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New Bill Would Deny Section 892 Benefits To Certain Sovereign Wealth Funds

Tax Talks on **August 1, 2023**

On July 26, 2023, Senate Finance Chairman Ron Wyden (D-OR) introduced the Ending Tax Breaks for Massive Sovereign Wealth Funds Act (the "bill"), which would deny the benefits of section 892 of the Internal Revenue Code[1] to sovereign wealth funds whose foreign government holds more than $100 billion of investable assets,[2] and either (i) is not a party to a free trade agreement or income tax treaty in effect with the United States or (ii) is North Korea, China, Russia, or Iran.[3] If the bill is passed, it would deny the benefits of section 892 to several of the largest sovereign wealth funds by assets.

Section 892 generally exempts foreign governments (including "integral parts"[4] of foreign governments and foreign governments' sovereign wealth funds and other "controlled entities"[5]) from U.S. federal income tax on income received from investments in U.S. stocks, bonds, and other securities, financial instruments held in the execution of governmental financial or monetary policy, and interest on deposits in banks in the United States. However, section 892 does not exempt from U.S. federal income tax any income that is derived from the conduct of a "commercial activity",[6] income received by a "controlled commercial entity" or received (directly or indirectly) from a "controlled commercial entity",[7] and income derived from the disposition of any interest in a controlled commercial entity.

The bill would generally apply to income received after December 31, 2023. However, the bill contains three grandfather provisions that would apply until 2026.

First, any investment made before the enactment of the bill would be grandfathered until 2026.

Second, any investment made after the enactment of the bill and before January 1, 2026 would be grandfathered until 2026, if the investment (i) is made pursuant to a binding contract that was in effect on the date of enactment and at all times thereafter before the investment; (ii) is required to be made on a fixed date and in a fixed amount; and (iii) does not allow any person to delay, deny, or excuse the investment. This grandfather provision would not apply to most commitments by sovereign wealth funds to contribute capital to private equity funds because those commitments do not typically require the investment to be made on a fixed date and in a fixed amount, and do typically allow the sponsor to delay, deny, or excuse the investment. This grandfather provision ends with respect to an investment in a U.S. corporation or U.S. or non-U.S. partnership if the section 892 investor makes another investment in the corporation or partnership.

Finally, less-than-10% investments in a domestic corporation or domestic or foreign partnership that is regularly traded on an established securities market would be grandfathered until 2026.

All of the grandfather provisions would expire after December 31, 2025, and, therefore, all income received in and after 2026 would be subject to the bill.

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[1] All references to “section” are to the Internal Revenue Code.

[2] The bill would not affect the availability of section 892 for financial instruments held in the execution of governmental financial or monetary policy, or interest on deposits in banks in the United States of moneys belonging to foreign governments. A financial instrument is held in the execution of governmental financial or monetary policy only if the primary purpose for holding the instrument is to implement or effectuate such policy. Treas. Reg. Sec. 1.892-3T(a)(5)(i). The bill, if enacted, would make the interpretation of this rule important.

It is the assets of the foreign government and not the size of a particular sovereign wealth fund that is relevant to determine whether a sovereign wealth fund is entitled to section 892 benefits. For instance, if a sovereign wealth fund holds $35 billion of investable assets but its sovereign holds more than $100 billion of investable assets, the sovereign wealth fund could be denied section 892 benefits under the bill even though it holds assets well below $100 billion.

The bill refers to “assets for investment or for the production of income” and would delegate regulatory authority to the IRS to define the types of assets taken into account under this definition (*e.g.*, it is not clear whether a foreign government’s cash not formally segregated for investment but with a transitory cash surplus in its central bank holds “assets for investment” or, if an airport owned by foreign governmental entity that derives fees from the leasing of takeoff and landing slots, the airport is an asset of the foreign government that is for “production of income”).

[3] The Senate Finance Committee’s one page summary is here; the press release is here .

The statute refers to “covered nations”, as defined in 10 U.S.C. section 4872(d)(2). This statute prohibits the Secretary of Defense from, among other things, procuring covered materials mined, refined, separated, melted or produced in any “covered nation”. Covered nations are defined as North Korea, China, Russia, or Iran. The Senate Finance Committee’s summary of the legislation refers to these four countries as “countries of concern”.

[4] An integral part of a foreign government is any person, body of persons, organization, agency, bureau, fund, instrumentality or other body, however designated, that constitutes a governing authority of a foreign country. Treas. Reg. Sec. 1.892-2T(a)(2).

[5] For an entity to qualify as a “controlled entity” of a foreign government, (i) it must be wholly owned and controlled by a foreign government directly or indirectly through one or more controlled entities; (ii) it must be organized under the laws of the foreign government by which it is owned; (iii) its net earnings must be credited to its own account or to other accounts of the foreign government, with no portion inuring to the benefit of any private person; and (iv) its assets must vest in the foreign government upon dissolution. Treas. Reg. Sec. 1.892-2T(a)(3).

[6] Section 892 does not define “commercial activity”. There is limited guidance in the regulations under section 892, which provide that a “commercial activity” includes (i) all activities that are ordinarily conducted with a view toward the current or future production of income or gain, whether conducted within or without the United States; and (ii) investments (including loans) made by a banking, financing, or similar business, even if the income derived from such investments is not considered to be income effectively connected to the active conduct of a banking, financing, or similar business in the United States. Treas. Reg. Sec. 1.892-4T(b); (c)(1)(iii). In addition, an activity may be considered a commercial activity even if it does not constitute a trade or business within the United States. Treas. Reg. Sec. 1.892-4T(b). Finally, Treas. Reg. Sec. 1.892-4T(c) provides a list of activities that are not “commercial activities”: (i) making and holding certain investments, including stocks, bonds, other securities, and financial instruments held in the execution of governmental financial or monetary policy; (ii) trading in stocks, securities or commodities for a foreign government’s own account; (iii) cultural events; (iv) nonprofit activities; (v) governmental functions; and (vi) purchasing activities.

[7] A controlled commercial entity is an entity engaged in commercial activities and (i) with respect to which the foreign government owns 50% of the value or voting interests or (ii) over which the foreign government has effective control. *See* section 892(a)(2)(B).

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