KPMG report: Final and proposed section 892 regulations

KPMG analysis and observations

December 23, 2025

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The U.S. Department of the Treasury and IRS (collectively, "Treasury") on December 15, 2025, published in the Federal Register a significant package of guidance under section 892 with respect to the tax exemption for income of foreign[1] governments. This package includes final regulations (T.D. 10042) (the "Final Regulations") and a new notice of proposed rulemaking (REG-101952-24) (the "Proposed Regulations").

The Final Regulations amend and finalize, to an extent, previous proposed and temporary regulations promulgated in 1988 (53 FR 24100) (the "1988 Temporary Regulations"), 2011 (76 FR 68119) (the "2011 Proposed Regulations"), and 2022 (87 FR 80097) (the "2022 Proposed Regulations").

This report includes initial analysis and observations regarding the provisions in the Final and Proposed Regulations.

Background and overview

Section 892 generally provides an exemption from U.S. federal income tax for certain investment income earned by foreign governments, their integral parts, and their wholly owned, same-country subsidiaries. The exemption applies to income from traditional passive investments, including stocks, bonds, and other securities, as well as income from financial instruments held in the execution of governmental financial or monetary policy. The exemption does not apply, however, to (1) income derived from the conduct of commercial activities, (2) income received from or by a controlled commercial entity (CCE), or (3) income from the disposition of interests in a CCE.

A CCE is any entity engaged in "commercial activities" anywhere in the world if the foreign government owns more than 50% of the entity, by vote or value, or has effective control over the entity. The 1988 Temporary Regulations define "commercial activity" broadly to include, subject to limited exceptions, all activities ordinarily conducted for the current or future production of income or gain, regardless of whether conducted within or outside the United States. Under this framework, only certain specifically enumerated investment activities—such as investing or trading in stocks, securities, or commodities for the foreign government's own account, or investing in financial instruments held in the execution of governmental financial or monetary policy—are excluded from treatment as commercial activities.

Applicability

Final Regulations

The Final Regulations generally apply to tax years beginning on or after the date the regulations were published in the Federal Register (i.e., December 15, 2025). Prior to finalization, taxpayers were permitted to rely on the 2011 Proposed Regulations, and subsequently on the 2022 Proposed Regulations, as provided in the respective preambles.

Taxpayers may elect to apply the Final Regulations to tax years beginning before the publication date, provided the statute of limitations under section 6501 remains open and the taxpayer and all related parties (within the meaning of sections 267(b) or 707(b)) consistently apply the Final Regulations in their entirety to the elected year and all succeeding tax years beginning before the finalization date. This elective

[1] For purposes of this report, "foreign" refers to entities or governments that are not of the United States; that is, "foreign" means "non-U.S."

retroactive application does not apply to Treas. Reg. § 1.892-3(a)(6) or the second sentence of Treas. Reg. § 1.892-5(a)(1), which were finalized in prior regulations.

The temporary regulations under Treas. Reg. §§ 1.892-4T and 1.892-5T remain effective for tax years beginning after June 30, 1986, until replaced by the Final Regulations. No transition period is provided for taxpayers that structured transactions in reliance on the 2011 Proposed Regulations.

KPMG observation

The preamble to the Final Regulations states that Treasury determined that specific transition rules are not necessary because Treasury believes the Final Regulations are consistent with the 2011 Proposed Regulations. However, taxpayers may have entered into long-term investments and structured their holdings in reasonable reliance on the statute or the previous proposed and temporary regulations. These legacy structures may now be inconsistent with the requirements of the final rules, and taxpayers with calendar or first quarter fiscal year-ends could face practical or commercial impediments to restructuring them before the regulations' effective date. In these situations, the exception for inadvertent commercial activity (discussed below) could provide critical relief, with the publication date of the Final Regulations serving as the date when commercial activity is identified, provided all its requirements are met (most notably, the pre-existence of adequate written policies and operational procedures and timely cure).

Proposed Regulations

The Proposed Regulations are proposed to apply to tax years beginning on or after the date those rules are finalized. Once finalized, a foreign government (within the meaning of Treas. Reg. §§ 1.892-2 and 1.892-2T) may elect to apply Prop. Treas. Reg. § 1.892-2(a)(4) (addressing the treatment of partnerships as controlled entities) retroactively to tax years of its directly or indirectly wholly owned entities beginning before the finalization date, provided the statute of limitations under section 6501 is open and the foreign government consistently applies the rule in its entirety to the elected year and all succeeding tax years beginning before the finalization date.

KPMG observation

Notably, and in a departure from many recent regulation packages (including the 2011 Proposed Regulations and 2022 Proposed Regulations), the preamble to the new Proposed Regulations does not contain an explicit statement permitting taxpayer reliance prior to finalization. While the proposed rules are not yet effective, they provide valuable insight into the current views of Treasury and the IRS on these complex issues. It therefore would be prudent for taxpayers to evaluate the potential impact of the Proposed Regulations on both their existing structures and future investment activities, rather than waiting for the rules to be finalized.

Final Regulations

Defining commercial activities

The Final Regulations retain a broad definition of "commercial activities," encompassing activities ordinarily conducted for the current or future production of income or gain, whether conducted inside or outside the United States. The determination turns on the *nature of the activity*, not the taxpayer's purpose or motivation. Commercial activities may include activities that do not constitute a trade or business under sections 162 or 864(b), reflecting Congress's use of a broader standard than the more common "trade or business" concept.

KPMG observation

The distinction between the broad "commercial activity" standard under section 892 and the trade or business standard under section 162 and the "U.S. trade or business" (USTB) standard under section 864 is critical. Activities that would give rise to a USTB if carried on within the United States generally will also constitute commercial activities, but the reverse is not always true. A key distinction is that the section 892 standard lacks the "regular and continuous" requirement applicable to finding a trade or business. Therefore, even a single transaction, such as originating one loan, could be sufficient to constitute a commercial activity. This distinction significantly limits the utility of relying on case law and other authority that analyzes whether a taxpayer's activities are frequent enough to constitute a trade or business or a USTB. While those authorities may provide little guidance, other authorities that focus on the fundamental nature of an activity (e.g., distinguishing an investment from active participation) may still provide useful analysis in determining the character of an activity for section 892 purposes.

Investment exception

Commercial activities do not include specified investment activities. The Final Regulations retain and clarify an exclusive list of non-commercial investments, including holdings of stocks, bonds, and other securities; loans; qualifying financial instruments; partnership equity interests, net leases of real property; non-income-producing real property; and bank deposits (in any currency). Investment status is not affected by transaction volume or the presence of unrelated activities. The Final Regulations do not adopt a bright-line rule distinguishing commercial lending from investing in loans based on public solicitation or transaction volume. The Proposed Regulations, discussed below, address when loan acquisitions constitute investments versus commercial activities.

The 1988 Temporary Regulations provide an exception for investments in financial instruments held in the execution of governmental financial or monetary policy. The 2011 Proposed Regulations would have modified this exception by providing that investments in financial instruments are not treated as commercial activities, without regard to whether the financial instruments are held in the execution of governmental financial or monetary policy. The Final Regulations follow the 2011 Proposed Regulations and expand the definition of "financial instruments" to include market-standard derivatives substantially consistent with the proposed section 864(b) trading safe harbor. A foreign government may invest or trade in such instruments for its own account as a nondealer without engaging in commercial activities. However, if a financial instrument confers beneficial ownership of an underlying asset, commercial activity is determined by reference to that asset. Additionally, holding currency, including non-functional currency, and bank deposits in any currency is not a commercial activity. However, the Final Regulations do not address the tax treatment of currency gains.

KPMG observation

The expansion of the "financial instrument" definition to align with the section 864(b) trading safe harbor is a significant and welcome clarification. It provides certainty that income derived from trading in a wide range of derivatives for a foreign government's own account is not income from a commercial activity. This change may create a refund opportunity for taxpayers who took a more conservative position in prior open years and paid tax on gains from such financial instrument trading or on other section 892 eligible income held within a commingled vehicle.

The Final Regulations also include rules for activities not covered by the investment exception. The receipt of fees—such as shared management or service fees in private equity or credit fund structures—does not by itself avoid commercial activity. Whether a foreign government is engaged in commercial activities depends on the nature of the underlying activities attributed to it (e.g., through partnership attribution or agency), not on the characterization of income as a “fee.” Further, holding or trading partnership equity interests for a foreign government’s own account and other than as a dealer is not, by itself, a commercial activity. Commercial activity arises only if the partnership’s commercial activities are attributed to the holder. Distributive shares of partnership income attributable to commercial activities and gains from dispositions of interests in partnerships that are engaged in commercial activities are generally not exempt under section 892.

KPMG observation

The preamble to the Final Regulations notes the government’s concern regarding arrangements where a foreign government investor shares in a fund’s management fee income. The analysis focuses on whether the commercial activities of the fund manager are attributable to the investor, not on the label given to the income stream. Arrangements like management fee offsets, rebates, or other structures that give the investor the economics of a share in management fees (beyond a refund of management fees paid) create a significant risk. In these cases, the manager’s activities may be attributed to the investor, causing the investment to be treated as a commercial activity.

The commercial activities of a partnership are generally attributed to its partners, even if a partner is not allocated income from the commercial activity. In the context of fee income, a section 892 investor that is a partner in a partnership that earns fee income should consider whether its partnership interest creates commercial activity exposure. In such a case, an investor would need to qualify for another exception (such as the qualified partnership exception, discussed below) to avoid being attributed commercial activities income. Taxpayers should carefully review all such economic arrangements in their fund investments, co-investments, and joint ventures with this standard in mind.

The Final Regulations do not finalize rules treating investments made by a banking, financing, or similar business as per se commercial activities. Instead, the Proposed Regulations address when loan and debt acquisitions constitute commercial activity, and withdraw the corresponding temporary regulation.

Controlled commercial entities

Under the Final Regulations, a CCE is any entity engaged in commercial activities, wherever conducted, if a foreign government holds (directly or indirectly) (1) at least 50% of the entity by vote or value, or (2) an interest that provides the foreign government with effective control of the entity. The definition of “entity” for these purposes applies solely for section 892(a)(2)(B) and includes corporations, partnerships, trusts (including certain pension trusts), and estates. In the Final Regulations, the term “effective practical control” has been replaced with the term “effective control” to be consistent with section 892(a)(2)(B)(ii). The Proposed Regulations address the definition of effective control.

U.S. real property holding corporations (USRPHCs) and U.S. real property interests (USRPIs)

In the Temporary Regulations, a USRPHC, as defined in section 897(c)(2), or a foreign corporation that would be a USRPHC if it were a domestic corporation, is treated as engaged in commercial activity. Therefore, a controlled USRPHC is a per se CCE. This is referred to as the "USRPHC per se rule." The 2011 Proposed Regulations provided that the disposition of a U.S. real property interest (USRPI), by itself, does not constitute the conduct of commercial activity. However, income derived from the disposition of a USRPI described in section 897(c)(1)(A)(i) (generally an interest in real property located in the United States or the Virgin Islands) will not qualify for the exemption from tax under section 892. The 2022 Proposed Regulations provided two exceptions to the USRPHC per se rule for: (1) a foreign corporation that is a qualified holder under Treas. Reg. § 1.897(l)-1(d) (i.e., qualified foreign pension funds or certain qualified controlled entities), or (2) a corporation (whether domestic or foreign) that is 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. This latter exclusion is referred to as the "minority interest exception," which allowed a foreign government to use a foreign controlled entity or a controlled domestic corporation to hold minority interests in USRPHCs without the holding company being treated as a CCE.

The Final Regulations significantly narrow the USRPHC per se rule by limiting the rule to domestic corporations. A foreign corporation is no longer treated as a CCE solely because it is a USRPHC. As a result, foreign government investors are not required to monitor the USRPHC status of foreign corporations for section 892 purposes.

The Final Regulations also retain the minority interest exception for domestic corporations. The Final Regulations clarify that the minority interest exception must be applied using a “balance sheet method,” under which ownership interests in noncontrolled corporations held by a domestic corporation are disregarded in determining whether the domestic corporation is a USRPHC.

KPMG observation

The elimination of the USRPHC per se rule for foreign corporations is one of the most significant and favorable changes in the Final Regulations, enabling a fundamental simplification of investment structures. Previously, some foreign government investors used a single holding structure for both 892-exempt investments and other activities (like U.S. real estate) in part to use the value of their exempt assets to “swamp” U.S. real property interests and avoid USRPHC status at the foreign parent level.

The new rule largely eliminates the need for this approach. It encourages a "bifurcated" strategy where investments intended to be exempt under section 892 are held in dedicated "clean" vehicles, entirely separate from entities holding commercial or non-exempt assets. This separation provides significant commercial flexibility for non-892 investments. Simultaneously, it allows the dedicated 892 vehicles to adopt stricter and more robust policies and procedures, strengthening their compliance position for the inadvertent commercial activity exception. This clarity is a welcome development, simplifying structuring and compliance for both foreign government investors and the managers of the funds in which they invest.

Inadvertent commercial activity exception

The Final Regulations provide a limited exception under which an entity that conducts only inadvertent commercial activity during a tax year is not treated as engaged in commercial activities, and is therefore not a CCE, if three conditions are satisfied: (1) the failure to avoid the activity was reasonable, (2) the activity is timely cured, and (3) appropriate records are maintained. Any income derived from inadvertent commercial activity, including activity attributed from a partnership, remains taxable and is not exempt under section 892. However, the income will not impede the foreign government’s ability to rely on section 892 for unrelated income.

Whether failure to avoid commercial activity is reasonable is determined based on all facts and circumstances, including the scale of the activity relative to the entity’s overall income and assets. Attribution from partnerships is taken into account proportionately. Reasonableness requires adequate written policies and operational procedures designed to prevent commercial activities and to monitor worldwide operations. “Adequate” means reasonably expected to be effective, not perfect in hindsight. The Final Regulations identify relevant factors but do not provide a bright-line safe harbor. Adequate written policies and operational procedures should:

- Prohibit the entity from engaging in commercial activities directly and through investments in entities whose activities could be attributed to it.

- Be communicated in writing to all persons who exercise discretionary authority to cause the entity to undertake an investment.
- Require an advance determination (by opinion of counsel or otherwise) as to whether an investment is commercial activity.
- Include an annual internal or external audit or review of direct investments and investments in entities whose commercial activities would be attributed to the tested entity.
- Require the result of periodic tests to be reviewed and certified by responsible employees who can cause the curing of any commercial activity disclosed in such procedures.

Employees of the entity or of a controlling entity may be designated to establish, follow, and enforce these policies, provided they exercise ordinary business care and prudence. Reliance on tax or legal advice alone is insufficient to satisfy this requirement.

KPMG observation

It cannot be overstated that having adequate written section 892 policies and procedures is a mandatory prerequisite for accessing the inadvertent activity exception. The regulations make it clear that written section 892 policies and procedures are not merely a "best practice" or something to be developed after an issue is found; they must be in place beforehand to establish that the failure to avoid the commercial activity was "reasonable." Foreign government investors who have not yet formalized their section 892 policies and procedures to the standard detailed in the regulations should do so immediately. This is the single most important step to ensure eligibility for this critical relief. In addition, for investments where a foreign government investor cannot rely on the "qualified partnership interest" exception, it should ensure that it communicates its section 892 policies to external investment managers.

The Final Regulations provide a 5% asset and income safe harbor. The safe harbor applies if both (1) assets used in commercial activities do not exceed 5% of total assets and (2) income from commercial activities does not exceed 5% of gross income, as determined using an applicable financial statement (including U.S. GAAP, IFRS, or other regulatory accounting standards). Asset values are measured using quarterly averages; income is measured annually.

In applying the safe harbor, qualified partnership interests are not included as an asset used in commercial activity of the tested entity, but the value of the qualified partnership interest is included in the entity's calculation of its total assets. Similarly, the distributive share of commercial activity income from a qualified partnership interest is not included as income earned by the entity from commercial activity, but is included in the entity's gross income and treated as commercial activity income for all other purposes of section 892.

KPMG observation

The safe harbor applies only if there are adequate written policies and procedures in place to avoid commercial activities, and it does not relieve the need to discontinue the commercial activity when it is discovered. Accordingly, investors cannot affirmatively apply the safe harbor. Instead, the safe harbor applies in place of the facts-and-circumstances analysis of whether failure to avoid commercial activity is reasonable.

Under the Final Regulations the commercial activity must be discontinued within 180 days of discovery by the responsible employees who are responsible for monitoring and reviewing the entity's commercial activity. For example, if an entity holding an interest as a partner in a partnership discovers the partnership is conducting commercial activity, the entity satisfies the cure requirement if, within 180 days, the entity discontinues the activity by divesting itself of its partnership interest (including by transferring its interest in the partnership to a related entity), or the partnership itself discontinues its conduct of commercial activity.

An entity may be able to satisfy the cure requirement by exchanging its partnership interest for one that is a qualified partnership interest within the same partnership, depending on the facts and circumstances. Adequate records of each discovered commercial activity and the remedial action taken to cure that activity must be maintained. The records must be retained as long as the contents may become material in the administration of section 892.

KPMG observation

The 180-day cure period is a key feature of the exception. A critical question is when "discovery" occurs for a pre-existing activity that was not considered a commercial activity under prior guidance but becomes one under the new Final Regulations or may be one in the government's view under the Proposed Regulations. For such activities, a reasonable position could be that "discovery" by a responsible employee occurs on the effective date of the Final Regulations. This could provide taxpayers with a 180-day window from that date to remediate legacy structures. However, this relief is only available if the taxpayer can satisfy the "reasonableness" requirement, which, as noted above, is contingent on having adequate policies and procedures already in place.

Annual CCE determination

Under the Final Regulations, whether a controlled entity is treated as a CCE is determined annually, by reference to the entity's tax year. If the entity engages in any commercial activity at any time during its tax year, it is treated as a CCE for the entire tax year. Conversely, an entity with no commercial activity during a tax year is not a CCE for that year, even if it engaged in commercial activities in prior years. For purposes of determining whether an entity is engaged in commercial activities during its tax year, that entity's activities during its immediately preceding tax year will also be taken into account to the extent relevant in characterizing the activities in the current tax year.

If the tax year of a corporation engaged in commercial activity is terminated as a result of an acquisition to which section 381(a) applies, the acquiring corporation generally does not succeed to the commercial activity of the distributor or transferor corporation for the acquiring corporation's applicable tax year. An important exception applies where both entities are controlled by the same foreign sovereign (e.g., a section 332 liquidation of a subsidiary), in which case the transferor's commercial activity causes the acquiring corporation to be treated as a CCE for the year of acquisition.

KPMG observation

The Final Regulations clarify that the determination of whether an entity has engaged in commercial activity is made on an annual basis; any commercial activity during the tax year taints the entire year. The regulations are silent, however, on the timing for testing "control." This creates uncertainty as to whether control is tested at a particular point in time (e.g., when an item of income is paid or accrued) or over a specific period (such as a tax year). This ambiguity is particularly relevant in years when a foreign government's ownership or control of a commercial entity change.

Another ambiguity not addressed by the regulations is the treatment of a dividend or accrued interest paid by a corporation that was formerly a CCE. For example, if a foreign government disposes of a sufficient interest in a CCE such that it no longer controls the entity, a subsequent dividend paid out of earnings and profits generated while the entity was a CCE appears to be eligible for the section 892 exemption (and similar treatment would be expected for payments of accrued but unpaid interest). Except as noted with respect to annual commercial activity testing, the determination of CCE status is made with respect to the status of the entity at the time the income is derived. Where dividend income is received when the distributing corporation is no longer a CCE with respect to the recipient, the source of the earnings and profits should not be determinative. This presents a key consideration for planning partial dispositions of investments and understanding the ramifications of dilution.

Commercial activities of partnerships

Under the Final Regulations, commercial activities conducted by an entity classified as a partnership for U.S. federal income tax purposes generally are attributed to its partners. The Final Regulations replace the prior temporary rules for publicly traded partnerships with a uniform attribution framework, subject to limited exceptions.

A partner is not treated as engaged in commercial activities solely because it is a member of a partnership that trades stocks, securities, commodities, or financial instruments for its own account, provided the partnership is not a dealer in such assets. This exception applies whether the trading is conducted directly by the partnership or through agents with discretionary authority. Even where commercial activities are not attributed to a partner (e.g., under the qualified partnership interest exception, discussed below), the partner's distributive share of partnership income remains taxable to the extent the partnership itself earns income from commercial activities. The Final Regulations do not expand the scope of income exempt under section 892.

Qualified partnership interest exception

The Final Regulations replace the "limited partnership exception" in the 2011 Proposed Regulations with a broadened "qualified partnership interest" ("QPI") exception, under which a foreign government or controlled entity that is not otherwise engaged in commercial activities is not deemed to conduct commercial activities solely by holding a passive partnership interest. Despite the QPI exception, a foreign government partner's share of partnership income will not be tax-exempt under section 892 if the partnership earned the income from commercial activity.

To qualify for the QPI exception, a holder must:

1) Have no personal liability for partnership obligations;
2) Have no authority to enter into contracts or act on behalf of the partnership;
3) Have no rights to participate in the partnership's day-to-day management or operations; and
4) Not control the partnership within the meaning of the section 892 regulations.

Within the QPI exception, partners may continue to hold certain rights to participate in management functions. The Final Regulations define "participation in management" as involvement in day-to-day management or operations. Rights limited to monitoring or protecting an investment—such as veto rights over extraordinary events, consent rights for major transactions, or participation on advisory committees—generally do not constitute management participation, provided they do not result in effective control. The determination is based on all facts and circumstances, including governing documents, side letters, applicable law, and actual conduct.

Comments to the previous regulations suggested the Final Regulations provide certainty to investors by incorporating one or more of three proposed safe harbors for determining whether the investor holds an interest as a limited partner in a limited partnership. The Final Regulations provide that a bright-line safe harbor that treats a partnership interest as a QPI if, throughout the tax year, the holder:

1) Has limited liability.
2) Does not possess the legal authority to bind or to act on behalf of the partnership.
3) Is not the partnership's managing partner, managing member, or an equivalent role under applicable law.
4) Does not own, directly or indirectly, more than 5% of either the partnership's capital interests or the partnership's profits interests.

Satisfaction of the safe harbor prevents attribution of commercial activities but does not exempt the investor's distributive share of commercial income from tax.

Tiered partnerships and multiple interests

The QPI exception applies on a "bottom-up" basis. An upper-tier partnership holding a QPI in a lower-tier partnership is not attributed the lower-tier partnership's commercial activities. If an upper-tier partnership holds interests in one or more lower-tier partnerships that conduct commercial activity and the foreign government's interest in the upper-tier interest is not a QPI, the commercial activities of the lower-tier partnerships would be attributed to the foreign government investor, unless the upper-tier partnership's interests in the lower-tier partnerships are QPIs.

All interests held by an investor in the same partnership are evaluated together in determining QPI eligibility. In addition, interests held by a foreign sovereign through integral parts, controlled entities, or controlled subsidiaries are aggregated. If any aggregated interest fails the QPI requirements, none of the interests qualify.

KPMG observation

All structures relying on the old limited partner exception in the 2011 Proposed Regulations must be re-evaluated under the new, more stringent QPI rules. In particular, the availability of the QPI exception only for minority interests in partnerships is an important change from the limited partnership exception in the 2011 Proposed Regulations, which contained no such limitation. It is critical to review partnership agreements and side letters to ensure the foreign government investor's rights are limited to permissible protective rights and do not cross into day-to-day management and to review allocations to ensure the investor does not control a relevant partnership. Any structures where an investor holds an unblocked interest in a partnership that receives commercial activity income and does not qualify for the QPI exception (including so-called "splitter" structures where the commercial activity income is specially allocated to another partner) should be addressed immediately.

In a helpful clarification, the preamble to the Final Regulations confirms that a foreign government investor may rely on the QPI exception even if it expected the partnership to engage in commercial activities at the time of its investment. This dispels a prior uncertainty where some practitioners believed the exception might only apply if the commercial activity was unexpected, similar to the standard for the inadvertent commercial activity exception. The final rules confirm that the QPI exception is a mechanical test based on the partner's rights and ownership, not its expectation regarding the partnership's underlying activities.

Proposed Regulations

Definition of controlled entity

Section 892 does not define the term "foreign government." Under the 1988 Temporary Regulations, a foreign government is limited to a foreign sovereign's integral parts and its "controlled entities." A controlled entity is defined as a juridical entity that is separate from the foreign sovereign and is wholly owned and controlled, directly or indirectly, by a single foreign sovereign. The temporary regulations further provide that a controlled entity does not include partnerships or other entities owned and controlled by more than one foreign sovereign.

The preamble to the Proposed Regulations notes that Treasury has expressed concern that the flush language in the temporary regulations could be misinterpreted as excluding only partnerships owned by multiple foreign sovereigns. The preamble clarifies that Treasury believes partnerships are excluded from the definition of a controlled entity regardless of whether they are wholly owned by a single foreign sovereign. Because partnerships are generally not subject to U.S. federal income tax at the entity level, the policy rationale underlying the controlled entity concept—which addresses whether a separate taxable entity may qualify for the section 892 exemption—does not apply.

Accordingly, the Proposed Regulations would clarify that an entity treated as a partnership for U.S. federal income tax purposes is not a controlled entity for purposes of section 892. This clarification would be implemented by removing the existing flush language following Treas. Reg. § 1.892-2T(a)(3) and replacing it with a new rule explicitly excluding partnerships from the definition of a controlled entity, along with conforming drafting changes.

KPMG observation

Foreign governments are treated as corporations for U.S. federal income tax purposes. While this clarification is helpful and creates structuring flexibility for investors, it may create a risk for foreign government investors that have been treating wholly owned partnerships as corporations for U.S. federal income tax purposes based on the temporary regulations. The Proposed Regulations do not provide any transition relief for such entities that might default to partnership status for U.S. federal income tax purposes under the Proposed Regulations. Therefore, taxpayers with entities whose classification is now uncertain should consider making a protective "check-the-box" election on Form 8832 if they want to secure corporate status for U.S. federal income tax purposes. In addition, affected taxpayers may wish to submit comments to Treasury requesting specific transition relief for legacy structures.

Contrary to other provisions in the Proposed Regulations, after the regulations are finalized, a foreign government may apply Prop. Treas. Reg. § 1.892-2(a)(4) retroactively to tax years of its directly or indirectly wholly owned entities beginning before the finalization date, provided the statute of limitations under section 6501 is open and the foreign government consistently applies the rule in its entirety to the elected year and all succeeding tax years beginning before the finalization date. The special reliance rule appears to be intended to align with several 2023 Private Letter Rulings (see, e.g., PLR 202343034) in which the IRS ruled that a partnership wholly owned by two or more members of the same foreign sovereign is not a per se corporation for U.S. federal income tax purposes.

Acquisition of debt

The Proposed Regulations establish an exclusive framework for determining when the acquisition of debt, including at original issuance, constitutes an investment rather than a commercial activity for purposes of section 892.

General rule

Under the Proposed Regulations, all acquisitions of debt are treated as commercial activities unless the acquisition qualifies as an investment under one of two specific safe harbors or under a facts-and-circumstances test. "Debt" is defined broadly to include any instrument treated as debt for U.S. federal income tax purposes, including financial instruments treated as debt. Any acquisition of debt undertaken in a dealer capacity is per se commercial activity. Notably, absent a safe harbor or favorable facts-and-circumstances determination, the general rule would treat even certain secondary market loan acquisitions in private transactions as commercial activity.

Investment safe harbors

The Proposed Regulations provide two narrow safe harbors under which debt acquisitions are treated as investment activity and therefore not commercial activity:

- **Registered Offering Safe Harbor**: Acquisitions of bonds or other debt securities in an offering registered under the Securities Act of 1933 qualify as investments, provided the underwriters are not related to the acquirer. Treasury requests comments on whether comparable offerings registered under foreign securities laws should also qualify.

- **Qualified Secondary Market Acquisition Safe Harbor**: Acquisitions of debt traded on an established securities market qualify as investments if the acquirer does not purchase from the issuer, does not participate in negotiating or structuring the debt, and does not acquire the debt from a commonly controlled or managed person (unless that person acquired the debt as an investment). Treasury and the IRS request comments on whether this safe harbor should extend to non-market-traded debt.

KPMG observation

These two safe harbors are limited in scope. The registered offering safe harbor does not extend to securities offerings outside the United States, which generally rely on an exemption from registration. If such securities are widely offered, an investment would likely nonetheless qualify under the facts and circumstances test.

The secondary market safe harbor looks to the broad definition of established securities market provided in regulations defining publicly traded partnerships. Although the standard those regulations provide would include debt investments that trade over the counter, provided a price is available through an interdealer quotation system, it is not clear it will apply in many cases where debt is not likely to be traded or quoted. In these cases, investors would need to rely on the facts and circumstances test.

Facts-and-circumstances test

Debt acquisitions that do not satisfy either safe harbor may still qualify as investment activity based on all relevant facts and circumstances. The Proposed Regulations provide a non-exclusive list of eight factors, focusing on whether the acquirer's expected return reflects solely a return on capital rather than compensation for lending or origination activities:

- 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
- Whether the acquirer materially participated in negotiating or structuring the terms of the debt
- 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 Federal tax purposes
- The form of the debt and the issuance process
- The percentage of the debt issuance acquired by the acquirer relative to the percentages acquired by other purchasers
- The percentage of equity in the debt issuer held or to be held by the acquirer
- The value of that equity relative to the amount of the debt acquired
- If 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 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 original unmodified debt, that the original unmodified debt would default

KPMG observation

The presumption that all debt acquisition is commercial activity represents a major shift that requires immediate attention even though these are merely proposed regulations. All credit portfolios relying on section 892 should be reviewed under this new framework. For investments requiring section 892 protection (i.e., those not qualifying for the portfolio interest exemption or an applicable tax treaty), a determination must be made as to whether a safe harbor applies. If not, a facts-and-circumstances analysis will be necessary. We recommend conducting this analysis on a representative sample of credit investments to identify potential risk areas if the entire portfolio cannot be quickly evaluated. In parallel, existing internal investment guidelines for both public and private debt should be revisited to understand whether they are consistent with the framework of the Proposed Regulations. If no such specific guidelines exist, they should be drafted and integrated into the broader written policies and procedures required to qualify for the inadvertent activity exception.

The examples in the Proposed Regulations illustrate Treasury's view that relatively limited lending activity—including a single loan—may constitute commercial activity if accompanied by origination-like conduct, while debt acquired alongside a substantial equity investment may qualify as investment activity even if acquired at original issuance. In one example, a foreign government is treated as engaged in commercial activity where it acquires a debt instrument at original issuance, materially participates in negotiations, and has no equity investment in the issuer, even though the foreign government extends only one loan per year. In another example, the Proposed Regulations treat as commercial activity a "significant modification" of a debt instrument where the foreign corporation was a member of the creditors' committee that materially participated in negotiating and structuring the terms of the modified debt, even though the debt was not distressed when acquired and the modification was prompted by a later default.

Treasury requests comments on whether the proposed facts-and-circumstances test under Prop. Treas. Reg. § 1.892-4(c)(1)(ii)(C) should include additional factors or illustrative examples relevant to foreign government investors. In particular, comments are requested on the circumstances, if any, under which acquisitions of distressed debt, broadly syndicated loans, revolving credit facilities, and delayed-draw debt obligations should be treated as investment activity rather than commercial activity for purposes of section 892.

Other changes

The Proposed Regulations retain the exception for investments in "other securities" and continue to define that term to include "any note or other evidence of indebtedness," which encompasses loans. Consistent with the introduction of a new, exclusive framework for determining when debt acquisitions constitute investment activity, the Proposed Regulations would remove "loans" from the list of per se non-commercial investments in the Final Regulations.

In addition, the Proposed Regulations would withdraw the special rule treating investments made by a banking, financing, or similar business as commercial activity. This change is conforming in nature, as the proposed debt acquisition framework would exclusively govern the investment versus commercial activity determination for all debt acquisitions.

Defining effective control

Section 892(a)(2)(B) defines a CCE as any entity engaged in commercial activities in which a foreign government either holds a 50% or greater ownership interest (by value or voting power) or otherwise exercises effective control. The 1988 Temporary Regulations interpret "effective control" broadly through an "effective practical control" standard, which may arise from minority ownership combined with creditor rights, contractual arrangements, regulatory authority, or other business relationships that allow a foreign government to exert influence over an entity's activities.

The Proposed Regulations significantly expand and clarify the effective control analysis by revising Treas. Reg. § 1.892-5T(c)(2) to adopt a comprehensive, facts-and-circumstances framework focused on whether a foreign government has control over an entity's operational, managerial, board-level, or investor-level decisions. Effective control may arise from equity or voting interests, debt or creditor rights, contractual or governance arrangements, regulatory authority, or any other relationship or arrangement that provides decision-making influence. No minimum equity ownership threshold is required for effective control.

Certain roles are treated as per se indicative of effective control. In particular, a foreign government is deemed to have effective control if it is, or controls an entity that is, a managing partner or managing member (or an equivalent role under local law), without the need for further factual analysis. By contrast, mere consultation rights, standing alone, do not constitute effective control.

KPMG observation

The proposed definition of effective control is expansive and creates new risk areas. This requires a review of all investment structures, particularly those where the foreign government: (1) holds supermajority or veto rights; (2) is a significant creditor; or (3) is invested in both a general partner/manager and a fund or portfolio company managed by that manager. A further ambiguity is that the Proposed Regulations do not address whether effective control must be exclusive to a single investor, or whether it is possible for multiple, unrelated investors to each be treated as having effective control over the same entity simultaneously. The possibility that multiple investors may have "effective control" is particularly relevant in the case of an investment where consent of a supermajority of investors is required to alter a business plan.

Treasury has requested comments on this proposal, creating an opportunity to provide feedback on its scope, especially regarding the aggregation of interests among functionally independent entities of the same sovereign.

The Proposed Regulations include illustrative examples clarifying that effective control may exist even where a foreign government holds only a minority equity interest—such as when it appoints a single director with unilateral authority to appoint or remove management—or where it exercises sufficient creditor rights, including veto power over key financial or operational decisions. Conversely, minority ownership without accompanying decision-making authority does not, by itself, result in effective control.

Examples 1 through 3 illustrate circumstances in which a foreign government does *not* have effective control. In these examples, a foreign government holds a minority ownership interest but lacks unilateral authority to elect the board, appoint management, or direct the entity's operational or investment decisions. Mere participation rights—such as an investment agreement setting general investment parameters or consultation rights on an investment committee without decision-making or execution authority—are insufficient to establish effective control.

Examples 4 and 5 demonstrate that effective control may exist despite minority ownership where governance or veto rights confer decisive influence. Effective control is found where a foreign government can appoint a single director with unilateral authority to appoint or remove management, or where it holds veto rights over key decisions such as dividend distributions, material capital expenditures, equity issuances, and the operating budget.

Examples 6 through 8 illustrate that effective control may also arise from non-traditional sources of influence. These include coordinated board control through business relationships with other investors ("soft power"), the exercise of regulatory authority over the entity, or creditor rights that provide veto power over significant financial or operational decisions. In such cases, the entity is treated as a CCE, and payments to the foreign government (including interest) do not qualify for the section 892 exemption.

The Proposed Regulations also provide that interests held by integral parts or controlled entities of the same foreign sovereign are aggregated for purposes of the effective control analysis. Treasury has requested comments on whether, and under what circumstances, controlled entities should be treated as functionally independent, as well as on the treatment of minority investors that hold veto or blocking rights through consent or supermajority provisions.

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