SIMPSON THACHER MEMORANDUM

Treasury Department Proposes New Regulations That Liberalize US Tax Rules Affecting Investments by Foreign Governments

November 4, 2011

On November 2, 2011, the Treasury Department proposed new regulations under Section 892 of the Internal Revenue Code that liberalize US tax rules affecting investments by foreign governments or their controlled entities. The proposal includes rules to eliminate some adverse effects of holding limited partner interests, and, thus, could make investments by sovereign wealth funds and other foreign governmental entities in private investment funds more attractive. The proposal also remedies various problems under the existing regulations that have previously impeded investment by foreign governments.

Although the regulations are not effective until published in the Federal Register as final, the preamble to the proposed regulations states that taxpayers may rely on the proposed regulations until final regulations are issued.

BACKGROUND

Section 892 exempts from US federal income tax certain investment income received by a foreign government or its controlled entities. However, the Section 892 exemption does not apply to income (i) derived from the conduct of any "commercial activity," (ii) received by or from a "controlled commercial entity" or (iii) derived from the disposition of any interest in a controlled commercial entity.

Under the regulations in effect before the new proposals, commercial activities of a partnership (other than a publicly traded partnership) were generally attributed to its partners, with potentially catastrophic consequences to any partner that happened to be a foreign government entity (that is, loss of US tax exemption for all of its income). Foreign government investors have been concerned that such unfavorable treatment could apply even if the only commercial activity of the partnership takes place outside the US. As a result, foreign governments have generally been sensitive to investing in partnerships that could be considered to be engaged in commercial activities, and have often required fund sponsors to agree to avoid such activities.

The proposed regulations provide favorable new rules regarding what activities are commercial activities and the circumstances in which an entity is a controlled commercial entity. These proposed rules in effect equalize in some respects the treatment of an "integral part" of a foreign sovereign and a "controlled entity" of a foreign sovereign.

PARTNERSHIP INVESTMENTS

The proposed regulations provide two new exceptions to the rule that partners in a partnership are deemed to be engaged in the partnership's commercial activity.

Limited Partner Exception. Under the proposed regulations, a foreign government will not be treated as engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership. A partnership interest is considered a limited partner interest for this purpose if the partner does not have rights to participate in the management and conduct of the partnership's business during the taxable year. Certain consent rights over extraordinary events are not considered participation in the management and conduct of the business. Even if this new exception applies, however, a partner's distributive share of the partnership's income attributable to such commercial activities will not be exempt from taxation under Section 892 and in most cases will cause the foreign government partner to have to file a US federal income tax return reporting such income. In addition, if the foreign government owns 50% or more of such partnership, no part of the foreign government partner's distributive share will qualify for exemption under Section 892. Significantly, these new rules mean that non-US commercial activities conducted by a partnership generally will not cause a partner meeting these requirements to be considered to be engaged in a commercial activity and such activities alone will not trigger any US tax or US tax return filing obligation for the foreign government partner.

Trading Exception. Under the proposed regulations, an entity will not be treated as engaged in commercial activity solely because it holds an interest in a partnership that engages in certain trading activity for the partnership's own account, provided that the partnership is not a dealer in the assets being traded. This aligns the rules under Section 892 with the rules in Section 864 that determine when such activity is a trade or business even if conducted through a partnership rather than conducted directly.

ACTIVITIES THAT ARE NOT COMMERCIAL ACTIVITY

The proposed regulations clarify that certain activities are not commercial activities. The disposition of a "United States real property interest" will not be considered a commercial activity, although any gain from such a disposition (other than of the stock of a "United States real property holding corporation" that is not a controlled commercial entity) will not qualify for the exemption from tax under Section 892 and will continue to be subject to US federal income tax under Section 897. Additionally, the proposed regulations clarify that investing and trading in "financial instruments" will not be considered commercial activities regardless of whether such financial instruments are held in the execution of governmental financial or monetary policy. This is an important clarification for investment funds that may have been concerned about whether certain ordinary course activities, such as entering into interest rate swaps in connection with borrowing, would have constituted commercial activities. However, the Section 892 exemption will continue not to apply to income from financial instruments, unless the instrument is considered held in the execution of governmental financial or monetary policy.

INADVERTENT COMMERCIAL ACTIVITY

Under the proposed regulations, an entity will not be considered to be engaged in commercial activity if it only engages in "inadvertent" commercial activity. Commercial activity is considered inadvertent for these purposes if (i) the failure to avoid the activity is reasonable, (ii) the activity is promptly cured and (iii) certain recordkeeping requirements are met. In no event

will a failure to avoid conducting commercial activity be considered to be reasonable unless adequate written policies and operational procedures are in place to monitor the entity's worldwide activities. A failure would be reasonable under a safe harbor if (i) the foregoing policies and procedures to monitor commercial activity were in place, (ii) not more than 5% of the entity's assets were used in commercial activities and (iii) not more than 5% of the entity's income was derived from commercial activity. Income from inadvertent commercial activity will remain outside the Section 892 exemption and thus generally subject to US federal income tax if conducted in the US.

ANNUAL DETERMINATION

Under the proposed regulations, the determination of whether an entity is engaged in commercial activities is made on an annual basis, without regard to whether the entity was engaged in commercial activities in a prior taxable year. There was previously a concern an entity would be permanently "tainted" as a result of any commercial activity in a prior taxable year.

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We will continue to monitor developments regarding these new proposals, which remain subject to change or interpretation. In the meantime, if you have questions or would like to discuss the new rules, please contact John Hart (jhart@stblaw.com; 212-455-2830), Nancy Mehlman (nmehlman@stblaw.com; 212-455-2328), Jason Vollbracht (jvollbracht@stblaw.com; 650-251-5305) or your regular Simpson Thacher tax department contact.

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