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Foreign Fund Was Engaged in a Trade or Business in the United States as a Result of Lending and Underwriting Activities

IRS Releases Chief Counsel Advice Memorandum 201501013, Treating a Foreign Fund with No Employees as Engaged in a Trade or Business in the United States Through the Lending and Underwriting Activities of the Fund's Manager, and Clarifying Trading Safe Harbors

SUMMARY

On January 2, 2015, the Internal Revenue Service (the "IRS") released Advice Memorandum 201501013 (the "Advice Memorandum") from the Office of Chief Counsel. The Advice Memorandum concludes that a partnership was engaged in a U.S. trade or business through lending and underwriting activities conducted by the Fund's manager (the "Fund Manager") on behalf of the Fund. The result would be that the Fund's partners were each subject to U.S. income tax return filing requirements and net-basis taxation on their respective portions of the Fund's income that was effectively connected with that U.S. trade or business. In coming to these conclusions, the Advice Memorandum argues for a more limited interpretation of when foreign persons can deal in stocks and securities in the United States without becoming subject to U.S. net-basis income tax on income from that activity.

More specifically, the Advice Memorandum concludes that (i) the Fund was engaged in a trade or business in the United States as a result of lending and underwriting activities conducted by the Fund Manager on behalf of the Fund; (ii) the Fund's lending and underwriting activities did not constitute "trading in stocks or securities" activities within the meaning of two statutory safe harbors pursuant to which activities conducted by or for a foreign person that might otherwise constitute a trade or business within the United States are treated as not being a trade or business within the United States (the "Trading Safe Harbors"); and (iii) even if the Fund's lending and underwriting activities constituted "trading

in stocks or securities" within the meaning of the Trading Safe Harbors, the Fund would have been ineligible for the Trading Safe Harbors as a result of the Fund's status as a "dealer" and its grant of discretionary authority to the Fund Manager to conduct lending and underwriting business in the United States on the Fund's behalf.

BACKGROUND

A foreign individual or corporation that is engaged in a "trade or business within the United States" is taxable on a net basis on its taxable income that is effectively connected with the conduct of that trade or business within the United States.[1] A foreign individual or corporation is considered to be engaged in a trade or business within the United States if that foreign individual or corporation is a member of a partnership that is engaged in a trade or business within the United States.[2] In determining whether a foreign person is engaged in a trade or business within the United States, activities undertaken on behalf of the foreign person by an agent are considered to be performed by the foreign person, regardless of the degree of control the foreign person exercises over the agent.[3]

Courts and the IRS have adopted a facts-and-circumstances test to evaluate whether the activities of a foreign person cause that person to be engaged in a trade or business within the United States. For a foreign person to be engaged in a trade or business within the United States, the foreign person's profit-oriented activities in the United States must be considerable, continuous, and regular.[4] In cases considering when lending rises to the level of a trade or business, courts have looked at factors including the total number of loans made, the amount of time and effort expended, whether the taxpayer made loans to unrelated borrowers, and whether the taxpayer actively sought out lending business and solicited borrowers.[5]

The Code provides that the term "trade or business within the United States" does not include, under certain circumstances, "trading in stocks or securities."[6] Specifically, there are two safe harbors pursuant to which activities conducted by or for a foreign person that might otherwise constitute a trade or business

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1 IRC 871(b)(1) and 882(a)(1).

2 IRC 875(1).

3 Rev. Rul. 55-617, 1955-2 C.B. 774 (holding that a foreign corporation was engaged in trade or business within the United States when it marketed goods in the United States through an independent "commission agent").

4 *De Amodio* v. *Comm'r*, 34 T.C. 894, 906 (1960), aff'd, 299 F.2d 623 (3rd Cir. 1962); *Lewenhaupt* v. *Com*m'*r*, 20 T.C. 151, 163 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955); *Pinchot* v. *Comm'r*, 113 F.2d 718, 719 (2d Cir. 1940).

5 *See*, *e.g.*, *Fuller* v. *Comm'r*, 21 T.C. 407, 412-413 (1953); *McCrackin* v. *Com*m'*r*, 48 T.C.M. 248 (1984); *Ruppel* v. *Comm'r*, T.C.M. 1987-248.

6 IRC 864(b).

within the United States are treated as not being a trade or business within the United States. The first Trading Safe Harbor (the "Independent Agent Safe Harbor") provides that the term "trade or business within the United States" does not include "trading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent."[7] Any foreign person, including a foreign dealer in stocks or securities, is eligible for the Independent Agent Safe Harbor.[8]

The second Trading Safe Harbor (the "Own Account Safe Harbor") provides that the term "trade or business within the United States" does not include "trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions."[9] A dealer in stocks or securities is not eligible for the Own Account Safe Harbor.

Treasury regulations explaining the safe harbors define a "dealer in stocks or securities" as "a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom."[10] A person that buys and sells, or holds, stocks or securities solely for investment or speculation is not a dealer.

CCA 201501013—FACTS

During the tax years at issue, a foreign feeder fund was a limited partner in the Fund, a limited partnership treated as a partnership for federal tax purposes.[11] The foreign feeder fund was taxed as a corporation for federal tax purposes and resident in a country that does not have a bilateral income tax treaty in effect with the United States.

During the tax years at issue, the Fund had no employees. The management of the Fund was conducted exclusively by the Fund Manager, which acted as the Fund's agent with full authority to perform every act necessary and proper to be done as fully as the Fund might or could do personally, and specifically to buy, sell, and otherwise deal in securities and related contracts for the Fund's account. The Fund Manager conducted an extensive lending and underwriting business on behalf of the Fund primarily

7 IRC 864(b)(2)(A)(i).

8 Treas. Reg. § 1.864-2(c)(1).

9 IRC 864(b)(2)(A)(ii).

10 Treas. Reg. § 1.864-2(c)(2)(iv)(a).

11 The Advice Memorandum states that the Fund was initially a State A limited partnership, but converted to a Country X exempted limited partnership during the last of the tax years at issue.

through an office in the United States. The Fund Manager provided similar services for other investment entities, and no employees of the Fund Manager worked exclusively for the Fund.

The Fund Manager, acting on the Fund's behalf, committed extensive time and resources to the Fund's lending activities, including negotiating directly with borrowers concerning all key terms of the loans and conducting due diligence on potential borrowers. The Fund often lent borrowers money in return for debt instruments that were convertible into the borrowers' stock at a future date. After converting a debt instrument into stock at a discount, the Fund sought to earn a spread by quickly disposing of the stock.

The Fund Manager, acting on the Fund's behalf, also committed extensive time and resources to conducting the Fund's stock underwriting activities. The Fund entered into a number of distribution agreements with unrelated issuers during the tax years at issue. A typical distribution agreement entitled an issuer to periodically issue and sell to the Fund shares of stock at a discounted price below the stock's lowest daily trading price during a period prior to the closing of the sale to the Fund, which stock the Fund would subsequently sell to others (both within the United States and abroad) at market prices. Because the Fund sold stock at market prices which it had purchased from the issuer at a discount, the Fund earned a spread on each share sold. Usually, an issuer also paid fees to the Fund, including commitment, structuring, and due diligence fees.

CCA 201501013—IRS ANALYSIS

FUND'S LENDING AND UNDERWRITING ACTIVITIES CAUSED FUND TO BE ENGAGED IN A TRADE OR BUSINESS WITHIN THE UNITED STATES

After looking at the facts and circumstances, the Advice Memorandum concludes that the Fund's lending and underwriting activities were profit-oriented activities that the Fund conducted on a "considerable, continuous, and regular basis" in the United States during the tax years at issue. In the opinion of the IRS, both the number of loans and Distribution Agreements the Fund entered into and the significant time, effort, and resources devoted to lending and underwriting activities result in the conclusion that the Fund's lending and underwriting activities rose to the level of a trade or business within the United States.

FUND'S LENDING AND UNDERWRITING ACTIVITIES DID NOT CONSTITUTE "TRADING IN STOCKS OR SECURITIES" WITHIN THE MEANING OF THE TRADING SAFE HARBORS

The Advice Memorandum concludes that the Fund's lending and underwriting activities also did not constitute "trading in stocks or securities" for purposes of the Trading Safe Harbors. The IRS bases its conclusion on Treasury regulations and analogies to authorities in other contexts which support the inference that lending and underwriting are distinctive activities that go beyond the mere "effecting of transactions in stocks and securities" and are therefore not treated as trading for purposes of the Trading Safe Harbors.

With respect to underwriting, the Advice Memorandum argues that the Fund's underwriting activities in the United States were more extensive than the limited underwriting activities permitted under the Trading Safe Harbors. Treasury regulations describe only a narrow set of circumstances under which a foreign underwriter may qualify for the Trading Safe Harbors. Specifically, a foreign underwriter will not be engaged in a trade or business within the United States if the foreign person acts as an underwriter for the purpose of making a distribution of stocks or securities of a domestic issuer exclusively to foreign purchasers of such stocks or securities.[12] The limited scope of the exception shows that distributing stocks or securities to U.S. customers exceeds the level of underwriting activity permitted to qualify as "trading in stocks or securities." Through its distribution agreements, the Fund purchased shares from U.S. issuers and sold those shares to purchasers in the United States and abroad. As a result, in the opinion of the IRS, the Fund's underwriting activities in the United States disqualify it from enjoying the benefits of the Trading Safe Harbors.

With respect to lending, the Advice Memorandum argues that the Fund's lending activities in the United States were too substantial to qualify for an exemption from net-basis taxation. Specifically, the IRS cites to regulations which explain the circumstances in which a foreign person is considered engaged in the active conduct of a banking, financing, or similar business in the United States, such that the earnings from such business are effectively connected with the conduct of a trade or business within the United States (and as a result are subject to tax on a net basis). Treasury regulations stipulate that a foreign person is considered engaged in the active conduct of a banking, financing, or similar business within the United States when the person makes "personal, mortgage, industrial, or other loans to the public" in the United States.[13] According to the IRS, these regulations imply that the conduct of that type of business in the United States qualifies as other than "trading in stocks or securities" for purposes of the Trading Safe Harbors and earnings therefrom are, as a result, appropriately subject to tax as effectively connected income.

In the tax years at issue, the Fund actively solicited unrelated borrowers in the United States and made multiple loans to those borrowers. Because the Fund made "personal, mortgage, industrial, or other loans to the public" in the United States, the Fund was engaged in the active conduct of a banking, financing, or similar business within the United States. The Advice Memorandum concludes that the Fund's lending activities, therefore, did not constitute trading in stocks or securities and did not qualify for exemption from net-basis taxation under the Trading Safe Harbors.

The Advice Memorandum also states that what constitutes "trading" for purposes of the Trading Safe Harbors is consistent with judicial determinations of the scope of trading activity in other contexts, in

[12] Treas. Reg. § 1.864-2(c)(2)(iv)(b)(1) & 1.864-2(c)(2)(iv)(c), Example (1).

[13] Treas. Reg. § 1.864-4(c)(5).

which trading is an activity designed to make a profit based on the change in value of traded assets, rather than an activity seeking profit for services or other functions provided.[14] According to the IRS, the Fund profited from its lending and underwriting activities by earning fees, a spread, and interest payments. The Fund did not seek to profit from a change in value of the securities it received from issuers and borrowers. As a result, the Fund's lending and underwriting did not constitute trading for purposes of the Trading Safe Harbors.

EVEN IF FUND'S LENDING AND UNDERWRITING ACTIVITIES WERE "TRADING IN STOCKS OR SECURITIES" WITHIN THE MEANING OF THE TRADING SAFE HARBORS, FUND WOULD STILL HAVE BEEN INELIGIBLE FOR THE TRADING SAFE HARBORS

The IRS also argues that, even if the Fund's lending and underwriting activities had constituted trading in stocks or securities, the Fund was nevertheless ineligible for the Independent Agent Safe Harbor because the Fund granted discretionary authority to the Fund Manager. Further, the Fund did not qualify for the Own Account Safe Harbor because the Fund acted as a dealer during the tax years at issue.

The Independent Agent Safe Harbor does not specifically state that a grant of discretionary authority precludes qualification under that safe harbor. However, the Advice Memorandum argues that the Independent Agent Safe Harbor does not apply if there is a grant of discretionary authority to an agent. The IRS relies heavily on the legislative history of the Trading Safe Harbors and the Treasury regulations interpreting them to support that position.[15] According to the IRS, by specifically permitting trading through resident agents granted discretionary authority in the Own Account Safe Harbor, while simultaneously limiting the scope of the Independent Agent Safe Harbor to trading "through a resident

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[14] *See*, *e.g.*, *United States* v. *Wood*, 943 F.2d 1048, 1051-52 (9th Cir. 1991) ("Traders ... are sellers of securities or commodities who 'depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost .... A trader performs no merchandising functions nor any other service which warrants compensation by a price mark-up of the securities he or she sells.") (quoting *Kemon* v. *Comm'r*, 16 T.C. 1026, 1033 (1951)); *Bielfeldt* v. *Commissioner*, 231 F.3d 1035, 1037 (7th Cir. 2000) ("[T]he trader's income is based not on any service he provides but rather on, precisely, fluctuations in the market value of the securities or other assets that he transacts in.").

[15] H.R. Rep. No. 1450, 89th Cong., 2d Sess., 1966-2 C.B. 965, 975-76: "Under present law, the granting of this discretionary authority may prevent a nonresident alien or foreign corporation from qualifying for [the pre-1966 statutory trading safe harbor]....your committee has amended present law to specifically provide that, except in the case of a dealer, the trading in stocks, securities, or commodities in the United States, for one's own account, whether by a foreign person physically present in the United States, through an employee located here, or through a resident broker, commission agent, custodian, or other agent – whether or not that agent has discretionary authority – does not constitute a trade or business in the United States....Although, under [section 864(b)], a dealer is specifically excluded from those who may grant discretionary authority and not be deemed to be conducting a business in the United States, he may trade in securities or commodities, for his own account, through a U.S. agent without being considered to be conducting a business in the United States."

broker, commission agent, custodian, or other independent agent," Congress implicitly defined an "independent agent" as an agent lacking discretionary authority.

The Advice Memorandum also bases its restrictive interpretation of the Independent Agent Safe Harbor on the way in which the Own Account Safe Harbor operates: in the Own Account Safe Harbor (which explicitly does not to apply to a "dealer in stocks or securities"), there is a narrow exception that allows a foreign dealer to qualify for the safe harbor when the foreign dealer effects transactions **of a customer** through an agent with discretionary authority.[16] In the opinion of the IRS, if a dealer could grant discretionary authority to a U.S.-resident agent to transact on the dealer's behalf and still qualify for the Independent Agent Safe Harbor, then there would be no need to provide (or illustrate) this exception to the Own Account Safe Harbor.

During the years at issue, the Fund had no employees of its own. Instead, the Fund conducted its business entirely through the Fund Manager, which had been granted discretionary authority to conduct a lending and underwriting business in the United States on behalf of the Fund. Therefore, as a result of the grant of discretionary authority the Advice Memorandum concludes that the Fund Manager was not a resident broker, commission agent, custodian, or other independent agent for purposes of the Independent Agent Safe Harbor during the years at issue and, accordingly, the Fund was not eligible for the Independent Agent Safe Harbor.

The Own Account Safe Harbor explicitly does not apply to a "dealer in stocks or securities." The Advice Memorandum concludes that the Fund was also ineligible for the Own Account Safe Harbor because its underwriting activities made it a "dealer in stocks or securities." A "dealer in stocks or securities" is "a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom."[17] Through its underwriting activity, the Fund was regularly engaged in purchasing stocks and selling them to customers with an intention of earning gains and profits from those purchases and sales, and it had an established place of business, through the Fund Manager. Moreover, according to the IRS, the number of transactions that occurred over the course of several years shows that the Fund regularly engaged in underwriting activity, and underwriting activity itself indicates dealer activity.[18]

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16 Treas. Reg. § 1.864-2(c)(2)(iv)(b)(2).

17 Treas. Reg. § 1.864-2(c)(2)(iv)(a).

18 *See Bielfeldt* v. *Commissioner*, 231 F.3d 1035, 1037 (7th Cir. 2000) (explaining that "the dealer's income is based on the service he provides in the chain of distribution of the goods he buys and resells, rather than on fluctuations in the market value of those goods, while the trader's income is based not on any service he provides but rather on, precisely, fluctuations in the market value of the securities or other assets that he transacts in.").

Upon concluding that the Fund was a dealer, the Advice Memorandum further concludes that the Fund was not eligible for either of limited exceptions to inclusion in the category of a "dealer in stocks or securities" in the regulations.[19]

CONCLUSION

The IRS may assert that foreign funds with fund managers in the United States which are engaged in either lending or underwriting activities are engaged in a trade or business in the United States. The IRS may also contend that lending and underwriting activities do not constitute "trading in stocks or securities" activities within the meaning of the Trading Safe Harbors. In addition, the grant of discretionary authority to a fund manager to conduct lending and underwriting business in the United States on the fund's behalf may disqualify the fund from the Independent Agent Safe Harbor even if it is considered to be trading in stocks or securities, and the Own Account Safe Harbor will not apply to a foreign fund that engages in lending or underwriting activities that would cause it to be categorized as a "dealer in stocks or securities."

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[19] Regulations provide two exceptions which permit a foreign person to engage in limited underwriting activities without being treated as a dealer. Specifically, a foreign person is not considered a dealer (1) if such person acts as an underwriter, or as a selling group member, for the purpose of making a distribution of stocks or securities of a domestic issuer **to foreign purchasers** of such stocks or securities, irrespective of whether other members of the selling group distribute the stocks or securities of the domestic issuer to domestic purchasers; or (2) solely because of transactions effected in the United States in stocks or securities pursuant to such person's grant of discretionary authority to make decisions in effecting those transactions, if such person can demonstrate to the satisfaction of the Commissioner that the broker, commission agent, custodian, or other agent to whom discretion was given and through whom the transactions were effected acted pursuant to such foreign person's written representation that the funds in respect of which such discretion was granted were the **funds of a customer** who is neither (i) a dealer in stocks or securities, (ii) a partnership the principal business of which is trading in stocks or securities for its own account, or (iii) a foreign corporation the principal business of which is trading in stocks or securities for its own account. Treas. Reg. § 1.864-2(c)(2)(iv)(b). The Fund's activities were not within the scope of these exceptions because (1) the Fund's distribution of stock was not limited to foreign purchasers, and (2) the Fund Manager was granted discretionary authority to conduct a lending and underwriting business in the United States on behalf of the Fund itself (rather than on behalf of customers of the Fund).

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