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UNITED STATES TAXATION OF FOREIGN GOVERNMENTS, INTERNATIONAL ORGANIZATIONS, AND THEIR EMPLOYEES—I.R.C. §§ 892, 893, 895 AND THE PROPOSED REGULATIONS†

by

Stephen P. Jarchow*

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† On July 2, 1980, after this Article went to print, the proposed regulation under § 892 was adopted with revision, reflecting some of the author's observations. 45 Fed. Reg. 48,882 (1980). The regulations concerning net leases were not finalized but were reproposed.

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A substantial increase in the investment activities of foreign sovereigns in the United States has occurred in recent years. Although much of this activity has been strictly related to express governmental functions, other ventures have had a decided commercial flavor. The United States tax treatment of foreign governments and related entities has caused increasing concern not only to those practitioners involved in advising the investors on a day-to-day basis, but also to those representing United States persons and entities engaged in transactions with foreign sovereigns. The United States has exempted certain types of income of foreign governments by express statute since the enactment of the income tax.\(^1\) Unfortunately, the precise scope of the exemption has always been somewhat unclear. Three sections of the Internal Revenue Code provide the basic format. Section 892 is the fundamental provision dealing with the tax treatment of income earned by foreign governments. It provides that the income of foreign governments or international organizations received from certain investments in the United States is not to be included in gross income and is exempt from United States income taxation. A corollary provision, section 893, exempts from tax the compensation of employees of a foreign government or international organization received for official services under certain conditions. Section 895 is a somewhat specialized Code section that exempts income derived by a foreign central bank of issue from obligations of the United States, or an agency or instrumentality thereof, owned by such bank, or from interest on bank deposits, unless the obligations or deposits are held or used for commercial banking. This provision is aimed at exempting foreign central banks not considered part of a foreign government under section 892.

On August 15, 1978, the Internal Revenue Service (IRS) issued proposed regulations under sections 892 and 893 in an effort to define and limit the scope of the available exemptions.\(^2\) While the proposed regulations reflect a diligent effort to deal with a difficult subject, they address many of the conceptual questions posed by section 892 in a manner many practitioners find troublesome. Numerous detailed comments have been submitted to the IRS criticizing various aspects of the proposed regulations.\(^3\) Originally, the IRS intended to issue final regulations in August 1979, but the ensuing debate within the IRS and the Treasury Department has caused delay. No definite date for issuance of final regulations has been set.

This Article examines section 892, explores its history, analyzes the proposed regulations under this section, and explains the related sections, 893 and 895.

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1. War Revenue Act, ch. 63, § 1211, 40 Stat. 300 (1917); see text accompanying note 7 infra.
3. See notes 82, 83, 87, 120, 126 & 129 infra.
I. Section 892

A. Background

Section 892 is the basic provision dealing with the tax treatment of income earned by foreign governments or international organizations:

The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.\(^4\)

The United States tax exemption for income earned by a foreign government\(^5\) is premised upon the international law concept of sovereign immunity. The parameters of sovereign immunity are somewhat obscure, however, and the tax exemption certainly reflects this lack of clarity.\(^6\)

Originally enacted as part of the Revenue Act of October 3, 1917, the exemption for foreign governments provided:

That nothing in Section II of the Act approved October third, nineteen hundred and thirteen, entitled “An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes,” or in this title, shall be construed as taxing the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to foreign governments.\(^7\)

Early in 1919, the entire federal income tax law was substantially restated and reenacted in the Revenue Act of 1918.\(^8\) Section 30 of the Revenue Act was amended to expand the categories of income covered by the initial

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5. Although the exemption for foreign governments applies to their political subdivisions, including municipalities (Treas. Reg. § 1.892-1(a) (1960); Rev. Rul. 72-54, 1972-1 C.B. 213), the assets generating the United States income must actually be owned by the foreign government (Treas. Reg. § 1.892-1(a) (1960); Rev. Rul. 69-361, 1969-1 C.B. 193). When the investment is not actually owned by, but is loaned to, a foreign government, income from investments is subject to tax (Treas. Reg. § 1.892-1(a) (1960); Rev. Rul. 69-361, 1969-1 C.B. 193).
statute to include income "from any other source within the United States." While the inclusion of this language arguably broadened the scope of the exemption, no substantive legislative comment exists on the intended effect of the provision. In 1945 a second amendment exempted certain income received by international organizations. The term "international organization" is defined in the International Organizations Immunities Act as "a public international organization in which the United States participates pursuant to any treaty or under the authority of any Act of Congress authorizing such participation . . . ."

The four specific requirements of an international organization are that (1) the organization is public rather than private; (2) the members of the organization are foreign governments; (3) the United States participates in the organization; and (4) the organization has been designated by Executive Order as entitled to enjoy the privileges, immunities, and exemptions under the International Organizations Immunities Act. The requirement that the organization be public rather than private is similar to the public purpose requirement for charitable foundations under United States tax law. It is apparently aimed at preempting the use of an international organization to foster private gain. The President has designated the World Bank, the International Monetary Fund, the Organization of American States, and the United Nations, among others, as qualifying organizations. The President may revoke his action with respect to any organization, in which case the application of section 892 would terminate. Without specifically revoking international organization designation, the President may withhold or withdraw any one or more of the privileges, exemptions, and immunities contemplated by the International Organizations Immunities Act, or make their application conditional. The number of privileges an organization must enjoy in order to be exempt under section 892 is unclear.

9. Id. § 213(b)(5).
10. International Organizations Immunities Act, § 1, 22 U.S.C. § 288 (1976). The extension of this exemption to international organizations is particularly important in the context of the § 893 exemption for international organization employees.
11. Id.
12. Id.
18. Id.
B. Exempt Entities

The nature of a "foreign government" under section 892 has long been the subject of considerable conjecture. An early ruling held that income received by a foreign ruler "in his individual capacity" was taxable, while income earned on "property belonging to the Crown" was not.\textsuperscript{20} This distinction, though appropriate, is of little assistance in the difficult factual determinations that necessarily arise.

Certain socialist and OPEC countries in which all or most economic endeavors emanate from the government pose especially perplexing conceptual and practical problems. Advisers of foreign clients have contended that commercial activity in the United States by OPEC or socialist countries is tax-exempt even when such activity is in direct competition with domestic operations.\textsuperscript{21} This troublesome situation is further complicated by the fact that in many countries separate investment by the ruling class, as individuals, is indistinguishable from investment by a foreign government.\textsuperscript{22}

1. Early Developments. Initially, the Bureau of Internal Revenue appeared to take a relatively flexible view and to permit exemption for income received from the sale of raw materials in the United States by delegates representing a foreign country,\textsuperscript{23} income from operations of vessels by agents of a foreign government,\textsuperscript{24} and income of a foreign government railroad.\textsuperscript{25} Similarly, in 1920 the Bureau rather matter-of-factly ruled that the Commonwealth Bank of Australia, one of the Australian central banks established legislatively as a separate corporate body, was a governmental agency of the Commonwealth of Australia and thus exempt.\textsuperscript{26} The Bureau appeared to take the sensible position that a foreign corporation that was wholly owned by a foreign government and that served a governmental function was, as a general matter, exempt from tax on income from sources within the United States.\textsuperscript{27}

\textsuperscript{20} O.D. 483, 2 C.B. 96 (1920) (declared obsolete by Rev. Rul. 70-293, 1970-1 C.B. 282). In 1923 the State Department advised the French Ambassador that securities owned by the reigning Prince of Monaco would be subject to United States inheritance taxes. In 1926 the Queen of Romania was advised that she would be exempt from United States income tax on her earnings from her visit to the United States. In 1971 an exemption was extended to a domestic corporation wholly owned by the Government of Nicaragua and operating a railroad in Nicaragua. See 2 G. Hackworth, Digest of International Law 404 (1941).

\textsuperscript{21} The ambiguity of the language "from any other source" in § 892 has prompted advisers to take the position that their foreign government clients have been exempt from United States taxation with respect to all activities and consequently do not need to file tax returns. As a result, foreign government investment has been largely undetected, and the IRS has made no effort to audit these potential taxpayers. The proposed regulations may mean a dramatic increase in audit activity.

\textsuperscript{22} See Fensterwald, Sovereign Immunity and Soviet State Trading, 63 Harv. L. Rev. 614, 621 (1950).


\textsuperscript{27} Id.
Subsequently, the Bureau proposed to allow a claim for refund of income taxes paid by a New York corporation engaged in commercial activities on the premise that it was wholly owned by a foreign government.\textsuperscript{28} When reviewing the proposed refund, the staff of the Joint Congressional Committee on Internal Revenue Taxation disagreed on the basis that the exemption for foreign governments “did not extend to separate corporations, which may be engaging in commercial activities, even though they are wholly owned by a foreign government.”\textsuperscript{29}

The imposition of tax on a New York business corporation engaged in commercial activities in the United States is reasonable and comports well with United States taxation of foreign entities in general.\textsuperscript{30} The Bureau reacted somewhat strangely to the position taken by the staff of the Joint Committee, however, by revoking the exemption of the Commonwealth Bank of Australia, stating that “the benefits of . . . [the predecessor to section 892] can not be extended to a corporation which is wholly owned by a foreign government inasmuch as a corporation is an entity separate and distinct from its sole stockholder.”\textsuperscript{31} One commentator observed:

Thus the Bureau, in effect, analogized to a New York business corporation an entity: (1) which was created by legislative act; (2) which was statutorily controlled by officials of the Australian government; (3) whose debt securities, the issuance of which were controlled by the Governor General, were guaranteed by the Commonwealth; and (4) whose profits inured to the Commonwealth.\textsuperscript{32}

The Commonwealth Bank performed governmental currency functions quite similar to those of the United States Federal Reserve Banks, and its tax status clearly should not have been handled so perfunctorily.\textsuperscript{33}

In 1946, the year of the bank’s revocation of exemption, the Commissioner of Internal Revenue also withdrew an earlier ruling by which he had held that the salaries of the United States employees of Corporacion de Fomento de La Produccion (Fomento), the Chilean National Development Agency, were exempt under the predecessor to section 893.\textsuperscript{34} The Commissioner predicated the reversal of position on the simplistic basis that Fomento was to be considered an entity separate from the Government of Chile and, consequently, in light of the New York corporation and Commonwealth Bank analysis, was not exempt. The United States Secretary of State requested the United States Secretary of the Treasury to reconsider, observing that the State Department had difficulty explaining to the Chilean Government representatives why a rule to withhold exemption was made applicable to Fomento based upon a holding relating only to a New York corporation, the organization and functions of which were quite

\textsuperscript{29} Id.
\textsuperscript{30} See generally I.R.C. §§ 881-884.
\textsuperscript{32} Tillinghast, supra note 19, at 510-11.
\textsuperscript{33} Treas. Reg. § 1.895-1(b)(2) (1967).
\textsuperscript{34} Tillinghast, supra note 19, at 511.
different from those of Fomento.\textsuperscript{35}

The Treasury Department response was apparently unsatisfactory because the conflict resulted in \textit{Vial v. Commissioner},\textsuperscript{36} a rare section 892/893 court appearance. The Tax Court determined Fomento to be an integral part of the Chilean Government and its employees accordingly exempt under the predecessor to section 893.\textsuperscript{37} Fomento received the proceeds of certain taxes imposed by the Chilean Government as well as financing from general government revenues. It was a vehicle through which the government administered funds received from the Export Import Bank and World Bank Development loans made on the government’s credit, and it was closely supervised by government officials. Therefore, it could reasonably be considered a governmental entity and clearly appeared to merit exemption. Unfortunately, the Tax Court, in a somewhat confusing opinion, focused not only on the functions of Fomento, but also on its nature as a separate legal entity. The Tax Court observed that Fomento was “not a corporation as that term is understood in the United States,”\textsuperscript{38} being a “legal person of public statute”\textsuperscript{39} as opposed to a sociedad anonima\textsuperscript{40} or business corporation, “a legal person of private statute.”\textsuperscript{41} The Bureau appeared to view this case as indicating that certain corporations could be so closely integrated with a foreign government that they would not be considered a separate corporation but rather a part of the foreign government. Consequently, the Bureau acquiesced in the \textit{Vial} decision,\textsuperscript{42} but did not alter its formal position that, as a general matter, the exemption did not apply to a separate corporation.

Similarly, a 1952 ruling that exempted the income of a foreign government-owned railway emphasized that “[t]he railway system in the instant case is so closely integrated with the executive arm of the foreign government as to be a part thereof.”\textsuperscript{43} The ruling cited the \textit{Vial} case but then contrasted the result in \textit{Vial} to the ruling that revoked the exemption of the Commonwealth Bank of Australia.\textsuperscript{44} Therefore, although Fomento and the railway were exempt, the Commonwealth Bank still was not, a rather anomalous result.

In 1955 the Service privately ruled that several foreign central banks would be exempt under section 892.\textsuperscript{45} Upon reviewing the resulting re-

\begin{itemize}
\item \textsuperscript{35} \textit{Id.} This exchange illustrates the political tug-of-war that can arise in a § 892 context.
\item \textsuperscript{36} 15 T.C. 403 (1950), \textit{acq.} 1952-1 C.B. 4.
\item \textsuperscript{37} 15 T.C. at 410.
\item \textsuperscript{38} \textit{Id}. at 404.
\item \textsuperscript{39} \textit{Id}
\item \textsuperscript{40} \textit{Id}. A sociedad anonima is a Chilean business entity that is generally viewed as a corporation in nontax business parlance. \textit{Id}. at 410.
\item \textsuperscript{41} \textit{Id}
\item \textsuperscript{42} 1952-1 C.B. 4.
\item \textsuperscript{43} I.T. 4082, 1952-1 C.B. 69, 71.
\item \textsuperscript{44} \textit{Id}. For a discussion of the Commonwealth Bank revocation, see text accompanying notes 30-33 \textit{supra}.
\item \textsuperscript{45} \textit{See} Tillinghast, \textit{supra} note 19, at 513. These rulings were reportedly quite cursory, without analysis of the troublesome issues.
\end{itemize}
fund claims, however, the Joint Committee again took the contrary position with the rather cavalier statement that "an entity with the attributes of an ordinary domestic corporation should not be considered a part of a foreign government." This turn of events added to the existing ambiguity and ultimately resulted in the enactment of section 895.

2. Redefinition of Exempt Entities. The Internal Revenue Service formally reconsidered its position on exempt entities in 1966 and concluded in Revenue Ruling 66-73 that an organization separate in form and wholly owned by a foreign government, no part of the net earnings of which inured to the benefit of any private individual, was exempt from tax under section 892, provided it was not a corporation as that term was generally understood in the United States. The IRS indicated that it would look at the purposes, functions, and activities of a particular organization to determine whether it most resembled a private United States corporation or a governmental body. The use of a United States standard for "corporateness" could be defended as a means of preventing the unwarranted extension of a tax advantage to private foreign businesses conducted through government corporations or agencies that were effectively in competition with United States firms. The ruling proved troublesome, however, because many corporations or agencies controlled by a foreign sovereign that were actually performing governmental functions could be routinely excluded from exempt treatment.

Several subsequent revenue rulings dealt with specific definitional problems under section 892, but the influence of Revenue Ruling 66-73 on these rulings remained unclear. Revenue Ruling 68-309 treated the European Communities (European Coal and Steel Community, European Economic Community, and the European Atomic Energy Community (Euratom)) as constituting, collectively and individually, a foreign government within the meaning of sections 892 and 893. While the result in this ruling appears intuitively appropriate, the European Communities should not be considered "governments." Such groups bear a far greater resemblance to international "organizations," which are only exempt under section 892 if the United States is a participant. Because of the latter requirement, the European Communities could not qualify for exemption unless they were construed to be governments, but the ruling perfunctorily

47. See text accompanying notes 176-94 infra.
49. Id.
50. Id.
51. But see Private Letter Ruling No. 5503235690A, issued in 1966 [copy on file at Underwood Law Library, Southern Methodist University], wherein the Commonwealth Bank of Australia was held to be exempt under § 892 presumably because it was part of the government, but no reference was made to Rev. Rul. 66-73, 1966-1 C.B. 174 (revoked by Rev. Rul. 75-298, 1975-2 C.B. 290).
52. 1968-1 C.B. 338.
attributed governmental status to the European Communities without adequate explanation of its holding or rationale. 54

Revenue Ruling 69-36155 held that section 892 did not apply to dividend income on certain investments administered by the board of governors of a hospital that was owned and operated by a foreign government. The investments represented the proceeds of private donations or bequests to the hospital, which was also supported by appropriated government funds. Although title to all hospital property was in the name of a government official, the board of governors administered the funds as trustee. The IRS found that under the applicable foreign law, the funds were not government funds. Accordingly, it held that the dividends paid were not exempt. 56 This holding is somewhat difficult to reconcile with Revenue Ruling 66-73 because the organization appeared to be wholly owned by the foreign government. The IRS did not clarify whether it reached a contrary determination because the income resulted from the investment of privately donated funds or rather because the members of the board of governors of the hospital were private citizens and not government officials.

In an interesting contrast, Revenue Ruling 72-18357 held that section 892 applied to investment income derived by the Staff Provident Fund (retirement fund) of the Organization for Economic Cooperation and Development (OECD), an international organization. The IRS found that the fund had no separate juridical personality, was administered directly by OECD officials and, though segregated from other assets, was treated by the OECD and its members as consisting of assets of the OECD. The fund described in Revenue Ruling 72-183 was based on a contributory scheme. Not only was an employee entitled to a return of his contributions plus interest upon termination of his employment for any reason, but he was also entitled to withdraw all such amounts at any time to reimburse the cost to him of certain old age, disability, and similar insurance. If the donations and bequests to the hospital in Revenue Ruling 69-361 were not considered government funds, the employee contributions in Revenue Ruling 72-183 should not be so considered, regardless of the manner in which they were viewed by the OECD and its members. Yet the inconsistency in these rulings is typical of the problems posed for those analyzing section 892. 58 Various political considerations undoubtedly influence the ultimate result in any ruling.

A similarly broad construction of section 892 occurred in Revenue Ruling 73-4659 which held that the Government of the Trust Territory of the

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54. The proposed regulations address these kinds of organizations under the heading of "transnational entities." See text accompanying notes 88-105 infra.
56. Id.
57. 1972-1 C.B. 213.
58. See Private Letter Ruling No. 780746 [copy on file at Underwood Law Library, Southern Methodist University].
Pacific Islands was a foreign government, even though the United States Department of Interior actually governed the Trust Territory. Therefore, the income from funds invested in securities of United States corporations by the Trust Territory Security Board was exempt under section 892.

3. Refining the Scope of Section 892. Revenue Ruling 66-73 was revoked in 1975 by the issuance of Revenue Ruling 75-298.\(^{60}\) This new effort to set forth the parameters of section 892 was a consequence, at least in part, of increased investment of OPEC funds in the United States.\(^{61}\) Revenue Ruling 75-298 held that income earned by a foreign central bank of issue within section 895, or by any other organization created by a foreign government, which does not engage in commercial banking or other than de minimis general commercial activities in the United States, will qualify for exemption under section 892 if certain requirements are met:

1. the bank or organization is wholly owned and controlled by a foreign government;
2. its assets and income are derived solely from its activities and investments and from the foreign government;
3. its net income is credited either to itself or to the foreign government, with no portion of its income inuring to the benefit of any private person; and
4. its investments in the United States, if any, include only those that produce passive income, such as currencies, fixed interest deposits, stocks, bonds, and notes or other securities evidencing loans.\(^{62}\)

The ruling indicated that the same four-pronged test will be applied for purposes of section 893. Therefore, a request for ruling under sections 892 or 893 in this context must include a description of activities and investments in the United States and a certification that the organization meets the four requirements.\(^{63}\)

In Revenue Ruling 75-298 the IRS no longer focused on the issue of whether an organization constituted a corporation as defined in the United States, but instead concerned itself with whether an organization would be considered part of a foreign government. The fact that the predominant purpose or activities of an organization were commercial in nature appeared to be no longer relevant, so long as it did not engage in commercial activities in the United States. This ruling proved helpful because it attempted to avoid much of the “United States-type corporation” inquiry that had been so confusing earlier. Nevertheless, it still focused on whether a separate organization existed, a concern that seems misplaced. The crucial factor should be whether a particular legal structure serves a function commonly conceived as governmental.

Subsequently, the IRS ruled in Revenue Ruling 76-329\(^{64}\) that a currency

\(^{60}\) 1975-2 C.B. 290.
\(^{61}\) Tillinghast, \textit{supra} note 19, at 518.
\(^{62}\) Rev. Rul. 75-298, 1975-2 C.B. 290. To the extent that the ruling produces adverse tax effects, it will not be applied retroactively. \textit{Id}
\(^{63}\) \textit{Id}
\(^{64}\) 1976-2 C.B. 223.
board created by a foreign government to issue and redeem currency, which met all the requirements of Revenue Ruling 75-298, was exempt under both sections 892 and 895 from tax on interest received from its investment in United States treasury bonds. The IRS viewed the board as engaged in neither commercial banking functions nor other commercial activity. This ruling demonstrates the application of the Revenue Ruling 75-298 requirements.65

4. The Proposed Regulations. As suggested by the preceding discussion, many conceptual questions have arisen regarding the nature of exempt entities under section 892. The confusion surrounding this issue was a primary motivation behind the IRS's attempt to rewrite the regulations. In formulating the proposed regulations, the IRS faced the technical problem of characterizing exempt and nonexempt activities in a convenient fashion. The proposed regulations distinguish between the terms "foreign sovereign" and "foreign government."66 A "foreign sovereign" appears to include both nonexempt commercial enterprises and exempt "foreign government" activities.67 Therefore, a "foreign government" is the exempt portion of a "foreign sovereign." The IRS thus indicates at this early juncture in the proposed regulations that it will be distinguishing between commercial and noncommercial activities, a distinction based on the traditional notion that sovereign immunity is available only for governmental activities.68

a. Integral Parts. The proposed regulations provide that a foreign government consists only of "integral parts" or "controlled entities" of a foreign sovereign.69

An "integral part" of a foreign sovereign is any person, body of persons, organization, agency, bureau, instrumentality, or body, however designated, that constitutes the governing authority of a foreign country that is not engaged in commercial activities in the United States. 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. It does not include any individual who is a sovereign, official, or administrator acting in a private or personal capacity.70

Although the IRS is attempting to make a distinction, as in previous rulings, between the government and the rulers as individuals,71 ascertaining the existence of an integral part would seem to be a difficult determination in many instances, particularly in certain socialist and OPEC nations.

70. Id. § 1.892-1(b)(2), 43 Fed. Reg. at 36112.
b. Controlled Entities. A “controlled entity” of a foreign sovereign is defined in the proposed regulations in language that tracks the requirements promulgated by the IRS in Revenue Ruling 75-298, with certain somewhat different references. Specifically, a “controlled entity” created by a foreign sovereign, which is not an integral part thereof, must meet the following requirements under the proposed regulations:

(i) It is wholly owned and controlled by a foreign sovereign;
(ii) It is organized under the laws of the foreign sovereign by which it is owned or, if the law of a State of the United States requires, organized under the law of that State;
(iii) Its net earnings are credited either 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;
(iv) Its assets must vest in the foreign sovereign upon dissolution; and
(v) It does not engage in the United States in commercial activities on more than a de minimis basis.

The first and second requirements are virtually the same as two of the requirements in Revenue Ruling 75-298. The third requirement as to the nature of organizational status replaces the requirement of Revenue Ruling 75-298 that assets and income be derived solely from an entity’s activities and investments and from the controlling foreign government. A controlled entity apparently cannot be organized under the laws of a different country than that of the controlling government. This requirement preempts, for example, an exemption for OPEC investments via a Swiss entity. A United States entity, however, may be a controlled entity of a foreign sovereign when its organization is required by the laws of a particular state. The fourth requirement further refines the third. The fifth requirement permits de minimis commercial activity, but probably is intended to replicate the prior limitation of the exemption to passive income. The proposed regulations also indicate that while de minimis commercial activity of a controlled entity will not preempt exemption, de minimis commercial income will be included in gross income of the foreign sovereign. This reference does not clarify whether tax is imposed on the controlled entity or the entire foreign sovereign, but the provision in the proposed regulations concerning filing of returns suggests that the controlled entity will be taxed as a separate unit.

The distinction between integral parts and controlled entities is neither conceptually appropriate nor practical because of the difficulty in evaluating whether an entity is “integral” or “controlled” and whether the five-
pronged test for a controlled entity is appropriate.\textsuperscript{80} The problem is further complicated because many foreign governmental agencies are different from any organization in the United States. The Tax Court in the \textit{Vial} case specifically noted that “it is not necessary that an exact counterpart for Fomento be found in our government. Perhaps none exists. Nevertheless, Fomento was a part of the Government of Chile.”\textsuperscript{81} While governments may be distinguished from nongovernments in most cases, distinguishing among various government agencies and organizations of the nations of the world based on the structure of such agencies, or even the types of activities they perform, is complex. Therefore, many practitioners have resisted the distinction in the proposed regulations between integral parts of a government and controlled entities.\textsuperscript{82}

Furthermore, as a matter of international comity and good international relations, the distinction between units of a government is inappropriate. The form that a foreign government uses to structure its affairs should not concern the IRS. If a government desires to create a department, agency, or authority to perform a particular task, this decision should have no effect on the tax treatment of the government and its units under section 892.\textsuperscript{83}

\textbf{c. Controlled Entities of Controlled Entities.} Under the proposed regulations, the definition of a controlled entity excludes organizations that are not created and wholly owned by a foreign sovereign.\textsuperscript{84} Specifically, the definition requires that a controlled entity be “created by a foreign sovereign”\textsuperscript{85} and that its net earnings and, upon dissolution, its assets, be credited to or vest in a foreign sovereign.\textsuperscript{86} Consequently, an organization that would otherwise be a controlled entity will fail to qualify if it is to any extent owned by another controlled entity. An amendment to the proposed regulations would be appropriate to exempt such entities in order to accommodate certain sub-agencies of foreign governments, as well as pension trusts that provide benefits for the employees of a controlled entity similar to those provided by a defined benefit plan for United States tax purposes.\textsuperscript{87}

\textbf{d. Transnational Entities.} The proposed regulations attempt to deal with the nature of cooperative ventures among foreign governments be-

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\textsuperscript{80} \textit{Id.} §§ 1.892-1(b)(1)-(3), 43 Fed. Reg. at 36113.
\textsuperscript{82} See, \textit{e.g.}, Letter from Gibson, Dunn & Crutcher to Commissioner of Internal Revenue (Jan. 22, 1979); Letter from Davis, Polk & Wardell to Commissioner of Internal Revenue (Jan. 18, 1979). [Copies of these letters are on file at Underwood Law Library, Southern Methodist University.]
\textsuperscript{83} Letter from Sullivan & Cromwell to Commissioner of Internal Revenue (Oct. 2, 1978) [copy on file at Underwood Law Library, Southern Methodist University].
\textsuperscript{85} \textit{Id.}
\textsuperscript{86} \textit{Id.} § 1.892-1(b)(3)(iii), 43 Fed. Reg. at 36113.
\textsuperscript{87} Letter from Levenfeld & Kanter to Commissioner of Internal Revenue (Oct. 13, 1978) [copy on file at Underwood Law Library, Southern Methodist University].
cause a foreign financial organization organized, wholly owned, and controlled by several foreign sovereigns to foster economic, financial, and technical cooperation between various foreign nations is not a controlled entity.

The rules that apply to a foreign sovereign [to exempt income of foreign governments and tax income on commercial activity] apply to political subdivisions of a foreign country and to “transnational entities.” A transnational entity is an organization created by several foreign sovereigns that has broad powers over external and domestic affairs of all participating foreign countries stretching beyond economic subjects to those concerning legal relations and transcending state or political boundaries.

This definition reflects the same IRS position articulated in several prior revenue rulings. Revenue Ruling 68-309, for example, perfunctorily held that the European Communities (European Coal and Steel Community, European Economic Community, and Euratom) constituted foreign governments within the meaning of sections 892 and 893. They would thus qualify as transnational entities under the proposed regulations. As emphasized in the preceding discussion, the European Communities are not “governments” in a classical sense, but resemble international organizations that are only exempt if the United States is a participant. Therefore, they could qualify for exemption only if construed as governments. This result has important practical implications in a section 893 context for employees of the European Communities who wish to obtain exemption of their salaries from United States taxation.

Several rulings subsequent to Revenue Ruling 68-309 reflect that many foreign entities would not be considered transnational entities under the new proposed regulations. Revenue Ruling 77-41 held that a financial organization wholly owned and controlled by four foreign governments and established under the laws of one of them “to foster economic, financial, and technical cooperation between various foreign nations” was not exempt as a foreign government or an international organization. Revenue Ruling 68-309 was distinguished on the basis that the organization in Revenue Ruling 77-41 was not empowered to exercise independently substantial governmental powers binding upon its members.
countries. The holding in Revenue Ruling 75-298 defining the requirements for exemption under section 892 was clarified and limited to organizations wholly owned and controlled by a single foreign government.

Similarly, Revenue Ruling 77-482 held that the East Caribbean Currency Authority was not a foreign government exempt under section 892. Nevertheless, the organization was considered to be a foreign central bank of issue within the meaning of section 895. Significantly, the exemption under section 895 and the regulations thereunder do not refer to the requirements of being wholly owned or controlled by a single foreign government or being an international organization recognized by the United States. This distinction between sections 892 and 895 has been discussed in a number of private letter rulings.

The concept of a transnational entity is apparently aimed at a special organization that overrides traditional trade barriers and seeks some form of political union. Apparently, few organizations other than the European Communities would qualify. One commentator has conjectured that a group of foreign countries might achieve section 892 exemption by having separate national agencies enter into a contractual arrangement to carry out certain economic objectives. This arrangement ideally would not be deemed the creation of a controlled entity that would have to meet the rigid requirements of the proposed regulations, but rather a partnership, with a “pass through” of the United States source income to each of the exempt participants. Alternatively, foreign governments might consider separately investing funds in the United States under their section 892 exemption and paying income over to a multinational entity.

C. Exempt Income

In the preceding section this Article has explored the various types of entities that have been afforded section 892 exemption in the past, as well as the classification of exempt entities under the proposed regulations. This section considers the various types of income that may qualify as exempt when earned by an exempt entity, both historically and under the proposed regulations. The characterization of exempt income, like that of

96. 1977-1 C.B. 227.
98. The controlled entity concept in Rev. Rul. 75-298 relates to a common situation wherein a single foreign government invests in the United States or conducts business in the United States through a single entity. The transnational entity concept is a new concept apparently aimed at obtaining exemption for the European Communities. Its basis is questionable.
100. I.R.C. § 895.
102. Tillinghast, supra note 19, at 521.
103. See text accompanying notes 73-74 supra.
104. Tillinghast, supra note 19, at 521.
105. Guttentag, supra note 65, at 521.
exempt entities, has been a perennial source of confusion for practitioners dealing with section 892.

1. Introduction. As originally drafted, the exemption under section 892 was expressly limited to income from securities and interest on bank deposits.\(^{106}\) In 1918, however, the statutory language was changed to include income of foreign governments from "any other source within the United States."\(^{107}\) Legislative history does not reveal whether this amendment was intended to extend the exemption to all income, including that from active commercial sources, or merely to other types of passive investment income. In recent years the IRS has taken a somewhat restrictive view on this point and has informally relegated the exemption to passive income.\(^{108}\) The IRS view is apparently based on the premise that sovereign immunity should be extended only to governmental, as contrasted with commercial, endeavors. While this rationale is generally accepted in related immunity areas,\(^{109}\) the authority for such a view is conflicting and not altogether persuasive.\(^{110}\)

2. The Proposed Regulations. The proposed regulations provide that amounts derived by a foreign sovereign from commercial activities in the United States are not income of a foreign government for purposes of the exemption under section 892.\(^{111}\) Thus, according to the strict language of the regulations, commercial income may be earned by a foreign sovereign, but not by a foreign government.\(^{112}\)

   a. Taxable Foreign Sovereigns. The proposed regulations indicate that commercial earnings are to be included in the income of the foreign sovereign and taxed under sections 881 or 882.\(^{113}\) The implication of the reference to these sections is that foreign sovereigns engaged in commercial activities in the United States will be taxed in a manner similar to foreign corporations.\(^{114}\) The reference to section 881 is somewhat ambiguous because that section generally relates to activities that would be considered noncommercial in character.\(^{115}\) This reference apparently encompasses

\(^{106}\) War Revenue Act, ch. 63, § 1211, 40 Stat. 300 (1917).
\(^{108}\) Tillinghast, supra note 19, at 508.
\(^{110}\) See letter from Gibson, Dunn & Crutcher and Davis, Polk & Wardell, supra note 82.
\(^{112}\) Id.
\(^{113}\) Id.
\(^{114}\) Id. § 1.892-1(e), 43 Fed. Reg. at 36113.
\(^{115}\) I.R.C. § 881(a) imposes a 30% tax on amounts received by foreign corporations from sources within the United States to the extent that such amounts are not connected with the conduct of a trade or business within the United States. Section 882(a) provides
net leases, realty rentals, and other related circumstances.\textsuperscript{116}

Some authority exists for treating foreign political parties and related organizations, if taxable, as foreign corporations.\textsuperscript{117} This analysis may be determinative for international organizations. While the inquiry with respect to foreign sovereigns themselves is more complicated, the recommended approach would be to treat them also as corporations. If a foreign sovereign is to be taxed at all, a determination that it should be taxed according to the other alternatives in the Code as a trust,\textsuperscript{118} partnership,\textsuperscript{119} or agency would unduly complicate an already difficult conceptual problem.

A contrary argument can be made, however, that foreign sovereigns do not fit any of the criteria for characterization as individuals, corporations, partnerships, or fiduciaries and therefore are exempt from tax. This argument, while admitting that corporate characterization may well be the simplest approach, asserts that a foreign sovereign does not possess a majority of the relevant corporate characteristics under the regulations.\textsuperscript{120} Strictly speaking, a foreign sovereign does not have "an objective to carry on business and divide the gains therefrom,"\textsuperscript{121} although the multiplicity of governmental activities may include this kind of endeavor. Nonetheless, a foreign sovereign is not formed by individuals or organizations for that purpose, but rather to further certain political, economic, and social ends. In addition, a sovereign can have personal liability for its actions, subject to the doctrine of sovereign immunity,\textsuperscript{122} and has no owners whose interests can be freely transferred.\textsuperscript{123}

Although few courts have dealt with the question of whether a sovereign is a corporation, some have held that it is not.\textsuperscript{124} As suggested by the formulation in the proposed regulations, the IRS and many practitioners have assumed that taxable foreign sovereigns may be subject to tax as corporations.\textsuperscript{125} One might still contend, however, that foreign sovereigns should not be taxed at all. The general concept of sovereign immunity, the lan-

\begin{footnotesize}
\textsuperscript{116} See text accompanying notes 145-48 infra.
\textsuperscript{118} I.R.C. § 641.
\textsuperscript{119} Id. § 701.
\textsuperscript{120} See generally W. BISHOP, INTERNATIONAL LAW 658-741 (3d ed. 1971).
\textsuperscript{121} Treas. Reg. § 301.7701-2(a)(ii) (1967).
\end{footnotesize}
Language of the Code, and the mechanics of entity taxation can all be invoked to support this argument, and these rationales may prevail in certain circumstances.\textsuperscript{126}

b. Noncommercial Activities.

(1) Portfolio Investments. The proposed regulations indicate that income from "investments in the United States in stocks, bonds, or other domestic securities, or the holding of deposits in banks in the United States which produce interest or dividends not effectively connected with the conduct of a trade or business within the United States"\textsuperscript{127} will be exempt. Some private letter rulings suggest, however, that the IRS will not look favorably on investments in securities that are not publicly traded; in other words, the interest must be portfolio rather than "controlling" in character in order to be exempt.\textsuperscript{128} The final regulations should include a clarification of whether the section 892 exemption applies to all investments in securities of United States corporations, or merely those that do not represent controlling interests.\textsuperscript{129}

A United States corporation, other than a controlled entity, that engages in United States commercial activities and that is owned by a foreign government pays the same United States income taxes as a corporation owned by private interests.\textsuperscript{130} Dividends paid by it to a foreign government shareholder have the same character whether the shareholder is a portfolio investor or owns a controlling interest in its shares. Therefore, in both cases, they should enjoy exemption as investment income under section 892.

(2) Cultural Activities. Under the proposed regulations, income from performances and exhibitions within the United States devoted to the promotion of the arts by cultural organizations is exempt.\textsuperscript{131} The IRS first formally recognized the exemption of this kind of governmental activity in 1959 in a ruling involving the Soviet film company Sovexport Film.\textsuperscript{132} The ruling appeared to limit the exemption to specific transactions under the Cultural, Technical and Educational Exchange Agreement of 1958, without comment on other activities.\textsuperscript{133}

Clearly, bona fide exportation of native culture merits exemption. Nev-

\textsuperscript{126} See Letter from Milbank, Tweed, Hadley & McCloy, \textit{supra} note 120.


\textsuperscript{129} Letter from American Bar Association, Taxation Section, to Commissioner of Internal Revenue (Oct. 18, 1978) [copy on file at Underwood Law Library, Southern Methodist University].

\textsuperscript{130} This conclusion is based on the general taxation provisions of the Code applicable to domestic corporations and the reference in Prop. Treas. Reg. § 1.892-1(a), 43 Fed. Reg. 36111, 36112 (1978), taxing foreign corporations.


\textsuperscript{132} [1959] 6 STAND. FED. TAX REP. (CCH) ¶ 6532.

\textsuperscript{133} \textit{Id}. 
TAXATION OF FOREIGN GOVERNMENTS

Pursuant to a general agreement on contracts, exchanges, and cooperation between the United States and a foreign country, the State Concert Bureau, a bureau of a foreign sovereign, entered into four separate contracts to be performed in 1979 with a U.S. corporation engaged in the business of promoting international cultural programs. Under the first contract, the State Concert Bureau agreed to send a singer and accompanists on tour for 3 weeks in the United States. Under the second contract, the Bureau agreed to send a conductor on tour for 4 weeks in the United States. Under the third contract, the Bureau agreed to send the State ensemble of folk dance on tour for 5 weeks in the United States. Under the fourth contract, the Bureau agreed to send the State ballet and opera troupe on tour for 6 weeks in the United States. The State Concert Bureau received approximately $80,000 from the performances and from the sale of programs from the tours. During 1979, the income received by the State Concert Bureau is exempt from taxation under paragraph (a)(2) of this section since the activities of the Bureau are not commercial activities under paragraph (c)(3)(ii) of this section. Depending on the facts and circumstances, the State Concert Bureau may be engaged in commercial activities where it receives income from sources within the United States derived from the tour groups' radio or television appearances, motion picture productions, or record and tape recordings.134

The example recognizes that an inquiry into facts and circumstances must be made in the case of cultural activities. It distinguishes between "main-line" cultural promotions and adjunct commercial earnings that are merely ancillary to the cultural ideal. A number of private letter rulings also illustrate that a factual inquiry is appropriate to determine whether particular cultural activities are to be considered governmental or commercial in nature.135

(3) Purchases of Goods. The proposed regulations specify that "[t]he mere purchase of goods in the United States for use by a foreign sovereign"136 is not a commercial activity; therefore, any income derived therefrom is exempt. This treatment comports with the traditional notion of those activities that constitute doing business in the United States, as well

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135. See Private Letter Ruling No. 7806072, 49 IRS Letter Ruls. (CCH) (Feb. 10, 1978); Private Letter Ruling No. 7806073, 49 IRS Letter Ruls. (CCH) (Feb. 10, 1978); Private Letter Ruling No. 7849014, 93 IRS Letter Ruls. (CCH) (Dec. 12, 1978). The letter from the American Bar Association, Taxation Section, supra note 129, indicates that while the treatment of performances and exhibitions devoted to the promotion of the arts by cultural organizations appears to be appropriate, it seems inconsistent with the general statement in the proposed regulations that the commercial character of an activity is determined by reference to its course of conduct rather than by reference to its source. Further, the letter suggests that athletic performances and exhibitions be added to the list of noncommercial activities, if the regulations intend to treat them as exempt.
as with several promulgations by the IRS.\textsuperscript{137} Two examples in the proposed regulations contrast different circumstances that can arise when determining commercial activities:

In 1979 a foreign sovereign organizes under its law M Corp. as a wholly owned government corporation under the auspices of the Ministry of Industry and Tourism. M Corp. engages in the purchasing in the United States of grain and other agricultural goods for free distribution to the poor in its foreign country. In addition, when purchases of grain exceed demand in its foreign country (which rarely occurs), M Corp. engages in the sale of the grain in the United States on a de minimis basis. M Corp. also engages in the trading of commodities futures through a resident broker. It does not have an office or other fixed place of business in the United States through which or by the direction of which the transactions in commodities futures are effected. The purchasing and trading activities of M Corp. are not commercial activities . . . . M Corp. is a controlled entity . . . . Accordingly, the income from these activities derived by M Corp. from sources within the United States is exempt from tax . . . . Any income derived by M Corp. from its sale of grain in the United States on a de minimis basis is not considered to be income of a foreign government and is subject to tax . . . .\textsuperscript{138}

The facts are the same as in [the preceding example], except that in 1979, M Corp. opens an office in Washington, D.C., through which transactions of selling commodities futures in the United States are effected. Since M is now considered to be engaged in a trade or business in the United States under section 864, these activities are commercial activities . . . . Since M engages in commercial activities on more than a de minimis basis, it is not a controlled entity. M is not entitled to the exemption from tax provided by section 892. Accordingly, M Corp. is taxed under the applicable provisions of sections 881 and 882. In addition, . . . M Corp. is not a foreign government for purposes of section 893.\textsuperscript{139}

Presumably, the proposed regulations are not basing the exemption solely on whether a foreign sovereign has a United States office from which purchases occur. While the existence of an office should be a relevant factor, many governments may have a base of operations from which purchases in the United States are made for purely governmental purposes. These examples no doubt are aimed at activities with commercial overtones, such as commodities trading, which are conducted from an established office on a continuous basis.

c. Commercial Activities. For purposes of the proposed regulations, commercial activities include “activities that constitute a ‘trade or business within the United States’ within the meaning of section 864(b).”\textsuperscript{140} This reference incorporates the extensive authority concerning the definition of

\begin{itemize}
    \item \textsuperscript{137} I.R.C. § 864(b)(1).
    \item \textsuperscript{139} Id. example (3)(b), 43 Fed. Reg. at 36114.
    \item \textsuperscript{140} Id. § 1.892-1(c)(1), 43 Fed. Reg. at 36113.
\end{itemize}
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a trade or business within the United States. 141 The proposed regulations also indicate that commercial activities include “activities customarily attributable to and carried on by private enterprise for profit in the United States,” 142 thereby further broadening the concept, although somewhat ambiguously. “The commercial character of an activity is determined by reference to a course of conduct . . . rather than by reference to its purpose.” 143 Moreover, the fact that a domestic governmental entity is engaged in the same or a similar activity does not mean that the activity will not be considered commercial. For example, operation of a railroad is specifically considered a commercial activity if conducted by a foreign sovereign. 144 Somewhat surprisingly, the proposed regulations specify that “net leases” 145 on property are considered to be commercial activities. 146 Apparently, the IRS has received a number of revenue ruling requests involving leasing transactions by foreign governments and has acted accordingly.

An example in the proposed regulations demonstrates that income derived from a hotel owned by a foreign government and operated by a United States agent will be considered as effectively connected with the conduct of a trade or business within the United States and will be taxed under section 882:

For 1979, the Office of the President of a foreign country invests funds from the foreign sovereign's treasury in publicly traded stocks, bonds, and other domestic securities, and interest bearing bank deposits, the income from which is not effectively connected with the conduct of a trade or business within the United States. The Office of the President has also purchased in 1979 a hotel in the United States which is operated by a U.S. agent. Income from its investments that do not constitute commercial activities . . . is exempt from taxation . . . . Income derived from the operation of the hotel is subject to tax . . . since the Office of the President is engaged in commercial activities in the United States by reason of its hotel operations. By reason of section 864(c)(3) and § 1.864-4(b), this income is effectively connected for 1979 with the conduct of a trade or business within the United States by the Office of the President and is taxed under section 882. 147

Thus, most real estate and net leasing activity apparently will not be exempt under section 892. While the IRS's general attitude toward commer-

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143. Id.
145. A net lease is an arrangement whereby the lessee assumes some or all of the expenses of maintaining the leased property. Generally, the arrangement results in a passive investment by the lessor. See generally Dreier, Real Estate Leasing Transactions, 32 N.Y.U. INST. FED. TAX. 619 (1968).
147. Id. § 1.892-1(h), example (1), 43 Fed. Reg. at 36113.
cial activities is plausible, the positions taken on net leasing and real estate activity are inconsistent with this attitude. These activities are often no more commercial in nature than the holding of portfolio securities. In fact, the statutory language of section 892 has prompted a number of practitioners to assume that net leasing and real estate investments are exempt and to so advise clients. As a result, the proposed regulations have caused a certain amount of conceptual and practical difficulty. Because at least some net leases and real estate activity clearly do not involve commercial activity, the final regulations should attempt to identify those net leases and real estate investments that are merely passive investment vehicles and hence merit exemption. The Treasury Department has informally indicated that the regulations are being revised to include this information and this effort is in part responsible for the delay in the issuance of final regulations.  

 d. Capital Gains. The proposed regulations do not specifically address the treatment of capital gains under section 892. According to the distinction between commercial and passive income adopted by the IRS in these regulations, capital gains from investment-type assets should be exempt, and capital gains from commercial-type assets should be taxable under section 892. Of course, certain provisions of the Code generally applicable to foreign taxpayers may exempt capital gains as well.  

e. Mechanics of Taxation. Under the proposed regulations commercial earnings are to be “included in the income of a foreign sovereign and taxed under [the rules of] section 881 or 882.” This provision suggests that foreign sovereigns engaged in commercial activities in the United States will be taxed in a manner similar to foreign corporations. The breadth of this analogy is unclear, however. Presumably, a foreign sovereign can participate in a corporate reorganization or liquidation transaction under certain circumstances subject, perhaps, to the requirements of section 367 and the regulations thereunder. The principles contained in sections 861 through 863 and the regulations thereunder govern the determination of whether income is from sources within or without the United States. Section 864(c) and the regulations thereunder are used to determine whether income is effectively connected with a trade or business. The rules of Treasury Regulations section 1.1441-1 “with respect to withholding of tax at [the] source under

148. Informal conversations between author and attorneys in United States Treasury Department, March 1980.  
149. See, e.g., I.R.C. §§ 871, 881, 882.  
151. I.R.C. § 367.  
155. I.R.C. § 864(c).  
section 1442 in the case of foreign corporations" will also apply.\textsuperscript{157}

A foreign sovereign may select any method of accounting permissible under section 446(c) and the regulations thereunder. Changes in the method of accounting are subject to the requirements of section 446(e) and the regulations thereunder.\textsuperscript{158} A foreign sovereign may select its annual accounting period in accordance with section 441 and the regulations thereunder. Changes in the annual accounting period are subject to the requirements of section 442 and the regulations thereunder.\textsuperscript{159}

\textbf{f. Effective Date.} By express provision, the proposed regulations do not apply to income from commercial activities of a controlled entity derived before the promulgation of final regulations.\textsuperscript{160} The failure to refer in this provision to income of a foreign sovereign itself apparently applies the proposed regulations retroactively to income of a foreign sovereign accruing in all years not barred by the statutes of limitation. The Treasury Department has informally explained that this retroactivity problem will be solved in the final regulations.\textsuperscript{161}

\section*{II. Section 893}

Section 893 exempts from tax the compensation of employees of a foreign government or international organization when the compensation is received for official services under certain conditions. This exemption was first enacted in 1935.\textsuperscript{162} It is not limited to diplomatic representatives, but extends to all qualifying employees. The exemption is available if:

1. [the] employee is not a citizen of the United States, or is a citizen of the Republic of the Philippines.; and

2. in the case of an employee of a foreign government, the services are of a character similar to those performed by employees of the Government of the United States in foreign countries; and

3. in the case of an employee of a foreign government, the foreign government grants an equivalent exemption to employees of the Government of the United States performing similar services in such foreign country.\textsuperscript{163}

\textsuperscript{158} Id. § 1.892-1(e)(1), 43 Fed. Reg. at 36113.
\textsuperscript{159} Id. § 1.892-1(e)(2), 43 Fed. Reg. at 36113.
\textsuperscript{160} Id. § 1.892-1(i), 43 Fed. Reg. at 36114.
\textsuperscript{161} Informal conversations between author and attorneys in United States Treasury Department, March 1980.
\textsuperscript{163} I.R.C. § 893(a). Private Letter Ruling No. 7839026, [1978] PRIV. LETTER RULS. (P-P) § 3480, dealt with a nonresident alien employed by a public international organization who was married to a United States citizen. The IRS held that the nonresident alien's compensation was exempt from tax under § 893(a) and excludable from the gross income of the spouses' jointly filed return. IRS interpretations of the predecessors to § 893 exempted cer-
The definitions of foreign government and international organization for this purpose are the same as in the case of section 892. As a result, many of the conceptual inquiries are the same for both section 892 and section 893.

The Secretary of State must certify to the Secretary of the Treasury the names of the foreign countries that grant an equivalent exemption to employees of the United States and the character of the services performed by employees in the foreign countries. The IRS last published a list of certified countries in 1940 and the list has since been declared obsolete. The State Department considers that most foreign countries satisfy the equivalent exemption requirements and reportedly freely issues the certificates.

"[I]ncome received by employees of foreign governments from sources other than their salaries, fees, or wages" from the foreign government is not exempt from income tax. Foreign journalists and newspaper correspondents in the United States usually are not exempt from tax even if their countries grant such an exemption to American newspaper correspondents. A pension received by a former representative of a foreign government is not exempt, because it is not received while the person is actually employed by a foreign government.

Revenue Ruling 75-425 sets forth an extensive analysis respecting aliens who are employed by foreign governments and international organizations and who file the waiver provided by the Immigration and Nation...


165. Id. § 892(b).


168. Treas. Reg. § 1.893-1(a)(3) (1960); Van Der Elst v. Commissioner, 223 F.2d 771 (2d Cir. 1955). Vial v. Commissioner, 15 T.C. 403 (1950), acq. 1952-1 C.B. 4, is normally discussed in a § 892 context, but actually was a § 893 case. Fomento, a Chilean agency, was held to be a part of the government; the petitioners, employees of Fomento, were considered employees of a foreign government and their compensation was considered to be received for official services. See text accompanying notes 34-42 supra. See also Chapman v. Commissioner, 9 T.C. 619 (1947), in which the compensation of an official of the League of Nations, temporarily residing in the United States for several war years and conducting his official duties here, was subject to tax. His living expenses at his residence and place of business in the United States were not deductible as traveling expenses.

A foreign central bank of issue qualifying under § 895 must often also qualify as a controlled entity of a foreign government under § 893 in order to obtain tax exemption for employees.


ality Act.\textsuperscript{172} This waiver, designed to assist such aliens in retaining their immigrant status, prevents exemption under section 893 from the date thereof.\textsuperscript{173} Nevertheless, the filing of a waiver has no effect on any exemption derived from a tax treaty, consular agreement, or other international agreement.\textsuperscript{174} Various revenue rulings apply these rules to foreign countries with which the United States has income tax treaties, consular agreements, and international agreements.\textsuperscript{175}

III. \textbf{SECTION 895}

Section 895\textsuperscript{176} provides that income derived by a foreign central bank of issue is exempt when the income is earned from obligations of the United States or one of its agencies or instrumentalities, including beneficial interests, participations, and other instruments issued under section 302(c) of the Federal National Mortgage Association Charter Act.\textsuperscript{177} “[T]he obligations or bank deposits from which the income is derived [must be] owned by the foreign central bank of issue.”\textsuperscript{178} The exemption does not apply, however, if the obligations or deposits are held or used in commercial banking.\textsuperscript{179} United States Postal Service obligations,\textsuperscript{180} Student Loan Marketing Association (Sallie Mae) stock and obligations,\textsuperscript{181} Small Business Association guaranty agreements,\textsuperscript{182} GSA obligations,\textsuperscript{183} and Commodity Credit Corporation guaranty agreements\textsuperscript{184} have been held to constitute obligations of the United States for purposes of section 895.

A foreign central bank of issue is defined as a bank that is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency.\textsuperscript{185} Generally, such a bank is the custodian of the banking reserves of the country under whose law it is organized.\textsuperscript{186} The exclusion applies to an instrumentality separate from a foreign government, whether or not owned in whole or in part by a foreign government, such as foreign banks organized and operated similar to the Federal Reserve System.\textsuperscript{187}

\textsuperscript{172} Immigration and Nationality Act § 247(b), 8 U.S.C. § 1257(b) (1976).
\textsuperscript{176} I.R.C. § 895.
\textsuperscript{178} Treas. Reg. § 1.895-1(c) (1963).
\textsuperscript{179} \textit{Id.} § 1.895-1(a).
\textsuperscript{185} Treas. Reg. § 1.895-1(b) (1963).
\textsuperscript{186} \textit{Id.}
\textsuperscript{187} \textit{Id.}
Section 895 originated in 1961 as a result of the controversy surrounding the Commonwealth Bank of Australia and other foreign central banks that had been accumulating substantial United States monetary reserves in the late 1950's. The United States imposed no withholding tax on bank deposit interest, but allowed no general exemption for interest on government obligations. Consequently, foreign central banks were less inclined to invest in government obligations than in private obligations. Section 895 attempts to remove this disincentive.

The IRS has provided no substantial formal interpretation of section 895. Revenue Ruling 75-298 purports to deal with the criteria for exemption of foreign central banks under section 892, but its reference to "any other organization" has been emphasized to such an extent that the ruling has come to be applied more extensively with respect to controlled entities. Revenue Ruling 76-329 did apply the rules of Revenue Ruling 75-298 and held that a foreign currency board was exempt under both sections 892 and 895. Several private letter rulings have similarly held that foreign central banks of issue were exempt under both sections 892 and 895, or alternatively, that one of these provisions applied, but not the other.

IV. OTHER EXEMPTION POSSIBILITIES FOR FOREIGN ENTITIES

A. Income Tax Treaties

A few of the income tax treaties to which the United States is a party deal with interest received by the governments involved. In addition, general treaty provisions may be applied to determine tax treatment. The majority of the treaties exempt interest income from taxation in the

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188. See Taylor, supra note 6, at 161. See also text accompanying notes 26-33 supra for a discussion of the Commonwealth Bank controversy.
190. Id.
196. ABA SECTION OF CORPORATION, BANKING AND BUSINESS LAW, A GUIDE TO FOREIGN INVESTMENT UNDER UNITED STATES LAW 22-31 (1979); S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS ¶ IX/2A(1) (1966). Common treaty provisions exempt certain types of income from tax or relegate the taxation of certain types of income to one or the other countries party to the treaty. Other common treaty provisions reduce tax rates or provide for special elections. In the absence of a governing treaty provision, the taxing statutes generally control.
source country when such income is not effectively connected with a permanent establishment in the source country.\textsuperscript{197} Other treaties provide related exemptions for interest.\textsuperscript{198} Because income tax treaties are bilateral in nature, they do not contain provisions expressly exempting international organizations. General exemption provisions that are found in most treaties exempting interest, certain gains and rentals from real property, and other items of income, however, might be construed as applicable in certain instances.

B. Other International Agreements

The United States has entered into a number of treaties of friendship, commerce, and navigation that may arguably affect the tax exemption for foreign governments.\textsuperscript{199} Certain immunity and most favored nation provisions might be used to support an argument for exemption. The United States has not entered into any international agreement affecting its right to tax international organizations. It has, however, entered into several constitutions and agreements that contain tax exemption provisions involving international funds and development banks.\textsuperscript{200}

V. Conclusion

The tax treatment of foreign governments, international organizations, and their employees has a difficult past and a controversial present. Consequently, practitioners in this area have mixed technical analysis with attempted clairvoyance in order to advise their clients. Some practitioners have taken the position that all income of foreign governments, regardless of the commercial nature is exempt from United States taxation. This approach has meant substantial tax savings for ventures emanating from foreign sovereigns and their ruling elite. The proposed regulations attempt to preempt aggressive tax avoidance by foreign governments and to define the parameters of the exemption under section 892. This Article has explored a number of technical and practical ambiguities that have been either further obscured or introduced by the proposed regulations. As a result of these ambiguities, the proposed regulations have generated considerable comment from practitioners and the issuance of final regulations has been delayed.

While the proposed regulations contain both technical and philosophical problems, they reflect an earnest effort to deal with a difficult subject. The final regulations should reconcile some of the present ambiguities and serve as useful guidelines for advising foreign governments, international organizations, and their employees.

\begin{footnotes}
\footnotetext[197]{S. Roberts & W. Warren, supra note 196, ¶ IX/15F(3).}
\footnotetext[198]{Id.}
\footnotetext[199]{See Tillinghast, supra note 19, at 527.}
\end{footnotes}