SUTHERLAND

LEGAL ALERT

November 8, 2011

# Proposed Section 892 Regulations Provide Relief From the "All or Nothing" Rule and Permit SWF Limited Partners to Avoid Commercial Activity Attribution

Proposed regulations issued under Internal Revenue Code section 892, on November 2, 2011, address some of the most criticized rules under temporary regulations issued more than 20 years ago. Under the controlled commercial entity (CCE) regulations, engaging in even a *de minimis* amount of commercial activity can result in characterization of non-integral controlled entities as CCEs (the so-called "all or nothing" rule). As described in more detail below, the proposed regulations would liberalize this rule by not classifying an entity as a CCE if its commercial activity is determined to be "inadvertent." If certain other conditions are met, a new safe harbor rule excludes commercial activities as long as 5% or less of the controlled entity's assets and income are from commercial activities, but corrective action is required to eliminate the commercial activity once discovered. Another significant change eliminates the partnership attribution rules in the context of limited partnerships, thereby allowing foreign governments and sovereign wealth funds (SWFs) to invest in limited partnerships as a limited partner without being classified as CCEs regardless of whether or not the partnership engages in commercial activities.

Although the proposed regulations provide much advocated change to the temporary regulations concerning the scope of activities that constitute commercial activities, the proposed regulations do not alter the scope of the section 892 tax exemption. Thus, although a controlled entity may not be characterized as a CCE under the more lenient proposed CCE regulations, it remains taxable on all income from commercial activities, including the deemed disposition of a direct interest in U.S. real property. In the limited partnership context, this may result in foreign governments being taxable on their distributive shares of income from commercial activities or the dispositions of U.S. real property, while retaining their section 892 exemption on all other eligible income.

The key points of the proposed regulations are as follows:

- Entities will not be considered "controlled commercial entities" if they engage in inadvertent commercial activities.
- The determination of whether an entity is a "controlled commercial entity" will be made on an annual basis.
- Only the nature of the activity, and not the purpose or motivation for engaging in the activity, will determine whether an activity is a "commercial activity."
- The investment in, and trading of, financial instruments will not be considered "commercial activities" regardless of whether the financial instruments are held in the execution of governmental financial or monetary policy.
- Entities will not be deemed to engage in "commercial activities" solely from the sale, disposition, or deemed disposition of United States Real Property Interests (USRPI) and the operation of section 897(h)(a)(1). The foreign government will, however, be subject to taxation on all USRPI gains.
- Entities that are not otherwise engaged in commercial activities will not be treated as engaged in such activities solely because they act as limited partners in a limited partnership.

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## CONTROLLED COMMERCIAL ENTITIES

A foreign government is not exempt from taxation under section 892 for any income that is received by or from a "controlled commercial entity." Under the temporary section 892 regulations currently in force, an entity that is controlled by a foreign sovereign, and not an "integral part" of the foreign sovereign, becomes a "controlled commercial entity" if it engages in *any* commercial activity, regardless of whether such commercial activity took place in the United States. Accordingly, the temporary regulations create an "all or nothing" situation in which foreign governments may become ineligible for the section 892 exemption due to insignificant commercial activities that are not connected to its operations in the United States.

The proposed 892 regulations modify the "all or nothing" situation by providing that a controlled entity will not be considered as engaging in commercial activities if it conducts only "inadvertent" commercial activities. Commercial activities only qualify as inadvertent when:

- The failure to avoid conducting the commercial activity is reasonable;
- The commercial activity is promptly cured; and
- Certain record maintenance requirements are met

**Reasonableness Safe Harbor**

Under the proposed regulations, the failure to avoid commercial activities will only be considered reasonable if the commercial entity has adequate written policies and operational procedures that monitor its worldwide activities. If written policies are in place, the determination of reasonableness is a facts and circumstances inquiry, with due regard being given to the number of commercial activities the entity conducted during the year, and the amount of income earned from, and the assets used in, the commercial activities. A safe harbor exists for reasonableness if (1) the value of the assets used in, or held for use in, the activity does not exceed 5% of the entity's balance sheet assets for the taxable year as prepared for financial accounting purposes, and (2) the income earned from the commercial activities does not exceed 5% of the entity's gross income as reflected on its income statement for the taxable year for accounting purposes.

**Cure and Record Maintenance Requirements**

Under the proposed 892 regulations, a commercial activity is considered timely cured if the entity discontinues the activity within 120 days of discovery. This process may involve the controlled entity discontinuing the commercial activity, divesting itself of a general partnership interest, or directing a general partnership to discontinue its commercial activities. To meet the record maintenance requirement, the entity must make and retain adequate records of its remedial actions. To qualify as inadvertent commercial activities, a controlled entity must always meet the cure and record maintenance requirements, regardless of whether or not the entity qualifies for the reasonableness safe harbor.

**Duration of Controlled Commercial Entity Status**

Under the proposed 892 regulations, the determination of whether an entity is a CCE will be made on a yearly basis without regard to whether the entity engaged in commercial activities in prior taxable years.

## COMMERCIAL ACTIVITY

The proposed 892 regulations restate the general rule, enunciated in the temporary regulations, that (with certain exceptions) activities that are ordinarily conducted for the current or future production of income or gain are considered commercial activities. However, the proposed regulations clarify that the nature of the activity, and not the government's purpose or motivation for the activity, is the determinative factor in considering whether an activity is a commercial activity, a non-profit activity, or a governmental function. The proposed 892 regulations also clarify that an activity may be considered a commercial activity even if it does not constitute a trade or business under section 162 or does not constitute the conduct of a trade or business in the United States for purposes of section 864(b).

**Non-Commercial Activities**

The temporary 892 regulations do not consider the investment in, and trading of, financial instruments as commercial activities so long as those financial instruments are "held in the execution of governmental financial or monetary policy." The proposed regulations eliminate this requirement and provide that investing in, and trading of, financial instruments will not be considered commercial activities regardless of the foreign government's policy decisions. It is important to note this modification only affects the definition of "commercial activity" under the proposed 892 regulations, which, consequently, affects whether a controlled entity will be considered a CCE. The change does not affect whether income from the investment in, or trading of, financial instruments is subject to exemption under section 892, because the exemption only applies to income and gain from financial instruments actually held in the execution of governmental financial or monetary policy.

The proposed regulations also clarify that an entity that holds passive investments and is otherwise not engaged in commercial activities is not deemed to be engaged in commercial activities solely due to the disposition (or deemed disposition) of a USRPI under section 897(a)(1) (relating to the Foreign Investment in Real Property Tax Act or "FIRPTA"). The income derived from the disposition of a USRPI, however, does not qualify for exemption under section 892. Therefore, a controlled entity would not, for example, be classified as a CCE for investing in a partnership that generated income subject to FIRPTA, but the entity would be taxable on its distributive share of such income.

## PARTNERSHIPS

Under the temporary 892 regulations, the commercial activities of a partnership are generally attributed to its general and limited partners, with a limited exception for publicly traded partnerships. The proposed 892 regulations expand the exception, previously only available to a partner in a publicly traded partnership, to all limited partners by modifying the attribution rule currently provided by Temp. Treas. Reg. §1.892-5T(d)(3). Under the proposed rule, an entity will not be treated as engaged in commercial activities solely because it is a limited partner in any limited partnership (including publicly traded limited partnerships). For example, a controlled entity of a foreign government that is a limited partner in a securities dealer partnership will not be treated as engaged in a commercial activity solely because of its limited partner interest. However, the distributive share of partnership income from the dealer activities will not be exempt from tax.

For purposes of the proposed regulation only, an interest in a partnership is treated as a limited partner interest only if that partner does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year under the governing partnership agreement. In the case of extraordinary events, consent rights are not treated as a right to participate in the management and conduct of the partnership's business.

Although the commercial activity of a limited partnership will not cause a controlled entity to be considered a CCE, the income from the partnership's distributive share of income attributed to the partnership's commercial activities is not exempt under section 892. If this portion of the regulation becomes final, a foreign government that is a limited partner in a limited partnership that engages in both exempt and non-exempt activities under section 892 could allocate all income from the non-exempt activities to the other partners if the allocation has substantial effect.

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*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*


| | | |
|---|---|---|
| William H. Bradley | 212.389.5020 | bill.bradley@sutherland.com |
| Daniel R. McKeithen | 404.853.8342 | daniel.mckeithen@sutherland.com |
| Carol P. Tello | 202.383.0769 | carol.tello@sutherland.com |
| Dwaune L. Dupree | 202.383.0206 | dwaune.dupree@sutherland.com |