ALERT MEMORANDUM

2025 Final and Proposed Section 892 Regulations

December 14, 2025

On December 12, 2025 the Internal Revenue Service (the "IRS") and the Treasury Department released final and proposed regulations providing long-awaited guidance under section 892 of the Internal Revenue Code, which generally exempts foreign governments from tax on certain U.S. investments.

Specifically, the **proposed regulations** provide potential rules for determining (i) **when the acquisition of debt instruments** by an investor otherwise entitled to the benefits of section 892 (a "section 892 investor") **could give rise to commercial activities**, as opposed to investment activity, and (ii) when a section 892 investor has "effective control" (f.k.a. "effective practical control") over an entity.

The **final regulations** discuss, among other matters, transactions by a section 892 investor in (i) **non-functional currency**, (ii) **derivatives**, and (iii) **partnership equity**.

The **final regulations** also (i) **revoke the rule** that a non-U.S. corporation that qualifies as a **U.S. real property holding corporation is deemed to be engaged in commercial activities**, (ii) revise the rules on the limited partnership interest exception (now, the "**qualified partnership interest**" or "QPI" exception) to the partner commercial activity attribution rule and (iii) amend the rules regarding **inadvertent commercial activities**.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Matt Brigham
+1 212 225 2102
mbrigham@cgsh.com

Bill McRae
+1 212 225 2188
wmcrae@cgsh.com

Jason Factor
+1 212 225 2694
jfactor@cgsh.com

Meyer Fedida
+1 212 225 2747
mfedida@cgsh.com

Susanna Parker
+1 212 225 2913
sparker@cgsh.com

Kylie Barza
+1 212 225 2164
kbarza@cgsh.com

Swift Edgar
+1 212 225 2736
sedgar@cgsh.com

JJ Gifford
+1 212 225 2279
jgifford@cgsh.com

David Maranjian
+1 212 225 2722
dmaranjian@cgsh.com

SAN FRANCISCO

Maureen Linch
+1 415 796 4420
mlinch@cgsh.com

I. Proposed Regulations on Debt Investments and Loan Origination:

- The proposed regulations represent the first attempt by the IRS to "provide a framework for determining when acquiring any debt, including at original issuance, qualifies as an investment for purposes of section 892," and is thus exempt from tax, or instead constitutes taxable commercial activity.
- As discussed below, under the proposed regulations a ***single loan purchased by a section 892 investor at original issuance can give rise to commercial activity*** if the loan purchase has certain characteristics (e,g., the section 892 investor offers to provide debt financing to a borrower, as opposed to being offered an investment opportunity to buy the loan, and structures and negotiates the terms of the debt).
- As a general matter, for purposes of determining whether the acquisition of debt is treated as an investment and not commercial activity, the proposed regulations adopt ***two bright-line safe harbors***, and then adopt a "***fact and circumstances" approach in other cases.***
- In the preamble to the final regulations, the IRS notes that "commercial activities" has a broader meaning than "trade or business" and potentially includes activities that may not constitute a trade or business. The final regulations provide that all activities that constitute a trade or business for purposes of section 162 or constitute (or would constitute if undertaken in the United States) a trade or business in the United States for purposes of section 864(b) generally are commercial activities. However, the preamble to the proposed regulations emphasizes that the proposed rules on investments in loans are solely for purposes of determining which activities constitute "commercial activities" within the meaning of section 892 – the proposed regulations are not intended to infer what types of activities would constitute a "trade or business" more generally.
- <u>*Bright-Line Safe Harbors*</u>:
  - The following two types of debt acquisition would qualify as investment activity under the proposed regulations:

(i) *Registered offerings*: the acquisition of bonds or other debt securities in an offering registered under the Securities Act of 1933, provided that the underwriters of the offering are not related to the acquiror of the debt.

- Comments were requested about which non-U.S. jurisdictions have securities laws similar to the Securities Act of 1933 that should be included in the safe harbor.

(ii) *Qualified secondary market acquisitions*: the acquisition of debt that is traded on an "established securities market", provided that: (a) the acquiror does not acquire the debt from the issuer or participate in the negotiation of the terms or issuance of the debt, and (b) the acquisition is not from a person that is under common management or control with the acquiror, unless that person acquired the debt as an investment.

Both of these safe harbors may be of limited applicability to a section 892 investor's debt investing activity as most debt instruments are not issued in registered offerings or traded on an established securities market – which is limited to certain national securities exchanges and interdealer quotation systems that regularly disseminate firm buy or sell quotes by identified brokers or dealers.

- <u>*Facts and Circumstances*</u>:
  - If the acquisition of a debt instrument fails to meet the requirements of either of the two safe harbors discussed above, then the acquisition still might qualify as an

investment "based on all the relevant facts and circumstances."

- In describing the facts-and-circumstances standard, the regulations provide the following non-exclusive list of factors to be considered:

(i) Whether the acquiror solicited prospective borrowers, or otherwise held itself out as willing to make loans or otherwise acquire debt in connection with its original issuance;

(ii) Whether the acquiror materially participated in negotiating or structuring the terms of the debt;

(iii) Whether the acquiror is entitled to compensation in connection with debt that is not treated as interest for U.S. federal income tax purposes;

(iv) The form of the debt and the issuance process (e.g., bank loan versus privately placed debt security);

(v) The amount of debt bought by the acquiror relative to other purchasers;

(vi) The percentage of equity in the debt issuer (if any) held or to be held by the acquiror;

(vii) The value of such equity relative to the value of debt acquired; and

(viii) If debt is deemed to be acquired in a debt-for-debt exchange under Treasury regulation section 1.1001-3 due to a modification of the debt's terms, whether there was a reasonable expectation at the time the unmodified debt was acquired, based on objective evidence (such as a decline in the financial condition of the issuer) that the debt would default.

- *Examples to illustrate facts-and-circumstances approach:*

- The proposed regulations contain five examples of loan acquisitions by a section 892 investor that either do or do not give rise to commercial activity under the facts-and-circumstances test, which examples are summarized below:

- Example 1: A ***single loan*** where the ***acquiror offered to make the loan to the non-U.S. borrower in which the acquiror owned no equity and then negotiated and structured the terms of the loan*** was held to give rise to ***commercial activity***.

- Example 2: ***A shareholder loan to a non-U.S. borrower*** was treated as ***an investment*** where the acquiror of the debt owned 80% of the borrower worth $80 million, and lent $50 million. The acquiror structured the terms of the loan.

- Example 3: In a ***forward flow*** fact pattern, the acquiror communicated in discussions with financial institutions that it was ***interested in purchasing privately placed debt of U.S. corporations***. The acquiror then, based on those discussions, purchased ten privately placed debt securities (offered under Reg S through private placement memoranda) at original issuance, where the acquiror (i) ***purchased less than one third of each offering***, and (ii) ***was not the largest single purchaser*** in any offering. The purchases were treated as investments.

- Example 4: A ***debt modification was treated as part of an investment*** where: (i) the unmodified debt was not in default when purchased in a secondary transaction; (ii) there was no objective indication at the time of purchase of the unmodified debt that it would default, and then (iii) when the debt finally did default due to unexpected changes in market conditions, the acquiror ***did not participate in the creditors' committee*** and thus did not negotiate any terms of the modified debt.

- Example 5: A ***debt modification*** did ***give rise to commercial activity*** where the facts were the same as in Example 4, except the acquiror ***did participate in the creditors' committee***, which in turn materially participated in negotiating and structuring the terms of the modified debt.

II. Proposed Regulations on "Effective Control"

- In response to several commentators, the IRS has also issued proposed regulations to provide more detailed guidance on what constitutes "effective practical control" of an entity for purposes of section 892, or "effective control" under the new terminology of the proposed regulations.
- If a section 892 investor has "effective control" over an entity that is engaged in commercial activities, then the entity is a "controlled commercial entity" (CCE) and the benefits of section 892 are not available in respect of amounts paid to, or received from, such entity.
- The regulations make it clear that "effective control" is, as under the current rules, determined under a facts-and-circumstances test that looks to the combined effect of all interests in an entity that a section 892 investor might hold, including: equity, debt, special voting rights, contractual rights against the entity, business relationships with the entity, regulatory authority over the entity, and any other interest or relationship that may confer influence over an entity.
- "Effective control" is achieved by any combination of the above-mentioned interests that results, directly or indirectly, in control of the operational, managerial, board-level or investor-level decision of the entity.
- The proposed regulations provide several examples applying the facts-and-circumstances approach, which make it clear, among other matters that:
  - ***Mere consultation rights (including through participation on an investment committee) do not confer effective control.***
  - ***The ability to appoint or dismiss management generally confers effective control.***
- In one example, the proposed regulations make it clear 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***.
  - Section 892 investors that have structured consent rights in investments in order to avoid effective control may want to revisit the negotiated rights in light of this example.

III. Final Regulations Confirm Certain Activities are not Commercial

The final regulations address (or explicitly decline to address) points that have been the subject of speculation for years, including:

- *Derivatives as Financial Instruments*: The final regulations generally provide that trading in financial instruments is not a commercial activity. The final regulations ***clarify the scope of the term "financial instrument"*** to more ***closely align with the derivatives trading safe harbor under the section 864(b)*** proposed regulations, including now covering derivatives over commodities.
- *Currency Positions*: The final regulations confirm that the ***exclusion from commercial activities*** for ***bank deposits include bank deposits in any currency***. However, the IRS and Treasury ***declined to address whether gains in respect of***

physical positions in nonfunctional currency should be excluded from commercial activity income.

- *Positions in Partnership Equity*: The final regulations also confirmed that ***holding or trading a partnership interest*** for a section 892 investor's own account and not as a dealer is not by itself a commercial activity, rather the determination generally is based on the activities of the partnership. However, the IRS and Treasury ***declined to address how gain on the sale of a partnership interest should be characterized*** for purposes of section 892.
- *Fee Sharing Arrangements*: The IRS also ***declined to adopt*** a commentator's proposal that a section 892 investor should not be considered engaged in commercial activity solely as a result of ***sharing in fee income earned by the sponsor*** in a private equity or private credit fund – notwithstanding that the section 892 investor provides no services to the payor of the fees or that the amount of the section 892 investor's fee entitlement is a direct function of the amount of equity owned by the section 892 investor.

IV. Final Regulations Address Entities Engaged in Commercial Activities

A. U.S. Real Property Holding Corporations ("USPRHC")

- The final regulations have ***revoked the rule that a non-U.S. entity qualifying as a USRPHC is deemed to be engaged in commercial activities.***
- Although ***U.S. corporations qualifying as a USRPHC generally are still deemed to be engaged in commercial activities, they can continue to use the minority interest exception from the 2022 proposed regulations***.
  - As a result, a section 892 investor can continue to use a U.S. corporate holding company to hold non-controlling interests in USRPHCs without causing the holding company to be a CCE.
  - In testing whether an entity is a USRPHC, these minority interests are not included in either the numerator or the denominator of the entity's balance sheet.

B. Partnerships

- Consistent with the 2011 proposed regulations, the final regulations provide that commercial activities of a partnership generally are attributable to its partners. The final regulations ***adopt the trading activity exception from the 2011 proposed regulations, expand (and rename) the limited partner exception*** and ***address how multi-tier partnerships and multiple interests in a partnership are taken into account.***
- Revised Qualified Partnership Interest Exception
  - The 2011 proposed regulations provided that commercial activity income attributed from a partnership to a "limited partner" would not cause the limited partner to be treated as engaged in commercial activities for purposes of determining whether the limited partner is a CCE.
    - The 2011 proposed regulations raised several questions about how much influence a partner could have over the partnership before losing its status as a "limited partner," and the final regulations provide additional guidance on this question.
  - The final regulations replace the so-called "limited partner exception" with an exception for a QPI. An interest can qualify as a QPI under either a general test or a safe harbor (discussed below).

- ***General Test*** – An interest is a QPI if the holder of the interest has no right to participate in day-to-day management of the partnership:
  - No personal liability for the partnership's obligations;
  - No right to contract or otherwise bind the partnership, or act on behalf of the partnership; and
  - A less-than-50% interest in the profits and capital of the partnership, and no effective control over the partnership.
- The final regulations contrast the right to participate in the ***day-to-day management with the right to monitor and/or protect one's investment***.
  - An example in the final regulations confirms that participation in a committee that makes non-binding recommendations on investor-level strategic matters does not prevent the section 892 investor from holding a QPI.
- ***Safe Harbor*** – To satisfy the safe harbor, a section 892 investor must own (directly or indirectly***) not more than 5% of the capital or profits interests*** in the partnership and the interest must ***satisfy three other requirements***:
  - Specifically, the investor cannot:
    - Have personal liability for the partnership's obligations;
    - Have any right to contract or otherwise bind the partnership, or act on behalf of the partnership; or
    - Be a managing member or managing partner or hold any similar position in the partnership.
- Aggregation and Tiering of Partnership Interests
  - The final regulations provide that if a section 892 investor owns more than one interest in a partnership (including indirectly), the interests are aggregated for purposes of determining whether any of the interests qualify as QPIs.
  - The final regulations helpfully confirm that an upper-tier partnership that holds a QPI in a lower-tier partnership is not attributed the lower-tier partnership's commercial activities for purposes of determining whether any partners in the upper-tier partnership (who may or may not hold QPIs in the upper-tier partnership) are CCEs.

C. Inadvertent Commercial Activity

- Consistent with the 2011 proposed regulations, the final regulations provide that inadvertent commercial activity will not, by itself, cause a section 892 investor to be engaged in commercial activity.
- With a few taxpayer-friendly modifications, the final regulations adopt both the proposed regulations' general rule for determining whether commercial activity is inadvertent and the proposed regulations' 5% asset and income safe harbor.
  - Commercial activity of a section 892 investor is inadvertent only if (A) failure to avoid conducting commercial activity is reasonable, (B) the commercial activity is timely cured, and (C) the section 892 investor maintains certain records of the activity.
  - Generally, in order to show that the failure to avoid commercial activity was reasonable, the section 892 investor must have adequate written policies and operational procedures to prevent it from engaging in commercial activity. ***The final regulations have added a non-exclusive list of factors for considering***

whether the section 892 investor's policies and procedures are adequate.

- For purposes of determining whether the ***5% asset and income safe harbors*** are met, the final regulations clarify that the section 892 investor's "***applicable financial statements***" (as defined in section 451(b)(3)) should be used.
- The final regulations ***extend the cure period*** from within 120 days of discovery to ***within 180 days of discovery***.
- The final regulations also confirm that the ***value of a QPI is not included in the numerator but is helpfully included in the denominator*** for purposes of determining whether the 5% asset test threshold is met. Similarly, for the 5% gross income test, the section 892 investor's distributive share of commercial activity income from a QPI is included in the denominator but not the numerator.

D. Annual Controlled Commercial Entity determination

- The final regulations generally retain the 2011 proposed regulations' ***annual determination of whether an entity is a CCE*** and clarify that the determination generally is made with respect to the entity's taxable year, subject to ***two exceptions*** described below.
- Under the final regulations, if the assets of a corporation engaged in commercial activity are acquired ***in a section 381 transaction*** (generally a tax-free asset acquisition where the acquiror inherits tax attributes of the transferor), ***the acquiror generally will be treated as conducting the commercial activity of the transferor for its taxable year that includes the acquisition***. An exception to this rule applies, where the transaction is with an unrelated party and the acquiror is not the entity that directly carries on the commercial activity (e.g., the assets are transferred in a transaction under Treasury regulation section 1.368-2(k)).
- The final regulations also provide that, to the extent relevant in characterizing an entity's activities in the current taxable year, an ***entity's activities during its immediately preceding taxable year*** will also be taken into account for purposes of determining whether the entity is engaged in commercial activity in the current taxable year. The IRS expressed concern that, if the activity in one taxable year is considered in isolation, that activity might not be considered a commercial activity even though it was part of a ***course of conduct or transaction spanning two taxable years*** which, taken as a whole, would give rise to commercial activity. In the preamble to the final regulations, the IRS also stated that although the regulatory test does not look past the immediately preceding year, other doctrines may still apply in making the commercial activity determination where the activities occur across multiple years in form and only one year in substance.

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