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February 2, 2012

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Emily S. McMahon
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Regulations under Section 892

Mr. Shulman, Mr. Wilkins and Ms. McMahon:

We are pleased to submit this letter[*] providing comments and recommendations on the proposed regulations (the "Proposed Regulations") released recently by the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") under section 892,[1] the Code section that generally provides an exemption from U.S. federal income tax for foreign sovereigns and entities controlled by foreign sovereigns (so-called

[*] The principal author of this letter is William L. McRae. Significant contributions were made by Kimberly Blanchard, Peter Blessing, Doug Borisky, Peter Connors, Jason Factor, Michael Farber, Patrick Gallagher, Stephen Land, John Lutz, Shane Milam, Erika Nijenhuis, Michael Schler, David Schnabel, Scott Semer, David Sicular, Eric Sloan, Gordon Warnke and Diana Wollman. This letter reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates. This letter may be cited as New York State Bar Association Tax Section, Letter on Proposed Regulations under Section 892 (Report No. 1257, February 2, 2012).

[1] Unless indicated otherwise, all section references in this letter are either to the Internal Revenue Code of 1986, as amended (the "Code") or to Treasury regulations promulgated thereunder.

"controlled entities")[2] in respect of investments in the United States. We believe that the Proposed Regulations represent a major advance towards rationalizing the regulatory regime under section 892, and we commend Treasury and the Service for undertaking this important project. As we have discussed in at least two prior reports, the regulations implementing section 892 have long contained numerous internal inconsistencies, formalistic rules and traps for the unwary that have had the effect of creating ─ without any identifiable underlying policy justification ─ significant risks for foreign sovereigns and sovereign wealth funds seeking to invest in the United States. Accordingly, the Proposed Regulations are most welcome. In our view, the most helpful aspect of the Proposed Regulations is the manner in which the Proposed Regulations address the so-called "all or nothing" rule ─ *i.e.,* the rule under which a controlled entity will be deemed a "controlled commercial entity" ineligible for the benefits of section 892 if the entity engages in, or is deemed to engage in, any amount of commercial activity anywhere in the world.

We agree strongly with the policy choice reflected in the Proposed Regulations of abandoning the "all or nothing" rule ─ while still taxing income from the relevant commercial activities where appropriate ─ in cases where an entity is appropriately viewed as a passive investor, and either is *deemed* to be engaged in commercial activity (*e.g.,* by reason of investing in a partnership)[3] or accidentally engages in a *de minimis* amount of commercial activity through a foot fault. This policy choice is implemented in the Proposed Regulations primarily by three rules. First, the Proposed Regulations contain a rule that commercial activity attributed from a limited partnership to its limited partners will not, without more, be taken into account for purposes of determining whether any of the limited partners is a controlled commercial entity (the "Limited Partner Exception"),[4] even though the exemption under section 892 otherwise will *not* be available to shield income from such commercial activity from taxation. Second, the Proposed Regulations also contain a rule that income realized by an entity from the disposition of a "United States real property interest" ─ while remaining subject to tax under section 897 in appropriate cases ─ will be disregarded for purposes of determining whether an entity realizing such income is a controlled commercial entity (the "Real Estate Exception"). Subject to the issues and recommendations discussed below, we believe that the Limited Partner Exception and the Real Estate Exception have the potential to be of significant use to sovereign investors in the

[2] Treasury regulation section 1.892-2T(a)(3) defines a "controlled entity" eligible for the benefits of section 892 as an entity that meets the following conditions: (i) the entity must be wholly owned and controlled by the relevant foreign sovereign, either directly or indirectly through one or more controlled entities, (ii) it must be organized under the laws of the controlling foreign sovereign, (iii) its net earnings must be credited to its own account or to other accounts of the controlling foreign sovereign, with no portion of its income inuring to the benefit of any private person, and (iv) its assets must vest in the foreign sovereign upon the entity's dissolution.

[3] Subject to the changes implemented through the Proposed Regulations, commercial activities conducted by a partnership are generally attributed to the partners under section 892. *See* Treasury regulation section 1.892-5T(d)(3) and proposed Treasury regulation section 1.892-5(b)(5)(i).

[4] As discussed below, the Limited Partner Exception is broader than its name would imply, and applies generally to certain types of investments in entities, such as limited liability companies, that are treated as partnerships for U.S. federal income tax purposes.

United States, and are consistent with recommendations that we provided to Treasury and the Service in our report dated June, 2008 (the "2008 Report").[5] Third, the Proposed Regulations introduce an exception from the "all or nothing" rule for actual, but inadvertent, commercial activity conducted by a controlled entity.

Finally, we note that the Proposed Regulations would remove the requirement that "financial instruments," as defined in Treasury regulation section 1.892-3T(a)(4), be "held in the execution of governmental financial or monetary policy" in order to fall explicitly within the rule that investing or trading in securities and financial instruments does not constitute commercial activity (the "Investing Exception" and "Trading Activity Exception"). We commend Treasury and the Service for clarifying the scope of the Investing and Trading Activity Exceptions, which were originally drafted at a time when the financial markets were very different from what they are today. We also believe, however, as discussed in more detail in our recommendation below, that the Proposed Regulations should be modified to address certain ambiguities in the current definition of "financial instrument," and to state explicitly that trading activity qualifying for the "securities trading" safe harbor under section 864(b) does *not* constitute commercial activity.

Because we agree generally with the policy choices underlying the Proposed Regulations, the purpose of this letter is to point out areas where we believe the Proposed Regulations either fall short of achieving their underlying policy objective or could benefit from further clarification. We understand that the Proposed Regulations are intended to address only a subset of the issues arising under section 892, and are *not* intended to constitute a comprehensive overhaul of the current regime. Accordingly, this letter will discuss only those concerns that we believe fall within the intended scope of the Proposed Regulations. For a more comprehensive discussion of issues arising under section 892 that are not addressed by the Proposed Regulations, we refer you to the 2008 Report, as well as to our report from 1988 in response to the issuance of regulations under section 892 in that year (the "1988 Report").[6] Both reports are included as exhibits to this letter.

The remainder of this letter provides specific comments and recommendations regarding the Proposed Regulations:

1. Eliminate the Rule That All Controlled Entities Qualifying as United States Real Property Holding Companies Are Controlled Commercial Entities.

Proposed Treasury regulation section 1.892-4(e)(1)(iv), which implements the Real Estate Exception, provides that the disposition of a U.S. real property interest, "by itself, does not constitute the conduct of a commercial activity," but that "gain derived from a disposition of a

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[5] *See* "Report on the Tax Exemption of Foreign Sovereigns Under Section 892 of the Internal Revenue Code," June, 2008, New York State Bar Association Tax Section.

[6] "Report on Temporary and Proposed Regulations under Section 892 of the Code," October 14, 1988, New York State Bar Association Tax Section.

U.S. real property interest defined in section 897(c)(1)(A)(i)[7] will not qualify for exemption from tax under section 892." As discussed above, we support the policy judgment embodied in the Real Estate Exception that controlled entities should be taxed on their U.S. real estate income where appropriate without losing the benefit of section 892 altogether under the "all or nothing" rule.

In order for the Real Estate Exception to achieve its intended purpose, however, we recommend that Treasury and the Service remove the rule contained in Treasury regulation section 1.892-5T(b)(1) that a " United States real property holding corporation, as defined in section 897(c)(2) or a foreign corporation that would be a United States real property holding corporation if it was a United States corporation, shall be treated as engaged in commercial activity, and, therefore, is a controlled commercial entity if [it is controlled by a foreign sovereign]."[8]

The definition of "United States real property holding corporation" under section 897(c)(2) generally refers to an entity with U.S. real estate assets that account for 50 percent or more of all of the entity's real estate and business assets. Accordingly, unlike the Proposed Regulations and the concept of "commercial activity" more generally, Treasury regulation section 1.892-5T(b)(1) determines an entity's entitlement to the benefits of section 892 by reference *solely* to the entity's *assets*, and takes no account of the entity's activities or how the entity realizes income from its assets. Consequently, Treasury regulation section 1.892-5T(b)(1) makes it possible for an entity to lose the benefit of section 892 altogether through the "all or nothing" rule, even in cases where *all* of the entity's real estate income otherwise qualifies for the benefit of the Real Estate Exception. In fact, if an entity's *only* real estate assets were, for example, stock in lower-tier United States real property holding corporations and net leases exempted from the definition of "commercial activity" under Treasury regulation section 1.892-4T(c)(1)(i), Treasury regulation section 1.892-5T(b)(1) could strip the entity of the benefits of section 892 even though all of its real-estate income would have been explicitly exempted from U.S. tax (and not just from the "all or nothing" rule) under section 892 ─ if only the entity's asset mix had been different.

Furthermore, Treasury regulation section 1.892-5T(b)(1) undermines the policy of exempting *deemed* commercial activity ─ as opposed to *actual* commercial activity conducted directly by a controlled entity ─ from the "all or nothing" rule. Under Treasury regulation section 1.892-5T(b)(1), a controlled entity might lose the benefits of section 892 even though it

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[7] As a general matter, gain realized by a foreign sovereign or controlled entity from the disposition of a United states real property holding corporation is exempt from tax under section 892(a)(1)(A)(i) as income from an investment in stock. *See* Treasury regulation section 1.892-3T(b), Example 1.

[8] The wording of Treasury regulation section 1.892-5T(b)(1) also is technically inaccurate, since the definition of a United States real property holding corporation extends to *any* corporation, whether domestic or foreign. *See* section 897(c)(2). As a general matter, however, an interest in a United States real property holding corporation will be considered to be a United States real property interest only if the corporation in question is domestic.

engages only in passive investments in securities, some of which constitute "United States real property interests" (*e.g.,* stock in a "real estate investment trust", interests in publicly traded "master limited partnerships" that invest in real estate). We do not believe that Treasury or the Service intended this result, as it undoes much of the benefit that otherwise would have been conferred by the Real Estate Exception. We also note that the "all of nothing" rule under Treasury regulation section 1.892-5T(b)(1) constitutes a trap for the unwary, since many foreign sovereign investors presumably could avoid the rule, for example, merely by holding U.S. real estate property interests in several different entities, so that no single entity had a concentration of real estate sufficient to qualify as a United States real property holding corporation.

For the reasons discussed above, we recommend that Treasury regulation section 1.892-5T(b)(1) be removed from the section 892 regulations.[9]

2. Provide Additional Guidance as to the Definition of "Interest as a Limited Partner in a Limited Partnership."

Proposed Treasury regulation section 1.892-5(d)(5)(iii)(A), implementing the Limited Partner Exception, provides that "[a]n entity that is not otherwise engaged in commercial activities (including, for example, performing services for a partnership as described in section 707(a) or section 707(c)) will not be deemed to be engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership." The regulation then goes on to state that the entity's share of partnership income from commercial activities will not be entitled to tax exemption under section 892.

As discussed above, we fully support the Limited Partner Exception. We believe that it has the potential to be of significant use to foreign sovereigns investing in the United States. We also agree with Treasury and the Service's decision to define the term "interest as a limited partner in a partnership" by reference to the specific sets of legal rights that may be conveyed by the equity interest. We think it is appropriate that the definition not be dependent on labels and that it apply equally to membership interests in limited liability companies and to other interests that function as passive equity investments in pass-through entities.

Towards this end, we recommend that Treasury and the Service consider changing the terminology employed to describe the exception so that it is not misconstrued as referring only to limited partnership interests under state or local law. Instead of referring to an "interest as limited partner in a limited partnership," for example, it might be more accurate (and somewhat less confusing) to refer to "a passive investment in a partnership or other flow-through entity."

To make The Limited Partner Exception as workable as possible, we believe that the definition of "interest as a limited partner in a limited partnership" should be clarified in certain respects. Proposed Treasury regulation section 1.892-5(d)(5)(iii)(B) states that, for these purposes:

[9] This recommendation is consistent with a similar recommendation in our 2008 Report.

> "an interest in an entity classified as a partnership for federal tax purposes shall be treated as an interest 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 taxable year under the law of the jurisdiction in which the partnership is organized or under the governing agreement. 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."

In considering this above-quoted definition, we note as an initial matter that there are many protections and rights that are afforded to limited partners in private equity funds (and also, although less commonly, in hedge funds and other alternative investment vehicles) that go beyond the protections and rights listed in the definition's final sentence. Limited partners in private equity funds often have consultation rights with regard to major strategic decisions in the management of the funds (e.g., a decision to extend the life of a private equity fund beyond its original term), as well as in respect of certain investments and other actions that may deviate from a set of defined policies (e.g., the right to be consulted before more than some fixed percentage of a fund's capital is invested in a certain type of asset). Such rights are most common in the case of private equity funds because limited partners in private equity funds are required to commit capital for a significant period of time and to forego the kind of liquidity available from publicly traded securities and from hedge funds that provide liquidity by periodic redemptions of capital. For that reason, most significant institutional investors in private equity funds demand greater oversight rights in order to monitor and protect their investments effectively. We believe that it would be inappropriate to require these investors to forgo these contractual protections as a condition to claiming the benefits of section 892.

One common example of oversight rights afforded to limited partners in private equity funds is membership on a fund's "advisory committee." Although the precise rights of an advisory committee are defined in the relevant governing agreements, and thus will vary from fund to fund, the general purpose of such committees is to allow the more significant limited partners in a fund the opportunity to meet periodically (usually annually) to attend a presentation on the fund's performance and prospects, and to be given the opportunity to vote on certain major strategic decisions. Advisory committees may also be allowed the right to veto certain investments that vary from pre-established parameters. In addition, it is common for limited partners in certain types of funds to enter into "side letters" with the management company permitting them, for example, to opt out of certain types of investments (on the grounds that such investments may present legal or regulatory issues that are specific to certain types of limited partners), or granting certain consultation rights regarding major investment decisions of the fund.

In considering these rights afforded to limited partners, it is worth noting that the rights usually do not allow limited partners any active role in formulating the strategy for a fund or in making the final determination as to the fund's specific investment decisions. For example, although limited partners might have the ability to prevent a fund from taking certain actions, they would not typically have the ability to require a fund manager to make specific investments or to otherwise take an active role in the day-to-day management of the fund.

We recommend the Limited Partner Exception be modified to provide more precise guidance as to what types of oversight rights, consultation rights and veto rights (if any) might be so broad as to constitute "participation in the management and conduct of the partnership's business." We further recommend that Treasury and the Service consider adopting a standard under which the kind of general oversight rights described above are treated as consistent with an investor's status as a limited partner, on the grounds that those rights serve the purpose of allowing an investor to monitor and protect its investment and do not convey any control over the day-to-day operations of the fund. One way to make this distinction in final regulations would be to adopt a rule under which an investor will not be denied the benefits of the Limited Partner Exception if: (i) the investor does not have the general authority to perform the types of day-to-day management activities traditionally exercised by a general partner, and (ii) another person (or persons) unrelated to the investor possesses and exercises control over the day-to-day management of the entity. It may also be appropriate for final regulations to list specific rights and powers that are considered to be inherently inconsistent with passive investment activity (e.g., the right to control ordinary-course personnel and compensation decisions or the right to enter into agreements with third parties on behalf of the entity).

Under the standard described above, we would expect that a typical investor in private equity fund (which almost certainly will be operated by a management company affiliated with the fund sponsor), would be entitled to the benefit of the Limited Partner Exception. By contrast, rights that allow investors to participate in the day-to-day management of the fund in a manner comparable to that of a general partner in a limited partnership would not qualify for the Limited Partner Exception.

Other areas in which our members thought clarification in this area would be useful include:

- Under what circumstances should the rights of one entity be attributed to another for purposes of the Limited Partner Exception? For example, if a controlled entity of a foreign sovereign owns an interest in a partnership that otherwise qualifies as an interest as a limited partner in a limited partnership but another entity also controlled by the foreign sovereign owns a general partnership interest, it might be appropriate to attribute the commercial activity of the second entity to the first. We recommend that Treasury and the Service consider adopting a standard that looks to coordinated activity and a purpose to avoid the application of the "all or nothing" rule. Part of the reason for our recommendation is that many foreign sovereigns employ multiple investment entities ─ often run by independent teams of investment professionals acting in competition with one another. We believe that it would be inappropriate, for example, to deny the benefits of the Limited Partner Exception to one entity investing in a private equity fund simply because, unbeknownst to that entity, an associated entity investing in the same fund received rights under a side letter to participate in the management and conduct of the fund's business. On the other hand, it may also be appropriate for the standard to incorporate certain rebuttable presumptions (e.g., that controlled entities of the same sovereign are presumed to act in coordination in the absence of evidence to the contrary) that would make the rule more administrable.

- We recommend that the rules be clarified to make explicit that the Limited Partner Exception, like the Real Estate Exception, applies to gain realized from the sale or disposition of a limited partnership interest (i.e., the gain may be taxable if appropriate, but will not, without more, cause an entity to be treated as a controlled commercial entity).

- The above-quoted definition of "interest as a limited partner in a limited partnership" refers to the partnership's "business" and seems to assume that a partnership always will be engaged in a "business." Many entities through which sovereign investors hold assets, however, are special purpose vehicles that exist merely to hold a single investment or portfolio of investments and clearly are not engaged in "business," as the concept is normally understood for U.S. federal income tax purposes. Accordingly, we recommend that Treasury and the Service consider clarifying that an investor will not be deemed to "participate in the management and conduct" of a partnership's business (and thus lose the benefit of the Limited Partner Exception) in cases where the partnership in question is an upper-tier entity that is not in fact engaged in any business and that affords the investor no day-to-day management rights over any lower-tier entity that is engaged in a business.

- Finally, it is quite common for a large investor in a private equity fund to make an additional passive investment in the general partner of the fund, the purpose of which is to increase its investment return by participating in the general partner's "carried interest". Many of our members believe that the Proposed Regulations as currently drafted would not disqualify an investment from the Limited Partner Exception merely because the limited partnership is itself a general partner in another entity. Given the prevalence of such structures and the severe consequences of failing under the "all or nothing" rule, however, other members believe that final regulations should confirm this interpretation.

3. Further Clarify the Scope of the Investing and Trading Activity Exceptions.

The Proposed Regulations would clarify that the Investing and Trading Activity Exceptions apply to trading in "financial instruments," regardless of whether or not the financial instruments are "held in the execution of governmental financial or monetary policy." This change is certainly welcome, particularly in light of the fact that the increasing significance of sovereign wealth funds in world financial markets has greatly expanded the types of investments that are regarded as part of legitimate and normal "governmental financial policy." The definition of "financial instruments" for these purposes, however, is ambiguous, and could be read as being too narrow to include most types of derivative transactions that sovereign investors enter into on a regular basis. Such a narrow reading of the definition of "financial instruments" would draw a distinction between different types of derivative contracts that we believe would be arbitrary and at odds with the Proposed Regulations' overarching goal of rationalizing the section 892 regime.

Treasury regulation section 1.892-3T(a)(4) defines the term "financial instrument" to include "any forward, futures, options contract, swap agreement or similar instrument in a functional or nonfunctional currency . . . or in precious metals . . . ." The meaning of this language is not entirely clear. On the one hand, it is possible to read the phrase "in a functional or nonfunctional currency" as referring to the *denomination* of a contract — so that, for example, a credit default swap or interest rate swap would qualify as a "financial instrument" whether denominated in dollars, sterling, euros or some other currency. Under that reading, all commonly used derivatives would qualify as "financial instruments," and we believe that reading reflects the most sensible construction of the term. It is also conceivable, however, to read the phrase "in a functional or nonfunctional currency" as referring to the assets *underlying* the derivative in question. Under this second reading, only currency derivatives and derivatives referencing precious metals would qualify as "financial instruments."[10]

The second, narrow reading of the definition of "financial instruments" described above would remove a large universe of commonly used derivatives from the Investing and Trading Activity Exceptions by introducing a distinction between different types of derivatives that we believe is without an identifiable policy justification. We further believe that such a distinction would undermine what we understand to be the purpose of the Proposed Regulations — *i.e.,* to distinguish legitimate investment and trading activities for an entity's own account from dealer activity and other types of business activity. For that reason, we recommend that Treasury and

[10] The more restrictive reading of the definition of "financial instruments" is supported by the fact that the regulation refers to contracts "in" a currency and "in" a precious metal, where the word "in" with regard to precious metals almost certainly refers to the asset underlying the derivative in question. On the other hand, it is difficult to imagine what the drafters of the definition might have had in mind in referring to a currency contract "in a functional currency," if they meant to refer to a currency derivative where the underlying asset is the investor's/trader's own functional currency. It is difficult to imagine a U.S. institution, for example, entering into a forward contract on the dollar, and equally difficult to imagine how such a contact could be viewed properly as a currency contract.

the Service clarify that this definition of "financial instruments" includes all types of market-standard derivatives.

In connection with this recommendation, we also wish to reiterate our recommendation in the 2008 Report for explicit confirmation that trading activities qualifying for the "securities trading" safe harbor under section 864(b) do not give rise to commercial activity under section 892. To be clear, we believe that the implementation of these two recommendations would merely clarify current law. We do not believe that the restrictive reading of the definition of "financial instruments" described above is the correct reading, because we do not believe that Treasury and the Service intended to draw a distinction between common, market-standard derivatives based on whether the underlying is currency, precious metal, or some other security or item of actively traded property. In fact, the preamble to the Proposed Regulations refers to "financial instruments, including derivatives" without any indication that the term is limited only to certain specific types of derivatives.

Furthermore, we believe that the Investing and Trading Activity Exceptions already apply to activities qualifying for the "securities trading" safe harbor. The language implementing the two exemptions contained in Treasury regulation section 1.892-4T(c)(1)(iii) — as well as the language contained in proposed Treasury regulation sections 1.892-4(e)(ii) and -5(d)(5)(ii) — follows the structure of the section 864(b) securities trading safe harbor and cross references the standards of the regulations under section 864(b), including for purposes of distinguishing securities trading activities from the activities of a dealer. At least for some purposes, therefore, the section 892 regulations adopt the standards of section 864(b) as their own. Finally, as discussed in the 2008 Report, it would be remarkable if either Congress or Treasury, having adopted rules designed to encourage non-U.S. parties to trade in the United States and to enter into derivative contracts with U.S. counterparties, would then apply the "all or nothing" rule to penalize that same behavior.

In the final analysis, the primary import of these points is *not* whether the activities in question will be subject to tax, since the activities in question almost always either will be eligible for the benefits of the section 864(b) securities trading safe harbor or for the sourcing rules that exempt income from swaps and similar contracts from withholding tax. Rather, the question is whether a controlled entity that takes positions in market-standard derivatives will need to be concerned about losing the benefits of section 892 altogether under the "all or nothing" rule. We believe the appropriate policy with respect to that issue is clear.

4. Issues Related to the Exception for Inadvertent Commercial Activity.

As discussed above, we commend Treasury and the Service for the introduction of an exception from the "all or nothing" rule for a controlled entity that engages in inadvertent commercial activity. This section proposes that Treasury and the Service clarify a few minor points regarding the scope of this safe harbor.

First, the safe harbor contained in Proposed Regulation section 1.892-5(a)(2)(ii)(C) states that, subject to certain conditions pertaining to written policies and operational procedures, an entity's failure to avoid commercial activity will be considered "reasonable" (and accordingly *not* taken into account for purposes of the "all or nothing" rule) if: (i) "[t]he value of all assets used in, or held for use in, all commercial activity does not exceed five percent of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes," and (ii) "[t]he income earned by that entity from commercial activity does not exceed five percent of the entity's gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes." Given the importance of the phrase "prepared for financial accounting purposes," we recommend that Treasury and the Service provide additional guidance as to what kinds of financial statements will satisfy this safe harbor.

For example, because sovereign wealth funds are not publicly traded entities or U.S. entities, we assume that the reference to financial statements in the safe harbor does not mean financial statements prepared in accordance with U.S. GAAP and that financial statements prepared in accordance with IFRS or any other reasonable set of accounting standards would qualify. Similarly, because foreign sovereigns and controlled entities generally are not required to file financial reports with third-party regulators, we assume that it is sufficient for purposes of this safe harbor to rely on financial statements that are prepared for internal purposes (*e.g.,* reports to the body within a foreign sovereign responsible for monitoring the investment activity). Several of our members believe that final regulations should explicitly confirm these assumptions.

Second, we encourage Treasury and the Service to consider situations where a controlled entity makes a legal judgment as to what constitutes commercial activity that, while reasonable, turns out in hindsight to be incorrect. For example, consider an investor that reasonably believes itself to be entitled to the benefit of the Limited Partner Exception, and later discovers that the Service considers its rights vis-à-vis the partnership in question rise to the level of "participation in the management and conduct" of the partnership's business. We recommend that Treasury and the Service consider adopting a rule that affords investors a reasonable period of time (*e.g.,* six months) to correct such mistakes (*e.g.,* by disposing of investments or amending the relevant documents to conform to the requirements of the Limited Partner Exception) before losing the benefit of section 892 altogether through the operation of the "all or nothing" rule.

We appreciate your consideration of our recommendations.

Respectfully submitted,

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Chair

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