KIRKLAND & ELLIS

Kirkland Alert

Treasury and IRS Issue New Section 892 Regulations Impacting Sovereign Investors and Fund Sponsors

18 December 2025

On December 15, 2025, the U.S. Department of the Treasury and the Internal Revenue Service published final and new proposed regulations under Section 892, which governs U.S. tax exemption for non-U.S. governments — including sovereign wealth funds and non-U.S. government pension funds (collectively, SWFs).[1] These regulations provide expanded guidance on the scope and application of the "commercial activity" and "controlled commercial entity" exceptions to the general Section 892 exemption. Notably, the new proposed regulations mark the IRS' first published attempt to articulate specific rules for determining when debt acquisitions constitute commercial activity for Section 892 purposes.

The final regulations generally apply to tax years beginning on or after December 15, 2025. The new proposed regulations will apply only to tax years beginning on or after the date they are published in final form — which may differ significantly from their proposed form — and thus, for calendar-year taxpayers, will not take effect until 2027 at the earliest.

Key Aspects of the Final Regulations

The final regulations generally adopt the framework in the proposed regulations issued in 2011 and 2022, with certain notable modifications and clarifications.

- *Broad Definition of "Commercial Activities":* Confirms that "commercial activities" broadly include all activities — whether conducted within or outside the U.S. — that ordinarily are conducted for the current or future production of income or gain, unless a specific exception applies. This determination is based solely on the nature

of the SWF's activities (including through attribution), without regard to the SWF's purpose or motivation for those activities.[2]

- *Investment and Trading Exceptions:* Provides detailed investment and trading exceptions to commercial activity treatment. In response to numerous comments, the regulations clarify that an SWF investing in or trading certain types of derivative financial instruments falls within these exceptions.[3]
- *USRPHC Per Se Rule:* Retains a *per se* rule under which a USRPHC automatically is treated as engaged in commercial activity but limits its application to U.S. corporations.[4] This reverses the approach in earlier proposed regulations, which extended the rule to non-U.S. corporations that would be USRPHCs if they were domestic.
- *Inadvertent Commercial Activities:* Introduces an exception for SWFs that otherwise would be treated as engaging in commercial activities in a taxable year where such activities are "inadvertent." To qualify, the failure to avoid commercial activities must be reasonable, timely cured, and supported by appropriate recordkeeping — in each case as determined under the detailed rules in the regulations.
- *Qualified Partnership Interest (QPI) Exception:* Provides that an SWF holding a QPI will not be treated as engaged in commercial activities solely by reason of holding an interest in a partnership that engages in commercial activities.[5] This exception generally follows the so-called "limited partner exception" in the 2011 proposed regulations, with certain refinements and additional requirements.
  - *QPI Definition:* A QPI generally includes any equity interest in a partnership for U.S. federal income tax purposes, provided that, at all times during the partnership's taxable year, the SWF: (1) has no personal liability for partnership obligations; (2) lacks authority to bind or act on behalf of the partnership; (3) does not control the partnership;[6] and (4) does not have rights to participate in the management or conduct of the partnership's business. Management rights are evaluated based on a facts-and-circumstances analysis and generally refer to participation in day-to-day operations. Customary investor protections — such as monitoring rights or approval rights over major strategic decisions — do not, by themselves, preclude QPI status.
  - *Aggregation Rule:* Where an SWF holds multiple direct or indirect interests in a partnership, those interests are aggregated for purposes of determining whether the SWF holds a QPI.[7]
  - *De Minimis Safe Harbor:* Under a new de minimis safe harbor, an SWF will be treated as holding a QPI if, at all times during the partnership's taxable year, the SWF (1) has no personal liability for partnership obligations; (2) lacks authority to bind or act on behalf of the partnership; (3) is not a managing member (or equivalent); and (4) does not directly or indirectly own more than 5% of the

partnership's capital or profits. Given the low ownership threshold, this safe harbor may be of limited practical utility.

- *Tiered Partnerships:* The QPI status determination is made at each level of a multi-tiered partnership structure, starting from the bottom and moving up to the SWF. Under this "bottom up" approach, if an upper-tier partnership's interest in a lower-tier partnership is a QPI, then that lower-tier partnership's commercial activities do not "tier up" to the upper-tier partnership.

Key Aspects of the New Proposed Regulations

Commercial Activity Debt Acquisition Rule

The new proposed regulations provide the IRS' first published attempt at detailed guidance on when debt acquisitions by an SWF — including through partnerships or by agents acting on the SWF's behalf — constitute "commercial activities" for Section 892 purposes. According to the preamble, this determination is made without regard to whether the acquisition is treated as part of a trade or business for U.S. tax purposes — i.e., the analyses are distinct. The preamble further clarifies that the proposed regulations are not intended to create an inference as to the circumstances in which debt acquisitions, including at original issuance, would or would not constitute a trade or business for any other purpose, including for determining whether income is "effectively connected" with a U.S. trade or business.

Under the proposed regulations, a broad, default "Commercial Activity Debt Acquisition Rule" would apply to treat any debt acquisition as a commercial activity, *unless* either one of two narrow safe harbors applies or a facts-and-circumstances exception applies.

- *Safe Harbors:* A debt acquisition would not be treated as a commercial activity if the debt either is acquired in a registered offering[8] or is traded on an established securities market.[9]
- *Facts-and-Circumstances Exception:* If neither safe harbor applies, then the Commercial Activity Debt Acquisition Rule applies *unless*, based on all relevant facts and circumstances, the acquisition qualifies as an investment activity. According to the preamble, relevant facts and circumstances are those indicating that the SWF's expected return from the debt is exclusively a return on its capital, rather than a return attributable to the SWF's activities. The following nonexclusive list of factors

is to be considered in this analysis, with each factor's weight depending on the particular facts and circumstances:

1. whether the acquirer solicited prospective borrowers, or otherwise held itself out as willing to make loans or otherwise acquire debt at or in connection with its original issuance;
2. whether the acquirer materially participated in negotiating or structuring the debt's terms;
3. whether the acquirer is entitled to compensation (whether or not labeled as a fee) that is not treated as interest for tax purposes;
4. the debt's form and issuance process (e.g., a bank loan versus a privately placed debt security issued under Regulation S or Rule 144A);
5. the percentage of the debt issuance acquired by the acquirer relative to other purchasers;
6. the percentage of the debt issuer's equity held or to be held by the acquirer;
7. the value of any such equity relative to the amount of the debt acquired; and
8. in the case of a debt-for-debt exchange resulting from a significant modification for tax purposes, whether there was a reasonable expectation at the time of the original acquisition — based on objective evidence, such as a deterioration in the issuer's financial condition or credit rating — that the original debt would default.

- *Agency Attribution:* Actions by an agent or a person otherwise acting on the SWF's behalf are treated as the SWF's actions for these purposes.
- *Requests for Comments:* Treasury and the IRS have specifically requested comments on the circumstances, if any, in which acquisitions of distressed debt, broadly syndicated loans, revolving credit facilities, and delayed-draw debt instruments should be treated as exempt investment activities, and whether additional factors should be included in the facts-and-circumstances exception.

Effective Control

The new proposed regulations also provide the IRS' first published attempt at detailed guidance on when an SWF is treated as having "effective control" of an entity for purposes of determining whether the entity is a "controlled commercial entity" of the SWF.[10]

- *Facts-and-Circumstances Test:* In general, effective control would be determined based on all facts and circumstances relating to the SWF's interests in the entity.[11] An SWF has effective control if any interest — direct or indirect, alone or in combination with other interests — gives the SWF control over the entity's operational, managerial, board-level, or investor-level decisions. By contrast, "mere consultation rights" with respect to such decisions would not, by themselves, constitute effective control.
- *Deemed Effective Control for Managing Members:* An SWF would be deemed to have effective control of an entity if the SWF either (i) is, or controls an entity that is, a managing partner or managing member of the entity, or (ii) holds, or controls an entity that holds, an equivalent role under the entity's applicable local law.[12]

Comments on the new proposed regulations are due by February 13, 2026.

For questions regarding these regulations, please reach out to any member of the Kirkland tax team, including the authors below.

---

1. Section references are to the Internal Revenue Code of 1986, as amended (the Code). ↩

2. Treasury and the IRS rejected a suggestion to limit the scope of "commercial activities" to activities that would constitute a trade or business under other Code provisions. ↩

3. The specified derivatives generally are those described in the proposed regulations under Section 864(b) (including, for example, interest rate, currency, equity, or commodity swaps, or options, forwards or futures contracts). According to the preamble, "[i]nvesting 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 bespoke, non-market standard derivatives; thus the expected return is generally a return exclusively on capital rather than on the activities conducted." ↩

4. A USRPHC (i.e., a U.S. real property holding corporation) generally is a U.S. corporation in which U.S. real property comprised at least 50% of such corporation's assets at any time during the most recent five-year period. ↩

5. However, holding a QPI may still cause an SWF to be treated as engaged in a U.S. trade or business under other Code provisions (depending on the partnership's activities and investments), and the SWF's distributive share of the partnership's income attributable to the conduct of any commercial activities will not be exempt from taxation under Section 892. ↩

6. Control for this purpose is determined under the "controlled commercial entity" rules in the final regulations. ↩

7. For example, if a controlled entity of an SWF holds a non-QPI partnership interest, no equity interest in that same partnership held by any other controlled entity of the SWF will qualify as a QPI. ↩

8. A registered offering is one that is registered under the Securities Act of 1933, provided that the underwriters are not "related" to the acquirer. ↩

9. For this purpose, an "established securities market" is defined consistently with the publicly traded partnership rules under Section 7704. The safe harbor is unavailable if the SWF acquires the debt directly from the issuer, participates in negotiating the debt's terms or issuance, or acquires the debt from a person that is under common management or control with the acquirer (unless that person itself acquired the debt as an investment under these rules). ↩

10. Under the final regulations, an entity engaged in commercial activities also will be a "controlled commercial entity" of an SWF if the SWF holds (directly or indirectly) any interest in the entity that (by vote or value) is 50% or more of the entity's total interests. ↩

11. Interests that may be relevant to the effective control analysis include: (1) equity interests; (2) debt interests; (3) veto or voting rights, including the power to appoint directors or managers; (4) contractual rights or arrangements with the entity or other interest holders; (5) business relationships with the entity or other interest holders; (6) regulatory authority over the entity; and (7) any other interest in or relationship with the entity that may confer influence over the entity's operational, managerial, board-level, or investor-level decisions. ↩

12. Control for these purposes is determined under the "controlled commercial entity" rules in the final regulations. ↩

Authors

Stephen Butler, P.C.

Partner / Austin / Houston

Mike Carew, P.C.

Partner / Chicago

David M. Grenker

Partner / New York

Meredith Levy, P.C.

Partner / New York

Lee Morlock, P.C.

Partner / Chicago

Mike Greenberg

Partner / Los Angeles

Marguerite R. Lombardo

Partner / Boston

JoAnne Mulder Nagjee

Partner / Chicago

Brandon Short

Partner / Boston

Jake Laubach

Associate / Dallas

Adam W. Strayer

Associate / Chicago

Related Services

Practices

- Tax

Suggested Reading

- 04 December 2025 Kirkland Alert UK Improves Draft Legislation Relating to Taxation of Carried Interest

- 02 December 2025 Kirkland Alert Treasury and IRS Issue Final Regulations on Excise Tax on Share Repurchases by Publicly Traded Corporations
- 23 October 2025 Kirkland Alert Treasury and IRS Issue New Taxpayer-Favorable Proposed Regulations on Domestically Controlled REITs