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Client Alert

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September 2009

IRS Internal Memorandum Attacks Lending Activities by Non-U.S. Investors

On September 22, 2009, the Internal Revenue Service (the "IRS") issued an internal memorandum from the Office of Chief Counsel to the Director of Field Operations in Manhattan (Financial Services) discussing the U.S. federal income tax treatment of certain lending activities by a non-U.S. corporation. In the memorandum, the IRS concluded that a non-U.S. corporation is engaged in a U.S. trade or business if it conducts certain lending activities through a U.S. agent engaged to perform services such as locating borrowers, performing credit analyses and negotiating borrowing terms. The memorandum concludes that, under such circumstances, the non-U.S. corporation's income from those activities would be subject to U.S. federal income tax and the non-U.S. corporation would be required to file U.S. federal income tax returns.

Although not binding authority, the memorandum is significant both because of the dearth of guidance on the proper U.S. federal income tax treatment for lending activities of non-U.S. persons as well as for the conclusion itself, which potentially could have adverse consequences on the future of many debt-oriented private investment funds.

Background

Overview of Relevant U.S. Tax Provisions. For U.S. federal income tax purposes, certain types of U.S.-source income earned by non-U.S. persons generally are subject to a withholding tax of 30%, unless reduced by an applicable income tax treaty. Income subject to this withholding tax is referred to as FDAPI ("fixed or determinable annual or periodical income").

In general, no U.S. federal income tax return is required to be filed by a non-U.S. person in connection with the receipt of items included in FDAPI, provided the proper amount of U.S. tax (if any) is withheld on behalf of that person.

Although FDAPI includes U.S.-source interest income, the withholding tax is not applicable to interest income that qualifies as "portfolio interest." Portfolio interest is defined generally as interest paid by a U.S. corporation or partnership on a registered debt obligation to a non-U.S. person that holds less than 10% of the voting power of the payor (in the case of a corporation) or less than 10% of the capital or profits of the payor (in the case of a partnership), other than certain types of contingent interest.

If, however, the non-U.S. person is engaged in "the conduct of a U.S. trade or business that is effectively connected with the United States," then the withholding rules above for FDAPI – including the exclusion from withholding for portfolio interest – generally do not apply to the income from those activities. Instead, the non-U.S. person's net income from those activities is subject to tax in the same way as if it was earned by a U.S. person, and the non-U.S. person is required to file a U.S. federal income tax return. In addition, if such non-U.S. person is a corporation, it may be subject to an additional "branch profits tax."

Although the Internal Revenue Code does not specify what constitutes carrying on a trade or business within the United States, the decided cases hold that "investing" in stock and securities in the United States does *not* constitute carrying on a trade or business. Moreover, the Internal Revenue Code provides a safe harbor that "trading" in stock and securities for a taxpayer's own account does *not* constitute carrying on a U.S. trade or business unless it is undertaken by a dealer in stock or securities.

U.S. Trade or Business and Lending Activities. Although non-U.S. persons generally are permitted to conduct their global financial management activities from the United States (such as trading in stock and securities, as noted above) with few or no U.S. federal income tax consequences, that is not the case if such activities are deemed to constitute the conduct of a U.S. lending trade or business. In this regard, the distinction between active lending activities (which constitute a U.S. lending business) and passive lending activities (which do not) is unclear. Because current law utilizes a facts and circumstances test to distinguish between active and passive lending activities, it is often difficult to determine what level of activity will constitute a U.S. lending trade or business.

The following facts and circumstances are relevant in distinguishing between active and passive lending activities: (1) the frequency and regularity of the loan activities; (2) the number and amount of the loans concluded; (3) the extent of finance activities in comparison to the overall activities of the lender; (4) whether the lender is heavily leveraged and intends to profit from a spread or other fees; (5) whether the loans were made for the purpose of maintaining equity investments as distinct from the purpose of earning interest; (6) the extent of negotiation and origination of loans; (7) whether the lender represented itself to the public as a lender or had a reputation in the community as a lender; and (8) whether the lender engaged in transactions with unrelated parties.

Unfortunately, this is not an exhaustive list of the factors considered in the lending trade or business determination. Furthermore, since "trade or business" status is relevant for many other U.S. federal income tax purposes (in addition to determining whether a non-U.S. person is engaged in a U.S. lending trade or business) and these factors are gleaned from those areas as well, there can be no assurance that the IRS would not weigh one factor more heavily than others for this particular purpose.

The Memorandum

The Facts. The memorandum addresses certain U.S. federal income tax consequences to a non-U.S. corporation ("Foreign Co") that entered into a services agreement with a U.S. company ("Origination Co"). Pursuant to this arrangement, in exchange for a fee, Origination Co provides services in the United States, including: solicitation of prospective borrowers, credit analyses, and negotiation of loan terms. Although final approval and execution of the loan documents is made by Foreign Co, Foreign Co does not maintain a U.S. office, and all activities of Foreign Co's employees are undertaken outside of the United States.

The Conclusion. Based on these facts, the memorandum concludes that Foreign Co is engaged in a U.S. trade or business under the rationale that the activities of Origination Co are attributable to Foreign Co. The memorandum provides that the conclusion would be the same whether or not Origination Co is viewed as a "dependent" or an "independent" agent. In addition, the memorandum concludes that the safe harbor for trading in stocks and securities for a non-U.S. person's own account does not apply to these facts since Foreign Co's lending activities do not constitute "trading."

The memorandum further concludes that Foreign Co's U.S.-source interest income is effectively connected with its U.S. trade or business. The conclusion is based on Treasury regulations that determine the portion of U.S.-source interest income that is effectively connected with a banking, financing or similar business conducted through an office in the United States. Under these regulations, U.S.-source interest income received from a banking, financing or similar business activity is effectively connected with a U.S. trade or business when the stock or securities giving rise to the income are attributable to the U.S. office through which the business is carried on. For purposes of determining whether U.S.-source interest income is attributable to a U.S. office, the U.S. office of a non-U.S. taxpayer's U.S. agent may be imputed to the non-U.S. taxpayer. Under this rule, the memorandum concludes that the U.S. office of Origination Co may be treated as Foreign Co's office since Foreign Co's lending business is deemed to take place from the U.S. office of Origination Co.

Significance. The memorandum demonstrates the IRS's view that the loan origination activities of a non-U.S. person's U.S. agent, without regard to whether such agent is dependent or independent, may be attributed to the non-U.S. person. This attribution could cause the non-U.S. person to be engaged in a U.S. trade or business (resulting in the imposition of a U.S. income tax liability on that non-U.S. person), even if the non-U.S. person does not have an office or other physical presence in the United States.

The memorandum, however, does not provide a detailed analysis of some of the fundamental issues affecting non-U.S. persons in the lending area. For example, the memorandum does not address what level of lending activities would give rise to a U.S. trade or business. Instead, the memorandum assumes that the activities conducted by Origination Co are conducted on a "considerable, continuous and regular basis." In addition, there is no discussion of what constitutes an "origination" (as opposed to an investment), including whether secondary market purchases could constitute an origination under certain circumstances. The memorandum also does not discuss whether U.S. lending activities by a non-U.S. person with an existing or simultaneous equity investment in the U.S. borrower would constitute a lending trade or business or whether such lending activities would be viewed instead as investing or trading for one's own account under the above referenced safe harbor.

Finally, the determination of the "agency" relationship itself is not fully addressed. For example, if Origination Co were to undertake its activities without a fee, but with an express or implied commitment by Foreign Co to purchase the debt obligations, would the activities of Origination Co be attributed to Foreign Co?

Impact for Debt-Oriented Private Investment Funds

For sponsors of, and investors in, private investment funds making investments in debt instruments, the issues surrounding the U.S. federal income tax treatment of the activities of these funds are not new or novel. In fact, these issues have been on the IRS priority guidance list for the past three years.

The memorandum, although not binding authority, does provide a glimpse into the potential future IRS scrutiny of loan origination activities. In this regard, it is noteworthy that the memorandum includes a statement indicating that the Office of Chief Counsel intends to analyze other strategies used by non-U.S. persons to originate loans in the United States.

In the meantime, structures that have been adopted to date should be re-evaluated by fund sponsors, their investors and their legal and tax advisors.

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