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November 29, 2023

Tax Court Holds Offshore Hedge Fund Was Engaged in U.S. Trade or Business

SUMMARY

In a November 15 opinion in *YA Global Investments LP* v. *Commissioner*,[1] the Tax Court ruled that a Cayman Islands hedge fund was engaged in a U.S. trade or business through an agency relationship with its U.S.-based manager, and that its operations were not covered by the investment exception or the securities trading safe harbor as the fund (through its agent, the investment manager) provided services to portfolio companies in addition to capital. The court based its opinion on the specific facts of the case, where the fund had continuous control of the manager's actions under the LP agreement and directly structured the securities it purchased with portfolio companies. However, it is possible that this decision will have wider implications to foreign partners of offshore funds.

BACKGROUND

Generally, foreign persons are only subject to U.S. income tax on the portion of their income that is effectively connected to a U.S. trade or business ("ECI"). In addition, an operation that only involves passive investment in U.S. securities is generally not considered a U.S. trade or business, while income and gains from securities trading, which is a U.S. trade or business, is exempted by a safe harbor.[2]

DISCUSSION

A. Agency Relationship

YA Global (the fund) was organized as a Cayman Islands exempted limited partnership, had no employees, and acted through its U.S.-based fund manager, Yorkville Advisors, which also served as the fund's general partner for part of the relevant period. The limited partner at issue was a foreign feeder fund, organized as a corporation.

The Tax Court focused on the investment management agreements between YA Global and Yorkville Advisors, which provided that YA Global "constitute[d] and appoint[ed]" Yorkville Advisors "as the Partnership's Agent and attorney-in-fact," that the partnership would "promptly advise" Yorkville Advisors "of any specific investment restrictions relating to the Account," and that "the activities engaged in by the Investment Manager on behalf of [YA Global] shall be subject to the policies of and control" of YA Global.[3] The court distinguished between a service provider and an agent, and cited to common law agency principles that a key difference between the two is that the principal in an agency relationship has the power to give interim instructions, whereas a service recipient can only provide instructions from the outset.[4] In the court's view, the investment management agreements' provisions gave the fund enough continuing control to cause Yorkville Advisors to be treated as its agent.

B. U.S. Trade or Business

According to the opinion, YA Global primarily invested in microcap and low-priced public companies traded in the over-the-counter public markets, and negotiated directly with the companies to purchase customized convertible debt, standby equity distribution agreements ("SEDAs"), and other securities. These securities typically gave YA Global the opportunity to eventually acquire stock at a discount to the market price, which it would then sell in the open market, earning a spread. In many of the transactions, the companies also paid Yorkville Advisors fees labeled as "structuring fees" or "monitoring fee."[5]

YA Global argued that it was simply an investor of securities earning income from putting its capital at risk, and was thus covered by either the investment exception or the security trading safe harbor from the general U.S. trade or business rule. However, the Tax Court viewed the discount from market price and the fees received by Yorkville Advisors as evidence that YA Global and Yorkville Advisors were providing valuable services in addition to capital. While the government had characterized these alleged services as lending and underwriting, the court stopped short of putting on exact labels, reasoning generally that "when the purchaser of a security goes beyond simply deciding whether to purchase a security on the terms offered and arranges and structures the transaction in which the security is issued, the issuer realizes a benefit beyond the receipt of capital. In that circumstance, the issuer would have reason to pay for that additional benefit."[6] A large part of the court's analysis focuses on YA Global's own record. Its presentation materials to prospective investors described the partnership's business as having a "competitive edge" in "deal origination," and its convertible debt transactions as generating a "[o]ne time, non-recurring" "banker's fee."[7] Importantly, the fees paid by the portfolio companies were not received by the partnership, which provided the capital, but by the investment manager, a structure the court takes to indicate that the investment manager provided valuable services to the portfolio companies. However, according to the private placement memorandum of the fund, fees earned by Yorkville Advisors in excess of its costs (e.g., overhead) were remitted to YA Global.[8] Thus, YA Global directly shared in the economics of the fees earned by the investment manager.

C. Effectively Connected Income

To determine the ECI of YA Global's U.S. trade or business, the Tax Court first ruled that YA Global was a securities dealer that regularly held itself out to deal in positions in securities with its portfolio companies (including through its marketing materials) that were effectively its customers. Since YA Global never specifically claimed special tax treatment for securities held by dealers for their own investments (although some of its agreements with portfolio companies claimed generally that the purpose of YA Global's purchase was investment), the court held that YA Global's gains from the securities should be calculated in accordance with the mark-to-market rule.[9] In addition, since the securities were personal property in the hands of YA Global and the sales of these securities were attributable to YA Global's deemed U.S. office where Yorkville Advisors resided, the gains were ordinary income and were ECI under the per se rule for U.S. source income from sale of personal property.[10] The court conceded that YA Global's dividend income on stock acquired under SEDAs would not be ECI if YA Global's operation was considered a banking, financing or similar business and specific conditions were met, but refused to examine the extent of such income as YA Global never advanced any arguments in this respect and the evidence was not sufficient for such determination.[11]

Finding that YA Global, through Yorkville Advisors, has a U.S. trade or business, that the trade or business was not covered by the investment exception or the security trading safe harbor, and that all of the partnership's gain or loss with respect to securities was effectively connected with its U.S. trade or business, the court determined that YA Global was liable for $57 million, plus penalties, for failing to withhold taxes with respect to its foreign partner.

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ENDNOTES

1 *YA Global Investments LP* v. *Commissioner*, 161 T.C. No. 11 (2023).

2 *Id.* at 20; Internal Revenue Code Section 864(b)(2)(A).

3 *YA Global Investments LP*, 161 T.C. No. 11, at 8-9.

4 *Id.* at 11.

5 *Id.* at 14-16, 51.

6 *Id.* at 32-33.

7 *Id.* at 16, 38.

8 *Id*. at 17, 29-30.

9 *Id*. at 45-49.

10 *Id.* at 60-61.

11 *Id.* at 62.

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