

THE JOURNAL OF FEDERAL AGENCY ACTION

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IRS Issues Final and Proposed Section 892 Regulations

Roger Wise, Susan R. Cohen, and Mohammad Ziny*

In this article, the authors review new final Department of the Treasury and Internal Revenue Service regulations that give foreign governments, their instrumentalities, and controlled entities—including sovereign wealth funds—further (and welcome) guidance with respect to investments in the United States and in U.S. private funds.

The Department of the Treasury and the Internal Revenue Service (IRS) have published final regulations under section 892 of the Internal Revenue Code¹ that largely adopt 2011 and 2022 proposed regulations, with modifications, and proposed regulations that provide guidance on when a foreign government’s acquisition of debt (including at original issuance) rises to the level of commercial activity and when a foreign government has “effective control” over an entity. The regulations give foreign governments, their instrumentalities, and controlled entities—including sovereign wealth funds—further (and welcome) guidance with respect to investments in the U.S. and in U.S. private funds.

What Is Section 892?

Section 892 broadly exempts certain investment income of foreign governments from U.S. federal income tax. A foreign government for this purpose includes an integral part or controlled entity of a foreign sovereign. Generally speaking, an integral part of a foreign sovereign is any person, organization, agency, or other body that constitutes a governing authority of a foreign country.

A “controlled entity” is a legally separate entity:

1. That is wholly owned and controlled, directly or indirectly, by the foreign sovereign;
2. That is organized under the laws of the foreign sovereign;
3. Whose net earnings only inure to the benefit of the foreign sovereign and not a private person; and
4. Whose assets vest in the foreign sovereign on dissolution.

Sovereign wealth funds and foreign governmental pension plans typically qualify as foreign governments under section 892.

The section 892 exemption generally applies to U.S.-sourced dividends, interest, and income from qualifying financial instruments. The exemption does not apply to:

1. Income from commercial activities conducted anywhere in the world (commercial activity income),
2. Income received by or from a controlled commercial entity (CCE), or
3. Gain from the sale or disposition of an interest in a CCE.

A CCE is an entity engaged in commercial activities anywhere in the world and controlled by the foreign sovereign, based either on direct or indirect ownership of a 50 percent or greater equity stake, by vote or value, or an interest providing the foreign sovereign “effective control” over the entity. For a controlled entity, this creates an “all-or-nothing” risk: any amount of commercial activity (even a *de minimis* amount) could cause the controlled entity to be treated as a CCE, denying the section 892 exemption not only for commercial activity income but also for all of the entity’s otherwise exempt investment income.

The final regulations mostly adopt the 2011 and 2022 proposed regulations to:

- Broaden the definition of “financial instruments” to explicitly include certain derivatives;
- Clarify the pathways to avoid attribution of partnership commercial activities (including by introducing the concept of a “qualified partnership interest”);
- Mitigate the oft-criticized “all-or-nothing” taint risk for controlled entities, via an “inadvertent commercial activity” exception and safe harbor;
- Narrow the application of the “per se” rule, which treated both United States real property holding corporations (USRPHCs) and foreign entities that would be so treated as “per se” engaged in commercial activity; and
- Provide that an entity’s conduct of commercial activity generally will be determined on an annual basis.

The proposed regulations address when:

- The direct or indirect acquisition (including origination) of debt by foreign governments (e.g., through private funds) results in commercial activity, and
- A foreign government is deemed to exercise “effective control” over a controlled entity (causing it to be a CCE if it has commercial activities).

Summary of Key Changes

Final Regulations

“Commercial Activity” and Derivatives

The final regulations retain a broad definition of “commercial activities,” rejecting requests to limit the definition to activity that would qualify as a trade or business under section 162 or a trade or business in the United States under section 864(b). The key question then effectively becomes whether a particular activity undertaken for the production of income or gain fits within an explicit exception provided in the regulations.

Such an exception provides that commercial activities do not include investing or trading, other than as a dealer, in any of the following: stocks, bonds, other securities, partnership equity interests, certain commodities, or financial instruments. Financial instruments are defined in a manner that is substantially similar to the definition in proposed Treasury Regulations under section 864(b) (including derivatives with respect to certain commodities). However, if a financial instrument, in substance, represents beneficial ownership of the referenced asset, the analysis looks through to that asset. The final regulations also clarify that the holding of bank deposits in any currency does not create commercial activity.

The regulations make clear that the holding or trading of partnership equity interests (other than as a dealer) is not, by itself, a commercial activity. However, if the partnership conducts commercial activities, those commercial activities will be attributed to its partners (unless the exception for “qualified partnership interests” applies, as discussed below).

The Department of the Treasury and the IRS expressly rejected a comment recommending that a foreign government investor in

a private fund should not be treated as conducting commercial activity solely by reason of receiving a share of fees for services performed by the private fund sponsor for a portfolio company or receiving fees incidental to providing capital for investment in debt or equity of an underlying issuer.

Partnership Attribution and Qualified Partnership Interest Exception

As a general rule, commercial activities of a partnership are attributed to its partners. A foreign government investing in a partnership, such as a private equity fund, thus faces the risk that the section 892 exemption will be lost because of the partnership's commercial activities. However, a partner will not be deemed to be engaged in commercial activity solely due to (1) ownership of an interest in a partnership that effects, for its own account as a non-dealer, transactions in stocks, bonds, other securities, partnership equity interests, certain commodities, or financial instruments, or (2) ownership of a "qualified partnership interest" (QPI).

The benefit of the QPI exception is to prevent the attribution of commercial activities from a partnership and the resultant loss of the section 892 exemption with respect to the other investments of a controlled entity.

The regulations make clear that, even when the QPI exception prevents such attribution of commercial activities, the controlled entity's distributive share of any commercial activity income from the partnership in which it holds a QPI is not exempt from taxation under section 892.

In general, a foreign government owns a QPI if the foreign government:

1. Has no personal liability for partnership obligations,
2. Lacks legal authority to bind or act for the partnership,
3. Does not control the partnership through ownership of a 50 percent or greater interest or an interest that provides effective control, and
4. Has no right to participate in day-to-day management or operations of the partnership's business.

A safe harbor for *de minimis* interests, under which a foreign government owning an interest in a partnership will be treated as

owning a QPI, repeats the first two general requirements stated above and additionally requires that the foreign government (1) is not the partnership's managing partner, managing member, or an equivalent role under applicable law, and (2) does not directly or indirectly own more than 5 percent of the partnership's capital or profits.

The regulations clarify that certain commonly negotiated participation rights of a partner with respect to monitoring or protecting its investment in a partnership (including oversight or supervision rights over major strategic decisions) do not prevent the partner's interest in the partnership from being a QPI so long as such rights do not result in "effective control" over the partnership.

Interests in a partnership are aggregated to determine if they qualify as QPIs to the extent a foreign sovereign directly or indirectly owns multiple partnership interests through one or more integral parts, controlled entities, or CCEs. Further, if any partnership interest held by a foreign sovereign (directly or indirectly through any such entity) is not a QPI, no other interest in the same partnership held (directly or indirectly) by that foreign sovereign can be a QPI.

The regulations apply a "bottom-up" approach in determining the attribution of commercial activities in the context of tiered partnership. For example, commercial activities of a lower-tier partnership will not be attributed to an upper-tier partnership that owns only a QPI in the lower-tier partnership. However, any income of the upper-tier partnership in respect of the QPI that is derived from the commercial activity of the lower-tier partnership will not qualify for the section 892 exemption.

Inadvertent Commercial Activity: Safe Harbor and Cure

Offering some relief from the all-or-nothing rule, the inadvertent commercial activity exception allows an entity to avoid CCE designation if (1) its failure to avoid conducting commercial activity is reasonable, (2) the commercial activity is cured within 180 days of discovery, and (3) it satisfies record maintenance and retention requirements. Whether a failure to avoid conducting commercial activity is "reasonable" will be based on all the facts and circumstances, and any such failure generally will not be considered reasonable unless there are adequate written policies and operational procedures to avoid commercial activity, as well as

monitoring and auditing procedures and obligations imposed on, and enforced by, “responsible employees.” As with the QPI exception, although this exception prevents CCE status, any income from the inadvertent commercial activity still will not qualify for the section 892 exemption.

The regulations also include a safe harbor that establishes that an entity’s failure to avoid commercial activity is reasonable if the entity has adequate written policies and operational procedures, and (1) the average quarterly value of the assets used in commercial activities is no more than 5 percent of total assets, and (2) the income from commercial activity is no more than 5 percent of gross income for the year, in each case as determined under applicable financial statements (which are not limited to generally accepted accounting principles) or, if none exist, books and records that are adequate to establish such amounts. For the asset and income percentage calculations, assets and income attributable to QPIs are included in the denominator but excluded from the numerator, which is a favorable result for taxpayers.

The cure and safe harbor concepts are familiar from the registered investment company and real estate investment trust qualification regimes. “Cure” can include, among other things, divestiture, including to a related corporation, or an amendment or exchange to convert a non-QPI in a partnership to a QPI in the same partnership. In all cases, the foreign sovereign must retain adequate records of the commercial activity and any actions taken to cure.

Narrowed USRPHC “Per Se” Rule; Minority-Interest Exception

The 1988 temporary regulations treated (1) a USRPHC or (2) a foreign corporation that would be a USRPHC if it were a domestic corporation as engaged in commercial activity and therefore a CCE if the applicable ownership or control thresholds were met. Under the final regulations, this USRPHC “per se” rule now applies only to domestic USRPHCs. Thus, foreign governments may invest in USRPHCs through foreign holding companies, and a “controlled entity” of a foreign sovereign (which, by definition, must be formed under the laws of the foreign sovereign) no longer needs to continuously monitor its “USRPHC” status to avoid the CCE taint that would have applied under the 1988 USRPHC “per se” rule (which was viewed by many as a “trap for the unwary”).

The 2022 proposed regulations provided an exception from the USRPHC “per se” commercial activity taint for a domestic

holding company treated as a USRPHC solely by reason of its direct or indirect ownership interest in one or more other corporations that are not controlled by the foreign government, and allowed taxpayers to rely on this minority interest exception until the 2022 proposed regulations were finalized. While the Department of the Treasury and the IRS viewed the final regulations' narrowing of the USRPHC "per se" rule as eliminating the need for the minority interest exception, the Department of the Treasury and the IRS, in recognition of the substantial costs foreign sovereigns would incur in restructuring investments made in reliance on the 2022 proposed minority interest exception, retained the exception in the final regulations. The final regulations clarify that, in testing a domestic holding company for USRPHC status under the minority interest exception, ownership interests in noncontrolled corporations are excluded from its balance sheet.

Annual CCE Determination

Like the 2011 proposed regulations, the final regulations provide that whether a CCE is engaged in commercial activity is generally determined on an annual basis (such that a CCE engaged in commercial activity at any time during a taxable year will be treated as a CCE for its entire taxable year). However, the final regulations additionally provide that the entity's activities during its immediately preceding taxable year must also be taken into account to the extent relevant in characterizing the activities in the current taxable year, so that (for example) a calendar-year CCE cannot split activities between December and January (where the activities, if accounted for together, would constitute commercial activity) to avoid CCE status. An entity whose year is split because of a tax-free reorganization or other section 381 transaction may also need to include activities of the prior year.

Proposed Regulations

Debt Acquisition as Commercial Activity

The proposed regulations offer two safe harbors under which the activity of lending or otherwise acquiring debt, including at original issuance, qualifies as investment (and not commercial) activity, and would require a facts-and-circumstances analysis

in all other cases. In all events, however, the acquisition of debt undertaken as a dealer constitutes commercial activity. The proposed regulations note that the determination of whether a debt acquisition is an investment under section 892 is separate from whether such an acquisition would qualify as a trade or business for purposes of section 162, section 166, or section 864. Accordingly, a debt acquisition could cause a controlled entity to lose its section 892 exemption even in a case where no tax would apply to the income from the debt under section 882 (relating to net income taxation of non-U.S. corporations of income effectively connected with a U.S. trade or business) or otherwise.

The first safe harbor treats acquisitions of bonds or other debt securities in a registered offering under the Securities Act of 1933 as investment activity, provided that the underwriters of the offering are not related to the acquirer of the debt. The Department of the Treasury and the IRS solicited comments regarding the circumstances in which the safe harbor should also be extended to offerings under foreign securities laws.

The second safe harbor treats qualified secondary market acquisitions of debt as investment activity, provided that the acquisition is not from a person who is under common management or control with the acquirer (unless that person acquired the debt as an investment, as determined under the section 892 regulations). This safe harbor generally applies to acquisitions of debt traded on an established securities market so long as the acquirer is not (1) purchasing the debt from the issuer, or (2) participating in the negotiation of the terms or issuance of the debt.

Outside these safe harbors, an investment in a debt instrument may still be an investment activity, but such characterization must be determined based on all relevant facts and circumstances, including the following non-exhaustive list of factors:

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 initial issuance,
2. Whether the acquirer materially participated in negotiating or structuring the terms of the debt,
3. Whether the acquirer is entitled to compensation that is not treated as interest for U.S. federal income tax purposes,

4. The form of the debt and the issuance process (e.g., whether it is a bank loan or a privately placed debt security),
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 debt is deemed acquired pursuant to a significant modification under Treasury Regulations section 1.1001-3, whether there was, when the original unmodified debt was acquired, a reasonable expectation that the original unmodified debt would default.

The Department of the Treasury and the IRS solicited comments on additional factors that should be considered, including in relation to the circumstances, if any, in which acquisitions of distressed debt, broadly syndicated loans, revolving credit facilities, and delayed drawdown obligations should be treated as investment, rather than commercial, activity for purposes of section 892.

The Department of the Treasury and the IRS deserve some credit for tackling the bedeviling issue of loan origination, but the proposed regulations provide comfort for relatively straightforward cases and avoid addressing the more difficult cases that are more common in practice (including those for which they have solicited comments, as discussed immediately above).

“Effective Control” by a Foreign Sovereign

As noted above, a foreign sovereign “controls” a commercial entity, making it a CCE, when it satisfies a 50 percent ownership threshold or otherwise exercises “effective control” over it, including, potentially, through a minority interest. The proposed regulations offer further guidance on when a foreign sovereign exercises effective control over an entity.

Generally, the proposed regulations provide that a foreign sovereign has effective control over an entity when it owns an interest or interests in the entity that, alone or in combination, result in the foreign sovereign having control over the operational, managerial,

board-level, or investor-level decisions of the entity. The interests can be equity interests, voting rights, debt interests (and related creditor rights), contractual rights in or arrangements with the entity or its other interest-holders, or any other relationship that provides influence over an entity's operational, managerial, board-level, or investor-level matters. The proposed regulations also note that a foreign sovereign will be deemed to have effective control over a commercial entity if the foreign sovereign holds or controls an entity that is a managing partner or managing member, or holds an equivalent role, in the commercial entity.

In examples, the proposed regulations indicate that a foreign sovereign has effective control of a corporation when it has the power to appoint a director who can either unilaterally dismiss the entity's manager (i.e., an officer whose responsibility is to manage the entity's operations) or unilaterally veto decisions such as dividend distributions, material capital expenditures, sales of new equity interests in the entity, or its operating budget. Another example concludes that a foreign sovereign has effective control of an entity pursuant to its rights, solely as a creditor of the entity, to restrict the entity's investments, asset dispositions, dividend distributions and stock redemption, additional borrowings and debt redemptions, and other capital expenditures.

On the other hand, the examples in the proposed regulations further illustrate that a foreign sovereign does not necessarily exercise effective control over an entity when it has an investment agreement with the entity establishing investment criteria for the entity or when it has the right to participate (as a consultant, with no executory power) in the entity's investment committee.

Effective Dates and Reliance

The final regulations apply to taxable years beginning on or after December 15, 2025 (the Federal Register publication date of the final regulations). Taxpayers may elect early application to a prior taxable year for which the period of limitations for assessment is still open if they and their related parties apply the final rules consistently to such taxable year and all succeeding taxable years beginning before December 15, 2025.

The proposed regulations generally apply to taxable years beginning on or after the date on which they are finalized in a forthcoming Treasury decision.

Notes

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1. Unless indicated otherwise, all section references herein refer to sections of the Internal Revenue Code of 1986, as amended.