REPORT ON THE TAX EXEMPTION FOR FOREIGN SOVEREIGNS UNDER SECTION 892 OF THE INTERNAL REVENUE CODE

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

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I. INTRODUCTION.

This report[1] discusses various policy and technical issues arising under section 892,[2] which provides an exemption from U.S. federal income taxation for certain types of income from investments by foreign sovereigns and non-commercial entities wholly owned and controlled by foreign sovereigns. Both Congress and the Treasury Department ("Treasury") have expressed a renewed interest recently in policies concerning investment in the United States by foreign sovereigns.[3] This interest has been driven to a large extent by the recent prominence of so-called "sovereign wealth funds" ("SWFs"), which are investment funds operated by or for the benefit of foreign sovereigns.

The purpose of this report is twofold. First, the report provides an overview of the history of the sovereign tax exemption and the policy considerations that have shaped the specific terms of the exemption since its initial enactment in 1917. We hope that the historical/policy overview might provide useful context for current policy discussions regarding section 892. Second, the report discusses several areas where we believe that either section 892 or the regulations thereunder should be changed. As we stated in our previous report from 1988 (the "1988 Report") and reiterate here, we believe that certain aspects of the section 892 regulations create significant "traps for the unwary" and points of uncertainty that do not serve any readily ascertainable policy objectives. Because those regulations remain effective in

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1 The principal drafters of this report are William L. McRae, Edward A. Saad, and Katherine F. Schulte. Helpful comments were received from Kim Blanchard, Douglas Borisky, Dave Lewis, David Mattingly, David Miller, Stephen Mills, Yaron Reich, Michael Schler, Scott Semer, David Sicular, Willard Taylor, and David Ware.

2 Unless indicated otherwise, all section references in this report are to the Internal Revenue Code of 1986, as amended (the "Code") or its predecessor statutes or to the Treasury regulations thereunder.

3 See letter dated May 13, 2008 from the Chairman and Ranking Member of the Senate Finance Committee to the Joint Committee on Taxation ("JCT") requesting an analysis of various aspects of section 892.

temporary form today, and have not been amended since their original issuance two decades ago, we believe that the recommendations contained in the 1988 Report continue to be valid. The 1988 Report is attached to this report.

In considering our recommendations for changes to the current rules, it is worth noting upfront that the practical impact of section 892 has narrowed over the last several decades, due to the introduction of several tax exemptions that are available both to sovereign and non-sovereign foreign investors in respect of specified types of income (*e.g.*, the exemption from withholding tax for "portfolio interest" and the "securities trading" safe harbor of section 864(b)). Currently, section 892 is relevant — to the extent relief is not otherwise provided under an applicable income tax treaty — primarily in respect of: (i) withholding taxes on U.S.-source dividend income, (ii) net income tax on gains from the disposition of interests in non-controlled United States real property holding corporations ("USRPHCs"), and (iii) withholding tax on 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 ten percent of the stock of the corporate borrower but does not control the corporate borrower).

Part II of this report discusses the history of section 892, the policy considerations that have shaped its development, and the principal substantive provisions of section 892, as well as observations regarding SWFs. Considering these matters, we recognize that Congress may wish to consider potential changes to the current scope and operation of section 892. Congress also may wish to consider the relationship between section 892 and the other exemptions available more generally for both sovereign and non-sovereign investors, as well as the relationship between section 892 and the U.S. tax treaty network. This report, however, does *not*

make recommendations regarding how the tax laws might be used to address the deeper economic and political issues presented by SWFs or by other market developments over the last two decades. Part III does provide recommendations, however, that we believe would help rationalize the current operation of section 892 and allow the statute to function in a manner more consistent with its current underlying policies. Part III also discusses several technical shortcomings in the section 892 regulations, which were issued in 1988 in both proposed and temporary form and remain effective today.

II. HISTORY, POLICY AND BACKGROUND.

Section 892 reflects an extension to the Code of the longstanding common law doctrine of "sovereign immunity" — that is, the doctrine that sovereign governments generally should not be subject to each other's jurisdiction in respect of state activities. The boundaries of the section 892 exemption historically have been shaped primarily by two competing policies. First, the U.S. Government historically has sought to encourage foreign sovereigns to deploy capital in the United States — through the purchase of U.S. Treasury obligations, as well as through other investments — in order to provide needed financing and to further U.S. foreign exchange policies. Second, the history of the sovereign tax exemption and the principle of sovereign immunity also reflect a countervailing concern that the tax laws should not subsidize active commercial activities or otherwise provide government-owned commercial enterprises with an unfair advantage in competing against private enterprises.

A. The Sovereign Immunity Doctrine Generally.

The notion that governments should not be under each other's jurisdiction is a longstanding common law principle that is reflected in United States caselaw dating back at least to 1812, when the U.S. Supreme Court articulated the principle in its decision in *The Schooner*

Exchange v. McFaddon and Others.[4] Specifically, that case involved the question of whether a French warship named the "Exchange" was exempt from U.S. jurisdiction while in a U.S. port. In holding that the vessel was not subject to U.S. jurisdiction, the Supreme Court stated the following:

> [T]he Exchange, being a public armed ship, in the service of a foreign sovereign, with whom the government of the United States is at peace, and having entered an American port open for her reception, on the terms on which ships of war are generally permitted to enter the ports of a friendly power, must be considered as having come into the American territory, under an implied promise, that while necessarily within it, and demeaning herself in a friendly manner, she should be exempt from the jurisdiction of the country.

While the general principle of sovereign immunity in U.S. jurisprudence dates back almost to the formation of the Republic, the scope of such immunity has been limited generally to cases where a foreign government (or government-owned entity) is acting in a "sovereign" capacity, as opposed to in a private or commercial capacity.[5] This distinction was codified by the Foreign Sovereign Immunities Act of 1976 (the "Foreign Sovereign Immunities Act"), which restricts grants of sovereign immunity to the non-commercial activities of foreign governments and government instrumentalities (including certain government-owned entities).[6] Thus, foreign governments are not immune from the jurisdiction of U.S. federal and state courts with respect to (i) commercial activities conducted within the United States, (ii) other activities within the United States that are related to commercial activities conducted outside the United

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4 11 U.S. (7 Cranch) 116 (1812).

5 H.R. Report No. 94-187 to the Foreign Sovereign Immunities Act (Sept. 9, 1976).

6 28 USC 1602 (part of the FSIA) from Public Law 94-583 (Oct. 21, 1976) reads: "§1602. Findings and declaration of purpose. . . . Under international law, states are not immune from the jurisdiction of foreign courts insofar as their commercial activities are concerned, and their commercial property may be levied upon for the satisfaction of judgments rendered against them in connection with their commercial activities. Claims of foreign states to immunity should henceforth be decided by courts of the United States and of the States in conformity with the principles set forth in this chapter."

States, or (iii) commercial activities outside the United States that have direct effects in the United States.[7]

B. The Historic Tax Exemption for Foreign Sovereigns.

The United States first enacted a tax exemption for foreign sovereigns in 1917, four years after the passage of the first modern federal income tax in 1913 and in response to a 1916 ruling by the predecessor to the Internal Revenue Service ("the Service") that U.S.-source interest and dividends paid to a foreign government constituted income from "commercial transactions" not eligible for the benefits of sovereign immunity.[8] Seeking to encourage foreign investments in the United States at a time when the country was at war and in need of financing, Congress passed the 1917 War Revenue Act, which, among other matters, provided that "nothing in [the tax law] shall be construed as taxing the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to foreign governments."[9] It is worth noting the implicit policy judgment underlying

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7 28 USC 1605(a): "A Foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case. . . (2) in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States." 28 USC 1603 of the FSIA defines commercial activity as follows: "(d) A 'commercial activity' means either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose. (e) A 'commercial activity carried on in the United States by a foreign state' means commercial activity carried on by such state and having substantial contact with the United States."

8 *See* T.D. 2425, 18 Treas. Dec. Int. Rev. 276 (1916). *See also* Sidney I. Roberts et al., *U.S. Tax Exemption for Foreign Governments and Controlled Entities After TRA*, 66 J. TAX'N 222 (1987).

9 War Revenue Act, §30, ch. 63, 40 Stat. 300, 337 (1917).

the War Revenue Act in favor of encouraging foreign investment at the expense of collecting tax revenues from foreign sovereigns.[10]

The following year, the Revenue Act of 1918 broadened the sovereign tax exemption to cover — in addition to income from U.S. securities and bank deposits, as discussed above — income "from any other source in the United States."[11] Although Congress did not explain its intent in adding the new language beyond stating that the new language was intended to expand the original exemption, it is fair to assume that the language was intended to encourage foreign sovereign investment in the United States.[12] Although this broad wording of the statutory sovereign tax exemption remained substantially unchanged from 1918 until 1986, both the Service and the JCT interpreted the statute to limit the scope of the exemption, as discussed immediately below.

C. Interpretation of the 1918 Statute: Different Approaches to Limiting Its Scope.

The earliest authority of which we are aware interpreting the 1918 statutory language did not involve income received directly by a foreign sovereign, but rather income

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10 *See* Kenneth Wood et al., *Sovereign Wealth Funds: The Benefits and Burdens of the Sovereign Immunity Exemption from Tax Under 892*, 37 TAX MGM'T INT'L J. 79 (2008). "The entry of the United States into World War I greatly increased the government's need for revenue, and Congress responded first by passing the 1916 Revenue Act and then the War Revenue Act of 1917, which generally lowered exemptions and sharply increased tax rates. However, the provisions also specifically exempted from tax the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States or moneys belonging to foreign government." (*Citing* U.S. Department of the Treasury Fact Sheet, available at http://www.treas.gov/education/fact-sheets/taxes/ustax.html).

11 "[The amount included in gross income] [d]oes not include the following items, which shall be exempt from taxation under this title:…(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source in the United States," Revenue Act of 1918, H.R. 12863, 65th Cong (1918).

12 The legislative history to the 1918 statutory language states merely the following: "Under the present law it is not necessary to include in gross income the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities owned by such foreign governments, or from interest on deposits in banks of the United States of moneys belonging to such foreign governments. The proposed bill, in addition to providing that the aforementioned income shall not be included in gross income, provides that income of foreign governments from any other source within the United States shall not be so included." H.R. Report No. 767 (CB 1939-1 Part 2 p. 86, 92).

received by the Australian central bank, which, at least as a technical legal matter, was a government-owned entity separate from the Australian government itself. While acknowledging the legal distinction, the Service ruled in 1920 that the central bank was entitled to the exemption under the 1918 statute on the grounds that the bank's capital and governance structures were such as to ensure that the bank would operate as an instrumentality of the Australian government:

> The Commonwealth Bank of Australia was established by an act of the legislature of Australia, which provided that the appointment of the governor of the bank and the control of its affairs should be vested in officials of the Government; that the capital necessary for its operations should be supplied solely by the sale of interest-bearing obligations, not entitling the purchaser thereof to any interest in the bank or to any share in its profits, the issuance and sale of which are to be controlled by the Governor General of the Commonwealth; that the securities so issued are guaranteed by the Commonwealth; that the Commonwealth is exclusively entitled to any profits of the bank and is the guarantor of its debts. Held, in view of the above, that the Commonwealth Bank of Australia is a Governmental agency of the Commonwealth of Australia, and exempt from income tax under section 213(b)(5) of the Revenue Act of 1918.[13]

In 1946, however, the Service revoked the 1920 ruling in response to a decision by the JCT to deny the foreign sovereign exemption to corporations owned by foreign governments. Specifically, the JCT refused to approve a tax refund for a domestic (New York) corporation that was wholly owned by a foreign government,[14] on the grounds that the domestic corporation was separate from the governmental shareholder and thus was not itself a foreign sovereign entitled to any tax exemption under the 1918 statutory language.[15] In other words, the JCT adopted a standard that looked to the *legal form* through which foreign governments made investments.

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13 O.D. 628, 3 C.B. 124 (1920). The central bank had been established as a corporation by the Australian legislature.

14 The JCT is a committee of Congress that is responsible, *inter alia*, for approving tax refunds in excess of specified amounts.

15 S. Rep't No. 163, 87th Cong., 1st Sess. 3 (1961) (discussing I.T. 3789).

In considering the JCT's refusal to approve the refund, it is worth noting that the corporation seeking the refund was domestic and purportedly was engaged in active commercial activities.[16] The JCT therefore might have considered attempting to draw a distinction based on the use of *domestic* corporations as business vehicles, or between "commercial" income, on the one hand, and income earned in the pursuance of a government's financial or monetary policies, on the other. A distinction based on the difference between "commercial" and "governmental" income arguably would have made more sense from a policy perspective, and would have been more consistent with the logic of the Service's 1920 ruling than a distinction based on whether the income in question was earned directly by the sovereign or through a government-owned entity. A distinction based on the type of income in question, however, may have been difficult for the JCT to reconcile with the plain meaning of the 1918 statutory language, which by its terms applies the exemption to *all* U.S.-source income earned by a foreign government.[17]

In revoking its 1920 ruling for the Australian central bank in response to the JCT's position, the Service held that, because a government-owned corporation is an entity separate from the foreign government for these purposes, such a corporation cannot be entitled to the sovereign tax exemption.[18]

The next authority of which we are aware that considers the issue of legal entities owned by foreign governments is from 1950, when the Tax Court issued its decision in *Louis*

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16 *Id.*

17 Indeed, in *Qantas Airways Ltd. v. United States*, discussed below in Section II.D, Qantas Airways, a corporation wholly owned by the Australian government, challenged (albeit unsuccessfully) the Service's authority under the 1918 statutory language to limit the sovereign tax exemption to specific types of income.

18 I.T. 3789, 1946-1 C.B. 100 (revoking O.D. 628, 3 C.B. 124 (1920)). As discussed below, I.T. 3789 itself was declared obsolete by Revenue Ruling 69-45, 1969-1 C.B. 313.

Vial.[19] That case involved the question of whether Louis Vial, an employee of a Chilean government-owned economic development agency and think tank named "Fomento," was entitled to a tax exemption available to employees of foreign governments under the predecessor to section 893.[20] Fomento was an entity formed by the Chilean government for the purpose of developing the Chilean economy, and Fomento attempted to further that goal through undertaking numerous economic studies and through making certain targeted investments in strategic industries.

The Service, adopting the distinction formulated by the JCT, argued that, because Fomento was an entity with separate legal personality under Chilean law, it was a government-owned "corporation" separate from the Chilean government, and that Mr. Vial was therefore ineligible for the tax exemption. The Tax Court held against the Service on the grounds that Fomento "was not a corporation within the meaning of that term as used in our law." The court noted that Fomento:

> had no stockholders or members and no provision was made for it to be owned by anyone. It was just a part of the government. Its governing body was fixed by law, the members of that [body] were such ex-officio or were appointed by the legislative or executive branch of the government. Its operations were closely regulated by law and subject to supervision and approval by governmental departments and officers.

In reaching its decision, the Tax Court also considered the argument that, although not a "corporation," Fomento might still be viewed as an "instrumentality, so separate from the government that its employees would not be employees of the government." The Tax

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19 15 T.C. 403 (1950).

20 Section 893 generally provides that the compensation received by employees of foreign governments and international organizations is exempt from U.S. income taxation. "Wages, fees, or salary of any employee of a foreign government or of an international organization (including a consular or other officer, or a nondiplomatic representative), received as compensation for official services to such government or international organization shall not be included in gross income and shall be exempt from taxation..." This exemption was first applied to the compensation of employees of the Commonwealth of the Philippines in 1935, and was enacted as law via the Revenue Act of 1942. *See* BNA 913-3rd at A-25.

Court noted, however, that the Service did *not* advance such an argument, and that the argument was "not sound" due to the close connections between Fomento and the Chilean government.

The Service acquiesced in the Tax Court's decision in *Vial*, and ruled in 1955 — albeit then through a private letter ruling, rather than published guidance — that the Australian central bank in fact was eligible for the sovereign tax exemption, notwithstanding the revocation of the original 1920 ruling.[21] The JCT later expressed disagreement with the Service's position, again because of the bank's status as a legal entity separate from the Australian government.[22]

In light of the uncertainty concerning the status of foreign central banks under the 1918 statutory language, Congress took action in 1961 to ensure that the U.S. tax laws would not discourage foreign central banks from investing in U.S. Treasury obligations, but at the same time reserved the right to tax commercial activities of foreign central banks. Specifically, Congress enacted section 895 as a supplement to section 892.[23] As originally enacted, section 895 read as follows:

> Income derived by a foreign central bank of issue from obligations of the United States owned by such foreign central bank of issue shall not be included in gross income and shall be exempt from taxation under [the income tax laws] unless such obligations are held for, or used in connection with, the conduct of commercial banking functions or other commercial activities.[24]

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21 *See* PLR 5503235690A (I.R.S. Priv. Ltr. Rul. 03-29-91 (Mar. 23, 1955)).

22 *See* S. Rep't No. 163, *supra* note 15; *See also* David R. Tillinghast, *Sovereign Immunity from the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations*, 10 LAW & POL'Y INT'L BUS. 495, 510-13 (1978).

23 *See* S. Rep't No. 163, *supra* note 15. As discussed below in Part III.B.1 of this report, the current sovereign tax exemption expressly applies to foreign central banks so long as they do not engage in commercial activities within the United States.

24 Pub. Law 87-29 (May 4, 1961).

The legislative history to section 895 indicates that section 895 was intended to protect the United States' gold reserves by encouraging foreign central banks to hold U.S. Treasury obligations, rather than redeem their dollar holdings for gold:

> [T]he United States imposes no tax on this bank deposit interest or on income from bankers' acceptances held by foreign central banks of issue. However, a tax may be imposed with respect to holdings of Treasury bills or other U.S. obligations if the central bank of issue is not a part of the foreign government itself. . . .
>
> Of particular importance at the present time is the improved effect that this [additional tax exemption] can be expected to have on the gold reserves of the United States. This is illustrated by the events of the last year when large volumes of funds seeking short-term investments flowed out of the United States because of temporary higher interest rates in foreign countries. Under these conditions the foreign governments where the funds were invested tended to acquire dollar assets as a result of these investments, in order to maintain the strength of the dollar as required by their International Monetary Fund commitments. Once these dollar balances are acquired, they can be converted by the foreign banking authority into gold or into other dollar assets such as bank accounts, bankers' acceptances, or Treasury bills. Conversion of these balances into gold, of course, increases the drain upon the [g]old reserves of the United States. On the other hand, deposits in U.S. banks, purchases of bankers' acceptances, or purchases of the U.S. Treasury bills do not have this adverse effect. The present tax which may be imposed upon investments in U.S. obligations, however, tends to discourage the purchase of Treasury bills and, therefore, increases the likelihood of conversion into gold.
>
> The exemption provided by the bill will not discriminate against domestic private enterprise because it is limited to U.S. Government obligations held by foreign banks in connection with their central banking functions and is not available in the case of balances held for commercial banking activities or any other commercial activities.
>
> The revenue effect of this proposal is expected to be negligible. It is believed that this will be true because foreign central banks of issue, where the tax is presently applicable, now tend not to hold their reserves in U.S. Government obligations but instead to hold them in gold or in dollar assets, income from which is exempt, such as bank accounts or bankers' acceptances.[25]

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[25] S. Rep't No. 163, *supra* note 15.

In the same year as the passage of section 895, the Service issued Revenue Ruling 66-73,[26] which attempted to reconcile (i) the *Vial* decision, (ii) the JCT's approach to *foreign* juridical entities and (iii) the Service's own views regarding the distinction between "commercial" activities and "governmental" activities. First, Revenue Ruling 66-73 acknowledged the "basic tax principle" as articulated in the 1946 revocation of the 1920 Australian central bank ruling that the sovereign tax exemption "cannot be extended to a corporation which is wholly owned by a foreign government inasmuch as a corporation is an entity separate and distinct from its sole stockholder."[27] The revenue ruling then noted, however, that the *Vial* decision interprets the term "corporation" as requiring more than mere separate legal personality, and used the *Vial* decision as grounds for holding that an entity is not a "corporation" for purposes of the sovereign tax exemption, unless the entity in question is engaged in private commercial activity.

Revenue Ruling 66-73 states that "it is now the position of the Service that an organization separate in form and wholly owned by a foreign government, and no part of the net earnings of which inures to the benefit of any private shareholder or individual, *regardless of where organized* and whether with stock outstanding, is exempt under section 892 of the Code, provided it does not constitute a corporation as that term is generally understood in the United States. . . ." The revenue ruling then goes on to define "corporation" in the following manner:

> Whether an organization constitutes a corporation as contemplated by this rule will depend directly upon its purposes, functions, and activities. Where its purposes, functions, and activities, taken as a whole, customarily are attributable to and carried on by private enterprise for profit in this country, it will be deemed to constitute a corporation separate from its owner even though in some instances governments also are engaged in the same or a similar activity in the United

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[26] 1966-1 C.B. 174. As discussed below, Revenue Ruling 75-298 subsequently revoked Revenue Ruling 66-73 and further broadened the exemption from tax for organizations created by a foreign government.

[27] *Id* (quoting I.T. 3789, C.B. 1946-1, 100).

> States. On the other hand, where the organization does not have purposes, functions, and activities of the type which are customarily attributable to and carried on by private enterprise for profit in this country, or, to the extent it has such purposes, functions, and activities, taken as a whole they are so circumscribed and limited that the organization does not in fact substantially resemble such a private enterprise, it will not be deemed to constitute a corporation separate from its owner, and hence will be entitled to the benefits granted by section 892 of the Code.

In sum, the Service interpreted the term "corporation" in such a way that the scope of the tax exemption was defined by two basic factors: (i) the corporation's *activities* giving rise to the income in question, and (ii) ultimate *beneficiaries* of the corporation's activities (*i.e.*, whether the corporation ultimately benefits governmental or private persons). Those are the two factors underpinning section 892 currently. In 1969, the Service declared obsolete its prior revocation of the 1920 ruling concerning the central bank of Australia.[28]

The Service further developed and refined its approach towards entities owned by foreign governments in Revenue Ruling 75-298,[29] which held that any entity wholly owned by a foreign government generally is eligible for the sovereign exemption so long as (i) it has no private investors or beneficiaries; (ii) it does not engage in material commercial activities in the United States; (iii) all of the income is credited to the entity or to the foreign government directly; and (iv) its investments in the United States, if any, produce only passive income.[30]

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28 Revenue Ruling 69-45, 1969-1 C.B. 313.

29 1975-2 C.B. 290.

30 In addition, Revenue Ruling 75-298 provided another set of standards explicitly for foreign central banks: "[I]ncome earned by a foreign bank that qualifies as a central bank of issue under section 895 of the Code, or by any other organization created by a foreign government, which does not engage in the United States in either commercial banking functions as described in section 1.864-4(c)(5)(1) of the Income Tax Regulations or in other commercial activities (on more than a *de minimis* basis in the United States), qualifies for the exemption from Federal income tax described in section 892, provided such bank or other organization meets the following requirements: 1) it is wholly owned and controlled by a foreign government; 2) its assets and income are derived solely from its activities and investments and from the foreign government; 3) its net income is credited either to itself or to the foreign government, with no portion of its income inuring to the benefit of any private person; and 4) its investments in the United States, if any, include only those which produce passive income, such as currencies, fixed interest deposits,

Under Revenue Ruling 75-298, an entity's unrelated non-U.S. commercial activities, if any, would not affect its eligibility.

D. The Foreign Sovereign Immunities Act, and 1980 Regulations.

The approach taken by the Service in Revenue Ruling 75-298 was consistent with the approach to sovereign immunity more generally taken by Congress in 1976 with the passage of the Foreign Sovereign Immunities Act. Very generally, and as discussed above in Section II.A, the Foreign Sovereign Immunities Act, which is still in force today, grants sovereign immunity only in cases where a foreign government or government instrumentality is acting in a "public" or "governmental" capacity, and not where it is acting in a "private" or "commercial" capacity.[31]

Following the enactment of the Foreign Sovereign Immunities Act, the first substantial Treasury regulations addressing the sovereign tax exemption were proposed in 1978 and issued in final form in 1980.[32] Similar to the approach of Revenue Ruling 75-298, the 1980 regulations restricted the scope of the sovereign tax exemption by limiting its application to investment income and providing that the exemption would not apply to income derived from commercial activities.[33]

The 1980 regulations provided that U.S.-source income of both "integral parts" of foreign governments and wholly owned government subsidiaries generally were exempt from

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stocks, bonds, and notes or other securities evidencing loans." (Rev. Rul. 75-298, 1975-2 C.B. 290). Revenue Ruling 75-298 thus revoked Revenue Ruling 66-73, discussed above.

31 H.R. No. 94-1487 to the Foreign Sovereign Immunities Act (Sept. 9, 1976).

32 T.D. 7707, 45 Fed Reg. 48882 (1980). Very modest Treasury regulations addressing the sovereign tax exemption were proposed in 1956 and issued in final form in 1957. Those regulations generally did not provide meaningful guidance to the sovereign tax exemption in section 892.

33 Former Treasury regulation section §1.892-1(a)(3) "The income derived by an integral part or controlled entity of a foreign sovereign from commercial activities in the United States is not income of a foreign government for purposes of the exemption from taxation provided in section 892. These amounts are included in income and taxed under appropriate Internal Revenue Code provisions."

U.S. taxation so long as the income was not derived from "commercial activities." Thus, while the 1980 regulations distinguished between foreign governments and their subsidiaries as a technical matter, the regulations effectively eliminated any practical differences in the application of the sovereign tax exemption based on that distinction and focused instead on the nature of the income in question.[34]

Qantas Airways, a corporation wholly owned by the Australian government, helped establish the legitimacy of the Service's approach to section 892 when Qantas unsuccessfully challenged the validity of the 1980 regulations in *Qantas Airways Ltd. v. United States*.[35] Qantas argued that, because the pre-1986 statutory sovereign tax exemption by its terms provided that *all* U.S.-source income of a foreign government was exempt from U.S. taxation, the 1980 regulations were an invalid interpretation of that statutory exemption insofar as they purported to exclude income derived from commercial activities from the scope of that exemption.

The Court of Appeals for the Federal Circuit held that the exclusion in the 1980 regulations was a reasonable construction of the statute, at least as applied to a government-owned entity such as Qantas, because section 892 did not require that government-owned entities be included within the scope of the term "foreign governments."[36] Accordingly, the Service was within its regulatory authority to set reasonable limitations on the sovereign tax exemption as applied to such entities. Upon remand the lower court found that Qantas Airways was not

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34 Treasury regulation section 1.892-1(b): "For purposes of this section, a foreign government consists only of integral parts or controlled entities of a foreign sovereign to the extent not engaged in commercial activities in the United States." Thus, the 1980 section 892 regulations distinguish between "integral parts" and "controlled entities" of a foreign government, but apply the same standard to both.

35 *Qantas Airways Ltd. v. United States*, 62 F.3d 385 (1995), rev'g 30 Fed. Cl. 851 (1994), cert. denied, 116 S. Ct. 10 (1996).

36 Section 892 merely provided that "foreign governments" were entitled to the sovereign tax exemption and did not provide a definition of the term "foreign government."

exempt from U.S. taxation under the pre-1986 sovereign tax exemption in respect of the income that it derived from leasing various U.S. real properties, because the leasing activities constituted commercial activities.[37]

E. Current Statute and Regulations.

As part of the overhaul of the Code in 1986, section 892 was comprehensively revised in a manner that in many significant respects conformed the sovereign tax exemption more closely to the approach taken in the Foreign Sovereign Immunities Act, discussed above, and to the Service's interpretation of the pre-'86 statute.[38] The principal result of the 1986 amendments to section 892 was to limit significantly the scope of the sovereign tax exemption, particularly with respect to commercial activities. Section 892 was amended again in 1988 to provide that foreign governments and non-commercial wholly owned governmental subsidiaries generally will be treated as corporate residents of their home country for purposes of the Code, and that they generally also will be so treated under an income tax treaty pursuant to which the United States receives reciprocal treatment.[39] The 1986 statutory language was supplemented in 1988 with extensive temporary Treasury regulations detailing the application of, and even further limiting, the revised statutory language. Both section 892 and the 1988 regulations remain substantially unchanged to this date, with the regulations continuing to be effective in temporary form.

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37 *Qantas Airways Ltd. v. United States,*Fed. Cl. 1997. The Federal Circuit, without written opinion, affirmed the decision of the Court of Federal Claims upon remand. (Fed Cir.1998).

38 As discussed above, the restrictive doctrine of sovereign immunity is codified in the Foreign Sovereign Immunities Act and generally grants sovereign immunity only where a foreign government is acting in a "public" governmental capacity, not where it is acting in a "private" commercial capacity.

39 Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). The 1988 amendment also further limited the scope of the sovereign tax exemption in respect of commercial activities by providing that income received *indirectly* from a "controlled commercial entity" (discussed below in Section II.E.3), and income and gain from the sale of interests in such entities, are not exempt under section 892.

As currently in force, section 892 and the regulations thereunder limit the sovereign tax exemption in three primary ways. First, they limit the sovereign tax exemption to certain specifically enumerated types of exempt income. Second, they explicitly exclude from the exemption any income "derived from the conduct of any commercial activity." Third, they explicitly exclude from the exemption any income received *by*, or received directly or indirectly *from*, a so-called "controlled commercial entity." Each of these features of the current rules is discussed below in Subsections 1, 2 and 3, respectively.

1. Categories of Exempt Income.

Section 892(a)(1) limits the sovereign tax exemption to "investments in the United States in (i) stocks, bonds, or other domestic securities owned by such foreign governments; (ii) financial instruments held in the execution of governmental financial or monetary policy; and (iii) interest on deposits in banks in the United States of moneys belonging to such foreign governments." Accordingly, under the section 892 regulations, the following categories of income and gain generally are exempt from U.S. taxation under section 892 in the hands of a foreign government or government-controlled entity, provided that the income in question is not received by or from a "controlled commercial entity" or derived from "commercial activities" conducted within or outside the United States:

- Dividends from non-controlled U.S. corporations.[40]

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[40] Treasury regulations section 1.892-3T(a)(1)(i). For this purpose a foreign sovereign will not be considered to control an entity unless it directly or indirectly owns at least 50 percent of the economic or voting interests in, or otherwise has effective practical control over, the entity.

Also, as discussed below in Section III.C.4, the Service recently announced that it will take the position that dividends received in respect of stock in a "real estate investment trust" ("REIT"), other than stock representing a 5-percent-or-less holding in a REIT listed on an established U.S. securities market, generally are not exempt under section 892 to the extent they are attributable to sales of underlying "United States real property interests" ("USRPIs"). *See* Notice 2007-55, 2007-27 I.R.B. 13. This position is based on section 897(h)(1), which generally treats such dividends in the hands of the foreign investor as gain from its direct sale of the underlying USRPIs.

- Gains from the sale of interests in non-controlled U.S. corporations,[41] including USRPHCs, which gains otherwise might be subject to net income tax under the Foreign Investment in Real Property Tax Act ("FIRPTA").[42]

- Interest on and gains from the sale of debt obligations of U.S. borrowers.[43]

- Interest on a foreign government's bank deposits in the United States.

- Income from investments in financial instruments, *provided* that the instruments are held in the execution of governmental financial or monetary policy.

- Any of the above categories of income or gain recognized as a distributive share of partnership or trust income.[44]

However, the sovereign tax exemption generally does *not* apply to the following items of income:

- Gains from the sale of real property in the United States.[45]

- Rental income from real property in the United States.[46]

- Gains from the sale of interests in trusts or partnerships (including "publicly traded partnerships," or "PTPs)."[47]

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41 Treasury regulations section 1.892-3T(a)(2). However, a nonresident's gain from the sale of personal property such as stocks and bonds held for investment, including currency gain, is generally considered non-U.S. source income that is not subject to U.S. federal income taxation without regard to section 892. *See* Sections 865(a) and 988(a)(3).

42 Treasury regulations section 1.892-3T(b), example 1 (where a controlled non-commercial entity of a foreign government owns 12 percent of the stock of a U.S. real property holding corporation, the gains from that sale are exempt from U.S. tax under section 892).

43 Treasury regulations sections 1.892-3T(a)(1)(i) and 1.892-3T(a)(2). Section 892 applies to any note or other evidence of indebtedness, including an annuity contract, a mortgage and a loan. Treasury regulation section 1.892-3T(a)(3).

44 P.L.R. 9643031 (October 25, 1996) (applying the sovereign tax exemption in connection with general U.S. tax rules for investments in partnerships, including the generally applicable partnership attribution rules in section 875, in ruling that a foreign sovereign's distributive share of partnership profits generally is exempt under section 892 only to the extent the underlying income itself would qualify as exempt income if recognized directly by the foreign government). Income from trusts should be treated in a similar manner in applying the sovereign tax exemption in connection with general U.S. tax rules for investments in trusts.

45 Treasury regulations section 1.892-3T(a)(1), flush language.

46 *Id.*

47 A partnership generally is treated as a PTP under section 7704 if interests in the partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

- Income from derivatives and other "financial instruments" that are not held in the execution of governmental financial or monetary policy.

2. Definition of "Commercial Activities."

The statutory language of section 892 does not define the term "commercial activities." The section 892 regulations define the term broadly to include, subject to significant exceptions, *all* activities, whether conducted within or outside the United States and whether or not constituting a trade or business, that are "ordinarily conducted with a view towards the production of income or gain."[48]

The most significant exceptions to this general definition are the investment and trading exceptions to commercial activities in Treasury regulation sections 1.892-4T(c)(1)(i) and (ii). The investment and trading exceptions exclude the following investment and trading activities from the definition of "commercial activities" for purposes of section 892:

- Investment Exception. "Investments in stock, bonds, and other securities; loans; investments in financial instruments held in the execution of governmental financial or monetary policy . . . and the holding of bank deposits in banks."[49]

- Trading Exception. "Effecting transactions" in "stocks, securities, or commodities" for a foreign government's own account, "regardless of whether such activities constitute a trade or business for purposes of section 162 or a U.S. trade or business for purposes of section 864."[50] For this purpose, "commodities" means "commodities of a kind ordinarily dealt in on an

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48 *See* Treasury regulation section 1.892-4T(b). The general definition of "commercial activities" in Treasury regulation section 1.892-4T(b) provides that an activity that does not qualify for an exception to the general definition of "commercial activities" may be considered a commercial activity even if such activity does not constitute the conduct of a trade or business in the United States under section 864(b). Section 864(b) provides that certain personal service activities and certain investment and trading activities (including certain activities by dealers) do not constitute the conduct of a trade or business within the United States.

49 Treasury regulation section 1.892-4T(c)(1)(i) (also providing that "[t]ransferring securities under a loan agreement which meets the requirements of section 1058 is an investment for [this] purpose" and that "[a]n activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities").

50 Treasury regulation section 1.892-4T(c)(1)(ii).

organized commodity exchange, but only if the transaction is of a kind customarily consummated at such place."[51]

These important exceptions to the definition of "commercial activities" generally are not available in respect of activities undertaken as a dealer, or investments (including loans) made by a "banking, financing or similar business."[52]

In addition, Treasury regulations section 1.892-4T(c)(2) states that certain cultural activities, such as organizing "performances and exhibitions within or outside the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations" are not considered to be commercial activities.

3. Definition of "Controlled Commercial Entity; "All or Nothing" Rule.

Section 892(a)(2)(A) limits the sovereign tax exemption by providing that the exemption does not apply to "any income (i) derived from the conduct of any commercial activity (whether within or outside the United States); (ii) received *by* a controlled commercial entity or received (directly or indirectly) *from* a controlled commercial entity; or (iii) derived from the disposition of any interest in a controlled commercial entity."[53] For these purposes, a "controlled commercial entity" is "any entity engaged in commercial activities (whether within or outside the United States) if the foreign government (i) holds (directly or indirectly) any interest in such entity which (by value or voting interest) is 50 percent or more of the total of such interests in such entity; or (ii) holds (directly or indirectly) any other interest in such entity which provides the foreign government with effective control of such entity."[54]

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51 *Id.*

52 Treasury regulation section 1.892-4T(c)(1)(ii) and (iii) (referring to the definition of the term "dealer" in Treasury regulation section 1.864-2(c)(2)(iv)(a)).

53 The limitations regarding income received *indirectly* from a controlled commercial entity or from the disposition of an interest in such an entity were added to section 892 in 1988.

54 Section 892(a)(2)(B) and Treasury regulation section 1.892-5T(a).

By referring merely to an entity "engaged in commercial activities," without any discussion of the level of such activities, the current definition of "controlled commercial entity" in section 892 — at least as interpreted by the current temporary regulations — operates to disqualify completely a government-owned entity from *any* benefits under section 892 if it is engaged in *any* level of commercial activity (no matter how trivial) anywhere in the world. (We refer to this rule as the "all or nothing" rule).[55] Interpreted in this manner, the definition of "controlled commercial entity" under current section 892 represents a significant departure from the approach of Revenue Ruling 75-298, which, as discussed in Section II.C, looked to whether a government-owned entity was a commercial enterprise on the basis of its activities "taken as a whole" and stated explicitly that certain "circumscribed and limited" commercial activities could be consistent with eligibility for the exemption. The "all or nothing" rule adopted under the current definition generally has been considered by tax practitioners and commentators to constitute a significant trap for the unwary.[56]

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55 Under a special rule for central banks, however, a foreign central bank of issue will only be considered a "controlled commercial entity" that is not entitled to benefits under section 892 if it is engaged in commercial activities within the United States. Section 892(a)(2)(B) (flush language). A central bank of issue thus generally must operate so that it is not engaged in any commercial activities *within the United States.*

56 *See, e.g.,* Kenneth Wood et al., *Sovereign Wealth Funds: The Benefits and Burdens of the Sovereign Immunity Exemption from Tax Under §892*, 39 TAX MGM'T INT'L J. 79 (2008). "Commercial activity is broadly defined as activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain. Such activity will taint the entire income of the entity, including otherwise exempt passive income, making it all subject to U.S. income tax. For example, if a controlled entity invests billions of dollars in U.S. equities and also owns a hot dog stand in its country of incorporation, that commercial activity will preclude any U.S. tax benefit under §892. The logic underlying this loss of all tax benefits because of an activity without any U.S. nexus is difficult to explain." *See also* Robert A. Bergquist, *U.S. Taxation of Foreign Governments and Their Controlled Entities*, 39 TAX NOTES 115, 130 (1988). "The dichotomy in treatment accorded to a 'controlled commercial entity,' on the one hand [which is subject to the all or nothing rule], and an 'integral part' of a foreign sovereign, on the other hand [which is not so subject], likely will also prove vexing."

F. Recent Developments; SWFs.

Although section 892 has not undergone any major revisions since 1988 (and the "temporary" regulations implementing section 892 generally have not changed since they first became effective in 1988), there has been a renewed interest in U.S. policies concerning investments in the United States by foreign sovereigns. This interest has been driven to a large extent by the recent prominence of SWFs. Very generally, SWFs manage the investment of a foreign sovereign's "excess" foreign exchange reserves (foreign exchange reserves in excess of "official" reserves necessary to support the country's currency and otherwise protect against financial shocks).[57] In addition, many SWFs, at least as the term is understood colloquially, constitute government-owned pension schemes for citizens of the relevant foreign sovereign.[58]

As the foreign exchange reserves of many foreign sovereigns have increased dramatically in recent years, those sovereigns have established or expanded SWFs to invest their excess reserves in a broader range of investments than traditional investments, which have been U.S. Treasuries and other bonds of the governments of developed countries. SWFs recently have chosen to invest instead in long-term equity positions and in other more risky financial assets not traditionally associated with foreign exchange investments of central banks in order to seek higher long-term returns and thereby establish greater fiscal revenue stability and intergenerational savings.[59]

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57 Press Release, Department of Treasury, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi, Mar. 20, 2008, available at http://www.treas.gov/press/releases/hp881.htm. The excess foreign exchange reserves of the most prominent SWFs in current markets typically are derived from (i) profits from the export of oil and other commodities, or (ii) trade surpluses in goods combined with exchange rate intervention.

58 SWFs can also serve as investment vehicles for private, or arguably private interests (such as the ruling family of a country), and thus may neither qualify, nor attempt to qualify, for exemption under section 892.

59 Press Release, Department of Treasury, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi, Mar. 20, 2008, available at http://www.treas.gov/press/releases/hp881.htm.

According to press reports, the largest SWFs currently are the Abu Dhabi Investment Authority, Singapore's sovereign wealth funds and Norway's government pension fund, with as much as $875 billion, $490 billion, and $380 billion in assets under management, respectively.[60] In recent months SWFs have acquired significant equity stakes in several large U.S. financial institutions seeking funding in connection with the recent liquidity crisis, and generally are expected to become more significant investors in the U.S. public and private equity markets.

Treasury recently held discussions with two prominent SWFs. These SWFs, owned by Abu Dhabi and Singapore, agreed to a SWF "Code of Conduct," in which the SWFs have pledged to conduct their affairs solely for the purpose of maximizing returns, and not to use their economic influence to further any broader political objectives of their respective governments.[61] In addition, Treasury recently proposed regulations clarifying that The Committee on Foreign Investment in the United States ("CFIUS") has the authority to review investments of any size for national security concerns.[62]

Treasury's recent advocacy of the SWF "Code of Conduct" and renewed interest in strategically important assets suggest that the policy issues raised by the new prominence of SWFs are *not* that they are engaged in profit-maximizing investment activities that could somehow benefit unfairly from a tax exemption intended for "governmental" activities, but rather that SWFs could be used to further governmental political agendas. Accordingly, the

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60 *Asset Backed Insecurity*, THE ECONOMIST, Jan. 17, 2008, available at http://www.economist.com/finance/displaystory.cfm?story_id=10533428.

61 Press Release, Department of Treasury, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi, Mar. 20, 2008, available at http://www.treas.gov/press/releases/hp881.htm.

62 Press release, Department of Treasury, Treasury Issues Proposed CFIUS Regulations; Lowery to Hold Briefing Today, Apr. 21, 2008, available at http://www.treas.gov/press/releases/hp937.htm. For the full text of the proposed regulations, *see* Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, available at http://www.treas.gov/press/releases/reports/proposed_regulations42108.pdf.

issues and concerns motivating the current debate over SWFs appear to be different from those that traditionally have informed the jurisprudence of section 892.

As discussed above, the sovereign tax exemption initially was enacted in 1917 to extend the international legal doctrine of sovereign immunity to U.S. tax laws, and to encourage foreign sovereign investment in the United States. Since that time, the U.S. markets have opened up to foreign investors and U.S. tax laws have developed to exempt broad categories of portfolio investment income in the hands of foreign investors generally (*e.g.*, the portfolio interest exemption, and the "securities trading" safe harbor under section 864(b)). In light of these developments, it may be appropriate for Congress to revisit the policies underlying section 892 with a view towards developing a more coherent and integrated approach to foreign investment. For example, does it make sense under section 892 to define "commercial activity" using different standards than apply more generally for determining whether private foreign parties are engaged in a U.S. trade or business? If portfolio interest is exempt from U.S. withholding tax, because of a desire to allow U.S. companies to raise debt financing in the overseas markets on more favorable terms, then what are the grounds for imposing withholding tax on portfolio dividends, except when paid to foreign investors other than sovereigns and their controlled entities? Does Congress wish to encourage debt investment in the United States more than equity investment?

In presenting the current report, we acknowledge that it is beyond our areas of expertise as tax lawyers to address whatever broader policy implications the recent prominence of SWFs might present in connection with economic and monetary policy, national security, globalization or similar matters. Similarly, we do not propose in the current report to offer recommendations as to how the U.S. tax system could be adjusted to further whatever new

policies Congress might choose to adopt in response to these concerns. Instead, this report accepts the balancing of historical policy concerns underlying section 892 as it currently exists and offers recommendations designed to rationalize the current operation of section 892 and to make section 892 and the regulations thereunder more consistent with the historical policy objectives of exempting from U.S. taxation passive investments made by foreign governments into the U.S. economy while also avoiding tax subsidies for the active commercial activities of foreign sovereigns and their state-owned enterprises.

As discussed in more detail below, we believe that the most significant issues for SWFs and other government-owned investment vehicles under the current section 892 regime relate to the "all or nothing" rule, which in combination with other technical provisions creates unnecessary foot faults that can cause essentially passive investment entities to be disqualified entirely from the sovereign tax exemption — even though the entities in question do not engage directly in, or control, any meaningful commercial activities. For example, SWFs often invest in the United States through limited partnership interests and similar instruments that might cause them to be *deemed* to be engaged in commercial activities under Treasury regulation section 1.892-5T(d)(3). In order to avoid complete disqualification from the benefits of section 892, these entities often spend considerable resources establishing "blocker" corporations and similar devices in order to structure their holdings of what are essentially passive investments. In this way, the current regime creates unnecessary transaction costs without furthering any readily discernable set of policies.

For the reasons stated above, we believe that a reworking of the current regime under section 892 to focus on *actual activities* conducted by SWFs and other state-owned investment vehicles, rather than deemed activities, and to provide a greater flexibility than the

"all or nothing" rule currently allows (perhaps through the adoption of a more principles based approach), would go a long way towards rationalizing the current operation of section 892 and elevating substance over form. The recommendations below therefore are intended to suggest some aspects of how such a reworking might be put into effect. As the discussion below hopefully makes apparent, our recommendations are intended to produce a regime whereby (i) certain types of passive income (such as portfolio dividends) will be exempt from U.S. taxation, unless they arise in connection with the actual conduct of an active business that is either controlled by, or engaged in directly by, a foreign sovereign, and (ii) the form through which such income is received becomes relatively unimportant.

III. TECHNICAL APPLICATION OF THE SOVEREIGN TAX EXEMPTION.

A. Overview.

This Part III provides recommendations to change the current operation of section 892 and the regulations thereunder. Part III.B, below, discusses larger "big picture" issues, and Section III.C then discusses certain more limited, technical points.

Before describing our recommendations, we believe that it is worthwhile to point out that the practical significance of section 892 is limited to specific types of income not addressed by other tax exemptions that are more widely available to non-U.S. investors. Specifically, we believe that the primary relevance of section 892 for a foreign sovereign under current law is with respect to (i) U.S. source *dividend income* received from non-controlled U.S. corporations,[63] which otherwise generally would be subject to U.S. withholding tax at a 30-percent rate, subject to the availability of reduced treaty rates; (ii) *gain* on the disposition of interests in non-controlled USRPHCs, including REITs, which otherwise generally would be

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63 *See* note 40, above, and Section III.C.4, below, discussing Notice 2007-55.

subject to net U.S. income tax;[64] and (iii) *interest income* received from a non-controlled borrower that is not otherwise eligible for the portfolio interest exemption (for example, because the foreign government in question holds more than ten percent of the stock of the corporate borrower but does not control the corporate borrower).[65]

For example, a foreign sovereign typically would not need the benefit of section 892 in respect of capital gains arising from investments in, or the trading of, stock, securities, commodities or most types of derivative financial instruments. Such gains generally are not subject to withholding tax, and are subject to U.S. net income tax in the hands of foreign investors only to the extent they are treated as effectively connected with a U.S. trade or business, in which case section 892 generally would not be available in any event.[66] Similarly, income from certain derivative financial instruments that is not treated as effectively connected with a U.S. trade or business generally is not subject to U.S. taxation in the hands of a foreign investor without regard to section 892.[67]

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64 Even in the absence of section 892, however, a foreign sovereign generally would not be subject to U.S. tax on gain either on (i) interests in a "domestically-controlled" REIT, or (ii) interests in a USRPHC that are publicly traded on an established U.S. securities market, provided that the sovereign investor owns no more than 5 percent of such interests.

65 *See* section 881. In addition, the portfolio interest exemption may not be available in the case of certain types of contingent interest payments that are linked to the borrower's profits or linked to certain assets held by the borrower. *See* section 871(h)(4). Even in the absence of the portfolio interest exemption, however, interest paid to a foreign sovereign may be exempt under an applicable income tax treaty. *See e.g.,* Article XI, section 3(a) of the Income Tax Treaty between the United States and Canada; Article 11, section 3(a) of the Income Tax Treaty between the United States and Japan.

66 Very generally, the so-called "section 864 trading safe harbor" provides that a foreign investor's active trading in stocks, securities, commodities and a broad range of derivative financial instruments for its own account (and not as a dealer) generally will not be treated as a U.S. trade or business, even if trading activities are conducted within the United States. *See* section 864(b) and the regulations thereunder. Although the concept of "commercial activity" for purposes of section 892 is distinct from that of "trade or business" for purposes of section 864, we cannot conceive of a case where trading activities failing to qualify for the safe harbor under section 864 should not also be viewed as giving rise to commercial activities.

67 Treasury Regulation section 1.863-7.

B. Discussion of General Issues.

1. "Integral Parts" and "Controlled Entities."

(a) Generally.

The statutory language of section 892 does not define the term "foreign government" for purposes of the sovereign tax exemption. However, the section 892 regulations provide that both "integral parts" of a foreign government and "controlled entities" of a foreign government are considered "foreign governments" entitled to the exemption under section 892.[68]

An "integral part" of a foreign government is "any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country."[69] In addition, in order for such an entity to qualify as an "integral part," the entity's net earnings must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person.[70] Thus, for example, the treasury or finance department of a foreign sovereign generally will qualify as an integral part of the foreign sovereign.

The section 892 regulations define the term "controlled entity" of a foreign government, on the other hand, as any entity that is separate in form from a foreign sovereign, or otherwise constitutes a separate juridical entity, if (i) it is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities; (ii) it is organized under the laws of the foreign sovereign; (iii) its net earnings are credited to its own

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68 *See* Treasury regulation section 1.892-2T(a)(1). The definitions of the terms "integral part" and "controlled entity" of a foreign government are discussed below in the text.

69 Treasury regulation section 1.892-2T(a)(2).

70 Income will be presumed *not* to inure to the benefit of private persons if such persons are the intended beneficiaries of a governmental program which constitutes a governmental function, unless those persons are using a governmental entity as a conduit for personal investment or are diverting income from its intended use through improper influence or control. Treasury regulation section 1.892-2T(b).

account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and (iv) its assets vest in the foreign sovereign upon liquidation.[71]

We suspect that the intention behind distinguishing "integral parts" from "controlled entities" was to apply a higher level of scrutiny to government-owned entities that might be characterized as fundamentally commercial enterprises, such as Qantas Airways. Although we do not dispute the conclusion that state-owned commercial enterprises should be subject to taxation in the United States to the same extent as privately-owned commercial enterprises, the currently regulatory distinction between controlled entities and integral parts of foreign governments is not well-tailored to serve the policy objective and, in addition to creating considerable uncertainty, produces dramatically different tax results based on essentially formalistic distinctions.

Under current law, the principal relevance of these definitions of "integral part" and "controlled entity" is that, as discussed above, a controlled entity will lose the benefits of section 892 *entirely* if it engages in *any* amount of commercial activity, because the controlled entity then would be treated as a disqualified "controlled commercial entity." If an "integral part" of a foreign government engages in commercial activity, on the other hand, it will lose the benefits of section 892 only with respect to income from the commercial activity, and will *retain* the benefits of the exception for any other qualifying income that it might receive. Because the definition of "integral part" is broad enough by its terms to encompass entities (such as funds) with legal personality apart from the government authority, however, it is not clear under the

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71 *See* Treasury regulation section 1.892-2T(a)(3).

current rules whether certain entities properly are viewed as "controlled entities" or "integral parts" for these purposes.[72]

For example, pension funds represent one type of entity whose classification seems ambiguous and somewhat arbitrary under these rules. On the one hand, a pension fund is a "fund," and thus can fall within the definition of an "integral part" of a foreign sovereign. On the other hand, if a pension fund is organized as a "trust," it may constitute a "controlled entity," because pension trusts are separate juridical entities. In addition, it is not uncommon for pension "trusts" in many foreign countries to be formed as corporations.[73] Recognizing that a slight structural difference (legal status as "trust" as opposed to "fund") could yield different entity classifications and, thus, greatly different tax treatment, we addressed this distinction in the 1988 report and concluded that pension trusts should be treated as integral parts of foreign sovereigns.[74] The 1988 report also recommended that the regulations be modified to clarify that a legal entity that qualifies as an integral part of a foreign government generally will not also be treated as a controlled entity or as a controlled commercial entity (*i.e.*, that status as an "integral

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72 Under a special rule for central banks, however, a central bank of issue that is a controlled entity will only be considered a "controlled commercial entity" that is not entitled to benefits under section 892 if it is engaged in commercial activities within the United States. Consequently, in order to qualify for the benefits of section 892, a "controlled entity" that is not a central bank generally must operate so that it does not engage in any commercial activities anywhere in the world, and a central bank of issue generally must operate so that it is not engaged in any commercial activities within the United States.

73 The Canadian government, for example, routinely uses corporate entities for government pension plans. Interest and dividends received by such Canadian entities generally are exempt from U.S. taxation, however, under Article XXI, Section (2) of the Canada-United States Income Tax Treaty.

74 NYSBA Tax Section Report, October 14, 1988. "As a result, a trusteed 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-trusteed 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 trusteed and non-trusteed 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."

part" serves as a safe harbor from the effects of the "all or nothing" rule). To the extent the "all or nothing" rule remains in effect, we continue to support these recommendations.

(b) Check-the-Box Rules.

We also suggest that Treasury consider revoking the rule, contained in Treasury regulation section 301.7701-2(b)(6), that any "business entity" wholly owned by a foreign government or integral part of a foreign government is a *per se* corporation. Under this rule, a limited liability company or other fiscally transparent entity wholly owned by a foreign government must be treated as a controlled entity separate from the government, even though under general U.S. tax principles the entity would be disregarded.

As originally adopted in 1997, Treasury regulation section 301.7701-2(b)(6) applied only to entities wholly owned by state and local governments and was intended to address a concern that such governments could abuse their tax exempt status under section 115. Section 115 generally exempts from taxation income "accruing to a State or any political subdivision thereof" and income earned by a wholly owned governmental subsidiary in respect of any "essential governmental function," provided that the income of the subsidiary accrues to the government.[75] We understand that, in adopting Treasury regulation section 301.7701-2(b)(6), the Service wanted to address the situation where, for example, a state government might (i) wish to operate a commercial enterprise, and use its tax exemption to reap an unfair competitive advantage, but (ii) might be prevented from the direct operation of a commercial business because of concerns about potential liabilities, concerns about whether such direct activity might be authorized under the state constitution, and similar concerns. If the government were able to operate the business through a wholly owned limited liability company and also

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[75] *See e.g.,* Revenue Ruling 77-261, 1977-2 C.B. 45 (income realized by a trust formed for purposes of managing state funds held not taxable, on the grounds that its activities constituted an essential governmental function and the income could be withdrawn on demand by the government).

treat that entity as a disregarded entity under the "check the box" rules, then the government could enjoy the benefits of limited liability and all of the other advantages of a business that is a separate, standalone legal and economic entity for all non-tax purposes but that is viewed as a governmental branch for U.S. federal income tax purposes. In order to prevent that result, Treasury regulation section 301.7701-2(b)(6) effectively removes the ability of state or local government to treat a separate legal entity as a mere governmental branch, with the result that the entity will be scrutinized on a standalone basis for purposes of determining its eligibility for exemption under section 115.[76]

Treasury regulation section 301.7701-2(b)(6) then was amended in 2002 to apply also to entities wholly owned by foreign sovereigns. Again, the concern apparently was that a foreign government could leverage its exemption under section 892 inappropriately by electing under the check-the-box rules to treat a wholly owned entity — but an entity operated as a separate and independent enterprise — as an "integral part" of the foreign government for purposes of section 892.[77] We believe, however, that the expansion of Treasury regulation section 301.7701-2(b)(6) to entities wholly owned by foreign governments was inappropriate as a policy matter, because the scope of the exemption under section 892 is much narrower than the scope of section 115 and does not present the same opportunity for abuse.

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76 The preamble to Treasury regulation section 301.7701-2(b)(6), when it was first proposed in 1996, states: "The proposed regulations also classify as corporations organizations that are recognized for federal tax purposes if they are wholly owned by a State, or any political subdivision thereof. Organizations wholly owned by a State that are not an integral part of the State must be recognized for federal tax purposes and scrutinized under section 115 (which excludes from gross income any income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia)." Notice of Proposed Rulemaking, 61 Fed. Reg. 21989, 21991 (May 13, 1996).

77 The preamble to the 2001 proposed amendments to Treasury regulation section 301.7701-2(b)(6) states: "The [Service] and Treasury believe that it is appropriate to treat a foreign government similarly to a State in this context. Thus, to achieve parallel tax treatment under the check-the-box regulations of a business entity wholly owned by a State or any of its political subdivisions and a business entity wholly owned by a foreign government, these proposed regulations provide that a business entity wholly owned by a foreign government cannot elect to be treated as a disregarded entity." Notice of Proposed Rulemaking, 66 Fed. Reg. 2854 (January 12, 2001).

In contrast to section 115, section 892 does *not* extend its benefits to income arising from commercial activities conducted by an "integral part" of a government. For that reason, the abuse that Treasury regulation section 301.7701-2(b)(6) originally attempted to address does not exist in the context of a foreign government. Furthermore, if a foreign government were able to avoid the effects of the "all or nothing" rule by electing to conduct commercial activities through an LLC that is treated as an "integral part," rather than trying to segregate commercial from non-commercial activities in separate legal entities, we believe that such a regime would be preferable to the current regime in that it would lead to fewer transaction costs and fewer chances for a foreign sovereign to make a costly planning mistake. Of course, the repeal of the "all or nothing" rule would radically lower the stakes of this issue.

2. The "All or Nothing" Rule Versus an Approach Based on the Totality of an Entity's Activities.

We recommend that the "all or nothing" rule for controlled entities be replaced with the Service's approach prior to 1986, under which a government-owned entity was not disqualified from the benefits of section 892 if, considering the entity's activities and purpose taken as a whole, the entity was not properly viewed as a commercial enterprise. This principles-based approach would reduce the undue emphasis currently placed on an entity's formal classification and focus more on the question of which types of *income* and *activities* Congress wishes to exempt from taxation.

Moreover, by focusing on what an entity *actually does*, such a principles-based approach would avoid certain traps for the unwary under current law where an entity that in fact holds nothing but passive investments is nonetheless *deemed* to be engaged in commercial activity — because, for example, of investments in limited partnership interests in widely-held partnerships, including partnerships that have no connection to the United States — and as a

consequence of the deemed commercial activity loses the benefits of section 892 altogether. Perhaps in order to avoid this result of treating fundamentally passive entities as controlled commercial entities, Treasury regulation section 1.892-5T(d)(2) provides a *general* rule that commercial activities of a subsidiary are *not* attributed to the parent. As discussed below in Sections III.C.3(b) and III.C.5, however, this general rule has several significant exceptions. Specifically, rules that provide for upward attribution in the case of partnership investments and certain investments in USRPHCs currently can apply along with the "all or nothing" rule to classify essentially passive investment vehicles as controlled commercial entities.

In our experience, the principal effect of the current "all or nothing" rule is to force sovereigns to structure their potentially "commercial" investments through "blocker" vehicles so as to isolate those investments from investments that clearly are not considered commercial activities under section 892—in much the same way that other tax-exempt entities structure their investments in business enterprises through blocker corporations. Consequently, the current "all or nothing" rule represents an administrative and operational burden for well-advised sovereigns and otherwise serves mainly as a trap for the unwary foreign sovereigns who fail to structure their investments properly.

We note that the readoption of the pre-1986 approach of looking to the totality of an entity's activities likely would require a legislative change to section 892. In the interim, however, we do not believe that the phrase "engaged in commercial activities" in section 892(a)(2)(B) necessitates the "all or nothing" rule in its current form, and we believe that Treasury has the authority to protect against the situation where a controlled entity loses the benefits of section 892 entirely because of a dispute over whether some minor or ancillary activity constitutes "commercial activity." For example, Treasury could draft a safe harbor in the

regulations to allow controlled entities to engage in some small level of commercial activity (income from which would *not* be exempt under section 892) without causing the entity to lose the benefits of section 892 entirely. For these purposes, the level of activity might be measured either by the income an activity produces or the resources it consumes, either on an absolute basis or measured as a percentage of the other income/resources of the entity in question. As an alternative, Treasury might also consider a regime whereby a controlled entity that finds itself inadvertently engaged in commercial activity is allowed to "purge" itself of the activity in a timely manner and thereby avoid classification as a controlled commercial entity.

By way of analogy, Treasury regulation section 1.501(c)(3)-1(c)(1) provides that an entity will be regarded as "operated exclusively" for one or more tax-exempt purposes within the meaning of section 501(c)(3) only if no more than an "insubstantial part of [the entity's] activities are not in furtherance of an exempt purpose." Presumably the decision to allow an insubstantial amount of non-exempt activity was intended to prevent a cliff effect similar to that of the "all-or-nothing" rule under section 892, where a small amount of activity can change the entire classification of a much larger enterprise.[78]

C. Specific Technical Issues.

In our view, the "all or nothing" rule for commercial activities of controlled entities, discussed above in Section III.B.2, is by far the most significant issue presented under the current rules. As discussed above, we recommend that Congress amend section 892 to replace this approach with one that considers the totality of a controlled entity's activities in determining whether it is a disqualified controlled commercial entity. We also recommend that

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[78] Similarly, Congress recently amended section 664(c) to replace an "all or nothing" rule that previously disqualified charitable remainder trusts from tax exempt status if they realized *any* "unrelated business taxable income" with a rule that allows the *entity* to retain its tax exempt status but imposes an excise tax on the improper *income*. *See* Tax Relief and Health Care Act of 2006.

in the interim Treasury and the Service amend the regulations to provide a safe harbor from the "all or nothing" rule for some acceptable level of commercial activity.

This Section III.C discusses certain other technical issues and suggests certain clarifications of and modifications to the current rules. While the practical importance of some of these issues would be significantly reduced if our recommendation were implemented to replace the "all or nothing" rule with a return to the Service's approach prior to 1986, we nonetheless believe that it would be useful to clarify or reconsider the issues discussed below.

1. Prohibited Private Benefits.

The section 892 regulations provide that, in order for the benefits of section 892 to be available to an "integral part" or "controlled entity" of a foreign government, its "net earnings . . . must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person."[79] For this purpose, income will be presumed *not* to inure to the benefit of a private person if such persons are the intended beneficiaries of a governmental program that is carried on by the foreign sovereign and the activities of which constitute "governmental functions" as defined in Treasury regulation section 1.892-4T(c)(4).[80] For example, income of government-funded retirement plans for government employees or non-government employees who perform governmental or social services generally will not be considered to inure to the benefit of a private person for this purpose.[81] Income will be presumed to inure to the benefit of private persons, however, if it does so through the use of a governmental entity as a conduit for personal investments or as a result of the

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79 Treasury regulation section 1.892-2T(a)(2) and 1.892-2T(a)(3)(iii) (emphasis added).

80 Treasury regulation section 1.892-2T(b).

81 Treasury regulation section 1.892-2T(c)(2), Examples (1)-(4) (providing, however, that income of a government-sponsored retirement plan will be considered to inure to the benefit of private persons for this purpose if the employees themselves are allowed to make contributions to the retirement plan).

income being diverted from its intended use through influence or control by means explicitly or implicitly approved by the foreign sovereign.[82]

We believe that the regulations should confirm explicitly that arm's-length incentive compensation of investment managers does not constitute a prohibited private benefit.[83] It is common practice for governments to hire investment professional to manage the government's investments. It also is standard practice in the investment management industry for investment managers to be compensated based on their investment performance—*i.e.*, by reference to the net income they are credited with having earned for their principal. For example, many hedge fund and private equity managers currently are compensated under the familiar "two and twenty" structure. Indeed, in the current debate regarding the appropriate tax treatment of such incentive arrangements, many policymakers take the view that an investment manager's share of underlying gain in these arrangements should be treated as fee income received in exchange for personal services that generally are subject to tax at ordinary income rates, and not as capital gains from investments that may be taxed at lower rates.[84] This view is based on the understanding that these incentive arrangements relate to an investment manager's role as a service provider.

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82 Treasury regulation section 1.892-2T(b).

83 *Cf.* section 4958 (imposing an "excess benefit" excise tax only with respect to insiders that receive excessive compensation or similar non-arm's length benefit from a section 501(c)(3) or (4) organization; no excise tax imposed on arm's length incentive compensation and no excise tax imposed on compensation paid to unrelated investment managers); section 4941 and Treasury regulation section 53.4941(d)-3(c)(1) and (2), Example(2) (imposing a "self-dealing" excise tax with respect only to insiders that receive compensation; no excise tax imposed on transactions with unrelated persons; no excise tax imposed arm's-length compensation paid to an insider that provides investment management services); *United Cancer Council, Inc. v. Commissioner*, 165 F.3d 1173, 1176 (7th Cir. 1999) (the inurement clause of section 501(c)(3) applies only to transactions with insiders).

84 *See, e.g.*, H.R. 3970, 110th Cong. (1st Sess. 1997) (proposing, among other matters, to treat such compensation explicitly as fee income).

In light of these considerations, we believe that customary, arm's-length incentive compensation arrangements should not be treated as impermissible private benefits under current law and confirmation of this interpretation would be helpful. In this regard, we note that foreign governments likely would be viewed as negligent if they did not hire professional investment managers and compensate them on the basis of their performance. Moreover, many regulators are likely to view this practice as a positive factor, because it suggests that the foreign governments are investing in a professional manner to maximize returns on their financial portfolio, and not for political or unrelated economic purposes.

2. Definition of "Commercial Activities."

(a) Investment Exception to Commercial Activities.

As discussed above in Section II.E.2, the investment exception to the definition of "commercial activities" in Treasury regulation section 1.892-4T(c)(1)(i) provides that investments in "financial instruments" are not "commercial activities" if the financial instruments are "held in the execution of governmental financial or monetary policy." As discussed above in Section II.E.1, section 892(a)(1)(A)(ii) employs the same condition in defining the scope of exempt income under section 892.[85] However, neither the investment exception to commercial activities nor the provisions defining the scope of exempt income under section 892 employ this condition in the case of investments in stocks, bonds, other "physical" securities, loans or bank deposits. Moreover, neither the preamble to the regulations nor the legislative history to section 892 explain the reason for this condition, and the regulations

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[85] Treasury regulation section 1.892-3T(a)(1) also reflects the same condition in repeating the statutory definition of exempt income.

provide only minimal guidance as to the meaning of the term "governmental financial or monetary policy."[86]

We suspect that Congress included this requirement in defining the scope of exempt income in section 892(a)(1) out of a desire to correct the overbreadth of the 1918 statutory language, discussed above, by reasserting the traditional distinction between "governmental" and "commercial" activities. In light of the uses to which derivatives are put in today's markets, however, we believe that derivatives positions are no more indicative of "commercial activity" than investments in physical securities, and do not see the policy purpose served by holding positions in "financial instruments" to a higher standard. Moreover, as discussed above in Section III.A, foreign investors generally are not subject to U.S. taxation on income or gain from derivative investments, unless those gains are effectively connected with a U.S. trade or business. It would therefore be quite ironic for a controlled commercial entity to lose the benefits of section 892 altogether under the "all or nothing rule" when the "commercial activity" giving rise to that result is explicitly exempt from U.S. taxation under provisions available to both sovereign and non-sovereign foreign investors.

Accordingly, we believe that the investment exception to commercial activities in Treasury regulation section 1.892-4T(c)(1)(i) should be modified to eliminate the condition that financial instruments be "held in the execution of governmental financial or monetary policy," so

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86 The section 892 regulations merely provide that "a financial instrument shall be deemed held in the execution of governmental financial or monetary policy if the primary purpose for holding the instrument is to implement or effectuate such policy," and an example establishing that the purchase of short-term government obligations "to ensure sufficient currency reserves" meets the requirement. Treasury regulation section 1.892-3T(a)(5).

that investments in financial instruments are subject to the same conditions as investments in stock, bonds or other "physical" securities for purposes of that exception.[87]

(b) Trading Exception to Commercial Activities.

We recommend that Treasury regulation section 1.892-4T be amended to state explicitly that trading activities that qualify for the "securities trading" safe harbor under section 864(b) — and thus that do *not* give rise to a U.S. trade or business— similarly will not be treated as commercial activities for purposes of section 892. To be clear, we believe that such a statement would amount to nothing more than a clarification of the current trading exception contained in Treasury regulation section 1.892-4T(c)(1)(ii), which follows the language and 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 securities dealer. An explicit statement conforming this point, however, would give foreign sovereigns greater certainty in structuring investments into the United States, and remove what worries might currently exist that the worldwide trading activities of a controlled entity could somehow cause the entity to be engaged in commercial activities and lose the benefits of section 892 under the "all or nothing" rule — even though many of the trading activities in question will not involve any contact with the United States whatsoever and generally would not constitute a U.S. trade or business even if they were conducted within the United States. It would be remarkable if either Congress or Treasury, having adopted rules designed to encourage non-U.S. investors to trade in the United States, then

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87 For similar reasons we also believe that it would make sense to eliminate this condition for purposes of defining the scope of exempt income in section 892(a)(1)(A)(ii) and Treasury regulation section 1.892-3T(a)(1)(ii). As discussed above, however, a foreign sovereign's derivative investments in the United States generally would not subject to U.S. tax without regard to section 892.

decided to use the "all or nothing" rule to punish controlled entities for engaging in the encouraged behavior.

3. Investments in Partnerships and Trusts.

The section 892 regulations create a number of uncertainties regarding the treatment of sovereign investments in pass-through entities such as partnerships and trusts. We believe that the section 892 regulations should be modified as discussed below to clarify and rationalize the treatment of such passthrough investments under section 892.

(a) Gain from Sale of Partnership and Trust Interests.

Treasury regulation section 1.892-3T(a)(2) provides that gains from dispositions of interests in partnerships and trusts are not exempt income under section 892.[88] In this regard, by not looking to the underlying assets or activities of the partnership in question, the regulations effectively adopt an entity approach in applying section 892 to a foreign sovereign's gain from the disposition of a partnership or trust interest.[89]

The practical effect of this rule is somewhat limited because under generally applicable U.S. tax rules, a foreign partner—whether or not a sovereign—generally is *not* subject to U.S. tax on its gain from the sale of a partnership interest, except to the extent the gain is treated as income that is effectively connected with a U.S. trade or business (*i.e.*, constitutes "effectively connected income" or "ECI") or is attributable to underlying USRPIs with built-in

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88 In addition, Treasury regulation section 1.892-3T(a)(3) provides that the term "other securities" does not include trust or partnership interests, other than interests in PTPs.

89 The Service, however, has adopted an aggregate approach in applying section 892 to a foreign sovereign's distributive share of partnership income. *See* PLR 9643031 (October 25, 1996) (applying section 892 in connection with general U.S. tax rules for investments in partnerships, including the generally applicable partnership attribution rules in section 875, in ruling that foreign sovereign's distributive share of partnership profits generally is exempt under section 892 to the extent the underlying income itself would qualify as exempt income if recognized directly by the foreign government). Accordingly, a foreign sovereign's distributive share of partnership income generally will be exempt under section 892 to the extent that (i) the underlying income itself would qualify as exempt income if recognized directly by the foreign government; *and* (ii) the partnership itself is not a "controlled commercial entity."

gain.[90] In the case of gain that is treated as ECI under U.S. tax law, we agree that such gain should not be eligible for the sovereign tax exemption under section 892 to the extent the relevant U.S. trade or business also constitutes "commercial activity," within the meaning of section 892. In the case of gain attributable to an underlying USRPI, the foreign partner generally is deemed under section 897(g) to have received that amount from a direct sale of the underlying USRPI and accordingly generally would be subject to U.S. net income tax in respect of that gain under FIRPTA. As discussed above in Section II.E.1, however, a foreign government's gain from *direct* investments in non-controlled USRPHCs generally qualifies as exempt income under section 892.[91]

We see no reason for treating a foreign government's gain relating to interests in USRPHCs differently for purposes of section 892 depending on whether the foreign government

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90 As discussed above in Section III.A, a nonresident's gain from the sale of personal property held for investment, including partnership interests, generally is considered non-U.S. source income that is not subject to U.S. federal income taxation without regard to section 892. *See* Sections 865(a) and (i)(5) and Section 988(a)(3). Under special rules for investments in U.S. real property, however, foreign investors generally are subject to net U.S. income tax on gain from investments in USRPIs, which generally include USRPHCs. *See* section 897. Section 897(g) provides that if a nonresident's gain from the sale of an interest in a partnership, trust or estate is attributable to built-in gain on underlying USRPIs, then the partner is deemed to have received that amount from a direct sale of the underlying USRPIs.

Under Revenue Ruling 91-32, 1991-1 C.B. 107, in certain circumstances a foreign partner is subject to U.S. tax on its gain from the sale of a partnership interest to the extent the gain is attributable to underlying built-in gain that would be treated as "effectively connected" to the partnership's U.S. trade or business if recognized directly by the partnership. In Revenue Ruling 91-32, the Internal Revenue Service concluded that, when a nonresident partner sells an interest in a partnership doing business in the United States, the asset sold technically is the partnership interest itself, and not the partner's distributive share of the partnership's assets. The ruling goes on, however, to apply an aggregate theory of partnerships to determine the source of the gain realized by the nonresident partner. In doing so, the ruling effectively develops an *ad hoc* reconciliation of the precepts for taxing gain on the disposition of directly held assets with the rules for taxing dispositions of partnership interests. As such, the ruling has been criticized as creating an "extrastatutory" taxing regime, and certainly should not be extended beyond its special circumstances. *See* Kimberly S. Blanchard, Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners, 76 Tax Notes 1331, 1335–36 (Sept. 8, 1997) ("There is simply no room to argue, under the Code as it has existed since 1954, that a sale of a partnership interest can under any circumstances outside of section 751 be treated as a deemed sale of an undivided share of the partnership's assets.")

91 Treasury regulation section 1.892-3T(a)(1) (flush language) (providing that income and gain from a "U.S. real property interest described in section 897(c)(1)(A)(i)," or a USRPI other than a USRPHC, is not exempt under section 892). Example (1) in Treasury regulation section 1.892-3T(b) clarifies that gain on the sale of interests in a non-controlled USRPHC generally qualifies as exempt income under section 892.

has disposed of its interests in a USRPHC directly or indirectly through the sale of a partnership or trust interest, and do not believe that such a result is intended under the regulations.[92] Accordingly, we believe that Treasury regulation section 1.892-3T(a)(2) should be amended to provide that gain realized on the sale of a partnership or trust interest will be exempt under section 892 to the extent that the gain relates to assets the gain from which would have been exempt under section 892 had the foreign sovereign held the underlying assets directly.

(b) Special Partnership Attribution Rule for Commercial Activities.

As discussed above in Section II.E.3, section 892 and regulations thereunder provide that an entity will be treated as a "controlled commercial entity" if it is "engaged in commercial activities (whether within or outside the United States)" and the foreign government directly or indirectly owns at least 50 percent of the economic or voting interests in, or otherwise effectively controls, the entity.[93] Treasury regulation section 1.892-5T provides detailed rules for purposes of applying this general definition, including attribution rules for activities of related "controlled entities"[94] and certain partnerships.

Treasury regulation section 1.892-5T(d)(3) provides a special partnership attribution rule under which activities of a partnership other than a PTP generally are attributed to its partners. In particular, that regulation provides that "except for partners of publicly traded partnerships, commercial activities of a partnership are attributable [sic] to its general and limited

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92 Indeed, as discussed above, the Service recently announced in Notice 2007-55 that, if a foreign sovereign is deemed to have disposed of underlying USRPIs under the "look-through" in section 897(h)(1) in the case of certain REIT dividends, then it will treat the foreign sovereign as having made those direct dispositions for purposes of section 892.

93 Section 892(a)(2)(B) and Treasury regulation section 1.892-5T(a).

94 An entity is a "controlled entity" for purposes of section 892 if it is directly or indirectly wholly-owned by a foreign government and satisfies certain other requirements discussed above in Section III.B.1.

partners for purposes of section 892."[95] In light of the considerations discussed below, however, we believe that Treasury regulation section 1.892-5T(d)(3) should be amended to provide that, absent some level of active involvement by a partner, the activities of a partnership will *not* be attributed to that partner for purposes of determining whether those partners are themselves "controlled commercial entities" under section 892.

As a practical matter, the special partnership attribution rule of Treasury regulation section 1.892-5T(d)(3) is relevant primarily for purposes of determining whether a controlled entity that is a partner in a partnership is a "controlled commercial entity." It generally does *not* affect the taxability of a foreign sovereign's *income or gain* from a partnership investment, because that issue is addressed by sections 875 and 882, which together (i) treat any foreign entity as being engaged in a U.S. trade or business conducted by a partnership in which such entity is a partner;[96] and (ii) impose a tax liability on the foreign entity's distributive share of ECI from such partnership.[97] In addition, it is worth noting that, because section 892(a)(2)(A)(ii) denies an exemption for income received directly or indirectly *from* a controlled commercial entity, the benefits of section 892 are unavailable in cases where a foreign government actually controls a partnership engaged in a U.S. trade or business (*e.g.*, if the foreign sovereign were the sole general partner of such a partnership).

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95 Example 4(c) in Treasury regulation section 1.892-5T(d)(4) confirms that the term "publicly traded partnership" for this purpose includes *all* entities that are PTPs as defined in section 7704 (and not only PTPs that are treated as corporations for U.S. tax purposes pursuant to section 7704). That example concludes that the real estate management activities of a PTP that manages an office building in New York and owns financial assets are not attributed to its general partner that is a controlled entity of a foreign government. The example refers to the general partner's "distributive share of partnership income."

96 We note that section 875 does not require "commercial activities" of a partnership to be attributed to its partners for purposes of section 892.

97 Accordingly, the partnership attribution rule in Treasury regulation section 1.892-5T(d)(3) would affect the taxability of a foreign sovereign's income or gain from a partnership investment only if a partnership's ECI was attributable to activities that were not "commercial activities" for purposes of section 892. We believe that such activities generally would constitute "commercial activities" in virtually all cases likely to arise under section 892.

Because section 892 does not, as a practical matter, provide a tax exemption for a partner's distributive share of partnership income from commercial activities, the relevant question in considering the utility of Treasury regulation section 1.892-5T(d)(3) is whether a controlled entity should be disqualified completely from the benefits of section 892 in respect of *all of its U.S. source income* merely because it invests in a partnership that engages in commercial activities. Given that many partnership investments take the form of minority limited liability interests in respect of which the "partner" is indistinguishable as an economic matter from a shareholder in a widely held corporation, we believe that attributing the activities of a partnership to its partners for purposes of determining whether a partner is a "controlled commercial entity" inappropriately elevates form over substance.

In fact, upward attribution of commercial activities from partnerships is arguably inconsistent with the approach taken in the more general attribution rules of Treasury regulation sections 1.892-5T(d)(1) and (2), which provide that activities of a "controlled entity" are *attributed downward* to its subsidiary controlled entities, if any, but *not upward* to its parent controlled entities, or across to its sister controlled entities.[98] We believe that the decision not to attribute the *activities* of lower-tier controlled entities up to parent controlled entities is consistent with the policies underlying section 892, because of the rule, discussed above in Section II.E, that *income* received *from* controlled commercial entities is not eligible for exemption. By ensuring that the appropriate income is taxable, that rule achieves the necessary policy objective of taxing commercial income and obviates the need to classify the receiving entity as a controlled commercial entity on the basis of what the entity only is deemed to do.[99]

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98 Of course, as in the case of upward attribution, the "all or nothing" rule creates traps for the unwary when applied in the context of downward attribution.

99 *See* section 892(a)(2) and Treasury regulation sections 1.892-4T and 1.892-5T(a)-(c).

For the reasons stated above, we would welcome a rule under which a partner will not be deemed to be engaged in the activities of the partnership for purposes of the "all or nothing" rule, unless the partner in fact is directly and actively engaged in the commercial activities of the partnership or actually controls those activities.

4. U.S. REIT Distributions; Notice 2007-55.

This Section III.C.4 provides some reactions to the recently issued Notice 2007-55,[100] in which the Service announced its intention to treat certain distributions (including liquidation distributions) paid to foreign sovereigns and their controlled entities in respect of REIT stock as income subject to U.S. taxation. Specifically, section 897(h) provides that distributions in respect of REIT stock (other than stock representing a 5-percent-or-less holding in REIT interests that are publicly traded on an established U.S. market) are to be treated as gain from the sale or disposition of a USRPI to the extent such distributions are attributable to any such gains realized by the REIT itself. Notice 2007-55 interprets this look-though rule of section 897(h) as overriding the general exemption under section 892 for income realized in respect of stock, on the grounds that, once the distributions have been recharacterized under section 897(h), they have lost their character as income in respect of stock.

Although most of our members agree generally with the approach taken in Notice 2007-55 and believe that the notice represents a fair interpretation of existing law, we also recognize that the relationship between sections 892(a) and 897(h) is unclear and that the notice does *not* represent the *only* fair interpretation of existing law. Specifically, given that section 892's exemption for stock-related income clearly trumps section 897 in the case of *gains* from the sale of stock in a USRPHC (including, we believe, gains realized from the liquidation of

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100 Notice 2007-55, 2007-27 I.R.B. 13.

USRPHCs that are not addressed by section 897(h)), a case can be made that section 892 should trump in the case of certain REIT distributions. For example, if a REIT disposes of a USRPI at a gain, and a foreign sovereign portfolio investor is able to sell its stock in the REIT before the gain is distributed (without entering into any arrangements to reacquire the stock or substantially identical interests in the REIT), the law seems clear that any gain realized by the investor from the sale of the stock would be eligible for exemption under section 892, regardless of the fact that some of the gain economically might represent a share of the REIT's gains in respect of the USRPI.[101]

The best policy reason for distinguishing a distribution made by a REIT from gain realized from a secondary-market disposition of stock in a USRPHC — and a reason which we believe is sufficient to justify the position taken in Notice 2007-55 — relates to the policy underlying FIRPA that gain from investments by foreign parties in U.S. real estate should be subject to *at least one* level of U.S. taxation. Viewed in light of this policy, it makes sense that a foreign sovereign's direct investment in U.S. real estate is *not* eligible for exemption under section 892, while an investment in a USRPHC that is a subject to U.S. tax at the corporate level generally is eligible. Similarly, we believe that it is appropriate to subject REIT distributions to

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101 We acknowledge, however, that section 897(h) provides a similar result for non-sovereign foreign investors that hold stock in "domestically controlled" REITs, and that a response to the example in the text might be to change the law and impose tax on a portion of the sovereign's gain from the sale. In addition, section 897(h)(5) contains a "wash sale" rule, under which gain from the sale of stock of a domestically controlled REIT is treated as gain from the sale of a USRPI in the amount of any dividends paid by the REIT that would have been so treated under section 897(h) had they been paid to the investor, provided that (i) the investor sells the stock during the 30-day period before the ex-dividend date for the dividend in question, and (ii) acquires, or enters into an option to acquire, a substantially identical interest in the REIT during the 61-day period beginning with the first day of the 30-day period described in clause (i). Although Notice 2007-55 does not mention the wash sale rule, we presume that the Service would take the view that gain that would have been taxable in the hands of a non-sovereign investor because of the wash sale rule also would be denied exemption under section 892 in the hands of a sovereign investor.

taxation when they relate to gain from the disposition of a USRPI that would otherwise escape U.S. taxation altogether as a result of the dividends paid deduction to which REITs are entitled.

On the other hand, there is also an argument that a foreign sovereign's investment in a non-controlled REIT effectively is a passive portfolio investment of precisely the type that section 892 is intended to facilitate, and there is no obvious reason why the investment should lose its character as a passive stock investment merely because the corporation issuing the stock holds real estate. Because there are no authorities or legislative history of which we aware that clearly articulate the intended relationship between the policies of section 892 and 897, any attempt to resolve such conflicts necessarily requires some judgment and interpretation, as evidenced in Notice 2007-55. In Notice 2007-55 the Service stated that it intends to issue regulations implementing the notice. This regulatory project might provide the appropriate opportunity to consider the interaction between the two Code sections in more detail.

5. Treatment of Controlled Entities Investing in USRPHCs.

Another example of a rule that we believe has the potential inappropriately to characterize controlled entities as "controlled commercial entities" on the basis of *deemed* commercial activity is contained in Treasury regulation section 1.892-5T(b)(2). That regulation provides that a foreign controlled entity will be deemed to be engaged in commercial activity (and thus constitute a controlled commercial entity) if it *would have been* classified as a USRPHC had it been domestic. Under that rule, a foreign controlled entity that holds portfolio investments in USRPHCs is classified as a controlled commercial entity if those investments constitute more than 50 percent of the entity's assets on an applicable testing date,[102] regardless

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[102] To be precise, section 897(c)(2) defines a USRPHC as a corporation where the fair market value of the corporation's USRPIs exceed 50 percent of the fair market value of (i) the corporation USRPHIs, *plus* (ii)

of whether: (i) the controlled entity engages in any direct management of U.S. real estate, or in any other activities apart from passive investment in securities that constitute USRPIs, (ii) the relevant foreign sovereign could have avoided this result merely by spreading the USRPHC investments among different controlled entities in a manner such that no single entity held more than 50 percent of its investments in USRPHCs, or (iii) gain from the USRPHC stock would have been exempt from FIRPTA if held directly by the foreign sovereign or through an "integral part" of the foreign sovereign.

Again, similar to the case of the partnership attribution rules discussed above, we are not arguing that income from USRPHC investments needs to be exempt from taxation in all cases (although we do find the inconsistent treatment of USRPIs under the current rules to be puzzling).[103] Rather, we believe that Treasury regulation section 1.892-5T(d)(2) creates a regime where the taxation of investments in USRPHIs are dependant entirely on the form through which the investments are held, which, again, creates an unnecessary trap for the unwary.

6. "Controlled Commercial Entities"; Definition of "Control."

A recommendation from the 1988 Report that bears repeating is the recommendation to clarify the definition of "control" contained in Treasury regulation sections 1.892-5T(a) and (c), which applies for purposes of determining whether a commercial entity is a disqualified "controlled commercial entity." As noted in the 1988 Report, for example, the current regulations are not clear as to what types of interests should be taken into account or what level of influence over an entity might constitute "effective practical control" over the entity, thus turning the entity potentially into a "controlled commercial entity." The 1988 Report

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interest in real estate located outside the United States *plus* (iii) any other assets which are used or held for us in a trade or business.

103 For example, see the discussion of U.S. REIT distributions and Notice 2007-55 in Section III.C.4, above.

recommends that the Service clarify that the references in the regulations to "interests" conferring control are to equity interests, and not to debt interests, and that creditor status alone is not enough to establish control. We also would welcome some regulatory examples illustrating specific situations in which a foreign sovereign was held to effective practical control.