

Sovereign Wealth Funds: Important Investors with Important Issues



Steven D. Bortnick
Steven.Bortnick@troutman.com



Morgan Klinzing
Morgan.Klinzing@troutman.com

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Financial Executives Alliance
A First Republic Affinity Group

Agenda

- **Types of entities that benefit from the special tax exemption**
 - Foreign governments and controlled entities
 - Pension plans
- **Income that is exempt from tax**
 - What is exempt and what is not
 - Special rules for real estate
 - Treaty overlap
 - Forms required to establish withholding exemption
- **Adverse consequences of income from commercial activities (“CAI”)**
 - Global impact
 - Consequences of investments in partnerships
 - Structural challenges and fixes





What percentage of your fund's commitments are held by SWFs?

- A. 0-10%
- B. 11-20%
- C. Over 20%

Who Benefits? Foreign Government Defined

- **Foreign Government means:**
 - **Integral part of foreign government (including political subdivisions)**
 - The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person.
 - **Controlled entity of foreign government**
 - Entity must be wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities;
 - Must be **organized under the laws of the foreign sovereign** by which owned;
 - Entity's net earnings must be credited to its **own account** or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and
 - Entity's assets **vest in the foreign sovereign** upon dissolution
 - A controlled entity does not include partnerships, or any other entity owned and controlled by more than one foreign sovereign.



Pension Trusts Treated as Controlled Entity of Foreign Government

- The trust is established exclusively for the benefit of (A) employees or former employees of a foreign government or (B) employees or former employees of a foreign government and non-governmental employees or former employees that perform or performed governmental or social services;
- The funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government;
- The trust forming a part of the pension plan provides for retirement, disability, or death benefits in consideration for prior services rendered; and
- Income of the trust satisfies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.



Pension Treated as Private – Not Foreign Government

Example in the regulations:

- Employees are allowed to make unlimited contributions to the trust, and such contributions are credited to the employee's account as well as interest accrued on such contributions. Retirement benefits will reflect the amounts credited to the individual accounts in addition to the usual annuity computation based on the final year's salary and years of service. A pension plan established under these rules is in part ***acting as an investment conduit***. As a result, the income of the trust is deemed to inure to the benefit of private persons. Accordingly, the trust is ***not considered a controlled entity of the foreign government***.

Establishing Foreign Government Status to Withholding Agents

Foreign governments claiming Section 892 benefits claim them on IRS Form W-8EXP, *Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting*.

- Relatively short compared to other W-8s. An IRS Form W-8BEN-E for foreign corporations is 8 pages, while IRS Form W-8EXP is only 2½ pages.

Part II Qualification Statement for Chapter 3 Status

10 For a foreign government:

- a I certify that the entity identified in Part I is a foreign government within the meaning of section 892 and the payments are within the scope of the exemption granted by section 892.

Check box 10b or box 10c, whichever applies.

- b The entity identified in Part I is an integral part of the government of _____ .
- c The entity identified in Part I is a controlled entity of the government of _____ .

11 For an international organization:

I certify that:

- The entity identified in Part I is an international organization within the meaning of section 7701(a)(18), and
- The payments are within the scope of the exemption granted by section 892.

Tax Exemption for Foreign Governments/Controlled Entities

- **Exempt Income:**
 - Income from investments in the United States in stocks, bonds, or other securities;
 - Income from investments in the United States in financial instruments held in the execution of governmental financial or monetary policy; and
 - Interest on deposits in banks in the United States of moneys belonging to such foreign government.
- **Other income:**
 - No exemption
 - Income earned from U.S. real property interests and FIRPTA gain also taxable

Investment Income

- **Investment income includes income and gain from stocks, bonds and securities**
 - Income from securities lending transactions covered
 - Dividend equivalents under 871(m)
- **Securities**
 - Any indebtedness
 - Annuity contracts
 - Bankers Acceptances
- **Excluded from definition of security**
 - Partnership interests (other than PTPs)
 - Commodities, forwards, futures and commodity options
 - Unless security under Section 864 (*i.e.*, securities traded for the taxpayer's own account)

- **Helpful only if held in the execution of governmental financial or monetary policy**
 - Forwards
 - Futures
 - Options
 - Swaps
 - Similar instrument (in functional or nonfunctional currency)
 - Similar instrument in precious metals if held by foreign government or central bank
 - Nonfunctional currency or gold if held physically by central bank of issue

Financial Instruments – Execution of Financial or Monetary Policy

- **Held in execution of financial/monetary policy if primary purpose for holding is to implement such policy**
 - In order to ensure sufficient currency reserves, the monetary authority of foreign country FC issues short-term government obligations. The amount received from the obligations is invested in U.S. financial instruments. Since the primary purpose for obtaining the U.S. financial instruments is to implement FC's monetary policy, the income received from the financial instruments is exempt from taxation under section 892.

Treaty Overlap

- **Foreign governments are treated as corporate residents of their respective countries for purposes of any income tax treaty if such government grants equivalent treatment to the US**
 - Covers income not exempt under 892 (*e.g.*, royalties)
 - Permanent establishment/business profits provisions likely not helpful due to restrictions on CAI
 - Impact of hybrid entities
 - Code provisions including 892 – US treatment relevant
 - Treaty provisions – Law in jurisdiction of treaty resident relevant

Income From USRPIs

- **Specifically, not exempt from tax**
- **Doesn't apply to stock of USRPHC**
 - Income and gain from stocks *is* exempt from tax
 - Exception for CAI doesn't apply, because corporation blocks the CAI
 - Concern if USRPHC is a controlled commercial entity (e.g., SWF forms its own US corporation to act as CAI blocker)
- **QFPF Overlap**
 - Qualified foreign pension funds are exempt from FIRPTA tax (if not otherwise ECI)
 - Foreign governmental pension funds may also qualify as QFPFs
 - No restriction on controlled commercial entity



Has the GP/IM agreed to avoid CAI?

- A. Yes
- B. No

Commercial Activities

- **Broadly Defined:**
 - All activities ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain are commercial activities.
 - Includes activities outside the US (unlike ECI)
 - Even if not considered a trade or business under ECI rules
- **Exception for Investments:**
 - Activities: Investments in stocks, bonds, and other securities; loans; the holding of net leases on real property or land which is not producing income (other than on its sale or from an investment in net leases on real property); and the holding of bank deposits in banks.
 - Investments in financial instruments held in the execution of governmental financial or monetary policy.



Trading Activities

- **Effecting stock, securities and commodities transactions for own account (even if trading that would be a trade or business) not commercial activity.**
 - Directly or through broker, commission agent, custodian or independent agent.
 - Commodities” means commodities of a kind customarily dealt in on an organized commodity exchange but only if the transaction is of a kind customarily consummated at such place.

Banking/Financing Activities

- **Investments (including loans) made by a *banking, financing, or similar business* constitute commercial activities.**
 - Raises the classic investment/trading in debt securities versus loan origination concern applicable to ECI questions.
 - Applies even if income is not effectively connected to banking, financing or similar business in the US.

Inadvertent Commercial Activities – Proposed Regulations

- **One dollar of CAI anywhere in world turns off 892 for controlled entity including dividends from such entity**
- **Proposed regulations**
 - Inadvertent commercial activities do not cause entity to be CCE
 - CAI still not entitled to exemption from tax
- **Requirements**
 - Failure to avoid commercial activity reasonable (written policies/procedures)
 - Promptly cured
 - Record maintenance
- **Safe Harbor**
 - Value of the assets used in CA no more than 5% of total BS assets, and
 - Income from CA does not exceed 5% of the entity's gross income as reflected on its income statement

Issues with Investments Through Partnerships

- **Character of income of partnership generally flows through to partners**
 - If partnership ETB, so are its partners (including LPs)
 - CAI in the hands of a partnership is CAI in the hands of SWF partners
 - Temporary Regulations clarify result
- **One dollar of CAI recognized by CCE anywhere in world turns off 892 for all income, not just CAI**

Proposed Partnership Rules

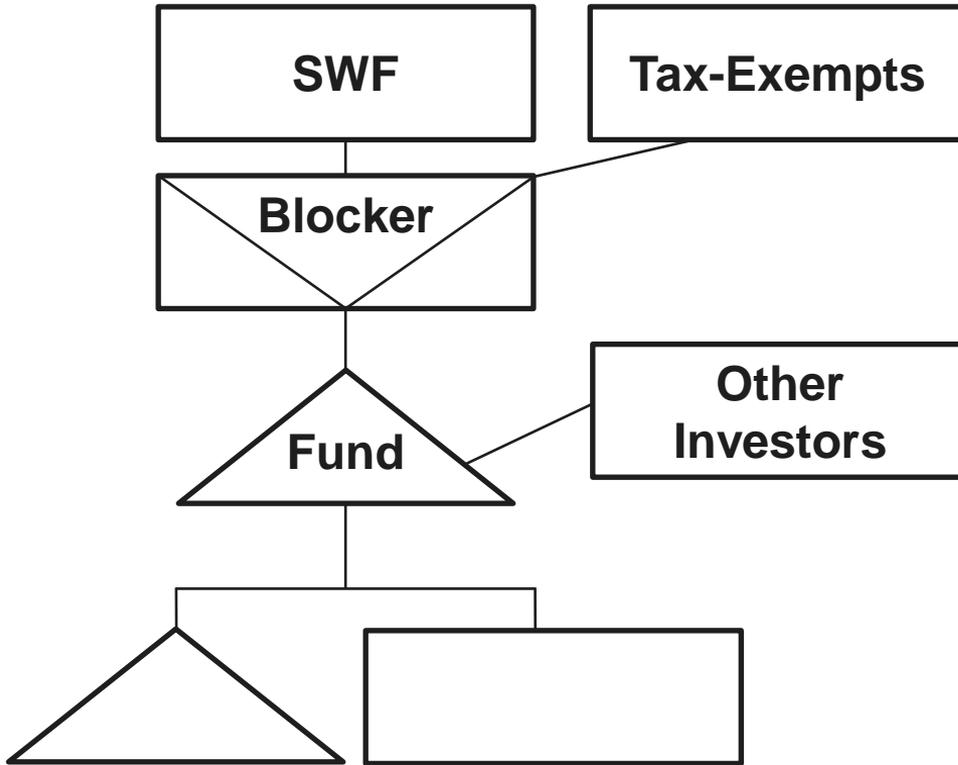
- **Proposed regulations intended to eliminate draconian result – activities not attributed if:**
 - Limited partner
 - Holder of the interest does not have rights to *participate in the management and conduct* of the partnership's business at any time during the partnership's taxable year under the law of the jurisdiction in which the partnership is organized or under the governing agreement
 - Impact of seat on LP advisory committee?
- **CAI Taxable**
 - No 892 on distributive share if partnership controlled commercial entity



**Does your fund use AIVs to preserve 892
benefits while avoiding CAI?**

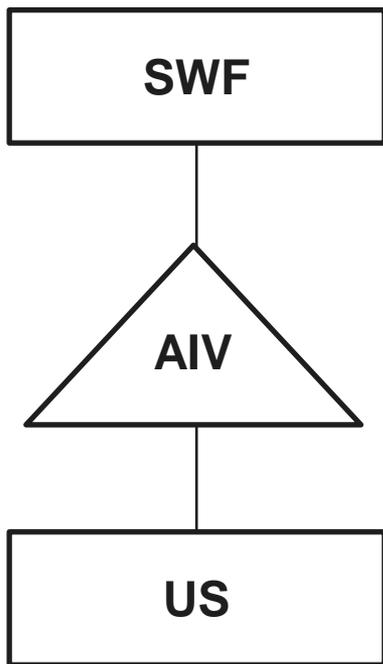
- A. Yes
- B. No

Use of CAI Blocker



- Blocker prevents CAI to SWF
- Blocker precludes 892 benefits for Fund income
- Blocker is partnership. Treaty benefits may apply. Local Law (not US tax) governs availability

Use of AIV for Dividend Paying Investment



- **SWF invests in AIV rather than Blocker**
 - SWF invests through Blocker with respect to foreign and non-dividend paying US investments
- **892 applies to US source dividends**
- **Avoid CAI in AIV**
- **SWF cannot be sole investor on AIV**
 - *Per Se Rule* – Deemed corporation



Partner, Tax
609.610.4171 mobile
609.951.4117 office
steven.bortnick@troutman.com

- Steve guides clients in transactional matters involving complex domestic and international tax issues with particular experience in the private equity space.
- Steve handles a broad range of transactions, including asset, stock, cross-border, and domestic acquisitions, recapitalizations and reorganizations. A significant portion of his practice focuses on structuring domestic and international private equity transactions. Steve also is regularly involved in the formation of global private equity funds.
- He is highly rated in Chambers USA: America's Leading Lawyers for Business for tax matters and is an active speaker and author.



Morgan Klinzing

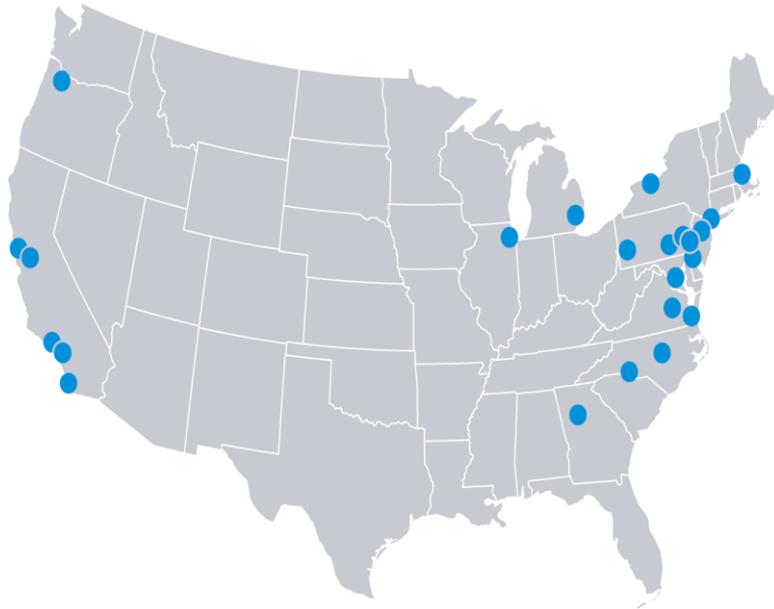


Associate, Tax
215.981.4560
morgan.klinzing@troutman.com

- Morgan's practice focuses on federal and international income tax, specifically on the private equity arena and pass-throughs.
- Morgan advises clients on federal and international income tax and private equity matters. Her practice includes advising on mergers, acquisitions, reorganizations, dispositions, capital markets, and restructurings. She is also involved in the formation of private equity and hedge funds.
- Morgan is an adjunct tax professor at Temple University Beasley School of Law, CLE Chair of the Partnership Committee of the Tax Section of the American Bar Association, and treasurer of the Philadelphia Tax Conference.



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