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Re: Comments on Section 892 Regulations

Caisse de depot et placement du Quebec, the Future Fund, and the New Zealand Super Fund welcome the opportunity to provide written comments regarding Temporary and Proposed Regulations issued by the Department of the Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**") in respect to the income of foreign governments under Section 892 (together the "**Regulations**").[1]

We are a group of government-owned investment funds and public pension funds from Canada, Australia, and New Zealand, respectively, invested across multiple asset classes throughout the world, with a significant number of investments in the United States, including U.S. infrastructure and real estate assets. Each of us, or investors we represent, are institutions treated as foreign governments as defined in section 892. Collectively, we manage over USD 370 billion in assets as at September, 2017.

1 All section referenced herein are to the Internal Revenue Code. The Proposed Regulations were issued November 3, 2011 by Treasury and the IRS.

Introduction

Most government-owned investment funds invest through separately organized entities wholly owned by the sovereign that qualify for the benefits of section 892 as "controlled entities." If such a controlled entity engages in any amount of "commercial activity," anywhere in the world, it loses the ability to benefit from the section 892 exemption entirely – even with respect to income not derived from such commercial activity – because the entity then becomes a "controlled commercial entity."

Under these rules, it is extremely important for sovereign investors to ensure that they do not become controlled commercial entities. In 2011, the IRS and Treasury released Proposed Regulations that provided some limited relief from the rules under which an entity would be treated as engaged in commercial activity. We are pleased that the Proposed Regulations were responsive to several important concerns of foreign governments. The Regulations move in the welcome direction of addressing some of the changes in the financial investment environment that occurred in the twenty four years since Treasury and the IRS last issued temporary regulations under Section 892 (the "**1988 Temporary Regulations**" or the "**Temporary Regulations**"). These rules are extremely important for foreign governments wishing to invest in the United States. However, the rules in the Proposed Regulations still provide an unduly burdensome definition of commercial activities and do not address a number of other issues under current law that make it more difficult for sovereign investors to invest in the U.S. markets, particularly with respect to infrastructure and real estate investments.

This comment letter recommends that Treasury and the IRS finalize the Proposed Regulations. It also suggests a number of changes that should be made to those Proposed Regulations, as well as raising certain other changes or clarifications that Treasury and the IRS should make to the regulations under Section 892. Specifically, this comment letter recommends: (1) the modification of the controlled commercial entity rules; (2) modifications to the definition of commercial activity; and (3) certain other changes discussed further in this comment letter, which are not addressed in the Proposed Regulations.

A. Modify the Controlled Commercial Entity Rules

1. *Introduce a Predominant Activity Concept for Becoming a CCE*

Section 892(a)(2)(B) defines a CCE as an entity that is "engaged in commercial activities (whether within or outside the United States)" (hereinafter, the "**Commercial Activity Requirement**"), if the government owns 50 percent or more of the vote or value of the entity, or any other interest that gives the foreign government effective control over the entity. The Temporary Regulations promulgated interpret this provision under an "all or nothing" test to determine if a controlled entity meets the Commercial Activity Requirement: if a controlled entity engages in *any* commercial activity (no matter how small), it becomes a CCE. This "all or nothing" approach serves as a trap for the unwary and can disqualify all of an entity's passive investments from exemption because of one insignificant activity that rises to the level of a commercial activity. Moreover, it causes funds to follow stringent structuring steps and the creation of holding or blocker entities to prevent the risk of any commercial activity income flowing into the fund. The Temporary and Proposed Regulations provide welcome, but limited, exceptions from this hair-trigger rule for inadvertent commercial activity, for attribution of commercial activities conducted by publicly traded partnerships and for limited partnerships in which a sovereign investor is a limited partner.

The "all or nothing" approach is not required by the statute. Although the language of section 892(a)(2)(B) and the relevant legislative history[2] demonstrate that Congress intended to deny an exemption to income received by and from controlled entities engaged in commercial activity regardless of where it takes place, they do not suggest that the exemption *must* be denied when the commercial activity is insubstantial relative to the entity's passive investment activity.[3] Stated differently, the "all or nothing" approach was not specifically mandated by Congress; rather, the Treasury is free to adopt a more measured approach in the Regulations.

Recommendation

> The exemption under Section 892 should be denied only when a controlled entity is predominantly engaged in commercial activity based on all facts and circumstances. This test would provide a fairer and more reasonable test than the current "all or nothing" determination of commercial activity. This would ensure that governmental investors do not inadvertently disqualify themselves from the exemption, and therefore would advance the tax policy goal of certainty in a manner that is fully consistent with the sovereign immunity policy behind section 892. We note that former IRS guidance provided that a government-owned entity was not disqualified if, taken as a whole, the entity's activities and purpose were not properly viewed as a commercial enterprise.[4] Focusing on the predominant activities of the entity based on all facts and circumstances would still capture state-owned postal entities, airlines, and other similar entities whose predominant activities are commercial in nature. However, controlled investment entities that make some non-controlling investments in for example private equity or hedge funds would not be caught by the commercial activity requirement because they simply failed to block income from that investment with an opaque entity.

Several examples illustrate how this rule would work in practice. The first is an airline wholly owned and controlled by a foreign government. The airline does not operate flights into the United States, but it invests excess working capital in United States securities. More than 50 percent of the airline's revenues and assets are attributable to the business of operating an airline. The airline is a CCE because it is predominantly engaged in a commercial activity. This is so notwithstanding that the airline is only engaged in investment activity in the United

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2 H.R. Conf. Rep. 99-841.

3 One passage from the Conference Report arguably supports the "all or nothing" approach:

> Under the conference agreement, as under the Senate amendment, if a controlled entity is itself engaged in commercial activity anywhere in the world, its income is treated like income of a privately owned entity. Income it receives is fully taxable and payments it makes are not eligible for the exemption. However, if a controlled entity is not itself engaged in any commercial activity, the agreement provides tax exemption for certain investment income earned by that controlled entity, whether or not any entity related to that controlled entity is engaged in commercial activity, and the agreement provides exemption for interest and dividend payments from the entity to the government.

H.R. Conf. Rep. 99-841, p. 4743. However, this particular reference to "<u>any</u>" commercial activity is intended to address the attribution of commercial activity among related parties, and should not be read to suggest that a de minimis amount of commercial activity taints an entity's exemption. Moreover, the reference only says that if an entity is <u>not</u> engaged in any activity, it is exempt. The quoted passage does not condition the exemption on the complete absence of commercial activity, it only states that the absence of such activity will be sufficient. The passage simply was not written to describe the characteristics of a "controlled commercial entity," and should not be interpreted as such.

4 Rev. Rul. 66-73, 1966-1 C.B. 174.

States.

The rule can further be illustrated by an investment fund wholly owned by a foreign government. The investment fund invests in securities around the world, including in the United States. Five percent of the investment fund's assets are invested in a minority position in a closely held German company engaged in a trade or business in Germany. The German company decides to expand business activities into the United States and files an election under Treasury Regulation Section 301.7701-3 to be classified as a partnership for United States federal income tax purposes, so that the German company's business activities may arguably be attributed to the fund. Because the investment fund is not predominantly engaged in a commercial activity, it should not be considered a CCE.

A similar situation is presented by a controlled entity of a foreign government that invests in an investment partnership with other investors, both U.S. and foreign. The investment partnership holds only stocks and securities of U.S. issuers. It is unclear whether the law of organization of the partnership gives its partners rights to participate in management, but the foreign government does not in fact participate in the management of the partnership. In connection with certain investments, the partnership engages in a small amount of activity that could be considered "commercial activity" within the meaning of the Regulations, such as taking fees from a portfolio company. As in the previous example, the controlled entity should not be considered to be a CCE by virtue of the activities of the investment partnership.

2. ***Convert inadvertent commercial activity exception into a de minimis rule***

As discussed above, we recommend that Treasury and the IRS revise the definition of a controlled commercial entity to apply only to an entity that is predominantly engaged in commercial activity based on all facts and circumstances. However, if Treasury and the IRS do not exercise their discretion to do so, we recommend permitting an entity that engages in a *de minimis* amount of commercial activity to not be treated as a controlled commercial entity.

The Proposed Regulations provide that for purposes of determining whether an entity is a CCE, an entity that conducts only inadvertent commercial activity will not be considered to be engaged in commercial activities. The Proposed Regulations provide that a failure to avoid commercial activity will only be considered to be inadvertent if the failure to avoid such activity is reasonable.[5] In order for the failure to be considered reasonable, the controlled entity must have "adequate written policies and operational procedures in place to monitor the entity's worldwide activities." Moreover, the entity must dispose of any commercial activity within 120 days of discovery. Provided that the entity has in place the requisite procedures, commercial activity is deemed to be *de minimis* if it is less than 5 percent of the entity's total activities with respect to both income and asset values.

We believe that Section 892 as amended in 1986 allows for a *de minimis* rule that is not dependent on inadvertence, and we encourage such a rule to be added in addition to the inadvertent commercial activity rule if Treasury and the IRS do not adopt our recommendation for a predominant activity rule. The legislative history to the modifications to Section 892 in 1986 indicates that the commercial activity rule was enacted because Congress believed it was inappropriate to provide nationalized or government-controlled business entities with a competitive tax advantage over fully taxable business entities. The

[5] Prop. Reg. Sec. 1.892-5(a)(2)(ii)(B).

legislative history further indicates that Congress did not intend to tax income from portfolio investments.[6]

However, because it is not uncommon for governmental investors to allocate a larger portion of their assets to one particular investment, a 5 percent threshold is too low. The risk of such a larger investment generating commercial activity is no less than it would be for a smaller investment. Finally, because it is not always possible for an SWF to determine the U.S. entity classification status of its non-U.S. investments due to limited access to the formation documents of such investments, governmental investors may risk exceeding the 5 percent threshold (*e.g.*, by investing in an entity that would not be considered a limited partnership or corporation for U.S. federal income tax purposes) simply due to a lack of information that would be considered adequate for making such determinations for U.S. federal income tax purposes. However, providing for a realistic *de minimis* safe harbor of 10 percent will go a considerable way toward alleviating these problems. Such a 10 percent threshold is already used in other areas of the federal income tax law, such as the denial of the portfolio interest exemption for interest received by a 10-percent shareholder under Section 871(h)(3).

Moreover, the use of gross income in any safe harbor can lead to difficulties in the application of the safe harbor. Specifically, a relatively minor (*i.e.*, under 5 percent) investment in terms of asset value could generate commercial activity income in a year in which the other assets in which the governmental entity invests perform poorly. Because the safe harbor under the current inadvertent commercial activity rule requires the use of gross income as reflected on the entity's income statement and therefore uses accounting concepts, such accounting principles often require that assets be marked to market. Therefore, the income statements of an entity are likely to reflect unrealized gains and losses, which presents additional risk that the use of commercial activity income for purposes of the safe harbor will lead to distortive effects. Thus, a safe harbor under a blanket *de minimis* rule should also be more focused on asset values.

The Proposed Regulations also provide that an entity that is not otherwise engaged in commercial activities will not be deemed to be engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership. While it is clear under the Proposed Regulations that limited partner interests do not cause a controlled entity to be treated as being engaged in commercial activity, the Proposed Regulations do not make clear

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[6] *See* S. Rep. 99-313:

> The committee's examination of current law's tax exemption for investment income of foreign governments has revealed several problems. First, the exemption extends to entities, even business corporations, wholly owned by foreign governments. This treatment tends to favor, for example, nationalized industries over privately owned industries. Under current law, the United States taxes U.S. source investment income received by a privately-owned foreign business corporation but not similar income received by a state-owned business corporation. The committee does not believe that this difference in treatment is appropriate.
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> Second, current law provides an exemption for income (such as interest and dividends) derived by foreign governments or governmental entities from U.S. businesses that they control. For example, a foreign government may buy a controlling interest in a U.S. corporation. Dividend and interest payments from that corporation to the foreign government escape U.S. shareholder level tax. While an exemption for income from passive investments may be appropriate in some cases, payments to a controlling entity, in the committee's view, are in the nature of a return on a direct investment, not on a portfolio investment. These payments, in the committee's view, are not passive investment income. The committee does not believe that exemption is appropriate in this case.

how limited partner interests must be accounted for in a safe harbor calculation. We believe that the value of the limited partner interests is included in the entity's calculation of its total assets, but is not included in the value of its commercial activity assets regardless of whether there may be some commercial activity assets held by the limited partnership. A rule contrary to this reading would be impossible to administer in the context of a fund of funds investment and would seemingly undermine the limited partnership rule contained in the Proposed Regulations.

> ***Recommendations***
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> If the "predominant activity" rule is not adopted, we recommend adding a *de minimis* rule permitting up to the greater of 10 percent of an entity's assets or income during a given tested year to be assets or income during that year used in the conduct of commercial activity regardless of whether such activities are inadvertent. This *de minimis* rule should be in addition to the existing inadvertent commercial activity rule.
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> Regulations should also clarify that for purposes of the safe harbor, a limited partner interest in a limited partnership is treated in its entirety as a non-commercial asset.

Moreover, with respect to the inadvertent commercial activity rule that we recommend be retained alongside a *de minimis* rule that is not based on inadvertence, Treasury and the IRS should provide specific examples of appropriate policies and procedures to be implemented. Because policies and procedures may vary by jurisdictions, governance standards, and investment strategy, illustrative examples of appropriate and adequate (or, alternatively, inadequate) policies and procedures will permit controlled entities to increase their certainty that their policies and procedures are adequate for purposes of the Proposed Regulations. Further, when a governmental investor invests into a fund, the governmental investor is forced to rely on the fund manager's ability to monitor the investments to ensure that they do not give rise to commercial activity (similar issues arise where the government makes investments through an account managed by an external service provider). Regulations should clarify that an entity can rely on the procedures of other parties and the information provided by such other parties in monitoring its own worldwide activities, unless the entity knows or has reason to know that such procedures are inadequate or that the information provided is inaccurate.

The Proposed Regulations provide that the figures for total assets and gross income are those reflected on the entity's balance sheet and income statement, respectively, "as prepared for financial accounting purposes." They do not, however, state which country's accounting standards should be used, so that arguably they could be interpreted to require looking to U.S. accounting standards. We do not believe it to be the intent of the Proposed Regulations to require a governmental investor to prepare U.S. GAAP financial statements where it does not already do so, and we therefore recommend clarifying that the safe harbor is calculated based on the balance sheet as prepared for financial accounting purposes using the financial accounting standards the entity uses to prepare its financial statements.

> ***Recommendations***
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> Regulations should provide specific examples of adequate policies and procedures and should make clear that a governmental investor may rely on investment managers' policies and procedures to monitor commercial activities where the government invests in funds or managed accounts.

Regulations should also clarify that local country accounting rules may be used as appropriate values for the purpose of monitoring the amount of commercial activity.

3. *Remove USRPHC tainting rule*

The Proposed Regulations provide that a disposition, including a deemed disposition under Section 897(h)(1), of a U.S. real property interest does not by itself constitute the conduct of a commercial activity. However, Temp. Treas. Reg. Sec. 1.892-5T(b) provides that, for purposes of testing whether an entity is a controlled commercial entity, any entity – whether U.S. or foreign – that is a U.S. real property holding corporation ("**USRPHC**") under section 897 is treated as engaged in commercial activities ("**USRPHC tainting**").

This rule can cause a controlled entity to be a controlled commercial entity simply because it holds passive investments in land rich companies or REITs, even though it may not earn commercial activity income. A company is a USRPHC if, of the sum of the value of its U.S. and non-U.S. real property interests and its trade or business assets, at least 50 percent is attributable to U.S. real property interests. Because a governmental investor cannot hold any trade or business assets without risking being engaged in commercial activity, it can be easy for a governmental investor to be caught by the USRPHC tainting rule. While cash, stocks, securities, receivables, options, and similar assets may be treated as trade or business assets for this purpose if the entity being tested for USRPHC status is primarily an investment company, regulations provide that an entity can only know with certainty that it can apply this rule if at least 90 percent of its assets are cash, stocks, securities, receivables, options, and similar interests.

For example, if 89 percent of a controlled entity's assets consist of direct investments in stocks (in non-USRPHCs) or bonds, but the other 11 percent of the entity's assets consist of an interest in a USRPHC, then under the general commercial activity rules, that controlled entity would have no commercial activity at all. However, it could nevertheless be considered a controlled commercial entity by virtue of the application of the USRPHC tainting rule. Further, where the stocks or bonds were held indirectly via a partnership, the controlled entity could be considered a controlled commercial entity pursuant to the USRPHC tainting rule merely by holding any interest in U.S. real estate (because partnership interests are not described in Treas. Reg. Sec. 1.897-1(f)(1)(iii)).

These results are fundamentally unfair. The legislative history to the Technical and Miscellaneous Revenue Act of 1988 states that for purposes of determining whether an entity is a controlled commercial entity, "a commercial entity is to include any U.S. real property holding corporation."[7] While under section 897, a non-U.S. corporation can be a USRPHC, it is clear that the intent of the legislative history was to ensure that foreign governments could not avoid the FIRPTA rules by investing in a minority interest in a U.S. corporation that is a USRPHC,[8] not to prevent non-U.S. governmental entities from qualifying for the benefits of Section 892 where they are merely passive investors.

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7 S. Rep. 100-445.

8 Given Congress's recent enactment of Section 897(l), which exempts qualified foreign pension funds from the application of FIRPTA and the clear policy objective to attract foreign investment in U.S. infrastructure, it is worth considering whether the policy concerns Congress articulated in 1988 are still applicable. In order to stimulate foreign investment in U.S. infrastructure, it may well be worth expanding Section 897(l) to apply to Section 892 eligible investors. A number of Section 892 eligible investors are governmental pension funds that also qualify for Section 897(l) benefits, but others that make global infrastructure investments are not.

The preamble to the Proposed Regulations states that the IRS and Treasury "believe that an entity that only holds passive investments and is not otherwise engaged in commercial activities should not be deemed to be engaged in commercial activities solely by reason of the operation of section 897(a)(1)."

Recommendation

We recommend removing the USRPHC tainting rule. The rule is unnecessary because if the section 892 investor owns direct interests in operating real estate, it is likely engaged in commercial activity. However, if it owns only investments in USRPHCs or limited partner interests in partnerships that hold real property and that qualify for the limited partner exception in the Proposed Regulations, there is no reason to treat the investor as engaged in commercial activity.

4. *Clarify limited partner exception*

The Proposed Regulations provide significant relief to controlled entities of foreign governments holding investments through limited partnerships, as long as the interests are limited partner interests. These changes are welcome. The Proposed Regulations provide that, in order to be a limited partner, the holder of the interest may not have rights to participate in the management and conduct of the partnership's business "under the law of the jurisdiction in which the partnership is organized or under the governing agreement." This relief will allow SWFs to simplify the structures through which they hold their investments without creating additional risk that they will be engaged in commercial activity. However, a number of uncertainties remain that make it difficult to rely on the limited partnership exception.

Large investors in funds are often members of a fund's advisory board, which may make nonbinding investment recommendations, and which may need to be advised in advance of major investments.

The Proposed Regulations provide some description of the types of rights that are permitted without disqualifying a partner as a limited partner, including consent rights in the case of extraordinary events, amendment of the partnership agreement, dissolution of the partnership, etc. However, a more extensive and specific list of permitted rights will help provide certainty as to the breadth of the limited partner exception.

Moreover, the limited partner exception appears not to be limited to situations in which the limited partnership is not a controlled commercial entity. In other words, as long as a person truly is a limited partner, the exception may apply even where such person owns a majority economic interest in the partnership. We welcome this rule but believe it would be helpful to specifically state it in the regulations so as to provide certainty.

Recommendations

We recommend regulations provide a more thorough and specific list of the types of rights that are permitted (or forbidden). Specifically, we recommend clarifying that none of the following constitute impermissible management or conduct of business: (1) consent rights over changes in rights to income or capital; (2) consent rights over changes in voting rights; (3) consent rights over changes in the investment legal structure; (4) consent rights over the cessation of an existing business or commencement of a new business; (5) consent rights over changes in the capital structure (debt/equity); (6) participation in an advisory board or certain rights granted under side letters, (7) consent rights over changes in key personnel and management involved in the partnership (analogous to removal of the general partner); (8) consent rights over decisions regarding diversification of the partnership's underlying investments beyond investment policy limits specified in the partnership agreement; (9) protective rights concerning conflicts of interest (*e.g.* general partner not acting in the interests of the limited partners or partnership fund); and, (10) veto rights over certain investments (for example, a right to veto politically untenable investments or to be excused from participation in such investments, or to investments that would be outside of the partnership's investment policy).

Additionally, we suggest the addition of a clarifying statement including but not limited to situations where this exemption may still be available even where the section 892 eligible foreign government investor has a greater than 50% economic interest in a partnership if, based upon all facts and circumstances, it otherwise meets the exception's criteria. Furthermore, we recommend that the limited partner exception accommodate evolving market practices by stating that the list of activities and rights that do not constitute impermissible management or conduct of business (as recommended above) is not exhaustive.

Moreover, as currently drafted, the Proposed Regulations imply that a SWF would need to obtain a local country determination whether it has rights to participate in the management and conduct of the partnership's business under local law, as well as possibly needing to obtain a determination whether the rights conferred under local law and the governing agreement could constitute "rights to participate in the management and conduct of the partnership's business" under U.S. federal tax law. This uncertainty has made it difficult to rely on the exemption because of the additional cost of obtaining both local law and U.S. tax opinions.

Recommendation

We recommend confirming that governmental investors may rely on the determination of local counsel that under the law of the jurisdiction in which the partnership is organized the governmental investor has rights not exceeding those of a limited partner (*i.e.*, that it does not have impermissible rights to participate in the management or conduct of the partnership's business that would preclude its partnership interest from benefitting from limited liability status) and/or by providing a more detailed list of specific rights that are permissible or impermissible (as discussed above). Our goal in making this suggestion is not to provide for a more permissive rule regarding what constitutes a limited partnership, but rather to maximize clarity, as governmental investors will be less likely to avoid investments in limited partnerships, including limited partnerships making investments in the United States, if they can conclude with greater certainty that they hold their interests as limited partners.

B. Definition of Commercial Activity

1. *Adopt a "Trade or Business" Standard*

The current Temporary Regulations under section 892 provide that an activity may be considered a commercial activity even if it does not constitute a trade or business conducted in the United States within the meaning of section 864(b). We are not aware of any policy reason for the distinction between "commercial activity" under section 892 and a "trade or business" under section 864(b) (other than the limitation under section 864(b) to that trade or business being conducted in the United States) and believe that it is inappropriate. Further, the existing body of law addressing the scope of the term "trade or business" would, if made applicable to section 892, provide invaluable guidance to foreign government investors.

The prior Regulations promulgated under section 892 before its amendment in 1986, specifically provided that "a particular activity in the United States that does not constitute the conduct of a trade or business in the United States under section 864(b) will be deemed not to be a commercial activity."[9] This provision was dropped from the current Regulations without explanation.

Recommendation

We recommend that regulations provide that an activity will not be commercial activity if it would not constitute a "trade or business" under section 864(b) if it would be carried on in the United States.

2. *Guidance on Primary Loan Investments*

The Temporary and Proposed Regulations provide that investments and trading in loans are not commercial activity, but that they may be commercial activity if undertaken in the conduct of a banking, financing, or similar activity or as a dealer, even if the income from such investments is not effectively connected income under Reg. Sec. 1.864-4(c)(5) – *i.e.*, if it is not effectively connected because not undertaken in the United States but would be if undertaken in the United States. We believe this rule is appropriate; however, there is some uncertainty as to whether loan origination activities could potentially still be commercial activity even outside of the two contexts described above. We recommend that regulations clarify that the above are the exclusive contexts in which lending activity is treated as commercial activity.

Recommendation

We recommend clarifying that engaging in lending activities, and charging associated fees, are not commercial activity unless they are part of a banking, financing, or similar activity, as defined in Reg. Sec. 1.864-4(c)(5), without regard to the limitation that the activity be undertaken in the United States, *i.e.*, unless the entity offers to make loans to the general public in any jurisdiction. In addition, regulations could provide that an entity will not be treated as engaged in commercial activity unless it makes more than 5 loans per year.

C. Consider Amendments Not Already Addressed by Proposed Regulations

1. *Revise Notice 2007-55*

We believe that it is appropriate to apply the section 892 exemption to all real estate investment trust ("**REIT**") distributions, as long as the REIT is not a controlled commercial entity.

In Notice 2007-55 (the "**Notice**"), the IRS announced that it would treat certain distributions in respect of REIT stock paid to foreign governments as not qualifying for the benefits of section 892. The Notice concerns the look-through rule of section 897(h)(1), which provides

[9] Prior Treas. Reg. Sec. 1.892-1(c)(2)(iv).

that distributions to foreign persons in respect of REIT stock[10] are to be treated as gain from the sale or exchange of a U.S. real property interest ("**USRPI**") to the extent the distributions are attributable to any such gains realized by the REIT itself. The Notice effectively interprets the rule of Section 897(h)(1) as trumping the rule in Section 892 that exempts income realized in respect of stock.

We think the Notice is inconsistent with the intent of Section 892 to exempt foreign governments on their passive investment income. Notwithstanding the rule in Section 897(h)(1), the governmental investor would in any case be receiving income from a stock investment. We believe that the approach more consistent with the intent of Section 892 would be to treat all distributions from non-controlled REITs as subject to the Section 892 exemption for stock related income.

Recommendation

We recommend withdrawing the portion of Notice 2007-55 that provides that section 892 benefits are not available for REIT capital gain distribution. In the alternative, we recommend at a minimum modifying the Notice such that it does not apply to REIT capital gain distributions attributable to a REIT's sale of shares in a USRPHC, as well as to a lower-tier REIT's sale of shares in a USRPHC.

2. *Gain from the sale of a partnership (or trust) interest*

The 1988 Temporary Regulations provide that gain on the disposition of an interest in a partnership or a trust is not exempt from taxation under Section 892. They also provide that a partnership interest is not treated as a security, unless the partnership is a publicly traded partnership. Presumably, by treating a publicly traded partnership interest as a security, gains from the disposition of such an interest could qualify for Section 892 benefits. However, an example in the Temporary Regulations[11] concludes that gain from the sale of such an interest does not qualify for section 892 benefits.

Regulations should clarify the treatment of partnerships and trusts. First, there is no good policy reason to deny Section 892 benefits for dispositions of partnership or trust interests where the assets held by the partnership or trust are stocks and securities that would qualify for Section 892 benefits if the governmental investor sold them directly. Moreover, in such a case, if a partnership had sold the assets, the governmental investor would be eligible for Section 892 benefits with respect to its distributive share of the gain. We believe that Treasury and the IRS should exercise their regulatory discretion to provide such a rule.

Moreover, where the partnership holds interests in USRPHCs, Section 897(g) provides that gain from the sale of the partnership or trust attributable to such U.S. real property interests is treated as gain from the sale of such property by the taxpayer. Thus, Section 897(g) provides a specific look-through rule. We recommend at a minimum that Treasury and the IRS clarify that, where a partnership or trust holds interests in USRPHCs, Section 897(g) applies to treat

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[10] Other than stock representing a 5-percent or lower holding in a REIT whose interests are publicly traded on a U.S. market. Presumably, the 5 percent limitation in the Notice would now be 10 percent, given the increase of the publicly traded company threshold for REITs in section 897.

[11] Temp. Treas. Reg. Sec. 1.892-3T(b), *Example 1*.

a selling partner or beneficiary as selling the underlying property (*i.e.*, stock), so that a governmental investor may be eligible for Section 892 benefits with respect to such gain.

Recommendation

We recommend modifying Temporary Treasury Regulation Section 1.892-3T(a)(2) to clarify that gain on the disposition of a partnership interest is exempt to the extent that such gain is attributable to partnership assets the gain on which would be exempt if held by the foreign government directly. In other words, we suggest that Treasury and the IRS clarify that the disposition of an interest in a partnership or trust is exempt from tax to the extent that a sale of the underlying assets would be exempt from tax. Alternatively, the Regulations should consider clarifying that the look-through rule for USRPIs under Section 897(g) applies to treat a selling partner or beneficiary as selling the actual underlying property, so that to the extent the partnership or trusts has USRPHCs, the Section 892 investor's portion of the gain from the sale of the partnership or trust interest that is attributable to such USRPHC is eligible for Section 892 benefits (provided the USRPHC is not a CCE).

3. *Clarify definition of "effective practical control"*

Section 892(a)(2)(B)(ii) provides that an entity is a "controlled entity" not only if the foreign government holds 50 percent or more of its interests by vote or value, but also if the foreign government holds any other interest in the entity which provides it with "effective control" over the entity. Temporary Treasury Regulation Section 1.892-5T(a)(2) uses the term "effective practical control." The current Temporary Regulations provide few examples on when a foreign government has "effective practical control," with the result that a government-owned entity faces uncertainty in many situations, including acquiring debt securities of U.S. issuers, particularly in distressed debt situations, investments in funds, and equity investments. The examples provided include a substantial minority interest where the remaining interest in the entity is widely held, as well as creditor, contractual, or regulatory relationships which, together with ownership interests, achieve effective practical control.

Recommendation

The meaning of "effective practical control" should be clarified with specific examples of arrangements and specific rules that do and do not constitute effective practical control. Specifically, regulations should provide that where a government owns a minority equity interest, by vote and value, in an entity and nothing else, the entity will never be treated as effectively controlled by the government. The current rule that provides that a minority interest on its own may constitute control leads to substantial uncertainty, and it is subject to factors beyond the government's control (*e.g.*, dependent on whether other investors act in concert). Moreover, regulations should also provide that a significant creditor interest in combination with a small equity interest of itself should not be treated as effective practical control.

Such additional guidance would be especially useful in the context of limited partnerships and limited liability companies, as well as in situations where government investment funds acquire debt securities of U.S. issuers, including distressed debt.

For example, uncertainty arises where a foreign government has a controlling interest in a fund manager, but only has a non-controlling minority interest in the investment fund operated by the fund manager. In such a case, does the effective practical control rule apply to mean that the fund itself is a controlled entity of the foreign government merely because it controls the fund manager? In such a scenario, the fund manager usually has a fiduciary duty to the fund investors, and accordingly is required to exercise its management discretion in such a way that it does not solely benefit the governmental investor. Regulations should similarly clarify that control over a fund manager does not lead to effective control over a fund in which the government owns only a minority interest, absent evidence that the government is using its control of the fund manager to actually control the fund.

4. *Clarify definition of "private inurement"*

The Proposed Regulations do not address the private inurement restrictions of Section 892. The financial services industry, with which SWFs regularly interact, commonly compensates advisors, brokers and employees based on asset performance, thus aligning their interests with investors. Such arrangements, if they are reflective of market terms, are common forms of remunerations that we do not believe implicate the private inurement restrictions.

Recommendation

> We recommend that regulations clarify that incentive compensation arrangements for investment advisors, brokers, or employees are not considered to be private inurement to the benefit of individuals that jeopardizes the eligibility of a controlled entity to claim an exemption under Section 892, provided that such compensation arrangements reasonably reflect market terms.

Conclusion

The Proposed Regulations provide significant relief in several areas of particular concern to foreign governments with investments in the United States. We appreciate the efforts undertaken by Treasury and the IRS in being responsive to several of the most important concerns voiced by foreign governments. We believe the comments and recommendations we have outlined above delineate additional important steps that may be taken to solve some of the problems encountered by foreign governments seeking to invest in the United States, and our recommendations will provide further certainty in applying the rules of Section 892.

Please feel free to contact us with any questions.

Sincerely,

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