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International Tax ADVISORY ■

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Foreign Fund's Lending and Underwriting Activities Constituted U.S. Trade or Business

In Chief Counsel Advice 201501013, released early this month, the IRS concluded that a foreign fund was engaged in a U.S. trade or business based on its lending and underwriting activity conducted by a U.S. resident fund manager under a management agreement. Because the fund was organized in a non-treaty jurisdiction, the fund was subject to U.S. income tax on income effectively connected with its lending and underwriting business.

Background

The fund began as a domestic limited partnership and later converted to a foreign partnership in a country with which the United States does not have a tax treaty. The fund was treated as a partnership for federal income tax purposes. The fund did not have employees during the years in question. Instead, its management was vested exclusively in a fund manager pursuant to a management agreement. The agreement appointed the manager as the fund's agent and fully authorized the manager to buy, sell and otherwise deal in securities and related contracts for the fund's account. The agreement also gave the manager the power to perform any necessary or proper act that the fund could take itself. The fund manager provided similar services to other persons, and none of the manager's employees worked exclusively for the fund.

Pursuant to the power granted in the management agreement, the fund manager, through its U.S. office, conducted an "extensive lending and stock distribution business" on the fund's behalf. The manager held the fund out to the market as a lender and underwriter and dedicated significant time and resources to generating business for the fund. On the lending side, the fund manager negotiated loan terms directly with borrowers on the fund's behalf. The fund often lent money in return for convertible debt instruments, which the fund typically converted and sold to earn the spread due to the discounted conversion price. Additionally, the fund earned various fees from borrowers.

On the stock distribution side, the fund manager also spent a substantial amount of time and resources conducting underwriting activities for the fund. The manager negotiated the terms of distribution agreements directly with issuers on the fund's behalf. The fund sometimes resold issuers' stock to U.S. purchasers. The fund generally earned a spread on the stock it purchased from the issuer under the distribution agreement and fees paid by the issuers for commitment, structuring and due diligence.

The CCA addressed three issues: (1) whether the fund was engaged in a trade or business in the United States (ETBUS); (2) whether the fund's lending and underwriting activities constituted "trading in stocks or securities" for purposes of the Trading Safe Harbors under Section 864; and (3) whether, even if the fund's activities did constitute trading in stocks or securities, the fund would be eligible for the Trading Safe Harbors. The fund's position was that it was not ETBUS but engaging in "mere investment activity." Alternatively, the fund argued that its activities were "trading in stocks or securities" under the safe harbors of Section 864 (the Trading Safe Harbors).

Issue One – Engaged in a Trade or Business in the United States

The Code does not define ETBUS, but cases and rulings generally treat profit-oriented activity in the United States as a trade or business within the United States if the activity is "considerable, continuous, and regular." Conversely, sporadic or ancillary activities typically do not rise to the level of a trade or business, nor does "merely managing one's own investments." In the lending context specifically, courts rely on various factors—e.g., the number of loans, the time and resources spent, transactions with unrelated parties, whether a taxpayer sought out and solicited borrowers—to determine whether lending activity constitutes a trade or business. The Code also specifically treats the performance of personal services in the United States as a trade or business within the United States, with some exceptions. In determining whether a foreign person is ETBUS, the activities performed by an agent on the foreign person's behalf are considered to be performed by the foreign person. This attribution, according to the IRS, obtains whether or not the foreign person exercises control over the agent.

The IRS concluded that the fund was ETBUS. The CCA found that the fund's lending and underwriting activities were profit-oriented and conducted in the United States on a considerable, continuous and regular basis. Although the fund manager actually conducted the business activities, the activities were attributable to the fund because the manager was the fund's agent and acting on the fund's behalf. Moreover, the extent of the lending and stock distribution activities went beyond passive investment: the fund made numerous loans and entered into dozens of stock distribution agreements and, through its agent, committed significant time and resources to the activities, including soliciting potential borrowers and issuers.

Issues Two and Three – Trading Safe Harbors

The IRS rejected the fund's alternative argument that its activities came within either of the two Trading Safe Harbors of Section 864. The first Trading Safe Harbor provides that ETBUS does not include "[t]rading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent." This safe harbor is available to any foreign person, including a dealer in stocks or securities, that does not have an office or fixed place of business in the United States at any time during the year through which the transactions in stocks or securities are effected. The second Trading Safe Harbor provides that ETBUS does not include "[t]rading 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." Dealers in stocks or securities cannot rely on this second safe harbor; however, other persons who have an office or place of business in the United States can.

As a threshold matter, the CCA notes that both Trading Safe Harbors apply to "trading in stocks and securities." The regulations interpret that term to mean "effecting transactions in stocks or securities," including "buying, selling … or trading in stocks, securities, or contracts or options to buy or sell stocks or securities." The IRS notes that the quantity of stock or securities transactions is irrelevant to determining whether a safe harbor applies.

The fund's lending and underwriting activities did not constitute "trading in stocks or securities" for purposes of the Trading Safe Harbors. According to the CCA, the fund's activities went beyond the scope of that term as set forth in the Section 864 regulations and authority in other contexts. With respect to the fund's lending activity, the IRS observed that Section 1.864-4 of the regulations specifically treats a foreign person as engaged in the active conduct of a banking business in the United States if the person makes loans to the public in the United States. Even though the cited regulation pertains to whether income is effectively connected with a banking business, the CCA apparently concluded that such lending activity could not qualify as trading in stocks or securities. The fund, through its manager, solicited and made loans to borrowers in the United States; consequently, it was engaged in the active conduct of a banking business, not trading in stocks or securities.

As for the fund's underwriting activity, the CCA notes that the Section 864 regulations confirm that underwriting is not trading within the meaning of the Trading Safe Harbors, with one narrow exception. The limited underwriting exception provides that a foreign underwriter will not be considered a dealer or treated as ETBUS if the person acts as an underwriter, or as a selling group member, for the purpose of distributing stocks or securities of a domestic issuer only to foreign purchasers. The fund distributed stocks or securities to U.S. purchasers (as well as foreign purchasers); therefore, its activity exceeded the scope of the limited exception and could not qualify for a Trading Safe Harbor.

The CCA also distinguishes the fund's activities from the concept of "trading" in the Section 1221(a)(1) context. Traders, as the courts have determined in this context, derive their income from market fluctuations in the stock or securities they buy and sell; they do not perform services that merit a markup above the price of the stock or securities. The fund, in contrast, earned interest and various fees from its lending and underwriting activities—in addition to the spread on its buying and selling of stock or securities.

Despite concluding that the fund's activities do not qualify for the Trading Safe Harbors, the IRS further concludes that, even if the fund's activities were "trading in stocks or securities," the fund would not be eligible for the Trading Safe Harbors. The fund was ineligible for the first Trading Safe Harbor because it had delegated discretionary authority to a U.S. resident agent—the fund manager—to conduct the lending and underwriting activities. The CCA reviews legislative history, statutory interpretation and prior decisions that excluded the activities of an independent agent vested with discretionary authority from the scope of the first Trading Safe Harbor—reading the first safe harbor as implicitly (if ironically) requiring that an "independent agent" lack discretionary authority. The CCA also cites several concurring commentators, while admitting that an independent agent may exercise discretionary authority on behalf of a principal in other contexts (e.g., an independent agent as an exception to "permanent establishment" pursuant to a tax treaty).

The fund was ineligible for the second Trading Safe Harbor because its underwriting activities made it a dealer in stocks or securities. Under the regulations, a dealer is "a merchant of stocks or securities, with an established place or 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." The CCA contrasts this definition with mere investment or speculation in stocks or securities. Through its underwriting activity, the fund regularly purchased stocks and sold them to customers with an expectation of profit. The fund acted as a middleman that provided issuers with access to public markets. The fund's underwriting income was not based on market fluctuations in the issuers' stocks but rather on the services the fund provided as an underwriter distributing the stocks. Without much exposition, the CCA also declares that the fund manager's office served as an "established place of business" for the fund within the meaning of the regulations because of the comprehensive grant of authority in the parties' management agreement.

Conclusion

The determination of whether a foreign person is ETBUS is a conceptual fog with few bright spots and points of reference. Judicial and administrative interpretations have resulted in a relatively low bar for an issue that can carry significant consequences for foreign taxpayers in non-treaty jurisdictions—namely, subjecting those persons to U.S. taxing authority. Even taxpayers covered by U.S. tax treaties, which generally apply the higher threshold of "permanent establishment" rather than ETBUS, can glean insight from the IRS's application of statutory rules. The CCA's detailed analysis of the meaning of "independent agent" and the distinction between "traders" and "dealers" in the context of the Trading Safe Harbors of Section 864 highlight the complex and fact-dependent nature of these issues.

CCA 201501013 adds another data point for analogy, but its analysis is sometimes strained or lacking—particularly in the way it glosses over the issue of attribution from an "agent." A number of tax practitioners have previously requested that the IRS and Treasury state their views on ETBUS and agent-principal attribution in formal regulations, rather than in ad hoc pronouncements. In the meantime, taxpayers engaged lending or stock or securities transactions, and whose status as ETBUS is unclear, should consult with professional advisors to ascertain their U.S. tax exposure.

For more information, contact **Edward Tanenbaum** at (212) 210-9425 or **Heather Ripley** at (212) 210-9549.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George B. Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Matthew P. Moseley
202.239.3828
matthew.moseley@alston.com

Daniel M. Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

ALSTON&BIRD LLP

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ■ 5th Floor ■ East Palo Alto, CA 94303-2282 ■ 650-838-2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.756.3300 ■ Fax: 202.756.3333