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Legislative Update

Analyzing the Impact of Proposed Section 892 Regulations on Sovereign Wealth Funds and Other Foreign Governmental Investors

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On Dec. 15, 2025, the IRS published proposed regulations under Section 892 of the Internal Revenue Code that provide additional guidance relating to the taxation of foreign government income from investments in the United States. This client alert summarizes the key changes and their practical implications.

Applicability Date

- The proposed U.S. Treasury regulations under Code Section 892 released on Dec. 15, 2025, (the Proposed Regulations) *apply to taxable years beginning on or after the date the Proposed Regulations are adopted as final U.S. Treasury regulations*.

    - ***Not Currently Effective***: Therefore, the Proposed Regulations are not currently effective, similar to proposed U.S. Treasury regulations under Code Section 892 that were issued in 2011 (the 2011 Proposed Regulations) and which were not immediately effective. However, taxpayers were able to immediately rely on the 2011 Proposed Regulations at their election.

    - The final U.S. Treasury regulations under Code Section 892 that were released on Dec. 15, 2025, (the Final Regulations) retained the general approach and structure of the 2011 Proposed Regulations, with certain revisions.

- ***No Current Reliance***: Unlike the 2011 Proposed Regulations, the preamble to the Proposed Regulations does not provide that the Proposed Regulations can be currently relied upon. Therefore, although instructive as to the IRS' expected approach regarding certain aspects of Code Section 892, there is no guarantee that the Proposed Regulations will be finalized in the same or similar form.

Acquisition of Debt: The Safe Harbors

- The acquisition of debt by a foreign government is considered a commercial activity *unless* (1) one of two safe harbors are met or (2) the acquisition of debt is more akin to "investment" activity under a facts-and-circumstances analysis.
  - For this purpose, "debt" means an obligation treated as debt for U.S. federal income tax purposes.
  - **Safe Harbor #1**: An acquisition of bonds or debt securities in an offering registered under the Securities Act of 1933 (provided the underwriters are not related to the acquirer).
  - **Safe Harbor #2**: An acquisition of debt that is traded on an established securities market, provided that:
    1. The acquirer does not acquire the debt from the debt issuer or participate in negotiation of the terms of the debt issuance (e.g., secondary acquisitions only); and
    2. The acquisition is not from a person that is under common management or control of the acquirer, unless that person acquired the debt consistent with either safe harbor.

Acquisition of Debt: Facts and Circumstances

- The acquisition of debt that does not meet either of the two safe harbors may still avoid being characterized as a commercial activity based on an analysis of all relevant facts and circumstances, including the following:
  1. Whether the acquirer solicited prospective borrowers, or otherwise held itself out as willing to make loans or otherwise acquire debt at initial issuance;
  2. Whether the acquirer materially participated in negotiating or structuring the terms of the debt;
  3. Whether the acquirer is entitled to fees or other compensation that is not treated as interest for U.S. federal income tax purposes (e.g., arrangement fees);
  4. The form of the debt and issuance process;
  5. The percentage of the debt issuance acquired by the acquirer;
  6. The percentage of equity in the debt issuer held by the acquirer;
  7. The value of that equity relative to the amount of debt acquired; and
  8. If the debt is acquired in a debt-for-debt exchange that is a "significant modification," whether there was a reasonable expectation at the time of acquisition of the original debt that the original debt would default.
- The Proposed Regulations provide five examples of a facts-and-circumstances analysis:
  - ***Example 1***: A foreign government's origination of one loan (i.e., negotiating and structuring) where the foreign government did not own any equity in the borrower is commercial activity.

- ***Example 2***: A foreign government's origination of a loan (i.e., negotiating and structuring) to a foreign corporation that it controls is *not* a commercial activity.

- ***Example 3***: A foreign government that provided terms for which it would enter into debt investments to unrelated placement agents (who participated in the structuring of the debt investments) is *not* engaged in commercial activity where it made direct investments in 10 privately placed debt securities of a U.S. corporation.

  - This example focused on the fact that the foreign government (1) did not materially participate in negotiating/structuring deal terms, (2) acquired less than 33% of the principal amount of each offering and (3) an unrelated purchaser acquired a larger percentage.

- ***Example 4***: A foreign government that acquired a "new" debt in a restructuring was *not* engaged in commercial activity where there was no expectation that the "original" debt would default and where the foreign government did not participate on the creditors' committee.

- ***Example 5***: A foreign government that acquired a "new" debt in a restructuring was engaged in commercial activity where the foreign government did participate on the creditors' committee and materially participated in negotiating and structuring the terms of the "new" debt.

Acquisition of Debt: Key Takeaways

- Consistent with the market approach prior to the Proposed Regulations, to the extent a foreign government is materially involved in negotiating and structuring a debt instrument, a foreign government will generally be engaged in a commercial activity.

  - Even a single origination can be commercial activity under the Proposed Regulations. This demonstrates how commercial activity income is broader than effectively connected income.

  - The Proposed Regulations appear to indicate that, despite listing numerous factors, the involvement of a foreign government in negotiating and structuring activities remains the most crucial factor.

- The Proposed Regulations also clarify that a foreign government's financing of an entity that it controls generally should not constitute commercial activity, even if the foreign government negotiates and structures such financing.

- The safe harbors provided in the Proposed Regulations are limited.

  - The activities covered by the safe harbors are not activities that tax practitioners have historically found problematic from a commercial activity perspective (e.g., acquisition of secondary debt where no negotiation/structuring activities have taken place).

- Commonly implemented structures, such as "season and sell" and arrangements like separately managed accounts, whereby sponsors present debt investment opportunities to foreign government investors, will continue to be analyzed from a facts-and-circumstances perspective.

  - The Proposed Regulations do not address whether the activities of an agent (e.g., investment manager or placement agent) will be attributed to the foreign government. The examples provided in the Proposed Regulations focus predominantly on the activities of the foreign government and its personnel than those who are related to it.

    - Absent additional guidance, it remains prudent for a foreign government to hold loans acquired through a season-and-sell structure through a non U.S. corporation.

    - For example, it is unclear whether the determination in Example 3 above would be different if the foreign government was related to the placement agents.

- Additionally, the examples in the Proposed Regulations clarify that participation as a member of a creditors' committee in a restructuring (which negotiates and structures the terms of a debt instrument) will be a commercial activity.

Effective Control: Overview

- Even if a foreign government owns less than 50% (directly or indirectly) of the value or voting interest of an entity, such an entity will be classified as a controlled commercial entity (CCE) if a foreign government holds (directly or indirectly) *any other interest in the entity that provides the foreign government with effective control of the entity*.

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

    - Mere consultation rights with respect to operational, managerial or board/investor-level decisions of an entity alone, however, does not rise to the level of effective control.

Effective Control: Relevant Factors

- The Proposed Regulations contain a nonexhaustive list of interests that factor in the analysis, including:

    1. Equity interests;

    2. Debt interests;

    3. Voting interests (including ability to appoint directors and veto decisions);

    4. Contractual rights;

    5. Business relationships with the entity;

    6. Regulatory authority over the entity; and

    7. Any 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."

- Furthermore, control over (or being) a managing partner or managing member of an entity will *per se* constitute effective control under the Proposed Regulations.

Effective Control: Examples Finding No Effective Control

- The Proposed Regulations contain eight examples that analyze various facts and circumstances:
  - Each example provides that (1) the foreign government holds a minority interest in the relevant entity (and in some examples, is the largest shareholder), (2) the other shareholders are unrelated and (3) generally 50% of the shareholders must approve election of directors, selection of officers and major corporate decisions.
  - ***Example 1***: No "effective control" where no other factors exist that provide foreign government additional control.
  - ***Example 2***: No "effective control" where the only additional factor is that the foreign government and entity have a management agreement in place that provides criteria for types of investments that can be made by the entity.
  - ***Example 3***: No "effective control" where the foreign government also is entitled to participate in the investment committee and has consultation rights with respect to acquisitions and sales of property of the entity.

Effective Control: Examples Finding Effective Control

- Again, each example provides that (1) the foreign government holds a minority interest in the relevant entity (and in some examples, is the largest shareholder), (2) the other shareholders are unrelated and (3) generally 50% of the shareholders must approve election of directors, selection of officers and major corporate decisions.
  - ***Example 4***: "Effective control" where the foreign government has the right to elect one of three directors that can unilaterally appoint or dismiss the manager of the entity.
  - ***Example 5***: "Effective control" where the foreign government has the right to elect one of three directors that alone can unilaterally veto dividend distributions, material capital expenditures, sales of new equity interests in the entity and the operating budget.
  - ***Example 6***: "Effective control" where the foreign government has the right to elect one of three directors but an unrelated investor derives significant revenues from the foreign government and directs its appointed director to vote with the foreign government's appointed director.
  - ***Example 7***: "Effective control" where the foreign government (which is not a shareholder) owns rights to and regulates business relating to a mineral (located in the foreign government's country) that is essential to the entity's business.
  - ***Example 8***: "Effective control" where the foreign government is a creditor (and not a shareholder) of the entity and the relevant credit agreement restricts the entity's ability to make asset dispositions, future borrowings, dividend distributions and other operational rights.

Effective Control: Takeaways

- Consistent with the market approach prior to the Proposed Regulations, mere consultation rights (including participation on an investment committee) will not alone generally give rise to a determination of effective control.
- However, the Proposed Regulations seemingly contemplate that certain consent/veto rights over operational decisions (e.g., an entity's right to make dividends, material capital expenditures, sales of new equity interests and control its operative budget) customarily provided to a foreign government could be found to confer effective control to the foreign government.
  - In that example, the foreign government was the only equity holder with those consent/veto rights. Therefore, it may be the case (but is uncertain) that such consent/veto rights are intended to confer effective control only when those rights are provided *exclusively* to the foreign government.
  - It is also uncertain whether each of the consent/veto rights described in the example would, without the others, confer effective control.
  - Presumably, other consent/veto rights related to the management or operations of an entity could potentially be problematic.
- The Proposed Regulations also confirm that being the largest equity owner of an entity is not enough to confer effective control if a foreign government does not otherwise have management or operational control over the entity.
  - It is fairly typical for a foreign government (in the aggregate) to hold up to 49% of the equity of an entity that is engaged in commercial activities. The Proposed Regulations should not impact the ability of a foreign government to do so.
- However, the Proposed Regulations broaden how effective control has historically been thought of by providing that effective control can be achieved where a foreign government does not hold an equity interest in an entity.

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