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Treasury and the IRS Release Final and Proposed Regulations on Section 892

Tax Talks on **January 16, 2026**

I. Introduction

On December 15, 2025, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") published final regulations (the "Final Regulations") and proposed regulations (the "Proposed Regulations") under section 892.[1] The Final Regulations finalize, with modifications, certain temporary and proposed regulations issued in 1998, 2011 and 2022.

Section 892 exempts a foreign government from U.S. federal income tax on certain qualified income received from investments in the United States in stocks, bonds, or other domestic securities, and financial instruments held in the execution of governmental financial or monetary policy. However, the exemption does not apply to income that is (i) derived from the conduct of any "commercial activity" (whether within or outside the United States), (ii) received by or from (directly or indirectly) a "controlled commercial entity", or (iii) derived from the disposition of any interest in a controlled commercial entity.[2]

A controlled commercial entity is any entity engaged in commercial activities if the foreign government (i) holds (directly or indirectly) 50% or more of the total voting power or value of the interests in the entity, or (ii) holds (directly or indirectly) any other interest in the entity which provides the foreign government with "effective control" of the entity.[3] Because any commercial activity of a controlled entity of a foreign government will cause the controlled entity to be a controlled commercial entity (and deny it the benefits of section 892), commercial activities have the effect of "tainting" other income of a controlled entity.[4]

The Final and Proposed Regulations provide guidance on the meanings of the terms of "commercial activity" and "controlled commercial entity". The Final Regulations are generally consistent with prior proposed regulations, with some modifications, and contain helpful clarifications; the Proposed Regulations are more controversial. The Proposed Regulations introduce a framework for determining when a "debt acquisition" gives rise to commercial activities;[5] this guidance also could be relevant in determining when loan origination gives rise to a U.S. trade or business for purposes of section 864(b). The Proposed Regulations also contain a more detailed definition of "effective control", with specific examples.[6]

The Final Regulations apply to taxable years beginning on or after December 15, 2025.[7] The Proposed Regulations generally would apply to taxable years beginning on or after finalization of the regulations and do not contain a transition or grandfathering rule for existing investments. Public comments on the Proposed Regulations must be submitted by February 13, 2026.[8]

II. Summaries of the Final and Proposed Regulations

A. Summary of the Final Regulations

- The Final Regulations indicate that the definition of "commercial activity" for purposes of section 892 is broader than "trade or business" under sections 162 or 864(b).[9] However, the only concrete difference appears to be the suggestion in the Proposed Regulations that a single origination can give rise to commercial activity, even if it does not rise to the level of a U.S. trade or business.[10]
- The Final Regulations provide that any commercial activity attributable to a foreign government investor through a partnership or an agent is treated as a commercial activity for purposes of section 892, unless a specific exception applies (e.g., the " qualified partnership interest exception" described below).[11] The preamble to the Final Regulations specifically notes that the commercial activities of a fund sponsor could be attributable to a foreign government investor, suggesting that management fee offsets for services performed by a fund sponsor give rise to a commercial activity.[12] Because of the close connection between section 892 and 864(b), the Final Regulations may give a preview of future guidance under section 864(b).
- The Final Regulations provide that investing and trading in financial instruments that are derivatives within the scope of the proposed regulations under section 864(b),[13] and the holding of a non-functional currency in a capacity other than a

dealer or financial institution are not commercial activities.[14]

- The Final Regulations finalize, with certain changes, the "limited partner exception" to commercial activity (and rename the exception as the "qualified partnership interest exception").[15] The Final Regulations contain a safe harbor that allows certain de minimis (5% or less) partnership interest holdings to qualify for the exception.[16]
- The Final Regulations provide that, while the activities of a partnership are attributable to a partner for purposes of determining whether the partner is engaged in commercial activities, the mere act of holding a partnership equity interest or effecting transactions in a partnership equity interest for a foreign government's own account and not as a dealer are not in themselves commercial activities.[17]
- The Final Regulations helpfully limit the "USRPHC per se rule" to domestic corporations.[18]
- The Final Regulations provide that an entity is not engaged in commercial activities if the entity inadvertently engages in the activity and certain other conditions are satisfied.[19]
- The Final Regulations contain guidance for when commercial activities of a lower-tier partnership are attributed to an upper-tier partnership.[20]

B. Summary of the Proposed Regulations

The Proposed Regulations primarily address when (i) a debt acquisition would constitute a commercial activity;[21] and (ii) a foreign government investor would have "effective control" over an entity for purposes of determining whether it is a controlled commercial entity.[22]

- The Proposed Regulations contain two safe harbors and a general facts and circumstances test under which the acquisitions of bonds or other debt securities would not give rise to commercial activities.[23]
    - Under the first safe harbor, the acquisition of bonds or other debt securities acquired in an offering registered under the Securities Act of 1933, as amended (the "Securities Act") would not give rise to commercial activities so long as the underwriters of the offering are not related to the acquirer.[24] This safe harbor is so narrow that it will have limited effect. Under the second safe harbor, the acquisition of debt traded on an established securities market from a person other than the issuer would not give rise to commercial activity so long as (i) the acquirer does not participate in negotiation of the terms or

issuance of the debt, and (ii) 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).[25] This safe harbor is also too narrow. The safe harbors would be much more useful if they were not limited to acquisitions of debt traded on an established securities market and permitted other types of debt acquisitions, such as purchases of private placement debt from an issuer; any additional or expanded safe harbors would remain useful if they limited the percentage of the offering that could be purchased by any single foreign government investor.

- The Proposed Regulations contain a general facts and circumstances test for debt acquisitions that do not satisfy either of the safe harbors. Under this test, whether a debt acquisition constitutes an investment (which does not give rise to commercial activity) or gives rise to commercial activity depends upon eight non-exclusive factors.[26] Treasury and the IRS should consider describing the principle underlying each of the eight factors and explaining how each factor relates to the principle, which would make the guidance more useful to foreign governments.

- If a foreign government has “effective control” of an entity engaged in commercial activities, the entity will be a controlled commercial entity of the government regardless of the amount of equity in the entity owned by the foreign government. The Proposed Regulations provide that any interest in an 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 results in effective control of the entity. [27] Additionally, under the Proposed Regulations, the power to veto decisions gives rise to effective control and, therefore, the mere power to approve a budget would give rise to effective control. [28] Treasury and the IRS should reconsider this rule because budget approval rights are common for minority investors; they are particularly important where the entity can call unlimited amounts of capital and they do not imply control over an entity.

III. Discussions of the Final and Proposed Regulations

A. Discussion of the Final Regulations

Defining Commercial Activities

Section 892 does not define the term “commercial activities”. The Final Regulations adopt a broad interpretation of this term and provide that, unless specifically excluded by the regulations, all activities (whether conducted within or outside the United States) that are ordinarily conducted for the current or future production of income or gain, are commercial activities and any activity that constitutes a “trade or business” under sections 864(b) or 162 will be considered a “commercial activity” under section 892, unless expressly excepted.[29] Moreover, the Preamble to the Final Regulations makes clear that the scope of “commercial activities” is different and broader than the concept of “trade or business” under sections 864(b) and 162.[30] While section 892 does not specifically identify activities that are and are not commercial activities, regulations under section 892 state that commercial activities do not include “investment activities”. The Final Regulations include certain guidance on the investment activity exception from commercial activity treatment.

a*. Financial Instruments*

Under section 892, only investments in the United States in financial instruments held in the execution of governmental financial or monetary policy are exempt from U.S. federal income taxation. The Final Regulations expand the exemption and provide that investing and trading by a foreign government investor in financial instruments that are derivatives within the scope of the proposed regulations under section 864(b) are not commercial activities (even if they are not held in the execution of governmental financial or monetary policies).[31] The proposed regulations under section 864(b) generally treat as derivatives (i) certain notional principal contracts and (ii) any option, forward contract, short position, or similar financial instrument in a (A) commodity of a kind customarily dealt in on an organized commodity exchange, (B) currency, (C) share of stock, (D) interest in a publicly traded partnership, (E) indebtedness, or (F) notional principal contract.[32] The preamble to the Final Regulations state that investing and trading in these types of financial instruments involve putting capital at risk and do not involve activities such as structuring the instrument, in contrast to structuring bespoke, non-market derivatives.[33]

b. *Fee Income*

A commentor to the prior proposed regulations requested that section 892 except from commercial activity treatment certain fee income received by a foreign government as a passive investor in a private equity or private credit fund if the fees are incidental to providing capital (e.g., the right to share in fees for services provided by the sponsor to portfolio companies). The Final Regulations did not adopt this recommendation. According to the preamble to the Final Regulations, to the extent the commercial activities of a fund sponsor are attributable to a foreign government investor in a fund by reason of partnership attribution or on the basis of agency, the foreign government is considered to conduct commercial activities. This reference in the preamble suggests that management fee offsets for services performed by a fund sponsor give rise to a commercial activity. Because of the close connection between section 892 and 864(b), the Final Regulations may give a preview of future guidance under section 864(b). This analysis applies regardless of whether the fees are actually or constructively received and regardless of whether the foreign government receives or shares in income labeled as a fee.[34]

c. *Partnership Equity Interests*

The Final Regulations clarify that, while the activities of a partnership are attributable to a partner for purposes of determining whether the partner is engaged in commercial activities, the mere act of holding a partnership equity interest or effecting transactions in a partnership equity interest for a foreign government's own account and not as a dealer are not in themselves commercial activities.[35]

Controlled Commercial Entities

The section 892 exemption does not apply to income received from a controlled commercial entity or gains from the disposition of an interest in a controlled commercial entity.

Under section 892(a)(2)(B), a controlled commercial entity is any "entity" engaged in commercial activities (within or outside the United States) if the foreign government holds (directly or indirectly) (i) a 50% or more interest (by vote or value) in the entity; or (ii) any other interest in such entity that provides the foreign government with "effective control" (discussed further below) over that entity.[36] The Final Regulations include certain provisions related to controlled commercial entities.

a. *USRPHCs*

Temporary regulations issued in 1998 provided that a U.S. real property holding corporation (a "USRPHC") or a foreign corporation that would be a USRPHC if it were domestic, is *per se* treated as engaged in commercial activity and is therefore a controlled commercial entity if the foreign government owns 50% or more of the vote or value of the entity or otherwise has effective control of the entity (the "USRPHC per se rule"). Under this rule, a controlled entity of a foreign government could be deemed to be a controlled commercial entity if it held too many U.S. real property interests. Proposed regulations issued in 2022 (and on which taxpayers were permitted to rely) included an exclusion from the USRPHC per se rule for a corporation that was a USRPHC solely by reason of its direct or indirect ownership in one or more other corporations that are not controlled by the foreign government (the "minority interest exception"). Foreign governments relied on the minority interest exception to establish domestic holding companies to hold minority interests in USRPHCs without causing the holding company to be treated as a controlled commercial entity (and therefore interest and dividends paid by the holding company were eligible for the section 892 exemption). However, the USRPHC per se rule was considered a trap for the unwary, and commentators requested it be withdrawn.[37]

The Final Regulations do not withdraw the USRPHC per se rule; however, they do limit its application to domestic corporations.[38] As a result, a foreign corporation would not be deemed to be engaged in commercial activities solely by reason of its status as an entity that would be a USRPHC if it were domestic.[39] Although the minority interest exception is no longer necessary (because a foreign entity need not be concerned that it will be treated as engaged in commercial activities by reason of holding minority interests in USRPHCs and therefore does not need to set up U.S. holding companies), the Final Regulations generally retain the monitory interest exception so that foreign governments that have implemented domestic holding corporation structures and relied on the exception do not have to incur the cost of unwinding these structures.[40]

b. *Qualified Partnership Interest Exception*

The commercial activities of an entity treated as a partnership for U.S. federal income tax purposes are generally attributed to its partners. The 2011 proposed regulations contained an exception pursuant to which an entity not otherwise engaged in commercial activities would not be deemed to be engaged in commercial activities solely by reason of being a limited partner in a limited partnership (the "limited partner exception"). Under the limited partner exception, a partner would be considered a "limited partner" if it did not have rights to participate in the management and conduct of the partnership's business. The Final Regulations generally adopt the limited partner exception with modifications, including renaming it as the "qualified partnership interest exception".[41] An interest in a partnership can qualify for the qualified partnership interest exception under a general rule or a de minimis safe harbor.

General Rule. Under the qualified partnership interest exception, an entity not otherwise engaged in commercial activities will not be deemed to be engaged in commercial activities (and, therefore, the entity will not be "tainted") solely because it holds a "qualified partnership interest", although a foreign government's share of the partnership's income from commercial activities will nevertheless be treated as commercial activity income and will not be exempt under section 892.[42]

An interest in an entity treated as a partnership for U.S. federal income tax purposes[43] will be eligible for the qualified partnership interest exception so long as the holder does not have any of the following:[44]

- personal liability for claims against the partnership;
- the right to enter into contracts or act on behalf of the partnership;
- "control" of the partnership (i.e., does not directly and indirectly hold 50% (by vote or value) or more of the interests in the capital or profits of the partnership or otherwise have "effective control" of the partnership, which is addressed by the Proposed Regulations, as discussed further below); or
- (the right 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 take an active role in formulating business strategy or in acquisitions or dispositions of investments.[45]

The lack of control requirement will prohibit any foreign government that owns 50% or more of a partnership (or that otherwise has effective control) from relying on the qualified partnership interest exception.

The Final Regulations generally provide that rights to participate in the management of a partnership's business do not include participation rights with respect to monitoring or protecting an investment in the partnership, including oversight and supervision in the case of major strategic decisions, such as the admission or expulsion of a partner; amendment of the partnership agreement; dissolution, merger or conversion of the partnership; unusual or non-ordinary course deviations from previously determined investment parameters; extending the term of the partnership; and the non-ordinary course disposition of all or substantially all of the partnership's assets.[46] Thus, rights to participate on an LP advisory board or committee that engages in oversight in respect of key investor-level strategic matters, but not day-to-day operations should be permissible.[47]

5% De Minimis Safe Harbor. The Final Regulations also adopt a four-part de minimis safe harbor pursuant to which the holder of an equity interest in a partnership will be treated as holding a qualified partnership interest so long as, at all times during the partnership's taxable year, the holder does not (i) hold (directly or indirectly) more than 5% of the capital or profits of the partnership; (ii) serve as a managing partner, managing member or hold an equivalent position; (iii) have personal liability for claims against the partnership; or (iv) have the right to enter into contracts or act on behalf of the partnership.[48]

Tiered Partnerships. The Final Regulations provide that an upper-tier partnership that holds an interest in a lower-tier partnership is not attributed any commercial activities of the lower-tier partnership, provided all such interests are qualified partnership interests (but any such commercial activity income is not eligible for exemption under section 892).[49]

Aggregation. If a foreign government directly or indirectly holds multiple interests in a partnership through one or more controlled entities or integral parts, then all such interests are aggregated for purposes of applying the qualified partnership interest exception. If any interest does not qualify, none of the interests qualify.[50] This provision may be difficult for foreign governments that have multiple integral parts and controlled entities that operate independently of each other to monitor.

Examples. The Final Regulations contain two examples illustrating the qualified partnership interest exception.[51] The examples generally indicate that the right to review and advise a partnership on material business contracts and business expenses will be considered a right to participate in the day-to-day management and operation of the partnership, causing a partnership interest to fail to be a qualified partnership interest, whereas the right to serve on a committee that makes non-binding recommendations, but not decisions, in respect of investor-level strategic matters would not cause a partnership interest to fail to be a qualified partnership interest. The distinctions that the examples seem to be trying to make is that direct advice in respect of the business operations of the partnership is bad, but advice relating to the terms of the partnership investment provided through a committee is good.

c. *Inadvertent Commercial Activities*

The Final Regulations adopt the 2011 proposed regulation that treats an entity that only engages in inadvertent commercial activity during a year as not engaged in commercial activity if (i) failure to avoid the activity is “reasonable” pursuant to a facts and circumstances test; (ii) the commercial activity is timely cured;[52] and (iii) certain record maintenance and retention requirements are met.[53] In addition, the Final Regulations include a “de minimis” safe harbor, whereby, provided that an entity has adequate written policies and operational procedures in place to monitor its worldwide activities, the entity’s failure to avoid commercial activity will be considered reasonable if (i) the value of the assets used or held for use in all of the entity’s commercial activities for the year does not exceed 5% of the entity’s total assets; and (ii) the income from the commercial activity during the year does not exceed 5% of the entity’s gross income for the year.[54]

d. *Annual Controlled Commercial Entity Determination*

The Final Regulations generally retain the annual controlled commercial entity determination rule contained in the 2011 proposed regulations under which a controlled entity that is engaged in commercial activities at any moment during a year is treated as a controlled commercial entity for the entire year, but clarify that the determination is based on the *taxable* year of the entity engaged in the commercial activity.[55] In applying this rule, an entity's activities in the immediately preceding year are relevant in characterizing the entity's activities in the current taxable year. If the taxable year of a corporation is terminated because of a section 381(a) acquisition (other than transactions in which both entities are controlled by the same foreign government, such as section 332(a) complete liquidations), the acquiring corporation generally does not inherit the commercial activity of the distributing corporation for the acquiring corporation's taxable year.[56] Notably, the Final Regulations do not address the time period for measuring control for purposes of the controlled commercial entity test. Accordingly, if a foreign government has control over a commercial entity for part, but not all, of a year, there is uncertainty as to whether the foreign government can rely on section 892 with respect to any income from the entity during the portion of the year in which it did not have control.

B. Discussion of the Proposed Regulations

As mentioned above, the Proposed Regulations primarily focus on two matters. First, they provide a new framework for determining when the acquisition of a debt instrument constitutes an investment as compared to a commercial activity for purposes of section 892. Second, they propose guidance on what constitutes "effective control" for purposes of determining whether an entity is a controlled commercial entity of a foreign government.

Acquisitions of Debt

The Proposed Regulations provide a general rule that the acquisition of a debt instrument is considered a commercial activity, unless the acquisition qualifies as an investment under either one of two safe harbors or under a facts and circumstances test.[57]

The Proposed Regulations make clear that (i) whether the acquisition of a debt instrument is an investment (and not a commercial activity) for these purposes is generally determined without regard to whether it is treated as a trade or business for U.S. federal tax purposes under section 162 or section 864(b) (and a single acquisition that is not an investment is a commercial activity)[58]; and (ii) "debt" means an obligation that is treated as debt for U.S. federal income tax purposes, regardless of its label.[59]

Safe Harbor 1 – Registered Offerings. Under the first safe harbor, the acquisition of bonds or other debt securities in a registered public offering is treated as an investment, provided the acquirer is not related to the underwriter. As drafted, this safe harbor would apply only to offerings under the Securities Act. However, Treasury and the IRS have requested public comments regarding whether this safe harbor should be extended to offerings registered under foreign securities laws.[60]

Safe Harbor 2 – Established Securities Market Acquisitions. Under the second safe harbor, the acquisition of debt traded on an "established securities market" (within the meaning of Treasury regulations section 1.7704-1(b)) is treated as an investment provided, (i) the debt is not acquired from the issuer, (ii) the debt is not acquired from related parties or persons under common management or control with the acquirer (unless such person also acquired the debt as an investment), and (iii) the acquirer does not participate in negotiating the terms or issuance of the debt instrument.[61] Treasury and the IRS have also requested public comments on this safe harbor, including whether and under what circumstances it should apply to debt that is not traded on an established securities market.[62] As mentioned above, the safe harbors are too narrow to be useful and should apply to private placements and other traditional secondary market transactions.

Facts and Circumstances Test. The Proposed Regulations provide that any debt acquisition that does not qualify under one of the two safe harbors may nevertheless be treated as an investment under a facts and circumstances test.[63] The Proposed Regulations contain a non-exclusive list of eight relevant factors to be considered, including:

- 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. *Presumably, if the acquirer is soliciting borrowers, it is acting more like a bank than a passive investor*.

- Whether the acquirer materially participated in negotiating or structuring the terms of the debt. *Negotiation is a hallmark of origination*.
- Whether the acquirer is entitled to compensation (whether or not labelled as a fee) that is not treated as interest. *Compensation other than amounts treated as interest is suggestive of services.*
- The form of the debt and the issuance process (including whether the debt is a bank loan versus a privately placed debt pursuant to Regulation S or Rule 144A of the Securities Act). *It would seem that private placements and Regulation S offerings are more investment-like than a bank loan*.
- The percentage of the debt issuance acquired by the acquirer relative to the percentages acquired by other purchasers. *Presumably, smaller percentages are more consistent with investment.*
- The percentage of equity in the debt issuer held or to be held by the acquirer. *Presumably, loans to related parties more closely resemble the extension of an equity investment.* The Proposed Regulations contain an example where the loan to an 80% subsidiary is an investment.
- The value of that equity relative to the amount of the debt acquired. *If the equity value is small relative to the value of the debt, the loan may be less likely to resemble an equity investment.*
- If the debt is deemed to be acquired in a debt-for-debt exchange as a result of a significant modification, whether there was a reasonable expectation, based on objective evidence, that the original unmodified debt would default. *There has been a long-held concern that purchasing debt in order to exchange it for substantially modified debt may give rise to an origination for tax purposes.*

The preamble to the Proposed Regulations indicates that facts and circumstances will be considered relevant only to the extent that a foreign government's expected return from acquiring the debt instrument is exclusively a return on its capital rather than a return from the activities it conducts.[64]

Treasury and the IRS have requested public comments on the general facts and circumstances test, particularly on additional factors or examples, as well as on the treatment of acquisitions of (i) distressed debt, (ii) broadly syndicated loans, (iii) revolvers; and (iv) delayed-draw debt loans.

The Proposed Regulations contain five examples designed to illustrate the application of the facts and circumstances test.[65] There are a number of takeaways from the examples.

- ***A Single Loan Can Be Commercial Activity***. In one example, a foreign government that held itself out as a lender and solicited, structured, negotiated and financed a single loan to a borrower in which it owned no equity was found to be engaged in commercial activities.[66] The example suggests that foreign governments should be cautious of investing in credit funds that rely on "bullets" to avoid being engaged in a U.S. trade or business.
- ***Certain Shareholder Loans May Be Treated As Investments***. In a second example, a foreign government's loan to an 80% owned entity was not a commercial activity where the value of the loan represented 50% of the foreign government's equity interest in the entity, suggesting that, at least in some cases, shareholder loans will not be considered commercial activities. [67]
- ***Certain Private Placements May Be Treated As Investments***. In another example, a foreign government met with unrelated private placement agents, communicated the terms on which the government would be willing to purchase debt (but did not negotiate or otherwise structure the debt), and purchased the privately placed debt of ten issuers at initial issuance. The foreign government purchased less than one third of the principal amount of each debt offering, and at least one other unrelated investor purchased a larger percentage of the debt offerings than the foreign government. The example holds that the purchase is an investment and not a commercial activity. [68]
- ***Participating On Creditor Committees Treated As Commercial Activity***. Finally, two other examples indicate that, in the case of defaulted debt (originally qualifying as an investment), being represented by an unrelated creditors' committee that negotiates on behalf of all lenders to significantly modify the debt, will not be considered a commercial activity. However, participating as a member of a creditors' committee that negotiates and structures the terms of modified debt will be considered commercial activity.[69]

Effective Control

As discussed above, if a foreign government has "effective control" over an entity engaged in commercial activities, the entity is a controlled commercial entity, even if the foreign government owns less than 50% of the vote and value of the entity.[70]

The Proposed Regulations provide that “effective control” exists where an interest in an entity, whether held alone or together with other interests, confers the ability to influence the entity’s operational, managerial, board-level, or investor-level decisions. Mere consultation rights with respect to these decisions do not alone give rise to effective control, but any veto right may.[71]

The determination of whether a foreign government has effective control will be based on all relevant facts and circumstances and is not limited to formal equity ownership.[72] In fact, a foreign government need not hold any particular amount (or any) equity in an entity to have effective control.[73] Interests giving rise to effective control may include equity or voting interests, debt, contractual or other arrangements, business relationships, regulatory authority, or any other relationship that provides decision-making influence.[74] A foreign government that is (or holds or controls an entity that is) a managing partner or managing member (or equivalent role) of an entity will have effective control over the entity.[75] Moreover, the preamble to the Proposed Regulations provides that for purposes of determining whether a foreign governmental entity has effective control of an entity, all interests directly or indirectly owned by an integral part or controlled entity of the foreign government would be considered together, regardless of whether the integral parts or controlled entities are functionally independent of one another.[76] Treasury and the IRS have requested comments regarding the circumstances under which the functional independence of controlled entities should be taken into account such that they should be considered independently for purposes of the effective control test.[77] The Proposed Regulations contain eight examples designed to illustrate the application of the effective control rules.[78]

Under the examples, an investment agreement setting out investment criteria,[79] and an investor’s right to participate on an investment committee to discuss investments, do not result in effective control.[80]

On the other hand, the examples indicate that the right to appoint one of three directors who holds a unilateral right to appoint or dismiss the manager or managing officer of an entity[81] or a unilateral right to veto dividend distributions, material capital expenditures, sales of new equity interests, and the operating budget, results in effective control.[82] Similarly, the ability to control the board of an entity due to influence over other investors,[83] the ability to influence an entity by reason of ownership of a significant resource used by the entity, or the ability to use regulatory authority to influence an entity, results in effective control of the entity. [84] Finally, an example in the Proposed Regulations finds that significant creditor rights (without any equity ownership), including restrictions on the type of investments an entity can make, along with restrictions and veto rights on asset dispositions, borrowings, and dividend payments, and stock repurchases, results in effective control.[85]

Treasury and the IRS have requested public comments on whether a holder of a minority equity interest should not be treated as having effective control over an entity if managerial or board-level decisions are subject to veto or “blocking” rights held by the holder and other holders (e.g., through consent, supermajority or other rights).[86] Consent rights over major actions (including, particularly for real estate transactions, consent over annual budgets) are common, even for small minority investors. These rights do not give rise to effective control in any sense, and Treasury and the IRS should consider amending the Proposed Regulations to so provide before they are finalized.

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[1] All references to “section” are to the Internal Revenue Code or to the Treasury regulations promulgated thereunder.

[2] § 892(a)(2)(A).

[3] § 892(a)(2)(B).

[4] Treas. Reg. § 1.892-5T(d)(4)(i)(C).

[5] Prop. Treas. Reg. § 1.892-4(c)(1)(ii).

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

[7] Treas. Reg. § 1.892-3(c).

[8] Preamble to the Proposed Regulations, p. 1.

[9] Treas. Reg. § 1.892-4(b); *see also* Preamble to the Final Regulations, p. 6.

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

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

[12] Preamble to the Final Regulations, p. 13.

[13] Treas. Reg. § 1.892-3(a)(4); *see also* Preamble to the Final Regulations, p. 10.

[14] Treas. Reg. § 1.892-4(c)(1)(i).

[15] Preamble to the Final Regulations, p. 39.

[16] Treas. Reg. § 1.892-5(d)(5)(iii)(C)(*1*)-(*4*).

[17] Treas. Reg. § 1.892-4(c)(1)(i) and (c)(2); *see also* Preamble to the Final Regulations, p. 14.

[18] Treas. Reg. § 1.892-5(b)(1)(ii)(A).

[19] Treas. Reg. § 1.892-5(a)(2)(ii).

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

[21] Prop. Treas. Reg. § 1.892-4(c)(1)(ii).

[22] Prop. Treas. Reg. § 1.892-5(c)(2). As mentioned above, a controlled commercial entity is any entity engaged in commercial activities if the foreign government (i) holds (directly or indirectly) any interest in the entity which (by value or voting power) is 50% or more of the total of the interests in the entity, or (ii) holds (directly or indirectly) any other interest in the entity which provides the foreign government with “effective control” of the entity.

[23] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)-(C).

[24] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(1).

[25] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(2).

[26] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(C)(*1*)-(*8*).

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

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

[29] Treas. Reg. § 1.892-4(b).

[30] Preamble to the Final Regulations, p. 6.

[31] Treas. Reg. § 1.892-3(a)(4); *see also* Preamble to the Final Regulations, p. 10.

[32] *See* Prop. Reg. § 1.864(b)-1(b)(2). The Final Regulations further provide that for investments in financial instruments that would result in beneficial ownership of the reference asset under general federal income tax principles, the analysis of whether a foreign government is engaged in a commercial activity is made by looking through the financial instrument to the reference asset. This is particularly relevant for a swap with respect to an illiquid asset (such as a non-syndicated loan).

[33] Preamble to the Final Regulations, p. 10.

[34] Preamble to the Final Regulations, pp. 12-13.

[35] Treas. Reg. § 1.892-4(c)(1)(i) and (c)(2).

[36] Section 892(a)(2)(B).

[37] Preamble to the Final Regulations, pp. 17-18.

[38] Treas. Reg. § 1.892-5(b)(1)(ii)(A).

[39] Preamble to the Final Regulations, pp. 19-20.

[40] Treas. Reg. § 1.892-5(b)(1)(ii)(B)*; see also* Preamble to the Final Regulations, pp. 19-20.

[41] Preamble to the Final Regulations, p. 39.

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

[43] The Final Regulations clarify that the limited partner exception and the qualified partnership interest exception are intended to apply to interests in any entity treated as a partnership for U.S. federal income tax purposes, including limited liability companies and other vehicles treated as partnerships for U.S. federal income tax purposes. *See* Preamble to the Final Regulations, p. 39.

[44] Treas. Reg. § 1.892-5(d)(5)(iii)(B)(1).

[45] In determining whether this right exists, all rights arising from all interests of the foreign government will be taken into account, including rights under law, the partnership agreement, side letters, shareholder agreements, creditor agreements and other contractual arrangements.

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

[47] Treas. Reg. § 1.892-5(c)(5)(iv)(B).

[48] Treas. Reg. § 1.892-5(d)(5)(iii)(C)(*1*)-(*4*).

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

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

[51] Treas. Reg. § 1.892-5(d)(5)(iv)(A)-(B).

[52] The Final Regulations increase the cure period from 120 days (under the 2011 proposed regulations) to 180 days of the date of discovery by employees responsible for monitoring the entity's commercial activities. *See* Treas. Reg. § 1.892-5(a)(2)(iii).

[53] *See* Treas. Reg. § 1.892-5(a)(2)(i)(A)-(C). As in the 2011 proposed regulations, there must be continuing due diligence to prevent this inadvertent commercial activity, evidenced by adequate written policies and operational procedures. The Final Regulations adopt examples of when written policies and operational procedures would be adequate to meet this due diligence requirement. Treas. Reg. § 1.892-5(a)(2)(ii)(B).

[54] Treas. Reg. § 1.892-5(a)(2)(ii)(C)(1)(i)-(ii).

[55] Treas. Reg. § 1.892-5(a)(3)(i).

[56] Treas. Reg. § 1.892-5(a)(3)(ii)(A).

[57] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)

[58] Preamble to the Proposed Regulations, p. 7.

[59] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(A).

[60] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(1).

[61] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(2).

[62] Preamble to the Proposed Regulations, p. 8-9.

[63] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(C).

[64] Preamble to the Proposed Regulations, p. 8.

[65] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D).

[66] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(*2*)

[67] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(*3*).

[68] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(*4*).

[69] Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(*5*)-(*6*).

[70] The Proposed Regulations would replace the term "effective practical control" (the term used under the 1988 temporary regulations) with "effective control," which is the term used in the statute. *See* Prop. Treas. Reg. § 1.892-5(c)(2)(i).

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

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

[73] Preamble to the Proposed Regulations, p. 12.

[74] Prop. Treas. Reg. § 1.892-5(c)(2)(i)(A)-(G).

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

[76] Preamble to the Proposed Regulations, pp. 12-13.

[77] Preamble to the Proposed Regulations, p. 13.

[78] Prop. Treas. Reg. § 1.892-5(c)(iii)(B)-(I).

[79] Prop. Treas. Reg. § 1.892-4(c)(iii)(C).

[80] Prop. Treas. Reg. § 1.892-4(c)(iii)(D).

[81] Prop. Treas. Reg. § 1.892-4(c)(iii)(E).

[82] Prop. Treas. Reg. § 1.892-4(c)(iii)(F).

[83] Prop. Treas. Reg. § 1.892-4(c)(iii)(G).

[84] Prop. Treas. Reg. § 1.892-4(c)(iii)(H).

[85] Prop. Treas. Reg. § 1.892-4(c)(iii)(I).

[86] Preamble to the Proposed Regulations, p. 13.

Related Professionals

- **Amanda H. Nussbaum**
  Partner
- **Christine Harlow**
  Partner
- **David S. Miller**
  Partner
- **Jean M. Bertrand**
  Partner
- **Martin T. Hamilton**
  Partner
- **Muhyung (Aaron) Lee**
  Partner
- **Richard M. Corn**
  Partner
- **Rita N. Halabi**
  Associate
- **Robert A. Friedman**
  Partner