New Regulations on Section 892 Tax Exemption Are a Mixed Bag

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The Treasury Department has released Final and Proposed Regulations under Section 892 of the Internal Revenue Code. The Final Regulations provide welcome clarification and improvements in several areas, including an upgraded "qualified partnership interest" ("QPI") exception with a safe harbor that blocks attribution of commercial activity from a partnership to a foreign government investor relying on Section 892 (a "Section 892 Investor") owning 5% or less of the partnership. The QPI exception protects these investors from being treated as a controlled commercial entity ("CCE"), otherwise resulting in the loss of their Section 892 exemption by investing in a partnership that engages in commercial activity.

The Proposed Regulations introduce rules that would create a new framework for determining when debt acquisitions constitute "commercial activity" and reflect a posture that could disrupt widely used approaches to financing and structuring U.S. investments. The framework provides for two (narrow) safe harbors and a facts-and-circumstances test and includes certain surprising examples (including an example in which a single, one-off loan is a commercial activity).

The Final Regulations generally apply to tax years beginning on or after December 15, 2025 and the Proposed Regulations are proposed to be effective after finalization. Taxpayers, however, can choose to apply the Final Regulations or the Proposed Regulations to open years.

Final Regulations

"Commercial Activities" Broader than Trade or Business

- The Final Regulations are clear that commercial activity for purposes of Section 892 is broader than trade or business activity for U.S. federal income tax purposes. Commercial activities include all activities (wherever conducted) that are ordinarily conducted for the current or future production of income or gain, even if not constituting a trade or business for U.S. tax purposes. Activities that constitute a trade or business for U.S. tax purposes are generally commercial activities, unless otherwise specified in the Final Regulations.

- The Final Regulations retain commercial activity exceptions from prior regulations for investing and trading in stocks, bonds and other financial instruments, including loans. The Final Regulations also confirm that the exception for financial instruments includes holding most derivatives, an improvement over the existing regulations.

  Comment: The existing regulations provide that commercial activity can exist even in the absence of a trade or business, though in practice many taxpayers viewed the standards as somewhat interchangeable. As noted below, the Proposed Regulations provide a stark example of this difference in proposing to treat certain acquisitions of debt as commercial activity in cases where there would be little to no risk that the acquisition would constitute a trade or business.

- After earlier proposed regulations were issued in 2011, the Treasury Department received comments on the scope of commercial activity for Section 892 purposes. In the preamble to the Final Regulations, the Treasury Department considered but specifically declined to adopt comments on the 2011 proposed regulations that would have provided an exemption for:

  - lending activities where the Section 892 Investor (directly or through a fund) does not (i) make loans to the general public or (ii) make more than five loans in a single year;

  - the receipt of fees, when incidental to providing capital for an investment in debt or equity of an underlying issuer; or

  - mere transitory ownership of a pass-through entity that is generating commercial activity.

Qualified Partnership Interest Exception

- As noted above, the Final Regulations include a QPI exception blocking attribution of commercial activity from a partnership to a Section 892 Investor. QPI status does not exempt a Section 892 Investor's distributive share of income from underlying commercial activities conducted by the partnership, but such activities will not be attributed to the Section 892 Investor to cause such partner to become a CCE and jeopardize such partner's status under Section 892 with respect to other income, even if derived from the same partnership. The QPI rules in the Final Regulations are a welcome improvement to the former, and much-maligned, "limited partner" exception ("LP Exception") in prior proposed regulations. To be a QPI, the partner must:

- have no personal liability for claims against the partnership;
- not have the authority to enter into contracts or act on behalf of the partnership;
- own less than 50% of the partnership by vote and value (must not control the partnership); and
- have no rights to participate in the day-to-day management and conduct of the partnership's business (based on all facts and circumstances).

- Unlike the LP Exception, the Final Regulations provide significantly more context to define the scope of impermissible management rights. Such rights include participating in ordinary-course personnel and compensation decisions or taking an active role in advising or formulating a business strategy or in respect of acquisition or disposition decisions regarding underlying investments.

  Comment: Under the Final Regulations, it is the existence of such rights that is key. It is irrelevant whether the rights are actually exercised. Limited partners in private funds typically do not have rights to participate in day-to-day business strategy or compensation decisions, nor are they given the right to take an active role in acquisition or disposition determinations regarding underlying investments.

- In a helpful addition, the Final Regulations also specify that rights designed merely to protect and monitor capital investment are not management rights that can undermine QPI status.

  Comment: This guidance is a welcome improvement from the current LP Exception and seems specifically intended to address the investment fund context. While questions could remain in certain cases, most typical investor protections found in side letters and LPAC participation would not be expected to prevent QPI status under the Final Regulations.

- The Final Regulations also include a new safe harbor for QPI status if a partner owns 5% or less of the capital and profits of the partnership, has limited liability for claims against the partnership and is not a managing partner or managing member of the partnership.

  Comment: The QPI safe harbor should provide valuable certainty for Section 892 Investors (and sponsors with commercial activity undertakings) where it applies. A

Section 892 Investor may represent less than 5% of the capital commitments in a sponsored fund, but nonetheless be outside of the safe harbor with respect to a parallel partnership or alternative investment vehicle of the fund of which it owns more than 5%.

- The Final Regulations provide for a 'bottom-up' application of the safe harbor in tiered partnerships, in which an upper-tier partnership holding a QPI in a lower-tier partnership is not attributed commercial activities of the lower-tier partnership, even where a Section 892 Investor's interest in the upper-tier partnership is not a QPI. This may be helpful for fund-of-ones or SMAs that invest into a coinvest or aggregator partnership for a minority position that otherwise meets the QPI standard or QPI safe harbor.

- If the same foreign sovereign holds multiple interests in a partnership (such as a fund) through different entities, such interests are aggregated for purposes of determining QPI status. If any of the interests do not qualify as a QPI, the other interests will also not qualify as QPIs.

  Comment: A number of foreign sovereigns have multiple, massive, standalone funds that are independent from each other and are frequent large investors in private investment funds. Under the aggregation rule, if the interest held by any investor fails to qualify as a QPI, the interests held by other investors of the same sovereign also will not be QPIs.

USRPHC Per Se Rule

- Under a "USRPHC Per Se Rule," any corporation owned by a Section 892 Investor that would have been a United States real property holding corporation (a "USRPHC") if it were a domestic corporation is a per se CCE. Under prior regulations, the USRPHC Per Se Rule applied to foreign corporations as well. The Final Regulations limit the USRPHC Per Se Rule to domestic corporations and provide that a foreign corporation cannot become a deemed USRPHC and thus a CCE.

  Comment: The new limitation on the USRPHC Per Se Rule is a welcome change for Section 892 Investors (and fund sponsors) who no longer have to monitor USRPHC investments made by foreign controlled entities.

- This USRPHC Per Se rule is subject to a limited minority interest exception. While the exception is arguably no longer relevant given the removal of foreign corporations from the USRPHC Per Se Rule, the Final Regulations retain this in consideration of Section 892 investors who structured investments in USRPHCs through domestic holding companies and would now otherwise incur substantial restructuring costs if the exception were removed.

Inadvertent Commercial Activity Exception

- The Final Regulations adopt, with improvements, the proposed regulations' exception for inadvertent commercial activities that are within a threshold amount and are cured within a specified period after discovery.

Annual Determinations

- The Final Regulations confirm that CCE status is generally determined on an annual basis based on the entity's taxable year, in appropriate cases taking into account activities that occurred in the preceding taxable year. Commercial activities from one taxable year accordingly will not necessarily cause a controlled entity to be a CCE in subsequent years.

Proposed Regulations

Low Bar for Commercial Activity with Respect to Debt Acquisitions

- The Proposed Regulations include a new framework to determine whether debt acquisitions are treated as commercial activity for purposes of Section 892. An unexpected example in the Proposed Regulations states that a single, one-off loan is commercial activity if the Section 892 Investor or its representative held itself out as a lender, materially participated in negotiations regarding the debt investment and the investor did not own any equity in the issuer. Another example could be read to suggest that shareholder loans may be treated as commercial activity if not issued at relatively low debt-to-equity ratios.

- More specifically, under the Proposed Regulations, any "debt acquisition," including at original issuance, is treated as a commercial activity, unless it meets one of two safe harbors or is characterized as an "investment" under a facts-and-circumstances test. The safe harbors cover (i) the acquisition of debt in a registered offering with underwriters unrelated to the acquirer and (ii) the acquisition of debt traded on an established securities market from a seller that is not the issuer and is not related to or under joint management with the acquirer (unless the debt qualified as an investment in the hands of the related seller).

- If the debt acquisition does not qualify for either safe harbor, a multi-factor analysis is required to determine if the acquisition is an investment. The Proposed Regulations include the following nonexclusive list of factors to consider:

- whether the acquirer solicited borrowers and or held itself out as willing to make loans or acquire debt at original issuance;
- whether the acquirer materially participated in negotiating and structuring debt terms;
- whether the acquirer is entitled to receive compensation not treated as interest (including original issue discount) for U.S. federal income tax purposes;
- the form of debt and the issuance process (e.g., whether the debt is a bank loan or a private placement);
- the percentage of debt acquired relative to the percentage acquired by other buyers;
- the percentage of equity in the debt issuer held by the acquirer and the value of that equity relative to the amount of debt acquired; and
- for debt work outs, whether there was a reasonable expectation at the time of the original debt purchase that the original debt would default.

Comment: The Proposed Regulations increase the risk that Section 892 benefits will not be available on interest from certain debt acquisitions, therefore requiring Section 892 Investors to rely on income tax treaty benefits (if available) or the U.S. domestic law portfolio interest exemption. In addition, for Section 892 Investors with a non-QPI partnership interest, there is a risk that commercial activity from debt acquisitions by the partnership could cause the investor to become a CCE and lose its Section 892 exemption entirely.

Comment: The Proposed Regulations may raise questions around routine shareholder or blocker loans. Given that shareholder loans typically are held by investors in equal proportion to underlying borrower equity, we expect fund sponsors and Section 892 Investors to treat such loans as investments under the facts-and-circumstances test, and to continue with the use of such loans in the private fund and private credit context. Overall, the Proposed Regulations on debt acquisitions may generate significant comments from the industry.

Comment: The Proposed Regulations provide an example concluding that, where a Section 892 Investor acquires a loan that becomes distressed after acquisition, the loan is not viewed as an "investment" if the Section 892 Investor is a member of the creditors' committee negotiating the terms of a modified loan. This is a puzzling result since the Section 892 Investor is only protecting its original investment in the purchased loan, which would be a significant investment feature in a trade or business analysis.

Comment: Both the Proposed Regulations framework on debt acquisitions and the QPI facts-and-circumstances test (where no safe harbor is available) also raise questions around withholding tax risk for withholding agents, including private fund sponsors.

- In the preamble to the Proposed Regulations, the Treasury Department invited comments on the treatment of distressed debt, broadly syndicated loans, revolving credit facilities and delayed-draw debt obligations. The comment period for the Proposed Regulations ends Friday, February 13, 2026.

Controlled Entities and Per Se Corporation Status

- The preamble to the Proposed Regulations indicates that a partnership owned by two controlled entities of the same sovereign can remain a partnership for U.S. federal tax purposes and will not be a per se corporation. The per se rule could cause a U.S. partnership to be treated as a U.S. corporation and cause a non-U.S. partnership formed outside the jurisdiction of the sovereign to be treated as a non-U.S. corporation that is not entitled to Section 892 exemption.

  Comment: This comment in the preamble is consistent with the conclusion in a 2023 private letter ruling and is significant in that it means a partnership indirectly wholly owned by a single sovereign can still be a partnership for U.S. federal tax purposes if it is owned by two brother-sister controlled entities. In certain cases, this could allow a sponsor to avoid being forced to make a small commitment to a fund-of-one with a Section 892 Investor to ensure the fund is treated as a partnership for U.S. federal tax purposes.

Controlled Commercial Entities

- CCEs include entities where a foreign government holds an interest which provides the foreign government with "effective control" over the entity. The Proposed Regulations provide that effective control includes any interest in the entity that, either separately or in combination, results in control over the operational, managerial, board-level, or investor-level decisions of the entity, considering all the facts and circumstances related to the interests.

  Comment: Determinations of whether an entity is a CCE of a Section 892 investor will need to be made taking into account all interests (including non-equity interests and even contractual arrangements) held by Section 892 Investors of the same foreign sovereign.

Comment: As with the new QPI exception, the Proposed Regulations seem intended to protect typical LPAC activity by providing that the mere right to be consulted with respect to operational, managerial, board-level, or investor-level decisions of an entity does not give rise to effective control.

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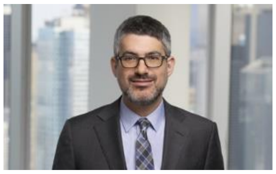
We will be monitoring comments from Treasury Department officials and comments submitted by stakeholders in the industry on the Proposed Regulations. We look forward to staying in touch as the process develops. Please do not hesitate to contact us with any questions on the Final Regulations, the Proposed Regulations, and impacts on your businesses.



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