November 2, 2011

# Proposed Amendments to Section 892 Regulations

The IRS has today released proposed amendments to the Code Section 892 regulations. Code Section 892 is the provision within the *Internal Revenue Code* that exempts foreign sovereigns from taxation in respect of investment income earned in the U.S. The primary amendments are described below.

## 1. Safe Harbour for Commercial Activity

Under the current rules, if an investor realizes a nominal amount of income from commercial activity or conducts nominal commercial activity anywhere in the world, the investor's ability to benefit from the Code Section 892 tax exemption is restricted.

The proposed regulations will treat an investor as *not* engaged in commercial activity if its only commercial activity is inadvertent.

In order for commercial activity to be considered inadvertent the following is required:

(a) the failure to avoid conducting commercial activity must be reasonable;

(b) the commercial activity must be promptly cured; and

(c) certain records maintenance requirements must be met.

Failure to avoid conducting commercial activity will not be considered reasonable unless adequate written policies and operational procedures are in place to monitor commercial activity worldwide. If adequate policies and procedures are in place, then the failure to avoid commercial activity will be reasonable if:

(a) the value of the assets used in commercial activity is less than 5% of the total assets on a book value basis; and

(b) the income from the commercial activity does not exceed more than 5% of total gross income.

From a practical perspective, this proposal provides some comfort to the Code Section 892 investor and will require that the investor introduce written procedures to seek to avoid commercial activity. Notably, however, nominal or

inadvertent commercial activity still needs to be rectified if discovered. Accordingly, from a practical perspective this means that investments that have a reasonable likelihood of producing commercial activity or ones that do inadvertently produce commercial activity will still need to be stopped up separate from investments that require Code Section 892 exemption benefits. Notably, given the change to the characterization of commercial activity of a partnership proposed in the regulations (described below), the incidence of inadvertent or nominal commercial activity by the investor is likely to be low.

**2. Commercial Activity – Financial Instruments**

The current regulations provide a "safe harbour" from commercial activity for investing in financial instruments as long as such investment is in execution of governmental or monetary policy. For this purpose, financial instruments include derivatives and likely hedging contracts. It was difficult to obtain comfort that an investor, if engaged in hedging, was doing so in execution of any governmental or monetary policy.

The proposed regulations provide that investments in financial instruments will not be commercial activity irrespective of whether they are held in execution of governmental or monetary policy.

From a practical perspective, we expect that this amendment should provide sufficient comfort to enable the investor to themselves engage in hedging without requiring the use of separate FX limited partnership structures. This should be confirmed with U.S. tax counsel. Notably, however, income derived from investments in financial instruments may not be exempt from taxation by virtue of Code Section 892. The proposed amendments simply ensure that the holding of such investments will not constitute commercial activity.

**3. Commercial Activity – Disposition of USRPI**

The proposed regulations clarify that a disposition of a US real property interest ("USRPI") will not, of itself, result in commercial activity. This was a position already taken by many Code Section 892 investors but this proposed amendment will provide comfort on this position.

The rulemaking release, however, states that:

> … as provided in 1.892-3T(a), the income derived from the disposition of the USRPI described in section 897(c)(1)(A)(i) shall in no event qualify for the exemption from tax under section 892.

USRPI described in 897(c)(1)(A)(i) is "real property" and does not describe shares of a corporation that is a US real property corporation. Accordingly, subject to confirmation by your U.S. tax counsel, it appears that the proposed regulations do not impact the ability of the investor to claim exemptions under Code Section 892 for disposition of USRPHC stock.

**4. Treatment of Partnerships**

A significant change under the proposed regulations is that commercial activity of a partnership will not be attributed to a limited partner that does not have rights to participate in the management and conduct of the business of the partnership.

This change will allow an investor, for the most part, to not be considered to realize commercial activity solely because a fund in which it has invested and which is a partnership for US tax purposes, realizes commercial activity. This is a significant benefit to the ongoing investment activities of the investor and may result in simplification of investment structures.

We expect considerable thought will have to be put into the question of what rights of limited partners may constitute a right to participate in management and conduct of the business of the partnership. This will be a matter of discussion in the drafting of future and likely current fund documents.

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