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The New Limited Partner Exception Under Section 892: How Helpful Is It?

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On November 2, 2011, the U.S. Internal Revenue Service (the "IRS") proposed significant changes to the rules governing the U.S. federal income taxation of foreign governments, including so-called sovereign wealth funds, particularly those whose investments are made by legal entities separate from, but controlled by, the foreign government ("Sovereign Controlled Entities"). Although these changes have been introduced in the form of proposed regulations (the "Proposed Regulations"), taxpayers may rely on the Proposed Regulations until final regulations are issued. The Proposed Regulations represent a welcome step toward providing relief for Sovereign Controlled Entities whose investment strategies include allocation of capital to alternative investment classes such as private equity and hedge funds. In particular, the Proposed Regulations contain a provision that offers a potentially significant benefit to Sovereign Controlled Entities that hold interests as limited partners in entities treated as partnerships for U.S. federal income tax purposes (the "LP Exception").[1] Under the current rules, Sovereign Controlled Entities often need to dedicate significant resources to structuring their investments if they are to preserve their eligibility for preferential tax treatment under Section 892 of the U.S. Internal Revenue Code (the "Code").[2] As discussed below, where the LP Exception applies, it may significantly reduce the cost and complexity associated with structuring such investments. However, the LP Exception, as formulated, is somewhat uncertain in scope and, as a result, may in some cases be of less utility than would be desirable.

Background

Under Section 892, Sovereign Controlled Entities may qualify for a special exemption from U.S. federal income tax that can be quite valuable with respect to income paid with respect to U.S. debt and equity securities. However, the exemption does not apply to any income derived from the conduct of any commercial activity, or to any income received by or from (or from the disposition of) a "controlled commercial entity"[3] (which includes any Sovereign Controlled Entity that is treated as engaged, directly or indirectly, in commercial activity). Regulations issued under Section 892 (nearly 25 years ago, when it was far less common for Sovereign Controlled Entities to invest funds outside of their own jurisdictions) provide that the commercial activities of a partnership (other than a partnership treated as a "publicly traded partnership" for U.S. federal income tax purposes) are attributable to its general and limited partners for purposes of Section 892. This attribution rule presents a daunting compliance burden for Sovereign Controlled Entities that invest in private equity and hedge funds. The issue for these investors is that if a partnership in which a Sovereign Controlled Entity is a partner has any commercial activity anywhere in the world, the Sovereign Controlled Entity itself is treated as engaging in commercial activities. In such case, the Sovereign Controlled Entity becomes a "controlled commercial entity", thereby losing the ability to benefit from the Section 892 exemption for any of its income, whether earned through the partnership from which the commercial activity is attributed or from other investments. To avoid this drastic consequence, Sovereign Controlled Entities are required to spend considerable time and effort negotiating contractual protection from fund managers and managing a cumbersome corporate structure designed to avoid exposing income from investments for which the Section 892 exemption may be relevant to commercial activity risk. The Proposed Regulations are intended to alleviate the burden on Sovereign Controlled Entities.

Limited Partner Exception

Under the LP Exception, an entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership (which, in general, would enable such entity to avoid becoming a controlled commercial entity, as described above). The LP Exception has the potential to be very helpful to Sovereign Controlled Entities. Importantly, though, even where the LP Exception applies:

- The Section 892 exemption will not apply to a limited partner's distributive share of any partnership income that is derived from the conduct of commercial activity. In other words, where the LP Exception applies, the partnership's commercial activity will not cause a Sovereign Controlled Entity to be a controlled commercial entity (that would be ineligible for the Section 892 exemption with respect to all of its income), but the entity's

share of partnership income derived from commercial activities will not qualify for the exemption; and

- If a Sovereign Controlled Entity has a 50% or greater direct or indirect interest in (or is deemed to have "effective practical control" over) the partnership, the partnership itself is a controlled commercial entity and, in such case, none of the Sovereign Controlled Entity's share of the partnership's income would be eligible for the Section 892 exemption (though in this case, the LP Exception would have the beneficial effect of permitting the Sovereign Controlled Entity to continue to benefit from the Section 892 exemption for its other investments).

Issues Raised by the Limited Partner Exception

While the LP Exception has the potential to be very helpful to foreign sovereign investors, as formulated in the Proposed Regulations, it suffers from technical shortcomings that could render it ineffective, or make it difficult to rely on, in some cases.

Ambiguity Regarding Limited Partner Classification

One of these shortcomings is the manner in which the term "limited partner" has been defined for purposes of the LP Exception. The Proposed Regulations treat as a limited partner (a "Section 892 LP") a partner that does not have any right to participate in the management and conduct of the partnership's business under the partnership's governing agreement or the law of the jurisdiction in which the partnership is organized. For this purpose, rights to participate in management do not include consent rights in the case of "extraordinary events" such as admission or expulsion of a partner, amendment of a partnership agreement, dissolution of a partnership, or disposition of all or substantially all of a partnership's property outside the ordinary course of its business. Based on this definition, it may not always be clear (absent additional guidance) whether various rights that may be accorded to a limited partner in an investment fund could be viewed as precluding Section 892 LP status. Examples of rights that may throw a limited partner's status as a Section 892 LP into doubt include a right to vote on the lifting of an investment restriction, a right to vote on key man replacements/lifting of investment suspensions, and the right to participate on an advisory board. While practitioners tend to believe that these rights may not amount to participation in management for the purposes of maintaining limited liability under local law, it is not as clear how they would be treated for purposes of the LP Exception. To further complicate matters, the statutory rights of limited partners may differ depending on the jurisdiction in which a partnership is organized, which could theoretically result in the LP Exception applying differently depending on the laws of the jurisdiction in which a partnership is organized. Given the dramatic consequences to a Sovereign Controlled Entity of failing to qualify as a Section 892 LP, such complexity and uncertainty should be avoided.

Much of this uncertainty could be avoided if a partner's limited liability status under the laws of the jurisdiction where the partnership is organized were to create a strong presumption that the partner is a Section 892 LP for purposes of the LP Exception, subject perhaps to narrow exceptions aimed at policing possible abusive situations.

Funds That May Invest in U.S. Real Estate

The LP Exception does not address a thorny issue that faces Sovereign Controlled Entities in the real estate context. For reasons that are not clear to commentators, the regulations under Section 892 deem any entity (whether domestic or foreign) that is a "U.S. real property holding corporation" (a "USRPHC")[4] to engage in commercial activities. Accordingly, if a Sovereign Controlled Entity is treated as a USRPHC as a result of its interest as a partner in a partnership that has direct or indirect holdings in U.S. real estate, such Sovereign Controlled Entity will be treated as engaged in commercial activities per se (and, as a result, will be treated a controlled commercial entity and will lose the benefit of the Section 892 exemption with respect to all of its income). This is a particularly difficult risk to address because it cannot be eliminated through the use of "blocker" entities, and the rules for determining when an entity is or has become a USRPHC are very complicated, tend to prevent portfolio investments from being taken into account in making the determination, and depend on factual developments that may be quite difficult to effectively track or control (e.g., the U.S. real estate holdings of portfolio companies).

The USRPHC rule described above is not expressly modified by the Proposed Regulations and, where it applies, appears to effectively override the LP Exception. In other words, a Sovereign Controlled Entity that is a Section 892 LP in a partnership may, nevertheless, be treated as a "controlled commercial entity" if the partnership owns or may own U.S. real estate assets (or equity in portfolio companies that, themselves, own U.S. real estate assets). Thus, it would appear that Sovereign Controlled entities investing in private equity or hedge funds that have or may have a U.S. real estate component to their investment activities may not comfortably rely on the LP Exception to avoid being treated as "controlled commercial entities." This may quite significantly reduce the practical scope of the LP Exception. It would be helpful for the IRS to modify the rules in the Proposed Regulations so that status as a Section 892 LP would prevent status as a controlled commercial entity under the USRPHC rule.

Conclusion

Although the Proposed Regulations represent a welcome change for Sovereign Controlled Entities that invest in alternative assets such as private equity and hedge funds, they may not, in their current form, alleviate the complexities of negotiating and structuring investment fund participations as much as they would first appear to. In fact, ironically, the apparent simplicity of the LP Exception could in some cases make Section

892 planning even more perilous than it already is, as it could lead some Sovereign Controlled Entities to be lulled into believing it protects them from losing the benefits of the Section 892 when it may not.

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Endnotes:

[1] In addition to entities organized as partnerships under local law, U.S. limited liability companies and certain foreign entities may also be treated as partnerships for U.S. federal income tax purposes.

[2] All Section references in this communication are to the Code.

[3] A controlled commercial entity is any entity that is engaged in commercial activity anywhere in the world if a foreign sovereign directly or indirectly owns 50 percent or more of such entity (by vote or value) or has "effective practical control" over such entity.

[4] The term "U.S. real property holding corporation" is defined in Section 897 and generally (but subject to certain exceptions) includes any entity treated as a corporation for U.S. federal income tax purposes (whether domestic or foreign), unless the entity can show that the fair market value of its assets that are "U.S. real property interests" exceeds the fair market value of the sum of its assets that are non-U.S. real property interests or used or held for use in a trade or business for purposes of this determination. Of relevance to Sovereign Controlled Entities, portfolio investments of investment funds are generally not treated as used or held for use in a trade or business. This can cause a Sovereign Controlled Entity to be a "controlled commercial entity" even if holds, directly or indirectly, a very small amount of "U.S. real property interests" when compared to its overall assets.