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Legal Update

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United States: Treasury Department finalizes long-awaited section 892 regulations

In brief

On December 12, 2025, US Treasury and the IRS issued long-anticipated final regulations under section 892 ("**Final Regulations**") and new proposed regulations under section 892 ("**Proposed Regulations**"). The Final Regulations clarify (i) the framework for determining when non-US government investors are engaged in commercial activity, and (ii) when entities are treated as controlled commercial entities (**CCEs**). The Final Regulations finalize proposed regulations issued in 2011 and 2022, with important modifications affecting non-US governments, sovereign wealth funds, central banks, certain foreign pension funds, and other similar investors ("**Section 892 Investors**") in private equity, private credit, infrastructure, and real estate investment structures. The Proposed Regulations provide guidance on determining (i) when the acquisition of debt rises to the level of commercial activity, and (ii) when an investor has effective control of an entity.

In this issue

Key takeaways

- **Broader Commercial Activity Definition**. The concept of "commercial activity" remains broader than the concept of "US trade or business" and is now explicitly independent of section 864(b).
- **Expanded Investment & Trading Safe Harbors**. Safe harbors now clearly cover standard market derivatives, offering greater certainty for common trading strategies. However, bespoke or asset-linked instruments are excluded.
- **Heightened Partnership Attribution Risk**. Partnership attribution remains a central risk. Simply labeling income as "fees" or "passive" will not prevent commercial activity income (**CAI**) attribution.
- **2011 LP Exception Conceptually Retained but Tightened**. The "limited partner exception" (**LP Exception**) from the 2011 proposed regulations has been conceptually retained and formalized into a "qualified partnership interest exception" (**QPI Exception**). However, the QPI Exception does not apply to "controlled" investments where the Section 892 Investor holds a 50% or greater interest (by vote or value) in, or has effective control over, the partnership,
- **Narrowed USRPHC *Per Se* Rule**. The USRPHC *per se* CCE rule is narrowed to apply only to domestic corporations, which is a favorable change for cross-border real estate investment structures.
- **Formalized Inadvertent Commercial Activity Exception**. While helpful, this exception requires robust compliance, including documentation, monitoring, and timely corrective actions.

The Final Regulations will take effect when published in the Federal Register and can, at the taxpayer's election, be applied retroactively for prior years for which the assessment limitation period has not yet closed. The Proposed Regulations would take effect when finalized and published in the Federal Register. Once finalized, those regulations, at the taxpayer's election, may be applied retroactively for prior years for which the assessment limitation period has not yet closed.

In more detail

Importance of section 892

Section 892 governs how the United States taxes income earned by non-US governments and their investment vehicles. Based on the principle of sovereign immunity, Section 892 Investors are generally exempt from US tax on US-source passive income, such as interest from US bank deposits, income from US securities, and returns from financial instruments held for monetary policy purposes. These exemptions apply whether the income is received directly by the non-US government or indirectly through entities that qualify as an "integral part" of the government or as a "controlled entity."

Conversely, income from "commercial activities" is taxable and not exempt. The regulations draw a clear line between tax-exempt passive investments and taxable commercial activities. "Commercial activities" of a non-US government are not exempt because the United States does not want to give non-US governments an unfair advantage over private US businesses. This distinction ensures that non-US governments are on a level playing field with US businesses when engaging in active commercial operations in the United States.

Commercial activity definition: broad, activity-based test retained

The Final Regulations confirm that a "commercial activity" includes any activity ordinarily carried out to earn income or gain, regardless of whether the activity constitutes a US trade or business under section 864 or a trade or business under section 162. The preamble specifies that, consistent with Congressional intent in selecting the term "commercial activity" as opposed to "trade or business", the commercial activity definition is meant to have a broader meaning and denote a standard more easily satisfied than the term "trade or business." The 2011 proposed regulations contained similar language, but the Final Regulations state the rule more definitively, and clarify that activities that constitute a trade or business for purposes of section 162 or constitute a US trade or business for purposes of section 864(b) are commercial activities for purposes of section 892, except as expressly provided otherwise.

Investment and trading exceptions retained; market-standard derivatives qualify for "Financial Instrument" safe harbor

The Final Regulations retain an exclusive list of non-commercial activities that may benefit from the "investment exception", which includes stocks, bonds, loans, financial instruments (including derivatives), partnership equity interests (but see "Partnership Attribution" discussion below), net leases, and non-income-producing real property. The Final Regulations specifically indicate that common market-standard derivatives fall under the "financial instruments" category, but if a derivative confers beneficial ownership of the underlying reference asset, the asset's nature governs over the general rule. In such a case, the determination of whether the Section 892 Investor is conducting commercial activity is made based on ownership of that asset and not with regard to the financial instrument.

The Final Regulations also retain the "trading exception" which provides that a Section 892 Investor trading for its own account in stocks, bonds, other securities, partnership equity interests, commodities, and financial instruments is not treated as engaged in commercial activities, unless it acts as a dealer.

Heightened Partnership Attribution Risk; "Limited Partner Exception" Conceptually Retained

The Final Regulations clarify that holding or trading partnership equity interests other than as a dealer is not by itself commercial activity, but holding a partnership equity interest can result in commercial activity if the partnership conducts commercial activity attributable to the holder of the interest, unless one or more exceptions under Treas. Reg. § 1.892-5 applies (for example, the new "qualified partnership interest exception" discussed below).

The preamble to Final Regulations clarifies that there is no exception from commercial activity for the receipt of fee income as a passive investor in a private equity or private credit fund. To the extent the commercial activities of a fund sponsor are attributable to a foreign government investor or on the basis of agency, the Section 892 Investor is considered to conduct commercial activity. This issue most commonly arises where a Section 892 Investor negotiates the right to share in fees for services provided to portfolio companies by the fund sponsor, e.g., by receiving the excess of management fee offsets.

Although arising in different statutory contexts, the courts' decisions in *Sun Capital Partners III, LP v. New England Teamsters* and *YA Global Investments, LP v. Commissioner* are commonly viewed as sending a consistent signal in respect of attribution and agency analyses for US federal income tax purposes, including for US trade or business and commercial activity determinations relevant to section 892. *Sun Capital* emphasized the economic and functional integration between a private equity fund and its

sponsor, treating management fee offsets as evidence that the fund was benefiting from management services rather than earning a purely passive return on capital. *YA Global* focused on substance over form principles to conclude that a non-US fund was engaged in a US trade or business based on its active involvement and sponsor-aligned economics, notwithstanding the formal interposition of management entities. These cases have been interpreted as supporting the view that fee sharing and other mechanisms economically align investors with commercial or management activities. As a result, market practice in recent years has been that Section 892 Investors elect to opt out of receiving excess management fee offsets out of concern that participation in such offsets could strengthen arguments for attribution of commercial activity or a US trade or business from the fund to the sovereign investor. Treasury and the IRS's commentary in the preamble to the Final Regulations is expected to further discourage Section 892 Investors from accepting excess management fee offsets, making opt-outs even more prevalent than before. Section 892 Investors will also need to pay special attention to any sponsor-linked economics to minimize the risk of commercial activity.

Consistent with taxpayer comments, the Final Regulations significantly broaden and clarify the scope of excepted partnership interests by introducing the QPI Exception to the general rule of partnership attribution of commercial activities. The QPI Exception is conceptually similar to the LP Exception from the 2011 proposed regulations, which focused on a fact-based test centered on the absence of participation in the partnership's management or operations. First, the Final Regulations clarify that excepted partnership interests include an interest in any domestic entity treated as a partnership for US federal income tax purposes (including an interest in an LLC). Second, the Final Regulations provide a more detailed set of criteria to determine whether a partnership interest participates in management. More specifically, for a partnership interest to qualify for the QPI Exception, the holder of the interest must not:

1. have personal liability for claims against the partnership;
2. have the right to bind or act on behalf of the partnership;
3. control the partnership (i.e., own, directly or indirectly, 50% or more of the vote or value of the partnership, or effectively control the partnership); and
4. have rights to participate in the day-to-day management or operation of the partnership's business at any time during the partnership's taxable year.

The Final Regulations specify that "rights to participate in the management and conduct of a partnership's business" means rights to participate in the day-to-day management or operation of the partnership's business, including, for example, the right to participate in ordinary-course personnel and compensation decisions, or the right to take active roles in formulating the partnership's business strategy or in respect of the partnership's acquisition or disposition of a specific investment. Conversely, "rights to participate in the monitoring or protection of a partner's capital investment" are not viewed as management or control rights. The Final Regulations adopt a slightly more expansive and commercially evolved list of permitted monitoring rights as compared to the oversight rights expressly permitted by the LP Exception by including oversight and supervision rights for major strategic decisions such as: admission or expulsion of a partner; hiring or firing key strategic personnel; amendment of the partnership agreement; dissolution, merger, or conversion of the partnership; unusual and non-ordinary course deviations from previously determined investment parameters; extending the term of the partnership's governing agreement; and disposition of all or substantially all of the partnership's property outside of the ordinary course of the partnership's activities.

The Final Regulations also provide for a *de minimis* investor safe harbor, the satisfaction of which allows the investor's interest in the partnership to qualify for the QPI Exception even if the partnership is engaged in commercial activity in a given year. This so-called "*de minimis* interest" safe harbor applies to a partnership interest holder who at all times during the partnership's taxable year:

1. has no personal liability for claims against the partnership;
2. has no right to bind or act on the partnership's behalf;
3. is not the partnership's managing partner, managing member or partner with an equivalent role under local law; and
4. does not own, directly or indirectly, more than 5% of the partnership's capital or profits interests.

The most significant change in the QPI Exception is that it does not apply where a Section 892 Investor "controls" the partnership. For this purpose, "control" means 50% or more ownership (by vote or value) or "effective control" of the partnership. Nothing in the 2011 LP Exception precluded its application to a majority Section 892 Investor in a partnership, but going forward, Section 892 Investors that make majority investments in club-style vehicles, co-investments, "funds of one," or separately managed accounts should carefully consider the impact of the QPI Exception not applying to their majority investments.

USRPHC *Per Se* Rule Relaxed

Under section 897 (commonly known as FIRTPA), non-US persons are subject to US tax on any gain recognized upon a disposition of a "United States real property interest" (**USRPI**). A USRPI includes real property located in the United States as well as interests in a "United States real property holding corporation" (**USRPHC**), which is generally a corporation (US or non-US), the assets of which consist of 50% or more USRPIs by value. The section 892 exemption does not override FIRPTA; it does not apply to gain from the disposition of a USRPI, but does apply to (and thus Section 892 Investors are exempt from tax on) gain on stock of a USRPHC that is not a CCE. Certain "qualified foreign pension funds" (**QFPFs**) are exempt from FIRPTA (and many Section 892 Investors are also QFPFs).

Historically, section 892's *per se* commercial-activity rule treated a USRPHC, including a foreign corporation that would be a USRPHC if it were a domestic corporation, as engaged in commercial activity.

Thus, if a foreign government "controlled" a USRPHC (or a foreign corporation that would be a USRPHC if it was a US corporation), such USRPHC would automatically be a CCE, even if such entity only engaged in passive investment activities (which would generally not constitute a commercial activity). This *per se* rule created some illogical results in practice. For example, if a foreign government only made passive real estate investments worldwide through a single local holding company, such local holding company could be treated as a CCE (and the income from such local entity would not qualify for the section 892 exemption) if the entity became a USRPHC solely due to the value of its US real estate investment holdings.

The 2022 proposed regulations attempted to relax the *per se* rule by providing two exclusions for: (i) a foreign corporation that is a qualified holder under Treas. Reg. § 1.897(l)-1(d) (referring to qualified foreign pension funds or certain qualified controlled entities), or (ii) a corporation that 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 foreign government (as determined under Treas. Reg. § 1.892-5T(a)). As a result of the latter exclusion in the 2022 proposed regulations, a foreign government could use a domestic holding company for those minority interests without that holding company being treated as a CCE ("**Minority Interest Exception**").

Under the Final Regulations, the USRPHC *per se* rule now applies only to US corporations that are USRPHCs so the exception for foreign corporations that are qualified holders in the 2022 proposed regulations is not necessary and therefore not finalized. Non-US corporations are excluded and no longer need to monitor compliance with the *per se* rule. The Minority Interest Exception is retained in the Final Regulations so corporations that are USRPHCs solely because of their holdings of minority interests in non-controlled corporations are also excluded. The Final Regulations clarify that the "Balance Sheet Method" is the only method available for purposes of applying this minority interest exception. Limiting the *per se* rule to US corporations represents a reasonable solution to minimize "traps for the unwary" fact patterns such as the one discussed above, while giving effect to Congressional intent as provided in the legislative history to section 892.

Inadvertent Commercial Activity Relief Retained but Increased Compliance

Under the Final Regulations, entities can be relieved of CCE status if commercial activity was inadvertent, documented, and cured within 180 days (as opposed to the 120-day deadline in the proposed regulations). The inadvertent commercial activity relief is only available to entities that have and enforce adequate written policies and operational procedures to monitor worldwide activities to prevent them from engaging in commercial activities within or outside the United States. The Final Regulations also require that the inadvertent commercial activity safe harbor be applied using a financial statement prepared in US GAAP, IFRS, or another method required under applicable regulatory accounting rules.

An entity can meet the safe harbor for inadvertent commercial activities if no more than 5% of its total assets and 5% of its gross income (calculated using quarterly averages for assets and full-year income) are attributable to commercial activities. The Final Regulations provide that the commercial activity asset of a qualified partnership interest is not included as an asset used in commercial activity of the entity for purposes of this safe harbor, but the value of the qualified partnership interest is included in the entity's calculation of its total assets for that purpose. Further, the entity's distributive share of commercial activity income from a qualified partnership interest is not included as income earned by the entity from commercial activity for purposes of the safe harbor, but is included in the entity's gross income for that purpose and treated as commercial activity income for all other purposes of section 892.

Annual CCE Determination Clarified

The Final Regulations clarify that the annual determination of whether an entity is a CCE is to be made with respect to the entity's taxable year. The entity's activities from the prior taxable year may be taken into account for the purpose of determining whether an entity is engaged in commercial activities to the extent relevant in characterizing current year activities. For example, this could apply where an activity in a single taxable year might appear non-commercial on its own, but is part of a broader two-year course of

conduct or transaction that is considered commercial when viewed as a whole. If a corporation acquires a CCE as a result of a corporate reorganization to which the carryover basis rules apply, the acquiring corporation does not succeed to the commercial activity of the transferor unless the acquiring corporation continues the commercial activity. However, if the acquiring corporation is controlled by the same foreign sovereign that controls the transferor, then the acquiring corporation will be treated as a CCE for the taxable year.

Proposed Guidance on Section 892 Treatment of Debt Acquisition

The preamble to the Final Regulations notes taxpayer comments highlighting uncertainty around when loan origination constitutes "commercial activity" for non-US governments and their controlled entities. Some comments 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, but Treasury and the IRS declined to adopt the suggested approach. Treasury and the IRS specified that neither offering loans to the public nor making a minimum number of loans is a necessary condition for loan origination to be considered commercial activity. Conversely, the absence of these factors does not guarantee that loan origination is not commercial.

Treasury and the IRS separately released the Proposed Regulations, which would establish a framework for determining when acquiring a loan or other debt, including at original issuance, is treated as an "investment" for section 892 purposes. The Proposed Regulations would provide as a general rule that all acquisition of debt is treated as commercial activity unless the acquisition is characterized as investment for purposes of section 892 under either of two safe harbors or under a facts-and-circumstances test discussed below:

Safe harbors:

1. 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, as an "investment" provided that the underwriters of the offering are not related to the acquirer.
2. The second safe harbor would treat a qualified secondary market acquisition of debt as an "investment." This generally would 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.

Facts-and-circumstances test:

Facts and circumstances would be relevant to the extent they indicate that the entity's expected return from acquiring the debt is exclusively a return on its capital rather than including a return on activities it conducts. The Proposed Regulations provide a non-exclusive list of relevant factors to be weighed in determining whether a debt acquisition is an excepted investment:

1. Whether the acquirer solicited prospective borrowers, or otherwise held itself out as willing to make loans or otherwise acquire debt at or in connection with its original issuance;
2. Whether the acquirer materially participated in negotiating or structuring the terms of the debt;
3. Whether the acquirer is entitled to compensation (whether or not labelled as a fee) that is not treated as interest (including original issue discount) for Federal tax purposes;
4. The form of the debt and the issuance process, including, for example, whether the debt is a bank loan or instead a privately placed debt security pursuant to Regulation S or Rule 144A under the Securities Act;
5. The percentage of the debt issuance acquired by the acquirer relative to the percentages acquired by other purchasers;
6. The percentage of equity in the debt issuer held or to be held by the acquirer;
7. The value of that equity relative to the amount of the debt acquired; and
8. If debt is deemed to be acquired in a debt-for-debt exchange as a result of a significant modification under Treas. Reg. § 1.1001–3, whether there was, at the time of acquisition of the original unmodified debt, a reasonable expectation, based on objective evidence, such as a decline in the financial condition or credit rating of the debt issuer between original issuance and the time of the acquisition of the original unmodified debt, that the original unmodified debt would default.

Under this new framework, "loans" would be removed from the list of "investments" in the Final Regulations that are not treated as commercial activities. The rule on banking, financing, or similar businesses in Treas. Reg. § 1.892–4T(c)(1)(iii) would also be withdrawn.

This issue is highly relevant given the growing participation of Section 892 Investors in private credit funds, which originate loans as a core activity. The lack of a bright-line test means that Section 892 Investors will need to carefully analyze loan origination platform

structures to determine the potential CAI exposure, noting that the framework for this analysis may evolve depending on whether the Proposed Regulations are finalized in their current form. Importantly, regardless of the number or size of the loan(s) acquired by the Section 892 Investor, if any one loan acquisition is viewed as a commercial activity under the Proposed Regulations, then the commercial activity cliff effect would be triggered.[1]

Proposed Guidance on Meaning of "Effective Control"

The Proposed Regulations provide long-awaited guidance on how to interpret the meaning of "effective control" as used in the section 892 regulations to determine whether an entity is a CCE. Under the Proposed Regulations, "effective control" would mean control of the operational, managerial, board-level, or investor-level decisions of the entity. However, mere consultation rights with respect to operational, managerial, board-level, or investor-level decisions of an entity (such as extending the term of the entity's investment period, change in control of the entity, or liquidation of the entity) would not alone give rise to effective control. We note that the facts and circumstances analysis provided for in the Proposed Regulations to determine whether "effective control" of an entity exists is similar to other areas of US federal income tax law.[2]

The Proposed Regulations also introduce a rule providing that a foreign government would be deemed to have effective control of an entity if the foreign government controls an entity that is a managing partner or managing member of such entity. This guidance is particularly relevant in the current private equity liquidity environment, where sponsors are increasingly offering general partner stake "sweeteners," enhanced governance rights, or platform-level participation to anchor sovereign investors as part of fundraising and liquidity solutions. Going forward, such arrangements entered into by Section 892 Investors will need to be carefully examined.

[1] *See*, *e.g.*, Prop. Treas. Reg. 1.892-4(c), Ex. 1.

[2] *See*, *e.g.*, *Framatome Connectors USA, Inc. v. Commissioner*, 118 T.C. 32 (2002), *aff'd*, 367 F.3d 694 (7th Cir. 2004) (parent corporation had effective control over its subsidiary for purposes of the interest allocation rules where it exercised pervasive control over the subsidiary's operations, business decisions, and financial affairs); *Alumax Inc. v. Commissioner*, 165 F.3d 822 (11th Cir. 1999) (found effective control based on the parent's operational oversight and approval authority over significant subsidiary decisions).

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