

Sovereign immunity: A US and European view

With the US recently proposing changes to the regulations under section 892 of the US Internal Revenue Code concerning investment through controlled entities by foreign governments including typical sovereign wealth funds, Peter Blessing and Ansgar Simon of Shearman & Sterling in New York provide an update on the US position and briefly compare the overall approach taken in the US with that taken in the UK, France and Germany.

For a sovereign state, exemption from tax in other states can be an important consideration when considering whether or not, or how, to make investments in those other states. It is an area of increasing significance, in part explained by the perceived prominence of sovereign wealth funds in recent years. Different states have taken different approaches to giving exemption from tax to other sovereign states. Some, like the US, take a rather more prescriptive approach than others (this is examined further below). As a result of this more prescriptive approach, the recently proposed changes to relevant provisions of US federal income tax (US tax) law are of significant interest.

Special US tax provisions relating to the commercial and investment activities of non-US governments have a long history, going back to 1917. These provisions, now contained in section 892 of the Internal Revenue Code, were last overhauled in 1986. They exempt from US tax certain qualified income of “foreign governments” (which for US tax purposes includes their wholly-owned entities). Not exempted, however, is any income that is (i) derived from the conduct of any commercial activity, (ii) received by a controlled commercial entity, (iii) received from such an entity, or (iv) derived from the disposition of any interest in such an entity. A controlled commercial entity is one that is engaged in commercial activity if the foreign government owns 50% or more by vote or value of any interest or otherwise has effective control.

Under Treasury regulations issued, in temporary form, in 1988 and not finalised or modified until additional regulations were proposed in November 2011 (with one small exception) (proposed regulations), any controlled entity of a foreign government that engages in the conduct of any commercial activity anywhere in the world at any time has been treated as a controlled commercial entity. In that case, every item of income of the entity has been characterised as commercial activities income, even if it is otherwise qualified income.

Commercial activities are broadly defined as those that are ordinarily conducted with a view towards current or future production of income or gain. The Code and the 1988 regulations contain a narrow list of exclusions, among them (1) investments in stocks, bonds and other securities, or loans and (2) investments in other financial instruments, but only if held in the execution of governmental financial or monetary policy.

The section 892 exemption from US tax for qualified income of foreign governments extends beyond the integral parts and functions of a foreign sovereign and includes a controlled entity of the sovereign. Control here differs from that for controlled commercial entities by requiring that the entity is wholly owned (and not merely 50% or more owned) by the foreign sovereign, either directly or through other such controlled entities, and organised under the laws of the foreign sovereign, and that certain other conditions are satisfied. It is such controlled entities, such as sovereign wealth funds or pension funds set up as separate entities by a for-

ign sovereign, which had much to fear from the rigid standard of the 1988 regulations. While it has been possible to structure around many constraints, costs and administrative burdens were involved, and there remained residual risk that some de minimis inadvertent commercial activity would make the section 892 exemption unavailable.

The proposed regulations address some, but not all, of the issues. They substantially modernise the concepts of commercial activity and controlled commercial entity. These changes significantly increase the flexibility of foreign governments to choose and structure investments using controlled entities without risking loss of the section 892 exemption.

Although the proposed regulations are not effective until published as final, the preamble notably states that taxpayers may rely

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on the proposed regulations, until final regulations are issued. The preamble does not indicate whether such reliance is only permitted from and after the date of release (November 2 2011), or for the entire current taxable year, but absent further guidance it would be the former.

Financial instruments and certain US real property interests

All investments in financial instruments (in addition to the already-exempted investment in stocks, bonds and other securities) are excluded from commercial activities under the proposed regulations, regardless of whether the investment is made in the execution of governmental financial or monetary policy. Thus, a controlled entity may invest in options, futures contracts, swaps or other derivatives without risking a loss of its section 892 exemption (though the treatment of foreign currency and precious metals derivatives remains unclear). While the income from such instruments continues not to be exempt from US tax under section 892 unless derived in the execution of governmental financial or monetary policy, such income or gain (other than certain US dividend equivalent amounts) generally is not subject to US tax in any event when recognised by a foreign person that is not a dealer. An issue to be clarified is the treatment of dividend equivalent amounts as exempt or not under section 892.

A disposition of a US real property interest does not constitute the conduct of a commercial activity, as clarified by the proposed regulations. Gain from the disposition of such an interest is generally treated as effectively connected with the conduct of a US trade or business. Gain from the disposition of a direct interest in US real property is not qualified income, nor is gain from the disposition of an indirect interest held through a partnership or through a controlled US real property holding corporation. By contrast, the section 892 exemption continues to be available for gain from the disposition of stock of a non-controlled US real property holding company. The proposed regulations, however, do not fix the outstanding issue that technically such exemption does not extend to the situation where such stock is held through a partnership. They also do not address a major trap under the 1988 regulations whereby a controlled entity may become a controlled commercial entity based on indirect US real property interests.

Exception for inadvertent tainted income

The proposed regulations also advance a more pragmatic approach to investments of foreign governments through controlled entities by allowing for inadvertent commercial activity without the loss of the section 892 exemption, provided the activity is cured within 120 days from its discovery. To be inadvertent, the failure to avoid conducting the commercial activity must be reasonable, which is determined based on all facts and circumstances (including the number of commercial activities and the amount of income earned therefrom). However, the controlled entity must have due diligence processes in place to prevent it from engaging in commercial activities, which must take

the form of adequate written policies and operational procedures to monitor the controlled entity's worldwide activities, and require that management-level employees make reasonable efforts to establish, follow and enforce such policies and procedures.

With such due diligence procedures in place, a failure to avoid commercial activities is reasonable so long as, during the relevant taxable year, (1) no more than 5% of the controlled entity's assets are used in, or held for use in, the commercial activities and (2) no more than 5% of its gross income is from commercial activities. Income from inadvertent commercial activities, however, is never eligible for the section 892 exemption. Accordingly, a US tax filing obligation, if otherwise required, cannot be avoided.

Changes relating to commercial activities of partnerships

Interests in partnerships posed another risk for controlled entities to lose their section 892 exemption. Under the 1988 regulations, commercial activities of a partnership for US tax purposes (other than a publicly traded partnership) passed through to and hence tainted a controlled entity that invested in it, even if the controlled entity was a passive limited partner and regardless of the extent of the partnership's commercial activities (including indirectly through other entities treated as partnerships).

A major change under the proposed regulations is to no longer attribute a partnership's commercial activities to a partner that qualifies as a limited partner. A limited partner is any partner that has no right to participate in the management and conduct of the partnership's business (other than consent rights in the case of certain extraordinary



The US Treasury will work with the IRS to modify the proposed regulations before implementation

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events) under either the agreement that governs the partnership or the laws of the jurisdiction in which the partnership is organised. This exception does not apply, however, if the partnership is itself a controlled commercial entity (e.g., because the controlled entity that is a limited partner in it owns more than 50% of the partnership interests by value). Further, the limitation for management participation leaves unclear situations involving membership on an advisory committee as opposed to an operating role, and where an affiliate holds an interest in a general partner.

For investments by controlled entities as limited partners in partnerships engaged in commercial activities, the section 892 exemption applies on an investment-by-investment basis. Accordingly, although allocations of partnership income derived from commercial activities (such as management fees) do not qualify for the section 892 exemption, they do not affect the exemption of a limited partner's allocable share of otherwise qualified income.

In another change relating to partnerships, the proposed regulations extend the exception in the 1988 regulations that trading in stocks, bonds, other securities or commodities by a partnership for its own account will not be treated as a commercial activity of a controlled entity partner (unless the partnership is treated as a dealer). The exception is also broadened to apply to trading in any other financial instrument.

Annual testing

Under the proposed regulations, it is now clear that turning into a controlled commercial entity does not taint a controlled entity for its entire future. Rather, controlled commercial entity status is determined on an annual basis and, therefore, may change from one year to the next. For example, an investment of a controlled entity held through a partnership that has commercial activities but also generates eligible income may enjoy exemption for eligible income, without restructuring, as of the beginning of the entity's first fiscal year for which the proposed regulations are effective (absent additional guidance, 2012 in the case of a calendar year entity).

Comparison with significant European jurisdictions

By way of contrast with the prescriptive approach in the US, many European jurisdictions either take a less specific approach, or make no provision at all, as regards conferring exemption from tax on governments of other states. As a result, many European jurisdictions have not made, or needed to make, any changes to their relevant regimes for substantial periods of time.

UK

In the UK, for example, all income and gains that are beneficially owned by the head of state or the government of a non-UK sovereign state are generally exempt from UK direct taxes under the general principle of sovereign immunity. However, income and gains arising from any enterprise that is commercial in nature may not be immune (and the immunity does not apply at all to UK value added tax or UK stamp taxes). Unlike the US, the UK does not normally extend immunity to income and gains beneficially owned by legal entities that are separate from the sovereign state itself, even if wholly-owned by the sovereign state (although sovereign immunity may be granted to public bodies that are emanations of the state). Sovereign status is not automatic from a UK perspective, and would need to be confirmed on application to the UK authorities.

France

Under French domestic law, foreign states benefit from an exemption from French tax only on dividends, interest and capital gains on the sale of French real estate and shares in French companies. Royalties, business income and rental income from French real estate received by foreign states remain subject to French taxation, subject to the applicable double taxation treaties. The sovereign exemption is subject to a prior ruling from the French Ministry of Finance when the investment of the foreign state allows it to take control over a French company. The exemption is generally not extended to legal entities separate from the state itself, except that foreign public institutions may benefit from it subject to a prior ruling from the French Ministry of Finance.

Germany

German tax law, on the other hand, does not provide for any specific tax exemption for income received by a non-German sovereign state (or any authority of such a state) or a legal entity which is legally or beneficially owned by such a sovereign state. This means that

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any German source income from investment or commercial activities of non-German sovereign states is generally subject to regular German corporate income taxation, regardless of direct or indirect investment structures. As a public law corporation, a non-German sovereign state is generally, subject to certain restrictions, also entitled to any tax relief (such as participation exemptions) that would apply to a German resident corporation. Further, a non-German sovereign state should generally be considered a qualifying person within the meaning of German double taxation treaties and therefore be entitled to benefits under such treaties.

A welcome step

With the proposed regulations, US tax law takes a welcome step to adapt to the investment realities faced by non-US governments and their wholly-controlled investment entities by making investments through private equity funds more flexible and allowing for investments in derivatives. It also removes the punitive and incurable cliff effect if such entities were to engage in commercial activities. There remain, however, problems under the regulations, in particular, the rule that can result in a controlled entity becoming a controlled commercial entity simply because of indirectly held US real property assets held on a look-through basis. It is anticipated that US Treasury and the Internal Revenue Service will modify the proposed regulations before their finalisation, taking into account such comments as may be received.

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