

U.S. Treasury Issues Final and Proposed Regulations Under Section 892 Affecting Foreign Government Investors

Jeffrey M. Bruns, JoonBeom Pae, Michelle M. Jewett,

*Matthew A. McDonald and Juan F. Lopez Valek**

In this article, the authors examine final regulations and new proposed regulations under Section 892 of the Internal Revenue Code, significantly clarifying when foreign governments and their controlled entities may claim exemption from U.S. federal income tax on investment income.

The U.S. Treasury Department and the Internal Revenue Service (IRS) have issued final regulations and new proposed regulations under Section 892 of the Code,¹ significantly clarifying when foreign governments and their controlled entities may claim exemption from U.S. federal income tax on investment income. The guidance is particularly relevant for sovereign wealth funds, central banks, public pension funds, and government-owned investment vehicles investing in U.S. credit, private equity, and real estate structures.

The Final Regulations, T.D. 10042,² are generally effective for tax years beginning on or after December 15, 2025, while the Proposed Regulations, REG-101952-24,³ address remaining areas of uncertainty and were subject to comment through February 13, 2026. However, taxpayers can apply the Final Regulations or the Proposed Regulations to open

years. Early adoption of the Final Regulations or Proposed Regulations generally requires that all persons “related”⁴ to the taxpayer consistently apply the Final Regulations or Proposed Regulations.

OVERVIEW OF SECTION 892

Section 892 generally provides an exemption from U.S. federal income tax for certain qualified income earned by foreign governments and foreign government-controlled entities from investments in the United States in stocks, bonds, other domestic securities, or financial instruments held in the execution of governmental financial or monetary policy. The exemption does not apply to:

- Income derived from commercial activities within or without the United States;

*The authors, attorneys with Mayer Brown, may be contacted at jbruns@mayerbrown.com, jpae@mayerbrown.com, mjewett@mayerbrown.com, mmcdonald@mayerbrown.com and jlopezvalek@mayerbrown.com, respectively.

- Income earned by, or received from, a controlled commercial entity (CCE);
- Gain from the disposition of an interest in a CCE;
- Gain from the disposition of a partnership equity interest.

The new guidance is intended to modernize and consolidate decades of temporary and proposed regulations and to address common issues arising in sovereign wealth fund, pension, credit, and private capital structures.

KEY TAKEAWAYS FROM THE FINAL REGULATIONS

Broad Definition of “Commercial Activity”

The Final Regulations reaffirm that commercial activity includes any activity ordinarily conducted for the current or future production of income or gain, regardless of whether the activity constitutes a U.S. trade or business under Sections 162 or 864. This definition is intentionally broader than traditional “trade or business” concepts and focuses on the nature of the activity, not the investor’s purpose or intent.

The Final Regulations therefore employ a broad definition, and provide that commercial activities potentially include activities that may not (or would not, if undertaken in the United States) constitute the conduct of a trade or business in the United States under Section 864(b).

Expanded and Clarified Investment Exception

Section 892 does not identify specific activi-

ties that do or do not constitute commercial activities. However, the regulations under Section 892 provide that commercial activities do not include investment activities, cultural events, governmental functions, purchasing of goods for use of the foreign sovereign, and non-profit activities.

The Final Regulations confirm that the following activities are not commercial activities when undertaken for a foreign government’s own account and other than as a dealer:

- Investments in stocks, bonds, and other securities;
- Financial instruments, including market-standard derivatives;
- Partnership equity interests (however, any commercial activities of the partnership are attributed to the foreign government partner, subject to certain exceptions discussed below);
- Net leases and ownership of non-income-producing real property;
- Bank deposits, including in non-functional currency; and
- Securities lending that satisfies Section 1058 requirements.

This clarification is particularly relevant for sovereign investors participating in fund structures, derivative programs, and securities lending arrangements.

Notably, in the Preamble to the Final Regulations Treasury decided not to adopt a comment that recommended that lending (and charging of associated fees) should not be treated as commercial activity unless an entity

offers to make loans to the general public or makes more than five loans in a single year. In explaining the reason for not adopting this comment, Treasury stated that it does not agree that making loans to the general public or making a particular minimum number of loans constitute necessary conditions for loan (or other debt) acquisitions to be commercial in character, or that a lack of those characteristics necessarily indicates absence of commercial activities.

Elimination of USRPHC Per Se Rule for Non-U.S. Corporations and Adoption of the Proposed Minority Interest Exception

Another welcome change in the Final Regulations relates to the long-criticized rule that treated non-U.S. corporations that are U.S. real property holding corporations (USRPHCs)⁵ as per se engaged in commercial activity, and thus as CCEs if they are controlled by a foreign government. Under the Final Regulations, foreign entities are no longer treated as engaged in commercial activity solely because they are treated as USRPHCs. This change allows a foreign government to invest in U.S. real estate through a controlled entity formed in its home jurisdiction without the need for intensive investment monitoring to confirm whether the entity is a USRPHC in order to maintain such controlled entity's eligibility for Section 892 benefits.

In addition, the Final Regulations adopt and finalize regulations that were proposed in 2022 establishing an exemption for USRPHCs from per se treatment as engaged in commercial activity, if the corporation is a USRPHC solely by reason of its direct or indirect ownership interest in one or more other corporations that

are not controlled by the applicable foreign government. Whether a corporation is a USRPHC solely by reason of its direct or indirect interest in one or more other corporations is determined by disregarding any direct or indirect interests held in corporations that are not controlled by the foreign government when applying the test for USRPHC status. This means that a foreign government-controlled entity could own 100% of a domestic USRPHC (the upper-tier USRPHC) that only owns minority interests in other USRPHCs (including U.S. real estate investment trusts) without causing either the controlled entity or the upper-tier USRPHC to be a CCE. Treasury noted that this minority interest exemption is no longer necessary given the elimination of the per se rule for non-U.S. USRPHCs (because foreign governments can now structure their investments in U.S. real estate solely through non-U.S. corporations without running afoul of the per se commercial activity rule), but Treasury chose to adopt the exemption because foreign government investors may have made investments through U.S. corporations in reliance on the previously proposed regulations.

Together, these changes to the per se commercial activity rules provide foreign governments and their controlled entities additional flexibility to use either U.S. or non-U.S. corporate subsidiaries when making minority investments in U.S. real property companies (including real estate investment trusts).

Partnership Attribution Rules and Qualified Partnership Interests

As mentioned above, investments in "other securities" for a foreign government's own account are not generally treated as commercial

activity. Temporary regulations provide that the term “other securities” does not include partnership interests (with the exception of publicly traded partnerships within the meaning of section 7704), which resulted in questions as to whether the disposition of a partnership interest would be treated as a commercial activity.

In this regard, the Final Regulations confirm that while holding a partnership interest is not itself a commercial activity, commercial activities conducted by a partnership are generally attributed to any foreign government partners, unless the foreign government holds a “qualified partnership interest” (QPI). A QPI is an equity interest in an entity that is classified as a partnership for U.S. tax purposes if the holder of such interest has limited liability, does not possess the legal authority to bind or act on behalf of the partnership, does not control the partnership and does not have the right to participate in the management and conduct of the partnership’s business.

The QPI exception is distinct from the limited partner exception from being engaged in a U.S. trade or business under Section 864(b), in that, while the U.S. trade or business limited partner exception focuses primarily on whether the partner has management rights or authority to act on behalf of the partnership, the QPI rules impose additional quantitative ownership thresholds that are specifically tailored to the Section 892 framework applicable to foreign governments. If a foreign government-controlled entity holds a QPI, attribution of commercial activity from the partnership to the controlled entity is effectively blocked for purposes of determining whether the controlled entity is a CCE and risking the controlled entity’s status under Section 892 with respect to other income. Notably, however,

QPI status does not exempt a foreign government from U.S. tax on its distributive share of income from underlying commercial activities conducted by the partnership.

The Final Regulations provide helpful clarifications with respect to the scope of impermissible management rights. Such impermissible rights include participating in ordinary-course personnel and compensation decisions and taking an active role in advising or formulating a business strategy or in making acquisition or disposition decisions regarding underlying investments (i.e., day-to-day management). The Final Regulations also clarify that rights designed merely to protect and monitor capital investment are not management rights that can threaten QPI status. Based on this guidance, it would appear that standard investor protections found in side letters or an investor’s participation on a limited partner advisory committee would not prevent QPI status under the Final Regulations.

Notably, the Final Regulations provide a bright-line safe harbor under which an interest of 5% or less in a partnership is treated as a QPI, provided the foreign government does not possess legal authority to act for the partnership or otherwise hold a management or equivalent role, thereby offering greater certainty than the more facts-and-circumstances-based limited partner exception from U.S. trade or business. The Final Regulations also confirm that the QPI exception applies to an equity interest in any entity classified as a partnership for tax purposes and is not limited to entities formed as limited partnerships under State or local law.

The Final Regulations also provide that the QPI exception applies to a tiered partnership

structure from the bottom up. In other words, an upper-tier partnership that holds a QPI in a lower-tier partnership is not attributed the lower-tier partnership's commercial activities. If, however, the upper-tier partnership's interest in a lower-tier partnership is not a QPI, the lower-tier partnership's commercial activity will be attributed to the upper-tier partnership and could, in turn, be further attributed to a foreign government investor holding an interest in the upper-tier partnership, unless the investor's interest in the upper-tier partnership is a QPI.

The Final Regulations provide that if a foreign government holds multiple classes of interests in the same partnership, or holds interests in a partnership through multiple integral parts or controlled entities, all interests held directly or indirectly by a foreign sovereign are aggregated and evaluated in their totality to determine whether the foreign sovereign has rights to participate in the management and conduct of that partnership's business.

Inadvertent Commercial Activity Relief

The Final Regulations introduce a formal inadvertent commercial activity exception, allowing a foreign government or controlled entity to preserve Section 892 eligibility if:

- The commercial activity was inadvertent and reasonable;
- It is cured within 180 days of discovery; and
- Adequate compliance policies and records are maintained.

Under a safe harbor, provided that adequate written policies and operational procedures are in place to monitor worldwide activities,

the failure to avoid commercial activity will be considered reasonable if (1) the value of the assets used in, or held for use in, all commercial activity does not exceed five percent of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes, and (2) the income earned by the entity from commercial activity does not exceed five percent of the entity's gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes.

The safe harbor must be applied using an applicable financial statement, which, pursuant to the discussion in the preamble, may include a financial statement prepared using U.S. GAAP, IFRS, or another method required under applicable regulatory accounting rules. The Final Regulations provide that if the entity does not prepare financial statements for financial accounting or regulatory reporting purposes, the entity may use books of account or records that are adequate and sufficient to establish the respective amount. The Final Regulations also provide that the determination of asset values for purposes of the safe harbor is made using the average of amounts as of the close of each quarter of the taxable year and the determination of income is made as of the end of the taxable year.

Importantly, the Final Regulations provide that the commercial activity asset of a QPI is not included as an asset used in commercial activity of the tested entity for purposes of this safe harbor, but the value of the QPI is included in the entity's calculation of its total assets for that purpose. Similarly, commercial activity income derived from a QPI is not included as income from commercial activity

of the tested entity for purposes of the safe harbor, but the income derived from a QPI is included in the entity's calculation of its total gross income for that purpose.

HIGHLIGHTS OF THE PROPOSED REGULATIONS

The Proposed Regulations address three unresolved areas and may materially affect credit strategies and governance rights. Specifically, they provide guidance for determining when an acquisition of debt by a foreign government is considered to be commercial activity, and when a foreign government has effective control of an entity engaged in commercial activities (thereby causing the entity to be a CCE). This guidance is analyzed below.

New Framework for Debt Investments

The Proposed Regulations provide that all acquisition of debt is considered to be commercial activity, unless it meets one of the safe harbors that treat debt acquired in a registered offering or in a qualified secondary market acquisition as a passive investment, or under a facts-and-circumstances test.

The first safe harbor would treat acquisitions of bonds or other debt securities acquired in an offering registered under the Securities Act of 1933, as amended (the Securities Act), as a passive investment that does not constitute a commercial activity provided that the underwriters of the offering are not related to the acquirer. Although the first safe harbor would apply only to offerings of debt securities registered under the Securities Act, in the preamble to the Proposed Regulations, the IRS recognizes that the securities laws of some foreign countries may provide a regulatory framework for debt offerings sufficiently similar

to the Securities Act such that this exception may appropriately apply in those circumstances.

The second safe harbor would also treat a qualified secondary market acquisition of debt as a passive investment that does not constitute a commercial activity. This would generally include acquisitions of debt traded on an established securities market, provided that the acquirer is not purchasing from the issuer or participating in negotiation of the terms or issuance of the debt and the acquisition is not from a person that is under common management or control with the acquirer, unless that person acquired the debt in a qualified secondary market acquisition. These safe harbors may have limited applicability, as it does not apply to most private loans that are generally not issued in an offering that is registered under the Securities Act or traded on an established securities market.

Debt acquisitions that do not meet either of these safe harbors may still be treated as a passive investment that does not constitute a commercial activity based on consideration of all relevant facts and circumstances. The facts and circumstances analyzed under the Proposed Regulations include:

- *Origination-type behavior:* Whether the acquirer solicited borrowers or otherwise held itself out as a lender or participant at original issuance.
- *Deal involvement:* The extent to which the acquirer participated in negotiating or structuring the debt terms.
- *Non-interest compensation:* Whether the acquirer receives fees or other compen-

sation not treated as interest (including OID) for U.S. tax purposes.

- *Instrument and process*: The nature of the debt and how it was issued (e.g., bank loan versus privately placed securities under Regulation S or Rule 144A).
- *Relative acquisition size*: The portion of the issuance acquired by the acquirer compared to other purchasers.
- *Equity relationship*: Whether, and to what extent, the acquirer holds equity in the issuer.
- *Debt-to-equity balance*: The value of any equity held relative to the amount of debt acquired.
- *Default expectations in exchanges*: In a deemed debt-for-debt exchange due to a significant modification, whether there was objective evidence at the time of acquiring the original debt that default was reasonably expected.

The application of the safe harbors and the facts-and-circumstances test is illustrated in a series of examples included in the Proposed Regulations, which reflect Treasury's view that even limited lending activity can constitute commercial activity for purposes of Section 892.

- Example 1 provides that making even a single loan per year may give rise to commercial activity where the foreign government materially participates in the issuance of the loan and the acquisition does not qualify under either of the applicable safe harbors or the facts-and-circumstances test. This example is surprising in that, unlike the standard for

determining whether an entity is engaged in a U.S. trade or business under Section 864, the frequency or regularity of the lending activity is not considered; however, this approach is consistent with decoupling Section 864 U.S. trade or business standards from commercial activity standards, as described in the Final Regulations.

- Example 2 illustrates that debt financing provided in connection with a significant equity investment may nevertheless be treated as an investment rather than a commercial activity, even where the debt does not qualify under the applicable safe harbors. In the example, a foreign corporation that owns a substantial equity interest in another foreign corporation also provides shareholder debt financing. Although the loan is issued at original issuance and outside a registered offering, the facts-and-circumstances test is satisfied. The example emphasizes that the foreign corporation did not hold itself out as a lender or solicit borrowers, and that the amount of debt was not significant relative to its equity investment, supporting the conclusion that the loan should be viewed as ancillary to the equity investment and therefore treated as an investment rather than as commercial activity for purposes of Section 892.
- Example 3 illustrates that acquisitions of privately placed corporate debt and U.S. Treasury securities at original issuance may nevertheless be treated as investments, rather than commercial activities, notwithstanding the failure to satisfy the registered-offering safe harbors. In the

example, a foreign corporation acquires multiple privately placed debt securities of U.S. corporate issuers through unrelated placement agents, as well as U.S. Treasury securities in a public auction. Although the foreign corporation communicates the terms on which it would be willing to purchase the debt, it does not hold itself out as a lender, solicit borrowers, or materially participate in structuring or negotiating the debt. The example emphasizes that the debt terms were set by unrelated placement agents or, in the case of Treasury securities, by the U.S. Treasury, and that the foreign corporation was not the largest purchaser in any offering. Taken together, these facts support the conclusion that the foreign corporation's activities reflect passive investment behavior, such that the debt acquisitions qualify as investments under the facts-and-circumstances test, and therefore do not constitute commercial activity for purposes of Section 892.

- Example 4 illustrates that a significant modification of a loan that previously qualified under a safe harbor may itself be treated as commercial activity if the resulting deemed re-issuance does not independently qualify under one of the safe harbors. The example further explains, however, that such deemed acquisition may still qualify as an investment under the facts-and-circumstances test where the foreign government did not participate in a creditors' committee that negotiated the modification, the loan was not in default when originally acquired, and there was no expectation at the time of acquisition that the borrower would default.

- By contrast, Example 5 provides that where the foreign government was a member of the creditors' committee that renegotiated the debt, the deemed acquisition of the significantly modified loan would not likely qualify as an investment under the facts-and-circumstances test, effectively foreclosing arguments that the activity was undertaken solely to protect the value of the original investment.

This framework is particularly relevant for private credit, direct lending, distressed debt, and structured finance strategies, and represents a clear departure from prior reliance on informal loan-origination concepts (although such guidance should not apply for purposes of analyzing whether there is a U.S. trade or business under Section 864), and is also relevant to leveraged blocker structures involving the holding of debt and equity interests by foreign government investors. As a result, foreign governments that have historically taken the position that making fewer than a threshold number of loans per year does not rise to the level of commercial activity may need to reassess their investment guidelines in light of the Proposed Regulations.

In the preamble to the Proposed Regulations, the Treasury Department invited comments on the treatment of distressed debt, broadly syndicated loans, revolving credit facilities and delayed-draw debt obligations.

Partnerships Excluded from "Controlled Entity" Definition

The Proposed Regulations clarify that partnerships are not "controlled entities" for Section 892 purposes and that partnerships will not be treated as per se corporations, even if wholly owned by two controlled entities of a

single foreign sovereign. This clarification aligns the regulations with the partnership pass-through regime and resolves longstanding interpretive ambiguity.

Expanded Guidance on “Effective Control”

Under prior guidance, whether or not an entity engaged in commercial activities is a CCE is tested by whether a foreign government (i) directly or indirectly holds 50% or more of the vote or value of the entity, or (ii) directly or indirectly holds any other interest which provides the government with “effective practical control” of the entity. The Proposed Regulations do not require any particular amount (or any) equity in an entity and use the term “effective control” to be consistent with Section 892. The Proposed Regulations elaborate on what constitutes effective control for CCE purposes, providing that the determination of effective control is made considering all the facts and circumstances related to the interests in an entity. Interests in an entity may include, for example, equity ownership, contractual rights, governance arrangements, debt instruments, regulatory powers, and business relationships that allow influence over management or operations. “Effective control” is achieved by any combination of the foregoing that results, directly or indirectly, in control of the operational, managerial, board-level, or investor-level decisions of the entity. Mere consultation rights (including through participation on an investment committee) do not confer effective control. A special rule provides that a foreign government is deemed to have effective control of an entity if the foreign government is, or controls an entity that is, a managing partner or holds equivalent role under local law.

Under the Proposed Regulations, the ability to appoint or dismiss management generally confers effective control. In one example, the Proposed Regulations conclude that effective control is conferred by veto rights over an entity’s dividend distributions, material capital expenditures, sales of new equity interests and the operative budget of the entity.

This expansion may affect minority investments with enhanced consent, veto, or board rights.

APPLICABILITY AND RELIANCE

The Final Regulations generally apply to tax years beginning on or after December 15, 2025, with optional application to open years subject to consistency. The Proposed Regulations are expected to apply prospectively once finalized, though taxpayers may be permitted limited retroactive reliance for certain provisions.

PRACTICAL IMPLICATIONS AND KEY TAKEAWAYS

Following the publication of the Final and Proposed Regulations, foreign government investors should consider reviewing their direct lending and credit strategies for compliance with the new debt framework; reassessing governance and control rights in portfolio companies and funds in order to ensure they are meeting any QPI exception on which they are relying; updating compliance policies to satisfy inadvertent activity safe harbors; and evaluating opportunities to simplify structures previously driven by the USRPHC per se rule.

NOTE:

¹References in this article are to sections of the

Internal Revenue Code of 1986, as amended, unless otherwise specified.

² <https://www.govinfo.gov/content/pkg/FR-2025-12-15/pdf/2025-22776.pdf>.

³ <https://www.govinfo.gov/content/pkg/FR-2025-12-15/pdf/2025-22775.pdf>.

⁴Neither the Final Regulations nor the Proposed Regulations provided guidance with respect to how to determine “relatedness” in the context of government

entities where there may be multiple levels of government (e.g., federal and state).

⁵Generally, a corporation that, at any time during the relevant testing period, holds U.S. real property interests the fair market value of which equals or exceeds 50 percent of the fair market value of its total real property interests and other assets used or held for use in a trade or business. See Section 897(c)(2).