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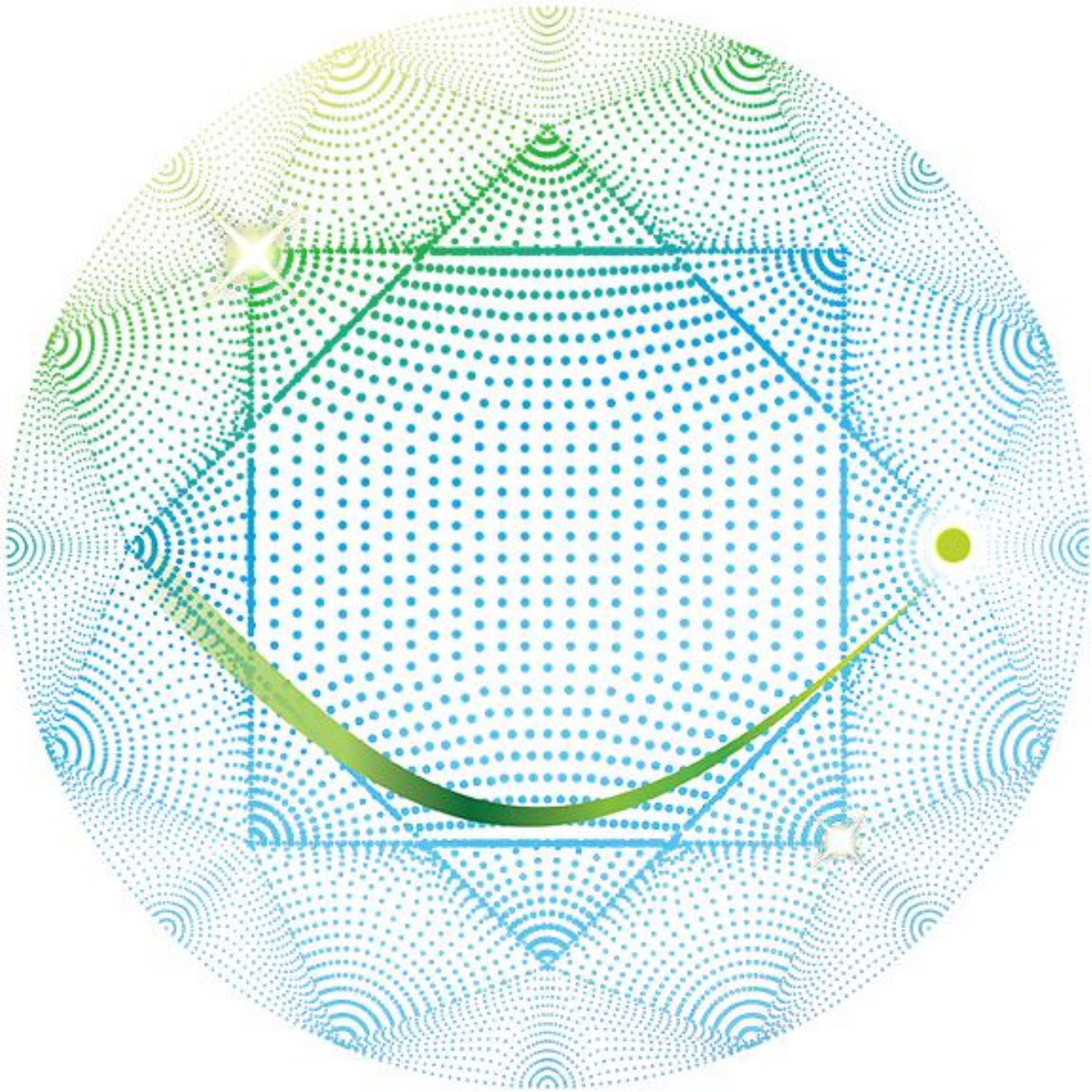

US tax impact to GCC SWFs on the issuance of final treasury regulations under Section 892

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Background

There is no doubt that United States of America (USA) is by far the largest economy in the world. With anticipated annual GDP of $32.6 trillion as of 1st quarter of 2026, USA has the world's seventh highest per capital GDP, and the US dollar is the currency mostly used in international transactions and is the world's foremost reserve currency. Foreign direct investments (FDI) in the US reached around $72 billion in the fourth quarter of 2025 and expenditures by foreign direct investors to acquire, establish, or expand U.S. businesses totalled $151.0 billion in 2024, according to preliminary statistics released today by the U.S. Bureau of Economic Analyst. Out of these foreign investors, global Sovereign Wealth funds play a pivotal role, especially Gulf Cooperation Council (GCC) based SWF funds.

The GCC region boasts some of the world's largest SWFs, with 13 GCC SWFs collectively managing over $4 trillion in assets such as Abu Dhabi Investment Authority (ADIA), Mubadala Investments, Qatar Investment Authority, Public Investment Fund (PIF) etc. These funds were set up to use excess reserve of petro dollar generated from the sale of petroleum products and diversify in both domestic and foreign markets. These SWF safeguard long-term economic sustainability, mitigate risks from hydrocarbon price volatility and slowly reduce their dependence on hydro carbon economy which will be depleted at certain point in the future.

Although GCC are the largest investors in the world, the irony is that currently there is no US tax treaty with these countries of the GCC and can certainly impact GCC private investors doing business in US in terms of 30% withholding tax on interest or dividend income derived from their US investments. However, SWFs enjoy the special privilege under the unique special US tax code section. Under Internal Revenue Code ("IRC") Section 892, foreign governments are generally exempt from US income taxation on certain qualified income received from US investments, however, there are certain circumstances which will disallow the benefits of Section 892 rules.

This article tries to capture the key concepts of what is exempt under Section 892, who is eligible, definition of controlled entity (CE) and controlled commercial entity (CCE) as well as the key recent updates on Section 892 rules where US Treasury and US Internal Revenue Service (IRS) promulgated long awaited final regulations (TD 10042) on December 15, 2025 along with the proposed regulation. However, this article will only cover some of the key updates of the final regulations.

Who is eligible for Section 892?

In general, IRC Section 892 applies to foreign governments or their integral parts such as bureau, SWF or other body that constitutes a governing authority of a foreign country. It also applies to controlled entity (CE) of a foreign government, which is separate in form from a foreign sovereign but wholly owned and controlled by a foreign government. In order to qualify for Section 892 exemption, foreign governments or their controlled entities CANNOT engage in commercial activity from anywhere in the world.

Section 892 exempts foreign governments and SWF on US tax on qualified Investment income such as dividends and interest income (i.e. FDAP income), gain from disposition of US stocks, bonds, or other securities, gain from disposition of minority interests in US real property holding corporations (USRPHC). However, Section 892 exemption does not apply for income received directly or indirectly from a controlled commercial entity (CCE), income from the disposition of interest in a CCE and income derived from the conduct of any commercial activity

What is commercial activity?

Commercial activity includes all activities inside or outside the US conducted with a view towards the current or future production of income.
Consisted with previous 2011 proposed regulations (REG-146537-06), the final Treasury regulations back in December 2025 clarify that any activity typically conducted for income or gain is considered commercial, regardless of the foreign government's motivations. The final regulation provides a broader definition of "commercial activities" for Section 892 purposes that includes any activities that quality as a trade or business under IRC Section 162, unless an exception applies such as qualified partnership interest (QPI) rule exists (to be discussed further below).

The final Treasury regulations specify certain activities that are not considered commercial for these purposes. These activities include holding investments in stocks, bonds, securities, loans, financial instruments, partnership equity interests as limited partners to the extent no active management participation, financial instruments, non-income-producing real property and bank deposits, engaging in trades including stocks, bonds, and commodities for the foreign government's own account and therefore exempt under Section 892 as they are not considered as commercial activities.

Inadvertent Commercial Activities

The final regulations is still adopting the 2011 proposed regulations' exception for "inadvertent commercial activity," and establish that an entity conducting only inadvertent commercial activity is not considered engaged in commercial activities if three conditions are met: (1) the failure to avoid the activity was reasonable such as due to lack of proper information/documentation from the investees, (2) the activity is timely cured within 180 days of finding, and (3) proper records are maintained.

The final regulations, like the 2011 proposed regulations, provide a safe harbor that applies if the assets and income from commercial activities do not exceed 5% of the assets reflected on the entity's balance sheet to be considered as inadvertent. If commercial activity is discovered, it must be discontinued or cured within 180 days of the date of discovery to preserve exemption eligibility, and records must be kept.

Who is Controlled Commercial Entity (CCE)

It is an entity in which foreign government holds directly or indirectly greater than 50% vote or value or any interest that would mean an effective control and engaged in commercial activity anywhere in the world. Any income generated in US by such commercially controlled entity **loses Section 892 exemption** for the foreign government or SWF and subject to regular US corporate income tax. CCE status is determined annually, considering both the current and immediately preceding tax year.

United States Real Property Holding Corporation (USRPHC)

As a general rule, under the Foreign Investment in U.S. Real Property Tax Act of 1980 (FIRPTA), the United States can tax gain recognized by a foreign person upon the sale of a U.S. real property interest (USRPI). The stock of a corporation holding significant amounts of USRPI, a U.S. real property holding corporation (USRPHC), is also treated as a USRPI. A foreign or domestic corporation is a U.S. real property holding corporation (USRPHC) if the fair market value (FMV) of its U.S. real property interest (USRPI) is at least 50 percent of the sum of the FMV of (1) its total USRPIs, (2) its total interest in real property located outside the United States (FRPI) and (3) any other assets used in a trade or business.

For the purposes of IRC Section 892, a USRPHC is generally treated as engaged in commercial activity and therefore considered as a CCE if foreign government meets the ownership or control thresholds which is also know as “USRPHC per se rule”. The final regulations narrow the USRPHC per se rule so that it only applies to domestic corporations that are USRPHCs but not the foreign corporations.

From practical purposes, this means that foreign CEs no longer need to constantly monitor their global assets to ensure U.S. real estate doesn't exceed 50% of their portfolio. This prevents a taint that would otherwise strip the section 892 exemption from all their other U.S. investments.

However, US corporations that are USRPHCs are generally still deemed to be engaged in commercial activities and to the extent foreign government/SWF has direct interest in such US corporation, such domestic corporations would be considered as CCE and no exemption allowed unless there is a “minority-interest exception”. The 2022 proposed regulations contained a "minority-interest exception," under which a corporation that is a USRPHC solely because of its ownership interest in one or more other corporations that are not controlled by the foreign government would not be a per se CCE.

The final regulations retain this rule, so an IRC Section 892 investor can continue to use a domestic corporation to hold minority interests in USRPHCs without causing the domestic holding corporation itself to be a CCE.

Partnership equity interest

The final regulation clarifies the rule that foreign governments merely holding US partnership interest is not by itself a commercial activity. However, the final regulations retain the rule that commercial activities conducted by the US partnership will be attributed to the partner and any gain/income from that partnership will not be exempt under Section 892 unless QPI exists.

The final regulations replace the "limited partner" exception with a "qualified partnership interest" (QPI) exception. The QPI exception may apply to any entity that is classified as a partnership for US federal income tax purposes, not only limited partnerships.
The final regulations contain both a general test and a safe harbor rule for determining whether a partnership interest is a QPI and SWF has to meet only one of them to qualify as QPI.

Under the general test, the holder of the partnership interest must have: i) no right to participate in the day-to-day management of the partnership, ii) no personal liability for the partnership's obligations, iii) no authority to contract for, bind, or act on behalf of the partnership, and iv) no control of the partnership (i.e., a less-than-50% interest in the profits and capital of the partnership, and no "effective control" over the partnership).

An IRC Section 892 investor must meet these safe harbor tests: i) own (directly or indirectly) 5% or less of the capital or profits interests in the partnership, ii) have no personal liability for the partnership's obligations, iii) have no right to contract, bind or act on behalf of the partnership, iv) not be a managing member or managing partner or hold a similar position in the partnership.

Effective dates

The final regulations apply to tax years beginning on or after December 15, 2025. However, taxpayers may choose to apply the final regulations to a tax year beginning before December 15, 2025, for which the statute of limitation remains open

Key takeaways

The final regulations, effective Dec. 15, 2025, provide detailed guidance on what constitutes commercial activity and certain inadvertent exceptions, definition of controlled commercial activity, USRPHC and qualified partnership interest. If a foreign government/SWF had previously relied on section 892 exemption rules and with the issuance of this new final regulation, stakeholders should carefully consider their current US structure in light of this new final regulation and see how this may impact such exemption and if their position may be affected such as whether activities constituted commercial activity, whether their investments considered as controlled commercial entity, whether their investments would be considered as USRPHC and if minority interest exception is provided, whether their US partnership interest will qualify as QPI under general or safe harbor rule etc.

This is even more important for GCC SWF investors because of the lack of treaty benefits with the USA. As the entire GCC SWF investors are increasing their appetite for US investments by making multi billion dollar deals either directly or in consortium with US private equity funds, the timing on the issuance of the final regulation on Section 892 rules couldn't be more perfect, and all SWFs should carefully assess these rules and make necessary changes to be in compliance with the law.

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