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TaxNewsFlash

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Proposed regulations: Foreign government income exception and definition of domestically controlled qualified investment entities (text of regulations)

The U.S. Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-100442-22) regarding the treatment of certain entities, including qualified foreign pension funds, for purposes of the exemption from taxation afforded to foreign governments.

The **proposed regulations** [PDF 316 KB] (as published in the Federal Register on December 29, 2022) also address the determination of whether a qualified investment entity (QIE) is domestically controlled, including the treatment of qualified foreign pension funds for this purpose.

Section 892(a)(1) exempts from U.S. taxation certain income derived by foreign governments. This exemption, however, does not apply to income that is (1) derived from the conduct of a commercial activity (whether within or outside the United States), (2) received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or (3) derived from the disposition of an interest in a controlled commercial entity. Section 897(a)(1) provides that gain or loss of a nonresident alien individual or foreign corporation from the disposition of a United States real property interest (USRPI) is taken into account under section 871(b)(1) or 882(a)(1), as applicable, as if the nonresident alien individual or foreign corporation were engaged in a trade or business within the United States during the taxable year and such gain or loss were effectively connected with that trade or business. Section 897(h)(2) provides that a USRPI does not include an interest in a domestically controlled qualified QIE (DC-QIE exception). Section 897(l) also provides an exemption to the application of section 897(a) on gain or loss on certain dispositions of, and distributions with respect to, USRPIs for certain foreign pension funds and their subsidiaries.

The proposed regulations provide guidance regarding:

- The coordination of the exemption under section 897(l) with section 892(a)
- The effect of section 897(l) on the DC-QIE exception
- Guidance for determining whether stock of a QIE is considered "held directly or indirectly" by foreign persons for determining whether a QIE is domestically controlled under section 897(h)(4)(B)

The proposed regulations under section 892 are proposed to apply to taxable years ending on or after the date the proposed regulations are published in the Federal Register, which is scheduled to be December 29, 2022. Taxpayers may rely on the proposed regulations under section 892 until the date of publication of the Treasury decision adopting the regulations as final in the Federal Register. Subject to a special rule for entity classification elections, the regulations under section 897 are proposed to apply to transactions occurring on or after the date the regulations are published as final regulations in the Federal Register; however, rules applicable for determining whether a QIE is domestically controlled may be relevant for determining QIE ownership during periods before the date these regulations are published as final regulations in the Federal Register to the extent the testing period related to a transaction that occurs after the date these regulations are published as final regulations in the Federal Register includes periods before that date. The IRS may challenge positions contrary to proposed Treas. Reg. §1.897-1(c)(3) and (4) before the issuance of final regulations relating to the topics addressed in those proposed rules.

Comments on the proposed regulations and requests for a public hearing are due by February 27, 2023.

The Treasury Department and IRS also filed a **notice** [PDF 222 KB] (as published in the Federal Register on December 29, 2022) that the comment period for regulations proposed under section 892 in 2011 (**REG-146537-06** [PDF 248 KB]) is reopened.

Additional comments and requests for a public hearing are due by February 27, 2023.

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