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Memorandum

IRS Releases Final and Proposed Regulations Under Section 892

December 15, 2025

On December 12, 2025, the Internal Revenue Service released final and proposed regulations under Section 892 of the Internal Revenue Code of 1986, as amended (the "Code"). The final regulations adopt many rules that were previously contained in temporary and proposed regulations published between 1988 and 2022 (the "prior regulations"), with several notable modifications. The proposed regulations put forth significant new frameworks to address when acquisition of a debt instrument is considered to be a commercial activity and when a foreign government has "effective control" of an entity that is engaged in commercial activities.

This memorandum provides a high-level summary of the final and proposed regulations with an emphasis on aspects relevant to private equity and private credit fund structures and foreign government investors that qualify for the benefits of Section 892 of the Code ("Section 892 investors"). Both fund sponsors and Section 892 investors should consider the application of the final and proposed regulations to their particular structures and investments.

Scope of Commercial Activities; Investments in Debt

The final regulations adopt a broad definition of "commercial activities" as all activities, whether conducted within or outside the United States, that are ordinarily conducted for the current or future production of income or gain, even if such activity does not constitute a trade or business for U.S. federal income tax purposes. Any activity that does constitute a trade or business under Sections 162 or 864(c) of the Code (or would if conducted in the United States) will continue to constitute a commercial activity unless otherwise specified in the regulations.

Under the final regulations, investments in bonds and other securities, as well as loans, continue to be carved out of commercial activities, regardless of the volume of the activity. However, the proposed regulations put forth a new framework under which, if finalized, an acquisition of debt would be treated as a commercial activity unless such acquisition qualifies as an "investment" under either of two safe harbors or a facts and circumstances test.

The proposed safe harbors would cover (a) the acquisition of debt issued in an offering registered under the Securities Act of 1933 (provided that the underwriters are not related to the acquirer) or (b) the acquisition of debt traded on an established securities market. Under the latter safe harbor, the acquirer may not acquire the debt from the issuer or participate in the negotiation of the terms or issuance of the debt and may not acquire the debt from a person under common management or control with the acquirer, unless the debt qualified as an investment in the hands of that person.

An acquisition of debt that does not qualify for a safe harbor may also be considered an investment based on all relevant facts and circumstances. These specifically include: (i) whether the acquirer solicited potential borrowers or held itself out as willing to make loans or acquire debt at original issuance; (ii) whether the acquirer materially participated in the negotiation or structuring of the terms of the debt; (iii) whether the acquirer is entitled to compensation (other than interest); (iv) the form of the debt and issuance process; (v) the percentage of the debt issuance acquired; (vi) the percentage of equity in the issuer held by the acquirer; (vii) the value of such equity relative to the amount of debt acquired; and (viii) in the case of modifications of debt, whether there was, at the time of acquisition of the original unmodified debt, a reasonable expectation based on objective evidence that the original unmodified debt would default.

Although commentators have in the past suggested providing a safe harbor for infrequent private lending activities (such as five or fewer loans per year), the final regulations specifically decline to adopt a safe harbor based on volume of activity. Examples in the regulations illustrate that while even an isolated debt financing can be treated as a commercial activity, frequent acquisitions of private placement debt may also be treated as investments based on the facts and circumstances. Additional examples address advances of debt to issuers in which a Section 892 investor holds an equity interest and participation in restructurings. The preamble to the proposed regulations solicits comments from the public on the treatment of distressed debt, broadly syndicated loans, revolving credit facilities and delayed-draw debt obligations, but no special rules for such investments are currently proposed.

This framework would, if finalized, be particularly relevant to the structuring and operation of private credit funds and negotiation of terms by Section 892 investors. Fund sponsors and Section 892 investors should review the proposed regulations and consider their potential application to existing fund structures and investments.

Effective Control

A controlled commercial entity is any entity engaged in commercial activities if a foreign government holds, directly or indirectly, a 50% or greater interest in the entity or holds, directly or indirectly, any other interest in the entity which provides the foreign government with effective control of the entity. Under existing temporary regulations, such control may be achieved through minority equity interests, alone or together with other relationships, such as creditor, contractual, and regulatory relationships. For this purpose, all interests owned directly or indirectly by a foreign government, even if through different agencies or entities, are considered together.

The proposed regulations would extend the existing temporary regulations and define effective control as the holding of any “interest” in an entity that, directly or indirectly, and separately or in combination with other interests, results in control of the operational, managerial, board-level or investor-level decisions of the entity. Such “interests” may include equity or debt interests, voting rights such as the power to appoint directors or veto decisions, contractual rights and arrangements with the relevant entity or its equityholders, business relationships, and regulatory authority. Under a new per se rule, a foreign government would be deemed to have

effective control of an entity if it controls that entity's managing partner, managing member, or person playing an equivalent role under local law.

The proposed regulations would also provide that mere consultation rights with respect to operational, managerial, board-level or investor-level decisions are not alone considered effective control. Although the scope of such decisions is not defined, examples address the participation of a Section 892 investor in the determination of investment criteria, investment committees, acquisitions and sales; veto rights over dividend distributions, material capital expenditures, sales of equity interests and operating budgets; and circumstances in which business and creditor relationships with the company or other equityholders may provide effective control, in each case showing that a fact-specific analysis is required.

If finalized, this aspect of the revised effective control test would have implications for terms typically negotiated by Section 892 investors in private investment funds. While many such terms can be expected to be considered consultation rights, fund sponsors and Section 892 investors should review existing terms in light of the proposed regulations.

The Qualified Partnership Interest Exception

The prior regulations provided all commercial activities of a partnership are attributed to its partners, subject to exceptions for trading activity (*i.e.* trading in stocks, bonds, other securities, commodities, and financial instruments) and holders of certain limited partnership interests. Under each exception, a Section 892 investor would not generally be attributed the commercial activities of the partnership (which could jeopardize its entitlement to Section 892 of the Code with respect to other income) but any income attributable to commercial activities and allocated to a Section 892 investor would not be eligible for exemption under Section 892 of the Code. The final regulations generally adopt this framework but with several notable changes.

Under the final regulations, the latter exception is now available for holders of a "qualified partnership interest." A partnership interest is a qualified partnership interest if the holder has limited liability, does not possess legal authority to bind or act on behalf of the partnership, does not control the partnership, and does not have rights to participate in the management and conduct of the partnership's business at any time during the taxable year, all of which are further defined in the regulations. Coordinating rules require aggregation of multiple partnership interests held by a foreign government and clarify the treatment of tiered partnerships.

Rights to participate in the management and conduct of a partnership's business are defined as rights to participate in day-to-day management, such as personnel and compensation decisions, formulating business strategy, and acquiring or disposing of specific investments. This generally does not include rights with respect to monitoring or protecting a partner's capital investment in the partnership, which may include oversight and supervision rights over the 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 diversions from agreed investment guidelines, extending the partnership's term, and

non-ordinary course disposal of all or substantially all of the partnership's assets. Whether an investor has rights to participate in the management and conduct of a partnership's business depends on all the facts and circumstances, including local law, the relevant partnership agreements, side letters and other contracts, and the conduct of the partnership and its partners.

Recognizing the complexity of the above determinations, the final regulations also adopt a safe harbor for small interest holders. The safe harbor is available for limited partners that have no personal liability for claims against the partnership, no right to enter into contracts or act on behalf of the partnership, are not managing members or partners, and do not directly or indirectly own more than 5% of either the partnership's capital or profits.

Both fund sponsors and Section 892 investors should carefully review their existing and future arrangements in light of the final regulations to determine whether the new qualified partnership interest exception is available in their particular circumstances, especially with respect to larger investors for whom the 5% safe harbor would not be available.

The Per Se USRPHC Rule

The prior regulations provided that any United States real property holding corporation (a "USRPHC"), and any foreign corporation that would be a USRPHC if it were a domestic corporation, is a per se controlled commercial entity, subject to an exception for any corporation that is a USRPHC solely by reason of directly or indirectly owning interests in one or more other corporations that are not controlled by the relevant Section 892 investor (the "minority interest exception"). The final regulations limit the per se rule above to domestic corporations that are USRPHCs, such that a foreign corporation will no longer be deemed a controlled commercial entity solely by reason of holding U.S. real property interests. The final regulations also retain the minority interest exception, with additional clarifications on the calculations necessary for compliance with the exception.

The final regulations may simplify investment allocation for Section 892 investors, many of whom have historically managed the per se USRPHC rule by allocating U.S. real estate investments to different holding vehicles. While the preamble to the final regulations notes that the minority interest exception is now arguably unnecessary, the exception is retained to provide relief to Section 892 investors who, in reliance on the prior regulations, have already entered into long-term minority investments in USRPHCs through domestic holding companies and would incur substantial costs in restructuring those investments.

Inadvertent Commercial Activity Exception

The prior regulations provided that if an entity conducts only inadvertent commercial activities, it would not be treated as engaged in commercial activities where the failure to avoid commercial activities is reasonable, the commercial activity is promptly cured, and certain records are maintained. In such case, any income derived from the commercial activity would still be subject to U.S. federal income tax and ineligible for exemption under Section 892 of the Code, but a Section 892 investor would not be considered engaged in commercial activities

more broadly (potentially jeopardizing the investor's entitlement to Section 892 of the Code with respect to other income).

The final regulations adopt the inadvertent commercial activity exception with some modifications. Whether a failure to avoid commercial activities is reasonable continues to be a facts and circumstances inquiry and requires continuing due diligence under adequate written policies and operational procedures. However, a safe harbor is now available where adequate written policies and operational procedures are in place, the value of assets used or held for use in all commercial activities does not exceed 5% of the relevant entity's total assets, the income earned from commercial activities does not exceed 5% of the relevant entity's gross income, in each case as reflected on its financial statements. The cure period for discontinuing inadvertent commercial activity is now extended to 180 days after discovery, rather than 120 days. Where a Section 892 investor is exposed to inadvertent commercial activities through a partnership, the Section 892 investor may cure the failure by causing the partnership to cease the activity or by disposing of the partnership interest (including by transferring it to a blocker entity treated as a corporation for U.S. federal income tax purposes). The final regulations leave open the possibility that a Section 892 investor holding a non-qualifying partnership interest (under the "qualifying partnership interest" exception described above) may cure inadvertent commercial activity by exchanging that interest for a qualifying partnership interest; however the effectiveness of such an exchange as a cure will depend on all the facts and circumstances, including whether the Section 892 investor has been actively involved in monitoring commercial activities.

Other Technical Changes; Effective Dates

The final regulations make certain other technical confirmations to the scope of commercial activities, including by confirming that investments in derivatives need not be held in the execution of governmental financial or monetary policy and that gain on the disposition of an interest in a "United States real property holding corporation" is not itself a commercial activity. The final regulations also clarify that whether a Section 892 "controlled entity" is engaged in commercial activities is generally tested on an annual basis with respect to the entity's taxable year, rather than the calendar year, and add a new one-taxable-year lookback period in testing commercial activities of controlled entities. The proposed regulations would also clarify that a "controlled entity" does not include a partnership, even if owned and controlled by a single foreign government.

The final regulations generally apply to taxable years beginning on or after December 15, 2025. However, taxpayers may choose to apply the final regulations to prior years if the statute of limitations on such years is still open and the taxpayer and all related entities consistently apply the final regulations to such years.

In many respects the final regulations are similar to prior proposed regulations, on which taxpayers had been permitted to rely. Given these similarities, the IRS did not provide a transition period between the effectiveness of those prior proposed regulations and the final regulations. Fund sponsors and investors should review structures set up in reliance on the prior proposed regulations to ensure their compliance with the new final regulations.

The proposed regulations would apply to taxable years beginning on or after the date of their finalization, without a transition period, other than a limited exception for the clarification that "controlled entity" does not include a partnership, which once finalized may be applied to prior open taxable years if applied consistently.

For further information regarding this memorandum, please speak to your regular contact in the Simpson Thacher Tax Department.

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