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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 10042]

RIN 1545-BG08

Income of Foreign Governments and of International Organizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the taxation of the income of foreign governments from investments in the United States. In particular, these final regulations provide guidance for determining when a foreign government is engaged in commercial activity and when an entity is a controlled commercial entity. The final regulations will affect foreign governments that derive income from sources within the United States.

DATES: *Effective date*: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability dates: For dates of applicability, *see* §§ 1.892-3(c), 1.892-4(d), and 1.892-5(e).

FOR FURTHER INFORMATION CONTACT: Jack Zhou at (202) 317-6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Authority

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 892 of the Internal Revenue Code (Code). These regulations are

issued under the express delegations of authority under sections 892(c) and 7805(a) of the Code.

Background

On June 27, 1988, the Department of the Treasury (Treasury Department) and the IRS published in the **Federal Register** a notice of proposed rulemaking (53 FR 24100) (1988 proposed regulations) with a cross-reference to temporary regulations under section 892 (TD 8211, 53 FR 24060) (1988 temporary regulations) to provide guidance concerning the taxation of income of foreign governments and international organizations from investments in the United States following changes made to section 892 of the Code by section 1247 of the Tax Reform Act of 1986 (1986 Act) (Public Law 99-514, 100 Stat. 2085, 2583). After the 1988 temporary regulations and 1988 proposed regulations were published, section 892(a)(2)(A) was amended by section 1012(t) of the Technical and Miscellaneous Revenue Act of 1988 (1988 Act or TAMRA) (Public Law 100–647, 102 Stat. 3342, 3527-28) to provide that income derived from the disposition of any interest in a controlled commercial entity (CCE) does not qualify for the exemption under section 892. Section 1019(a) of TAMRA states that, except as otherwise provided, any amendments made by TAMRA are effective as if included in the provision of the 1986 Act to which such amendment relates.

On August 1, 2002, the Treasury Department and the IRS published § 1.892-5(a)(3) in the **Federal Register** (TD 9012, 67 FR 49864) to provide that the term “entity” for purposes of section 892(a)(2)(B) (defining “controlled commercial entity”) includes partnerships (2002 final regulations).

On November 3, 2011, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (76 FR 68119) that would provide additional guidance for determining when a foreign government is engaged in commercial activity (2011 proposed regulations). On December 29, 2022, the Treasury

Department and the IRS published in the **Federal Register** a notice (87 FR 80108) to reopen the comment period for the 2011 proposed regulations.

Also on December 29, 2022, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (87 FR 80097) that would make changes to § 1.892-5T(b)(1) to provide exceptions to the general rule that a United States real property holding corporation (USRPHC), as defined in section 897(c)(2), which may include a foreign corporation, is treated as engaged in commercial activity and, therefore, is a CCE if the requirements of § 1.892-5T(a)(1) or (2) are satisfied (2022 proposed regulations).

The Treasury Department and the IRS received comments on the 2011 proposed regulations and the 2022 proposed regulations, all of which are available at *https://www.regulations.gov* or upon request. A public hearing was not requested and none was held. After taking into account and addressing those comments, this Treasury decision finalizes, with modifications, the 2022 proposed regulations and the 2011 proposed regulations. In addition, this Treasury decision finalizes proposed § 1.892-3(a)(4) of the 1988 proposed regulations in accordance with the modifications recommended by the comments to the 2011 proposed regulations, which were reiterated by a comment to the 2022 proposed regulations. Since reopening the comment period of the 2011 proposed regulations has not resulted in any new or different comments, § 1.892-3(a)(4) is finalized without reproposing the provision (as discussed in part II.B.2 of the Summary of Comments and Explanation of Revisions). Terms used but not defined in this preamble have the meaning provided in the final regulations.

Summary of Comments and Explanation of Revisions.

The final regulations retain the general approach and structure of the 2011 proposed regulations and the 2022 proposed regulations, with certain revisions. This

section of the preamble discusses the comments received in response to the 2011 proposed regulations and the 2022 proposed regulations, and explains the revisions reflected in the final regulations.

I. *Overview*

Section 892 exempts a foreign government from U.S. income taxation under subtitle A of the Code on certain qualified income received from investments in the United States in stocks, bonds, or other domestic securities, or financial instruments held in the execution of governmental financial or monetary policy. Section 892(a)(1)(A). This exemption does not apply to income that is (1) derived from the conduct of any commercial activity (whether within or outside the United States), (2) received by a CCE or received (directly or indirectly) from a CCE, or (3) derived from the disposition of any interest in a CCE. Section 892(a)(2)(A).

Section 892 does not define the term "foreign government." The 1988 temporary regulations generally define a foreign government to consist only of integral parts and controlled entities of a foreign sovereign, and define an "integral part" of a foreign sovereign to include any body, however designated, that constitutes a governing authority of a foreign country. *See* § 1.892-2T(a)(2). The 1988 temporary regulations generally define a "controlled entity" of a foreign sovereign to mean an entity that is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity if it satisfies certain requirements, including that it is wholly owned and controlled by the foreign sovereign directly or indirectly through one or more controlled entities. *See* § 1.892-2T(a)(3). The 1988 temporary regulations provide that a controlled entity does not include partnerships or any other entity owned and controlled by more than one foreign sovereign. Thus, a foreign financial organization organized and wholly owned and controlled by several foreign sovereigns to foster economic, financial, and

technical cooperation between various foreign nations is not a controlled entity for purposes of section 892. *See* § 1.892-2T(a)(3).

Section 892(a)(2)(B) provides that, for purposes of section 892(a)(2)(A), a CCE is any entity engaged in commercial activities (whether within or outside the United States) and in which a foreign government holds (directly or indirectly) interests that meet specified thresholds. The 2002 final regulations provide that the term "entity" in section 892(a)(2)(B) means a corporation, a partnership, a trust (including a pension trust described in § 1.892-2T(c)), and an estate. *See* § 1.892-5(a)(3).

Section 892(c) authorizes the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 892.

II. *Defining Commercial Activities*

A. *General rule*

The 1988 temporary regulations define commercial activities to include all activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain. *See* § 1.892-4T(b). Furthermore, those regulations provide that an activity may be considered commercial activity even if that activity does not constitute the conduct of a trade or business in the United States under section 864(b). *Id.*

The 2011 proposed regulations would continue to define commercial activities to include all activities (whether conducted within or outside the United States) which are ordinarily conducted for the current or future production of income or gain, and provide that only the nature of the activity, not the purpose or motivation for conducting it, is

determinative of whether the activity is commercial in character.[1] *See* proposed § 1.892-4(d) (which corresponds to the rule in § 1.892-4T(b)). Moreover, the 2011 proposed regulations would provide that an activity may be considered commercial activity even if that activity does not constitute a trade or business for purposes of section 162 or does not constitute (or would not constitute if undertaken in the United States) the conduct of a trade or business in the United States for purposes of section 864(b). *Id.*

Several comments generally recommended that the final regulations should not distinguish between commercial activity under section 892 and a trade or business under section 864(b), or should provide that an activity will not be treated as commercial activity if it would not constitute a trade or business under section 864(b) if it were carried on in the United States. The comments recommended that the final regulations provide additional guidance by making the existing Treasury regulations under section 864(b) applicable to foreign governments under section 892.

The Treasury Department and the IRS agree that, subject to express exceptions, an activity that constitutes a trade or business for purposes of section 162 or constitutes (or would constitute if undertaken in the United States) a trade or business in the United States for purposes of section 864(b) is commercial activity; however, the best reading of the term "commercial activities" as used in section 892 is that it has a different and broader meaning than "trade or business" under sections 162 and 864. In drafting section 892, Congress opted for a different term, "commercial activities," instead of the familiar term "trade or business." The word "activities" denotes a standard more easily

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[1] The 2011 proposed regulations provided rules in proposed § 1.892-4(d) and (e) that correspond to the same rules stated in § 1.892-4T(b) and (c). These final regulations revise the structure of the provisions of the 2011 proposed regulations to be consistent with the structure of the 1988 temporary regulations.

satisfied than the term “trade or business.” Congress’s decision to use a different term should be given effect.

The final regulations therefore employ a broad definition, and provide that commercial activities potentially include activities that may not (or would not, if undertaken in the United States) constitute the conduct of a trade of business in the United States under section 864(b). Accordingly, the final regulations do not adopt the comments to limit the definition of commercial activities to activities that are a trade or business under section 864(b). In addition, the final regulations clarify that activities that constitute a trade or business for purposes of section 162 or constitute (or would constitute if undertaken in the United States) a trade or business in the United States for purposes of section 864(b) are commercial activities for purposes of section 892, except as expressly provided otherwise.

Another comment suggested that the position taken in proposed § 1.892-4(d) (that an activity may be considered commercial activity even if it does not constitute a trade or business) appears contrary to the rules of proposed § 1.892-4(e)(1)(ii), which would provide that effecting transactions in securities, commodities, or financial instruments for a foreign government’s own account does not constitute commercial activity regardless of whether the activity constitutes a trade or business. The Treasury Department and the IRS do not agree with this comment, and are of the view that the 2011 proposed regulations are internally consistent. Proposed § 1.892-4(d) would define the term commercial activities generally to include activities beyond those that would constitute a trade or business, while proposed § 1.892-4(e)(1)(ii) would provide a specific exception to that general rule for trading activities. The final regulations remove the reference to trade or business activity to clarify the trading exception under § 1.892-4(c)(2) (formerly proposed § 1.892-4(e)(1)(ii)).

B. *Investment exception*

Section 892 does not identify specific activities that do or do not constitute commercial activities. However, the regulations under section 892 provide that commercial activities do not include investment activities, cultural events, governmental functions, purchasing of goods for use of the foreign sovereign, and non-profit activities. *See*, for example, § 1.892-4T(c).

The 2011 proposed regulations would provide an exclusive list of investments that are not treated as commercial activities. This list includes investments in stocks, bonds, and other securities (as defined in § 1.892-3T(a)(3)); loans; investments in financial instruments (as defined in § 1.892-3T(a)(4)); the holding of net leases on real property; the holding of real property which is not producing income (other than on its sale or from an investment in net leases on real property); and the holding of bank deposits in banks. *See* proposed § 1.892-4(e)(1)(i) (which corresponds to § 1.892-4T(c)(1)(i)). The 2011 proposed regulations' investment exception also would provide that transferring securities under a loan agreement which meets the requirements of section 1058 is an investment and not commercial activity, and that an activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

The 2011 proposed regulations also would provide that investments (including loans) made by a banking, financing, or similar business constitute commercial activities, even if the income derived from such investments is not considered to be income effectively connected with the active conduct of a banking, financing, or similar business in the United States by reason of the application of § 1.864-4(c)(5). *See* proposed § 1.892-4(e)(1)(iii) (which corresponds to § 1.892-4T(c)(1)(iii)).

1. Investment in Loans

The exclusive list of investments that are not treated as commercial activities under the 2011 proposed regulations includes the term "loans." *See* proposed § 1.892-4(e)(1)(i) (which corresponds to § 1.892-4T(c)(1)(i)). A comment stated that there is uncertainty as to the circumstances in which loan origination is commercial activity. The comment recommended that lending (and charging of associated fees) should not be treated as commercial activity unless an entity offers to make loans to the general public or makes more than five loans in a single year.

The recommendation of the comment is not adopted in the final regulations because the Treasury Department and the IRS do not agree that making loans to the general public or making a particular minimum number of loans constitute necessary conditions for loan (or other debt) acquisitions to be commercial in character, or that a lack of those characteristics necessarily indicates absence of commercial activities. The Treasury Department and the IRS are separately proposing rules in this issue of the **Federal Register** as to when acquiring a loan or other debt, including in connection with original issuance, is treated as an investment for purposes of section 892.

2. Investment and Trading in Financial Instruments

The 1988 temporary regulations provide an exception from commercial activities for investments in financial instruments held in the execution of governmental financial or monetary policy. *See* § 1.892-4T(c)(1). The 2011 proposed regulations would have modified this exception by providing that investments in financial instruments (as defined in § 1.892-3T(a)(4)) are not treated as commercial activities, without regard to whether the financial instruments are held in the execution of governmental financial or monetary policy. *See* proposed § 1.892-4(e)(1)(i) (which corresponds to § 1.892-4T(c)(1)(i)). The 2011 proposed regulations also would have added financial instruments (as defined in § 1.892-3T(a)(4)) to the trading exception under § 1.892-4T(c)(1)(ii), without regard to whether the financial instruments are held in the execution

of governmental financial or monetary policy. *See* proposed § 1.892-4(e)(1)(ii). Section 1.892-3T(a)(4) defines financial instrument to include any forward, futures, options contract, swap agreement or similar instrument in a functional or nonfunctional currency (as defined in section 985(b)) or in precious metals when held by a foreign government or central bank of issue (as defined in § 1.895-1(b)).

Numerous comments to the 2011 proposed regulations recommended clarifying that all transactions in financial instruments that are within the scope of the trading safe harbors under section 864(b), including derivative transactions within the scope of the 1998 proposed regulations (63 FR 32164, June 12, 1998) under proposed § 1.864(b)-1, be treated as within the investment and trading exceptions of proposed § 1.892-4(e)(1)(i) and (ii) (which correspond to § 1.892-4T(c)(1)(i) and (ii)). Certain of these comments asserted that investing in these financial instruments is no less passive than a direct investment in stocks or securities and, therefore, the recommended clarification would be consistent with the purposes of section 892. Comments also recommended expanding the definition of the term "financial instrument" in § 1.892-3T(a)(4) to include all types of market standard derivatives. The recommendation was reiterated by a comment to the 2022 proposed regulations.

The Treasury Department and the IRS generally agree that investing and trading by a foreign government investor in financial instruments that are derivatives within the scope of the proposed regulations under section 864(b) are not commercial activities. *See* Prop. Reg. § 1.864(b)-1(b)(2), 63 FR 32164, June 12, 1998. Investing and trading in such financial instruments generally involve only putting capital at risk and do not involve activity such as structuring the instrument, in contrast to structuring of bespoke, non-market standard derivatives; thus, the expected return is generally a return exclusively on capital rather than on the activities conducted. Accordingly, the final regulations adopt these comments by revising the definition of the term "financial

instrument" under § 1.892-3(a)(4) to include financial instruments that are derivatives, which the final regulations define in a manner that is substantially similar to the definition in proposed § 1.864(b)-1(b)(2). As a result, a foreign government may invest and effect transactions (as a nondealer) for its own account with respect to these expanded types of financial instruments without being treated as engaged in commercial activities. *See* § 1.892-3(a)(4)(i). If, however, a contract or other financial instrument would be characterized under general Federal income tax principles as resulting in beneficial ownership of a reference asset, the determination of whether the foreign government investor is conducting commercial activity is made based on ownership of that asset and not with regard to the financial instrument. Moreover, if a contract or similar arrangement is not a derivative described in § 1.892-3(a)(4)(i), and does not otherwise qualify as an investment within the meaning of § 1.892-4(c)(1), effecting a transaction for one's own account in that contract or similar arrangement may be commercial activity unless it is within the scope of an exception to commercial activities under §§ 1.892-4(c) and 1.892-4T(c). The final regulations also make changes to the structure of § 1.892-3T(a)(4) by separating the provision into separate paragraphs for ease of reference. *See* § 1.892-3(a)(4)(i) and (ii). The final regulations finalize proposed § 1.892-3(a)(4) of the 1988 proposed regulations with modifications in accordance with the comments discussed above, together with the changes described herein, and remove the provision from the temporary regulations that were published on the same date.

3. Holding of Non-functional Currency

A comment recommended adding the holding of non-functional currency in a capacity other than a dealer or financial institution to the exclusive list of investments that are not treated as commercial activities. The Treasury Department and the IRS agree with this comment because solely holding one's own cash, whether or not in

functional currency, is not an activity ordinarily conducted for the current or future production of income or gain. Although currency deposited in a bank may produce income or gain, merely depositing currency does not rise to the level of commercial activity. Since a foreign government entity generally would hold currency (whether functional or non-functional) in a bank deposit, the Treasury Department and the IRS are revising the rule for holding of bank deposits to clarify that the exception includes the holding of bank deposits in any currency. *See* § 1.892-4(c)(1)(i). The comment also recommended excluding currency gains from commercial activity income, but this recommendation is beyond the scope of the final regulations. Therefore, the final regulations do not adopt this recommendation.

4. Receipt of Certain Fee Income

A comment recommended an exception from commercial activity for the receipt of certain fee income as a passive investor in a private equity or private credit fund. The comment noted that foreign governments and their controlled investment vehicles that invest in private equity or similar funds may negotiate for the right to share in fees for services provided to portfolio companies by the sponsor of the fund. The comment thus recommended that a foreign government investor should not be treated as conducting commercial activity solely by reason of receiving a share of the fees for services performed by the sponsor if the foreign government holds (directly or indirectly) an equity interest in the underlying fund, subject to certain conditions. The comment also asserted that a foreign government investor should not be treated as conducting commercial activity if it receives fees incidental to providing capital for an investment in debt or equity of an underlying issuer. The comment contended that the receipt of these types of fees is not commercial activity because the fees are payable for making, continuing to make, or having made capital available to the underlying issuer for an investment otherwise described in § 1.892-4T(c)(1).

The final regulations do not adopt this comment. The Treasury Department and the IRS are of the view that, for purposes of determining whether a foreign government is engaged in commercial activities, the best reading of the term "commercial activities" is that it is concerned with the nature of the activity performed by, or attributable to, the foreign government. To the extent the commercial activities of a fund sponsor are attributable to a foreign government investor in a privately managed fund under § 1.892-5(d)(5)(i) (attribution from an entity classified as a partnership), or on the basis of agency, the foreign government investor is considered to conduct commercial activity unless one or more exceptions under § 1.892-5 (for example, the qualified partnership interest exception under § 1.892-5(d)(5)(iii)(B)) applies. This analysis applies without regard to whether the foreign government actually or constructively receives or otherwise shares in income labelled as a fee. The final regulations do not treat the receipt of any particular type of fee as alone determinative of whether a foreign government conducts commercial activities. This approach is consistent with Federal tax principles which analyze the substance of a transaction, rather than its label or form.

5. Partnership Equity Interests

The 2011 proposed regulations would provide, in relevant part, that investments in other securities (as defined in § 1.892-3T(a)(3)) or generally effecting transactions in other securities (as defined in § 1.892-3T(a)(3)) for a foreign government's own account as a nondealer do not constitute commercial activities. *See* proposed § 1.892-4(e)(1)(i) and (ii) (which correspond to § 1.892-4T(c)(1)(i) and (ii)). Section 1.892-3T(a)(3) provides that the term "other securities" does not include partnership interests (with the exception of publicly traded partnerships within the meaning of section 7704). As a result of the cross-reference to § 1.892-3T(a)(3) in proposed § 1.892-4(e)(1)(i) and (ii), comments have requested clarification as to whether a disposition of a partnership interest would be treated as commercial activity for purposes of section 892.

The Treasury Department and the IRS have determined that holding or trading partnership equity interests for one's own account and other than as a dealer is not by itself commercial activity. Rather, holding equity interests in a partnership (including holding by an entity incident to trading partnership equity interests for one's own account and other than as a dealer) results in commercial activity if the partnership conducts commercial activity that is attributed to the holder. If this were not the case, there would be no need for a rule attributing the commercial activities of a partnership to its partners or for the exception to that rule for qualified partnership interests as defined in § 1.892-5(d)(5)(iii)(B). The exclusion of partnership equity interests from the definition of "other securities" for purposes of the investment and trading exceptions should not be read as implying that holding or trading such interests for one's own account and other than as a dealer are commercial activities. Accordingly, although a partner may be attributed commercial activities conducted by a partnership, the final regulations provide that the mere act of holding a partnership equity interest or effecting transactions in a partnership equity interest (for a foreign government's own account and other than as a dealer) are not in themselves treated as commercial activities. *See* § 1.892-4(c)(1)(i) and (c)(2). Further, pursuant to section 892(a)(2)(A), a foreign government's distributive share of partnership income attributable to commercial activities is not exempt from taxation under section 892. Moreover, pursuant to § 1.892-3T(a)(2) and (3), gain from the disposition of a partnership equity interest is not exempt from taxation under section 892 (though, depending on the partnership's assets and activities, it may be under the generally applicable Code provisions).

Comments also recommended that any income earned through a partnership and any gain arising from the disposition of a partnership interest be exempt under section 892 to the extent such income or gain would be exempt if realized directly by a foreign government. These recommendations pertaining to the types of income that are

exempt under § 1.892-3T(a), however, are beyond the scope of the final regulations. Therefore, the final regulations do not adopt these recommendations.

6. Banking, Financing, or Similar Business

With respect to the 2011 proposed regulations' provision that otherwise qualifying investments made by a banking, financing, or similar business would constitute commercial activities, comments recommended that the final regulations define banking, financing, or similar business by reference to § 1.864-4(c)(5)(i) without regard to the limitation that the activities be undertaken in the United States.

The Treasury Department and the IRS address this comment by proposing new rules included in this issue of the **Federal Register** for determining the circumstances in which acquisitions of loans (and other debt) are investments or commercial activities for purposes of section 892, and, in doing so, propose to withdraw § 1.892-4T(c)(1)(iii) (the rule that treats investments and loans made by a banking, financing, or similar business as commercial activities). Therefore, the final regulations do not adopt the comment or finalize proposed § 1.892-4(e)(1)(iii) in the 2011 proposed regulations because it repeats the text of § 1.892-4T(c)(1)(iii).

III. *Controlled Commercial Entities*

Consistent with section 892(a)(2)(B), proposed § 1.892-5(a)(1) would define CCE to mean any entity (including a controlled entity as defined in § 1.892-2T(a)(3)) that is engaged in commercial activities (whether conducted within or outside the United States) if the foreign government holds (directly or indirectly) any interest in such entity which (by value or voting power) is 50 percent or more of the total of such interests in such entity, or holds (directly or indirectly) any other interest in such entity which provides the foreign government with effective practical control of such entity. The 2011 proposed regulations would define entity for purposes of section 892 and the regulations thereunder to include a corporation, a partnership, a trust (including a

pension trust described in § 1.892-2T(c)), and an estate. The 2002 final regulations, however, define entity only for purposes of section 892(a)(2)(B). Consistent with the 2002 final regulations, the final regulations provide that the definition of "entity" in § 1.892-5(a) is for purposes of section 892(a)(2)(B) only.

Several comments requested further detail on the definition of effective practical control, including additional examples of arrangements and rules to illustrate the definition. Other comments made specific recommendations for what should not be treated as effective practical control, such as normal creditor interests and holding solely a minority equity interest (by vote and value) without more.

The Treasury Department and the IRS generally agree with the comments that the definition of effective practical control under § 1.892-5T(c)(2) would be made clearer by inclusion of additional details and examples. The final regulations replace the term "effective practical control" with the term "effective control" to be consistent with section 892(a)(2)(B)(ii). *See* § 1.892-5(a)(1)(iii)(B) and (c)(2). No inference is intended that the term "effective control" has any meaning different from that of "effective practical control." In a separate notice of proposed rulemaking published in this issue of the **Federal Register**, the Treasury Department and the IRS propose rules for defining effective control. *See* proposed § 1.892-5(c)(2).

One comment recommended clarifying that control with respect to entities held through a partnership be determined based on a foreign government's indirect interest through the partnership rather than based on the direct interest held by the partnership. The recommendation requires modifying § 1.892-5T(c), which is outside the scope of these final regulations. Therefore, the final regulations do not adopt this recommendation.

A. *U.S. real property holding corporations and U.S. real property interests*

The 1988 temporary regulations provide that 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 and, therefore, is a CCE, if a foreign government meets certain ownership or control thresholds with respect to that USRPHC or foreign corporation (the USRPHC per se rule). *See* § 1.892-5T(b)(1).

Proposed § 1.892-4(e)(1)(iv) of the 2011 proposed regulations would provide that a disposition, including a deemed disposition under section 897(h)(1), of a U.S. real property interest (as defined in section 897(c)) (USRPI), by itself, does not constitute the conduct of commercial activity. However, as provided in § 1.892-3T(a), the 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) shall in no event qualify for the exemption from tax under section 892.

The 2022 proposed regulations would revise § 1.892-5T(b)(1) by providing two exclusions from the USRPHC per se rule for: (i) a foreign corporation that is a qualified holder under § 1.897(l)-1(d) (referring to qualified foreign pension funds or certain qualified controlled entities), or (ii) a corporation 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 (as determined under § 1.892-5T(a)). As a result of the latter exclusion in the 2022 proposed regulations, a foreign government could use a domestic holding company for those minority interests without that holding company being treated as a CCE (the minority interest exception).[2] The 2022 proposed regulations would apply to taxable years ending on or after December 28, 2022, when

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[2] The 2022 proposed regulations would also clarify § 1.892-5T(b)(1) by replacing the phrase "or a foreign corporation that would be a United States real property holding corporation if it was a domestic corporation" with "which may include a foreign corporation" when referencing section 897(c)(2) to define a USRPHC. *See* proposed § 1.892-5(b)(1)(i).

finalized. The preamble provided that taxpayers may rely on the 2022 proposed regulations, including the minority interest exception, until the date the regulations are published as final regulations in the Federal Register.

Comments recommended that the final regulations withdraw the USRPHC per se rule. They asserted that there is no policy rationale under section 897 for the USRPHC per se rule in the context of section 892 and that it is merely a "trap for the unwary" that causes section 892 investors to devise ways to plan around the rule. One comment asserted that the 1988 Act's legislative history (discussed below) addressed only a foreign government's disposition of an investment in a domestic USRPHC, rather than demonstrating an intent to treat a foreign USRPHC as a per se CCE. Another comment recommended that the rule should apply solely to an entity that would be a USRPHC if the reference to USRPI in section 897(c)(2) were replaced with a cross reference to the definition of a USRPI in section 897(c)(1)(A)(i). Another comment recommended replacing the USRPHC per se rule with a rule that treats the gain or loss on the sale of a controlled USRPHC as if it were derived from commercial activity, similar to the rule under section 897(a) which treats gain or loss realized from the disposition of a USRPI as effectively connected with a U.S. trade or business. This comment explained that this recommendation is better aligned with the 1988 Act's legislative history.

Several comments recommended that the final regulations clarify or expand the application of the minority interest exception. Two comments made recommendations that would modify the assets to be taken into account for the minority interest exception, such as by disregarding USRPIs that do not collectively exceed ten percent of an entity's assets after excluding USRPIs that qualify for the minority interest exception. Other comments recommended other ways of expanding the minority interest exception, including by taking into account noncontrolling interests in noncorporate

entities and investments in debt instruments or other financial instruments that could be treated as USRPIs.

The 1988 Act's legislative history includes a statement that "a commercial entity is to include any U.S. real property holding corporation (sec. 897(c)(2))." S. Rep. No. 100-445, 306 (1988). Although the legislative history does not expressly distinguish between domestic and foreign USRPHCs, the Treasury Department and the IRS have determined that limiting the USRPHC per se rule to domestic corporations is appropriate to preserve U.S. taxation of gain on the sale of shares of a controlled domestic USRPHC, consistent with the legislative history, while at the same time addressing the concerns of commenters as to application of the rule to foreign USRPHCs. The Treasury Department and the IRS also have determined that applying the USRPHC per se rule only to domestic corporations more directly addresses the concerns raised by comments that controlled entities, which are necessarily foreign and otherwise eligible for the section 892 exemption, must continuously monitor their investments to ensure that they do not become subject to the USRPHC per se rule. Thus, the final regulations limit the USRPHC per se rule to domestic corporations and do not deem a foreign corporation to be engaged in commercial activity solely by reason of its status as a USRPHC. *See* § 1.892-5(b)(1)(ii)(A). Due to this change in the USRPHC per se rule in the final regulations, the proposed exception for foreign corporations that are qualified holders under § 1.897(l)-1(d) is not necessary and so is not finalized. Therefore, foreign government investors as defined in § 1.892-2T(a) and foreign government pension funds that are qualified holders under § 1.897(l)-1(d) do not need to monitor their own USRPHC status for purposes of the USRPHC per se rule.

Similarly, the change in the USRPHC per se rule in the final regulations renders the proposed minority interest exception unnecessary because, under the final regulations, foreign governments have the alternative of investing directly or through

foreign holding companies. However, the Treasury Department and the IRS understand that foreign government investors have relied on the minority interest exception for taxable years ending on or after December 28, 2022, as permitted by the preamble to the 2022 proposed regulations, and have entered into long-term minority interest investments in USRPHCs using domestic holding companies. If the minority interest exception were not finalized, the Treasury Department and the IRS understand, these investors could incur substantial costs to restructure these investments. Accordingly, the final regulations retain the minority interest exception (with certain clarifying modifications). *See* § 1.892-5(b)(1)(ii)(B). The Treasury Department and the IRS are of the view that adopting the minority interest exception does not present policy concerns under section 897 in the context of section 892 because the exception allows foreign government investors to use domestic holding companies for investments that could otherwise be entered into directly or by using foreign holding companies and therefore does not present an opportunity to facilitate the inappropriate avoidance of section 897.

With respect to the minority interest exception, a comment asserted that there are two possible interpretations of the phrase "solely by reason of its direct or indirect ownership interest in one or more other corporations": (1) any ownership interests in noncontrolled corporations are removed from an entity's balance sheet before performing the asset test under section 897 to determine whether USRPIs constitute 50 percent or more of the value of the entity's assets (the Balance Sheet Method); and (2) noncontrolling interests in USRPHCs are treated as "good" assets for purposes of the asset test under section 897 and thereby are included in the denominator but not the numerator (the Good Asset Method).

The Treasury Department and the IRS have determined that the correct interpretation of the minority interest exception in § 1.892-5(b)(1)(ii)(B) requires use of the Balance Sheet Method, and thus it (and not the Good Asset Method) is the only

method permitted to be used when applying this exception. That is because a corporation applying the Good Asset Method could satisfy § 1.892-5(b)(1)(ii)(B) even if it held a controlling interest in a USRPHC or a direct interest in U.S. real estate. In that case, the corporation would not be 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," as required for the exception to apply. Thus, the final regulations provide that the phrase "solely by reason of its direct or indirect ownership interest in one or more other corporations that are not controlled by the foreign government" means disregarding any ownership interests, held directly or indirectly, in noncontrolled corporations determined under § 1.892-5(a)(1), after applying the asset test under section 897(c)(2) and § 1.897-2. For example, if a controlled entity (CE) within the meaning of § 1.892-2T(a)(3) does not own any assets other than 100 percent of the interests in a USRPHC whose only asset is a minority interest in a real estate investment trust (REIT), neither the USRPHC directly owned by CE nor CE itself (which does not hold any other assets) would be treated as a CCE pursuant to § 1.892-5(b)(1)(ii)(B). The asset test under § 1.897-2(e)(3) provides that CE, which holds a controlling interest in the USRPHC within the meaning of § 1.897-2(e)(3)(iii) (flush language), holds a proportionate share of each asset held by the USRPHC. Thus, because CE holds a controlling interest in the USRPHC, the USRPHC's minority interest in the REIT is treated as held by CE. That ownership interest in the REIT, which is a noncontrolled corporation (within the meaning of § 1.892-5(a)(1)), however, is disregarded when determining whether the USRPHC and CE are USRPHCs for purposes of § 1.892-5(b)(1)(ii)(B). Therefore, after having applied the asset test under § 1.897-2, including the look-through rules of § 1.897-2(e)(3), and then removing such minority interests from the balance sheets of the USRPHC and CE, neither the

USRPHC nor CE are USRPHCs and therefore are not CCEs pursuant to § 1.892-5(b)(1)(ii)(B).

Additionally, the final regulations do not adopt the comments previously discussed relating to expanding the scope of the minority interest exception. The Treasury Department and the IRS have determined that expanding the scope of the minority interest exception may result in foreign governments holding (through a controlled U.S. corporation) active rather than passive, noncontrolling investments in U.S. real property, which would be contrary to the purpose of the CCE rules.

A comment recommended that the parent-to-subsidiary attribution rule of § 1.892-5T(d)(2)(ii) not apply where the parent corporation is treated as engaged in commercial activity under § 1.892-5T(b)(1) because it is a USRPHC. This recommendation is beyond the scope of the final regulations. Therefore, the final regulations do not adopt this recommendation.

B. *Inadvertent commercial activity exception*

The 2011 proposed regulations would treat an entity that conducts only inadvertent commercial activities in a particular tax year as not engaged in commercial activities if (1) failure to avoid conducting the commercial activity is reasonable as described in proposed § 1.892-5(a)(2)(ii); (2) the commercial activity is promptly cured as described in proposed § 1.892-5(a)(2)(iii); and (3) the record maintenance requirements described in proposed § 1.892-5(a)(2)(iv) are met (the inadvertent commercial activity exception). However, any income derived from any foreign government's inadvertent commercial activity, including activity attributed from a partnership, would not qualify for exemption from tax under section 892. *See* proposed § 1.892-5(a)(2)(i).

Comments recommended that the final regulations provide for a new rule permitting a specified percentage of an entity's assets or income during a tested year to

be derived from the conduct of commercial activities regardless of whether the commercial activities were inadvertent and regardless of whether the requirements for the inadvertent commercial activity exception were satisfied. The comment asserted that section 892 allows for such a de minimis rule.

The final regulations do not adopt these comments. Section 892(a)(2)(B) provides that any entity engaged in commercial activities is a CCE if either clause (i) or (ii) of section 892(a)(2)(B) is satisfied. The provision notably does not provide for a quantitative threshold for determining whether an entity is engaged in commercial activities. Therefore, the Treasury Department and the IRS have determined that a quantitative threshold for determining whether an entity is engaged in commercial activities is inconsistent with section 892. However, the Treasury Department and the IRS have also determined that the best reading of section 892(a)(2)(B) is that an entity is not "engaged" in commercial activities where reasonable precautions were taken to avoid the commercial activities, but the entity nevertheless conducted such activities inadvertently. Accordingly, the exception in § 1.892-5(a)(2) finalizes providing targeted relief in the case of an entity that inadvertently conducts commercial activity, provided that the activity is discontinued in a timely manner.

A comment requested that the Treasury Department and the IRS prescribe procedures to simplify the tax payment and return filing obligations arising from inadvertent commercial activity. This comment is beyond the scope of the final regulations and, therefore, it is not adopted.

1. Whether Failure to Avoid Conducting Commercial Activities is Reasonable

Subject to the continuing due diligence requirement under proposed § 1.892-5(a)(2)(ii)(B) and a safe harbor under proposed § 1.892-5(a)(2)(ii)(C), the 2011 proposed regulations would provide that whether an entity's failure to avoid engaging in commercial activity is reasonable is determined in light of all the facts and

circumstances. Due regard will be given to the number of commercial activities conducted during the taxable year, and the amount of income earned from, and assets used in, the conduct of the commercial activities in relationship to the entity's total income and assets. The 2011 proposed regulations would also provide that for purposes of § 1.892-5(a)(2)(ii)(A) and (C), where commercial activity conducted by a partnership is attributed under § 1.892-5(d)(5)(i) to an entity owning an interest in the partnership, assets used in the conduct of the commercial activity by the partnership are treated as assets used in the conduct of commercial activity by the entity in proportion to the entity's interest in the partnership, and the entity's distributive share of the partnership's income from the conduct of the commercial activity is treated as income earned by the entity from the conduct of commercial activities.

Comments recommended that the final regulations provide that the continuing due diligence and other requirements to satisfy the inadvertent commercial activity exception do not apply where an entity reasonably concludes that it holds an interest as a limited partner in a limited partnership described in proposed § 1.892-5(d)(5)(iii)(B). The final regulations do not adopt this comment because the inadvertent commercial activity exception and qualified partnership interest exception are provided for different reasons and apply in different situations. *See*, for example, § 1.892-5(a)(2)(ii)(A), which acknowledges the separate exception for qualified partnership interests by citing to § 1.892-5(d)(5)(i) (attribution from an entity classified as a partnership that is subject to the qualified partnership interest exception under § 1.892-5(d)(5)(iii)). The inadvertent commercial activity exception may be available when it is not reasonably expected for an entity's investment to result in the attribution of commercial activities. In contrast, the qualified partnership interest exception may be available even when an entity invests in a partnership that it expects will deliberately conduct activities that may be treated as commercial activities. Therefore, whether an entity reasonably concludes that it

qualifies for the qualified partnership interest exception is not a factor in determining whether the inadvertent commercial activity exception is available for activities conducted by the partnership in which the entity invests.

Proposed § 1.892-5(a)(2)(ii)(B) provides that a failure to avoid commercial activity will not be considered reasonable unless there is continuing due diligence to prevent the entity from engaging in commercial activities within or outside the United States as evidenced by having adequate written policies and operational procedures in place to monitor the entity's worldwide activities.

Comments requested additional details and illustrations with respect to "adequate written policies and operational procedures." One comment recommended a safe harbor in which an entity will be treated as having adequate written policies and operational procedures if the entity satisfies certain specified requirements, including that the entity (1) establish a written policy that prohibits the entity from engaging in commercial activities both directly and through investments in entities whose activities could be attributed to it for purposes of section 892, (2) communicate that written policy and its operational procedures to employees of the entity and other persons who have a relationship with the entity, and (3) periodically review a representative sample of the entity's investments. Another comment recommended replacing the word "adequate" with "reasonably suitable" because an entity that fails the inadvertent commercial activity exception did not, by definition, have "adequate" written policies and operational procedures.

The final regulations do not adopt the comment requesting a change to the description of written policies and operational procedures to "reasonably suitable," but instead provide examples of facts and circumstances that may be used to determine whether a written policy or operational procedure is considered adequate. *See* § 1.892-5(a)(2)(ii)(B). The description of written policies and operational procedures as being

"adequate" does not mean that the policies and procedures, viewed with hindsight, had the effect of completely preventing commercial activities, but instead means that there is a reasonable expectation that the policies and procedures will be adequate for that purpose, considering all facts and circumstances. In determining whether written policies and operational procedures are considered adequate, the final regulations adopt, with modifications, the factors recommended by the comment but without providing a safe harbor. *See* § 1.892-5(a)(2)(ii)(B)(*1*) through (*5*).

Another comment recommended adopting a standard of review for determining reasonableness by taking into account whether commercial activity is de minimis. The final regulations do not adopt this comment because, as described above, the Treasury Department and the IRS have determined that a quantitative threshold for determining whether an entity is engaged in commercial activity is inconsistent with section 892.

Proposed § 1.892-5(a)(2)(ii)(B) also provides that a failure to avoid commercial activity will not be considered reasonable if the management-level employees of the entity have not undertaken reasonable efforts to establish, follow, and enforce the written policies and operational procedures. Comments recommended that the final regulations include within the scope of this rule the management-level personnel of an entity that is affiliated with the foreign government investor or that is responsible for the management of its investments. Comments similarly recommended that an entity should be able to rely on the establishment and enforcement of policies and procedures of the investment manager of (or those of another third-party controlling investments by) funds or managed accounts in which the entity invests.

In response to these comments, the final regulations provide that either employees of the entity claiming the inadvertent commercial activity exception or employees of any of its controlling entities (such control determined within the meaning of § 1.892-5(a)(1)) may be designated to establish, follow, and enforce the adequate

written policies and operational procedures to appropriately monitor the worldwide activities of the entity claiming the inadvertent commercial activity exception. *See* § 1.892-5(a)(2)(v)(B). Moreover, the final regulations concentrate on any employees who have these oversight responsibilities, rather than solely on management-level employees, because management-level employees are not always the only employees undertaking efforts with respect to the written policies and operational procedures. However, regardless of where the responsible employees are located, the written policies and operational procedures must be adequate within the meaning of the final regulations. *See* § 1.892-5(a)(2)(ii)(B). Further, the responsible employees must in all cases undertake reasonable efforts (meaning exercising ordinary business care and prudence) in light of all facts and circumstances to establish, follow, and enforce the written policies and operational procedures.

Comments also requested with respect to the "reasonable efforts" requirement that reasonable reliance on competent tax advisors should constitute a reasonable effort to avoid conducting commercial activity, even if the advice is incorrect in hindsight. Other comments recommended creating a safe harbor under which an entity would be treated as having undertaken reasonable efforts if it had relied on tax advice that is a reasoned opinion rendered based on pertinent information and before the undertaking of the commercial activity.

The Treasury Department and the IRS have determined that an entity's failure to avoid commercial activity will not be treated as reasonable solely on the basis of obtaining a tax opinion or legal advice. Obtaining a tax opinion or legal advice alone does not supersede the need for employees of the entity claiming the inadvertent commercial activity exception (or employees of a controlling entity within the meaning of § 1.892-5(a)(1)) to take reasonable efforts to establish, follow, and enforce the applicable written policies and operational procedures to prevent the applicable entity

from engaging in commercial activity. Accordingly, the final regulations do not adopt this comment with respect to proposed § 1.892-5(a)(2)(ii)(B).

2. Inadvertent Commercial Activity Safe Harbor

The 2011 proposed regulations would provide a safe harbor under which, if there are adequate written policies and operational procedures in place, the entity's failure to avoid the conduct of commercial activity during a taxable year will be considered reasonable if it satisfies the following two conditions: (1) the value of the assets used in, or held for use in, all commercial activity does not exceed five percent of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes, and (2) the income earned by the entity from commercial activity does not exceed five percent of the entity's gross income as reflected on its income statement for the taxable year as prepared for financial accounting purposes. Proposed § 1.892-5(a)(2)(ii)(C).

Numerous comments recommended that the final regulations provide additional information about the meaning of "prepared for financial accounting purposes." Because foreign government entities are not publicly traded and are not domestic entities, they are not required to prepare financial statements under U.S. GAAP. Therefore, comments recommended that the final regulations provide that financial statements maintained under IFRS or an entity's local accounting rules or, if the entity does not prepare separate financial statements, books and records maintained in the ordinary course of its operations or for purposes of monitoring its investments will qualify for use under this safe harbor. A comment observed that many entities that own financial assets are required to use, or do use, mark-to-market accounting which, in the case of the income test, may distort an entity's eligibility for the safe harbor. The same comment also requested guidance regarding when both the income and assets limits

are to be calculated and using what convention (for example, average of the quarter-end or month-end).

The Treasury Department and the IRS have determined that the safe harbor must be applied using an applicable financial statement as defined in section 451(b)(3) and § 1.451-3(a), which may include a financial statement prepared in U.S. GAAP, IFRS, or another method required under applicable regulatory accounting rules. The final regulations provide that if the entity does not prepare financial statements for financial accounting or regulatory reporting purposes, the entity may use books of account or records that are adequate and sufficient to establish the respective amount. The final regulations also provide that the determination of asset values for purposes of the safe harbor is made using the average of amounts as of the close of each quarter of the taxable year and the determination of income is made as of the end of the taxable year. Whether mark-to-market accounting is required with respect to financial assets will depend upon the method used by the applicable financial statement. The quarterly averaging method is unnecessary for the income portion of the safe harbor because income (in contrast to assets) is measured over a period rather than as of specific dates.

A comment recommended that the final regulations increase the safe harbor thresholds to ten percent (from five percent) to alleviate challenges with obtaining necessary information about Federal entity classification status of foreign investments. Another comment recommended that only asset values be used for the safe harbor. The comment also recommended that where an entity holds an interest as a limited partner under proposed § 1.892-5(d)(5)(iii), the value of that interest be included in the entity's calculation of its total assets, but not included in the value of its commercial activity assets.

The Treasury Department and the IRS have determined that an analysis of both the entity's income and assets and a five percent threshold are reasonable and appropriate for a safe harbor that relates to inadvertent commercial activity. The five percent threshold for this purpose is used to substantiate that the commercial activity is inadvertent, rather than permitting a de minimis rule that ignores any evidence of the commercial activity being inadvertent, such as, for example, having in place adequate written policies and operational procedures. Therefore, the final regulations do not adopt the comment to increase the safe harbor thresholds or to limit the safe harbor measurements to assets only. The Treasury Department and the IRS do agree with the comment on the treatment of qualified partnership interests in the safe harbor asset test. The final regulations provide that the commercial activity asset of a qualified partnership interest that is described in § 1.892-5(d)(5)(iii) is not included as an asset used in commercial activity of the tested entity for purposes of this safe harbor, but the value of the qualified partnership interest is included in the entity's calculation of its total assets for that purpose. *See* § 1.892-5(a)(2)(ii)(A) and (a)(2)(ii)(C)*(2)*. Furthermore, the final regulations provide that a tested entity's distributive share of commercial activity income from a qualified partnership interest that is described in § 1.892-5(d)(5)(iii) is not included as income earned by the entity from commercial activity for purposes of this safe harbor, but is included in the entity's gross income for that purpose and treated as commercial activity income for all other purposes of section 892. *Id*.

3. Cure Requirement

The second requirement to qualify for the inadvertent commercial activity exception is that the commercial activity must be promptly cured as described in proposed § 1.892-5(a)(2)(iii). A cure is considered prompt under proposed § 1.892-5(a)(2)(i)(B) if the entity engaging in inadvertent commercial activity discontinues the activity within 120 days of discovering it. *See* proposed § 1.892-5(a)(2)(iii). The third

requirement is that adequate records of each discovered commercial activity and the remedial action taken to cure that activity must be maintained. The records must be retained so long as the contents thereof may become material in the administration of section 892. *See* proposed § 1.892-5(a)(2)(iv).

The proposed rule would provide, as an example, that if an entity holding an interest as a general partner in a partnership discovers that the partnership is conducting commercial activity, the entity will satisfy the cure requirement if, within 120 days of the discovery of the commercial activity, 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.

Comments recommended that the final regulations provide a period that is greater than 120 days from the date of discovery for an entity to cure the inadvertent commercial activity. One comment recommended a six-month (or 180 days) cure period, and another comment requested that the cure period be the greater of 120 days or the length of the notice and exit terms to which the entity is contractually bound under the relevant governing document of the investment, plus 45 days to initiate the process of notice and exit. Another comment asserted that a period longer than 120 days is required because of the time needed to craft a legal plan effecting the discontinuance of the commercial activity and, in some cases, to obtain required governmental or third-party approvals. Yet another comment recommended tolling the curing period until the commercial activity is discovered by an officer or employee of the entity who is reasonably expected to be aware of the significance of the activity.

The Treasury Department and the IRS have determined that a period greater than 120 days to cure the inadvertent commercial activity is reasonable and appropriate to accommodate foreign legal and commercial or contractual considerations. The final

regulations extend the cure period to 180 days from the date of the discovery by the employees who are responsible for monitoring and reviewing the entity's commercial activity pursuant to § 1.892-5(a)(2)(ii)(B) (the rule providing responsible employees undertake reasonable efforts to establish, follow, and enforce the adequate written policies and operational procedures). However, the final regulations do not adopt the other comments because adopting them would provide an entity the ability to select its own cure period based on contractual terms or by disputing whether an officer or employee of the entity was reasonably expected to have been aware of the significance of the activity.

Comments requested that the final regulations provide that an entity that is engaged in commercial activity solely by attribution through its interest in a partnership may cure inadvertent commercial activity by exchanging (including by amending the terms of) its partnership interest for one that qualifies for the exception under proposed § 1.892-5(d)(5)(iii) (the qualified partnership interest exception). The final regulations provide that an entity may, depending on the facts and circumstances, be able to satisfy the cure requirement by exchanging its partnership interest for one that is a qualified partnership interest within the meaning of § 1.892-5(d)(5)(iii) in the same partnership (including a deemed exchange from an agreed modification of terms). The final regulations do not adopt the comment as a bright-line rule because the Treasury Department and the IRS are concerned about the potential of abuse, such as negotiating for a partnership interest to be automatically exchanged for a different interest upon the discovery of commercial activity. Such an automatic feature also is inconsistent with the principles of satisfying the inadvertent commercial activity exception, which requires an entity's active involvement. The final regulations retain the language from proposed § 1.892-5(a)(2)(iii) that divesture by an entity of its interest in a partnership may be achieved by transferring its interest in the partnership to a related

entity, such as to a related entity classified as a corporation for Federal tax purposes, so that commercial activity is not attributable to an entity that is eligible for the section 892 exemption.

Finally, a comment recommended that the final regulations use the term "promptly" in § 1.892-5(a)(2) rather than interchangeably using "promptly" and "timely." In the comment's view, the term "timely" indicates a deadline imposed by a governmental body. The final regulations do not adopt this comment, but instead replace the term "promptly" in § 1.892-5(a)(2)(i)(B) with the term "timely." Because § 1.892-5(a)(2)(i)(B) provides that the commercial activity is promptly cured as described in § 1.892-5(a)(2)(iii) which in turn describes a "timely" cure (relevant to a particular time period), it is appropriate to revise the general rule in § 1.892-5(a)(2)(i)(B) as requiring a "timely" cure.

C. *Annual CCE determination*

Proposed § 1.892-5(a)(3) would provide that, if an entity described in proposed § 1.892-5(a)(1)(i) or (ii) (relating to whether the entity is controlled by a foreign government) engages in commercial activities at any time during the taxable year, the entity will be considered a CCE for the entire taxable year. An entity not otherwise engaged in commercial activities during a taxable year will not be considered a CCE for a taxable year even if the entity engaged in commercial activities in a prior taxable year.

A comment recommended that the final regulations expressly provide that the relevant taxable year for purposes of this rule is the taxable year of the entity. Another comment requested guidance on whether an entity's commercial activity carries over to an acquiring entity in an asset reorganization or a transaction in which the transferee retains the tax attributes of the transferor under section 381.

The final regulations generally adopt the comment's recommendation that the annual determination of whether an entity is a CCE under proposed § 1.892-5(a)(3) be

made with respect to the entity's taxable year, which may be less than a 12-month period if, for example, the entity's taxable year is terminated as a result of a transaction or reorganization. *See* § 1.892-5(a)(3)(i). If the taxable year of a corporation engaged in commercial activity is terminated as a result of an acquisition to which section 381(a) applies (except for a complete liquidation under section 332(a), which acquisition would fall within the exception to this general rule as described below), the acquiring corporation generally does not succeed to the commercial activity of the distributor or transferor corporation for the acquiring corporation's applicable taxable year, provided that after the acquisition, the acquiring corporation is not the entity that directly carries on such commercial activity. *See* § 1.892-5(a)(3)(ii)(A). This condition might be met in the case of reorganizations followed by transfers described in § 1.368-2(k). However, if the corporation engages in an acquisition to which section 381(a) applies with another corporation controlled by the same foreign sovereign under § 1.892-5(a)(1), for example, in a complete liquidation of a subsidiary under section 332(a), then the distributor or transferor corporation's commercial activity will cause the acquiring corporation to be treated as a CCE for the acquiring corporation's taxable year in which the acquisition occurred. *See* § 1.892-5(a)(3)(ii)(B).

As a result of adopting the taxable year as the relevant measurement period for the annual CCE test, it is possible without further safeguards that activity in one taxable year, considered in isolation, might not be characterized as commercial, even though it is part of a course of conduct or transaction spanning two taxable years which, taken as a whole, is characterized as commercial activity. For example, consider a controlled entity whose taxable year is the calendar year and conducts activity in December of year 1 that relates to a transaction the controlled entity enters into in January of year 2. Without any additional guardrails to the annual CCE test, if the January transaction in isolation is not considered commercial activity, and no commercial activities were

otherwise performed by the controlled entity in year 2, the controlled entity would not be treated as a CCE in year 2, even if the activities in December of year 1 and January of year 2 constitute commercial activities when considered together. To address this scenario, the final regulations provide that for purposes of determining whether an entity is engaged in commercial activities during its taxable year, that entity's activities during its immediately preceding taxable year will also be taken into account to the extent relevant in characterizing the activities in the current taxable year. *See* § 1.892-5(a)(3)(i). The Treasury Department and the IRS concluded that this test should not look past the immediately preceding year for reasons of administrability, but other doctrines may still apply to activities that occur across multiple years in form and only one year in substance when making the commercial activity determination.

Another comment recommended that an entity that is a CCE under § 1.892-5T(b)(1) solely because it is a USRPHC should not be treated as a CCE for its entire taxable year if the entity ceases to be a USRPHC on any determination date under § 1.897-2(c) or through operation of the cleansing rule of section 897(c)(1)(B). The Treasury Department and the IRS have determined that an exception to proposed § 1.892-5(a)(3) in this limited situation would be inconsistent with the treatment of other types of entities that do not have the option to cleanse themselves of CCE status. Moreover, since the 2011 proposed regulations were published, the cleansing rule of section 897(c)(1)(B) generally was eliminated for regulated investment companies (RICs) and REITs and, therefore, adopting this comment would have limited effect only for domestic corporations that are not RICs or REITs. In addition, the final regulations provide that only domestic corporations are subject to the rule in § 1.892-5(b)(1)(i) that treats controlled USRPHCs as CCEs. This change to § 1.892-5(b)(1) narrows the scope of entities that are treated as CCEs, thereby partially addressing the comment's concerns. Therefore, the final regulations do not adopt this comment.

D. *Commercial activities of partnerships*

The 1988 temporary regulations generally attribute all commercial activities of a partnership to its general and limited partners except for partners of publicly traded partnerships (PTP). *See* § 1.892-5T(d)(3). Proposed § 1.892-5(d)(5)(i) of the 2011 proposed regulations generally would attribute commercial activities of an entity classified as a partnership for Federal tax purposes to its partners, subject to two exceptions, for trading activity and for limited partnership interests. *See* proposed § 1.892-5(d)(5)(ii) and (iii). The preamble to the 2011 proposed regulations explained that the limited partnership interest exception under proposed § 1.892-5(d)(5)(iii) "modifies the existing exception to the partnership attribution rule for PTP interests by providing a more general exception for limited partnership interests." Comments noted that it may be necessary to amend § 1.892-5T(d)(3) and (4) to coordinate with the final regulations to the extent they preserve proposed § 1.892-5(d)(5). The final regulations withdraw § 1.892-5T(d)(3) and, in its place, adopt proposed § 1.892-5(d)(5)(i) with minor modifications. In addition, the final regulations modify § 1.892-5T(d)(4) by removing Example 4, which is obsoleted by the final regulations.

The trading activity exception under proposed § 1.892-5(d)(5)(ii) would provide that an entity not otherwise engaged in commercial activities will not be considered to be engaged in commercial activities solely because the entity is a member of a partnership (whether domestic or foreign) that effects transactions in stocks, bonds, other securities (as defined in § 1.892-3T(a)(3)), commodities (as defined in proposed § 1.892-4(e)(1)(ii)), or financial instruments (as defined in § 1.892-3T(a)(4)) for the partnership's own account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects such transactions for the account of the partnership. This exception does not apply to any member in the case of a partnership

that is a dealer in stocks, bonds, other securities, commodities, or financial instruments, as determined under the principles of § 1.864-2(c)(2)(iv)*(a)*. The final regulations adopt proposed § 1.892-5(d)(5)(ii) with minor modifications.

A comment recommended that transitory ownership of a pass-through entity not result in attribution of commercial activity from that pass-through entity. The final regulations do not adopt this comment because of administrability challenges as to whether a transfer was transitory. No other comments were received with respect to the attribution of commercial activities by a partnership under proposed § 1.892-5(d)(5)(i) or the trading activity exception under proposed § 1.892-5(d)(5)(ii). Instead, comments made recommendations about the treatment under section 892 of income derived from partnerships or gain arising from the disposition of a partnership interest.

The 2011 proposed regulations would not alter the treatment of the income derived by an entity. For example, proposed § 1.892-5(d)(5)(iii)(A) would provide that, despite an entity that holds an interest as a limited partner in a limited partnership not being treated as conducting commercial activities, that entity's distributive share of partnership income will not be exempt from taxation under section 892 to the extent that the partnership derives such income from the conduct of commercial activity. With the exception of § 1.892-3(a)(4) (regarding the definition of financial instruments), the final regulations do not address the items of income that are exempt under section 892. Accordingly, recommendations about the treatment under section 892 of income derived from partnerships or gain arising from the disposition of a partnership interest are outside the scope of the final regulations and are not adopted.

E. *Qualified partnership interest exception*

The 2011 proposed regulations would provide for a limited partnership interest exception in which an entity that is not otherwise engaged in commercial activities (including, for example, performing services for a partnership as described in section

707(a) or section 707(c)) will not be deemed to be engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership. Proposed § 1.892-5(d)(5)(iii)(A). The 2011 proposed regulations also would provide that a foreign government member's distributive share of partnership income will not be exempt from taxation under section 892 to the extent that the partnership derived such income from the conduct of commercial activity.

For this purpose, an interest in an entity classified as a partnership for Federal tax purposes would be treated as an interest as a limited partner in a limited partnership if the holder does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year under the law of the jurisdiction in which the partnership is organized or under the governing agreement. *See* proposed § 1.892-5(d)(5)(iii)(B). The 2011 proposed regulations would provide that rights to participate in the management and conduct of a partnership's business do not include consent rights in the case of extraordinary events such as admission or expulsion of a general or limited partner, amendment of the partnership agreement, dissolution of the partnership, disposition of all or substantially all of the partnership's property outside of the ordinary course of the partnership's activities, merger, or conversion. *Id.*

1. Tax Classification as a Partnership

Comments recommended that the final regulations confirm that § 1.892-5(d)(5)(iii) does not apply solely to limited partnerships under State or local law. To this end, the comments recommended replacing the phrase "interest as a limited partner in a limited partnership" with "a passive investment in a partnership or other flow-through entity" or expressly providing that interests as a limited partner in limited liability companies and other vehicles not taking the form of State law partnerships can qualify under § 1.892-5(d)(5)(iii).

The Treasury Department and the IRS are of the view that the 2011 proposed regulations already would provide that a qualifying partnership interest can include certain interests other than interests in a State law limited partnership. By providing that "an interest in an entity classified as a partnership for Federal tax purposes is treated as an interest as a limited partner in a limited partnership," the 2011 proposed regulations were not confining the scope of the exception to State law partnerships. Thus, for example, an interest in a limited liability company that is classified as a partnership for Federal tax purposes may qualify under proposed § 1.892-5(d)(5)(iii) if the other requirements are satisfied. To make this clearer, the final regulations adopt the term "qualified partnership interest" rather than "interest as a limited partner in a limited partnership." No inference is intended by this change as to the meaning of the phrase "limited partner" in other Code sections or Treasury regulations.

Because the qualified partnership interest exception applies to more than only State law partnerships, the Treasury Department and the IRS determined that the qualified partnership interest exception should set forth uniform requirements applicable to all relevant juridical forms to which the qualified partnership interest exception may apply. Accordingly, the final regulations contain requirements that a holder of a qualified partnership interest must not (1) have personal liability for claims against the partnership; or (2) have the right to enter into contracts or act on behalf of the partnership. These requirements are generally consistent with the rights of a limited partner under relevant State law, but apply regardless of the legal form of the entity or the governing law.

Further, the Treasury Department and the IRS agree with the comment that the qualified partnership interest exception should be available only for passive investments in partnerships. To that end, in addition to the two requirements provided in the previous paragraph, the qualified partnership interest exception retains the requirement

that the holder of the partnership interest must not have rights to participate in the management and conduct of the partnership's business and adopts a requirement that the holder must not control the partnership within the meaning of § 1.892-5(a)(1). The Treasury Department and the IRS have determined that these four requirements are necessary and appropriate guardrails to help ensure that the qualified partnership interest exception is available only to partnership equity interest holders with passive participation in the partnership. Accordingly, the final regulations do not adopt a separate comment suggesting that a greater than 50 percent economic interest (which would constitute a controlling interest in an entity under § 1.892-5(a)(1)(iii)(A)) in a partnership could be a qualified partnership interest.

2. Rights to Participate in the Management and Conduct of a Partnership's Business

With respect to the requirement under the qualified partnership interest exception that the holder does not have rights to participate in the management and conduct of the partnership's business, comments recommended that the final regulations provide greater specificity on exactly which rights satisfy the definition. For example, a comment recommended that the final regulations adopt a standard under which general oversight rights, consultation rights, and veto rights are treated as consistent with holding an interest as a limited partner under proposed § 1.892-5(d)(5)(iii)(B) because these rights serve the purpose of allowing the investor to monitor and protect its investment and do not convey control over the partnership's day-to-day operations. Another comment recommended that the final regulations provide that consent rights customarily granted to a significant lender, such as approval of a borrowing entity's annual budget, major transactions and expenses, and other similar items be permitted under § 1.892-5(d)(5)(iii)(B). Other comments recommended that the final regulations provide that investor rights typically granted by side letters, including certain veto rights and consent rights with respect to key decisions and extraordinary events outside of a

partnership's day-to-day management, are consistent with holding an interest as a limited partner. Comments also recommended that the final regulations provide that holding an interest as a limited partner can include participating on a partnership's investment advisory committee or holding a minority position on a partnership's governing committee because these roles are consistent with being a passive investor by providing investors with consent rights normally afforded to minority investors for the purpose of monitoring and protecting their investments.

These comments generally suggested that participation in the management and conduct of a partnership's business refers to participation in the day-to-day management or operation of the partnership's business and does not include participation in activities relating to monitoring and protecting the partnership interest holder's capital investment. The Treasury Department and the IRS agree, and the final regulations clarify that rights to participate in the management and conduct of a partnership's business mean rights to participate in the day-to-day management or operation of the partnership's business. The final regulations also provide that rights to participate in monitoring or protecting the partnership interest holder's capital investment in the partnership do not constitute rights to participate in the management and conduct of the partnership's business, to the extent such rights are not rights to participate in the day-to-day management or operation of the partnership's business and do not result in effective control under § 1.892-5(a)(1)(iii)(B).

Due to the highly fact-intensive nature of determining whether rights to participate in the management and conduct of a partnership's business exist, the final regulations do not provide an exclusive list of rights that would (or would not) be consistent with participating in the management and conduct of a partnership's business. Instead, the Treasury Department and the IRS have determined that this analysis should be based on a holistic review taking into account all the facts and circumstances. The final

regulations do specify, however, that participation in the management and conduct of a partnership's business includes the right to participate in ordinary-course personnel and compensation decisions, and the right to take active roles in formulating the business strategy for the partnership. The final regulations also specify that rights to monitor or protect capital investment in the partnership may include oversight or supervisory rights in the case of major strategic decisions, such as admission or expulsion of a partner, amendment of the partnership agreement, or dissolution of the partnership, unusual and non-ordinary course deviations from previously determined investment parameters, extending the term of the partnership's governing agreement, merger or conversion of the partnership, or disposition of all or substantially all of the partnership's property outside of the ordinary course of the partnership's activities. Facts and circumstances pertaining to the analysis of participation in the management and conduct of a partnership's business may be identified by reference to, for example, the conduct of the relevant parties, the law of the jurisdiction in which the partnership is organized, the governing documents of the partnership, contractual agreements such as side letters, shareholders' agreements, and the partnership's agreements with creditors. *See* § 1.892-5(d)(5)(iii)(B).

Comments also recommended that the final regulations eliminate the rule that the law of the jurisdiction in which a partnership is organized determines whether a partner has rights to participate in the management and conduct of the partnership's business. These comments asserted that making this determination under this standard would be complex and burdensome. These comments, therefore, also recommended that an investor be permitted to rely on the advice of local counsel when determining whether the investor has rights exceeding those permitted under proposed § 1.892-5(d)(5)(iii)(B).

The final regulations do not adopt these comments because the Treasury Department and the IRS have determined that the relevant law of the jurisdiction in which the partnership is organized often sets forth certain default rights where rights are not expressly provided by the entity's governing documents, and that those default rights are relevant to a facts and circumstances analysis.

No inference is intended as to the meaning of the phrase "participate in the management and conduct of the partnership's business" or similar phrases and standards in other Code sections and Treasury regulations.

3. Qualified Partnership Interest Safe Harbors

A comment recommended that 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 first safe harbor would be available to investors who have obtained legal opinions stating that the investors are, in fact, and, at law, limited partners with limited liability. The second safe harbor recommended by the comment would cover interests in widely held investment partnerships with more than ten unrelated partners. The third recommended safe harbor would cover investors who hold less than a prescribed percentage of interests in a partnership. The comment recommended taking into account all investors both in the main investment vehicle and any related parallel or alternative investment vehicles for purposes of determining whether an investor qualifies for the widely held or the de minimis safe harbors.

The final regulations adopt a safe harbor for a holder who at all times during the partnership's taxable year (1) has no personal liability for claims against the partnership; (2) has no right to enter into contracts or act on behalf of the partnership; (3) is not a managing member or managing partner, and does not hold an equivalent role under applicable law; and (4) does not directly or indirectly (under the principles of § 1.892-

5(d)(5)(iii)(B)*(2)(iii)*) own more than five percent of either the partnership's capital interests or the partnership's profits interests. *See* § 1.892-5(d)(5)(iii)(C). The Treasury Department and the IRS have determined that this safe harbor would ease the compliance burden for those investors who fall within its scope. The first two requirements typically would be met by a holder treated as a limited partner under State law. As to the last two requirements, an investor with no more than five percent of a partnership's capital or profits interests and who is neither a managing member (in the case of an entity organized as a limited liability company) nor a managing partner (in the case of an entity organized as a partnership) is unlikely to control the partnership under § 1.892-5(a)(1) or have any rights to participate in the management and conduct of a partnership's business and thus can be treated as a passive investor. Although a foreign government investor, for example, that satisfies the requirements of the safe harbor is not attributed the partnership's commercial activities, the investor's distributive share of the partnership's income from the conduct of commercial activity is not exempt from taxation under section 892. *See* § 1.892-5(d)(5)(iii)(A).

4. Holding Multiple Interests in a Partnership or in Tiered Partnerships

Finally, comments made requests and recommendations regarding tiers of partnerships and attribution of the qualified partnership interest exception among classes of partnership interests. Comments recommended that the final regulations provide rules for the operation of the qualified partnership interest exception in tiered partnership structures. These comments asserted that an investor should not be deemed to participate in the management and conduct of a lower-tier partnership's business if that investor holds an interest in an upper-tier partnership that does not engage in any commercial activity and does not afford the investor any rights to participate in the management and conduct of the lower-tier partnership's business. In other words, these comments requested that the final regulations apply a "bottom-up"

approach in determining whether the requirements for the qualified partnership interest exception are met.

Another comment requested that the final regulations provide guidance on whether the rights of one class of partnership interest could be attributed to another class of partnership interest when determining whether an investor, who holds multiple classes of partnership interests, satisfies the exception under proposed § 1.892-5(d)(5)(iii). The comment asserted that the qualified partnership interest exception should apply in situations where an investor, in addition to holding its interest as a limited partner in a limited partnership, also holds an interest as a limited partner in the general partner of the same limited partnership.

The final regulations adopt with modifications the comment that the qualified partnership interest exception applies from the bottom up. An upper-tier partnership that holds a qualified partnership interest in a lower-tier partnership is not attributed the lower-tier partnership's commercial activities. If, however, the upper-tier partnership's interest in a lower-tier partnership is not a qualified partnership interest, the lower-tier partnership's commercial activity will be attributed to the upper-tier partnership and could, in turn, be further attributed to a foreign government investor holding an interest in the upper-tier partnership unless the investor holds a qualified partnership interest in the upper-tier partnership. *See* § 1.892-5(d)(5)(iii)(D).

The rules in § 1.892-5(d)(5)(iii)(D) applicable to tiered partnerships may provide relief in certain circumstances if, in addition to holding directly a qualified partnership interest in a lower-tier partnership, the foreign government investor holds a qualified partnership interest in the entity that is a general partner of the lower-tier partnership and does not have rights to participate in the management and conduct of the general partner's business in managing the lower-tier partnership.

With respect to holding multiple classes of interests in the same partnership, the final regulations provide that all interests held in a partnership by an investor are evaluated in their totality to determine whether the investor has rights to participate in the management and conduct of that partnership's business. *See* § 1.892-5(d)(5)(iii)(B)*(2)(i).* Thus, the final regulations do not adopt the approach that the qualified partnership interest exception ignores other interests held by an investor in the same partnership.

The final regulations also provide that where a foreign sovereign holds directly or indirectly multiple interests in a partnership through one or more integral parts or controlled entities as defined in § 1.892-2T, or controlled subsidiaries under § 1.892-5(a)(1), all of these entities' interests in the partnership are aggregated for purposes of the qualified partnership interest exception. To the extent any one entity's interest or all of the interests aggregated together fails to satisfy the qualified partnership interest exception, then none of the entities would qualify for the qualified partnership interest exception. *See* § 1.892-5(d)(5)(iii)(B)*(2)(iii).*

F. *Other comments and revisions*

In addition to the comments and revisions described in parts II and III of this Summary of Comments and Explanation of Revisions, the final regulations include several drafting changes. The final regulations revise the structure of the provisions of the 2011 proposed regulations to be consistent with the structure of the 1988 temporary regulations. In doing so, the final regulations change the placement of rules under § 1.892-4(c).

There were numerous comments that were outside the scope of the final regulations and, therefore, are not adopted by the final regulations. Several comments recommended that § 301.7701-2(b)(6) (treating a business entity wholly owned by a foreign government as a per se corporation) be modified so that a business entity that is

wholly owned by a foreign government is not precluded from electing to be disregarded as an entity separate from its owner. Another comment requested guidance on whether incentive compensation arrangements for investment advisors, brokers, or employees would cause an entity to fail the requirement under § 1.892-2T(a)(3)(iii) (requiring that net earnings of the entity be credited to its own account or to other accounts of the foreign sovereign, with no portion of the entity's income inuring to the benefit of any private person) to be a controlled entity. The comment also requested guidance on whether an entity established under a statute with a separate legal personality can be an "integral part" of a foreign sovereign under § 1.892-2T(a). Finally, a comment recommended modifying § 1.882-5(a)(6) to remove the limitation on a foreign government's ability to deduct its allocable interest expense. The final regulations do not adopt these comments because they are outside the scope of the final regulations. However, the final regulations modify § 1.882-5(a)(6) to update the cross-reference to § 1.892-5.

IV. *Applicability Dates*

The 2011 proposed regulations were proposed to apply on the date the final regulations are published in the **Federal Register**. *See* proposed §§ 1.892-4(f) and 1.892-5(e). The preamble to the 2011 proposed regulations provided that taxpayers may rely on the 2011 proposed regulations until final regulations are issued. The 2022 proposed regulations were proposed to apply to taxable years ending on or after December 28, 2022. *See* proposed § 1.892-5(b)(1)(iii). The preamble to the 2022 proposed regulations provided that taxpayers may rely on the 2022 proposed regulations until the date of publication of the final regulations in the **Federal Register**. The rules under §§ 1.892-4T and 1.892-5T are effective for taxable years beginning after June 30, 1986, until, and only to the extent that, they are replaced by these final regulations.

The Treasury Department and the IRS have determined that the applicability date of the 2025 final regulations should be consistent with the 2011 proposed regulations and generally apply to taxable years beginning on or after the date the regulations become finalized in the **Federal Register**. A comment recommended that when the 2011 proposed regulations are finalized, taxpayers be permitted to apply the provisions of the final regulations to all open taxable years. The Treasury Department and the IRS agree that taxpayers should be permitted to apply the rules of the 2025 final regulations, once finalized, to their open taxable years subject to consistency requirements. Accordingly, except in the case of § 1.892-3(a)(6) and the second sentence of § 1.892-5(a)(1) (rules finalized in prior regulations), the final regulations provide that a taxpayer may choose to apply the 2025 final regulations to a taxable year beginning before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** (finalization date) if the period of limitations on assessment of the taxable year is open under section 6501 and the taxpayer and entities that are related (within the meaning of section 267(b) or section 707(b)) to the taxpayer consistently apply the rules of 2025 final regulations in their entirety to the taxable year and all succeeding taxable years beginning before the finalization date.

Another comment recommended that taxpayers who have structured investments in reliance on the 2011 proposed regulations be given a transition period to undertake any necessary restructuring if the final regulations are different from the 2011 proposed regulations. The final regulations do not adopt this comment. The Treasury Department and the IRS have determined that the provisions of the final regulations are consistent with the 2011 proposed regulations and the differences do not require a transition period. A separate notice of proposed rulemaking is published in this issue of the **Federal Register** which contains proposed changes and modifications that are materially different from the 2011 proposed regulations.

Special Analyses

I. *Regulatory Planning and Review – Economic Analysis*

These final regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (July 4, 2025) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520) (PRA) generally requires that a Federal agency obtain the approval of the OMB before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information in these final regulations contains recordkeeping requirements. The recordkeeping requirements are necessary for the IRS to validate if certain entities have met the regulatory requirements and are entitled to the inadvertent commercial activity exception under section 892. No public comments received by the IRS were directed at the recordkeeping requirements. The recordkeeping requirements in § 1.892-5(a)(2)(ii)(B) and § 1.892-5(a)(2)(iv) are approved by OMB under Control Number 1545-2239.

III. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this rulemaking will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act. This certification is based on the fact that the final regulations affect foreign governments, including their controlled entities, with income from sources within

the United States. Accordingly, the entities affected by the final regulations are not considered small entities, and a regulatory flexibility analysis under the Regulatory Flexibility Act is not required.

IV. *Section 7805(f)*

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business. No comments on that notice of proposed rulemaking were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

V. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. These final regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

VI. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. These final regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order.

Statement of Availability of IRS Documents

IRS guidance cited in this preamble is published in the Internal Revenue Bulletin and is available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *https://www.irs.gov*.

Drafting Information

The principal authors of the final regulations are Jack Zhou of the Office of Associate Chief Counsel (International), and Joel Deuth, formerly of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, the Treasury Department and the IRS amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries for §§ 1.892-3 and 1.892-4 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Section 1.892-3 also issued under 26 U.S.C. 892(c).

* * * * *

Section 1.892-4 also issued under 26 U.S.C. 892(c).

* * * * *

Par. 2. Section 1.882-5 is amended by revising paragraph (a)(6) to read as follows:

§ 1.882-5 Determination of interest deduction.

(a) * * *

(6) *Special rule for foreign governments*. The amount of interest expense of a foreign government, as defined in § 1.892-2T(a), that is allocable to ECI is the total amount of interest paid or accrued within the taxable year by the United States trade or business on U.S. booked liabilities (as defined in paragraph (d)(2) of this section). Interest expense of a foreign government, however, is not allocable to ECI to the extent that it is incurred with respect to U.S. booked liabilities that exceed 80 percent of the total value of U.S. assets for the taxable year (determined under paragraph (b) of this section). This paragraph (a)(6) does not apply to controlled commercial entities within the meaning of § 1.892-5.

* * * * *

Par. 3. Section 1.892-3 is revised to read as follows:

§ 1.892-3 Income of foreign governments.

(a) *Types of income exempt*—(1) *In general*. For further guidance, *see* § 1.892-3T(a)(1).

(2) *Income from investments*. For further guidance, *see* § 1.892-3T(a)(2).

(3) *Securities*. For further guidance, *see* § 1.892-3T(a)(3).

(4) *Financial instrument*—(i) *Definition*. For purposes of this paragraph (a), the term *financial instrument* includes:

(A) Any interest rate, currency, equity, or commodity (as the term is used in section 864(b)(2)(B) and § 1.864-2(d)) notional principal contract (as the term is used in section 475(c)(2)); or

(B) Any evidence of an interest in options, forward or futures contracts, and any other similar contracts, the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following:

(*1*) Commodity (as the term is used in section 864(b)(2)(B) and § 1.864-2(d));

(*2*) Currency;

(*3*) Share of stock;

(*4*) Partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust;

(*5*) Note, bond, debenture, or other evidence of indebtedness; or

(*6*) Notional principal contract described in paragraph (a)(4)(i)(A) of this section.

(ii) *Special rule*. For purposes of paragraph (a)(4)(i) of this section, nonfunctional currency or gold is a financial instrument when physically held by a foreign central bank of issue (as defined in § 1.895-1(b)).

(5) *Execution of financial or monetary policy*. For further guidance, *see* § 1.892-3T(a)(5).

(6) *Dividend equivalents.* Income from investments in stocks includes the payment of a dividend equivalent described in section 871(m) and the regulations in this part under section 871(m).

(b) *Illustrations*. For further guidance, *see* § 1.892-3T(b).

(c) *Applicability dates*. (1) Paragraph (a)(4) of this section applies to taxable years beginning on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. *See* § 1.892-3T(a)(4), as contained in 26 CFR in part 1 in effect on April 1, 2025, for the rules that apply to taxable years beginning before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. A taxpayer may choose to apply paragraph (a)(4) of this section to a taxable year beginning before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, if the period of limitations on assessment of the taxable year is open under section 6501 and the taxpayer and entities that are related (within the meaning of section 267(b) or section 707(b)) to the taxpayer apply this rule and §§ 1.892-4 and 1.892-5 in their entirety to the taxable year

and all succeeding taxable years beginning before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

(2) Paragraph (a)(6) of this section applies to payments made on or after December 5, 2013.

Par. 4. Section 1.892-3T is amended by revising paragraph (a)(4) to read as follows:

§ 1.892-3T Income of foreign governments (temporary regulations).

(a) * * *

(4) *Financial instrument*. For further guidance, *see* § 1.892-3(a)(4).

* * * * *

Par. 5. Section 1.892-4 is added to read as follows:

§ 1.892-4 Commercial activities.

(a) *Purpose*. The exemption generally applicable to a foreign government (as defined in § 1.892-2T) for income described in §§ 1.892-3T and 1.892-3 does not apply to income derived from the conduct of commercial activity (whether within or outside the United States), income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or income derived from the disposition of any interest in a controlled commercial entity. This section provides rules for determining whether income is derived from the conduct of commercial activity. The rules in this section also apply in determining under §§ 1.892-5T and 1.892-5 whether an entity is a controlled commercial entity.

(b) *In general*. Except as provided in paragraph (c) of this section, all activities (whether conducted within or outside the United States) that are ordinarily conducted for the current or future production of income or gain are commercial activities. Only the nature of the activity, not the purpose or motivation for conducting the activity, is determinative of whether the activity is commercial in character. For purposes of this

paragraph (b), activities that constitute a trade or business for purposes of section 162 or constitute (or would constitute if undertaken in the United States) a trade or business in the United States for purposes of section 864(b) are commercial activities except as otherwise provided in paragraph (c) of this section.

(c) *Activities that are not commercial*—(1) *Investments*—(i) *In general*. Subject to the provisions of this paragraph (c), the following are not commercial activities: investments in stocks, bonds, and other securities (as defined in § 1.892-3T(a)(3)); loans; investments in financial instruments (as defined in § 1.892-3(a)(4)); the holding of partnership equity interests; the holding of net leases on real property; the holding of real property which is not producing income (other than on its sale or from an investment in net leases on real property); and the holding of deposits in any currency in banks. Transferring securities under a loan agreement which meets the requirements of section 1058 is an investment for purposes of this paragraph (c)(1)(i). An activity will not cease to be an investment solely because of the volume of transactions of that activity or because of other unrelated activities.

(ii) [Reserved]

(iii) *Banking, financing, etc*. For further guidance, *see* § 1.892-4T(c)(1)(iii).

(2) *Trading.* Effecting transactions in stocks, bonds, other securities (as defined in § 1.892-3T(a)(3)), partnership equity interests, commodities, or financial instruments (as defined in § 1.892-3(a)(4)) for a foreign government's own account does not constitute commercial activity. Such transactions are not commercial activities regardless of whether they are effected by the foreign government through its employees or through a broker, commission agent, custodian, or other independent agent and regardless of whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. Such transactions undertaken as a dealer (as determined under the principles of § 1.864-2(c)(2)(iv)(*a*)), however,

constitute commercial activity. For purposes of this paragraph (c)(2), the term *commodities* means commodities of a kind customarily dealt in on an organized commodity exchange but only if the transaction is of a kind customarily consummated at such place.

(3) *Disposition of a U.S. real property interest*. A disposition (including a deemed disposition under section 897(h)(1)) of a U.S. real property interest (as defined in section 897(c)), by itself, does not constitute the conduct of commercial activity. As described in § 1.892-3T(a), however, gain derived from a disposition of a U.S. real property interest defined in section 897(c)(1)(A)(i) will not qualify for exemption from tax under section 892.

(4) *Cultural events*. For further guidance, *see* § 1.892-4T(c)(2).

(5) *Non-profit activities*. For further guidance, *see* § 1.892-4T(c)(3).

(6) *Governmental functions*. For further guidance, *see* § 1.892-4T(c)(4).

(7) *Purchasing*. For further guidance, *see* § 1.892-4T(c)(5).

(d) *Applicability date.* Except as otherwise provided in this paragraph (d), this section applies to taxable years beginning on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. *See* § 1.892-4T, as contained in 26 CFR in part 1 in effect on April 1, 2025, for the rules that apply to taxable years beginning before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. A taxpayer may choose to apply this section to a taxable year beginning before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, if the period of limitations on assessment of the taxable year is open under section 6501 and the taxpayer and entities that are related (within the meaning of section 267(b) or section 707(b)) to the taxpayer apply this section and §§ 1.892-3(a)(4) and 1.892-5 in their entirety to the taxable year and all succeeding taxable years beginning before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Par. 6. Section 1.892-4T is amended by revising paragraphs (a), (b), and (c)(1)(i) and (ii) to read as follows:

§ 1.892-4T Commercial activities (temporary regulations).

(a) *Purpose*. For further guidance, *see* § 1.892-4(a).

(b) *In general*. For further guidance, *see* § 1.892-4(b).

(c) * * *

(1) * * *

(i) *In general*. For further guidance, *see* § 1.892-4(c)(1)(i).

(ii) *Trading*. For further guidance, *see* § 1.892-4(c)(2).

* * * * *

Par. 7. Section 1.892-5 is revised to read as follows:

§ 1.892-5 Controlled commercial entity.

(a) *In general*—(1) *General rule and definition of the term controlled commercial entity*. (i) Under section 892(a)(2)(A)(ii) and (iii), the exemption generally applicable to a foreign government (as defined in § 1.892-2T) for income described in §§ 1.892-3T and 1.892-3 does not apply to income received by a controlled commercial entity or received (directly or indirectly) from a controlled commercial entity, or to income derived from the disposition of any interest in a controlled commercial entity.

(ii) For purposes of section 892(a)(2)(B) and this section, the term *entity* includes a corporation, a partnership, a trust (including a pension trust described in § 1.892-2T(c)), and an estate.

(iii) The term *controlled commercial entity* means any entity (including a controlled entity as defined in § 1.892-2T(a)(3)) engaged in commercial activities (as defined in §§ 1.892-4T and 1.892-4) (whether conducted within or outside the United States) if the foreign government—

(A) Holds (directly or indirectly) any interest in such entity which (by value or

voting power) is 50 percent or more of the total of such interests in such entity; or

(B) Holds (directly or indirectly) any other interest in such entity which provides the foreign government with effective control of such entity.

(2) *Inadvertent commercial activity*—(i) *General rule*. For purposes of section 892(a)(2)(B) and paragraph (a)(1) of this section, a tested entity that conducts, including by attribution, only inadvertent commercial activity will not be considered to be engaged in commercial activities. However, any income derived from any foreign government's inadvertent commercial activity (including activity attributed from a partnership) will not qualify for exemption from tax under section 892. Commercial activity of a tested entity will be treated as inadvertent commercial activity only if:

(A) Failure to avoid conducting the commercial activity is reasonable as described in paragraph (a)(2)(ii) of this section;

(B) The commercial activity is timely cured as described in paragraph (a)(2)(iii) of this section; and

(C) The record maintenance requirements described in paragraph (a)(2)(iv) of this section are met.

(ii) *Reasonable failure to avoid commercial activity*—(A) *In general.* Subject to paragraphs (a)(2)(ii)(B) and (C) of this section, whether a tested entity's failure to prevent its worldwide activities from resulting in commercial activity is reasonable will be determined based on all the facts and circumstances. Due regard will be given to the number of commercial activities conducted during the taxable year and the activities in the immediately preceding taxable year to the extent relevant in characterizing the activities in the current taxable year, as well as the amount of income earned from, and assets used in, the conduct of the commercial activities in relationship to the tested entity's total income and assets. For purposes of this paragraph (a)(2)(ii)(A) and paragraph (a)(2)(ii)(C) of this section, where commercial activity conducted by a

partnership is attributed under paragraph (d)(5)(i) of this section to a tested entity owning an interest in the partnership—

(*1*) Assets used in the conduct of the commercial activity by the partnership are treated as assets used in the conduct of commercial activity by the entity in proportion to the tested entity's interest in the partnership; and

(*2*) The tested entity's distributive share of the partnership's income from the conduct of the commercial activity is treated as income earned by the tested entity from the conduct of commercial activities.

(B) *Continuing due diligence requirement*. A failure to avoid commercial activity will not be considered reasonable unless there is continuing due diligence to prevent the tested entity from engaging in commercial activities within or outside the United States as evidenced by having adequate written policies and operational procedures, within the meaning of this paragraph (a)(2)(ii)(B), in place to monitor the tested entity's worldwide activities. A failure to avoid commercial activity will not be considered reasonable if responsible employees have not undertaken reasonable efforts, based on all facts and circumstances, to establish, follow, and enforce such written policies and operational procedures with respect to the tested entity. For purposes of this paragraph (a)(2)(ii)(B), all facts and circumstances are considered in the determination of whether written policies and operational procedures are considered adequate, including whether the written policies and operational procedures:

(*1*) Prohibit the tested entity from engaging in commercial activities both directly and through investments in entities whose commercial activities would be attributed to the tested entity within the meaning of this section;

(*2*) Are communicated in writing to all persons who exercise discretionary authority, acting alone or as part of a decisional body, to cause the tested entity to undertake an investment;

(*3*) Require an advance determination, by receipt of an opinion of counsel or otherwise, as to whether an investment is commercial activity;

(*4*) 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 within the meaning of this section; and

(*5*) Require the result of periodic tests to be reviewed and certified by responsible employees who have authority and obligation to cause the curing of any commercial activity disclosed in such procedures.

(C) *Safe Harbor*—(*1*) *In general*. Provided that adequate written policies and operational procedures are in place to monitor the tested entity's worldwide activities as required in paragraph (a)(2)(ii)(B) of this section, the tested entity's failure to avoid commercial activity during the taxable year will be considered reasonable if:

(*i*) The value of the assets used in, or held for use in, all commercial activity does not exceed five percent of the total value of the assets reflected on the tested entity's balance sheet for the taxable year, determined using the average of the value of the assets as of the close of each quarter of the taxable year, as prepared for an applicable financial statement as defined in section 451(b)(3) and § 1.451-3(a), or, if the tested entity is not required to prepare a balance sheet for an applicable financial statement, as reflected in the books of account or records that are adequate and sufficient to establish the amount; and

(*ii*) The income earned by the tested entity from commercial activity does not exceed five percent of the tested entity's gross income as reflected on its income statement for the taxable year, as prepared for an applicable financial statement as defined in section 451(b)(3) and § 1.451-3(a), or, if the tested entity is not required to prepare an income statement for an applicable financial statement, as reflected in the books of account or records that are adequate and sufficient to establish the amount.

(*2*) *Calculation of total assets and income*. For purposes of paragraph (a)(2)(ii)(C)(*1*) of this section, the amount of total assets includes the value of the tested entity's qualified partnership interests under paragraph (d)(5)(iii) of this section, and the amount of total gross income includes the tested entity's distributive share of income, including income derived from commercial activity, from partnerships in which the tested entity holds a qualified partnership interest under paragraph (d)(5)(iii) of this section.

(iii) *Cure requirement*. A timely cure is considered to have been made if the tested entity discontinues the conduct of the commercial activity within 180 days of the date of discovery of the commercial activity by responsible employees who are responsible for monitoring and reviewing the tested entity's commercial activity pursuant to paragraph (a)(2)(ii)(B) of this section. For example, if a responsible employee discovers that the partnership in which the tested entity holds an interest as a partner is conducting commercial activity, the entity will satisfy the cure requirement if, within 180 days of that person discovering the commercial activity, the tested entity discontinues the conduct of the activity by divesting itself of its interest in the partnership (including by transferring its interest in the partnership to a related entity), or the partnership discontinues its conduct of commercial activity. The tested entity may, depending on the facts and circumstances, be able to satisfy the cure requirement if, within 180 days of a responsible employee discovering the commercial activity, the tested entity exchanges its interest in the partnership for one that is a qualified partnership interest, within the meaning of paragraph (d)(5)(iii) of this section, of the same partnership (including a deemed exchange from an agreed modification of terms).

(iv) *Record maintenance*. Adequate records of each discovered commercial activity and the remedial action taken to cure that activity must be maintained. The records must be retained so long as the contents thereof may become material in the administration of section 892.

(v) *Definitions*. The following definitions apply for purposes of this paragraph (a)(2).

(A) *Tested entity*. A *tested entity* means an entity that is engaged, including by attribution under paragraph (d)(5)(i) of this section, in commercial activity without regard to paragraph (a)(2)(i) of this section.

(B) *Responsible employees*. Responsible employees may include employees of a tested entity or employees of an entity that controls (within the meaning of paragraph (a)(1) of this section) the tested entity.

(C) *Reasonable efforts*. The term *reasonable efforts* means exercising ordinary business care and prudence.

(3) *Annual determination of controlled commercial entity status*—(i) *In general*. If an entity described in paragraph (a)(1) of this section engages in commercial activities at any time during its taxable year, the entity will be considered a controlled commercial entity for its entire taxable year. An entity that is not engaged in commercial activities during its taxable year will not be considered a controlled commercial entity for its taxable year. For purposes of determining whether an entity is engaged in commercial activities during its taxable year, that entity's activities during its immediately preceding taxable year will also be taken into account to the extent relevant in characterizing the activities in the current taxable year.

(ii) *Certain corporate acquisitions*—(A) *In general*. For purposes of paragraph (a)(3)(i) of this section, if the assets of a corporation that is engaged in commercial activity in a taxable year are acquired by another corporation in an acquisition described in section 381(a), then, except as provided in paragraph (a)(3)(ii)(B) of this section, the acquiring corporation will not be treated as conducting commercial activity for the taxable year in which the acquisition occurs solely by reason of acquiring and holding the distributor or transferor corporation's assets, provided that the taxable year of the

distributor or transferor corporation ends under section 381(b), and after the acquisition, the acquiring corporation is not the entity that directly continues the distributor or transferor corporation's commercial activity. If the taxable year of the distributor or transferor corporation does not end as a result of such acquisition, the acquiring corporation will be treated as conducting commercial activity for the taxable year in which the acquisition occurs.

(B) *Exception*. If the acquisition described in paragraph (a)(3)(ii)(A) of this section to which section 381(a) applies is between corporations that are controlled by the same foreign sovereign within the meaning of paragraph (a)(1) of this section, the acquiring corporation will be treated as conducting commercial activity for the taxable year of the acquiring corporation in which such acquisition occurs regardless of whether the taxable year of the distributor or transferor corporation ends as described in section 381(b) or whether the acquiring corporation directly continues the distributor or transferor corporation's commercial activity.

(b) *Entities treated as engaged in commercial activity*—(1) *United States real property holding corporations*—(i) *General rule.* Except as provided in paragraph (b)(1)(ii) of this section, a corporation that is a United States real property holding corporation as defined in section 897(c)(2), is treated as engaged in commercial activity and, therefore, is a controlled commercial entity if the requirements of paragraph (a)(1)(iii)(A) or (B) of this section are satisfied.

(ii) *Exceptions*. Paragraph (b)(1)(i) of this section does not apply to the following—

(A) Corporations that are foreign; or

(B) A corporation that is a United States real property holding corporation, as defined in section 897(c)(2), solely by reason of its direct or indirect ownership interest in one or more other corporations that are not controlled by the foreign government (as

determined under paragraph (a)(1) of this section). For this purpose, the phrase *solely by reason of its direct or indirect ownership interest in one or more other corporations that are not controlled by the foreign government (as determined under paragraph (a)(1) of this section)* means disregarding any ownership interests, held directly or indirectly, in noncontrolled corporations (as determined under paragraph (a)(1) of this section), after applying the asset test under section 897(c)(2) and § 1.897-2.

(2) *Central banks*. For further guidance, *see* § 1.892-5T(b)(2).

(3) *Pension trusts*. For further guidance, *see* § 1.892-5T(b)(3).

(c) *Control*—(1) *Attribution*. For further guidance, *see* § 1.892-5T(c)(1).

(2) *Effective control*. For further guidance, *see* § 1.892-5T(c)(2).

(d) *Related controlled entities*—(1) *Brother/sister entities*. For further guidance, *see* § 1.892-5T(d)(1).

(2) *Parent/subsidiary entities*. For further guidance, *see* § 1.892-5T(d)(2).

(3) [Reserved]

(4) *Illustrations*. For further guidance, *see* § 1.892-5T(d)(4).

(5) *Partnerships*—(i) *General rule*. Except as provided in paragraphs (d)(5)(ii) and (iii) of this section, the commercial activities of an entity classified as a partnership for Federal tax purposes are attributable to its partners for purposes of section 892. For example, if an entity described in paragraph (a)(1)(iii)(A) or (B) of this section holds an interest as a general or limited partner in a partnership that is engaged in commercial activities, except as provided in paragraphs (d)(5)(ii) and (iii) of this section, the partnership's commercial activities are attributed to that entity for purposes of determining if the entity is a controlled commercial entity within the meaning of section 892(a)(2)(B) and paragraph (a)(1) of this section.

(ii) *Trading activity exception*. An entity not otherwise engaged in commercial activities will not be considered to be engaged in commercial activities solely because

the entity is a member of a partnership (whether domestic or foreign) that effects transactions in stocks, bonds, other securities (as defined in § 1.892-3T(a)(3)), partnership equity interests, commodities (as defined in § 1.892-4(c)(2)), or financial instruments (as defined in § 1.892-3(a)(4)) for the partnership's own account or solely because an employee of such partnership, or a broker, commission agent, custodian, or other agent, pursuant to discretionary authority granted by such partnership, effects such transactions for the account of the partnership. This paragraph (d)(5)(ii) does not apply to any member in the case of a partnership that is a dealer in stocks, bonds, other securities, partnership equity interests, commodities, or financial instruments, as determined under the principles of § 1.864-2(c)(2)(iv)(*a*).

(iii) *Qualified partnership interest exception*—(A) *General rule*. An entity that is not otherwise engaged in commercial activities (including, for example, performing services for a partnership as described in section 707(a) or section 707(c)) will not be deemed to be engaged in commercial activities solely because it holds a *qualified partnership interest* in a partnership, notwithstanding that the entity may be considered as being engaged in a trade or business within the United States under section 875(1). Nevertheless, pursuant to section 892(a)(2)(A)(i), a foreign government member's distributive share of partnership income will be treated as from commercial activity, and thus will not be exempt from taxation under section 892 to the extent that the partnership derived such income from the conduct of commercial activity. For example, where a controlled entity described in § 1.892-2T(a)(3) that is not otherwise engaged in commercial activities holds a qualified partnership interest in a partnership that is a dealer in stocks, bonds, other securities, partnership equity interests, commodities, or financial instruments in the United States, although the controlled entity partner will not be deemed to be engaged in commercial activities solely because of its interest in the partnership, its distributive share of partnership income derived from the partnership's

activity as a dealer will not be exempt from tax under section 892 because it was derived from the conduct of commercial activity.

(B) *Qualified partnership interest*—(*1*) *In general*. Solely for purposes of paragraph (d)(5)(iii) of this section, an interest classified as equity in an entity classified as a partnership for Federal tax purposes is treated as a qualified partnership interest if the holder of such interest has limited liability within the meaning of § 301.7701-3(b)(2)(ii) of this chapter, does not possess the legal authority to bind or to act on behalf of the partnership, does not control the partnership within the meaning of paragraph (a)(1) of this section, and does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year.

(*2*) *Rights to participate in the management and conduct of a partnership's business*—(*i*) *In general*. Rights to participate in the management and conduct of a partnership's business mean rights to participate in the day-to-day management or operation of the partnership's business, including, for example, the right to participate in ordinary-course personnel and compensation decisions, or take active roles in formulating the partnership's business strategy or in respect of the partnership's acquisition or disposition of a specific investment. The existence of these rights is determined based on all facts and circumstances. In addition to the conduct of relevant parties, such determination shall consider the totality of all rights arising from all direct or indirect interests of the holder of the partnership, including rights provided under the law of the jurisdiction in which the partnership is organized, the partnership's governing documents, contractual agreements such as side letters, shareholders' agreements, and agreements with creditors of the partnership.

(*ii*) *Rights to participate in the monitoring or protection of a partner's capital investment*. Rights to participate in the management and conduct of a partnership's business generally do not include participation rights with respect to monitoring or

protecting the partner’s capital investment in the partnership, but only if such rights do not include rights to participate in the day-to-day management or operation of the partnership’s business and do not result in effective control under paragraph (a)(1)(iii)(B) of this section. These rights may, subject to the limitations of the previous sentence, include oversight and supervision rights in the case of major strategic decisions such as: 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 deviations from previously determined investment parameters; extending the term of the partnership’s governing agreement; and disposition of all or substantially all of the partnership's property outside of the ordinary course of the partnership's activities.

(*iii*) *Holding more than one interest in a partnership*. If a foreign sovereign holds directly or indirectly interests in a partnership through one or more integral parts or controlled entities (within the meaning of § 1.892-2T) or entities controlled by such foreign sovereign under paragraph (a)(1) of this section, then such interests are aggregated for purposes of this paragraph (d)(5)(iii)(B)(*2*). For example, if a controlled entity (within the meaning of § 1.892-2T) of a foreign sovereign or an entity controlled by the foreign sovereign under paragraph (a)(1) of this section holds a partnership interest that is not a qualified partnership interest, then any other equity interest held in the same partnership by any other controlled entities of the foreign sovereign is also not treated as a qualified partnership interest. Furthermore, if a foreign sovereign directly or indirectly holds more than one interest in a partnership through one or more integral parts or controlled entities (within the meaning of § 1.892-2T) or entities controlled by such foreign sovereign under paragraph (a)(1) of this section and those partnership interests in the aggregate result in a disqualification from qualified partnership interest, then each such interest in the partnership is not treated as a qualified partnership

interest.

(C) *Safe harbor for de minimis interests.* For purposes of this paragraph (d)(5)(iii), a holder of an interest classified as equity in an entity classified as a partnership for Federal tax purposes is treated as holding a qualified partnership interest (within the meaning of paragraph (d)(5)(iii)(B) of this section) if the holder at all times during the partnership's taxable year:

(*1*) Has limited liability within the meaning of § 301.7701-3(b)(2)(ii) of this chapter;

(*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; and

(*4*) Does not own, directly or indirectly (under the principles of paragraph (d)(5)(iii)(B)(*2*)(*iii*) of this section), more than five percent of either the partnership's capital interests or the partnership's profits interests.

(D) *Tiered partnerships*. The rules of this paragraph (d)(5)(iii) apply in cases where a partnership (lower-tier partnership) that conducts commercial activity has a partner that is a partnership (upper-tier partnership). If an upper-tier partnership holds no interest in the lower-tier partnership other than a qualified partnership interest, within the meaning of paragraph (d)(5)(iii)(B) or (C) of this section, the lower-tier partnership's commercial activity is not attributed to the upper-tier partnership. Nevertheless, the upper-tier partnership's distributive share of the lower-tier partnership's income that is derived from the conduct of commercial activity will not be exempt from tax under section 892.

(iv) *Illustration*. The following examples illustrate the application of this paragraph (d)(5):

(A) *Example 1*—(*1*) *Facts*. K is a controlled entity of a foreign sovereign under § 1.892-2T(a)(3). K holds a 20 percent equity interest in Opco, a domestic limited liability company that is classified as a partnership for Federal tax purposes. Opco owns and manages an office building that produces income from rental and advertising activities that constitute commercial activity under § 1.892-4. Under the governing agreement and the applicable law of Opco, K is not liable for the debts of or claims against Opco by reason of being a member, does not possess the legal authority to bind or act on behalf of Opco, and does not control Opco within the meaning of paragraph (a)(1) of this section. K is not the managing member of, and does not hold an equivalent role under applicable law in, Opco. Pursuant to a side letter between K and Opco, K, however, has rights to review and advise on Opco's material business contracts and business expenses.

(*2*) *Analysis*. Opco's commercial activity is attributable to K under paragraph (d)(5)(i) of this section unless K's interest in Opco is a qualified partnership interest. K's interest in Opco does not satisfy the safe harbor under paragraph (d)(5)(iii)(C) of this section because K holds a 20 percent equity interest in Opco. Under all facts and circumstances as provided in paragraph (d)(5)(iii)(B) of this section, K's rights to review and advise on Opco's material business contracts and business expenses constitutes the right to participate in the day-to-day management and operation of Opco's business. As a result, K's interest in Opco is not a qualified partnership interest. Therefore, Opco's commercial activity is attributable to K under paragraph (d)(5)(i) of this section, and K will be treated as a controlled commercial entity.

(B) *Example 2*—(*1*) *Facts*. The facts are the same as in paragraph (c)(5)(iv)(A) of this section (*Example 1*), except that K does not have rights to review and advise on Opco's material business contracts and business expenses. Instead, K is a member of Opco's member committee that only has the ability to make non-binding

recommendations, but not decisions in respect of investor-level strategic matters such as dissolution of the partnership, deviations from previously determined investment parameters, and extending the term of the partnership's governing agreement. The extent of K's membership and participation in Opco's member committee does not result in control over Opco within the meaning of paragraph (a)(1) of this section. K does not otherwise have control over Opco within the meaning of paragraph (a)(1) of this section.

(*2*) *Analysis*. Although K is on Opco's member committee, the committee only has the ability to make non-binding recommendations but not decisions of an investor-level nature in respect of strategic matters, and not in respect of Opco's day-to-day operations. As a result, Opco's commercial activities will not be attributable to K pursuant to paragraph (d)(5)(iii)(A) of this section. Accordingly, if K is not treated as engaged in any other activities that are commercial activities, K will not be a controlled commercial entity. The portion of K's distributive share of income from Opco, however, that is derived from commercial activity will not be exempt from tax under section 892.

(e) *Applicability date.* Except as otherwise provided in this paragraph (e), this section applies to taxable years beginning on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. *See* §§ 1.892-5 and 1.892-5T, as contained in 26 CFR in part 1 in effect on April 1, 2025, for the rules that apply to taxable years beginning before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. A taxpayer may choose to apply this section to a taxable year beginning before [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, if the period of limitations on assessment of the taxable year is open under section 6501 and the taxpayer and entities that are related (within the meaning of section 267(b) or section 707(b)) to the taxpayer apply this section and §§ 1.892-3(a)(4) and 1.892-4 in their entirety to the taxable year and all succeeding taxable years beginning before **[INSERT**

DATE OF PUBLICATION IN THE FEDERAL REGISTER]. The rule in paragraph (a)(1)(ii) of this section applies on or after January 14, 2002.

Par. 8. Section 1.892-5T is amended by:

a. Revising paragraph (a), the heading of paragraph (b), and paragraph (b)(1);

b. Removing and reserving paragraph (d)(3); and

c. Revising paragraph (d)(4).

The revisions read as follows:

§ 1.892-5T Controlled commercial entity (temporary regulations).

(a) *In general*. For further guidance, *see* § 1.892-5(a).

(b) *Entities treated as engaged in commercial activity*—(1) *U.S. real property holding corporations*. For further guidance, *see* § 1.892-5(b)(1).

* * * * *

(d) * * *

(4) *Illustrations*. The principles of this section may be illustrated by the following examples.

(i) *Example 1*. (A) The Ministry of Industry and Development is an integral part of a foreign sovereign under § 1.892-2T(a)(2). The Ministry is engaged in commercial activity within the United States. In addition, the Ministry receives income from various publicly traded stocks and bonds, soybean futures contracts and net leases on U.S. real property. Since the Ministry is an integral part, and not a controlled entity, of a foreign sovereign, it is not a controlled commercial entity within the meaning of paragraph (a) of this section. Therefore, income described in § 1.892-3T is ineligible for exemption under section 892 only to the extent derived from the conduct of commercial activities. Accordingly, the Ministry's income from the stocks and bonds is exempt from U.S. tax.

(B) The facts are the same as in paragraph (d)(4)(i)(A) of this section, except that the Ministry also owns 75 percent of the stock of R, a U.S. holding company that owns

all the stock of S, a U.S. operating company engaged in commercial activity. Ministry's dividend income from R is income received indirectly from a controlled commercial entity. The Ministry's income from the stocks and bonds, with the exception of dividend income from R, is exempt from U.S. tax.

(C) The facts are the same as in paragraph (d)(4)(i)(A) of this section, except that the Ministry is a controlled entity of a foreign sovereign. Since the Ministry is a controlled entity and is engaged in commercial activity, it is a controlled commercial entity within the meaning of paragraph (a) of this section, and none of its income is eligible for exemption.

(ii) *Example 2*. (A) Z, a controlled entity of a foreign sovereign, has established a pension trust under the laws of the sovereign as part of a pension plan for the benefit of its employees and former employees. The pension trust (T), which meets the requirements of § 1.892-2T(c), has investments in the U.S. in various stocks, bonds, annuity contracts, and a shopping center which is leased and managed by an independent real estate management firm. T also makes securities loans in transactions that qualify under section 1058. T's investment in the shopping center is not considered an unrelated trade or business within the meaning of section 513(b). Accordingly, T will not be treated as engaged in commercial activities. Since T is not a controlled commercial entity, its investment income described in § 1.892-3T, with the exception of income received from the operations of the shopping center, is exempt from taxation under section 892.

(B) The facts are the same as paragraph (d)(4)(ii)(A) of this section, except that T has an interest in a limited partnership (that is not a qualified partnership interest within the meaning of § 1.892-5(d)(5)(iii)) which owns the shopping center. The shopping center is leased and managed by the partnership rather than by an independent management firm. Managing a shopping center, directly or indirectly through a

partnership of which a trust is a member, would be considered an unrelated trade or business within the meaning of section 513(b) giving rise to unrelated business taxable income. Since the commercial activities of a partnership are attributable to its partners, T will be treated as engaged in commercial activity and thus will be considered a controlled commercial entity. Accordingly, none of T's income will be exempt from taxation under section 892.

(C) The facts are the same as paragraph (d)(4)(ii)(A) of this section, except that Z is a controlled commercial entity. The result is the same as in paragraph (d)(4)(ii)(A) of this section.

(iii) *Example 3*. (A) The Department of Interior, an integral part of foreign sovereign FC, wholly owns corporations G and H. G, in turn, wholly owns S. G, H and S are each controlled entities. G, which is not engaged in commercial activity anywhere in the world, receives interest income from deposits in banks in the United States. Both H and S do not have any investments in the U.S. but are both engaged in commercial activities. However, only S is engaged in commercial activities within the United States. Because neither the commercial activities of H nor the commercial activities of S are attributable to the Department of Interior or G, G's interest income is exempt from taxation under section 892.

(B) The facts are the same as paragraph (d)(4)(iii)(A) of this section, except that G rather than S is engaged in commercial activities and S rather than G receives the interest income from the United States. Since the commercial activities of G are attributable to S, S's interest income is not exempt from taxation.

Frank J. Bisignano,

Chief Executive Officer.

Approved: October 30, 2025

Kenneth J. Kies,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2025-22776 Filed: 12/12/2025 8:45 am; Publication Date: 12/15/2025]