debt-financed property (such as margin stock or real estate subject to a mortgage), because there is no necessary connection between income from such property and the existence of a commercial activity. Similarly, under the proposed regulations, income from publicly traded limited partnerships is eligible for the section 892 exemption but, under section 512(c)(2), income from certain publicly traded partnerships is deemed to constitute UBTI. Viewing the UBTI rule strictly as a safe harbor in the section 892 context would partially resolve these conflicts, but the proposed regulations should nevertheless expressly address them in order to remove all ambiguity.

Finally, example (2)(b) of Prop. Reg. S 1.892-5T(d)(4) states that the operation by a section 401(a) pension trust of a shopping center through a partnership constitutes an unrelated trade or business under section 513(b) of the Code and would generate UBTI. As to the first part of the statement, the comment made above that such a determination should not be dispositive of the existence of a commercial activity for section 892 purposes applies. The assertion that the activity described yields UBTI should be deleted because of the potential application of section 512(b) of the Code. Thus, both the example and the text relating to the "UBTI rule" should be amended to clarify that only the existence of an unrelated trade or business under central bank of

issue, but apparently not if held by another element of a foreign government. There appears to be no sound policy reason for this limitation, which should be deleted from the proposed regulations.

On a related point, taking the proposed regulations as they currently read, income earned by a central bank of issue from a loan of gold would not qualify for the exemption, since the gold is not held by the lending central bank during the term of the loan. The proposed regulations should be amended to provide that such income will, in fact, be eligible for the section 892 exemption as derived from a permitted financial instrument, as well as to provide that both gold and nonfunctional currency will qualify as "financial instruments" if held or owned by any element of a foreign government as long as the "financial or monetary policy" test is satisfied.

ii. Securities. The Internal Revenue Service has issued private letter rulings to the effect that stock index futures contracts are not securities for purposes of section 864(b)(2)(A) of the Code (see. e.g., Ltr. Rul. 8540034). Prop. Reg. § 1.892-3T(a)(3) provides that an instrument will qualify as an "other security" if it is treated as a security for purposes of section 864(b)(2)(A) of the Code. Assuming the correctness of the holding in those private letter rulings, therefore, a foreign government must rely on section 864(b)(2)(B), which generally section 513(b)

should be relevant in the section 892 context, and that only as a safe harbor and not as a substantive rule.

v. Cross-References. The proposed regulations under section 892 should contain more liberal cross-references to existing regulations that have an impact in this area. Examples might include references to Temp. Reg. § 1.897-9T(e) (and its successor provision in final regulations), relating to FIRPTA considerations as they apply to foreign governments and international organizations, and references to the various provisions that modify or remove the applicability of information reporting and backup withholding requirements to foreign governments and international organizations [e.g., Treas. Reg. §§ 1.6042-2(a)(2), 5f.6045-1(c)(3)(i)(B), and 1.6049-4(c)(1)(ii)]. Certain other regulatory provisions might also be amended to refer to the regulations under section 892 that provide the definitions of a foreign government and of an international organization (e.g., the regulations under section 893 should contain a cross-reference to Prop. Reg. § 1.892-7T(a) and its successor provision in the final regulations).

i. Specific Assets and Income Items

i. Financial Instruments. Prop. Reg. § 1.892- 3T(a)(4) provides that the term "financial instrument" includes gold and nonfunctional currency that is physically held by a provides a

tax exemption for a foreign person's commodity trading income, in order to exempt income from stock index futures contracts from U.S. taxation. Such contracts are more akin to commodity forward or futures contracts and commodity options than to physical commodities. A better and more coherent approach would therefore be to treat stock index futures contracts as "other securities" for purposes of Prop. Reg. § 1.892-3T(a)(3).

On a related point, Prop. Reg. § 1.892-3T(a)(3) provides that commodity forwards, futures and options are not "other securities" for section 892 purposes unless they are securities under section 864(b)(2)(A). In fact, commodity instruments are covered by section 864(b)(2)(B). Clarification of the types of commodity forwards, futures and options that will qualify as "other securities" for section 892 purposes would be helpful.

5. Technical Comments

In addition to the foregoing matters, the proposed regulations contain certain technical and clerical errors or shortcomings that should be corrected when the proposed regulations are finalized.

a. The effective dates of T.D. 8211 and INTL-285-88 (taxable years beginning after June 30, 1986) differ from the effective date of the regulations set forth in Prop. Reg. § 1.892-1T(b) and of the amendments made to Code section 892 by the

Act (income received (or accrued, according to the "Blue Book" explanation of the Act, at page 1061) after June 30, 1986). The Treasury Decision and the notice of proposed rulemaking should be amended to correct the erroneous effective dates set forth therein. The suggestion made in this paragraph, if adopted, should be the subject of a prompt I.R.S. notice or announcement to provide taxpayers with immediate guidance.

b. Item (viii) in Example (1) of Prop. Reg. § 1.892-3T(b) (gain from the disposition of a publicly traded partnership interest owned by a controlled entity of a foreign sovereign) should be included in the list of income items that qualify for the section 892 exemption, in accordance with the substantive rule set forth in Prop. Reg. § 1.892-3T(a)(3), which provides that interests in publicly traded partnerships are "securities" entitled to the section 892 exemption. (See paragraph 4.d.i above for a discussion of the appropriate scope of the substantive rule.) The suggestion made in this paragraph, if adopted, should be the subject of a prompt I.R.S. notice or announcement to provide taxpayers with immediate guidance.

c. The reference in item (ix), Example (1) of Prop. Reg. § 1.892-3T(b) to a "United States real property holding company" should be changed to replace the word "company" with the word "corporation", to conform to the terminology used in section

897(c)(2) of the Code. On a related point, the phrase ", or a foreign corporation that would be a United States real property holding corporation if it were a United States corporation," should be deleted, since foreign corporations can be United States real property holding corporations under section 897(c)(2) of the Code.

d. The parenthetical language in Prop. Reg. § 1.892-4T(c)(1)(i) (relating to net leases of real property as commercial activities), which has been carried over from section 1.892-1 (2)(i) of the 1980 Regulations, is awkward and should be clarified. The following language is suggested: "{other than from net leases thereon or upon its sale)".

Furthermore, the proposed regulations carry over the rule of the 1980 Regulations that the holding of a net lease on real property is not a commercial activity for section 892 purposes. However, there is no guidance in the proposed regulations on what constitutes a "net lease" for this purpose, and none was forthcoming (although indications were that some such guidance would in fact be provided) under the 1980 Regulations either. A definition of the term "net lease" in Prop. Reg. § 1.892-4T(c)(1)(i) would be helpful.

e. The reference to "Federal Aviation Authority" in Prop. Reg. § 1.892-4T(c)(4) should more properly read "Federal Aviation Administration". However, it is understood that the FAA

no longer owns or operates any airports in the United States. Thus, we suggest that the reference to the FAA be dropped and replaced by inserting "airports" before "local transportation services" in Prop. Reg. § 1.892-4T(c)(4).

f. Since the proper identification of the specific owner of an asset is so important in determining the availability of the section 892 exemption, a statement or example should be added to Prop. Reg. § 1.892-2T to import specifically the general rule that a foreign government is treated as the owner of assets held by a grantor trust in accordance with the provisions of sections 671 et seq., of the Code.