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Report No. 1521
February 13, 2026

The Honorable Scott Bessent
Secretary of the Department of the
Treasury, and Acting
Commissioner of the Internal
Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Kenneth J. Kies
Assistant Secretary (Tax Policy) of
the Department of the Treasury, and
Acting Chief Counsel of the Internal
Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: NYSBA Tax Section Report No. 1521 - Report on Final and Proposed Regulations under Section 892

Dear Secretary Bessent and Assistant Secretary Kies:

Please see attached Report No. 1521 of the Tax Section of the New York State Bar Association (the "**Report**") on the final and proposed Treasury Regulations (the "**2025 Regulations**") issued by the Internal Revenue Service (the "**IRS**") and the Department of the Treasury ("**Treasury**") under IRC section 892, regarding the taxation of certain investments in the United States by foreign governments. The 2025 Regulations were published on December 15, 2025.

The Report makes recommendations for revisions to the 2025 Regulations, focusing on, among other topics, certain tax policy and tax administration aspects of the proposed regulations intended to (i) distinguish acquisitions of debt by a foreign government that should qualify as exempt investment from debt acquisitions that should constitute taxable commercial activity, and (ii) determine when a foreign government is in effective control of an entity. In general, the Report recommends that regulations articulate underlying principles more clearly in order to

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facilitate application of facts-and-circumstances tests by taxpayers and the government in an appropriate manner.

We appreciate consideration of our Report by the IRS and Treasury. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'L M Garrett', with a horizontal line extending to the right.

Lawrence M. Garrett
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NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT ON FINAL AND PROPOSED REGULATIONS UNDER SECTION 892

February 13, 2026

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I. Introduction

This report¹ of the Tax Section of the New York State Bar Association (this “**Report**”) addresses a notice of proposed rulemaking (the “**2025 Proposed Regulations**”) and final regulations (the “**Final Regulations**”) published by the Internal Revenue Service (the “**IRS**”) and the Department of the Treasury (“**Treasury**”) on December 15, 2025 under section 892 of the Internal Revenue Code of 1986, as amended (the “**Code**”),² regarding the taxation of certain investments in the United States by foreign governments.

Part II of this Report summarizes our principal recommendations for guidance from the IRS and Treasury. Part III provides general background on the relevant aspects of section 892 and the related regulations. Part IV summarizes certain relevant recommendations we have made in our prior reports discussing section 892. Part V summarizes the relevant provisions of the 2025 Proposed Regulations and Final Regulations. Part VI provides a detailed discussion of our comments and recommendations for guidance related to the 2025 Proposed Regulations. Part VII provides a detailed discussion of our comments and recommendations related to the Final Regulations and recommendations for guidance on issues not addressed by the 2025 Proposed Regulations or Final Regulations including a transition rule.

II. Summary of Recommendations

As an initial matter, we commend the IRS and Treasury for updating section 892 guidance in a thoughtful manner through the issuance of the Final Regulations and the 2025 Proposed Regulations. We understand that they were drafted by the IRS and Treasury with a view toward reflecting in regulatory rules current conservative market practices that have developed over past decades as section 892 has become more relevant to the U.S. markets and to provide clarity and predictability to those practices without causing undue disruption to the markets. However, as discussed below, there are several areas where these regulations can be viewed as departures from current conservative market practices, and consequently they have raised concerns for sovereign investors and their advisors. Thus, we believe taxpayers and the IRS and Treasury would benefit from revisions to certain aspects of the Final Regulations and the 2025 Proposed Regulations—in some cases to articulate more clearly the standards that the IRS and Treasury believe should underpin section 892, and at least in the case of the new “qualified partnership interest” (“**QPI**”) rules (discussed below), to provide relief to taxpayers

¹ The principal authors of this report are Matthew Brigham, Kathryn Kelly, and William McRae, with substantial assistance from Jennifer Fitzgerald, Yara Mansour, Ray Noonan, and Kathy Zhang. Helpful comments were received from Michael Paul Alcan, Kimberly Blanchard, Andrew Braiterman, Robert Cassanos, Josiah Child, Matthew Donnelly, Pamela Endreny, Jason Factor, Lawrence Garrett, Marcy Geller, Gabriel Grossman, Daniel Hanna, Lorenz Haselberger, Jennifer Lee, Lea Li, John Lutz, Alex Marcellesi, David Miller, Arvind Ravichandran, Yaron Reich, David Rievman, Elena Romanova, Michael Schler, Paul Seraganian, Eric Sloan, Wade Sutton, Jonathan Talansky, Joseph Tootle, Edward Wei, Daniel Winnick, and Libin Zhang.

² Unless indicated otherwise, all “section” references are to the Code, all references to the “1954 code” are to the Internal Revenue Code of 1954, as amended, “Treas. Reg. §” and “Temp. Treas. Reg. §” references are to the Treasury regulations promulgated under the Code, and all “Prop. Treas. Reg. §” references are to proposed Treasury regulations promulgated under the Code.

who structured investments in reliance on the prior limited partner exception contained in the 2011 Proposed Regulations (defined below).

Our principal recommendations regarding the 2025 Proposed Regulations include the following:

1. The IRS and Treasury should articulate clearly general principles for determining whether an acquisition of debt is investment or commercial activity for purposes of section 892(a) and revise the examples to take those principles into account.
2. The registered offering debt acquisition safe harbor should be broadened to include certain private placements along with certain offerings registered under foreign securities laws.
3. The secondary market debt acquisition safe harbor should be expanded to include certain acquisitions of debt that is not traded on an established securities market.
4. The IRS and Treasury should change the statement in the 2025 Proposed Regulations that actions of a debt acquirer's "agent or a person otherwise acting on behalf of the acquirer" will be attributed to the acquirer for purposes of the debt acquisition rules. In its current form, the statement is too unclear to be a workable standard and, if it is retained in some other form, the IRS and Treasury should consult with market participants to develop and articulate a more refined standard for attribution to ensure that it achieves the intended objectives and does not unintendedly result in market confusion or disruption.
5. The 2025 Proposed Regulations' guidance regarding the meaning of "effective control" under section 892(a)(2)(B) should distinguish between rights that convey "effective control" over the management and operations of a business and rights that permit the monitoring and protection of investment.
6. The IRS and Treasury should consider whether the 2025 Proposed Regulations might provide procedures for controlled entities and integral parts of the same foreign sovereign to obtain comfort from the IRS that they will not be aggregated for purposes of determining the existence or absence of effective control.

Our principal recommendations regarding the Final Regulations include the following:

7. The requirement that a partner not "control" a partnership within the meaning of section 892 should be removed from the QPI exception because (i) the QPI exception properly requires limitations on a partner's governance rights independent of section 892 control, and (ii) section 892 control can be achieved through owning 50 percent of the value of a partnership without any

voting or governance rights, making the standard overbroad in our view. In addition, this requirement is a reversal of the IRS's and Treasury's prior position on this point, and its inclusion in the Final Regulations has caught many market participants off guard.

8. The IRS and Treasury should clarify that the inadvertent commercial activity exception can be relied on (i) by a foreign government that incorrectly but reasonably treated a partnership interest as qualifying for the QPI exception and (ii) by a partnership for purposes of determining whether the partnership is a controlled commercial entity.

In addition, with respect to both the 2025 Proposed Regulations and the Final Regulations, the IRS and Treasury should provide transitional relief to protect certain existing investments from the retroactive application of the regulations.

III. Section 892: Summary and Background

Section 892 provides an exclusion from income, and a resulting exemption from income tax, for income from certain investments in U.S. stocks, bonds, and other domestic securities made by “foreign governments.”³

The section 892 exclusion does not apply to any income derived by a foreign government from the conduct of “commercial activity” (wherever conducted), any income received by a “controlled commercial entity,” or any income received, directly or indirectly, from (including from the disposition of an interest in) a controlled commercial entity.⁴ Although the phrase “commercial activity” is not defined in the Code, it has been defined in regulations to include any activity “ordinarily conducted” for the current or future production of income or gain.⁵ The IRS and Treasury view the definition of “commercial activity” as broader than the definition of “trade or business,” as that term is used under section 864.⁶

A “controlled commercial entity” is any entity engaged in commercial activities of any magnitude anywhere in the world if a foreign government holds, directly or indirectly, (i) a 50-percent-or-greater interest in the entity (by value or vote) or (ii) any other interest in the entity

³ Section 892(a)(1). The statutory exemption also applies to income from financial instruments held in the execution of governmental financial or monetary policy and interest on deposits in U.S. banks of moneys belonging to such foreign governments. *Id.*

⁴ Section 892(a)(2)(A).

⁵ Treas. Reg. § 1.892-4(b); Temp. Treas. Reg. § 1.892-4T(b) (1988).

⁶ 90 Fed. Reg. 57902 (Dec. 15, 2025).

that provides the foreign government with “effective control” of the entity.⁷ Partnerships are among the types of entities that can constitute a controlled commercial entity.⁸

The Code also does not define “foreign government.” The Treasury regulations define a “foreign government” for purposes of section 892 as the “integral parts” or “controlled entities” of a foreign sovereign.⁹ An “integral part” is defined in Temp. Treas. Reg. § 1.892-2T(a)(2) as “any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country.” The Treasury regulations define a “controlled entity” as an entity “that is separated in form from a foreign sovereign or otherwise constitute a separate juridical entity” and that satisfies additional requirements relating to its organization, ownership, and earnings.¹⁰ A “controlled entity” does not include partnerships.¹¹

The Code also does not define “effective control,” although the Treasury regulations have defined “effective practical control” since 1988 and the term has been used in interpretations of other provisions of the Code (each discussed below).

The following sections summarize the development of section 892 and provide certain background relevant to the 2025 Proposed Regulations and the Final Regulations.

a. Sovereign Immunity Doctrine and Historic Sovereign Tax Exemptions

Section 892 has its origins in the common law doctrine of sovereign immunity, *i.e.*, the principle that sovereign governments should not be subject to each other’s jurisdiction when conducting state activities.¹² The first predecessor to section 892 was enacted as part of the War Revenue Act of 1917, which included a provision excluding (among other items) “the income of foreign governments received from investments in the United States in stocks, bonds, or other

⁷ Section 892(a)(2)(B). A central bank of issue is treated as a controlled commercial entity only if it is engaged in commercial activities within the United States. *Id.*

⁸ Treas. Reg. § 1.892-5(a)(1)(ii).

⁹ Temp. Treas. Reg. § 1.892-2T(a)(1).

¹⁰ Temp. Treas. Reg. § 1.892-2T(a)(3). The additional requirements are that (i) it is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities; (ii) it is organized under the laws of the foreign sovereign by which it is owned; (iii) its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and (iv) its assets vest in the foreign sovereign upon dissolution. *Id.*

¹¹ *Id.*

¹² For a history of the development of section 892, see Staff of the J. Comm. on Tax’n, *Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States*, JCX-49-08 (June 17, 2008) and our 2008 Report (as defined below).

domestic securities.”¹³ The exclusion was significantly expanded in 1918 to include income “from any other source within the United States.”¹⁴ From 1918 to 1986, this statutory exclusion largely remained unchanged.¹⁵

In Rev. Rul. 66-73, the IRS first ruled under what circumstances a separately formed organization wholly owned by a foreign government would qualify for the exemption under section 892 of the 1954 code.¹⁶ In 1978, the IRS and Treasury promulgated proposed regulations under the 1954 code, which were finalized in 1980, that removed certain “commercial activity” income from the scope of the exemption, including when earned by a controlled entity or an integral part of a foreign government.¹⁷

In enacting the Code in 1986, Congress reenacted and substantially revised section 892, including by codifying and revising the 1980 regulatory exception for commercial activity income and introducing a statutory regime excluding certain income and gains from “controlled

¹³ War Revenue Act of 1917, Pub. L. No. 65-50, §1211, 40 (Pt. 1) Stat. 300, 337. The 1917 exemption also included the exclusion under current law for deposit interest paid by U.S. banks. *Id.*

¹⁴ Pub. L. No. 254, 40 (Pt. 1) Stat. 1057 (1919). This expansive language was eventually removed from the Code in 1986. *See infra* note 18.

¹⁵ Revenue Act of 1921, Pub. L. No. 67-98, § 213(b)(5), 42 Stat. 227, 239; Revenue Act of 1924, Pub. L. No. 68-176, § 213(b)(5), 43 Stat. 253; Revenue Act of 1926, Pub. L. No. 69-20, § 213(b)(5), 44 Stat. 9; Revenue Act of 1928, Pub. L. No. 70-562, § 116(c), 45 Stat. 791, 823; Revenue Act of 1932, Pub. L. No. 72-154, § 116(c), 47 Stat. 169; Revenue Act of 1934, Pub. L. No. 73-216, § 116(c), 48 Stat. 680; Revenue Act of 1936, Pub. L. No. 74-740, § 116(c), 49 Stat. 1648; Revenue Act of 1938, Pub. L. No. 75-554, § 116(c), 52 Stat. 447; Internal Revenue Code of 1939, ch. 2, § 116, 53 Stat. 1; International Organizations Immunities Act, Pub. L. No. 79-291, § 4(c), 59 Stat. 669, 670–71 (1945) (extending the exclusion to international organizations); Internal Revenue Code of 1954, Pub. L. No. 83-591, § 892, 68A Stat. 1, 284.

For reference, the exclusion under the 1939 and 1954 codes consisted of a single sentence (adapted from the foregoing predecessor revenue acts): “The income of foreign governments or international organizations received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments or by international organizations, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments or international organizations, or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.”

¹⁶ 1966-1 C.B. 174, *revoked by* Rev. Rul. 75-298, 1975-2 C.B. 290 (*obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388).

¹⁷ Income of Foreign Governments, 43 Fed. Reg. 36111 (Aug. 15, 1978); T.D. 7707, 45 Fed. Reg. 48882 (July 22, 1980); *see Qantas Airways Ltd. v. United States*, 62 F.3d 385 (Fed. Cir. 1995) (finding the regulations a reasonable construction).

commercial entities” from the exemption.¹⁸ Section 892 was the subject of technical corrections in 1988 and 1990, but otherwise has not been amended since 1986.¹⁹

Regulations under post-1986 section 892 were first published (in proposed and temporary form) in 1988 (the temporary regulations, the “**1988 Temporary Regulations**”).²⁰ Minor subsequent regulations were finalized in 2002 and 2013.²¹ Proposed regulations under section 892 regarding the treatment of commercial activities by foreign governments (discussed in relevant part below) were published in 2011 (the “**2011 Proposed Regulations**”), and proposed regulations were published under section 892 in 2022 addressing the treatment of United States real property holding corporations.²² Parts of both the 2011 Proposed Regulations and the 2022 proposed regulations were finalized by the Final Regulations.

b. Additional Relevant Background to the 2025 Proposed Regulations

As described above, the section 892(a)(1) exemption for a foreign government extends to “bonds ... or other domestic securities” but does not apply to income “derived from the conduct of any commercial activity.”²³ Moreover, the section 892(a)(1) exemption does not apply to any income received from (or on the disposition of interests in) an entity engaged in commercial activities anywhere in the world if the entity is “controlled” by the foreign government.²⁴ For this purpose, as discussed above, one way that a foreign government “controls” an entity is if the foreign government holds an interest in the entity that provides the foreign government with “effective control” of the entity.²⁵

The following sections discuss the treatment under section 892 of investments by foreign governments in loans and other debt instruments and the meaning of “effective control,” both of which are addressed in the 2025 Proposed Regulations.

¹⁸ Tax Reform Act of 1986, Pub. L. No. 99-514, § 1247(a), 100 Stat. 2085, 2575–77.

¹⁹ Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1012(s)(1)(A)(ii), 102 Stat. 3342, 3530; Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11321(a), 104 Stat. 1388, 1388-466.

²⁰ T.D. 8211, 53 Fed. Reg. 24060 (June 27, 1988).

²¹ T.D. 9012, 67 Fed. Reg. 49862 (Aug. 1, 2002) (providing that a partnership may be a controlled commercial entity); T.D. 9648, 78 Fed. Reg. 73079 (Dec. 5, 2013).

²² Income of Foreign Governments and International Organizations, 76 Fed. Reg. 68119 (Nov. 3, 2011); Guidance on the Foreign Government Income Exemption and the Definition of Domestically Controlled, 87 Fed. Reg. 80097 (Dec. 29, 2022).

²³ Section 892(a)(2)(A); Temp. Treas. Reg. § 1.892-3T(a)(1).

²⁴ Section 892(a)(2)(A).

²⁵ Section 892(a)(2)(B)(ii).

i. Loans and Other Debt Investments

The Code does not explain when the making of a loan or other debt investment or the acquisition of a “bond” or “other domestic securit[y]” constitutes commercial activity for purposes of section 892.

Under the 2011 Proposed Regulations, income from “loans” and other investments in debt generally qualified for the section 892 exemption when not derived from the conduct of commercial activity.²⁶ The 2011 Proposed Regulations provided that investments in “loans” were not commercial activities unless those loans were “made by a banking, financing, or similar business.”²⁷ The 2011 Proposed Regulations did not define “a banking, financing, or similar business,”²⁸ but presumably looked at least to some degree to the identical terms under section 864, which applies for determining when the acquisition of debt could give rise to a “trade or business conducted within the United States.”

Section 864(c)(4) provides that, for purposes of the tax imposed by sections 871(b) and 882, interest, or amounts received for the provision of guarantees of indebtedness, is treated as effectively connected with the conduct of a U.S. trade or business if it is attributable to an office or other fixed place of business within the United States and is derived in the active conduct of “a banking, financing, or similar business” within the United States. Treas. Reg. §1.864-4(c)(5) provides that a non-U.S. person is considered:

to be engaged in the active conduct of a banking, financing, or similar business in the United States if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States: (a) [r]eceiving deposits of funds from the public, (b) [m]aking personal, mortgage, industrial, or other loans to the public, (c) [p]urchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness, (d) [i]ssuing letters of credit to the public and negotiating drafts drawn thereunder, (e) [p]roviding trust services for the public, or (f) [f]inancing foreign exchange transactions for the public.

Section 864(c)(4) uses the exact same term, “banking, financing, or similar business,” as was used in the 2011 Proposed Regulations and therefore provided a useful analogue for determining when investments in loans constituted commercial activity. The 2011 Proposed Regulations, however, provided that income earned by a banking, financing, or similar business

²⁶ Prop. Treas. Reg. § 1.892-4(e)(1)(i) (2011) (noting that, subject to the exceptions for commercial activity (discussed below), “the following are not commercial activities: ... loans.”).

²⁷ Prop. Treas. Reg. § 1.892-4(e)(1)(iii) (2011).

²⁸ *Id.*

constituted income from commercial activities, even if it was not considered to be effectively connected income by reason of Treas. Reg. § 1.864-4(c)(5).²⁹

ii. Effective Control

The Code does not define “effective control” under section 892(a)(2)(B). The 1988 Temporary Regulations do not define “effective control” but provide under the heading “Control—(2) Effective practical control”: “An entity engaged in commercial activity may be treated as a controlled commercial entity if a foreign government holds sufficient interests in such entity to give it ‘effective practical control’ over the entity.”³⁰ The 1988 Temporary Regulations go on to provide that the term “effective practical control” takes into account interests other than equity ownership, such as creditor, regulatory, or commercial relationships or the ability to influence an entity’s activities through control of a strategic natural resource.³¹

c. Relevant Background to the Final Regulations

The following section discusses the so-called “all or nothing” rule that applies to controlled entities of foreign sovereigns that are engaged in commercial activity and the limited partner exception that was introduced by the 2011 Proposed Regulations, which mitigated the impact of the “all or nothing” rule for investments in certain partnership interests and which was adopted, with certain material modifications, in the Final Regulations.

i. “All or Nothing” Rule

Under section 892(a)(2)(B), all income received from or by a controlled commercial entity is excluded from section 892. Under the “all or nothing” interpretation of the 1988 Temporary Regulations, even a *de minimis* amount of commercial activity anywhere in the world can disqualify *all* of the income received by a controlled entity from the benefits of section 892. No such rule applies to integral parts of a foreign sovereign.

ii. Limited Partner Exception

The 1988 Temporary Regulations provided that the commercial activity of a partnership was attributable to its partners, subject to a narrow exception for publicly traded partnerships.³² The 2011 Proposed Regulations would have significantly broadened the exception from commercial activity attribution for limited partners in a limited partnership if the limited partner did not have rights to participate in the management and conduct of the partnership’s business at any time during the partnership’s taxable year under the law of the jurisdiction in which the

²⁹ See Prop. Treas. Reg. § 1.892-4(e)(1)(iii) (2011).

³⁰ Temp. Treas. Reg. § 1.892-5T(c)(2). Although these temporary Treasury regulations use the term “effective practical control,” the 2025 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).

³¹ *Id.*

³² Temp. Treas. Reg. § 1.892-5T(d)(3) (1988).

partnership was organized or under the governing agreement.³³ Rights to participate in the management and conduct of a partnership's business did not include consent rights in the case of extraordinary events such as admission or expulsion of a general or limited partner, amendment of the partnership agreement, dissolution of the partnership, disposition of all or substantially all of the partnership's property outside of the ordinary course of the partnership's activities, or a merger or conversion of the partnership.³⁴

IV. Summary of Prior Reports and Certain Recommendations

We have discussed section 892 at length in three prior reports: We addressed the 1988 Temporary Regulations in a 1988 report,³⁵ in 2008, we wrote a report addressing issues under section 892 arising from the significant growth of foreign government investment in the United States;³⁶ and we addressed the 2011 Proposed Regulations in a 2012 report.³⁷

Many of the considerations we raised in our prior reports are addressed in the 2025 Proposed Regulations and the Final Regulations. We summarize certain of our prior recommendations that are relevant to this Report's recommendations regarding the 2025 Proposed Regulations and Final Regulations below.

a. Effective Control

In our 1988 Report, we noted that the definition of "effective practical control" as the term is used in the 1988 Temporary Regulations should be clarified, both to specify that normal creditor status (regardless of the size of the relevant debt) does not rise to the level of effective practical control and to require a minimum equity interest before a foreign government can be considered to have effective practical control over an entity. In our 2008 Report, we again noted the need for a clear definition of effective practical control and observed that the 1988 Temporary Regulations do not make clear what types of interests should be taken into account or what level of influence over an entity might constitute effective practical control.

b. "All or Nothing" Rule and Partnership Attribution

In each of our prior reports we have addressed the so-called "all or nothing" rule of section 892(a)(2)(B). We have recommended, and continue to recommend, that section 892(a)(2)(B) be interpreted so as not to have such an "all or nothing" effect by eschewing the

³³ Prop. Treas. Reg. § 1.892-5(d)(5)(iii)(B) (2011).

³⁴ *Id.*

³⁵ N.Y. State Bar Ass'n Tax Section, Report No. 589, *Report on Temporary and Proposed Regulations under Section 892 of the Code* (Oct. 14, 1988) (the "**1988 Report**").

³⁶ N.Y. State Bar Ass'n Tax Section, Report No. 1157, *Report on the Tax Exemption of Foreign Sovereigns Under Section 892 of the Internal Revenue Code* (June, 2008) (the "**2008 Report**").

³⁷ N.Y. State Bar Ass'n Tax Section, Report No. 1257, *Letter on Proposed Regulations under Section 892* (Feb. 2, 2012) (the "**2012 Report**").

focus on the formal classification of an entity as an integral part or a controlled entity, and instead grounding the eligibility for the exemption under section 892 on whether, considering an entity's activities and purpose as a whole, the entity is properly viewed as a commercial enterprise.³⁸ The Final Regulations did not adopt this recommendation.

As noted above, the 1988 Temporary Regulations provided that the commercial activity of a partnership was attributable to its partners, subject to a narrow exception for publicly traded partnerships.³⁹ In our 1988 Report, we noted that the partnership exception should be extended to all widely held limited partnerships, whether or not publicly traded, in which a foreign government does not have control over the partnership's business. We expanded on this point in our 2008 Report and recommended that eligibility for section 892 be modified to focus on an entity's actual commercial activities and not activities that it is deemed to engage in as a result of being a partner in a partnership.

As discussed above, the 2011 Proposed Regulations would have included a significantly broadened exception from commercial activity attribution for certain limited partners in a limited partnership.⁴⁰ We expressed support for this exception in our 2012 Report and recommended that the exception be clarified to include membership interests in limited liability companies and other interests in entities that are classified as partnerships for tax purposes. We also recommended that the IRS and Treasury address how participation on an advisory committee or holding certain veto or consultation rights affect the analysis of whether a limited partner had rights to participate in the management and conduct of the partnership's business, and we recommended that different entities controlled by the same foreign government not be attributed each other's rights or activities for purposes of this test where such entities' activities were not otherwise coordinated and did not have a purpose to avoid application of the "all or nothing" rule.

The Final Regulations include an exception from the commercial activity partnership attribution rule for QPIs.⁴¹ This exception differs in material respects from the exception described in the 2011 Proposed Regulations and is discussed in more detail below.

V. Summary of 2025 Proposed Regulations and Final Regulations

a. 2025 Proposed Regulations

The 2025 Proposed Regulations address three topics: (i) the exclusion of partnerships from the definition of "controlled entity" under Temp. Treas. Reg. § 1.892-2T(a)(3), which

³⁸ See Rev. Rul. 75-298, 1975-2 C.B. 290 (analyzing whether a government owned entity was a commercial enterprise based on its activities "taken as a whole"); 2008 Report at 33. This recommendation was not adopted in the 2011 Proposed Regulations or the 2025 Proposed Regulations.

³⁹ See *supra* note 32.

⁴⁰ See *supra* note 33.

⁴¹ Treas. Reg. § 1.892-5(d)(5)(iii)(B).

describes entities that are entitled to section 892 benefits; (ii) the treatment of an acquisition of debt as investment activity or commercial activity; and (iii) the definition of “effective control” under section 892(a)(2)(B). This Report provides recommendations regarding the latter two topics addressed in the 2025 Proposed Regulations and therefore provides a detailed summary of those rules below.

i. Loans and Other Debt Investments

The 2025 Proposed Regulations introduce a general facts-and-circumstances test and two safe harbors for determining whether the acquisition of debt is investment or commercial activity for purposes of section 892.⁴² In the preamble to the 2025 Proposed Regulations, the IRS and Treasury state that the proposed rules are intended to establish “the exclusive set of rules for determining whether acquiring debt, including at original issuance, is treated as investment and thus not as commercial activity for purposes of section 892.”⁴³

The two debt acquisition safe harbors in the 2025 Proposed Regulations are:

- Registered offerings. An acquisition of bonds or other debt securities in an offering registered under the Securities Act of 1933, as amended (the “**Securities Act**”), is not commercial activity if the underwriters are not related to the acquirer within the meaning of sections 267(b) and 707(b).⁴⁴
- Qualified secondary market acquisitions. An acquisition of debt traded on an established securities market within the meaning of Treas. Reg. § 1.7704-1(b) 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 within the meaning of” Prop. Treas. Reg. § 1.892-4(c)(1)(i).⁴⁵

The IRS and Treasury requested comments regarding the circumstances, if any, under which (i) the registered offering safe harbor should be extended to offerings registered under foreign

⁴² Prop. Treas. Reg. § 1.892-4(c)(1)(ii).

⁴³ 90 Fed. Reg. 57930 (Dec. 15, 2025). The IRS and Treasury note that whether debt acquisition is an investment for purposes of section 892 would be determined without regard to whether the debt acquisition is treated as a trade or business for federal tax purposes, and that no inference is intended as to the circumstances in which acquiring debt would or would not be a trade or business for other purposes of the Code (including sections 864, 162, or 166). *Id.*

⁴⁴ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(1).

⁴⁵ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(2).

securities laws and (ii) the qualified secondary market safe harbor should apply to acquisitions of debt that is not traded on an established securities market.⁴⁶

If a debt acquisition does not satisfy one of these safe harbors, a facts-and-circumstances test applies to determine if the acquisition is an investment or commercial activity. The preamble to the 2025 Proposed Regulations provides that: “[i]n general, facts and circumstances would be relevant to the extent they indicate that the entity’s expected return from acquiring the debt is exclusively a return on its capital rather than including a return on activities it conducts.”⁴⁷ The test is based on “all relevant facts and circumstances,” and the 2025 Proposed Regulations set forth the following eight non-exclusive factors:⁴⁸

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

⁴⁶ 90 Fed. Reg. 57930 (Dec. 15, 2025).

⁴⁷ *Id.*

⁴⁸ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(C)(I)-(8).

original unmodified debt, that the original unmodified debt would default.

The 2025 Proposed Regulations include the following examples illustrating the facts-and-circumstances test:

- Isolated debt financing. A single loan was commercial activity when a controlled entity that did not own equity in the foreign borrower offered to make a non-registered loan (thereby soliciting and holding itself out as a lender), structured and negotiated the loan's terms, and made the loan on those terms at original issuance.⁴⁹
- Debt financing combined with 80-percent equity investment. A single loan acquired at original issuance was investment when the lender owned 80 percent of the equity of the borrower, 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 borrower'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 borrower (\$80 million of \$100 million outstanding equity).⁵⁰
- Private placement. Purchases at original issuance of U.S. Treasury debt securities and ten privately placed debt securities of "several" domestic corporations, each offered under Regulation S through a private placement memorandum, were investment, even when the foreign government met with unrelated placement agents, shared its interest in purchasing privately placed debt of U.S. corporate issuers, and communicated the terms on which the government would be willing to purchase that debt.⁵¹ The purchase was not commercial activity because (a) the purchaser did not hold itself out as a lender, solicit borrowers, or "materially" participate in structuring or negotiating the terms of the debt; (b) the debt was offered in the form of a privately placed security; and (c) the purchaser acquired less than one-third of principal and was not the largest purchaser of any debt offering based on principal amount.⁵²
- Debt Modification and creditors' committees. Purchase of a debt in year 1 with no objective indication that the borrower would default, which debt then defaulted in year 4 due to unexpected market changes, was investment when the foreign

⁴⁹ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(2) (Ex. 1). The example notes that "[a]lthough the [controlled entity] made only one loan in year 1, the number of loans does not change the determination that the acquisition is commercial activity." *Id.*

⁵⁰ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(3)(ii) (Ex. 2).

⁵¹ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(4)(i) (Ex. 3).

⁵² Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(4)(ii) (Ex. 3).

government did not participate in the creditors' committee that represented all creditors and negotiated the significant modifications to the debt.⁵³ By contrast, under the same facts, a foreign government that was a member of a creditors' committee that materially participated in negotiating and structuring the terms of significantly modified debt was engaged in commercial activity.⁵⁴ If the foreign government is a member of the creditors' committee, it is "presumed" to have materially participated in negotiating and structuring the terms of the debt.⁵⁵

The IRS and Treasury requested comments regarding whether the facts and circumstances test should include additional factors or examples and the circumstances, if any, under which acquisitions of certain specific types of debt should be treated as investment for purposes of section 892.⁵⁶

ii. Definition of Effective Control

Under the 2025 Proposed Regulations, "effective control" of an entity under section 892(a)(2)(B) would be determined based on all facts and circumstances, and would look to whether the foreign government's interest in the entity "directly or indirectly, separately or in combination with other interests, results in control of the operational, managerial, board-level, or investor-level decisions of the entity."⁵⁷ Mere consultation rights over these decisions do not result in effective control.⁵⁸ For this purpose, interests that can convey 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), regulatory authority over the entity, and "[a]ny other interest in or other relationship with the entity that may provide influence over decisions relating to the entity's operations, management, board-level, or investor-level matters."⁵⁹

Although the examples discussed below reiterate that veto rights are interests that may result in effective control, the 2025 Proposed Regulations do not provide an exhaustive list of which veto rights alone (or in combination) result in effective control.⁶⁰ The IRS and Treasury requested comments regarding the circumstances under which a minority equity interest holder

⁵³ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(5)(ii) (Ex. 4).

⁵⁴ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(6)(ii) (Ex. 5).

⁵⁵ *Id.*

⁵⁶ 90 Fed. Reg. 57930 (Dec. 15, 2025).

⁵⁷ Prop. Treas. Reg. § 1.892-5(c)(2).

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

should not be treated as having effective control (or as having at least 50-percent voting power) of an entity when “managerial or board level decisions of the entity are subject to veto or “blocking” rights of the holder and other holders (for example, through consent rights, supermajority requirements, or otherwise).”⁶¹

The 2025 Proposed Regulations contain the following examples that illustrate the definition of “effective control”:

- Minority Interest with no Governance or Control Rights. A controlled entity 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.⁶² There is no effective control even if the controlled entity is a party to an investment agreement with the entity that establishes criteria for what types of investments the entity can make.⁶³ Similarly, there is no effective control if the controlled entity discusses acquisitions and sales of property as a member of the entity’s investment committee (as long as the controlled entity has no right to approve or execute the acquisitions and sales).⁶⁴
- Power to Appoint or Dismiss Manager. A controlled entity that has the power to appoint or dismiss unilaterally the person responsible for managing the entity’s operations has effective control of the entity.⁶⁵
- Unilateral Veto Rights. A controlled entity that appoints a single director who has unilateral veto rights over dividend distributions, material capital expenditures, sales of new equity interests, and the entity’s operating budget has effective control.⁶⁶
- Business Relationships. A controlled entity that appoints one of three directors of an entity has effective control of the entity when an unrelated investor that appoints one of the two remaining board members derives significant revenue from the controlled entity and “as a matter of course” always votes with the controlled entity.⁶⁷

⁶¹ 90 Fed. Reg. 57932 (Dec. 15, 2025).

⁶² Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(B)(2) (Ex. 1).

⁶³ Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(C)(2) (Ex. 2).

⁶⁴ Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(D)(2) (Ex. 3).

⁶⁵ Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(E)(2) (Ex. 4).

⁶⁶ Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(F)(2) (Ex. 5).

⁶⁷ Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(G)(2) (Ex. 6).

- Regulatory Authority. A foreign government that owns all mineral rights to a mineral in a country constitutes an interest that gives a controlled entity effective control over an entity the primary business of which is extracting and marketing the mineral from the country.⁶⁸
- Certain Creditor Rights. A controlled entity that is solely a creditor of an entity has effective control of the entity if the credit agreement imposes restrictions on the types of investments the entity can make, disposition of assets, levels of debt, and dividends and provides the controlled entity veto rights over dividends, stock repurchases, additional borrowing, capital expenditures, the annual operating budget, and the redemption of subordinated debt.⁶⁹

The preamble to the 2025 Proposed Regulations also indicates that the determination of whether a foreign government has “effective control” of an entity under section 892(a)(2)(B) takes into account all direct and indirect interests in the entity held by the foreign government—in effect, by aggregating all interests of the foreign government held by each of its controlled entities and integral parts.⁷⁰ The IRS and Treasury requested comments regarding the circumstances under which controlled entities should be considered separately for purposes of determining effective control because they are functionally independent.⁷¹

iii. Effective Date of 2025 Proposed Regulations

The 2025 Proposed Regulations generally would apply to taxable years beginning on or after the date that they are finalized.⁷²

b. Final Regulations

The Final Regulations finalize, with modifications, portions of the 2011 Proposed Regulations, the 2022 proposed regulations, and the 1988 proposed regulations, and principally address three topics: (i) the finalization of Prop. Treas. Reg. § 1.892-3(a)(4) of the 1988 proposed regulations defining “financial instrument,” (ii) the definition of commercial activity for purposes of section 892(a)(2), which is set forth in Treas. Reg. § 1.892-4, and (iii) the determination of whether an entity is a “controlled commercial entity” within the meaning of section 892(a)(2), including by reason of the attribution of commercial activity from a partnership to its partners, which is set forth in Treas. Reg. § 1.892-5. This Report provides

⁶⁸ Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(H)(2) (Ex. 7).

⁶⁹ Prop. Treas. Reg. § 1.892-5(c)(2)(iii)(I)(2) (Ex. 8).

⁷⁰ 90 Fed. Reg. 57931-57932 (Dec. 15, 2025).

⁷¹ *Id.*

⁷² Prop. Treas. Reg. §§ 1.892-2(e), 1.892-4(d), 1.892-5(e).

recommendations with respect to the latter two topics and therefore provides a detailed summary of those rules below.

i. Definition of Commercial Activity

Consistent with the 1988 Temporary Regulations, the 2011 Proposed Regulations generally defined commercial activities to include all activities “ordinarily 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.⁷³ The Final Regulations finalize these rules in the 2011 Proposed Regulations with the following changes:⁷⁴

- Nondealer transactions in partnership interests do not themselves give rise to commercial activity. The Final Regulations provide that merely holding or trading partnership interests (for the foreign government’s own account and other than as a dealer) is not, by itself, a commercial activity.⁷⁵ Additionally, the IRS and Treasury declined to change the rule in Treas. Reg. § 1.892-3T(a)(2) and (3) to exempt income earned through, or gain from the disposition of, a partnership interest under section 892 (where, were the partnership treated as an aggregate, section 892 would exempt the income or gain from the partnership’s assets) on the basis that this change was beyond the scope of the Final Regulations.⁷⁶
- Foreign Currency. The Final Regulations provide that holding non-functional currency in a bank deposit does not give rise to commercial activity.⁷⁷

ii. Qualified Partnership Interest Exception

As discussed above, under the 1988 Temporary Regulations, the commercial activities of a partnership are generally attributed to its partners for purposes of determining whether an entity

⁷³ Prop. Treas. Reg. § 1.892-4(d) (2011); *see also* Temp. Treas. Reg. § 1.892-4T(b) (1988).

⁷⁴ *Id.* 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. T.D. 10042, 90 Fed. Reg. 57904 (Dec. 15, 2025). 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.” *Id.*

⁷⁵ Treas. Reg. § 1.892-4(c)(1)(i) and (2). The preamble to the Final Regulations noted that “holding equity interests in a partnership (including holding by an entity incident to trading partnership equity interests for one’s own account and other than as a dealer) results in commercial activity if the partnership conducts commercial activity that is attributed to the holder.” T.D. 10042, 90 Fed. Reg. 57904 (Dec. 15, 2025).

⁷⁶ T.D. 10042, 90 Fed. Reg. 57904 (Dec. 15, 2025).

⁷⁷ Treas. Reg. § 1.892-4(c)(1)(i).

partner is engaged in commercial activity for purposes of section 892(a)(2).⁷⁸ The 2011 Proposed Regulations proposed an exception to this attribution rule for certain limited partners in a limited partnership.⁷⁹

The Final Regulations reformulate the limited partner exception from the 2011 Proposed Regulations by (i) introducing the term “qualified partnership interest”; (ii) adding a new requirement that the holder of a QPI not “control” the partnership, either by owning a 50-percent-or-greater interest (by vote or value) in the partnership or by having “effective control” of it; and (iii) adding a safe harbor for certain small partnership interests.⁸⁰

The Final Regulations clarify that the QPI exception is not exclusive to state-law limited partnerships and is available to equity interests in any entity classified as a partnership for U.S. federal income tax purposes.⁸¹ Because the exception was extended to non-state-law limited partnerships such as general partnerships, the Final Regulations introduce additional requirements to make QPIs uniform in certain respects, including that the holder must not have personal liability for claims against the partnership or have the right to enter into contracts or act on behalf of the partnership.⁸² As under the 2011 Proposed Regulations, the holder also must not have the right to participate in the management and conduct of the partnership’s business.⁸³

The Final Regulations 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 (determined based on all facts and circumstances) and does not include rights to monitor and protect an investor’s capital investment in the partnership.⁸⁴ Permissible monitoring rights

⁷⁸ Temp. Treas. Reg. § 1.892-5T(d)(3).

⁷⁹ Prop. Treas. Reg. § 1.892-5(d)(5)(iii)(A) (2011); *see supra* Section III.c.ii.

⁸⁰ Treas. Reg. § 1.892-5(d)(5)(iii). Under a “de minimis” interest exception, the Final Regulations treat a partnership interest as a QPI if the holder (i) has no personal liability for the debts of or claims against the entity, (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 (or equivalent role for a different type of entity). Treas. Reg. § 1.892-5(d)(5)(iii)(C).

Like the limited partner exception in the 2011 Proposed Regulations, the QPI exception only prevents attribution of commercial activity for purposes of applying section 892(a)(2) and does not affect the application of section 875 or the taxation of the foreign government partner’s distributive share of partnership income, gain, deduction or loss.

⁸¹ Treas. Reg. § 1.892-5(d)(5)(iii)(B)(1).

⁸² Treas. Reg. § 1.892-5(d)(5)(iii)(B). The Final Regulations also provide that an upper-tier partnership that holds a QPI in a lower-tier partnership is not attributed the lower-tier partnership’s commercial activities. Treas. Reg. § 1.892-5(d)(5)(iii)(D).

⁸³ *Id.*

⁸⁴ Treas. Reg. § 1.892-5(d)(5)(iii)(B)(2)(ii).

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.⁸⁵ The preamble to the Final Regulations states that the IRS and Treasury agreed with commenters that the following rights are all consistent with monitoring and protecting an investment and do not provide control over a partnership's day-to-day business: (i) general oversight rights, consultation rights, and veto rights; (ii) "consent rights customarily granted to a significant lender" such as approval rights over the annual budget, major transactions, and major expenses; and (iii) veto rights over key decisions and extraordinary events outside of day-to-day management.⁸⁶

Importantly, the Final Regulations add a new requirement, which was not proposed in the 2011 Proposed Regulations, that the holder of the partnership interest not own 50 percent or more of the value or voting interests of the partnership or have "effective control" of the partnership, in each case as determined under section 892(a)(2) (the "**No Control Requirement**").⁸⁷ 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 the partnership cannot rely on the QPI exception to avoid the attribution of commercial activity from the partnership. Although the preamble to the Final Regulations indicates that the adoption of this requirement was to "ensure that the qualified partnership interest exception is available only to partnership equity interest holders with passive participation in the partnership," the requirement applies without regard to whether the holder has the right to participate in the management of the partnership's business.⁸⁸

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 QPI exception.⁸⁹ If any of the entities' interests do not qualify for the exception, none of the foreign government's other interests in the partnership can qualify.⁹⁰

⁸⁵ *Id.*

⁸⁶ T.D. 10042, 90 Fed. Reg. 57912 (Dec. 15, 2025).

⁸⁷ Treas. Reg. § 1.892-5(d)(5)(iii)(B)(1).

⁸⁸ T.D. 10042, 90 Fed. Reg. 57911 (Dec. 15, 2025).

⁸⁹ Treas. Reg. § 1.892-5(d)(5)(iii)(B)(2)(iii). This concept is similar to the aggregation principle for purposes of determining "effective control" in the 2025 Proposed Regulations described above. *See supra* Section V.a.ii.

⁹⁰ *Id.*

iii. *Effective Date of the Final Regulations*

The Final Regulations generally apply to tax years beginning on or after December 15, 2025.⁹¹

VI. Recommendations Related to the 2025 Proposed Regulations

a. Recommendations regarding debt investments

The 2025 Proposed Regulations begin with the premise that an “acquisition of debt is considered commercial activity” unless the acquisition qualifies as an investment, either under one of two safe harbors, discussed below, or under a facts-and-circumstances test.⁹² Because the safe harbors, at least in their current form, are likely to apply only to a narrow set of debt acquisitions, the vast bulk of acquisitions of debt obligations by foreign sovereigns are expected to be evaluated by reference to the relevant facts and circumstances.

As an initial matter, we do not agree with the notion that any debt acquisition is properly treated as *per se* “commercial activity” in the absence of a specific exception. As a general matter, the mere acquisition of an asset should never, without more, be considered commercial activity, and the mere acquisition of a debt instrument normally would be considered a classic example of investment. Furthermore, there are examples, accepted both in the caselaw and by the IRS, of loan origination activities that were found eligible for the benefits of section 892 (or its predecessor) on the grounds that the activities were conducted for the purpose of advancing a specific governmental agenda. In Private Letter Ruling 9235061⁹³ an export-import bank of a foreign government was ruled eligible for the benefits of section 892(a) in respect of loans it made to U.S. borrowers to facilitate the purchase of goods from the bank’s jurisdiction in furtherance of the government’s development goals.⁹⁴ Similarly, in *Vial v. Commissioner*,⁹⁵ the Tax Court held that a Chilean development bank making loans to further specific economic projects was properly treated as a governmental entity entitled to the benefits of the predecessor to section 893 (under the Internal Revenue Code of 1939)—again, on the grounds that the loans it made were in furtherance of governmental, as opposed to commercial, goals. We observe that such loan origination might not fit cleanly into the exceptions provided in the proposed debt acquisition rules and yet also might not properly be viewed as “commercial activity.”

⁹¹ Taxpayers generally may elect to apply the Final Regulations to prior open tax years, if the taxpayer and its related entities (within the meaning of sections 267(b) or 707(b)) apply the Final Regulations, in their entirety, to that year and all succeeding taxable years beginning before December 15, 2025.

⁹² Prop. Treas. Reg. § 1.892-4(c)(1)(ii).

⁹³ June 5, 1992.

⁹⁴ In PLR 202536015 (June 9, 2025), an international development bank similarly was acknowledged to be entitled to the benefits of section 895(b).

⁹⁵ 15 T.C. 403 (1950).

In addition, we note that the notion that debt acquisition is presumed to be “commercial activity” appears to contradict the well-established “trading safe harbor” that was recently finalized in Treas. Reg. § 1.892-4(c)(2), which provides that “[e]ffecting transactions in stocks, bonds, other securities (as defined in [Treas. Reg. §] 1.892-3T(a)(3) [*i.e.*, debt instruments]), partnership equity interests, commodities, or financial instruments (as defined in [Treas. Reg. §] 1.892-3(a)(4)) for a foreign government’s own account does not constitute commercial activity.”⁹⁶ It is not clear how the proposed debt acquisition rules would interact with the trading safe harbor. Prop. Treas. Reg. § 1.892-4(c)(1)(ii) provides that “[a]n acquisition of debt is considered a commercial activity . . . notwithstanding any other provision of this section, unless the acquisition qualifies as an investment under [the proposed debt acquisition safe harbors or the facts and circumstances test].” Although this language could be read to supply a coordination rule between the proposed debt acquisition rules and the other commercial activity exceptions, we do not believe that such a reading is appropriate, as it would have the effect of removing all debt acquisition from the trading safe harbor (and overriding any other potentially available exception from commercial activity). In particular, we believe that the trading safe harbor represents another context in which the acquisition of debt might be considered not to constitute “commercial activity” even if, for whatever reason, one of the proposed debt acquisition exceptions did not specifically apply.

Regardless of how the IRS and Treasury decide to address the more general points about debt acquisition described above, the scope of the debt acquisition safe harbors should be expanded significantly by, for example, broadening (i) the registered offering debt acquisition safe harbor to include certain private placements (and offerings registered under foreign securities laws), and (ii) the qualified secondary market debt acquisition safe harbor to include acquisitions of debt not traded on an established securities market, but meeting the other requirements of the safe harbor in order to ensure that the secondary market purchase was sufficiently independent of the debt origination. In addition, we believe that, in order to avoid market confusion, the facts-and-circumstances test needs either (i) to reinstate the distinction drawn in the 2011 Proposed Regulations between investments in bonds and loans, on the one hand, and activities giving rise to a “banking, financing or similar business” on the other, or (ii) to the extent that the IRS and Treasury conclude that commercial activity is broader than activity undertaken as part of (or for the purpose of furthering) such a business, to go beyond a mere listing of factors and to articulate clearly principles for determining whether debt acquisition is investment or commercial activity, with revised examples illustrating the application of such principles (*e.g.*, illustrating when loan origination is permissible).

i. Expand the debt acquisition safe harbors

Under the 2025 Proposed Regulations, the acquisition of debt is treated as investment and not commercial activity if the debt is acquired in either: (1) a registered offering, or (2) a qualified secondary market acquisition. We welcome the inclusion of safe harbors in the 2025 Proposed Regulations’ debt acquisition framework; however, we are concerned that these proposed safe harbors are too narrowly drawn. The preamble to the 2025 Proposed Regulations states that: “In general, facts and circumstances would be relevant to the extent they indicate that

⁹⁶ (Emphasis added.)

the entity’s expected return from acquiring the debt is *exclusively a return on its capital* rather than including *a return on activities it conducts*.⁹⁷ We discuss in greater detail below whether this principle is sufficient in the context of the facts-and-circumstances test. However, assuming that this principle should animate the safe harbors distinguishing debt investment from commercial activity, there are common examples of debt acquisitions other than registered offerings that we believe fall into the former category and that could easily be included in the safe harbors.

For example, we recommend expanding the registered offerings safe harbor to include, at a minimum, debt acquired in private placements conducted under Rule 144A of the Securities Act (“**Rule 144A**”), as well as in offerings registered under foreign securities laws that are sufficiently similar to the Securities Act. Additionally, we recommend removing the “established securities market requirement” for a qualified secondary market acquisition and replacing it with additional requirements that distinguish a secondary market purchase of debt from an origination. These proposals are discussed in more detail below.

1. Expand the registered offering debt acquisition safe harbor in Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(I) to include private placements and offerings registered under foreign securities laws

Under Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(1), an acquisition of bonds or other debt securities is an investment if the bonds or other debt securities are acquired in an offering (i) that is registered under the Securities Act, and (ii) where the underwriters of the offering are not related to the acquirer under sections 267(b) and 707(b). We believe the purpose of this safe harbor is to define a set of transactions in which (i) debt is purchased at original issuance and (ii) the parties that are in fact providing structuring and marketing services in connection with the issuance (the “underwriters”) are clearly distinguishable from the ultimate investors, who are acting in a sense as customers of the underwriters.

While we certainly agree with the IRS and Treasury that an acquisition by a sovereign investor of debt in a registered offering from an unrelated underwriter is properly characterized as investment activity, we believe the safe harbor could be easily expanded without compromising its integrity. Specifically, Rule 144A allows for underwriters to conduct marketing and sales of debt securities to investors without having to register such securities with the Securities and Exchange Commission, provided the debt securities are offered only to “Qualified Institutional Buyers” (“**QIBs**”). In other words, the stated purpose of Rule 144A is to allow for essentially the same distribution process that applies in registered offerings, except that actual registration is not required due to the presumed sophistication of the targeted investor base. Like registered offerings, offerings under Rule 144A are made with the use of offering documents describing the terms of the proposed securities, as well as the relevant information pertaining to the issuer. Such offerings rely on underwriters acting effectively as intermediaries between the issuer and the ultimate investors, thereby ensuring an equal degree of distance between an issuer and the QIB purchasing a debt security as one would find between an issuer and the purchaser of debt in a registered offering.

⁹⁷ 90 Fed. Reg. 57930 (Dec. 15, 2025) (emphasis added).

Because private placements represent a significant portion of all corporate debt offered in the United States (approximately 10 percent⁹⁸ of all U.S. corporate bond offerings in 2024), the inclusion of Rule 144A offerings in the safe harbor would go a long way toward providing certainty for “standard” market placements. Furthermore, to the degree that the IRS and Treasury are concerned with ensuring that a Rule 144A offering maintains the appropriate level of separation between the issuer of debt securities and the ultimate holder of those securities, the safe harbor could contain additional conditions if that were deemed advisable. The safe harbor might apply only to private placements made under offering documents pursuant to Rule 144A where: (i) the acquirer does not participate in structuring the terms of the debt securities (other than responses to standard inquiries by the underwriter to gauge investor interest in the offering, or customary due diligence communications with the underwriter that would be reasonably necessary for an informed decision to purchase a debt security and that would be allowed in a registered offering as well), (ii) the acquirer does not receive, directly or indirectly, any portion of the fees or other origination profit earned by the underwriter in respect of its activities with respect to the structuring, negotiation, placement or sale of such debt security, and (iii) the acquirer acquires no more than 33 percent of all of the debt obligations of the particular tranche or class offered at that time by that obligor (in order to ensure the acquirer is not such a significant creditor of the issuer as to encourage privity with the issuer and to comport with the similar limitation contained in Prop. Treas. Reg. § 1.892-4(c)(1)(i)(D)(4) Example 3 (“Private placement of debt securities and U.S. Treasury securities as investment”). We do not believe that additional requirements along those lines would represent a material burden or would require underwriters in Rule 144A offerings to modify their behavior in a meaningful way.⁹⁹

The IRS and Treasury also requested comments regarding the circumstances, if any, in which the registered offerings safe harbor should be extended to offerings registered under foreign securities laws that are sufficiently similar to the Securities Act. Presumably, the criteria for allowing non-U.S. securities regimes to be included in the safe harbor would be whether those regimes facilitate a process in which the debt is issued into a public market in an intermediated manner (*i.e.*, through underwriters or placement agents), such that there is little chance of negotiation between the acquirers of debt and the issuer (negotiation between a lender and a borrower being a feature of a banking business or activity beyond the mere investment of capital). Based on how foreign securities laws and exchanges have been addressed in other sections of the Code, we believe there are two potential approaches. Under the first approach, the registered offering safe harbor could be expanded to also refer to foreign securities laws that the Secretary has determined are adequate to carry out the purposes of Prop. Treas. Reg. § 1.892-4(c)(1)(ii). This would allow the IRS and Treasury to publish an “angel list” of foreign securities

⁹⁸ See SIFMA Research 2025 Capital Markets Fact Book (July 2025). In 2024, corporate bond issuances totaled approximately \$1.9 trillion and private placements of debt totaled \$208 billion.

⁹⁹ This rule also would be consistent with other regulatory attempts to define a public offering of securities more broadly than a registered offering. See, e.g., Treas. Reg. § 1.355-7(h)(11) (defining a “public offering” as an acquisition of stock for cash where the terms of the acquisition are established by the acquired corporation or the seller with the involvement of one or more investment bankers and the potential acquirers have no opportunity to negotiate the terms of the acquisition).

laws that meet these requirements.¹⁰⁰ This is consistent with the approach under section 1256(g)(7) where the Secretary has published an angel list of foreign exchanges and boards of trade and other markets that have rules similar to those of a national securities exchange registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the CFTC. Alternatively, the IRS and Treasury could adopt a principles-based approach by identifying specific requirements that a foreign securities law would need to satisfy in order to qualify for the safe harbor. This was the approach adopted by the IRS and Treasury for the mark-to-market rules under section 1296. Under the section 1296 regulations, a foreign exchange must be regulated or supervised by a governmental authority of the country in which the market is located and have certain specified characteristics.¹⁰¹ The publicly traded partnership rules under section 7704 combined these two approaches by both listing specific criteria for a foreign exchange to qualify and also listing specific foreign exchanges.¹⁰²

We recommend adopting a principles-based approach because, once the principles are established, practitioners can exercise judgment by reference to the appropriate principles as cases arise on the ground, and then adapt as markets change, or as the securities laws of different jurisdictions change, without the need for further action from the IRS or Treasury. One possibility for such an approach is to ensure that the applicable foreign securities law address resales of securities by underwriters (unrelated to the issuer) pursuant to an offering memorandum to investors that either (i) have access to sufficient information about the issuer through published financials and offering documents or through some other legally sanctioned means that protect the investor from misinformation or fraud, or (ii) are considered sophisticated enough to act responsibly without the full level of protection afforded to members of the general public.

¹⁰⁰ The IRS has issued several revenue rulings blessing different non-U.S. exchanges, including the Intercontinental Exchange, the Dubai Mercantile Exchange, the London International Financial Futures and Options Exchange, Eurex Deutschland, the Bourse de Montreal and the European Energy Exchange. *See* Rev. Rul. 2007-26, 2007-1 C.B. 970, Rev. Rul. 2009-4, 2009-5 I.R.B. 408; Rev. Rul. 2010-3, 2010-3 I.R.B. 272; Rev. Rul. 2013-5, 2013-9 I.R.B. 525; Rev. Rul. 2024-22, 2024-43 I.R.B. 980; Rev. Rul. 2024-23, 2024-43 I.R.B. 981.

¹⁰¹ *See* Treas. Reg. § 1.1296-2(c)(1)(ii) (requiring that the exchange have the following characteristics: (A) the exchange has trading volume, listing, financial disclosure, surveillance, and other requirements designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open, fair and orderly, market, and to protect investors; and the laws of the country in which the exchange is located and the rules of the exchange ensure that such requirements are actually enforced; and (B) the rules of the exchange effectively promote active trading of listed stocks).

¹⁰² *See* Treas. Reg. § 1.7704-1(b)(3) (“A foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934 described in paragraph (b)(1) or (2) of this section (such as the London International Financial Futures Exchange; the Marche a Terme International de France; the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited; the Frankfurt Stock Exchange; and the Tokyo Stock Exchange).”).

2. Expand the qualified secondary market debt acquisition safe harbor in Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(2) to include acquisitions of debt that is not traded on an established securities market

The 2025 Proposed Regulations provide a second safe harbor for an acquisition of debt (i) which is “traded on an established securities market” (within the meaning of Treas. Reg. § 1.7704-1(b)); (ii) in which the acquirer does not acquire the debt from the debt issuer or participate in the negotiation of the terms or issuance of the debt; and (iii) which is not from a person that is under common management or control with the acquirer, unless that person acquired the debt as investment within the meaning of the 2025 Proposed Regulations.¹⁰³

The additional safe harbor for secondary market acquisitions of debt is welcome. We agree with the IRS and Treasury that the second and third requirements in the 2025 Proposed Regulations are needed to help ensure that the debt is acquired in a true secondary market purchase. However, we believe that the first requirement—that the debt be traded on an “established securities market” within the meaning of Treas. Reg. § 1.7704-1(b)—is unnecessary.

We believe the logic underlying the safe harbor is that debt purchased in a true secondary market transaction is properly viewed as an investment asset, on the grounds that the purchaser of the debt, by definition, was not involved in the negotiation or origination of the debt and thus could not have provided any services to the issuer in connection with debt issuance or have undertaken other activities in connection with the debt issuance that could give rise to commercial activity. If we have understood that logic correctly, there is no reason why debt purchased in a private transaction is inherently less of a *bona fide* secondary market transaction than debt purchased on an established securities market—instead, the requirements listed above in clauses (i) and (ii) appear to be the primary relevant factors.

In attempting to identify conditions that could distinguish true secondary market purchases of debt from purchases that are somehow integrated with the origination of the debt, the IRS and Treasury might find it useful to refer to guidelines for “collateralized loan obligation” (“CLO”) structures. Tax advisors often provide guidelines in CLO structures for the purposes of ensuring that an offshore loan acquisition vehicle is not engaged in a lending business for purposes of section 864.¹⁰⁴ Those guidelines often attempt to distinguish an originator of debt from a secondary purchaser of debt, and in that context look to factors such as:

(i) whether the purchaser of debt in the secondary market had the ability to evaluate the debt, and determine its value, before purchasing the debt and after the debt had already been funded (or least had in place a binding commitment to fund) by the originator;

(ii) whether there was a decent time period between the origination of the debt and the

¹⁰³ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(B)(2).

¹⁰⁴ For an example of model CLO guidelines, see James M. Peaslee and David Z. Nirenberg, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS AND RELATED TOPICS (5th ed. 2018), Appendix C.

secondary market purchase;

(iii) whether the purchaser of debt in the secondary market participated in negotiating the terms of the debt (presumably with an eye toward a future purchase);

(iv) whether the originator of the debt was prepared to hold the debt on its books as a long-term investment at the time of origination;

(v) whether the originator was related to the purchaser or controls the purchaser or might be viewed as acting in concert with the purchaser (consistent with the requirement above in the 2025 Proposed Regulations); and

(vi) whether the acquiror in the secondary market purchases such a large portion of the debt as to suggest a significant level of influence over the management of the debt going forward (again as a potential suggestion that this might give rise to privity between the borrower and the purchaser of the debt).

Perhaps factors such as these, or other factors taken from market practice in the CLO space, might prove useful to the IRS and Treasury in considering the appropriate scope of the secondary market safe harbors.

- ii. *Clearly articulate a general principle for determining whether an acquisition of debt is investment or commercial activity for purposes of section 892(a) and revise the examples accordingly*
 1. Consider retention of the standard in the 2011 Proposed Regulations for distinguishing investment and commercial activity versus developing a new paradigm

In considering the facts-and-circumstances test, we observe as an initial matter that the acquisition of debt or any other asset (other than as a dealer) is not ordinarily considered to constitute commercial activity. For that reason, we believe that the 2025 Proposed Regulations require the addition of *some activity* that is clearly related to the acquisition of debt, but not fully integral to it, in order to find the existence of commercial activity arising from the debt acquisition. We also believe, as discussed immediately below, that the 2011 Proposed Regulations provided a serviceable framework for identifying such activity, but that the 2025 Proposed Regulations, in their current form, do not provide a clear alternative framework.

As discussed above, the 2011 Proposed Regulations drew a distinction between investments in bonds and loans, on the one hand, and activities giving rise to a “banking, financing or similar business” on the other.¹⁰⁵ The reference to a “banking, financing or similar business” was generally understood to allow taxpayers to look to well understood standards under section 864 and the relevant common law for distinguishing a mere investment in debt (the outlay of capital in the expectation of receiving a return thereon) from the *business of providing*

¹⁰⁵ Prop. Treas. Reg. § 1.892-4(e)(1)(iii) (2011).

*debt financing as a service to customers and in conjunction with related services (such as underwriting) to customers.*¹⁰⁶ This distinction in turn allowed taxpayers to look to certain traditional factors under section 864, including whether the lender: (i) holds itself out to the public as willing to make loans to the public, (ii) has privity with the borrower and negotiates the terms of the debt instrument directly with the borrower, (iii) receives compensation for specific services, such as structuring or marketing/syndicating a debt instrument, or (iv) engages in other activities that have the effect of creating a *customer* relationship between the lender and the borrower (*i.e.*, turning the lender into a service provider to the borrower).¹⁰⁷ While the application of these standards to specific debt acquisitions often involved the exercise of professional judgment (as is the case with any facts-and-circumstances test), and while practitioners have expressed a desire for more specific guidance on how to apply those standards for purposes of section 892, the standards generally provided guidance sufficient to allow the market for sovereign investment in U.S. debt obligations to function with a reasonable degree of predictability. We are not aware of this standard leading to systemic, or even widespread, abuse, and would note that the factors listed to be considered under the 2025 Proposed Regulations in many ways seem to draw from this standard, or something similar to it. Accordingly, we believe the standard in the 2011 Proposed Regulations for distinguishing investment from commercial activity in the context of debt acquisition remains a viable conceptual framework, and whatever its imperfections, its retention (perhaps with modifications to address concerns of the IRS and Treasury) would have the benefit of avoiding risk of market disruption in light of the fact that market participants already have adjusted to it.

The IRS and Treasury appear to have abandoned the old reference to a “banking, financing or similar business,” because they intend that the 2025 Proposed Regulations reflect the view that “commercial activity” is a broader term, but they have not provided a clear alternative standard. Instead, the 2025 Proposed Regulations provide a list of eight non-exclusive factors for evaluating whether a debt acquisition constitutes an investment or commercial activity, but they do not articulate the *principles that make those factors relevant*. The first factor listed in the 2025 Proposed Regulations, for example, is 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.” On its face, this standard could be interpreted as something very much like the presence of a “banking, financing or similar business” mentioned in the 2011 Proposed Regulations. Under a literal reading of the text of the 2025 Proposed Regulations, however, there is no guidance to tell taxpayers how to weigh any of the eight factors without the benefit of this historical context, and the examples, taken as a whole, suggest that, with very narrow exceptions, negotiating terms of a loan on original

¹⁰⁶ The courts and the IRS view a lender who is a bank or thrift as rendering services to the borrower by making a loan. See *Burbank Liquidating v. Comm’r*, 39 TC 999 (1963); Rev. Rul. 72-238, 1972-1 C.B. 65.

¹⁰⁷ See generally, *e.g.*, David S. Miller, *The Tax Guide to Offshore Lending*, 74 TAX LAW. 523 (Spring 2021). Similar standards are used in market-standard guidelines for offshore “collateralized loan obligation” vehicles, which are securitization vehicles, usually incorporated offshore, that purchase loans of U.S. borrowers on a regular basis for securitization purposes, and that need to avoid being treated as engaged in a trade or business within the United States. See also Chief Counsel Advice 201501013 (Sept. 5, 2014) (summarizing relevant caselaw); Chief Counsel Attorney Memorandum 2009-010 (Sept. 22, 2009) (same).

issuance is commercial activity and not investment, without illustrating a satisfactory unifying principle distinguishing what should be permissible from what should not.

The preamble to the 2025 Proposed Regulations does reference a potential overarching principle for differentiating investment from commercial activity when it states that: “In general, facts and circumstances would be relevant to the extent they indicate that the entity’s expected return from acquiring the debt is *exclusively a return on its capital* rather than including *a return on activities it conducts*.”¹⁰⁸ We believe that the most sensible interpretation of the standard articulated in the preamble is to allow activities aimed simply at supporting a foreign government’s return on its capital (*e.g.*, review of an issuer’s financial statements and other activities conducted for the *benefit of the debt holder*) to be treated as part of a sovereign’s investment activity, and to treat activities performed as *services to borrowers or potentially other third parties*, from which a sovereign hopes to benefit separately in some way, as commercial activity—*i.e.*, to make the relevant distinction one between return on capital versus services income.¹⁰⁹ If this is the standard the IRS and Treasury are proposing, that standard should be set forth explicitly in the text of the regulation.¹¹⁰

If the IRS and Treasury were to state an explicit principle along the lines discussed above (return on capital versus payment for services) with a sufficient level of detail, they could adopt a standard for purposes of section 892 that might have several elements in common with the definition of a “banking, financing or similar business,” but that nonetheless would be a standalone concept under section 892 and not tied explicitly to that definition. Regulations that finalize the 2025 Proposed Regulations could then accommodate situations that could arise in the future where some kind of service provided by a sovereign is properly viewed as commercial activity, even if the service might not give rise to the entirety of a “banking, financing or similar business.”¹¹¹

¹⁰⁸ 90 Fed. Reg. 57930 (Dec. 15, 2025) (emphasis added).

¹⁰⁹ A similar distinction has been recognized by the Supreme Court in *Whipple v. Commissioner*, 373 U.S. 193 (1963).

¹¹⁰ Another potential standard would be to look to the motivation behind the lending activity and inquire whether the activity is intended, or appears intended, to create a customer relationship between the lender and the borrower. For example, although a sovereign lender provides no services to a borrower currently, perhaps the lender could otherwise hold itself out as willing to make loans in the future in a way that might encourage the borrower to look to the sovereign lender as a future source of financing. To be clear, we believe the prior standard of looking to whether the sovereign lender was in a “banking, financing or similar business” addressed these points well.

¹¹¹ At one level, this standard seems similar to the prior standard of a “banking, financing or similar business”—in that both standards appear to differentiate the mere outlay of capital for a return from the outlay of capital combined with some additional activities now or in the future (*e.g.*, currently providing the borrower with services or developing customer relationships to be exploited in the future) on the part of the sovereign debt acquirer. To the degree the acquirer of debt is compensated for “activities it conducts” for the benefit of the borrower or otherwise as a service to third parties—such as acting as underwriter for the borrower—those activities appear to give rise to the kinds of services that are part of a “banking, financing, or similar business.” In fact, it is difficult for us to imagine circumstances in which such activities could give rise to commercial activity without also being at least suggestive of a “banking, financing or similar business.” For that reason, if

2. Particular applications of a new framework in the context of an acquirer negotiating and structuring the terms of a debt on original issuance

One point in the 2025 Proposed Regulations that we believe deserves particular consideration is the degree to which an investor is able to maximize the return on, or protect the integrity of, its investments in an active manner without giving rise to commercial activity. For example, one criterion mentioned in the facts-and-circumstances test is whether “the acquirer materially participated in negotiating or structuring the terms of the debt.” Under the prior standard that looked to the existence of a banking, financing or similar business, this factor was viewed as evidence that a lender and a borrower had privity with one another, which then could be a factor suggesting either that they had a customer relationship, or the potential to develop such a customer relationship in the future. This factor is also best understood in the context of underwriters that structure the terms of debt instruments for purposes of creating a marketable instrument, which can be viewed as a service to a borrower. For these reasons, conservative advisors told their sovereign clients to limit, or avoid altogether, circumstances in which they were negotiating actively the terms of a debt instrument prior to funding it.

We do *not* believe, however, that this market practice should be viewed to suggest that *any* negotiation of the terms of a debt instrument should give rise to commercial activity *in all cases*. To the contrary, there are clear cases where a sovereign is acting entirely in its capacity as an investor and is negotiating the terms of a debt instrument solely for the purposes of *protecting its investment, maximizing investment returns, or pursuing an inherent governmental function*.

Example 5 of the 2025 Proposed Regulations, titled “Debt Restructuring as Commercial Activity,” appears to penalize a foreign government for engaging in the kind of negotiations that we believe are fully consistent with the foreign government’s status as an investor and are not suggestive of commercial activity. In that example, a sovereign investor purchases debt at a time when there are “no objective indications” that the debt could end up in default due to a deterioration in the issuer’s credit quality. Once the issuer is in bankruptcy, however, the sovereign creditor becomes a member of the creditors’ committee and, as a result, is presumed to have materially participated in negotiating and structuring the terms of a modified debt instrument given to creditors in connection with the bankruptcy. This activity is deemed in the example to give rise to commercial activity.¹¹²

If Example 5 in fact reflects the intentions of the IRS and Treasury to treat activities fundamentally related to the protection of a prior capital investment as commercial activity and not as investment activity, we recommend that the point be made explicitly through a clear

the 2025 Proposed Regulations are intended to suggest some set of activities that constitute commercial activity but that are not connected to a “banking, financing or similar business” or are not undertaken with the objective of furthering such a business, we would recommend that this point be more clearly articulated than it currently is in the 2025 Proposed Regulations.

¹¹² Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(D)(6)(ii) (Ex. 5).

explanation of the relevant guiding principles when the 2025 Proposed Regulations are finalized. However, we also recommend that the IRS and Treasury do *not* adopt such a narrow definition of investment activity. Such a narrow definition could mean that no sovereign debt acquisition ever would qualify as an investment for these purposes except in cases where the sovereign acts in an excessively passive, and potentially irresponsible, manner. For minority creditors, committee participation is often a defensive necessity: Creditors that remain outside a committee may face materially worse outcomes, including inferior exchange ratios, exclusion from key negotiations, or effective subordination through the issuance of new super-senior or “priming” debts.¹¹³

Accordingly, we recommend a reworking of Example 5 in Prop. Treas. Reg. § 1.892-2(c)(1)(i)(D) to acknowledge that participation on a creditor’s committee in a bankruptcy can be consistent with investment. If a creditor participates in a creditors’ committee in bankruptcy to ensure the best possible return on its prior investment (and nothing more), that participation appears to us to be consistent with the actions of a rational investor and responsible custodian of capital. Participation on such a committee does not typically involve the management of the debtor’s operations, nor does it entail directing the debtor’s business activities.¹¹⁴ On the other hand, if a sovereign uses such participation as an opportunity, for example, to establish a closer relationship with a borrower with a view toward future business, or as an opportunity to be compensated by others for providing structuring advice, then such activities could reasonably be said to give rise to commercial activity and not to pursue investment returns.

Consistent with our view of creditor participation on a creditors’ committee, we think the regulations also should address the case in which a creditors’ committee requires members to provide additional capital, commonly referred to as “new money,” as a condition to maintaining the value or priority of an existing investment.¹¹⁵ In distressed scenarios, such funding is not

¹¹³ These dynamics are particularly acute in the context of so-called “lender-on-lender violence,” a now-common feature of distressed capital structures. In many recent restructurings, certain creditor groups have used liability management transactions to advantage themselves at the expense of similarly situated lenders through priming financings, drop-down structures, or selective exchange offers. The risk posed by such transactions is not that a creditor will fail to extract sufficient commercial return, but that its existing investment will be involuntarily subordinated or stripped of value by the actions of other creditors. Participation on a creditors’ committee in this setting is therefore not indicative of operating a lending business, but rather a means of defending a proprietary interest against opportunistic value transfer by third parties.

¹¹⁴ Moreover, under *Alabama Asphaltic Limestone Co. v. Commissioner*, 315 U.S. 179 (1942), when a corporation is deeply insolvent, its creditors effectively displace shareholders as the holders of the proprietary interest in the enterprise. In such circumstances, creditors are viewed as exercising “effective command” over the debtor’s assets not to operate a business, but to protect their economic stake in a failing investment. Committee participation in this context represents the management of a proprietary interest in distressed property, a function fundamentally distinct from engaging in a commercial lending business.

¹¹⁵ Backstop premiums and similar commitment fees paid in connection with new money financings likewise should generally be treated as investment-related returns rather than compensation for services performed in a loan origination business. The economic value of the backstop arises from capital at risk and balance-sheet exposure, not from the performance of lending services, underwriting activities, or ongoing origination functions. See N.Y. State Bar Ass’n Tax Section, Report No. 1500, *Report on Certain Fees* at 3 and 21-24 (Sept. 13, 2024).

undertaken to negotiate superior economics or to expand a lending business, but instead functions as a replacement for, or reinforcement of, an investment in a company that has already lost value and needs additional cash funding to operate without undertaking undue risk in respect of such funding. As such, where the economic position of the issuer has deteriorated, the provision of additional capital is often the only means by which an existing creditor can prevent further erosion of its position or an outright loss. Of course, our proposed Example 5 and the current Example 5 both assume that the creditor's initial debt position was acquired at a time when the borrower was not already at risk of default and where there was no objective reason to expect the debt investment to need restructuring. By contrast, it might be advisable to contrast these cases with an example of a creditor that purchases debt of a distressed issuer at a steep discount with the intention of being able to rework the debt and enter into a closer financing relationship with the distressed borrower.

Another instance in the 2025 Proposed Regulations where underlying guiding principles are unclear and a regulatory example may be thought to imply an overly broad scope for commercial activity is Example 2 in the 2025 Proposed Regulations. Prop. Treas. Reg. § 1.892-4(c)(1)(i)(C)(6) includes the “percentage of equity in the debt issuer held or to be held by the acquirer” as one of the factors relevant to determining whether the debt acquisition is an investment or commercial activity. Example 2 then illustrates the principle by treating as an investment a loan of \$50 million to a corporation in which the lender owns 80 percent of the stock, worth \$80 million. We believe both the factor and the example illustrating it could be more useful if it were made clear why equity ownership is relevant for these purposes. We believe that equity ownership is relevant to the extent that a lender has a large enough equity investment in a borrower to be concerned with the overall success of the borrower's business and to be motivated to advance funds to the borrower as a means of supporting that equity investment. The decision by equityholders to capitalize an entity with equity or with a combination of debt and equity, including at the outset of an investment, is a fundamental feature of investment decisionmaking. As the Supreme Court noted, “[t]his Court has observed repeatedly that ... a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not”¹¹⁶ In that vein, Congress has generally afforded significant latitude in the Code to the basic decision of whether to capitalize a business enterprise with debt or equity, perhaps most notably in the legislative history to section 7701(o), in which Congress noted such a decision was generally to be excluded from the application of the economic substance doctrine.¹¹⁷

¹¹⁶ *Comm'r. v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (citations omitted). See also *Higgins v. Smith*, 308 U.S. 473, 477 (1940); *Old Mission Portland Cement Co. v. Helvering*, 293 U.S. 289, 293 (1934); *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

¹¹⁷ See Staff of the J. Comm. on Tax'n, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act,"* JCX-18-10 (March 21, 2010), at 152 (“The provision is not intended to alter the tax treatment of certain basic business transactions . . . Among these basic transactions are [] the choice between capitalizing a business enterprise with debt or equity . . .”). We observe that whether the resulting instruments actually constitute debt or equity is a distinct determination (and rightly the subject of scrutiny under federal income tax law) from whether the taxpayer in effect has a choice of whether to capitalize the entity with debt or equity for federal income tax purposes.

If we have understood the rationale behind this factor correctly, then Example 2 might be expanded to illustrate this point in different contexts. For example, the size of the equity position relative to the debt position might be more relevant than the absolute percentage of equity in a borrower held by a creditor. Perhaps there are circumstances where the debt position could be larger than the equity position and still be viewed as an investment motivated by a desire to support the equity. Presumably, there are equity investments well below the 80 percent mentioned in Example 2 that could support the treatment of a debt acquisition as an investment under this rationale, just as there are equity investments that are simply too small to be considered serious drivers of a shareholder's decision to provide funding to the issuer. Examples exploring these points in more detail could provide welcome guidance.

In that vein, as a variation on Example 2 in Prop. Treas. Reg. § 1.892-2(c)(1)(i)(D), we further recommend considering an example where a group of equityholders, including a foreign government with a minority equity investment, is offered the opportunity to negotiate, structure, and make a loan to an equity issuer.¹¹⁸ We believe that such a loan also is consistent with investment activity.

Example 1 is a closer case. As described above, the Example provides that the making of a single loan is commercial activity under the circumstances described therein. However, the description of such circumstances is quite brief. The Example posits that representatives of the controlled entity offered to provide debt financing to a foreign corporate borrower and that such representatives structured and negotiated the terms of the loan. To be sure, these facts are potentially indicative of something beyond the simplest form of investment, as they suggest that the controlled entity solicited a borrower and held itself out as a lender. However, no information is given as to the broader context for the controlled entity's actions and their purpose, so that one cannot fully evaluate their relevance. What if, for example, the controlled entity's purpose clearly was unrelated to any wider commercial agenda, or was in furtherance of a governmental objective, such as providing needed support to an important national industry, or developing the government's economic agenda? Accordingly, while we acknowledge the IRS and Treasury's position that a single loan in a certain context can give rise to commercial activity, we recommend that Example 1 be expanded to explain more fully what the essential elements of that context are.

iii. Articulate a clearer standard for attributing actions of another person to an acquirer of debt

The 2025 Proposed Regulations state that, for purposes of applying the debt acquisition safe harbors and the facts-and-circumstances factors, "actions by an agent *or a person otherwise*

¹¹⁸ In a situation where an equity issuer becomes distressed, equityholders (particularly fund investors) will often make "rescue loans" *pro rata* in accordance with their equity investment to safeguard those investments, and even minority shareholders are motivated in such circumstances to make a loan in order not to be subordinated to the other equityholders that will now have creditor positions. Of course, it is also possible in such scenarios that the loans will not be made fully *pro rata* relative to equity investments for any number of reasons.

acting on behalf of the acquirer are treated as the actions of the acquirer” (the “**agency/on behalf of rule**”).¹¹⁹

The proposition that a principal is attributed the actions of its agent is an obvious, noncontroversial statement of tax law. Indeed, even though this proposition is generally applied, there is no mention of it in section 892 or the existing regulations under section 892; nor is it mentioned anywhere in section 864 or the related regulations relating to the determination of whether a foreign person is engaged in a U.S. trade or business.¹²⁰ It appears, therefore, that this sentence was added to the 2025 Proposed Regulations to establish that actions by “a person otherwise acting on behalf of the acquirer” are treated as actions of the acquirer.¹²¹ As discussed below, the addition of this language to the section 892 regulations for the first time is problematic because the language appears to expand the scope of agency attribution in a manner that is uncertain and potentially overbroad. As a result, we are concerned that inclusion of the agency/on behalf of rule in the 2025 Proposed Regulations in its current form could result in market confusion and, because it is susceptible of being interpreted in an unintendedly broad manner, could disrupt widely accepted market transactions and practices as market participants steer clear of certain relationships in order to avoid being attributed commercial activity of persons who might be considered to act on their behalf. If there are specific relationships that the IRS and Treasury wish to target with the agent/on behalf of rule, they should describe them more clearly than the current formulation does. Accordingly, we recommend that the IRS and Treasury reconsider this phrase with a view to clarifying and limiting its scope, or to replacing it with an alternative approach, and in either case to consult with market participants before finalizing this provision to ensure that it does not have unexpected or inappropriate consequences.

We acknowledge that the IRS and Treasury may have a legitimate interest in clarifying at least certain aspects of agency attribution, and there is some uncertainty about when an agency relationship might exist, even without regard to the expanded agency/on behalf of rule. The law of agency may vary from jurisdiction to jurisdiction and, in any event, there is a question as to whether there is a federal tax law concept of agency that overlays particular state, local, or foreign agency principles. For example, in *YA Global Investments, LP v. Commissioner*,¹²² the Tax Court recently held that the relationship between the parties was one of “agency,” which is defined by the Restatement (Third) of Agency as “the fiduciary relationship that arises when one person (a ‘principal’) manifests assent to another person (an ‘agent’) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or

¹¹⁹ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(A) (emphasis added).

¹²⁰ Thus, for example, section 864(c)(5)(A) and Treas. Reg. § 1.864-7(d)—which limit attribution from an agent in certain circumstances—are predicated on the unstated proposition that, absent these special rules, an agent’s actions or office would be attributed to its principal for purposes of section 864.

¹²¹ Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(A).

¹²² 161 T.C. 173 (2023).

otherwise consents so to act.”¹²³ The Tax Court interpreted this definition by concluding that “[i]t is ‘[t]he power to give interim instructions [that] distinguishes principals in agency relationships from those who contract to receive services provided by persons who are not agents.’”¹²⁴ We believe this interpretation is based on a misreading of the Restatement, but if the interpretation is accepted, it suggests that a foreign person can avoid an agency relationship by forgoing the power to give interim instructions, which in turn would present a change to how agency was understood prior to this case.¹²⁵

Given the uncertainty that may exist around the concept of agency, we acknowledge that the IRS and Treasury may have a legitimate interest in adopting an attribution rule that looks beyond mere agency, as determined under non-tax common law, in order to achieve greater clarity as to where an action of one party properly is attributed to another and to ensure that the resulting rule is consistent with appropriate tax policy. This expansion could cover situations where, for example, one party invests another with irrevocable authority in order to avoid an agency relationship, in reliance on *YA Global*. There may be other situations that are tantamount to an agency relationship but do not meet the technical standard for agency under common law. However, we are concerned that the insertion of the agency/on behalf of rule in its current formulation into the regulations under section 892 will not result in clarity but instead will create confusion.

The principal concern we have with the agency/on behalf of rule is that it appears to create a standard for attribution independent of the agency standard that could be interpreted more broadly than intended. For example, acquirers of debt often engage with counterparties (or their agents), including banks, underwriters and placement agents, that are acting in their own interest and for their own benefit (or for their counterparty principal), and are not agents of the debt acquirer but may have interests that coincide with the interests of the debt acquirer (including the interest in consummating a transaction). Thus, to illustrate one type of situation that is implicated by this provision, as indicated in Example 3 of the 2025 Proposed Regulations,¹²⁶ it is not uncommon for a potential acquirer of privately placed debt to indicate its interest to financial institutions acting as placement agents and to communicate the terms on which the acquirer would be willing to purchase that debt. If these placement agents take the acquirer’s communications into account in structuring the terms of the debt for their issuer clients, could these placement agents be viewed as “acting on behalf of the acquirer”? Such a reading of this language—which appears at least plausible—would be a significant expansion of established agency principles as they currently are understood and has the potential to create a

¹²³ Restatement (Third) of Agency, § 1.01 (Am. Law Inst. 2006) (hereinafter “**Restatement**”).

¹²⁴ 161 T.C. at 182 (quoting Restatement, § 1.01 cmt. f).

¹²⁵ This troubling interpretation appears to be based on a misreading of the Restatement, since that same Restatement comment provides that, “to the extent the parties have created a relationship of agency . . . the principal has a power of control even if the principal has previously agreed with the agent that the principal will not give interim instructions to the agent or will not interfere in the agent’s exercise of discretion.” Restatement, § 1.01 cmt. f.

¹²⁶ Prop. Treas. Reg. § 1.892-4(c)(1)(D)(4).

significant chilling effect on inbound investment activity. Variations on this paradigm are quite common. For example, an acquiror (or its representatives) may deal with counterparties or other market participants that clearly are not agents of the acquiror but that may structure transactions taking into account terms that they believe (or are told) would meet the interests of potential acquirers.

Moreover, to the extent the agency/on behalf of rule is intended to be limited to the application of section 892, we do not understand the policy rationale for adopting a separate standard under section 892 that is different from the standard applicable under section 864 or for other purposes under the Code. Although “commercial activity” is defined differently than “engaged in a U.S. trade or business,” we do not believe that this distinction is relevant to the issue of attribution of activities to a taxpayer. To the contrary, a uniform standard of agency attribution would facilitate compliance with these rules by investment funds and agents, since they typically have relationships with both sovereigns and other foreign persons on whose behalf they are often investing in the same transactions.

We note that the 2025 Proposed Regulations do not coordinate the agency/on behalf of rule with other provisions of the section 892 regulations (including the Final Regulations). For example, as discussed above, the recently finalized trading safe harbor in Treas. Reg. § 1.892-4(c)(2) provides that effecting transactions in stocks and securities for a foreign government’s own account does not constitute commercial activities “regardless of whether they are effected by the foreign government through its employees or through a broker, commission agent, custodian, or other independent agent and regardless of whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions.”¹²⁷ We think that this well-established standard for trading in debt would be difficult to coordinate with the agency/on behalf of rule in the context of the acquisition of debt.

In conclusion, we believe that the agency/on behalf of rule in its current formulation is too unclear to be a workable standard. If the IRS and Treasury determine that some form of the agency/on behalf of rule is necessary, we recommend that they explain its intended scope and provide guidance and examples illustrating when it does and when it does not apply. Alternatively, consideration should be given simply to clarifying that a person will be treated as a principal in an agency relationship even if it grants plenary irrevocable authority to its agent and forgoes the power to give interim instructions (and adding any other clarifications the IRS and Treasury deem necessary to prevent avoidance of agency on the basis of technical exceptions in the Restatement). In all events, before finalizing the 2025 Proposed Regulations with the “on behalf of” phrase, we recommend that the IRS and Treasury consult with market participants to develop and articulate a more refined standard for attribution. This would help to ensure that the final regulation achieves the intended objectives and is not susceptible of an unintendedly broad interpretation that could cause market confusion or disruption.

¹²⁷ See also Treas. Reg. § 1.892-5(d)(5)(ii) (similar rule for partnerships). This rule conforms to Temp. Treas. Reg. § 1.892-4T(c)(1)(ii) and incorporates into section 892 the safe harbor for trading in securities for a taxpayer’s own account found in Treas. Reg. § 1.864-2(c)(2).

b. Recommendations regarding effective control

- i. *Distinguish between rights that convey effective control over the management and operations of a business and rights that permit the monitoring and protection of investment*

The preamble to the 2025 Proposed Regulations requests comments as to the circumstances, if any, in which a minority equity interest holder in an entity should be treated as having effective control (or as having at least 50 percent of the voting power) of the entity if managerial or board-level decisions of the entity are subject to veto rights of the holder and other holders.¹²⁸ We discuss our recommendations below.

As a threshold matter, we note the implicit assumption that the inquiry into effective control is reserved for *minority* equity interests—that is, interests that confer less than 50 percent of the voting power and economic rights in an entity. Accordingly, before determining whether effective control might be present, it is first necessary to determine whether control is present under the 50-percent threshold in section 892(a)(2)(B)(i). In the absence of such control by reference to the 50-percent threshold, effective control traditionally has been understood to refer to leverage over an entity held by a minority equityholder that gives the minority equityholder an outsized ability to direct the entity’s actions through informal means. The examples referred to in Treas. Reg. § 1.892-5(c)(2)(iii) are (1) rights to a mineral and ability to regulate all businesses engaged in its extraction when the entity’s business primarily consists of extracting and marketing that mineral and (2) creditor rights over the type of investments and other major decisions that an entity can make.¹²⁹ We believe that those examples, as well as the other references to effective control discussed below, support the notion that effective control properly is understood as leverage over an entity amounting to an ability to direct action, as opposed to mere veto rights without more.

For purposes of the initial inquiry into whether an investor has 50 percent of the voting power over an entity, there is significant caselaw looking to the overall effect of an equity holder’s rights against an entity for purposes of measuring basic voting power at the shareholder level. *Alumax v. Commissioner*,¹³⁰ for example, stands for the proposition that the voting power of stock held by a majority shareholder can be reduced for tax purposes (and, by implication, the voting power of a minority shareholder increased) via arrangements that give a minority shareholder veto rights over material decisions typically within the sole discretion of the board.¹³¹ Under the *Alumax* court’s reasoning, although the voting power of shares is typically

¹²⁸ 90 Fed. Reg. 57932 (Dec. 15, 2025).

¹²⁹ Treas. Reg. § 1.892-5(c)(2)(iii)(H) (Ex. 7), (I) (Ex. 8).

¹³⁰ *Alumax Inc. v. Comm’r*, 165 F.3d 822, 826 (11th Cir. 1999).

¹³¹ *Alumax*, 165 F.3d at 824. See also *Framatome Connectors USA Inc. v. Comm’r*, 118 T.C. 32 (2002) (rejecting taxpayer’s argument that it held more than 50 percent voting power in a subsidiary (despite not holding 50 percent of vote or value on the face of governing documents) due to certain tie-breaking rights in a separate shareholder agreement); *Fish v. Comm’r*, T.C. Memo. 2013-270 (rejecting taxpayer’s argument that its voting interest in an entity was reduced below 50 percent due to other holders’ “veto powers over...many management

measured by the power to elect directors to the board,¹³² this convention assumes the board possesses the traditional powers associated with boards under corporate law. If those powers are fettered by contractual veto rights, the determination of voting power must be adjusted accordingly.

Exactly how the voting power should be adjusted to produce a specific percentage of voting power, however, is not clear from the caselaw.¹³³ *Alumax* and similar authorities characterize veto and consent rights over matters that are traditionally the province of the board as according up to a 50-percent voting right to the holder of such right as to each specific matter.¹³⁴ As described below, this point is of some significance to markets, because as discussed below, it is common for sovereign investors to seek to protect their investments through various consent rights and veto rights, and it is equally common for them to structure those rights with the intention of not triggering 50-percent voting control over an entity for these purposes. However, the extension of this seemingly simple premise to situations where only some subset of board matters are the subject of veto rights or in which there are multiple veto right holders quickly becomes an arithmetic quagmire. Short of the most straightforward circumstances, such as when there are only two shareholders and unanimous vote of the board is required on all matters, we expect the impact of veto rights on the mechanical 50 percent vote test to be so

matters” because the taxpayer retained the ability to elect three out of five board members); *cf. Hermes Consol. Inc. v. U.S.*, 14 Cl. Ct. 398 (1988) (rejecting the IRS’s argument that a taxpayer that held a 33-percent voting interest in an entity along with independent right to approve or disapprove fundamental corporate decisions equivalent to those of the only other interest holder in fact held 50 percent of voting power because the taxpayer lacked the power to elect 50 percent of the board).

¹³² See Rev. Rul. 69-126, 1969-1 C.B. 218 (“[P]articipation in the management of the subsidiary through election of the board of directors is the criterion of the voting power in this case.”); Rev. Rul. 84-6, 1984-1 C.B. 178 (“The voting power held by a shareholder of any class of stock is the shareholder’s proportionate share of the percentage of the total number of directors that that class of stock is entitled to elect as a class.”); *Erie Lighting Co v. Comm’r*, 93 F.2d 883 (1st Cir. 1937) (reversing the Board of Tax Appeal’s decision that a class of stock that did not have the right to participate in the election of directors but had significant voting rights over various management matters was voting stock because “these matters are not a basis for holding that ... the preferred stockholders control the management of the business enterprise. That is left to the board of directors.”).

¹³³ We note that *Alumax* and related authorities demonstrate how the presence of negative rights (veto rights) can preclude the assertion of positive rights (*i.e.*, the voting power typically accorded to the holder of a majority of common stock), not how negative rights can equate to control over an entity’s management or operations. The outcome in *Hermes* demonstrates the analytical challenges associated with successfully arguing that negative control rights accord a minority shareholder 50 percent or more of voting power. *Hermes*, 14 Cl. Ct. at 403 (noting that the taxpayer “came close” to controlling 50 percent of voting power but “never quite reached that key percentage” because, while the taxpayer had 50 percent of the voting power with respect to several key decisions, the fact that it held “barely” 50 percent of such power with respect to these decisions due to the presence of another holder with identical rights meant that the failure to hold 50 percent of rights to appoint board members caused the taxpayer to fall below 50 percent overall voting power). See our more detailed discussion of the distinction between negative and positive rights, *infra*.

¹³⁴ See *Alumax*, 165 F.3d at 826 (noting that, on the board of a two-shareholder corporation that can only act by unanimous vote, the power to elect 80 percent of the board is equivalent to the power to elect 50 percent of a “normal” board and finding that, with respect to the six matters that required unanimous approval of the two shareholders of the entity, “the [taxpayer]-elected directors’ voting power effectively declined to 50 [percent].”).

nuanced as to not be useful analytically. Accordingly, we believe the purposes of section 892 are best served by also analyzing veto and consent rights under the “effective control” prong of the statute and inquiring as to whether such rights have the effect of conferring on a minority shareholder the kind of extraordinary ability to direct action that is the hallmark of the effective control standard.

In interpreting the “effective control” standard of section 892(a)(2)(B)(ii), the 2025 Proposed Regulations state that “effective control is achieved by 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.” All of the facts and circumstances related to the interests are considered in determining effective control.

Initially, we recommend the examples be revised to start with the more readily apparent and long-understood situation in which a significant minority equity investment alone can itself convey “effective control” that was first noted in the 1988 Temporary Regulations, *i.e.*, because the balance of the entity’s equity interests are sufficiently dispersed among holders that, under the facts and circumstances, there is no bloc that could counter the significant minority equityholder’s influence over the entity’s management and operations. In addition, although we view as appropriate a facts-and-circumstances approach that focuses on control over the management and operations of a commercial entity, we request clarification on the question of how “right[s] to veto decisions” are taken into account. This is a matter of importance to the markets because it is common for sovereign investors (like other investors) holding minority positions in entities to negotiate veto or consent rights over various matters such as related-party transactions between the manager of the entity and its affiliates, extreme deviations from the entity’s purported business model, the incurrence of debt beyond a certain level, declaration of bankruptcy, or elevation of expenditures above some agreed upon margin. The intent of such veto or consent rights is to ensure that the minority investor *is protected* against managerial decisions that either may *disadvantage the minority investor* relative to other stakeholders, or *fundamentally alter the entity’s financial profile* without the minority investor’s consent.¹³⁵ Such rights properly are perceived as a means of allowing the investor to preserve and monitor its capital investment, *not* as a means of exercising control over the management or operations of the entity. We believe that it would be appropriate for the final regulations on effective control to acknowledge this distinction and to treat such *defensive* rights as not giving rise to effective control in the absence of other extraordinary facts.

This recommendation is consistent with the approach adopted by the IRS and Treasury regarding the definition of a QPI in the Final Regulations, where the IRS and Treasury drew a distinction between (i) oversight rights, veto rights and consultation rights allowing for an investor to “monitor and protect” its investment, and (ii) other rights allowing for more direct input into the day-to-day operation of a partnership.¹³⁶ This recommendation also is consistent

¹³⁵ Investments in real estate projects often have unlimited capital commitments and veto rights over extraordinary increases in proposed budgets is often the only way that minority investors can protect against unlimited liability.

¹³⁶ T.D. 10042, 90 Fed. Reg. 57912 (Dec. 15, 2025). The Final Regulations specify that rights to monitor or protect capital investment may include oversight or supervisory rights in the case of major strategic decisions such as admission or expulsion of a partner, amendment of the partnership agreement, or dissolution of the partnership,

with the following observation in our 2012 Report in the similar context of the limited partner exception under the 2011 Proposed Regulations (now the QPI exception in the Final Regulations):

[Consultation and veto] rights are most common in the case of private equity funds because limited partners in private equity funds are required to commit capital for a significant period of time and to forego [sic] the kind of liquidity available from publicly traded securities and from hedge funds that provide liquidity by periodic redemptions of capital. For that reason, most significant institutional investors in private equity funds demand greater oversight rights in order to monitor and protect their investments effectively. We believe that it would be inappropriate to require these investors to forgo these contractual protections as a condition to claiming the benefits of section 892.

For the reasons discussed above, we believe that Example 5 under Prop. Treas. Reg. § 1.892-5(c)(2), relating to veto rights, should be reworked to provide more detail as to what specific veto rights (as applied to the facts) caused the sovereign in that example to have effective control. Example 5 describes an investor with the right to appoint one of the three directors in the entity, and this appointed director in turn has rights “unilaterally” to veto dividend distributions, material capital expenditures, sales of new equity interests and the operating budget of the entity.

As an initial matter, we agree that the ability to veto an operating budget or any “material” capital expenditure could under certain circumstances confer effective control over an entity—for example, if the implication of those veto rights is that the entity in question is unable to operate at the most basic day-to-day level without the explicit consent of the holder of such rights. In this rather extraordinary instance, if a veto over the operating budget constitutes the ability to reject the budget over any line item, no matter how trivial, that right could in fact allow the veto holder enough leverage to direct the managerial and operational decisions of the entity. A similar outcome could result if a veto holder in fact had a choke-hold over any but the most trivial of capital expenditures. Such veto rights, however, are uncommon in our experience, and are not indicative of the kinds of protections that sovereign investors often are granted. As indicated above, it would be more common for a sovereign to have a veto right over an *increase* in the operating budget year-over-year above some specified percentage,¹³⁷ or to have a veto right over a single capital expenditure that would be so large relative to an entity’s balance sheet as to be unexpected and to raise questions about whether the entity is pursuing the general business strategy the investor expected at the time of making the investment. Again, the purpose of such rights is to allow an investor to *protect and monitor its investment*, and we would

unusual and non-ordinary course deviations from previously determined investment parameters, extending the term of the partnership’s governing agreement, merger or conversion of the partnership, or disposition of all or substantially all of the partnership’s property outside of the ordinary course of the partnership’s activities. Treas. Reg. § 1.892-5(c)(5)(iii)(B)(2)(ii).

¹³⁷ The appropriate percentage may vary depending on the type of business, its historical variation in costs, and its short and intermediate term plans for growth, among other factors; however, we would expect the number to be determined so as to distinguish between ordinary course variations in budget and more extraordinary operational shifts.

welcome more detailed examples that made the distinction between such protective and defensive veto rights, on the one hand, and rights the give an investor leverage to participate in the entity’s management on an inappropriately granular level, on the other. We recommend that the principle of distinguishing between rights associated with monitoring and controlling and investment and rights conferring the ability to direct management or operations be clearly drawn in the regulations and that the examples be modified to contain sufficient detail to allow for analysis based on this distinction.

Moreover, for purposes of simply illustrating the types of actual effective control that may have concerned Congress (or may concern the IRS and Treasury), we do not think it is helpful to tax administration to base foundational examples on fact patterns that represent atypical (and practically abusive) arrangements structured to disguise effective control. We do not believe, for example, that many practitioners were surprised to learn that effective control could arise from the ability to appoint the single director that in turn could appoint or dismiss unilaterally the senior manager of an entity as in Example 4, or from the kind of power described in Example 7, where the foreign government regulates an entity’s business and owns crucial inputs to that business. We do, however, believe that the market would benefit from a more detailed and nuanced discussion of the kinds of minority veto and consent rights that are considered consistent with the protection and monitoring of an investment, as opposed to those that are viewed as going beyond that limited purpose.

We discuss below several ways in which future guidance could inform the determination of whether one or more veto rights provide the right to monitor and protect an investment or effective control.

1. Clarify that “effective control” under section 892(a)(2)(B)(ii) means the ability to direct an entity’s management or operations

We recommend that the standard for establishing effective control in the 2025 Proposed Regulations be revised to clarify that control of “operational, managerial, board-level, or investor-level decisions” equates to “effective control” of an entity when control over such decisions amounts to an outsized influence over the entity that allows a minority shareholder to direct action at the entity by directing the management or operations of the entity.

We note that this emphasis on the direction of management and operations is consistent with how the term “effective control” has been interpreted for other purposes under the Code.¹³⁸ Before 1984, section 367(a) caused certain outbound transfers of property to be taxable to the U.S. transferor unless the IRS issued a ruling that the transfer was made without a principal purpose to avoid tax.¹³⁹ Under the ruling guidelines, a taxpayer would receive favorable consideration if, immediately after the exchange, the shareholders of the U.S. corporation did not own (directly or indirectly) more than 50 percent of the total combined voting power of the

¹³⁸ Other bodies of law also define control in terms of managerial authority. *See, e.g.*, Delaware General Corporation Law § 144(e)(2), discussed *infra*.

¹³⁹ Section 367(a)(1) (1983); *see* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 131(a), 98 Stat. 494, 662 (1984) (eliminating exception to rule if nonavoidance was established to the satisfaction of the Secretary).

transferee foreign corporation.¹⁴⁰ However, the IRS declined to issue favorable rulings in several instances where shareholders of the U.S. corporation held less than 50 percent of voting stock but had “effective control” of the transferee foreign corporation determined based on the ability to direct an entity’s “day-to-day activities.”¹⁴¹ In one section 367(a) ruling, the shareholder of a domestic target corporation held 43.2 percent of the voting stock of the acquiring foreign corporation. The IRS ruled that the shareholder exercised “effective or practical control” over the foreign corporation because the shareholder was the president and treasurer of the foreign corporation—“the two most significant corporate officers”—and therefore was “in a position to direct [its] day-to-day activities.”¹⁴²

Similarly, Treasury regulations define “effective control” for purposes of section 4943 (imposing tax on the “excess business holdings” of a private foundation under certain circumstances) as “the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise.”¹⁴³ Authorities under section 4943 draw a distinction between taxpayers that “have a voice” in management decisions and those that have authority over operation and management in determining effective control.¹⁴⁴ In one ruling, where any board action of the foundation required majority approval and the relevant individuals held the right to appoint certain members to the board of directors and executive committee (but not a majority of the members), the IRS observed that, while these individuals had “a voice in the management and policies of [the corporation], they [did] not control [the corporation].”¹⁴⁵ In another ruling, the IRS concluded that where relevant individuals held the right to appoint directors to the finance, executive development, and compensation committee (but not the majority of directors on any committee), the individuals had a “voice in the management and policies” of the corporation without controlling it.¹⁴⁶

Similarly, in recent amendments to the Delaware General Corporation Law, a “controlling shareholder” of a corporation is defined, among other tests, as a shareholder having: “the power functionally equivalent to that of a stockholder that owns or controls a majority in voting power of the outstanding stock of the corporation entitled to vote generally in the election of directors by virtue of ownership or control of at least $\frac{1}{3}$ in voting power of the outstanding stock of the corporation entitled to vote generally in the election of directors or in the election of directors

¹⁴⁰ Rev. Proc. 68-23, 1968-1 C.B. 821.

¹⁴¹ *See, e.g., infra* note 142.

¹⁴² PLR 8707006 (July 30, 1984). The IRS also noted that the shareholder “holds knowledge and expertise in the business of [the foreign corporation] that no other individual has.”

¹⁴³ Treas. Reg. § 53.4943-3(b)(3)(B)(ii); *see also* PLR 9336040 (June 15, 1993) (ruling that an individual who had “full authority to run [the corporation]’s day-to-day operations,” and “[did], in fact, oversee its affairs, and all of its operating subsidiaries, on a full-time basis” exercised effective control over the corporation).

¹⁴⁴ *See infra* notes 145-146.

¹⁴⁵ PLR 7926107 (Mar. 28, 1979).

¹⁴⁶ PLR 8052107 (Oct. 3, 1980).

who have a majority in voting power of the votes of all directors on the board of directors *and power to exercise managerial authority over the business and affairs of the corporation.*¹⁴⁷

We recommend the standard in Prop. Treas. Reg. § 1.892-5(c)(2) be revised to accord with the authorities discussed above by clarifying that “effective control” of an entity equates to *the ability of a minority equityholder to compel action by the entity through the direction of the management or operations* of the entity, taking into account all sources of leverage available to the minority equityholder.¹⁴⁸

2. The guidance interpreting “voting rights” under section 892(a)(2)(B)(ii) should distinguish between positive and negative rights, and absent extraordinary circumstances, purely negative rights should not be treated as giving rise to effective control

We recommend that the 2025 Proposed Regulations be refined to account for differences in types of “voting rights” for purposes of section 892(a)(2)(B)(ii). Specifically, we recommend that guidance distinguish between rights that empower a holder to direct an entity to take action (which we call positive rights, *e.g.*, to appoint an executive or to compel the exploitation or disposition of a material asset) and rights that empower a holder to veto a decision or prevent an entity from taking action (which we call negative rights). As discussed above, because we believe that effective control is best understood as the ability to direct the management and operations of an entity, we do not recommend that negative rights be treated as giving rise to effective control, except in cases, such as those discussed above, where veto rights amount to a 50-percent voting interest or provide enough leverage to confer positive control rights.

In analyzing negative control rights and the situations in which they could confer effective control, we think it important to distinguish rights that belong only to a single investor and rights that are shared by many. For example, if one person has the ability to veto an operating budget (as in Example 5), under certain extraordinary circumstances, that person can have effective control over an entity, as discussed above. On the other hand, if several investors

¹⁴⁷ Delaware General Corporation Law § 144(e)(2)(c) (emphasis added).

¹⁴⁸ In connection with the discussion above, we note an instance in which the 2025 Proposed Regulations abandon the facts and circumstances analysis in favor of the mechanical “special rule” contained in Prop. Treas. Reg. § 1.892-5(c)(2)(ii), which contains an internal inconsistency. This rule provides that a foreign government is “deemed to have effective control of an entity if the foreign government is, or under [Treas. Reg. § 1.892-5(a)(1)] *controls* an entity that is, a managing partner or managing member of such entity, or *holds or controls* an entity that holds an equivalent role with respect to such entity under local law applicable to the entity.” (Emphasis added.) Although we understand the rationale for finding control over an entity where the foreign government controls the party that manages the entity, we do not see the reason for: (i) requiring control in the case of an actual managing partner or managing member, but then (ii) replacing that requirement with the lower “*holds or controls*” standard for an entity that plays an equivalent role under local law. Furthermore, it is not clear why, say, a 5-percent stake in an entity that is the local law equivalent of a managing partner (which stake would normally be conferred for economic, not governance, reasons) automatically should cause the foreign government to be deemed to control the relevant downstream entity. We recommend instead that the special rule adopt a uniform requirement of “control” over all entities performing this managing function, and that the phrase “*holds or controls*” be replaced with a simple requirement of “control.”

in an entity have the ability to veto the operating budget, then none of them really has the leverage to force its will on the others—the veto rights merely become a requirement that no operating budget can be adopted without the consensus of the relevant investors. In such a case, we think it would be inappropriate to view each investor with such a veto right as having effective control over the entity in question, because no single investor has a power that is both necessary and sufficient to cause the entity to act. Although the 50-percent-or-greater (vote or value) ownership test under section 892(a)(2)(B)(i) clearly contemplates that it is possible for two investors to “control” the same entity for purposes of section 892, we do not believe that two investors should be deemed to have effective control of the same entity. As discussed above, we believe that effective control is best understood as the ability to direct the management and operations of an entity, which is something greater than the ability to create a managerial deadlock. We recommend that the guidance be clarified to provide that only one person (including its affiliates to the extent described below) can have effective control of an entity under section 892(a)(2)(B).

Finally, for the reasons stated above, we think that circumstances in which a minority investor can achieve “effective control” (*i.e.*, direction of management and operations) over an entity via the presence of its negative veto or consent rights is likely to be uncommon in the marketplace, and therefore we caution against basing examples for generally applicable guidance on unusual fact patterns more likely to be found in situations of impermissible abuse or avoidance. As noted above, we recommend examples follow the model of the 1988 Temporary Regulations and clearly demonstrate the more common fact patterns where “effective control” could be present.

- ii. *Provide procedures for controlled entities and integral parts of the same foreign sovereign to obtain comfort from the IRS that they will not be aggregated for purposes of determining “effective control” under section 892(a)(2)*

The preamble to the 2025 Proposed Regulations requests comments as to the circumstances, if any, in which controlled entities within the meaning of Treas. Reg. § 1.892-2T(a)(3) are “functionally independent of one another” and, accordingly, should be considered separately for purposes of analyzing effective control under section 892(a)(2).¹⁴⁹

As a default rule, the 2025 Proposed Regulations would provide that, for purposes of the “effective control” analysis under section 892(a), the aggregation rule of Temp. Treas. Reg. § 1.892-5T(c)(1)(i) would apply such that any interest owned directly or indirectly by an integral part or controlled entity would be attributed to the foreign sovereign. The IRS and Treasury have inquired under what circumstances this default rule should not apply, and we understand this question as being related to when two controlled entities should be presumed to act, or not, in concert with one another in order to combine different formal and informal levers over an

¹⁴⁹ We recommend that the IRS and Treasury also consider the circumstances where aggregation might not be appropriate for purposes of determining whether a partnership interest held by a sovereign is a QPI or for purposes of determining whether holdings by different functionally independent entities should be aggregated under an upward attribution test for purposes of various numerical thresholds that might be relevant (*e.g.*, the 10-percent ownership threshold applicable to the portfolio interest exemption).

entity to achieve a common result. We discuss below some examples of how the aggregation rule might be relevant in practice, some general principles and factors that could be employed to rebut a presumption of aggregation and suggest procedures the IRS and Treasury might employ to permit taxpayers to rebut the presumption of aggregation.

For example, if one controlled entity is a major creditor of a corporation, and another controlled entity has a significant minority interest in the corporation, the determination of whether those two entities together have effective control over the corporation may depend on whether the two controlled entities combine forces to direct the corporation's management and operations, as opposed to each controlled entity acting on a purely standalone basis without consulting or even informing the other. Similarly, if two or more sovereign wealth funds owned by the same sovereign each invest in a corporation's stock on a purely independent and uncoordinated basis, they may find themselves owning in the aggregate stock in excess of the 50-percent threshold for control (or in excess of the 10-percent threshold for qualifying for the portfolio interest exemption, in the case of debt acquired through different special purpose vehicles not claiming section 892 benefits) even though neither sovereign wealth fund was aware of the other's purchase or able to influence the other's purchase in any manner.

The fact that two entities might be “functionally independent” as a formal matter—*e.g.*, because they belong to different branches of a single foreign government, or have different mandates—strikes us as likely necessary, but not sufficient, for a determination that they should be respected as standalone entities for purposes of determining effective control. Rather, we recommend a standard based on the existence or nonexistence of a formal or informal understanding *to make a coordinated investment*.

A similar standard is applied elsewhere in the Code. For example, for purposes of segregating shareholder groups under section 382, a group of persons that have “a formal or informal understanding amongst themselves to make a coordinated acquisition of stock” are treated as a single entity that can then be tested as five-percent shareholder whose acquisition of stock is taken into account in determining whether an ownership change has occurred. Treas. Reg. § 1.382-3(a)(1)(i) provides that “[a] principal element in determining if such an understanding exists is whether the investment decision of each member of a group is based upon the investment decision of one or more other members.”

Similarly, Treas. Reg. § 1.355-6(c)(4) provides that two or more persons that “have a formal or informal understanding among themselves to make a coordinated acquisition of stock” (and therefore are treated as acting pursuant to a “plan or arrangement”) are aggregated in determining whether a 50-percent or greater interest in such corporation has been acquired.¹⁵⁰ As under section 382, “a principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders.”¹⁵¹

¹⁵⁰ Treas. Reg. § 1.355-6(c)(4)(ii).

¹⁵¹ *Id.* The examples under Treas. Reg. § 1.355-6(c)(4)(ii) are nearly identical to those in Treas. Reg. 1.382-3(a)(1)(i). Treas. Reg. § 1.355-6(c)(4)(iii). We note that, while sections 355(d) and 382 also have more mechanical aggregation rules to determine the level of stock ownership held by related persons and do not seek to determine the existence or absence of effective control, the coordinated acquisition standard employed in

When applying such a standard for purposes of determining effective control, a presumption of coordinated activity may be generally appropriate in the case of two or more controlled entities of the same sovereign, given the reasonable expectation that different parts of the same political entity generally would operate in conjunction with one another to pursue a coordinated agenda. However, it is equally clear that there are circumstances in which such a presumption may be reasonably rebutted. Numerous foreign governments invest in the United States and elsewhere through multiple independent entities or bodies with wholly distinct governance structures, financial assets, investment objectives, and personnel and often are prevented under their local laws from engaging in the kind of coordinated activities that might cause different sources of influence over an entity to be aggregated to give rise to effective control.

For example, some sovereigns have established more than one sovereign wealth fund with the requirement that decision-making and reporting within each fund be siloed off from decision-making and reporting within other funds. This approach has been justified on the grounds that such compartmentalization allows for healthy competition between funds and allows different funds to serve as a testing ground for different investment strategies and philosophies without outside interference from “sister” entities. An aggregation rule that would apply without exception to controlled entities that are either not permitted or are practically unable to share the information about the details of their holdings with each other is overinclusive, and in many instances, unadministrable.

The challenge that faces the IRS and Treasury in determining when to respect two or more controlled entities as true standalone entities is an evidentiary one. The IRS would need a certain level of comfort before assuming that two entities controlled by a non-U.S. sovereign are operating sufficiently independently of one another for these purposes, and it is difficult to know what specific evidence the IRS could rely on as a general matter. Below is a list of several factors that we think provide some objective indication that two or more controlled entities operate independently of one another:

- Entities serving distinct governmental interests. Entities such as pension funds, especially in a federal government system, can operate completely separately from each other and in many respects view themselves as *servicing different governmental interests*, albeit within a larger system.
- Independent boards. Controlled entities that are board-operated and have different boards from one another with limited overlapping membership and operate independently, at least as a formal matter.
- Independent officers and employees. Similar to the independent board factor, establishing that no officers or employees of the controlled entities overlap also helps demonstrate that the controlled entities are independent. Additionally,

those sections still seems a useful construct in determining the existence or absence of effective control under section 892.

demonstrating that officers and employees are not provided any incentives (monetary or otherwise) to invest alongside other controlled entities of the same foreign government provides additional support for actual independence.

- Separate governing documents. Controlled entities governed by separate charters, bylaws, operating agreements, constitutions or other governing documents setting forth the entity's governance and operations are formally independent and this fact may support a finding that they are functionally independent.
- Investment committee. Many controlled entities delegate investment decision-making to separate investment committees whose members are different from the members of the boards. A lack of overlapping membership can be an indication that decision-making is in the hands of specialists expected to operate on a standalone and independent basis.
- Separate legal and regulatory regimes. Sometimes, controlled entities are subject to different legal and regulatory requirements in their jurisdiction. For example, pension funds and sovereign wealth funds of the same government often operate under different legal requirements and are subject to different controls on their activities. This may indicate both formal and actual independence.
- Separate offices. The physical separation of the operations of controlled entities may be an indicator of formal and actual independence.
- Separate investment strategies. The controlled entities may have different guidelines, terms, or written investment strategies that govern the investments they make. Controlled entities operating under different investment strategies generally would be expected to react differently to situations as they arise and may have conflicting motivations. This may demonstrate both formal and actual independence.
- Separate financial statements. Another factor supporting formal independence is the maintenance of separate financial statements by the controlled entities.
- Written confidentiality policy. Having a written policy or policies in place requiring confidentiality with regard to the entity's investments, effectively preventing information sharing or coordination with other controlled entities. This indicates formal independence.

Of course, while these factors, and others, may be helpful in suggesting a level of independence among different controlled entities, none of the factors is dispositive. Furthermore, given the variety of legal regimes in place in different jurisdictions, as well as differences in cultural norms and political expectations, it is difficult to apply these factors uniformly to all the situations that may be relevant in respect of different sovereign investors. For that reason, we recommend that the IRS and Treasury consider allowing controlled entities seeking certainty that they are treated as independent from one another for purposes of effective control to apply for a private letter ruling or similar type of comfort. The process we envision is

one in which the relevant investors are allowed to explain to the IRS their governance situation in detail and explain any “guardrails” that might be in place to prevent coordinated activity between them. The IRS in turn would have the ability to ask questions and conduct diligence before issuing formal comfort. To the degree the IRS and Treasury believe the factors above are useful, such factors might be listed, along with other factors considered relevant, in a Revenue Procedure for investors seeking a ruling.

Another alternative/additional procedure that might be useful could be one where sovereign entities are allowed to take a view that they are separate from another and certify that fact to the IRS with an explanation of the relevant circumstances. An example where such a procedure might be useful could be the accidental and uncoordinated acquisition by two independent entities of stock in the same issuer, which is discovered by them after the fact. In such a case, if the entities later became aware of each other’s ownership of stock in the same corporation, perhaps they could take the view that purchases should not be properly aggregated, while alerting the IRS to relevant facts through some sort of self-certification process. The filing of such a certificate might provide comfort to withholding agents. The degree to which such a procedure is viable will depend to some degree on whether certain upward attribution tests (*e.g.*, under section 318 or section 892) are viewed as purely mechanical.

Furthermore, if the IRS agrees that such a process is viable and useful, we see no reason why the opportunity to present facts to the IRS for purposes of obtaining a ruling and undergoing diligence should be limited to “controlled entities,” as opposed to “integral parts” of a foreign government. While it is true that “integral parts” are, by definition, viewed as extensions of a single foreign sovereign in a basic sense, the distinction between and “integral part” and a “controlled entity” is sometimes difficult to delineate precisely, and in any event, there may be cases where an investor that is considered an integral part of a foreign government can operate independently of another integral part or of a different controlled entity and be able to demonstrate its independence to the satisfaction of the IRS.

VII. Recommendations Related to the Final Regulations and Issues Not Addressed By the 2025 Proposed Regulations or Final Regulations

a. Remove the No Control Requirement from the QPI exception

We recommend that the Final Regulations be revised to remove the No Control Requirement from the definition of QPI, consistent with the approach in the 2011 Proposed Regulations. The addition of the No Control Requirement in the Final Regulations is a deviation from the approach of the 2011 Proposed Regulations that has caught many sovereign investors off guard and significantly raised the stakes for them if a fund in which they own a majority of the equity is engaged in commercial activity for reasons beyond the sovereign’s control. In addition, we believe that the No Control Requirement is not necessary to achieve the policy goals of ensuring that only truly passive partners benefit from the QPI exception and preventing the use of partnerships to achieve inappropriate tax benefits under section 892 for truly commercial businesses. Rather, the introduction of the No Control Requirement introduces unnecessary confusion to the application of the other well understood QPI requirements derived from the limited partner exception in the 2011 Proposed Regulations, as there is significant conceptual overlap between the elements of control under section 892(a)(2)(B) and Tres. Reg. § 1.892–

5(a)(1) and the QPI requirement that the foreign government not have rights to participate in the management and conduct of the partnership's business.

i. Align with the approach in the 2011 Proposed Regulations

The limited partner exception from the 2011 Proposed Regulations was introduced to prevent a sovereign investor that is a controlled entity from losing the benefits of section 892 altogether under the “all or nothing” rule merely because of commercial activity that the investor is *deemed* to be engaged in by virtue of holding a purely passive investment in a partnership or other entity, such as a limited liability company, that is classified as a partnership for U.S. federal income tax purposes. The approach adopted by the 2011 Proposed Regulations was to remove the benefits of section 892 in respect of any income from commercial activity earned by a sovereign investor because of a limited partnership investment, but otherwise not to strip the limited partner of the benefits of section 892 altogether by attributing commercial activity to the limited partner.

The 2011 Proposed Regulations did not impose a limit on the amount of equity in a partnership that a sovereign entity investor could hold (or require that the partner not have effective control over the partnership) while also benefitting from the limited partner exception.¹⁵² In fact, the preamble to the 2011 Proposed Regulations clearly implied that the limited partner exception could apply even in cases where the partnership in question might constitute a controlled commercial entity.¹⁵³ Specifically, in describing the effect of the limited partner exception the preamble provided:

Although the commercial activity of a limited partnership will not cause a controlled entity of a foreign sovereign limited partner meeting the requirements of the exception for limited partnerships to be engaged in commercial activities, the controlled entity partner's distributive share of partnership income attributable to such commercial activity will be considered to be derived from the conduct of commercial activity, and therefore will not be exempt from taxation under section 892. Additionally, *in the case of a partnership that is a controlled commercial entity, no part of the foreign government partner's distributive share of partnership income will qualify for exemption from tax under section 892.*¹⁵⁴

We agree with the approach taken in the 2011 Proposed Regulations that any amount of equity in a partnership can be consistent with qualification for the limited partner exception, provided that the interest in question otherwise constitutes a passive investment that does not confer the ability to participate in the management and conduct of the partnership's business.

¹⁵² Prop. Treas. Reg. § 1.892-5(d)(5)(iii) (2011). Although we acknowledge that there are forms of “voting” control or effective control that could have caused a partner to fail to qualify for the limited partner exception under the 2011 Proposed Regulations or fail to satisfy the definition of QPI under the Final Regulations, the concepts are not coterminous.

¹⁵³ 76 Fed. Reg. at 68119 (November 3, 2011).

¹⁵⁴ *Id.* (emphasis added).

The most common example of a situation in which this point is relevant is one where a sovereign entity decides to purchase 50 percent or more of the capital interests in an investment partnership—in fact it is not uncommon for sovereigns to own nearly 100 percent of the capital interests in entities that constitute a “fund of one” or “separately managed account.” In those cases, the control over the management of the investment partnership is ceded to a third-party investment manager or “sponsor” that is charged with all investment and business decisions taken on behalf of the partnership (and potentially compensated through an interest in the profits generated by partnership). Sovereigns typically would seek to avoid realizing any commercial activity income through such an arrangement and would demand covenants from the sponsor to use a high level of care to avoid such income. However, sovereigns typically also would have looked to the limited partner exception as an important backstop protection in the event that somehow the partnership did turn out to be engaged in commercial activity inadvertently (*e.g.*, through an acquisition of a loan that the IRS considers to constitute commercial activity under a facts-and-circumstances test even though the sponsor viewed the loan as an investment). We note that these arrangements, which relied on the structure of the limited partnership exception in the 2011 Proposed Regulations, are prevalent in the market.

ii. The No Control Requirement is unnecessary to give effect to the QPI exception and the purposes of section 892 in the partnership context

The preamble to the Final Regulations indicates that the four requirements for a QPI are needed to ensure that the QPI exception is only available to foreign governments that are passive investors in a partnership. In this regard, we believe the requirements that the foreign government does not have (i) personal liability for claims against the partnership, (ii) legal authority to bind or act on behalf of the partnership, or (iii) rights to participate in the management and conduct of the partnership’s business are sufficient to ensure that the sovereign is acting as a passive investor. To the extent the No Control Requirement is concerned with governance rights and voting power, it is redundant with requirement (iii) and thus superfluous to this goal. To the extent the No Control Requirement is concerned with economic ownership, it is irrelevant to this goal, as discussed above.

We acknowledge that a foreign government should not be able to use a fiscally transparent entity to avoid the effects of the “all or nothing” rule with respect to its operation of a business or commercial activity through a controlled entity.¹⁵⁵ The classic example of this

¹⁵⁵ Recently, in PLR 202343034 (July 28, 2023), the IRS made the following comments regarding the differences between the terms “controlled entity” and “controlled commercial entity”:

The addition of partnerships to the regulatory definition of the term “entity” for purposes of a [controlled commercial entity] under section 892(a)(2)(B) was a limited departure from the treatment of partnerships as aggregates for purposes of section 892 and does not dictate the meaning of the term “entity” in the phrase “controlled entity.” The change applied to a different and broader class of partnerships through which foreign governments invested and was not limited to controlled entities as defined in Treas. Reg. § 1.892-2T(a)(3). Specifically, a [controlled commercial entity] includes any entity at least 50 percent owned by a foreign government, while only an entity that is 100 percent owned by a foreign sovereign can be a controlled entity. For purposes of section

problem is that a foreign government should not be able to operate a serious commercial enterprise—say, a national airline—and achieve the benefits of section 892 for certain assets held by that enterprise (*e.g.*, the airline, which for all intents and purposes is operated as a full-fledged commercial business, should not be able to claim section 892 benefits with respect to dividends and interest earned by holding its operating capital in U.S. stocks or bonds). Such a result would be possible if the entity operating the airline were a partnership or disregarded entity that was not subject to the controlled commercial entity rule or the per se corporation rule of Treas. Reg. § 301.7701-2(b)(6). However, because both would-be disregarded entities and partnerships that are engaged in commercial activities and controlled by a foreign government are controlled commercial entities by application of section 892(a)(2)(B) and Treas. Reg. § 1.892-5(a)(1), sovereign investors do not enjoy section 892 benefits for income received by or from these entities.¹⁵⁶ In the foregoing airline example, the controlled commercial entity rule ensures that section 892 benefits are denied with respect to the airline’s operating capital invested in U.S. stocks or bonds (in the same manner as if the partnership were a corporation). We believe that because the controlled commercial entity rules do not allow sovereigns to benefit from their exemption under section 892 with respect to their distributive share of income from a partnership that engages in commercial activity, eliminating the No Control Requirement would not afford sovereigns with any competitive advantage or impermissible tax benefit as compared to other non-sovereign investors.

In addition to the loss of section 892 benefits with respect to partnership income, under the Final Regulations, a foreign government partner that is a controlled entity suffers a second legal consequence for holding a controlling interest in a partnership that is engaged in commercial activity: attribution of the partnership’s commercial activity to the partner and *total* loss of all section 892 benefits for *everything* owned by the partner. This result is precisely the outcome the limited partner exception in the 2011 Proposed Regulations was intended to avoid for passive partners and is a trap for the unwary in the far more common case encountered in today’s markets—a foreign government holding the majority of the equity in an investment fund.¹⁵⁷ This separate application of *two distinct* and *adverse* consequences of violating the No Control Requirement is also, frankly, counter-intuitive and confusing to practitioners.

In the case of a foreign government taking a majority equity position in an investment fund, it would be typical for the sponsor to undertake, at some specified level of care, to operate the fund so as to avoid engaging in commercial activities at the fund level. However, consider the case where the fund is treated as engaged in commercial activity—perhaps, returning to an example discussed above, because of a mistaken legal judgment made by the sponsor as to whether the facts and circumstances of a debt acquisition give rise to commercial activity, or

892(a)(2)(B) only, Treas. Reg. § 1.892-5(a)(3) reflects the decision that treatment of a partnership as an entity is most appropriate for that provision.

¹⁵⁶ See, *e.g.*, PLR 202551011 (Sept. 16, 2025) (noting that “[t]he Treasury Department and the IRS recognized that use of partnerships by foreign governments could present concerns similar to those presented by disregarded entities but chose to address those concerns differently [] ... by treating them as potentially CCEs”).

¹⁵⁷ Alternatively, the foreign government may simply have committed enough capital to a more widely marketed fund to account for the majority of fund equity.

because of an operational error. It is likely in such a case that the vast bulk of the fund's investments have nothing to do with the commercial activity and dwarf the commercial activity in terms of economic importance. In such a case, it strikes us as inappropriate to deny the sovereign entity investor the benefit of section 892 in respect of *all* investments made by the investor, especially given that the foreign government usually would have no control over the sponsor's day-to-day decisions or operations.

iii. The No Control Requirement confuses application of the QPI exception given the conceptual overlap with limited partner concepts

We note that the standard of the QPI requirements to establish passive investor status and the control standards in section 892(a)(2)(B) have considerable overlap. For example, under the Final Regulations, a partnership interest that has “rights to participate in the management and conduct of the partnership’s business,” which means “rights to participate in the day-to-day management or operation of the partnership’s business,” is excluded from the QPI exception, the determination of which is based on all the facts and circumstances and on the “totality of all rights arising from all direct or indirect interests of the holder.”¹⁵⁸ Under the 2025 Proposed Regulations, any interest in a partnership that, based on all the facts and circumstances, “either separately or in combination, results in control over the operational, managerial, board-level, or investor-level decisions of the entity” conveys “effective control” of the partnership under section 892(a)(2)(B) and Treas. Reg. § 1.892-5(a)(1).¹⁵⁹ The conceptual overlap of these distinct standards makes their tandem application unintuitive and the determination of whether the QPI exception applies unnecessarily circuitous. Given these conceptual similarities, it does not seem that the reference to effective control in the No Control Requirement is necessary to achieve the purpose of the QPI rules as we understand them.

For the reasons discussed above, we recommend removing the No Control Requirement. The issues policed by the No Control Requirement are more appropriately addressed under the controlled commercial entity rules of section 892(a)(2)(B) and Treas. Reg. § 1.892-5(a)(1). However, if the No Control Requirement is maintained, the rule is a significant enough departure from the 2011 Proposed Regulations that we would suggest it be re-proposed for additional taxpayer comment.

b. Clarify the interaction of the inadvertent commercial activity exception with the QPI exception, and the availability of the inadvertent commercial activity exception at the partnership level

We appreciate the Final Regulations' generally taxpayer favorable modifications to the 2011 Proposed Regulations on inadvertent commercial activity. However, the statement in the preamble to the Final Regulations that “. . . the inadvertent commercial activity exception and the qualified partnership interest exception are provided for different reasons and apply to different situations” could be read as suggesting that a foreign government that invests in a partnership

¹⁵⁸ Treas. Reg. § 1.892-5(d)(5)(iii).

¹⁵⁹ 90 Fed. Reg. 57931 (Dec. 15, 2025).

interest that it reasonably believes is a QPI would be wholly precluded from relying on the inadvertent commercial activity exception if the IRS determines that it does not satisfy the requirements to be a QPI.

Alternatively, the preamble discussion could simply be intended to confirm that the continuing due diligence and other requirements apply for purposes of determining whether the failure to avoid engaging in commercial activity was reasonable. We believe the latter approach is more appropriate, because the purpose of the inadvertent commercial activity exception is to provide relief from the “all or nothing” rule in cases where a taxpayer has engaged in commercial activity (or, as in the case of partnership attribution, is merely *deemed* to be engaged in commercial activity) though a misjudgment or mistake that was reasonable. We see no reason why the policy underlying that exception should not apply to a partner that made a reasonable-but-ultimately-incorrect judgment that its interest in a partnership constituted a QPI. We therefore recommend that the IRS and Treasury clarify that the inadvertent commercial activity rule can apply to an investor that reasonably believes that it has satisfied the QPI exception—as long as each of the other requirements for the inadvertent commercial activity exception is satisfied separately.

In addition, we recommend that the IRS and Treasury clarify that a partnership can rely on the inadvertent commercial activity exception for purposes of determining whether the partnership is a controlled commercial entity. If the IRS and Treasury do not accept our recommendation to remove the No Control Requirement from the definition of QPI, then this point becomes particularly significant. Specifically, without the inadvertent commercial activity exception, a controlled entity owning more than 50 percent of a partnership’s equity (as a limited partner) could lose the benefits of section 892 altogether because of a reasonable misjudgment or mistake on behalf of an unrelated general partner that would have been eligible for the exception had the controlled entity engaged in the inadvertent commercial activity directly. This application of the “all or nothing” rule to a controlled entity that is merely deemed to engage in commercial activity because of a passive investment is exactly the result that the original limited partner exception was intended to avoid.

c. Provide guidance clarifying the treatment of certain dispositions of partnership interests

One issue that we believe deserves to be addressed more fully in the regulations under section 892 is the treatment of gain arising from the disposition of a partnership interest.¹⁶⁰

By way of background, the preamble to the Final Regulations notes that commenters had asked for a rule to the effect that the sale of a partnership interest by a sovereign would be

¹⁶⁰ We recognize that this issue might be more appropriate for guidance under Treas. Reg. § 1.892-3 and Temp. Treas. Reg. § 1.892-3T, which are focused on characterizing income earned by foreign governments, as opposed to the activities conducted by them which are addressed in the 2025 Proposed Regulations. However, we felt it appropriate to discuss the issue in this Report in an effort to assist the IRS and Treasury in what we understand to be a larger project of identifying technical aspects of the current rules under section 892 that provide, in our view needlessly, technical hurdles to the policy of creating a well understood and predictable investing environment in the United States for investors seeking to benefit from section 892.

entitled to the benefits of section 892 to the same extent that a sale of the partnership's underlying assets would be so entitled.¹⁶¹ The most common circumstance in which this issue has potential consequences is one where a sovereign owns equity in a partnership that in turn owns equity in a United States real property holding corporation within the meaning of section 897 (a "USRPHC"). If the sovereign's indirect ownership in the USRPHC stock is not a controlling interest for purposes of section 892, the partnership could sell the USRPHC stock, and distribute the proceeds to the sovereign partner, with the sovereign partner enjoying an exemption from any related gain by virtue of section 892.¹⁶²

By contrast, if the sovereign were to sell the partnership interest directly, there is a question as to whether the gain from the sale of a partnership interest that is attributable to USRPHC stock would similarly benefit from section 892 because Treas. Reg. § 1.892-3T(a)(2) states that gain on the disposition of an interest in a partnership is not exempt from taxation under section 892. Read literally, this rule has the effect of turning nontaxable sales into taxable sales simply because the assets sold might be held in an investment partnership, rather than directly.

We believe that it is reasonable to argue that this result is prevented by the application of section 897(g), which provides that:

Under regulations prescribed by the Secretary, the amount of any money, and the fair market value of any property, received by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate shall, to the extent attributable to United States real property interests, be considered as an amount received from the sale or exchange in the United States of such property.

If one reads this provision as applying to the sales of partnership interests for purposes of section 892 as well as section 897, then it would appear that the gain realized by a foreign sovereign investor on the disposition of the partnership interest in the example above would be treated simply as a sale of the underlying USRPHC stock, and the benefits of section 892 would be unaffected by the fact that the stock was held in partnership form. However, the application of section 897(g) to the example above has never been explicitly confirmed by the IRS or Treasury.

In our view, a disparity in treatment on what amounts to identical items of gain in the example above presents a trap for the unwary. Sovereigns that are sensitive to this issue are likely to require that any exit from such a partnership investment be effected by a sale of USRPHC stock at the partnership level, followed by a distribution of the exempt gains to the partner. Other sovereigns legitimately may see no difference as a substantive matter in how they

¹⁶¹ 90 Fed. Reg. 57911 (Dec. 15, 2025).

¹⁶² See PLR 9643031 (July 29, 1996) ("A partner's distributive share of income from the Partnership shall be exempt under section 892 of the Code to the extent that the income would have been exempt if received directly by the partner in the same manner as received by the Partnership.").

exit the investment and may choose to sell partnership equity and perhaps unknowingly incur tax.

Accordingly, we recommend that the IRS and Treasury consider clarifying that the look-through treatment for the disposition of partnership interests provided in section 897(g) applies for purposes of section 892 as well. Such a clarification would be consistent with proposed Treasury regulations issued in 2022 (on which taxpayers were permitted to rely), allowing corporate “blockers” to own noncontrolling stakes in USRPHCs without being deemed to be engaged in commercial activity as a result of such holdings.¹⁶³ The reason for allowing the exception provided in the preamble to the 2022 proposed regulations is that a foreign government could hold noncontrolling stakes in USRPHCs directly without being deemed to be engaged in a commercial activity, and should not be penalized merely by holding those assets indirectly through a separate controlled entity.¹⁶⁴ A similar rationale was cited in the preamble to the Final Regulations when this rule was preserved for domestic blockers that own USRPHC stock.¹⁶⁵

d. Provide guidance regarding the treatment under section 892 of currency gains

We recommend that the final rules under section 892 adopt a rule that gains from transactions in non-functional currencies do not, without more, give rise to commercial activity. Sovereign investors routinely invest in jurisdictions around the world and accordingly may hold positions denominated in numerous currencies—just as would be the case for any large, international investment institution. For that reason, for the vast majority of significant sovereign investors, transactions in different currencies are simply unavoidable. Transactions, at least in physical currencies, however, are not addressed by the text of section 892, leaving open the possibility such transactions could give rise to commercial activity. We believe it would be inappropriate, however, to treat a controlled entity as engaged in commercial activities simply because it transacted in nonfunctional currencies, when avoiding such transactions may be a near impossibility for any serious investment institution. The point becomes even more clear when one considers that the Final Regulations make clear that investment and trading activities in currency *derivatives* are exempted from commercial activity, as opposed to simple positions in physical currency.¹⁶⁶

While we welcome the guidance that holding deposits in a non-functional currency does not give rise to commercial activity, we believe the specificity of that rule can lead to confusion, as sovereigns with investments denominated in different non-functional currencies attempt to

¹⁶³ Prop. Treas. Reg. § 1.892-5(b)(1)(ii) (2022).

¹⁶⁴ 87 Fed. Reg. 80097 (Dec. 29, 2022).

¹⁶⁵ 90 Fed. Reg. 57905 (Dec. 15, 2025).

¹⁶⁶ Prop Treas. Reg. § 1.892-4(e) (investments and trading in financial instruments is not a commercial activity); Treas. Reg § 1.892-3(a)(4) (defining “financial instrument” to include currency notional principal contracts, and options, forwards or futures contracts and any other similar contracts, the value of which, or any payment or other transfer with respect to which is determined by reference to a currency).

distinguish between the kind of activities related to such investments that might or might not raise a problem. If the IRS and Treasury have a specific concern related to transactions in non-functional currencies, we request that they identify it, so that sovereign investors can be clear which activities they should avoid. We see no purpose served by the current state of uncertainty.

e. Provide a transition rule for existing investments

The operation of section 892 often depends on the application of facts-and-circumstances tests without clear rules, and on the interpretation of provisions that may not be entirely clear. Consequently, foreign governments have been required to make considered judgments about the application of various rules and standards under section 892, as the size of their investments into the United States, and the potential negative consequences of mistakes or misjudgments, have both increased dramatically over the past decades.

For this reason, we believe that it is appropriate to apply some sort of transitional relief or grandfathering rule to prevent the retroactive application of regulations in a manner that could penalize interpretations of section 892 that are inconsistent with the final rules but that nonetheless represent objectively reasonable, good faith efforts to apply the rules of section 892 responsibly.

One obvious case where grandfathering strikes us as appropriate is the No Control Requirement for the QPI exception. Whatever response the IRS and Treasury believe constitutes an appropriate response to our concerns regarding this rule, discussed elsewhere in this Report, it is clear that this rule represents a deviation from the 2011 Proposed Regulations,¹⁶⁷ and we believe that many foreign governments may have had legitimate expectations that the limited partner exception of the 2011 Proposed Regulations was available for 50 percent-or-greater stakes in partnerships. We believe it would be appropriate to continue to apply the pre-existing limited partner exception to limited partnership interests held prior to the effective date of the Final Regulations, or at a minimum give the relevant limited partners a significant time period to reorganize their limited partnership interests in a manner that does not pressure them to dispose of partnership equity on a rush basis. If the IRS and Treasury are worried about people abusing a grandfathering safe harbor by “stuffing” additional capital into an existing limited partner interest, one potential approach may be to limit grandfathering to foreign governments’ capital commitments to the limited partnership as of the date the Final Regulations were published. Alternatively, the IRS and Treasury could include a 10-year transition period for a foreign government’s existing limited partner capital commitments. The 10-year transition period is consistent with the transition period in the final regulations on domestically controlled real estate investment trusts that were issued in April 2024 and should be sufficient to cover the expected life of most private equity and similar investment funds recently formed under current market conditions.¹⁶⁸

As the discussions of debt acquisitions and “effective control” indicate, we believe the 2025 Proposed Regulations require clarification. Moreover, we believe that the current lack of certainty in the market over many aspects of those rules makes grandfathering appropriate.

¹⁶⁷ See *supra* Section VII.a.

¹⁶⁸ T.D. 9992, 89 Fed. Reg. 31618 (Apr. 24, 2024).

There are many areas under current law where sovereign investors have to make difficult judgments and interpretations, and they should be evaluated on the objective reasonableness of those judgments and interpretations as of the time when they were made.

For example, to the degree a foreign government, prior to the finalization of the 2025 Proposed Regulations, exercised reasonable judgment under the then-current state of the law to structure investments or to adopt policies regarding the acquisition of debt, we agree that it is appropriate for the final regulations on these topics to be applied only on a prospective basis (as currently provided). However, we also would seek to ensure that, to the extent that prior investment structures are still in place, or that past practices might have an impact on the treatment of current investments, such structures and practices are evaluated on the basis of the rules as they existed at the time the foreign government made the relevant judgments. The appropriate inquiry should be whether a foreign government's practices represented an objectively reasonable and responsible interpretation of the law at the relevant time.