

New proposed regulations liberalize the U.S. tax rules relating to foreign wealth funds and foreign governmental entities

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Tax Alert

On November 2, 2011, the IRS issued new proposed regulations that, when finalized, will significantly liberalize and clarify the rules under Section 892 of the Internal Revenue Code, which provides a tax exemption under certain circumstances for foreign governments and their controlled entities (which can include sovereign wealth funds). Under the existing "temporary" regulations (which have been in place since 1988), foreign governments lose the Section 892 tax exemption with respect to income earned by "controlled commercial entities" – that is, entities that are engaged either directly or indirectly through a partnership in commercial activities anywhere in the world – and with respect to income or gain from "controlled commercial entities." Under the existing temporary regulations, a sovereign wealth fund could lose its Section 892 exemption because of a passive investment in a foreign company engaged in business entirely outside the United States merely because the foreign company is classified as a partnership for U.S. tax purposes.

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