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June 13, 2008

Rep. Charles B. Rangel, Chair
House Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Rep. Jim McCrery, Ranking Minority
House Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Sen. Max Baucus, Chair
Senate Finance Committee
U.S. Senate
Washington, DC 20510

Sen. Charles E. Grassley, Ranking Minority
Senate Finance Committee
U.S. Senate
Washington, DC 20510

The Honorable Eric Solomon
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The Honorable Douglas Shulman
Commissioner
Internal Revenue Service
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Washington DC 20224

Edward D. Kleinbard
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Joint Committee on Taxation
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Washington, DC 20515

Re: NYSBA Report on the Tax Exemption for Foreign Sovereigns Under Section 892 of the Internal Revenue Code

Dear Sirs:

We write to recommend changes to section 892 of the Internal Revenue Code and its regulations.

Very generally, section 892 provides a very limited exemption from U.S. federal income tax to foreign sovereigns and non-commercial entities that are wholly owned and controlled by foreign sovereigns (e.g., "sovereign wealth funds").

Section 892 reflects the longstanding common law doctrine of "sovereign immunity" — that sovereign governments generally should not be subject to each other's jurisdiction in respect of state activities. However, over the years, section 892 has been expanded to encourage foreign sovereign investment in the United States and significantly restricted by Congress, the Treasury Department, and the Internal Revenue Service to deny the exemption to foreign sovereigns on their commercial activities and to entirely deny the exemption to their controlled entities that engage in any commercial activities.

While the section 892 exemption has expanded and contracted, the United States has expanded the exemptions from U.S. federal income tax for passive foreign investors generally to include portfolio interest income, many categories of income and gain on financial instruments, and many categories of capital gain (except, generally, gain in respect of United States real property interests, including "United States real property holding corporations).

Therefore, today, the benefits of the section 892 exemption are effectively limited to (i) U.S.-source dividend income received from non-controlled U.S. corporations which otherwise would be subject to U.S. withholding tax at a 30% rate, subject to the availability of reduced treaty rates, (ii) gain on the disposition of interests in non-controlled United States real property holding corporations, including U.S. REITs, which would otherwise generally be subject to net U.S. income tax, and (iii) interest income received from a non-controlled U.S. borrower that is not otherwise eligible for the portfolio interest exemption (for example, because the foreign government or sovereign wealth fund in question holds more than 10% of the stock of the corporate borrower but does not control the corporate borrower).

However, section 892 and its regulations contain a significant number of "traps for the unwary". The most significant of these traps, which we refer to as the "all or nothing rule," provides that if a sovereign wealth fund or other entity wholly owned by a foreign sovereign engages in *any* commercial activity *anywhere in the world*, the entity is *completely disqualified* from any benefit under section 892.

We acknowledge that Congress may decide to further restrict section 892 to deny foreign sovereigns and their controlled entities the limited subsidy they now enjoy, or may decide to further expand the exemptions from U.S. federal tax available to foreigners generally (so that section 892 becomes less important), but these decisions involve a variety of policies that are beyond our area of expertise as tax lawyers.

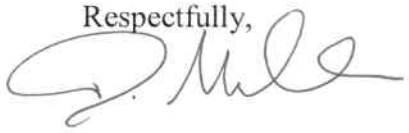
Therefore, in the attached report, we generally accept the balancing of historical policy concerns underlying section 892 as it currently exists and offer recommendations designed to rationalize the current operation of section 892 and make it and its regulations more consistent with the historic policy objectives of exempting the income and gain on passive investments made by foreign governments and their controlled entities in the United States from U.S. taxation while also avoiding tax subsidies for the active commercial activities of foreign sovereigns and their wholly-owned entities.

In short, we recommend that Congress replace the "all or nothing" rule for controlled entities with a rule that provides that the benefits of section 892 are entirely denied to a controlled entity only if the entity in question is — on the basis of all of its activities taken as a whole — properly considered to be a commercial enterprise. As a result, all of the commercial income of a controlled entity that is effectively connected to a trade or business in the United States would be subject to tax (as is the case under current law), but only fundamentally commercial entities would lose the benefits of section 892 altogether. This approach effectively was the approach adopted by the Internal Revenue Service prior to 1986, and we believe that this approach best balances the policies that section 892 today reflects and minimizes inadvertent foot faults.

However, until Congress amends section 892, we recommend that Treasury and the Internal Revenue Service amend the regulations under current section 892 to provide a rule similar to the rule currently in effect for tax-exempt organizations that engage in some non-charitable commercial activities — in other words, a state-owned entity would retain its section 892 exemption so long as no more than an "insubstantial part" of the entity's activities are commercial. Sovereigns today can avoid the all-or-nothing rule by holding each investment through a separate legal entity, but there is no tax policy reason to require them to do so, and there is no tax policy reason to penalize those that do not. We also suggest a number of technical changes, clarifications and modifications to the existing regulations.

We appreciate your consideration of our report. Please let us know if you would like to discuss these matters further or if we can assist you in any other way.

Respectfully,



David S. Miller

cc: Honorable Donald L. Korb
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