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U.S. Taxation of Sovereign Wealth Fund Investments in Funds (and Real Estate): Where We Stand Today

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This article reviews the U.S tax regimes that apply to investments by sovereign wealth funds in the United States, with a particular focus on U.S. real property. The author then explains the interaction of these tax regimes and recently promulgated regulations on typical investment structures, distills the rules into analytical principles for reviewing investments by sovereign wealth funds in the U.S., and provides examples of typical fact patterns and how they are affected by these tax regimes and principles.

Introduction

Sovereign wealth funds (SWFs) continue to have an important role in funding investments in the United States, with one prominent recent example being a planned investment by Norway's SWF of $11 billion in U.S. real estate, a sector crucial to eventual U.S. economic recovery.[1] Naturally, tax planning is an integral component of structuring investments by SWFs, especially those involving real estate.

The United States has recently and significantly improved the rules in this area, especially with respect to investments in most types of hedge

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[1] Devin Banerjee, "Norway Wealth Fund to Spend $11B Adding U.S. Real Estate" (Bloomberg.com, Dec. 1, 2012), available at http://www.bloomberg.com/news/2012-11-30/norway-wealth-fund-to-invest-11-billion-in-u-s-property.html.

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funds.[2] Funds that have a real estate focus, however, do not benefit to the same extent. Because the policies undergirding taxation of SWFs and the general taxation of investment in real property by foreign persons are so different, they interact in unusual ways. The areas of potential conflict have been addressed only superficially in the Internal Revenue Code and regulations, and investors may encounter surprising outcomes.

Key Concepts

The key to understanding SWF taxation in the U.S. is understanding the basic categories of rules that apply. These are:

- Rules regarding foreign-source income;
- Rules regarding U.S. fixed, determinable, annual, or periodic (FDAP) income, roughly synonymous with passive income;
- Rules regarding effectively connected income (ECI);
- Rules regarding investment in U.S. real property;
- Rules regarding the income of foreign governments; and
- Rules regarding the income of controlled entities of foreign governments, which most closely, but not perfectly, correspond to the concept of SWFs.

Generally, foreign-source (non-U.S.) income of a non-U.S. person (whether an individual or an entity) is not subject to U.S. taxation absent something that relates that income to a U.S. trade or business under the default rules or a permanent establishment based on the application of an income tax treaty.[3] The most common form of foreign-source income of concern to those structuring investments is gains from disposition of U.S. investments. These gains are sourced as foreign under the Code and are not subject to taxation.[4]

FDAP income covers categories of income such as dividends, interest, royalties, and other income not treated as U.S. effectively connected income.[5] This income is subject to U.S. withholding tax.[6] Unless a tax treaty applies

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[2] See William M. Funk, "United States Open for Sovereign Wealth Fund Investment: The Proposed 892 Regulations" (RealTaxLaw, Nov. 21, 2011), available at http://www.realtaxlaw.com/home/index.php?option=com_content&view=article&id=69%3Aunited-states-open-for-sovereign-wealth-fund-investment-the-proposed-892-regulations&catid=42%3Afund-taxation&Itemid=1.

[3] IRC §§ 872(a), 882(b). References in the text to Section are to the Internal Revenue Code of 1986 (as amended) (the "Code" or "IRC"), unless otherwise specifically stated.

[4] IRC § 865(a).

[5] IRC §§ 871(a)(1), 881(a).

[6] IRC § 1441(a).

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or special statutory provisions apply, as in the case of portfolio interest, the withholding tax rate is 30 percent.[7]

ECI is income that is connected with a U.S. trade or business, and the quantum of activity that results in a finding of a U.S. trade or business depends on whether the permanent establishment rules apply to the taxpayer and on the income involved.[8] (This income is also interpreted by the Internal Revenue Service as including gains from disposition of an interest in a partnership conducting a U.S. trade or business.[9]) The ECI of a foreign person is taxed in the same way that income of a U.S. person is taxed, on a net basis under graduated income tax rates or capital gains tax rates as applicable.[10]

Investment in U.S. real property by foreign persons is governed by the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA),[11] and Code Sections 897 and 1445 are frequently called FIRPTA. Direct sales of U.S. real property are taxed as ECI, as are sales of partnership interests to the extent attributable to real property and sales of stock of "United States real property holding corporations," domestic corporations for which more than 50 percent of the value is attributable to U.S. real property.[12] The result of FIRPTA taxation is that income from such sales by foreign persons is treated the same as that from sales by U.S. persons. To ensure enforcement of the FIRPTA rules, generally a purchaser of U.S. real property owned by a foreign person must withhold 10 percent of the gross purchase price and pay such amounts to the IRS.[13]

Income of foreign governments from U.S. stocks, bonds, or other securities; from U.S. bank deposits; and from financial instruments held to carry out financial or monetary policy is completely exempt from U.S. taxation under Section 892(a)(1). Income that is from commercial activities (which need not rise to the level of a U.S. trade or business), from a controlled commercial entity, or from disposition of a controlled commercial entity (as defined below), is not exempt under Section 892(a)(1), however; other provisions of tax law apply to such income.

Income of controlled entities is exempt under Section 892 as long as the controlled entity does not become a controlled commercial activity.[14]

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[7] Id.

[8] See De Amodio v. Comm'r, 34 TC 894 (1960).

[9] Rev. Rul. 91-32, 1991-1 CB 107.

[10] IRC §§ 871(b)(1), 882(a)(1).

[11] Enacted as Subtitle C of Title XI (the "Revenue Adjustments Act of 1980") of the Omnibus Reconciliation Act of 1980, P. L. No. 96-499, 94 Stat. 2599, 2682 (Dec. 5, 1980).

[12] IRC §§ 897(a)(1), 897(c)(2).

[13] IRC § 1445(a).

[14] IRC § 892(a)(2)(A)(ii).

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A controlled entity can become a controlled commercial entity if it engages in commercial activity anywhere or if it holds a 50 percent interest in a controlled commercial entity or has an interest that provides a foreign government with such control of a controlled commercial entity.[15] Things can get a bit tricky here. The definition of "commercial activity" is "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."[16] So there is income that is defined as exempt and there are activities that are defined as commercial activities. But there is no explicit statement that income that is not exempt is income from a commercial activity. Rather, as stated in recent proposed regulations (discussed below), commercial activity is determined based on the nature of the activity.[17]

Recent Clarification in Regulations

SWFs received some important guidance over a year ago when proposed regulations were issued under Section 892.[18] As I mentioned in a blog post at that time,[19] the key clarifications that taxpayers are permitted to rely upon are:

- Investment in or trading of financial instruments (such as swaps) is not considered commercial activity, period.[20]
- Investment in a partnership that invests in or trades financial instruments will not be considered commercial activity by the controlled entity.[21]
- Being engaged in inadvertent commercial activity will not automatically disqualify controlled entities (including SWFs) from their tax exemption.[22]
- A controlled entity that fails the test for a tax exemption in one year may cure its failure and qualify in a subsequent year.[23]

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[15] IRC § 892(a)(2)(B).

[16] Treas. Reg. § 1.892-4T(b).

[17] Prop. Reg. § 1.892-4T(d). Examples of commercial activities that are specifically mentioned are acting as a dealer in securities or financial instruments or holding real property that generates income from activities greater than holding net leases. Prop Reg. § 1.892-4T(e).

[18] REG-146537-06, 76 Fed. Reg. 213 (Nov. 3, 2011).

[19] See Funk, supra note 2.

[20] Prop Reg. § 1.892-4(e)(1).

[21] Prop. Reg. § 1.892-5(d)(5)(ii).

[22] Prop. Reg. § 1.892-5(a)(2).

[23] Prop. Reg. § 1.892-5(a)(3). Please note that the definition of "controlled entity" under Treas. Reg. § 1.892-2T(a)(3) is likely to be encompassed within the broader definition of "controlled commercial entity" in Prop. Reg. §§ 1.892-5(a)(1)(i) or (ii).

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- A controlled entity that is a limited partner in a partnership, lacking rights to participate in management of the partnership, will not be considered to be a controlled commercial entity if the partnership engages in commercial activity. The income attributable to the commercial activity, however, will not be exempt from taxation.[24]

As a result, two features of the overall context should be kept in mind when reviewing any SWF investment:

1. Attribution of income that is not exempt under Section 892 does not necessarily result in attribution of commercial activities.
2. Income that is not explicitly exempt under Section 892 may still be exempt under other sections.

Practical Considerations

The current state of the law, for those who are considering how to structure transactions, is actually quite favorable. There are some quirks in the regulations, however, that require planning to address unusual constraints on exiting real estate investments. Consider the following basic examples, and how they play out.

> ***Example 1: Partnership Investment in Nanoblink Trading, LLC:*** Assume that the Oasis Fund, organized by the government of Sandypeace and funded with a gross tax on sales of oil extracted in Sandypeace, buys a minority interest in Nanoblink Trading, LLC, a hedge fund that has invented and now uses faster-than-light technology to make its trades on non-FIRPTA securities faster than those made by other high-frequency traders. It also hedges risk using swaps and other financial instruments. All the income the Oasis Fund is allocated by Nanoblink Trading should be exempt income under Section 892.
>
> But what happens when the Oasis Fund sells its interest? The fund probably will not be able to get a private letter ruling indicating that sales proceeds are exempt under Section 892.[25] Time to panic? Not really. None of the activities of Nanoblink Trading was commercial. None should constitute a trade or business under the trading safe harbor.[26] So there is nothing that would suggest that disposition of the interest is an activity that by its nature would be

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[24] Prop. Reg. § 1.892-5(d)(iv), Ex. 3.

[25] PLR 9643031 (July 29, 1996).

[26] IRC § 864(b)(2); Treas. Reg. § 1.892-4T(c)(2).

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considered commercial activity, the primary worry of the Oasis Fund. The gains are exempt as foreign-source income. This result is not as desirable as a clean, direct conclusion of exemption under Section 892, especially given the size of SWF investments, but it is also not the trap so often stated.

Example 2: Partnership Investment in Somnambulism Investments, LLC: Assume that the Creditor Fund (CF), organized and funded by the government of Pacific Manufacturers Republic, buys a 40 percent interest in Somnambulism Investments, LLC (SI), an unusually aggressive hedge fund. SI invests in anything that is publicly traded and is known for having taken recent positions of a 20 percent stake in Moontree Hotels, Inc., a publicly traded corporation, and a 20 percent stake in the Florida Swampland Mutual Fund, a regulated investment company which itself owns nothing but large positions in real estate investment trusts. Once informed about FIRPTA, CF panics and immediately considers selling its interest in SI.

Depending on what percentage of SI's investments is considered attributable to CF, CF may have some component of its allocable share of SI capital gain income treated as derived from sales of U.S. real property holding corporations (USRPHC) and which otherwise could be subject to FIRPTA.[27] While the regulations do not treat direct disposition of such stock as failing the Section 892 exemption, disposition of the SI interest has no safe harbor for exemption. In the absence of the Section 892 exemption, the rules outside of Section 892 may apply, which in this scenario means the application of FIRPTA based on allocation of gain among partnership assets. Some of the dividends from Florida Swampland may also be treated as taxable under FIRPTA, because of the level of ownership in the mutual fund via SI.

Prior to the proposed regulations under Section 892, because FIRPTA could apply, for controlled entities such as SWFs, CF's sale of its SI interest could theoretically have been deemed sufficient commercial activity to convert a SWF from a controlled entity to a controlled commercial entity that is fully taxable under the basic rules regarding FDAP. The proposed regulations, fortunately, would protect the status of CF and prevent the attribution of commercial activity.[28]

[27] IRC § 897(g).

[28] Prop. Reg. § 1.892-4(e)(1)(iv).

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There is still the matter of how much income will be treated as exempt and how much as taxable. Focusing on this issue, CF may prefer that SI first distribute its respective percentage of Moontree and Florida Swampland mutual fund shares to CF for direct disposition, thus allowing CF's dispostions to qualify as exempt under Section 892 before CF exits SI.[29] As there is nothing that explicitly provides that selling the SI interests without the prior distributions and sales described above would result in the same exemption, CF would be wise not to dispose of SI interests until CF's interest has been purged of real-estate flavored investments.

Conclusion

As with any potential investment, there are tax challenges and opportunities. With the application of due diligence and forethought, the tax law in this area is as manageable as the law regarding other types of sophisticated investment structuring. When an investment would trigger a FIRPTA analysis in the case of a generally taxable foreign investor, advisors should be alert to the need to be particularly sensitive to the unusual features of Section 892. Still, the rules regarding investment by SWFs in real estate could better serve the interests of fostering a recovery in the real estate sector.

There are extant proposals from commentators to conform the rules regarding disposition of partnership interests to the rules regarding disposition of assets owned by the partnership.[30] Other proposals recommend going further, to graft the rules regarding unrelated business taxable income and unrelated debt-financed income (rules that provide robust tax exemptions for income from investments by tax-exempt entities in real property) onto Section 892.[31]

Given the persistent disagreement among the houses of Congress about priorities and new taxes on some types of investment income, however, proposals that would serve to reduce taxes on investment by large entities may not be welcome. Despite significant agreement among commentators in this area, reform may have to wait.

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[29] See Kimberly S. Blanchard, "FIRPTA in the 21st Century, Installment Six: FIRPTA Withholding Where a § 892 Investor is a Partner," 38 Tax Mgmt. Int'l J. 1 (May 2009) (discussing distributions of shares for disposition to avoid tax trap).

[30] Patricia McDonald, "The Partnership Trap Under Section 892," 14 Bus. Entities 5 (Sept./Oct. 2012).

[31] William M. Funk, "On and Over the Horizon: Emerging Issues in U.S. Taxation of Investments," 10 Hous. Bus. L. J. 1, 14-18 (2010).

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