View on our website.

GIBSON DUNN

Tax Update December 15, 2025

IRS and Treasury Issue Guidance Under Section 892 Regarding the Taxation of Foreign Governments

The Proposed Regulations would make major changes to existing law and, if finalized, could significantly alter the terms on which many foreign governments invest in the United States.

On December 12, 2025, the IRS and Treasury issued final regulations (the "Final Regulations") and a notice of proposed rulemaking (the "Proposed Regulations") regarding the taxation of investments in the United States by foreign governments.

The Final Regulations finalize, with some changes, regulations proposed in 2011 and 2022 that address when a foreign government is engaged in a commercial activity and when an entity is a controlled commercial entity with respect to a foreign government. The Proposed Regulations would make major changes to existing law and, if finalized, could significantly alter the terms on which many foreign governments invest in the United States. Accordingly, this alert discusses the Proposed Regulations first, then discusses the Final Regulations.

EXECUTIVE SUMMARY

Proposed Regulations

- **Effective Control Defined**
    - Facts and circumstances analysis of whether a foreign government controls operational, managerial, board-level, or investor-level decisions.
    - Veto rights over key decisions can create effective control; mere consultation rights do not.
    - Interests are aggregated across controlled entities and integral parts of the same foreign government.
- **New Rules For When Debt Acquisition Is Commercial Activity**
    - More restrictive framework for determining whether debt investments constitute commercial activity.
    - Two new safe harbors for registered offerings and certain secondary market acquisitions.
    - If outside safe harbors, facts-and-circumstances test applies; negotiation or structuring involvement likely gives rise to commercial activity, particularly if no accompanying equity investment.

Final Regulations

- **Commercial Activity Defined**
    - No special exclusion for fee income from funds.
    - Selling partnership interests and investing in certain derivatives generally not commercial activity.
- **USRPHC Rule Eliminated for Non-U.S. Corporations**. Removes *per se* commercial activity rule for all non-U.S. corporations.
- **Qualified Partnership Interest Exception**
    - Applies broadly to partnership interests meeting four conditions:
        - Minority ownership and no effective control.
        - Limited liability.
        - No authority to contract on partnership's behalf.
        - No day-to-day management and operational control rights.
    - Safe harbor for non-managing partner interests of not more than 5 percent with limited liability and no authority to contract.

- **Other Highlights**
    - Inadvertent commercial activity exception retained with longer, 180-day cure period.
    - Annual controlled commercial entity test confirmed with clarifications.

Effective Dates

- Proposed Regulations: apply after finalization.
- Final Regulations: effective for tax years beginning on or after December 15, 2025, with elective retroactive application.

Discussion

I. Proposed Regulations

A. Definition of Effective Control

Section 892 generally provides an exemption from taxation for certain U.S.-source income earned by foreign governments; however, the exemption does not apply to income received by or from (or from the disposition of) any entity that is engaged in commercial activities anywhere in the world and in which the foreign government holds a controlling interest or an interest that gives it "effective control" of the entity.[1]

Neither the Code nor prior Treasury regulations define "effective control," although temporary Treasury regulations issued in 1988 provide that this term includes relationships other than ownership, such as commercial relationships and the ability to influence an entity's activities through control of a critical input or regulatory approvals.[2] The Proposed Regulations would define effective control and describe the relationships that can create effective control.

Under the Proposed Regulations, effective control is determined based on all facts and circumstances and looks to whether the foreign government holds control over operational, managerial, board-level, or investor-level decisions of the entity.[3] Mere consultation rights over these decisions do not result in effective control.[4] For this purpose, interests that can constitute effective control include equity interests, debt interests, voting rights (including the power to appoint directors or managers and to veto decisions), contractual rights (including shareholder agreements), business relationships (including business relationships with other interest holders), and regulatory authority.[5]

1. Examples of Effective Control

Examples in the Proposed Regulations illustrate these principles and can be summarized as follows:

- *Minority interest; no control or veto rights not effective control.* A foreign government that holds a minority equity interest in an entity without any contractual or local law right to appoint a majority of the entity's directors, any power to compel or veto an action, or any

business relationship that creates influence over the entity does not have effective control of the entity. This is the case even if the foreign government is a party to an investment agreement that establishes criteria for what types of investments the entity can make or the foreign government discusses acquisitions and sales of property as a member of the entity's investment committee (so long as the foreign government has no right to approve or execute the acquisitions and sales).

- *Power to appoint or dismiss manager is effective control*. By contrast, a foreign government that has the power to appoint or dismiss the person responsible for managing the entity's operations has effective control of the entity.
- *Veto rights may be effective control.* Veto rights over certain actions may result in effective control over the entity, although the Proposed Regulations do not provide an exhaustive list of which veto rights alone (or in combination) result in effective control.[6] Notably, one example concludes that veto rights over dividend distributions, capital expenditures, sales of new equity interests, and the operating budget, taken together, result in effective control.
- *Certain creditor rights can result in effective control*. A foreign government can also have effective control even if it is solely a creditor of the entity if the credit agreement imposes sufficient restrictions on the entity's capital transactions and the foreign government has sufficient veto rights.

2. Aggregation Rule

The preamble to the Proposed Regulations also indicates that the effective control analysis aggregates interests of the same foreign government, even if two different controlled entities of the same foreign government are managed separately or are not aware of each other's rights with respect to the relevant entity. The IRS and Treasury requested comments on when controlled entities should not be aggregated because they are functionally independent.

B. New Rules for Debt Investments

The exemption under section 892(a)(1) does not apply to income derived from commercial activities and a "controlled entity" of a foreign government that is engaged in commercial activities anywhere in the world is not eligible for the section 892 exemption. Under regulations proposed in 2011 (the "2011 Proposed Regulations"), investments in "loans" are not commercial activities unless those loans are "made by a banking, financing, or similar business."[7]

The Proposed Regulations would establish an alternative, seemingly more restrictive, framework for determining whether the origination or other acquisition of debt constitutes commercial activity, composed of two narrow safe harbors and a general facts-and-circumstances test.[8]

1. Acquisition of Debt Safe Harbors

The two safe harbors are:

- Registered offerings. An acquisition of debt in an offering registered under the Securities Act of 1933 is not commercial activity if the underwriters are not related to the acquirer.[9]

- Qualified secondary market acquisitions. An acquisition of debt traded on an established securities market is not commercial activity if (a) the acquirer does not acquire the debt from the issuer, (b) the acquirer does not participate in the negotiation of the terms or issuance of the debt, and (c) the acquisition is not from a person that is under common management or control with the acquirer, unless that person acquired the debt as an investment (and not a commercial activity).[10]

2. Acquisition of Debt Facts-and-Circumstances Test; Examples

If a debt acquisition does not satisfy one of the safe harbors, a facts-and-circumstances test applies to determine if the acquisition is a commercial activity. The non-exclusive set of factors include:

1. whether the acquirer solicited prospective borrowers or held itself out as willing to make debt investments;
2. whether the acquirer materially participated in negotiating or structuring the terms of the debt;
3. whether the acquirer is entitled to compensation that is not treated as interest for U.S. federal income tax purposes;
4. the form of the debt and the issuance process (including whether the debt is a bank loan or privately placed);
5. the share of the borrower's 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 the debt is deemed to be acquired in a debt-for-debt exchange as a result of a significant modification, whether there was, at the time of the acquisition of the original unmodified debt, a reasonable expectation, "based on objective evidence," that the original unmodified debt would default.

An example in the Proposed Regulations indicates that even one debt financing could constitute commercial activity if a foreign government that did not own equity in the borrower offered to make a loan and structured and negotiated the loan's terms. On the other hand, another example suggests that providing debt financing directly to an 80 percent-owned entity may not be commercial activity. In that example, the loan does not give rise to commercial activity even though the foreign government's representatives structured the terms of the loan, because the foreign government did not hold itself out as a lender, owned a substantial percentage of the issuer's equity, and acquired an amount of debt ($50 million) that was "not significant" relative to the value of the foreign government's equity interest in the issuer ($80 million).[11]

In addition, the examples make clear that, in the case of a debt restructuring, being a member of a creditors' committee that materially participates in negotiating the restructuring causes the resulting deemed debt acquisition to be commercial activity. However, merely being represented

by a creditors' committee does not necessarily cause a debt acquisition to constitute commercial activity.

Foreign governments seeking to make debt investments should carefully consider the impact of these Proposed Regulations, including the risks of affirmatively seeking debt investment opportunities, acquiring debt in entities in which the foreign government has no existing equity investment, and serving on creditors' committees.

C. Effective Date of Proposed Regulations

The Proposed Regulations described above generally would apply to taxable years beginning on or after the date that they are finalized.

II. Final Regulations

A. Defining Commercial Activity

As described above, the benefits of section 892 are not available for income derived from a "commercial activity" or to a controlled entity of a foreign government that is engaged in commercial activities. The 2011 Proposed Regulations generally defined commercial activities to include all activities conducted for the current or future production of income or gain, regardless of where the activity is conducted, the purpose or motivation for conducting the activity, and whether the activity constitutes a trade or business for other purposes of the Code.[12] The Final Regulations finalize the 2011 Proposed Regulations in this respect with the following changes and observations:

1. Fee income does not receive special treatment. In the preamble to the Final Regulations, the IRS and Treasury rejected a comment recommending an exception from commercial activity treatment for certain fees received as a passive investor in a private equity or private credit fund. The preamble leaves open the possibility that the commercial activities of a fund sponsor may be attributed to a foreign government investor from the investor's interest in a partnership or "on the basis of agency" and notes that this applies "without regard to whether the foreign government actually or constructively receives or otherwise shares in income labeled as a fee."

2. Selling partnership interests generally does not give rise to commercial activity. The Final Regulations provide that merely holding a partnership interest or selling the interest (for the foreign government's own account and other than as a dealer) is not, by itself, a commercial activity.[13]

3. Investments in certain derivatives generally are not commercial activity. The Final Regulations provide that certain specified derivatives qualify as "financial instruments," which do not generally give rise to a commercial activity.[14]

B. USRPHCs: Elimination of Per Se Commercial Activity Rule for Non-U.S. Entities

Under temporary regulations from 1988, a foreign corporation that is a United States real property holding corporation ("USRPHC")[15] is *per se* treated as engaged in commercial activity and thus not entitled to benefits under section 892.[16] Because of this rule, non-U.S. controlled entities of

foreign governments had to carefully monitor their direct and indirect investments in U.S. real estate to ensure they were not USRPHCs.[17]

The Final Regulations eliminate entirely the *per se* commercial activities rule for all non-U.S. USRPHCs. This welcome change in the Final Regulations eliminates the burden of foreign governments having to continuously monitor whether their controlled entities are USRPHCs.

C. The Final Regulations Revise and Clarify the Qualified Partnership Interest Exception

Generally, the commercial activities of a partnership are attributed to its partners.[18] However, under the 2011 Proposed Regulations, an entity that is not otherwise engaged in commercial activities will not be deemed to be engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership.[19] The Final Regulations adopt this exception, with several notable revisions and clarifications, including introducing the term "qualified partnership interest" and adding a new requirement that the holder of a qualified partnership interest not have control over the relevant partnership, and adding a safe harbor for certain partnership interests that constitute not more than five percent of the partnership's capital or profits as further described below.[20]

1. Qualified partnership interest not limited to limited partnerships; four requirements. The Final Regulations clarify that the exception applies to any interest in an entity classified as a partnership for U.S. federal income tax purposes that meets four requirements (a "qualified partnership interest") and not exclusively to an entity organized as a limited partnership under State law.[21]

2. The first three requirements—limited partner interests. The first three requirements are consistent with the rights of limited partners under state law (and were present in the 2011 Proposed Regulations), namely, that the holder of the partnership interest: (i) does not have personal liability for claims against the partnership; (ii) does not have the right to enter into contracts or act on behalf of the partnership; and (iii) does not have the right to participate in the management and conduct of the partnership's business.[22]

   The Final Regulations helpfully clarify that participating in the "management and conduct of a partnership's business" refers to rights to participate in day-to-day management or operations and does not include rights to monitor and protect an investor's capital investment in the partnership. Permissible monitoring rights include oversight and supervision rights in the case of 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 the ordinary course of the partnership's activities.

3. The fourth requirement—minority ownership and no effective control. Importantly, the Final Regulations add a fourth requirement: that the holder of the partnership interest not have effective control of the partnership or own 50 percent or more of the value or voting interests of the partnership.[23] As a result, a foreign government that holds 50 percent or more of the interests in an entity classified as a partnership or that has effective control over such entity cannot rely on the qualified partnership interest exception to avoid the attribution of commercial activity from a partnership.

4. Aggregation of Interests. The Final Regulations also specify that when a foreign government holds multiple interests in a partnership (directly or indirectly) through one or more entities qualifying for benefits under section 892, all of the entities' interests in the partnership are aggregated for purposes of the qualified partnership interest exception (and if any of the interests do not qualify for the exception, none of the foreign government's other interests in the partnership can qualify).[24] This concept is similar to the aggregation principle for purposes of the effective control analysis in the Proposed Regulations described above.

5. Safe harbor. The Final Regulations include a safe harbor that treats a partnership interest as a qualified partnership interest if the holder (i) has limited liability, (ii) does not possess the legal authority to bind or act on behalf of the partnership, (iii) does not directly or indirectly own more than five percent of a partnership's capital or profits interests, and (iv) is not a managing member or managing partner of the partnership.[25]

6. Tiered partnerships. The Final Regulations also address application of the qualified partnership exception between tiers of partnerships and provide that an upper-tier partnership that holds a qualified partnership interest in a lower-tier partnership is not attributed the lower-tier partnership's commercial activities.[26]

D. Inadvertent Commercial Activity Exception

The 2011 Proposed Regulations allow an entity to avoid being treated as a controlled commercial entity if the failure to avoid commercial activity is reasonable, the commercial activity is promptly cured, and certain record maintenance requirements are met.[27] The Final Regulations adopt this exception with minimal changes.[28]

E. Annual Controlled Commercial Entity Test

Finally, the Final Regulations adopt the rule in the 2011 Proposed Regulations that status as a controlled commercial entity applies for the entire taxable year if an entity engages in commercial activities at any time during that year.[29] The Final Regulations adopt this approach, but clarify that (i) the relevant taxable year is the taxable year of the entity engaging in the commercial activity, (ii) if the taxable year of an entity that is engaged in commercial activity terminates in connection with its acquisition by another entity controlled by the same foreign government, the acquiring entity will be treated as conducting commercial activity in the taxable year of the acquiring entity in which the acquisition occurs, and (iii) an entity's activities during its immediately preceding tax year will be taken into account to the extent they are relevant in characterizing the entity's activities in the current tax year.[30]

F. Effective Date of Final Regulations

The Final Regulations generally apply to tax years beginning on or after December 15, 2025. However, taxpayers generally may apply the Final Regulations to prior open tax years if the taxpayer and its affiliates apply the Final Regulations, in their entirety, to all such taxable years beginning before December 15, 2025.

[1] Section 892(a)(2)(B). Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), all "Treas. Reg. §" and "Temp Treas. Reg. §" references are to the Treasury regulations promulgated under the Code (or to the Final Regulations to be promulgated), and all "Prop. Treas. Reg. §" references are to the 2011 Proposed Regulations, the 2022 Proposed Regulations, or the 2025 Proposed Regulations (each as defined in this alert).

[2] Temp. Treas. Reg. § 1.892-5T(c)(2). Although these temporary Treasury regulations use the term "effective practical control," the Proposed Regulations and the Final Regulations replace the term "effective practical control" with the term "effective control" to be consistent with section 892(a)(2)(B)(ii).

[3] Prop. Treas. Reg. § 1.892-5(c)(2).

[4] *Id.*

[5] *Id*.

[6] The IRS and Treasury request comments on when veto rights should not be treated as giving a foreign government effective control of an entity.

[7] Prop. Treas. Reg. § 1.892-4(e)(1)(iii). The 2011 Proposed Regulations do not define a banking, financing, or similar business.

[8] The preamble to the Proposed Regulations explains that the determination of whether the acquisition of debt is commercial activity is made without regard to whether the debt acquisition is a trade or business for other U.S. federal income tax purposes.

[9] For this purpose, relatedness is determined under sections 267(b) and 707(b).

[10] For this purpose, whether debt is publicly traded on an established securities market is determined under Treas. Reg. § 1.7704-1(b).

[11] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(3)(ii) (Ex. 2).

[12] Prop. Treas. Reg. § 1.892-4(d).

[13] Treas. Reg. §1.892-4(c)(1)(i) and (2). The IRS and Treasury declined to change the rule in Treas. Reg. § 1.892-3T(a)(2) and (3) that gain from the disposition of a partnership interest is not exempt from tax under section 892 on the basis that this change was beyond the scope of the Final Regulations. 90 F.R. 57,904.

[14] Treas. Reg. § 1.892-3(a)(4)(i). The specified derivatives are those described in Prop. Treas. Reg. § 1.864(b)-1(a). The regulations also provide that holding non-functional currency does not give rise to commercial activity.

[15] Generally, a USRPHC is any corporation if the value of its direct and indirect interests in U.S. real property represents at least 50 percent of the aggregate value of its real property (both U.S. and non-U.S.) and business assets.

[16] Temp. Treas. Reg. § 1.892-5T(b)(1).

[17] Temp. Treas. Reg. § 1.892-5T(b)(1). The regulations proposed in 2022 (the "2022 Proposed Regulations") introduced an exception to the 1988 per se rule—corporations that are USRPHCs solely by reason of their direct or indirect ownership in one or more other corporations that are not controlled by the foreign government would no longer be treated as per se engaged in commercial activity. Because, under the Final Regulations, foreign corporations are no longer subject to the *per se* rule, the exception in the 2022 Proposed Regulations for certain foreign corporations is unnecessary and was not included in the Final Regulations. However, investors currently relying on the exception in the 2022 Proposed Regulations may continue to do so.

[18] Temp. Treas. Reg. § 1.892-5T(d)(3).

[19] Prop. Treas. Reg. § 1.892-5(d)(5)(iii)(A).

[20] Treas. Reg. § 1.892-5(d)(5)(iii)(B). The Final Regulations specify that "control" for this purpose is within the meaning of Treas. Reg. § 1.892-5(a)(1) (and accordingly the test is 50 percent of vote or value or effective control, as described above).

[21] *Id*. The Final Regulations use the term "qualified partnership interest" rather than "interest as a limited partner in a limited partnership" to clarify the broader application of this exception to any entity that is classified as a partnership for U.S. federal income tax purposes.

[22] Prop. Treas. Reg. § 1.892-5(d)(5)(iii)(A).

[23] Treas. Reg. § 1.892-5(d)(5)(iii)(B).

[24] Treas. Reg. § 1.892-5(d)(5)(iii)(B)(2)(iii).

[25] Treas. Reg. § 1.892-5(d)(5)(iii)(C).

[26] Treas. Reg. § 1.892-5(d)(5)(iii)(D).

[27] Prop. Treas. Reg. § 1.892-5(a)(2). The cure period in the 2011 Proposed regulations is 120 days and is extended to 180 days in the Final Regulations.

[28] Notably, the IRS and Treasury declined to add a safe harbor for an entity that obtains a tax opinion or legal advice with respect to commercial activities, which certain commenters had requested. The preamble provides that obtaining a tax opinion or legal advice does not supersede the need for employees of the entity (or of its controlling entity) to use reasonable efforts to establish and follow procedures for avoiding commercial activity.

[29] Prop. Treas. Reg. § 1.892-5(a)(3).

[30] Treas. Reg. § 1.892-5(a)(3)(i).

The following Gibson Dunn lawyers prepared this update: Matt Donnelly, Kathryn Kelly, Yara Mansour, Ray Noonan, Eric Sloan, Edward Wei, and Dan Zygielbaum.

Gibson Dunn lawyers are available to assist in addressing any questions you may have regarding these regulations. To learn more about these issues or discuss how they might impact your business, please contact the Gibson Dunn lawyer with whom you usually work, the authors, or any member of the firm's Tax and Tax Controversy and Litigation practice groups:

Tax:
Dora Arash – Los Angeles (+1 213.229.7134, darash@gibsondunn.com)
Sandy Bhogal – Co-Chair, London (+44 20 7071 4266, sbhogal@gibsondunn.com)
Michael Q. Cannon – Dallas (+1 214.698.3232, mcannon@gibsondunn.com)
Jérôme Delaurière – Paris (+33 (0) 1 56 43 13 00, jdelauriere@gibsondunn.com)
Anne Devereaux* – Los Angeles (+1 213.229.7616, adevereaux@gibsondunn.com)
Matt Donnelly – New York/Washington, D.C. (+1 212.351.5303, mjdonnelly@gibsondunn.com)
Benjamin Fryer – London (+44 20 7071 4232, bfryer@gibsondunn.com)
Evan M. Gusler – New York (+1 212.351.2445, egusler@gibsondunn.com)
James Jennings – New York (+1 212.351.3967, jjennings@gibsondunn.com)
Kathryn A. Kelly – New York (+1 212.351.3876, kkelly@gibsondunn.com)
Brian W. Kniesly – New York (+1 212.351.2379, bkniesly@gibsondunn.com)
Pamela Lawrence Endreny – Co-Chair, New York (+1 212.351.2474, pendreny@gibsondunn.com)
Kate Long – New York (+1 212.351.3813, klong@gibsondunn.com)
Gregory V. Nelson – Houston (+1 346.718.6750, gnelson@gibsondunn.com)
Benjamin Rapp – Munich/Frankfurt (+49 89 189 33-290, brapp@gibsondunn.com)
Jennifer Sabin – New York (+1 212.351.5208, jsabin@gibsondunn.com)
Eric B. Sloan – Co-Chair, New York/Washington, D.C. (+1 212.351.2340, esloan@gibsondunn.com)
Edward S. Wei – New York (+1 212.351.3925, ewei@gibsondunn.com)
Lorna Wilson – Los Angeles (+1 213.229.7547, lwilson@gibsondunn.com)
Daniel A. Zygielbaum – Washington, D.C. (+1 202.887.3768, dzygielbaum@gibsondunn.com)

Tax Controversy and Litigation:
Saul Mezei – Washington, D.C. (+1 202.955.8693, smezei@gibsondunn.com)
Sanford W. Stark – Chair, Washington, D.C. (+1 202.887.3650, sstark@gibsondunn.com)
C. Terrell Ussing – Washington, D.C. (+1 202.887.3612, tussing@gibsondunn.com)

**Anne Devereaux, of counsel in the firm's Los Angeles office, is admitted to practice in Washington, D.C.*