Treasury Finalizes and Proposes Regulations Governing the Section 892 Tax Exemption for Foreign Governments

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December 17, 2025

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Executive Summary

- **What's new:** Treasury released final and proposed regulations clarifying the Section 892 tax exemption for foreign governments, including rules on commercial activities, partnership interests, acquisitions of debt and standards for effective control.
- **Why it matters:** These developments impact foreign governments and their controlled entities investing in the U.S., as the rules determine the scope of the Section 892 tax exemption.
- **What to do next:** Foreign governments should consider reviewing their U.S. investments and partnership arrangements to evaluate the effect of the new regulations and consider applying the final rules to prior, open taxable years, if beneficial.

On December 12, 2025, Treasury released final regulations (the Final Regulations), as well as proposed regulations (the Proposed Regulations), relating to the Section 892 tax exemption for certain income of foreign governments. The Final Regulations promulgate rules proposed in 1988, 2011 and 2022 with modifications. These new final rules include a partial repeal of the rule that deems a "United States real property holding corporation" (USRPHC) to be engaged in "commercial activities" and finalize the so-called "limited partner exception" (referred to in the Final Regulations as the "qualified partnership interest" exception). The Proposed Regulations propose standards for when an acquisition of debt is treated as commercial activity and standards for determining "effective control."

The Final Regulations apply to taxable years beginning on or after December 15, 2025 (the date the Final Regulations were published in the Federal Register). Taxpayers may also apply the Final Regulations to prior, open taxable years, subject to consistency requirements. The Proposed Regulations are proposed to apply to taxable years beginning on or after the date the Proposed Regulations are finalized.

Below is a summary of key provisions contained in the Final and Proposed Regulations, together with our analysis of the potential impact.

1. Final Regulations

A. Deemed CCE in Case of Controlled USRPHC

In general, a foreign government entity is ineligible for the Section 892 exemption if it is treated as engaged in "commercial activities." Under temporary regulations issued in 1988, an entity that is a USRPHC (*i.e.*, a corporation more than 50% of whose assets are "U.S. real property interests") would be deemed to be engaged in commercial activity, even if it did not actually engage in commercial activity. As a result, a foreign government entity whose assets were too concentrated in U.S. real estate (including other USRPHCs) could become a "controlled commercial entity" (CCE) and thus could lose its Section 892 exemption. The Final Regulations partially repeal this "deemed CCE" rule for any foreign corporation (including, for example, any "controlled entity" treated as a foreign government). Thus, the deemed CCE rule is now only relevant to a U.S. corporation that a foreign government controls — in such a case, if the U.S. corporation

is a USRPHC, the foreign government's income from that corporation may be ineligible for Section 892 (unless its USRPHC status is attributable solely to ownership of noncontrolling interests in other corporations).

B. Qualified Partnership Interest Exception

As a general rule, commercial activities of an entity classified as a partnership for U.S. tax purposes are attributed to its partners for purposes of Section 892. As a result, an entity of a foreign government that invests in a partnership that conducts even a small amount of commercial activity could lose the Section 892 exemption on all of its income. To provide limited relief from this draconian result, under the regulations proposed in 2011 (the 2011 Proposed Regulations), a "limited partner exception" prevented the attribution of commercial activities to a partner that holds an interest as a limited partner in a partnership. A partner was generally treated as qualifying for the exception if it did not have rights to participate in the management and conduct of the partnership's business (excluding consent rights in the case of certain extraordinary events, which were permitted).

The Final Regulations clarify and expand this exception to cover the holder of a "qualified partnership interest." For purposes of the exception, a partnership interest is treated as a qualified partnership interest if: (i) the partner does not have rights to participate in the management and conduct of the partnership's business, (ii) the partner does not otherwise "control" the partnership and (iii) certain other requirements (referred to in this client alert as the baseline requirements) are met (namely, the holder must have limited liability for the partnership's debts and not have the authority to bind or act on behalf of the partnership).

Note: A holder controls a partnership if it holds, directly or indirectly, 50% or more of the interests of the partnership by vote or value or any interest that provides it with "effective control" of the partnership. Consequently, the qualified partnership interest exception does not apply, and attribution of any commercial activities of a partnership is unavoidable under the Final Regulations, in the case of a holder that owns 50% or more of the partnership.

Note: The Final Regulations note that, while the holder of a qualified partnership will not be attributed the commercial activities of the partnership for purposes of Section 892, it may nevertheless be treated as engaged in a U.S. trade or business under Section 875 (and thus may still have a U.S. filing obligation).

1. Facts and Circumstances Test

The existence of rights to participate in the management and conduct of the partnership's business is determined under all the facts and circumstances, taking into account the conduct of the relevant parties and the totality of all rights arising from all direct or indirect interests in the partnership that the foreign sovereign holds, including rights provided under the law of the jurisdiction in which the partnership is organized, the partnership's governing documents, contractual agreements such as side letters, shareholders' agreements, and agreements with creditors of the partnership.

- In general, rights to participate in the management and conduct of a partnership's business *mean rights to participate in the day-to-day management or operation of the partnership's business*, including the right to participate in ordinary-course personnel and compensation decisions, or 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.

  For example, a right pursuant to a side letter to review and advise on the material business contracts and business expenses of a partnership is a right to participate in the day-to-day management or operation of the partnership's business.

- On the other hand, rights to participate in the management and conduct of a partnership's business generally do **not** include *participation rights with respect to monitoring or protecting the partner's capital investment in the partnership*, including oversight and supervision rights in the case of major strategic decisions.

  For example, oversight and supervision rights in the case of unusual and non-ordinary-course deviations from previously determined investment parameters or dispositions of all or substantially all of the partnership's property are participation rights with respect to monitoring or protecting the partner's capital investment in the partnership.

  Note: The general rule that participation rights with respect to monitoring or protecting the partner's capital investment in the partnership (such as oversight and supervision rights in the case of dispositions of all or substantially all of the partnership's property) do not constitute rights to participate in the management and conduct of a partnership's business does not apply if the participation rights constitute rights to participate in the day-to-day management or operation of the partnership's business (such as the right to take an active role in respect of the partnership's disposition of a specific investment) or result in effective control.

2. The 5% Safe Harbor

Under a small-partner safe harbor, the holder of a partnership interest is treated as holding a qualified partnership interest (notwithstanding whether the interest would qualify under the facts and circumstances test) if each of the following conditions is satisfied:

- The holder does not own, directly and indirectly, more than 5% of either the partnership's capital or profits interests.
- The holder is not the partnership's managing partner, managing member or an equivalent role under applicable law.
- The baseline requirements are met.

The safe harbor is thus generally available regardless of the governance rights the holder of the qualified partnership interest has, as long as they do not cause the holder to be a managing member (or similar), and otherwise do not violate the baseline requirements.

Note: The safe harbor may be helpful to sovereign investors in larger funds and in funds-of-funds that are not themselves engaged in commercial activities and acquire small stakes in underlying funds.

C. Other Rules Contained in the Final Regulations

1. Investing and Effecting Transactions in Derivatives

The Final Regulations include derivatives in the definition of the term "financial instruments," which can generally be held and traded without constituting commercial activity. Accordingly, a foreign government may hold and trade (as a nondealer) financial instruments, including derivatives, without being treated as engaged in commercial activities.

2. Commercial Activities Versus Trade or Business

The Final Regulations establish a general rule that an activity that would constitute a trade or business under Section 162 or a U.S. trade or business (if undertaken in the U.S.) under Section 864(b) is a commercial activity unless an exception applies. However, the preamble confirms that an activity undertaken in the U.S. can be commercial activity even if it does not give rise to a U.S. trade or business. Thus, Treasury has made clear its view that the concept of commercial activity is broader than the U.S. trade or business concept, not only as a function of geography.

3. Inadvertent Commercial Activity

The Final Regulations finalize, with certain modifications, the limited relief provision contained in the 2011 Proposed Regulations for a foreign government that inadvertently engages in commercial activities. The revised provision: (i) provides a nonexclusive list of factors for purposes of the continuing requirement to conduct due diligence; (ii) includes new rules related to the determination of total assets and income for purposes of the "reasonable failure to avoid commercial activity" safe harbor; and (iii) describes, as an example of a method for meeting the cure requirement, the exchange of an interest in a partnership conducting commercial activity for an interest in a qualified partnership interest. Foreign governments should consider adopting (or revisiting) written policies to comply with the due diligence requirement noted above.

II. Proposed Regulations

A. Acquisitions of Debt

As in other cases, where the sovereign investor is a creditor, the potential exemption of interest from U.S. federal income tax under Section 892 is only relevant to the extent the interest income would otherwise be subject to U.S. tax (generally, when the interest is U.S.-source and the portfolio interest exemption would not otherwise apply). However, because no income received by a CCE is eligible for the section 892 tax exemption, whether an acquisition of debt constitutes commercial activity for purposes of Section 892 is relevant with respect to income derived from other sources, including interest income from a borrower in which the foreign government owns a sufficient equity interest to be ineligible for the portfolio interest exemption.

For purposes of Section 892, investments in securities are generally not commercial activities. Current law, however, provides limited guidance on the extent to which loans may be considered as other than mere investments (or otherwise constitute commercial activities). The Final Regulations provide that, in general, investing in loans is not a commercial activity but that investments (including loans) made by a banking, financing or similar business constitute commercial activities, even if the income derived is not considered as effectively connected with the active conduct of a banking, financing or similar business. The preamble to the Final Regulations notes that Treasury does not agree with comments advocating that, in order to constitute commercial activities, an entity must "mak[e] loans to the general public or mak[e] a particular minimum number of loans."

Under the Proposed Regulations, the acquisition of debt is treated as a commercial activity unless the acquisition qualifies "as investment" under a facts and circumstances test or under one of two safe harbors (for registered offerings and "qualified secondary market acquisitions"). For purposes of applying the facts and circumstances test and safe harbors, actions by an agent or a person otherwise acting on behalf of the acquirer are treated as the actions of the acquirer, and the acquisition of debt undertaken as a dealer constitutes commercial activity without regard to the safe harbors or the facts and circumstances test.

The preamble to the Proposed Regulations requests comments "on the circumstances, if any, in which acquisitions of distressed debt, broadly syndicated loans, revolving credit facilities, and delayed-draw debt obligations should be treated as investment rather than commercial activities for purposes of Section 892."

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1. Facts and Circumstances Test

The facts and circumstances test for determining whether an acquisition of debt constitutes commercial activity is applied based on all relevant facts and circumstances. For this purpose, the Proposed Regulations provide that relevant facts and circumstances include:

- 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.
- Whether the acquirer materially participated in negotiating or structuring the terms of the debt.
- Whether the acquirer is entitled to compensation (whether or not labeled as a fee) that is not treated as interest (including original issue discount) for U.S. federal income tax purposes.
- 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.
- The percentage of the debt issuance acquired by the acquirer relative to the percentages acquired by other purchasers.
- The percentage of equity in the debt issuer held or to be held by the acquirer.
- The value of that equity relative to the amount of the debt acquired.
- If debt is deemed to be acquired in a debt-for-debt exchange as a result of a significant modification under § 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.

The preamble to the Proposed Regulations states that, in general, "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."

Although the list of factors described above is similar to the factors contained in customary loan origination guidelines utilized by foreign sovereigns and other foreign investors, examples in the Proposed Regulations suggest that Treasury views certain activities that would normally comply with such guidelines as being sufficient to constitute commercial activity. For example:

- The Proposed Regulations treat as commercial activity a *single* loan acquired by a foreign corporation where: (i) through its representative, the foreign corporation held itself out as a lender and solicited the debt, structured and negotiated the debt, and funded the debt at original issuance, and (ii) the foreign corporation acquired the debt in the form of a loan and did not own any equity in the debt issuer.

  Note: While a single loan is commonly viewed as not continuous enough to give rise to a U.S. trade or business, the concept of commercial activity, as the preamble to the Final Regulations indicates, is viewed by Treasury as broader than the U.S. trade or business concept. This is further supported by the statement in the preamble to the Proposed Regulations that, in issuing the proposed acquisition of debt rules, "no inference is intended . . . as to the circumstances in which acquiring debt, including at original issuance, would or would not be a trade or business for other purposes of the Code, including Section 864." That being said, given that, under the Final Regulations, any activities that constitute a U.S. trade or business (or would if undertaken in the U.S.) are generally commercial activities, one would think that if an acquisition of debt is not a commercial activity, it should likewise not give rise to a U.S. trade or business.
- In another example, the Proposed Regulations treat as commercial activity a "significant modification" of a debt instrument where the foreign corporation was a member of the creditors' committee that materially participated in negotiating and structuring the terms of the modified debt, even though the debt was not distressed when acquired but the modification was prompted by a later default.

  Note: Most loan origination guidelines permit a foreign corporation to negotiate a significant modification as long as it is doing so in order to protect an investment that has gone into distress and the debt was not distressed when originally acquired by the foreign corporation. This example thus may be another instance where Treasury's view of commercial activities is potentially broader than what may constitute a U.S. trade or business.

By contrast, the Proposed Regulations treat as investment a single $50 million loan acquired by a foreign corporation, notwithstanding that its management structured the terms of the debt and that the debt was acquired at original issuance, where: (i) the foreign corporation did not hold itself out as a lender or solicit borrowers, and (ii) the foreign corporation owned 80% of the equity interests of the debt issuer, which had a total value of $100 million (and, thus, was considered as owning a substantial percentage of the equity interests in the debt issuer and acquired an amount of debt that was, according to the Proposed Regulations, "not significant" relative to the value of its equity investment).

Note: This example indicates that, while the acquisition of a single loan may constitute commercial activity in certain circumstances, capitalizing a subsidiary with debt may not, provided that the amount of leverage is not excessive.

2. Safe Harbors

Registered offerings: Under the registered offerings safe harbor, an acquisition of bonds or other debt securities in an offering registered under the Securities Act of 1933 is treated as investment, provided that the underwriters are unrelated to the acquirer.

Qualified secondary market acquisitions: Under the qualified secondary market acquisitions safe harbor, an acquisition of debt traded on an established securities market is treated as investment, provided that:

- The acquirer does not acquire the debt from the debt issuer or participate in the negotiation of the terms or issuance of the debt.
- The acquisition is not from a person that is under common management or control with the acquirer (unless that person acquired the debt as investment).

The preamble requests comments "on this safe harbor, including the circumstances, if any, in which it should apply to an acquisition of debt that is not traded on an established securities market."

Note: If the proposed qualified secondary market acquisitions safe harbor is not expanded, an acquisition of debt from an affiliate or commonly managed fund (for example, in the case of a "season and sell" approach) will need to be analyzed under the facts and circumstances test.

B. Effective Control

An entity that is engaged in commercial activities is treated as a CCE if a foreign government "controls" it. As indicated above, a foreign government "controls" an entity if the government holds, directly or indirectly, 50% or more of the interests of the entity by vote or value or any interest that provides it with "effective control" of the entity. The Final Regulations cross-reference the temporary regulations, which used the term "effective practical control," and which state that effective practical control may be achieved through a minority interest which is sufficiently large to achieve effective control, or through creditor, contractual or regulatory relationships which, together with ownership interests held by the foreign government, achieve effective control.

The Proposed Regulations provide that effective control is generally achieved by any interest in the entity that, directly or indirectly, either separately or in combination with other interests, results in control of the operational, managerial, board-level or investor-level decisions of the entity.

1. Facts and Circumstances Test

The determination of effective control is made considering all of the facts and circumstances related to the interests in an entity (unless the foreign government is or controls an entity that is a managing partner or member of the entity, in which case the foreign government is deemed to have effective control).

- 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) do not alone give rise to effective control.

  For example, the Proposed Regulations treat as not having effective control the holder of 40% of the equity interests of a corporation where the holder is entitled to participate in an investment committee and has the right only to discuss acquisitions and sales of property but has no right to decide or execute acquisitions or sales and no other rights.

- For purposes of the facts and circumstances test, interests in an entity may include, for example: (i) equity and debt interests, (ii) voting rights in the entity, including the power to appoint directors or managers and to veto decisions, or (iii) contractual rights in or arrangements with the entity, or with other interest holders in the entity.

  For example, the Proposed Regulations treat as having effective control the holder of equity interests of a corporation where the holder is entitled to appoint one out of three directors and that director alone has rights to unilaterally veto dividend distributions, material capital expenditures, sales of new equity interests in Corp 1 and the operating budget.

  Note: Although on its face this example, Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(F), Ex. 5, seems to involve rights that foreign government investors customarily receive in joint venture transactions, a close reading of the example (the director "*alone*" has unilateral rights), together with the preamble's description of a parallel example (where one director has the "*sole power*" to unilaterally appoint or dismiss the manager), suggests that the examples may be understood to address circumstances in which no other holder has unilateral veto rights. This understanding could be consistent, moreover, with the preamble's request for comments regarding circumstances where decisions are subject to veto rights "of the holder and *other holders*."