Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Proposed Regulations Issued under Section 892

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations issued under section 892. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William M. Paul  
Chair, Section of Taxation

cc: Emily S. McMahon, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
William J. Wilkins, Chief Counsel, Internal Revenue Service  
Manal S. Corwin, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury  
Michael J. Caballero, International Tax Counsel, Department of the Treasury
The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Len Schneidman and Michael J. Miller of the Committee on U.S. Activities of Foreigners and Tax Treaties. Substantial contributions were made by Ian Bristol, Janine Burman, Alan T. Cathcart, William Corcoran, Eduardo A. Cukier, Mario Fulgieri, Alan Granwell, Witold M. Jurewicz, Jim Lynch, Jonathan Marseglia, Mark Melton, and Jeffrey M. Trinklein. The Comments were reviewed by Alan I. Appel, Chair of the Committee on U.S. Activities of Foreigners and Tax Treaties. The Comments were further reviewed by Fred Murray of the Section's Committee on Government Submissions and by Joan Arnold, Council Director for the Committee on U.S. Activities of Foreigners and Tax Treaties.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact: Len Schneidman          Michael J. Miller
         (617) 292-8422          (212) 903-8757
         len.schneidman@wtas.com  mmiller@rhtax.com

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EXECUTIVE SUMMARY

These Comments address the proposed regulations released by the Treasury Department on November 3, 2011 under section 892 (the "Proposed Regulations"). Comments on the Proposed Regulations were requested to be submitted by February 1, 2012.

Section 892 provides an exemption from U.S. federal income taxation (the "sovereign exemption") for certain types of income from investments by "foreign governments." Pursuant to section 892(a)(2)(A), the sovereign exemption does not apply to any income:

(i) derived from the conduct of any commercial activity (whether within or outside the United States),

(ii) received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or

(iii) derived from the disposition of any interest in a controlled commercial entity.

The Proposed Regulations would:

1. Permit certain inadvertent commercial activities to be disregarded in determining whether a controlled entity is a controlled commercial entity ("CCE").

2. Adopt an annual test for CCE status.

3. Provide additional guidance as to what activities constitute the conduct of commercial activity, including the expansion of certain existing safe harbors.

4. Modify the existing rule that attributes the commercial activities of a partnership to all of its partners, to provide an exception for any entity that is considered to own "an interest as a limited partner in a limited partnership."

As explained in greater detail below, our recommendations are as follows:

1. We recommend that, in connection with the proposed exception for inadvertent commercial activity:

   a. An entity with de minimis commercial activities be deemed to satisfy the requirement of having reasonably failed to prevent its worldwide activities from resulting in

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1 Notice of Proposed Rulemaking, REG-146537-06 (Nov. 3, 2011). References to a "section" herein are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated herein, and references to a "Reg. §" are to the Treasury Regulations issued under the Code.

2 The preamble to the Proposed Regulations (the "Preamble") states that comments must be received within 90 days from the date of publication in the Federal Register.
commercial activities. This could be accomplished, for example, by amending the proposed safe harbor to eliminate the due diligence requirement.

b. The due diligence requirement be: (i) clarified to provide that the requisite written policies and operational procedures must be "reasonable" (rather than "adequate"); (ii) clarified to provide additional guidance as to what will qualify as "reasonable efforts," and that a safe harbor apply where an entity has engaged competent advisors to provide guidance on an investment and provided such advisors, on an ongoing basis, with all of the information reasonably believed to be pertinent; and (iii) modified to provide that the requisite "reasonable efforts" may be carried out by employees (or officers) of an affiliated entity.

d. The requirement to promptly "cure" an inadvertent commercial activity be clarified (i) to confirm (if we are correct) that discontinuing the inadvertent commercial activity within 120 days of discovery is the exclusive means of satisfying the cure requirement (rather than a safe harbor); (ii) to provide that, in the case of a entity considered to be engaged in commercial activity solely by reason of being a partner in a partnership that is so engaged, the exchange of such entity's interest for one that qualifies for "non-attribution" (by reason of being "an interest as a limited partner in a limited partnership") qualifies as discontinuing the commercial activity; and (iii) to provide that discovery be limited to discovery of the commercial activity by an officer or employee of the entity who would reasonably be expected to be aware of the significance of conducting commercial activity.

e. The safe harbor be modified so that, in the case of an entity that does not prepare separate financial statements, the income and asset tests may be applied by reference to other books and records maintained by or for the entity in the ordinary course of business.

2. We recommend that, in connection with the requirement of annual testing for CCE status, guidance be provided as to whether the "taint" of having engaged in commercial activities carries over to a controlled entity that acquires the assets of the CCE in a reorganization or other transaction in which the transferee would normally succeed to certain tax attributes of the transferor under section 381.

3. We recommend that the "per se corporation" rule of Treasury Regulation section 301.7701-2(b)(6) be modified so that a business entity that is wholly owned by a foreign government is not precluded from electing to be disregarded as an entity separate from its owner.

4. We recommend that the provision of the existing temporary regulations that deems any United States real property holding corporation ("USRPHC") to be engaged in commercial activity be eliminated. Alternatively, we recommend that, the provision be modified to apply solely to a corporation that would be a USRPHC if the references in section 897(c)(2) to United States real property interests were replaced by references to United States real property interests described in section 897(c)(1)(A)(i).

5. We recommend that the safe harbor, whereby certain investments and transactions in stocks, securities, financial instruments and commodities are not considered to constitute
commercial activities, be amended to include investments by a foreign government, for its own account, in derivatives, as defined in Proposed Regulation section 1.864(b)-1.

6. We recommend that the rule treating the making of investments by a banking, financing, or similar business as commercial activities be clarified to incorporate the definition of a banking, financing, or similar business set forth in Treasury Regulation section 1.864-4(c)(5)(i).

7. We recommend that, with respect to the proposed attribution exception for any entity that holds "an interest as a limited partner in a limited partnership":
   a. Proposed Regulation section 1.892-5(d)(5)(iii)(B), which provides that a partnership interest "shall be treated" as an interest as a limited partner in a limited partnership if a "no-right-to-participate test" (described below) is satisfied, be clarified to confirm that a partnership interest will qualify for the attribution exception only if the no-right-to-participate test is satisfied.
   b. The no-right-to-participate test be modified to permit certain typical consent rights, as part of an investment advisory committee, with respect to relatively infrequent, key decisions outside day-to-day management. We also request confirmation that the execution of certain side letters will not violate the no-right-to-participate test.

8. We recommend that, in the case of a foreign sovereign that is a partner in a partnership, the regulations be clarified to confirm that the foreign sovereign's distributive share of any income earned through a partnership qualifies for exemption under section 892 to the same extent as if such income had been earned directly by the foreign sovereign. We recommend that, for this purpose, the regulations be amended to clarify that CCE status for any relevant entity be based on the indirect interest of the foreign sovereign, not the direct interest of the partnership.

9. We recommend that, in the case of a foreign sovereign that disposes of an interest in a partnership, the regulations provide that the foreign sovereign's gain on such disposition may qualify for exemption under section 892 to the extent such gain is attributable to assets of the partnership with respect to which gains would have so qualified if earned directly by the foreign sovereign. We recommend that, for this purpose, the regulations be amended to clarify that CCE status for any relevant entity be based on the indirect interest of the foreign sovereign, not the direct interest of the partnership.

10. We recommend that, when the Proposed Regulations are finalized, taxpayers be permitted to apply the provisions of such regulations to all open taxable years.
I. Overview of Section 892 and Existing Temporary Regulations

A. Introduction

Section 892 provides a sovereign exemption for certain types of income from investments by "foreign governments." The types of income that may potentially qualify, and the requirements for availability of the exemption, are described below.

B. Foreign Government

The statute does not define the term "foreign government." Pursuant to certain temporary regulations promulgated on June 27, 1988 (the "Temporary Regulations"), the term "foreign government" includes the "integral parts" and "controlled entities" of a foreign sovereign.

An integral part of a foreign sovereign is "any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country." An integral part of a foreign sovereign.

A controlled entity of a foreign sovereign is defined as follows:

(3) Controlled entity. -- The term "controlled entity" means an entity that is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity if it satisfies the following requirements:

(i) It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;

(ii) It is organized under the laws of the foreign sovereign by which owned;

(iii) Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and

(iv) Its assets vest in the foreign sovereign upon dissolution.

Note that, because such regulations were promulgated prior to the effective date of the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, 102 Stat. 3342 the "sunset" provisions of section 7805(e)(2) do not apply.


Temp. Reg. § 1.892-2T(a)(2). The regulation adds that "The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person. An integral part does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity. Consideration of all the facts and circumstances will determine whether an individual is acting in a private or personal capacity."

Temp. Reg. § 1.892-2T(a)(3). The regulation adds that "a controlled entity does not include partnerships or any other entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial
C. Categories of Exempt Income

The categories of income that may qualify for the sovereign exemption (the "exempt 892 income") are set forth in section 892(a)(1). Under section 892(a)(1), the sovereign exemption may apply to income received by a foreign government from:

(A) investments in the United States in--

   (i) stock, bonds, or other domestic securities owned by such foreign governments, or

   (ii) financial instruments held in the execution of government or monetary policy, or

(B) interest on deposits in banks in the United States of moneys belonging to such foreign governments.

The Temporary Regulations clarify that income from investments in stocks, bonds or other securities includes gain from the disposition of such investments, as well as income earned from engaging in section 1058 securities lending transactions.

The Temporary Regulations provide that the exemption does not apply to "income earned from a U.S. real property interest described in section 897(c)(1)(A)(i)", "any gain derived from the disposition of a U.S. real property interest defined in section 897(c)(1)(A)(i)", or "gain on the disposition of an interest in a partnership or a trust".

The Temporary Regulations also elaborate on what constitutes a security for purposes of the sovereign exemption:

For purposes of paragraph (a) of this section, the term “other securities” includes any note or other evidence of indebtedness. Thus, an annuity contract, a mortgage, a banker’s acceptance or a loan are securities for purposes of this section. However, the term “other securities” does not include partnership interests (with the exception of publicly traded partnerships within the meaning of section 7704) or trust interests. The term also does not include commodity forward or futures contracts and commodity options unless they constitute securities for purposes of section 864(b)(2)(A).

organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity for purposes of this section."


D. Commercial Activity Disqualifiers

1. Overview

Pursuant to section 892(a)(2)(A), the sovereign exemption does not apply to any income:

(i) derived from the conduct of any commercial activity (whether within or outside the United States),

(ii) received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or

(iii) derived from the disposition of any interest in a controlled commercial entity.

If, therefore, an integral part of a foreign sovereign engages directly in commercial activity, the income arising from such commercial activity is ineligible for the sovereign exemption, but the exempt 892 income (income derived from qualified investments) remains eligible. In contrast, however, if a controlled entity engages in commercial activity, anywhere in the world, such that the controlled entity becomes a CCE, then all income received by or from such entity (including from the disposition of such entity) is ineligible. In light of this "all or nothing" rule, even a minor "foot-fault" that causes a controlled entity to be considered engaged in commercial activity can have devastating and disproportionate consequences.

2. Scope of Commercial Activity

As noted above, income derived from the conduct of any commercial activity is ineligible for the sovereign exemption. Unfortunately, the statutory language of section 892 provides no guidance as to what does or does not constitute commercial activity.

The Temporary Regulations generally provide that, unless a safe harbor applies, "all activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain are commercial activities." They further provide that "[a]n activity may be considered a commercial activity even if such activity does not constitute the conduct of a trade or business in the United States under section 864(b)."

The Temporary Regulations provide a safe harbor, however, pursuant to which the making of certain investments, and certain trading activities, are excluded from the scope of commercial activities. 9 For example, subject to certain exceptions (for dealers and investments made by a banking, financing, or similar business) exempt activities include:10

- Investments in stocks, bonds, and other securities.

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9 Temp. Reg. § 1.892-4T(c)(1).
10 Temp. Reg. § 1.892-4T(c)(1)(i) - (iii).
• Loans.

• Investments in financial instruments held in the execution of governmental financial or monetary policy.

• The holding of net leases on real property or land that is not producing income (other than on sale or from net leases).

• The holding of bank deposits in banks.

• Effecting transactions in stocks, securities, or commodities for a foreign government's own account, regardless of whether effected by the foreign government through its employees, or through a broker, commission agent, custodian, or other independent agent, and regardless of whether any such employee or agent has discretionary authority to make decisions in effecting the transactions.

However, "[i]nvestments (including loans) made by a banking, financing, or similar business constitute commercial activities, even if the income derived from such investments is not considered to be income effectively connected to the active conduct of a banking, financing, or similar business in the U.S. by reason of the application of § 1.864-4(c)(5)."

The Temporary Regulations also provide safe harbors for certain performances and exhibitions of amateur athletic events and events devoted to the promotion of the arts; non-profit activities; government functions; and the mere purchasing of goods.

3. Definition of Controlled Commercial Entity

As indicated above, section 892(a)(2)(A)(ii) and (iii) provide that any income derived by or from a CCE, or from the disposition of an interest in a CCE, is ineligible for the sovereign exemption. For this purpose, section 892(a)(2)(B) defines CCE as follows:

(B) Controlled commercial entity. For purposes of subparagraph (A), the term "controlled commercial entity” means any entity engaged in commercial activities (whether within or outside the United States) if the government—

(i) holds (directly or indirectly) any interest in such entity which (by value or voting interest) is 50 percent or more of the total of such interests in such entity, or

(ii) holds (directly or indirectly) any other interest in such entity which provides the foreign government with effective control of such entity.


12 Temp. Reg. § 1.892-4T(c)(2) - (5).
For purposes of the preceding sentence, a central bank of issue shall be treated as a controlled commercial entity only if engaged in commercial activities within the United States.

The Temporary Regulations reiterate the provisions of the statute and, in addition, set forth a number of rules for when the commercial activities of an entity will or will not be attributed to another entity. These rules provide as follows:

- **Brother/sister entities.** Commercial activities of a controlled entity are not attributed to such entity's other "brother" or "sister" entities.\(^{13}\)

- **Subsidiary to parent attribution.** Commercial activities of a subsidiary controlled entity are not attributed to its parent.\(^{14}\)

- **Parent to subsidiary attribution.** Commercial activities of a parent controlled entity are attributed to its subsidiary.\(^{15}\)

- **Partnerships.** Except for partners of publicly traded partnerships, commercial activities of a partnership are attributable to its general and limited partners for purposes of section 892.\(^{16}\)

The Temporary Regulations also provide that "[a] United States real property holding corporation, as defined in section 897(c)(2) or a foreign corporation that would be a United States real property holding corporation if it was a United States corporation, shall be treated as engaged in commercial activity" and is therefore a CCE if controlled by a foreign sovereign.\(^{17}\)

II. **Comments on the Proposed Regulations**

A. **Introduction**

On November 3, 2011, the Treasury Department released Proposed Regulations that would supplement, and in some respects modify, the Temporary Regulations that have been outstanding since 1988.\(^{18}\) As discussed in greater detail below, the Proposed Regulations would:

- Permit certain inadvertent commercial activities to be disregarded in determining whether a controlled entity is a CCE.

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\(^{13}\) Temp. Reg. § 1.892-5T(d)(1).


\(^{15}\) Temp. Reg. § 1.892-5T(d)(2)(ii). Therefore, otherwise-qualifying investment income derived by a subsidiary controlled entity does not qualify for the sovereign exemption if the subsidiary's parent is a CCE.

\(^{16}\) Temp. Reg. § 1.892-5T(d)(3). Presumably, the outdated reference to "general and limited partners" includes all members of a limited liability company classified as a partnership for U.S. federal tax purposes.

\(^{17}\) Temp. Reg. § 1.892-5T(b)(1).

\(^{18}\) Notice of Proposed Rulemaking, REG-146537-06 (Nov. 3, 2011).
• Adopt an annual test for CCE status.

• Provide additional guidance as to what activities constitute the conduct of commercial activity, including the expansion of certain existing safe harbors.

• Modify the existing rule that attributes the commercial activities of a partnership to all of its partners by providing an exception for any entity that is considered to own "an interest as a limited partner in a limited partnership."

The Proposed Regulations would take effect as of the date of publication of the Treasury decision adopting them as final regulations in the Federal Register. The Preamble also notes that taxpayers may rely on the Proposed Regulations until final regulations are issued.

B. Definition of Controlled Commercial Entity

1. Proposed Regulations

   a. Exception for Inadvertent Commercial Activity

   As noted above, the “all or nothing” rule provides that, if a controlled entity is engaged in commercial activity, anywhere in the world, all income received by or from such entity (including from the disposition of such entity) is ineligible for the sovereign exemption. As noted in the Preamble, several comments to the Treasury Department raised the concern that the "all or nothing" rule represents an unnecessary administrative and operational burden for foreign governments and a trap for unwary foreign governments that inadvertently conduct a small level of commercial activity.

   In response to these concerns, the Proposed Regulations would provide an exception whereby an entity will not be considered to be engaged in commercial activities if it conducts only “inadvertent commercial activity.” It should be emphasized that this "Inadvertent Commercial Activity Exception" would apply solely for purposes of determining whether an entity is a CCE. All of the income derived from such “inadvertent commercial activity” would remain ineligible for the sovereign exemption.

   The Inadvertent Commercial Activity Exception would apply only if: (1) the failure to avoid conducting the commercial activity is “reasonable” (the "reasonableness requirement"), (2) the commercial activity is “promptly cured” (the "cure requirement") and (3) certain record maintenance requirements are met. Each requirement is described in greater detail below.

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21 Id. (emphasis added).
i. **Reasonableness Requirement**

(A). **In General**

Whether the reasonableness requirement is met generally would be determined in light of all the facts and circumstances.\(^{22}\) Due regard will be given to the number of commercial activities conducted during the taxable year and in prior taxable years, as well as the amount of income earned from, and assets used in, the conduct of the commercial activity in relation to the entity’s total income and assets, respectively.\(^{23}\) For this purpose, where a commercial activity conducted by a partnership is attributed under Proposed Regulation section 1.892-5(d)(5)(i) to an entity owning an interest in the partnership (1) the assets used in the conduct of the commercial activity by the partnership are treated as assets used in the conduct of commercial activity by the entity in proportion to the entity's interest in the partnership; and (2) the entity’s distributive share of the partnership’s income from the conduct of the commercial activity shall be treated as income earned by the entity from the conduct of commercial activities.

(B). **Due Diligence Requirement**

A failure to avoid commercial activity will not be considered reasonable unless there is continuing due diligence to prevent the entity from engaging in commercial activities within or outside the United States, as evidenced by having adequate written policies and operational procedures in place to monitor the entity’s worldwide activities.\(^{24}\) A failure to avoid commercial activity will not be considered reasonable if the management-level employees of the entity have not undertaken "reasonable efforts" to establish, follow, and enforce such written policies and operational procedures.\(^{25}\)

(C). **Safe Harbor**

The Proposed Regulations provide a safe harbor pursuant to which an entity's failure to avoid commercial activity will be considered reasonable if, in addition to satisfying the continuing due diligence requirement: (1) the value of the assets used in, or held for use in, all commercial activity does not exceed five percent of the total value of the assets reflected on the entity’s balance sheet for the taxable year as prepared for financial accounting purposes; and (2) the income earned by the entity from commercial activity does not exceed five percent of the entity’s gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes.

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\(^{23}\) **Id.**


\(^{25}\) **Id.**
ii. **Cure Requirement**

Under the Proposed Regulations, the Inadvertent Commercial Activities Exception will apply only if, among other requirements, the commercial activity is "promptly cured."\(^{26}\) For this purpose, a "timely cure shall be considered to have been made if the entity discontinues the conduct of the commercial activity within 120 days of discovering the commercial activity."\(^{27}\)

The Proposed Regulations provide an example regarding the cure requirement where a controlled entity holds an interest as a general partner in a partnership that is conducting commercial activities.\(^{28}\) The example concludes that the controlled entity will satisfy the cure requirement if within 120 days of discovering the commercial activity either (a) it divests itself of the interest in the partnership (including a transfer to a related party) or (b) the partnership discontinues its commercial activities.\(^{29}\)

iii. **Record Maintenance**

The Proposed Regulations require an entity to maintain adequate records of each discovered commercial activity and the remedial action taken to cure that activity.\(^{30}\) An entity must retain those records so long as the contents thereof may become material in the administration of section 892.\(^{31}\)

b. **Annual Testing**

Pursuant to section 892(a)(2)(B), a controlled commercial entity is defined as any controlled entity "engaged" in commercial activities. Neither this provision of the Code nor the corresponding provision of the Temporary Regulations indicates whether, or for how long, a controlled entity that previously engaged in commercial activities remains "tainted" as a CCE.

The Proposed Regulations would resolve this uncertainty by adopting an "annual testing rule," to the effect that if a controlled entity "engages in commercial activities at any time during a taxable year, the entity will be considered a controlled commercial entity for the entire taxable year."\(^{32}\) A controlled entity that is not engaged in commercial activities at any time during the taxable year, however, will not be considered a CCE for such year, "even if the entity engaged in commercial activities in a prior taxable year."\(^{33}\)


\(^{28}\) Id.

\(^{29}\) Id.


\(^{31}\) Id.


\(^{33}\) Id.
2. Comments
   
a. Exception for Inadvertent Commercial Activity

   Preliminarily, we appreciate the tremendous difficulty faced by the Treasury Department in attempting to alleviate the disproportionately punitive nature of the "all or nothing" rule within the confines of the statute.\textsuperscript{34} The proposed Inadvertent Commercial Activities Exception would provide welcome relief to many foreign sovereigns with controlled entities that have unintentionally engaged in some minimal amount of commercial activity. We do, however, have several comments regarding matters where we believe clarifications or modifications would be helpful.

   i. Reasonableness Requirement

   As noted above, the reasonableness requirement is satisfied only if, among other things, a continuing due diligence requirement is satisfied "by having adequate written policies and operational procedures in place to monitor the entity's worldwide activities."\textsuperscript{35}

   We anticipate, however, that many controlled entities that inadvertently engage in some minimal level of commercial activity will be unable to satisfy the due diligence requirement, because they will not have the requisite written policies and operational procedures in place. Given the severe consequences attendant to the conduct of commercial activities under the all or nothing rule, we recommend that the standard of review to determine if reasonableness is met should take into account situations in which commercial activity is truly minimal.

   Accordingly, we recommend the adoption of a \textit{de minimis} rule, whereby an entity with \textit{de minimis} commercial activities would satisfy the reasonableness requirement, even if its written policies and procedures fall short of the mark.\textsuperscript{36} This could be accomplished, for example, by amending the proposed safe harbor to eliminate the due diligence requirement.\textsuperscript{37}

   To the extent that the due diligence requirement continues to apply, we are concerned that the meaning of “adequate” policies and procedures may be unclear. In particular, it may be argued that if the policies and procedures were adequate, no commercial activity would have occurred; so, by definition, the policies and procedures are always inadequate when a failure to avoid conducting commercial activities occurs. To eliminate this concern, we recommend that “adequate” be replaced with “reasonably suitable.”

   Notably, even if the requisite policies and procedures are in place, the reasonableness requirement will be satisfied only if management-level employees of the entity have undertaken

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\textsuperscript{34} Whether the "all or nothing" rule serves any coherent policy objective seems doubtful, but we recognize, of course, that this is not a problem the Treasury Department is empowered to solve.


\textsuperscript{36} In effect, inadvertence would be presumed in such circumstances.

\textsuperscript{37} Each test could, for example, be applied by reference to the entity's financial statements or, if no such statements exist, other books and records prepared in the ordinary course of business.
"reasonable efforts" to establish, follow, and enforce such policies and procedures.\(^{38}\) We recognize that the inquiry is inherently fact-specific, but we believe it would be helpful for the Treasury Department and the Service to provide guidance as to what qualifies as “reasonable efforts” for this purpose. We recommend that a safe harbor apply where the entity has engaged competent advisors to provide guidance on an investment and provided such advisors, on an ongoing basis, with all of the information reasonably believed to be pertinent. Alternatively, examples of what efforts do and do not qualify as reasonable would be helpful. We also recommend that an entity be permitted to use employees (or officers) of an affiliated entity to make the requisite reasonable efforts.

Whether not the safe harbor is amended (to eliminate the due diligence requirement) as recommended above, we note that there may be entities that do not prepare separate financial statements. We recommend that, in such circumstances, an entity be permitted to apply the safe harbor by reference to other books and records that may be maintained by or for the entity in the ordinary course of business.

\[\text{ii. Cure Requirement}\]

The Proposed Regulations provide that the cure requirement is satisfied if the entity discontinues the conduct of the commercial activity within 120 days of discovering the commercial activity.\(^ {39}\) Preliminarily, we assume that this 120-day rule was intended as the exclusive means of satisfying the cure requirement, and not a safe harbor, but we recommend that this be clarified, and if possible it be a safe harbor.

Furthermore, we believe that additional guidance should be made available for an entity that is engaged in inadvertent commercial activity solely by reason of being a partner in a partnership that is so engaged (whether directly or through a lower-tier partnership). In such circumstances, we believe that exchanging the entity's partnership interest for one that qualifies for "non-attribution," as an "interest as a limited partner in a limited partnership," as a safe harbor, but we recommend that this be clarified, and if possible it be a safe harbor.

We also recommend that "discovery" for these purposes be limited to discovery of the commercial activity by an officer or employee of the entity who would reasonably be expected to be aware of the significance of conducting commercial activity.

Finally, we note that the Proposed Regulations appear to use the terms "promptly" and "timely" interchangeably.\(^ {41}\) We recommend that the usage be consistent, and believe that

\(^{38}\) Id.


\(^{40}\) See Prop. Reg. § 1.892-5(d)(5)(iii).

\(^{41}\) Proposed Regulation section 1.892-5(a)(2)(i)(B) requires that the commercial activity be "promptly cured as described in paragraph (a)(2)(iii) of this section," but the latter provision describes the circumstances in which a "timely cure" is considered to have been made.
promptly is more in keeping with the intent. We view "timely" as indicating a deadline imposed by a governmental body.

b. **Annual Testing**

As noted above, the Proposed Regulations would adopt an annual testing rule for CCE status. An argument could be made that the entity should cease to be a CCE as of the day (or moment) that it ceases to engage in commercial activities, but we believe the approach of the Proposed Regulations is reasonable. The Treasury Department's confirmation that a controlled entity's commercial activity "taint" disappears after the end of the taxable year is extremely helpful.

We note, however, that the Proposed Regulations speak only to the status of the specific controlled entity that conducted commercial activities during a portion of the taxable year. A controlled entity that discovers it is a CCE and terminates its commercial activity may take certain steps in an attempt to avoid earning nonqualifying income for the remainder of the year. For example, it may transfer its (noncommercial) assets to another controlled entity in a reorganization or other transaction in which the transferee would normally succeed to certain tax attributes of the transferor under section 381. Since the transferee would presumably not have conducted commercial activities at any time during the year, it would presumably take the position that all of its income (including any income realized with respect to assets received from the transferor CCE) qualifies for the sovereign exemption.

It is not clear to us whether Treasury would view such a transaction as an abusive attempt to circumvent the annual testing rule and therefore take the position that the transferor's commercial activity "taint" carries over to the transferee. Our uncertainty derives in part from the fact that it is not clear to us whether the determination that CCE status should remain in place for the entire taxable year is based on policy grounds, or on considerations such as administrability and simplicity. We recommend that this point be clarified.

c. **Per Se Corporation Rule**

The entity-classification regulations include a rule that, though not addressed in either the Temporary or Proposed Regulations, is of critical importance to foreign sovereigns. Pursuant to Treasury Regulation section 301.7701-2(b)(6), the list of "per se corporations" includes:

A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in § 1.892-2T.

In the absence of this provision, a business entity that is wholly owned by an "integral part" of a foreign sovereign could elect to be classified as a disregarded entity for U.S. federal tax purposes. Consequently, the income of the disregarded entity would presumably be subject

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43 See Reg. § 301.7701-3(a). This assumes, of course, that the entity is not considered a per se corporation for some other reason.
to the more favorable rules applicable to integral parts, thereby avoiding potential application of the disproportionately punitive "all or nothing" rule.

Since any commercial income of the disregarded entity would, in any event, be ineligible for the sovereign exemption, we do not believe such planning would lead to an abuse or evasion of the rules. Therefore, we believe a change is supported by the policy of the statute, and accordingly, we recommend that Treasury Regulation section 301.7701-2(b)(6) be modified to remove the reference to entities owned by foreign governments.

C. **Definition of Commercial Activity**

1. **Proposed Regulations**

   For the most part, the Proposed Regulations merely reiterate the existing provisions of the Temporary Regulations as to what does or does not constitute commercial activity. They would, however, make two changes described below.

   a. **Disposition of USRPI**

      Section 897(a)(1) provides that a foreign corporation (or nonresident alien) must (1) take into account gain or loss from the disposition of a United States real property interest ("USRPI") as if the taxpayer were engaged in a trade or business within the United States and (2) as if such gain or loss were effectively connected with that trade or business. This has caused some concern as to whether a foreign sovereign that disposes of a USRPI may be deemed to be engaged in commercial activities solely by reason of such disposition.

      The Proposed Regulations provide that the disposition of a USRPI does not, by itself, constitute the conduct of a commercial activity.\(^{44}\) This rule would also apply to any "deemed disposition under section 897(h)(1)."\(^{45}\) Of course, any gain derived from the disposition of a USRPI described in section 897(c)(1)(A)(i) (i.e., "dirt") would remain ineligible for the sovereign exemption.\(^{46}\)

   b. **Expansion of Financial Instruments Safe Harbor**

      As indicated above, the Temporary Regulations include a safe harbor providing that the conduct of commercial activity does not include investments in financial instruments held in the execution of governmental financial or monetary policy. In response to comments the Proposed Regulations would expand this safe harbor to eliminate the requirement that such instruments be held in the execution of governmental financial or monetary policy.\(^{47}\)

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\(^{44}\) Prop. Reg. § 1.892-4(e)(1)(iv).

\(^{45}\) Id.

\(^{46}\) Temp. Reg. § 1.892-3T(a)(1) (flush language).

\(^{47}\) Prop. Reg. § 1.892-4(e)(1)(i).
It should be emphasized, however, that this change in the Proposed Regulations is limited to the issue of what constitutes commercial activity; it does not affect the scope of what income qualifies for the sovereign exemption. As noted in the Preamble, income from financial instruments will qualify for exemption only if such instruments are held in the execution of governmental financial or monetary policy.

2. Comments

a. Disposition of USRPI

As noted above, the Proposed Regulations provide that the disposition of a USRPI does not, by itself, constitute the conduct of a commercial activity.\(^{48}\) In our view, such confirmation is helpful and appropriate. In addition, the Temporary Regulations include a somewhat related rule upon which we feel compelled to comment (although this rule is not addressed by the Proposed Regulations).

Under the Temporary Regulations, "[a] United States real property holding corporation, as defined in section 897(c)(2) or a foreign corporation that would be a United States real property holding corporation if it was a United States corporation, shall be treated as engaged in commercial activity" and is therefore a CCE if controlled by a foreign sovereign.\(^{49}\)

Such a bright-line rule may conceivably have merit in the case of a corporation that principally owns United States real property interests described in section 897(c)(1)(A)(i) (i.e., "dirt"), but a corporation may be considered a USRPHC solely by reason of holding a minority interest in another USRPHC. For example, suppose that X is a controlled entity the only asset of which is a 1% interest in stock of a USRPHC, with a fair market value of $1 million. Under section 897(c)(2), X is a USRPHC because the fair market value of all of its USRPIs ($1 million) equals or exceeds 50% (and is in fact 100%) of the total fair market value of its worldwide real estate and business assets ($1 million). Consequently, the Temporary Regulations deem X to be engaged in commercial activities solely by reason of owning a 1% interest in a USRPHC. We do not believe this result is desirable.

Notably, the result would be no different if X’s assets consisted of (1) a 1% interest in a USRPHC, with a fair market value of $1 million, and (2) a 15% interest in a foreign hedge fund, with a fair market value of $3 million. Under section 897(c)(2), X is a USRPHC because the fair market value of all of its USRPIs ($1 million) equals or exceeds 50% (and is in fact 100%) of the total fair market value of its worldwide real estate and business assets ($1 million).\(^{50}\) The


\(^{49}\) Temp. Reg. § 1.892-5T(b)(1).

\(^{50}\) It is assumed that the special rule for investment companies, as set forth in Treasury Regulation section 1.897-1(f)(3)(ii), does not apply. Under this regulation, certain investments assets (that do not constitute USRPIs) of an entity are presumed to be used or held for use in a trade or business if the principal business of the entity is trading or investing in such assets for its own account. An entity is presumed to have such a principal business if the fair market value of the applicable investment assets equals or exceeds 90 percent of the sum of the total fair market value of the entity's total real estate and business assets (including such investment assets).
foreign hedge fund interest not relevant to this calculation, because it is not a real estate or business asset.\(^{51}\)

We do not believe these results are desirable, and recommend that this USRPHC rule be eliminated. If this suggestion is not adopted, we recommend that the provision be modified to apply solely to a corporation that \textit{would be} a USRPHC if the references in section 897(c)(2) to USRPIs were replaced by references to USRPIs described in section 897(c)(1)(A)(i).\(^{52}\)

b. \textbf{Expansion of Financial Instrument Safe Harbor}

In our view, expanding the safe harbor for investments in financial instruments to eliminate the requirement that such instruments be held in the execution of governmental financial or monetary policy is helpful and supported by the policy underlying the statute. A corresponding expansion of the definition of exempt 892 income would, of course, have been welcome as well; but we recognize that such further change would be difficult to reconcile with the statutory language of section 892(a)(1)(A)(ii).

c. \textbf{Investments in Derivatives}

Pursuant to certain safe harbors, commercial activities do not include, among other things, (1) investments in stocks, bonds, other securities, and certain financial instruments, and (2) transactions (other than by a dealer) in stocks, securities, or commodities for a foreign government's own account.\(^{53}\) As noted above, the Proposed Regulations expand the safe harbor for investments in financial instruments by eliminating the requirement that the financial instruments be held in the execution of governmental financial or monetary policy.

However, neither the Temporary Regulations nor the Proposed Regulations include any safe harbor for derivatives.\(^{54}\) In contrast, certain proposed regulations released in 1998 extend the section 864(b) safe harbor (under which certain transactions in stocks, securities, or commodities for the taxpayer's own account are not considered a "trade or business within the United States") to transactions in derivatives, and provide a detailed definition of the term "derivative" for this purpose.\(^{55}\) We recommend that the regulations be modified so that transactions by a foreign government, for its own account, with respect to derivatives (as so defined) do not constitute commercial activities.

\(^{51}\) Indeed, even if the foreign hedge fund were a corporation whose only assets consisted of foreign real estate, the stock of such corporation would not be taken into account, because there is no USRPHC counterpart that would treat stock of a foreign corporation as an interest in real property located outside the United States.

\(^{52}\) The rules of section 897(c)(5) would be retained so that it would still be possible to "look through" stock of a controlled USRPHC to the underlying United States real property interests described in section 897(c)(1)(A)(i).

\(^{53}\) Temp. Reg. § 1.892-4T(c)(1)(i).

\(^{54}\) Depending on the circumstances, a derivative may or may not be eligible for some other safe harbor.

\(^{55}\) See Prop. Reg. § 1.864(b)-1.
d. **Definition of Banking, Financing, or Similar Business**

The Proposed Regulations provide that "[i]nvestments (including loans) made by a banking, financing, or similar business constitute commercial activities, even if the income derived from such investments is not considered to be income effectively connected to the active conduct of a banking, financing, or similar business in the U.S. by reason of the application of §1.864-4(c)(5)."\(^56\)

Since the commercial activities that are relevant for purposes of section 892 may occur anywhere in the world, the Proposed Regulations provide, quite properly, that the absence of effectively connected income under Treasury Regulation section 1.864-4(c)(5) (e.g., by reason of conducting the relevant activities entirely outside the United States) does not preclude a foreign government from being engaged in a banking, financing, or similar business.

The Proposed Regulations are, however, silent as to what constitutes a "banking, financing, or similar business." Unless it is determined that policy considerations dictate otherwise, we recommend that the regulations be clarified to provide that the definition set forth in Treasury Regulation section 1.864-4(c)(5)(i)\(^57\) should govern for purposes of section 892 as well.\(^58\)

D. **Partnership Issues**

1. **Proposed Regulations**

   a. **Attribution Exception for Certain Limited Partners**

   As noted above, the Temporary Regulations provide that, except for partners of publicly traded partnerships, commercial activities of a partnership are attributed to its general and limited partners for purposes of section 892.\(^59\) The Proposed Regulations would introduce an exception for certain passive partners.

   Under the Proposed Regulations, an entity that is not otherwise engaged in commercial activities will not be deemed engaged in commercial activities solely because it holds "an

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57 Notably, Treasury Regulation section 1.864-4(c)(5) provides guidance as to (i) what constitutes a banking, financing, or similar business; (ii) when such a business is considered to be conducted in the United States; and (iii) when certain items of income will be considered "effectively connected" with the conduct of a banking, financing, or similar business in the United States (e.g., by reason of the relevant stocks or securities being attributable to a U.S. office and certain other requirements being satisfied).

58 Indeed, this may already be the informal position of the Service under the identically worded provisions of the Temporary Regulations. See PLR 9235061 (June 5, 1992). In this ruling, the Service concluded that a foreign government's export credit agency was not engaged in commercial activities under the Temporary Regulations, because its lending activities did not constitute a banking, financing, or similar business within the meaning of Treasury Regulation section 1.864-4(c)(5)(i).

The Proposed Regulations provide a "no-right-to-participate test," pursuant to which an interest in an entity classified as a partnership for federal tax purposes "shall be treated as an interest as a limited partner in a limited partnership if the holder of such interest 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 law of the jurisdiction in which the partnership is organized or under the governing agreement." 61 For this purpose, rights to participate in the management and conduct of a partnership's business do not include "consent rights in the case of extraordinary events such as the admission or expulsion of a general or limited partner, amendment of the partnership agreement, dissolution of the partnership, disposition of all or substantially all of the partnership’s property outside of the ordinary course of the partnership’s activities, merger or conversion." 62

b. Safe Harbor for Certain Partnership Trading Activities

As noted above, the Temporary Regulations provide that certain trading activities of a foreign sovereign for its own account do not constitute commercial activity. 63 However, some commentators have expressed concern that no corresponding rule applies in the case of comparable trading activities of a partnership with a foreign sovereign partner.

The Proposed Regulations address this concern by providing that an entity not otherwise engaged in commercial activities will not be considered so engaged solely because the entity is a partner in a partnership (whether domestic or foreign) that effects transactions in stocks, bonds, or other securities, commodities, or financial instruments for the partnership's own account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects such transactions for the account of the partnership. 64

2. Comments

a. Attribution Exception for Certain Limited Partners

As noted above, the Temporary Regulations attribute the commercial activities of a partnership to all partners in the partnership. Consequently, foreign governments are wary of causing their controlled entities to invest in entities classified as partnerships for federal tax purposes, for fear that any commercial activity of any such partnership would, through attribution, cause the controlled entity making the investment (and any subsidiary) to be treated

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60 Prop. Reg. § 1.892-5(d)(5)(iii)(A). Nevertheless, the foreign government’s “distributive share of partnership income derived from the conduct of a commercial activity will not be exempt from tax under section 892.”


63 Temp. Reg. § 1.892-4T(c)(1)(ii).

as a CCE. Given the extraordinarily punitive impact of the "all or nothing" rule described above, CCE status is a daunting prospect.

Pursuant to Proposed Regulation section 1.892-5(d)(5)(iii)(A), an entity that is not otherwise engaged in commercial activities will not be deemed engaged in commercial activities solely because it holds "an interest as a limited partner in a limited partnership." For purposes of the discussion below, an interest that meets this definition is referred to as a "Qualifying LP Interest."

The attribution exception for any entity that holds a Qualifying LP Interest will, in many instances, provide much-needed comfort to foreign sovereigns that they will not be subject to the disproportionately punitive "all or nothing" rule solely by reason of owning a purely passive interest in a partnership over which their controlled entities have no control. We do, however, have several comments regarding matters where we believe clarifications or modifications would be helpful.

First, we assume that a partnership interest will be a Qualifying LP Interest only if the no-right-to-participate test is satisfied, but this is not entirely clear from the Proposed Regulations. We recommend that this be clarified.

Second, the no-right-to-participate test may be unduly restrictive, thereby causing foreign governments to eschew investing in limited partnerships in certain situations. For example, it is not uncommon for a private equity fund to establish an “advisory committee,” and for certain large investors to negotiate with the fund for inclusion in the advisory committee. The advisory committee offers passive investors a small measure of oversight over a general partner with little equity investment in the partnership, but no influence over the vast majority of management decisions or day-to-day operations. For example, a partnership agreement may provide for advisory committee approval of (i) increasing partnership leverage above a predetermined level, (ii) transactions between the partnership and the general partner or an affiliate of the general partner, or (iii) investments that may violate investment diversification requirements of the partnership.

As the Proposed Regulations are presently drafted, there appears to be a substantial risk that such limited consent rights violate the no-right-to-participate test, because the events to which such consent rights relate may not qualify as extraordinary. Nevertheless, such consent rights seem sufficiently limited in scope that the holder should still be viewed as a largely passive investor to whom the attribution of commercial activities is not appropriate. Accordingly, we recommend that the regulations be modified to provide that rights to participate in the management and conduct of a partnership’s business also do not include typical consent rights, as part of an investment advisory committee, with respect to relatively infrequent, key decisions outside day-to-day management, such as those described above.

Similarly, it is not uncommon for foreign sovereign investors to negotiate side letter provisions, e.g., to require the fund to make some level of effort to avoid engaging in commercial activities, or to provide information needed to satisfy local regulatory requirements. We assume
that such side letters generally would not violate the no-right-to-participate test, but request confirmation.

Finally, we note that a provision in the Final Regulations may be necessary to amend the Temporary Regulations, if any remain after adoption of the Final Regulations, to coordinate their provisions with those in the Proposed Regulations. Temporary Regulation section 1.892-5T(d)(3) provides that, "[e]xcept for partners of publicly traded partnerships, commercial activities of a partnership are attributable to its general and limited partners for purposes of section 892." This general rule should, of course, be subject to the new exception introduced by the Proposed Regulations.

b. Safe Harbor for Certain Partnership Trading Activities

As indicated above, the Proposed Regulations would expand certain existing safe harbors for trading activities conducted directly by a foreign government so that they similarly apply to trading activities of a partnership in which a foreign government is a partner. In our view, the application of aggregate principles is well-supported by the policies underlying the statute and we support adoption of this change.

c. Income Earned Through Partnerships

Neither the statute, the Temporary Regulations, nor the Proposed Regulations expressly address the question of whether a foreign sovereign's distributive share of income earned through a partnership may qualify for the sovereign exemption under an aggregate approach to partnerships. Nevertheless, it is widely understood (and in at least one private letter ruling, the IRS has confirmed) that the sovereign exemption applies (to the extent that the foreign sovereign's distributive share of the partnership's income would have qualified if earned directly by the foreign sovereign partner).65

Moreover, the application of aggregate principles in this context seems implicit in both the Temporary Regulations and the Preamble. For example, in the context of the rule attributing the commercial activities of a partnership to its general and limited partners, the Temporary Regulations continue to point out that "where a controlled entity is a general partner in a partnership engaged in commercial activities, the controlled entity's distributive share of partnership income (including income described in § 1.892-3T) will not be exempt from taxation under section 892."66 The strong implication is that, absent any commercial activity problem, the controlled entity's distributive share of any qualifying income would have qualified for the sovereign exemption.

Similarly, in the context of describing the new rule that precludes attribution to the holder of a Qualifying LP Interest, the Preamble states that "the controlled entity partner's distributive share of partnership income attributable to such commercial activity will be considered to be derived from the conduct of commercial activity, and therefore will not be exempt from taxation.

65 See PLR 9643031 (Oct. 25, 1996).
under section 892." Again, the strong implication is that, to the extent the partnership earns qualifying income unrelated to any commercial activity, the controlled entity's distributive share may qualify for the sovereign exemption to the same extent as if such income had been earned directly by the controlled entity, rather than through the partnership. We recommend that the regulations be amended to expressly confirm this result.

We also recommend that the regulations clarify that CCE status in this context is based on the interest in the relevant entity that is indirectly held by the foreign sovereign, not the interest directly held by the partnership. For example, if a foreign sovereign owns a 1% interest in a partnership, and the partnership owns 100% of the stock of a domestic corporation, the regulations should confirm that the foreign sovereign's distributive share of any dividends received by the partnership from the domestic corporation may qualify for the sovereign exemption, because the corporation is not a CCE with respect to the foreign sovereign.

d. Sale of Partnership Interest

As noted above, the income that may qualify for the sovereign exemption is limited to income from stocks, bonds, other securities, certain financial instruments held in the execution of government financial or monetary policy, and certain bank deposits. The Temporary Regulations provide that the term "other securities" does not include partnership interests (other than publicly traded partnership interests described in section 7704), or interests in trusts. Moreover, they expressly provide that "[g]ain on the disposition of an interest in a partnership or a trust is not exempt from taxation under section 892." It is not clear whether the import of this provision is that section 892 can never apply when a foreign sovereign disposes of an interest in a partnership (or trust), or whether aggregate principles may still be applied to "look through" the interest in the partnership to the underlying assets for purposes of section 892. In this regard, we note that the principal scenario in which this question arises is one where the foreign sovereign sells an interest in a partnership that owns stock of a domestic corporation that is described in section 897(c)(1)(A)(ii), because the corporation is (or, during the applicable look-back period, was) a USRPHC.

In this situation, U.S. tax may potentially be imposed on a foreign partner in the partnership solely because section 897(g) imposes an aggregate approach for purposes of applying the FIRPTA rules. In our view, it would be improper to impose FIRPTA tax under an aggregate approach, without consistently applying an aggregate approach to permit application of the sovereign exemption under section 892. Accordingly, we recommend that the regulations be modified to provide that any gain arising from the disposition of a partnership

69 References to "FIRPTA" are to the Foreign Investment in Real Property Tax Act, Pub. L. No. 96-499, § 112(a), 94 Stat. 2599, 2682-87 (1980).
70 In this regard, we note that, even in the absence of regulations, the Service has previously applied an aggregate approach where sales of partnership interests are concerned. See Rev. Rul. 91-32, 1991-1 C.B. 107.
interest may qualify for the sovereign exemption to the extent that such gain is attributable to assets of the partnership with respect to which gains would have qualified for the sovereign exemption if earned directly by the foreign sovereign, e.g., gains with respect to a USRPHC that is not a CCE.

We also recommend that the regulations clarify that CCE status in this context is determined by reference to the interest in the relevant entity that is indirectly held by the foreign sovereign, not the interest directly held by the partnership. For example, if a foreign sovereign owns a 1% interest in a partnership, and the partnership sells 100% of the stock of a domestic USRPHC, the regulations should confirm that the foreign sovereign's gain from the sale of such 1% partnership interest qualifies for the sovereign exemption, because the USRPHC is not a CCE with respect to the foreign sovereign.

E. Effective Date

As noted above, the Proposed Regulations would take effect as of the date of publication of the Treasury Decision adopting them as final regulations in the Federal Register. Pursuant to the Preamble, taxpayers may rely on the Proposed Regulations until Final Regulations are issued.

It is not clear, however, whether taxpayers are permitted to apply the proposed regulations for taxable years that closed prior to issuance of the Proposed Regulations. We recommend that, when the Proposed Regulations are finalized, taxpayers be permitted (but not obligated) to apply the provisions of such regulations to all open taxable years, provided that they do so consistently.