INTERNATIONAL TAX REVIEW

Sovereign wealth funds become visible

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Sovereign wealth funds have recently become a talking point worldwide. Yet Babak Nikravesh, partner at Hogan Lovells, says that they have been a consistent feature of US investment for decades

Favourable US tax rules for sovereign wealth funds

The US has long been an attractive market for foreign investors, in part because of its favourable income tax regime. Foreign investors generally are not subject to US tax on capital gains from the sale of stocks and securities or on interest income from bank deposits and debt obligations that produce portfolio interest. Additional tax benefits also may be available to those investors whose countries have concluded an income tax treaty with the US.

But for a particular breed of foreign investor, the tax advantages of US investment are even more extensive. Sovereign wealth funds (SWFs), though only recently gaining attention in the popular US press, have for decades been significant investors in the US, and it is their capital that is behind many of the prominent investment funds making news. The US Internal Revenue Code devotes an entire section to these types of investors, known in US tax parlance as foreign governments, and affords them special treatment.

Exempt income

For SWFs that qualify as foreign governments, income from the following types of investments is exempt from US tax under section 892 of the code:

- Stocks, bonds or other domestic securities.
- Financial instruments held in the execution of governmental financial or monetary policy.
- Interest on bank deposits.

To some extent, the foreign government exemption overlaps with the exemption afforded to foreign investors in general. One need not qualify as a foreign government to be exempt from bank deposit interest, for example. In several key respects, however, the foreign government exemption is considerably broader. Dividend income is exempt under section 892, as are gains from the sale of stock in US corporations whose assets consist mostly of US real estate. The receipt of so-called section 306 stock – typically preferred stock received in certain tax-free corporate reorganisations and divisions that generally give rise to ordinary income rather than capital gain on its disposition – is also exempt under section 892. And whereas the portfolio interest exemption does not extend to interest received by a 10% shareholder, such income is exempt under section 892, as long as it is not received by or from a controlled commercial entity (discussed below).

Eligible investors: foreign governments

Though SWFs may take a number of guises and may be capitalised with funds from a variety of sources, the exemption applies only to those SWFs which meet the regulatory definition of a foreign government. Notably, a foreign government need not be a national level body to qualify; political subdivisions, such as provincial or municipal bodies, can also enjoy the exemption.

A foreign government is the exempt portion of a foreign sovereign, and to qualify under section 892 must take one of two forms. A foreign government can be a controlled entity, which is an entity that is separate in form from the foreign sovereign; is wholly owned and controlled by the foreign sovereign; is organised under the laws of the foreign sovereign; whose net earnings are credited to its own account, with no portion inuring to the benefit of any private person; and whose assets vest in the foreign sovereign upon dissolution. Examples of a controlled entity include a company established to invest government monies, or a pension trust established to fund retirement, disability or death benefits for governmental employees.

A foreign government can also be an integral part, which is any organisation or other body that constitutes a governing authority of a foreign country, and whose earnings are credited to its own account with no portion inuring to the benefit of any private person. A nation's parliament or governmental ministries are classic examples of integral parts. An individual, such as a king or other ruler, can also qualify as an integral part as long as that person is acting in an official and not a private or personal capacity.

The distinction between the two types of foreign governments is not well defined. Because the focus of the test for each differs – on form in the case of controlled entities and on function in the case of integral parts – there is the possibility of overlap between the two. The analysis is complicated by the absence of any coordination rule between the two regimes and the Internal Revenue Service's unwillingness to issue rulings on the correct determination of foreign government status. The distinction between types of foreign governments is immaterial to determining the scope of the section 892 exemption, but it is nevertheless important in assessing the impact to the foreign government of commercial activities.

The commercial activity problem

The exemption from US income tax under section 892 is not available for income derived from the conduct of any commercial activity. Commercial activities are those which are ordinarily conducted with a view towards the current or future production of income or gain. The commercial activity concept is broader than the more familiar US trade or business concept – even activities outside the US, which have no connection with US businesses, fall within its net. By contrast, pure investment activities, such as investments in stocks or financial instruments, net leases on real property or loans that do not rise to the level of a banking, financing or similar business, are not commercial, regardless of volume.

The exemption is also unavailable for income received by or from a controlled commercial entity of a foreign government. An entity is a controlled commercial entity if it is controlled by the foreign government and is engaged in commercial activities anywhere in the world. Thus, an entity whose US investments are entirely passive but happens to engage in even the most minor amount of commercial activity in another country is a controlled commercial entity for US tax purposes, if the foreign government possesses the requisite level of control. Control exists if the government, directly or indirectly, holds 50% or more of the total interests in such entity (measured by vote or by value) or if the government exercises effective practical control over it. Ownership of 49%, coupled with creditor or contractual relationships (for instance) may be enough to achieve such effective control. And because ownership and control can be established indirectly, foreign government investors should be careful when making co-investments alongside the pass-through investment funds in which they are also investors.

Any entity can become a controlled commercial entity. For instance, a foreign government that owns more than 50% of the interests in a partnership that engages in commercial activity will render the partnership a controlled commercial entity. Because any activity conducted by a partnership is viewed as conducted by each of its partners, a controlled entity whose sole investment is in such partnership will itself become a controlled commercial entity. Thus, SWFs hoping to qualify as controlled entities and which participate in investment funds should ensure that such funds (which are commonly organised as pass-through or fiscally transparent vehicles for US tax purposes) do not engage in commercial activities or invest in other flow-through entities that do so, other than through a blocker corporation that can stop the upward commercial activity attribution.

The commercial activity taint

The consequences of commercial activity attribution and controlled commercial entity status are potentially wide-reaching. Not only is the immediate income of the foreign government entity that is engaged (or is deemed engaged) in commercial activity not eligible for income tax exemption, but, in the case of a controlled entity, all of its income, including its passive income, is also rendered ineligible. And as the commercial activities of a parent-controlled entity are attributed to its subsidiaries, all such subsidiaries will be tainted.

Under the applicable rules, it is unclear when, or possibly whether, the commercial activity taint ends. Certainly no guidance has been issued in this regard, although for various reasons the taint should last no longer than the duration of the commercial activity itself. The rules are also silent with respect to income that is generated during a period of commercial activity but distributed (in the case of a corporation) at a time when there is no such activity. Again, despite the absence of authority, the correct answer should be that in the case of corporate distributions controlled commercial entity status is relevant only at the time of the distribution, not when the income was generated.

The severe consequences stemming from commercial activity illustrate why integral part status is preferable to controlled entity status. Whereas commercial activity will cause a controlled entity to be treated as a controlled commercial entity and will render all of such entity's income ineligible for exemption, an integral part is not at risk of tainting. An integral part engaged in commercial activity will be subject to US tax only with respect to its commercial activity income; non-commercial activity income will remain eligible for exemption. As explained previously, however, it is not easy to distinguish between the two regimes. SWFs that assume they qualify as integral parts are cautioned to consider the consequences of being wrong.

The trouble with real estate

Foreign investors with some US investment experience know that the touchstone for US net basis taxation is whether a foreign person has income that is effectively connected with a US trade or business. Income that is so connected – known as effectively connected income (ECI) – is taxed at the same graduated rates applying to US persons.

Since passage of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), gain and loss of foreign taxpayers from the disposition of a US real property interest is treated as ECI. A US real property interest includes all manner of real property holdings, such as interests in land, buildings, mineral deposits and natural resources like timber located in the US. Also included is an interest in any US corporation that is (or, at any time in the previous five years while owned by a foreign person, was) a US real property holding corporation. A US real property holding corporation is a domestic corporation that principally owns US real property interests.

Regulations issued under FIRPTA provide that a foreign government is subject to tax on dispositions of US real property interests except to the extent specifically otherwise provided in the section 892 regulations. The section 892 regulations make three points with respect to real estate. First, income from a direct interest in real estate, including gain from its disposition, is not eligible for exemption. Second, gains from interests in US real property holding corporations – being stock of a domestic corporation – do qualify for exemption. However, this exemption only applies with respect to portfolio size investments since, thirdly, an investment by a foreign government that is too large may cause the US real property holding corporation to become a controlled commercial entity. Thus, ownership of a US real property holding corporation, or even a foreign corporation that would be a US real property holding corporation if it were domestic, in excess of a certain level, will cause distributions or gain from the sale of that investment to be ineligible for exemption under section 892. Nevertheless, gain on the disposition of an interest in a foreign corporation, even one holding mostly US real property interests, would not be subject to US tax.

To avoid FIRPTA, foreign investors often endeavour to own real estate investments that do not constitute US real property interests. For instance, stock of a domestic corporation that is regularly traded on an established securities market is treated as a US real property interest only if held by a person who, during an applicable testing period, did not actually or constructively own more than 5% of that class of stock. Moreover, while many real estate investment trusts (REITs) are in fact US real property-holding corporations, all of them are not.

By statute, a domestically-controlled REIT is one such exception. A domestically-controlled REIT is a REIT in which less than 50% in value of its stock is held by foreign persons. Thus, a foreign investor who sells an interest in a domestically-controlled REIT will not be subject to US tax under FIRPTA.

Recent guidance concerning REITs

A REIT is taxable as a corporation that invests principally in real estate and mortgages and elects special tax treatment. It has been referred to colloquially as a mutual fund for real estate. Like a mutual fund, a REIT may deduct dividends it distributes to its shareholders, effectively allowing it to serve as a tax conduit. Thus, REITs are generally not subject to any entity-level tax, instead passing their taxable ordinary income and capital gains through to their shareholders. Foreign investors in REITs generally are subject to US withholding tax on ordinary dividends received from the REIT at the statutory rate of 30%. In the case of foreign government shareholders, such dividends are entirely exempt from US tax.

Historically, the intersection between the FIRPTA rules and the foreign government exemption has been ill-defined. An issue that many practitioners have debated is the correct tax treatment of REIT capital gain distributions; that is, distributions from REITs that arise from the sale of their underlying real estate portfolio. Had such real estate been held directly by the foreign government, these gains clearly would have been taxable. But a foreign government that owns stock in a REIT is merely a shareholder whose income takes the form of corporate distributions. Are capital gain distributions a return on stock that is exempt under section 892, or a disposition of real estate subject to tax under FIRPTA?

Until recently, most practitioners agreed that such distributions were exempt under section 892 because they were derived from an investment in US stocks, bonds or other domestic securities, which of course includes shares in a REIT, and that the foreign government exemption trumped FIRPTA. However, on June 13 2007, the IRS published Notice 2007-55 in which it announced its view that foreign governments are subject to tax on distributions of US real property gains from REITs, whether such distributions take the form of capital gain dividends or liquidating distributions. The IRS indicated that it would challenge any assertions to the contrary, and that in due course it would issue regulations under section 892 to clarify its position.

There are many strong arguments as to why the IRS is mistaken in its conclusion, but the IRS has been granted broad statutory authority to issue regulations under section 892, and the forthcoming regulations purportedly will be an exercise of that authority. Although the planned regulations may very well contradict the plain meaning of the authorising statute, sustaining a challenge to the IRS's position may be difficult. Moreover, any such challenge would probably not be resolved for some time, and therefore would not help foreign governments (or their investment fund withholding agents) answer the immediate question of what to do about their prior REIT investments where an exemption from capital gain dividends was asserted.

As a result, many foreign government investors have been forced to reassess their REIT investments. For future investments, it is expected that foreign governments will prefer alternative exit strategies, such as the disposition of REIT stock, or alternative investment structures, perhaps involving the use of US corporations or synthetic investment arrangements. Fund and REIT sponsors are certainly thinking carefully about how best to structure their funds in the light of the IRS Notice, so as to continue to attract SWF capital.

UBTI confusion

Foreign governments often invest alongside US tax exempt investors like pension plans and university endowments. In so doing, foreign government investors are often uncertain about whether and to what extent the rules concerning unrelated business taxable income (UBTI) apply to them. Although of great importance to US tax exempts, these rules do not apply to foreign governments with the exception of pension trusts. Thus, the concerns over and structuring solutions for certain UBTI-issues – like debt-financed income arising from leveraged investments – are generally of no concern to foreign governments.

Of course, the interests of US tax exempts and foreign governments are often aligned since commercial activity income can also constitute UBTI. But for the most part the tax considerations for each type of investor are distinct. The issue of UBTI is relevant to foreign government-sponsored pension trusts insofar as the rules provide pension trusts with a limited exception to controlled commercial entity status. Under the rules, a pension trust will not be treated as a controlled commercial entity if it earns only non-UBTI income. Although the mere receipt of non-UBTI commercial activity income will not render a pension trust a controlled commercial entity, such income is still not eligible for exemption under section 892.

Conclusion

SWFs are major investors in the US, and the level of their US investment activity is projected to increase. The attractiveness of the US market for foreign investors generally and SWFs in particular is due in no small part to the favourable US tax climate. However, the applicable tax rules are complex, often unclear, and in many cases present traps for the unwary. Recent controversial guidance concerning capital gain and liquidating distributions from REITs highlight the uncertain and evolving nature of the law.

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