ROBERTS & HOLLAND LLP

April 22, 2026

Treasury Issues Proposed Regulations on the Taxation of Foreign Governments

By: Ezra Dyckman and Charles S. Nelson

Originally Published in the New York Law Journal

In recent years, foreign sovereign wealth funds have become major investors in U.S. real estate. New proposed regulations provide important guidance on the U.S. income tax consequences of those investments.

As background, under Section 892 of the Internal Revenue Code, a foreign government's income from U.S. investments in stocks, bonds, and other securities is generally exempt from U.S. income tax. However, income that a foreign government receives from the conduct of commercial activity, or which is received by or from a controlled commercial entity, is not exempt from U.S. tax. Engaging in commercial activities can also sometimes cause a foreign government to be taxable on other income. For this purpose, a "controlled commercial entity" is defined as any entity engaged in commercial activities if the foreign government owns at least 50% of the interests in such entity (either by vote or value), or if the foreign government owns another interest in the entity that gives it effective control of the entity.

On December 15, 2025, the Treasury Department issued proposed regulations that provide additional guidance for foreign governments on when certain investments will be subject to U.S. tax. In particular, the proposed regulations provide clarification on two important issues.

First, the proposed regulations provide detailed rules for when the acquisition of debt by a foreign government will be considered commercial activity, and thus taxable in the U.S. The proposed regulations provide that the acquisition of debt, whether by origination or purchase, is generally considered commercial activity. However, the acquisition of debt will not be considered commercial activity if it is pursuant to an offering that is registered under the Securities Act of 1933 or purchased on an established securities market and certain other requirements are met.

Assuming an acquisition of debt does not meet one of these two safe harbors, it could still not be treated as commercial activity if, based on the facts and circumstances, the debt was acquired as an investment. Among the factors that are relevant to this determination include whether the acquirer solicited prospective borrowers, whether the acquirer materially participated in negotiating or structuring the terms of the debt, whether the acquirer received any fees or other compensation, the form of the debt issuance process, the percentage of the debt issuance acquired, the percentage of equity in the issuer held by the acquirer and the value of such equity relative to the acquired debt, and whether the debt was distressed.

The proposed regulations give several examples that illustrate these rules. For instance, if a foreign government originates a single loan, it will be treated as engaged in commercial activity if it solicited, structured, negotiated, and funded that loan, even if it made no other loans or held no other debt.

This is an unexpected result, because many people would not have anticipated that the origination or acquisition of a single loan would create commercial activity, especially if these activities do not rise to the level of a trade or business under general income tax principles. Given this very low standard, foreign governments will need to be extremely cautious regarding loan origination activity if they wish to avoid being subject to U.S. income tax.

A second important area in which the proposed regulations provide guidance relates to the definition of a controlled commercial entity. If a foreign government owns 50% or more of an entity, the entity will automatically be considered a controlled commercial entity. However, it was previously less clear under what circumstances a minority interest in an entity might give a foreign government effective control over the entity, making it a controlled commercial entity that is subject to U.S. tax.

The proposed regulations provide that a foreign government has effective control of an entity if it has an interest in an entity that directly or indirectly results in control of the operational, managerial, board-level, or investor-level decisions of the entity. This determination takes into account the foreign government's equity interests, debt interests, voting rights, contractual rights, business relationships, and regulatory authority. A foreign government is also deemed to have effective control over any entity in which it is a managing partner, managing member, or holds a similar position.

The proposed regulations make clear that if a foreign government owns less than 50% of an entity, and has no special voting, veto, or other special rights or relationships, then the foreign government will not have effective control over the entity. The regulations also make clear that mere consultation rights and investment guidelines also do not create effective control.

The most surprising aspect of the proposed regulations relates to veto rights a foreign government may have over decisions of an entity. Previously, most practitioners thought that minority protections, such as veto rights and major decision rights, would not cause a foreign government to have effective control over an entity. However, the proposed regulations contain an example in which a foreign government is deemed to have effective control over a corporation because it has the right to appoint a director who can unilaterally veto dividend distributions, material capital expenditures, sales of new equity interests in the corporation, and the operating budget.

It is unclear exactly what Treasury intended with this example. If it applies broadly to situations in which the consent of minority members of an entity is required for major decisions, it could have the strange effect of causing multiple members of an entity to be treated as having effective control. Moreover, this interpretation could significantly affect foreign governments' willingness to invest in U.S. real estate. It is common for sovereign wealth funds to acquire large minority interests (sometimes as high as 49%) in entities that own U.S. real estate, usually through REITs or other blocker corporations. Those sovereign wealth funds invariably insist on consent rights over major decisions, but if such rights subjected their investments to U.S. taxation, they would likely be much less willing to make such investments. There is also no grandfathering of existing governance arrangements, so if the regulations are finalized, many sovereign wealth funds might find that entities in which they already hold interests are subject to U.S. tax.

The proposed regulations are not effective until finalized, and many hope that the Treasury Department will make changes, particularly regarding veto rights of foreign governments. In the meantime, foreign governments will need to carefully structure debt and equity investments in U.S. real estate if they wish to avoid U.S. taxation.

Ezra Dyckman and Charles S. Nelson are partners of Roberts & Holland LLP.