IRS RELEASES PROPOSED SECTION 892 REGULATIONS; PRIVATE EQUITY FUND INVESTMENTS BY FOREIGN GOVERNMENT PARTNERS POTENTIALLY AFFECTED

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To Our Clients and Friends:

Today the IRS released proposed regulations that provide guidance in determining when a foreign government's investment income will be exempt from U.S. tax under Section 892 of the Internal Revenue Code. The proposed regulations liberalize the existing rules in several respects, especially for investments by foreign governments in partnerships that derive income not covered by the Section 892 exemption. These changes will likely facilitate foreign government investment in private equity funds and other managed investment vehicles.

Background. Under Section 892, certain qualified investment income (*e.g.*, interest, dividends, capital gains from stocks and securities) of a foreign government is exempt from taxation. However, the exemption does not apply to income that (1) is derived from the conduct of a commercial activity, (2) is received by or from a "controlled commercial entity" or (3) is derived from the disposition of an interest in a controlled commercial entity.

Under current law, if an entity controlled by a foreign government engages in even a *de minimis* amount of commercial activity, it will be a controlled commercial entity and will consequently lose its exemption under Section 892. Moreover, the commercial activity of a partnership is generally attributed to its partners. Since foreign governments often invest in private equity funds and other investment partnerships through controlled entities, these rules have made such investors highly sensitive to investment partnerships conducting any amount of commercial activity. The proposed regulations provide a new limited partner exception that should alleviate some of the concerns regarding investments in partnerships, in addition to other guidance.

Limited partner exception. The proposed regulations provide a major exception to the existing rule that commercial activities of a partnership (including entities taxed as partnerships) are attributable to its partners or members. An entity will not be deemed to be engaged in commercial activities solely because it holds an interest as a "limited partner in a limited

partnership," which requires that the partner or member cannot have any rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year. Consent rights over extraordinary events such as the expulsion of a partner, the dissolution of the partnership or the sale of substantially all of the partnership's assets are not considered rights to participate in the management of the partnership for this purpose. This exception should generally apply to typical limited partner investments in private equity funds, although the nature of any rights granted to a foreign government investor under the partnership agreement or a side letter will require careful review to ensure that such rights do not result in participation in the management and conduct of the partnership's business. Even if the exception does apply, the foreign government limited partner's distributive share of the partnership's commercial activity income will be subject to U.S. tax.

Clarification of "commercial activity". The proposed regulations clarify that the disposition of a U.S. real property interest does not constitute the conduct of a commercial activity, although gain from the disposition of a U.S. real property interest (other than stock in a U.S. real property holding corporation) is subject to U.S. tax. The proposed regulations also clarify that investing in financial instruments, such as forwards, futures, options and derivatives, is not commercial activity, even if the income or gain from any of such investments is not exempt from tax under Section 892.

Commercial activities of controlled entities. The proposed regulations provide that an entity will not be a controlled commercial entity if it engages in only "inadvertent" commercial activity. Commercial activity is inadvertent if the failure to avoid it is reasonable under the circumstances and is cured within 120 days of discovery. A failure would be deemed reasonable if the entity maintains adequate policies and procedures to avoid commercial activities, less than five percent of the entity's assets are used in commercial activities and commercial activity income is less than five percent of the entity's gross income. However, any income from the inadvertent commercial activity will still be subject to U.S. tax. The proposed regulations also clarify that the determination of whether an entity is engaged in commercial activity is generally made on an annual basis.

Partnerships involved in trading activities. The proposed regulations clarify that an entity will not be treated as engaged in commercial activities solely because it is a partner in a partnership (not otherwise engaged in commercial activities) that engages (on its own or through a broker, agent or custodian) in trading activity for the partnership's own account.

Effective date. Although the proposed regulations are not effective until published as final regulations, the preamble states that taxpayers may rely on the proposed regulations until final regulations are issued.

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