

## Federal & International Tax ADVISORY

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### **YA Global, the Existence of a U.S. Trade or Business, and the Search for Greater Clarity**

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On November 15, 2023, the United States Tax Court issued its opinion in [YA Global Investments LP v. Commissioner](#). Tax professionals had anticipated the opinion for over a decade, wondering to what extent it might provide guidance in several “gray” areas of the tax law involving attribution of business activities to U.S. agents, the status of financing activities constituting investing, trading, and lending activities in the United States, the definition of a “dealer in securities,” and related issues.

While the Tax Court ruled in favor of the IRS, the ruling was mostly based on a set of unfortunate facts for the taxpayer and generally does not easily lend itself to further delineating more nuanced factual scenarios. While the opinion addresses numerous issues of potential interest to investment funds and their sponsors and investors, this advisory focuses on the Tax Court’s views on the existence of a U.S. trade or business.

#### **The Importance of a U.S. Trade or Business**

Absent application of a tax treaty or specific statutory exception, a non-U.S. person is taxable on a net basis at applicable rates on any income it derives if that income is effectively connected with a U.S. trade or business. The Code does not contain a precise definition of the term “trade or business.” Rather, tax professionals rely on a line of judicial decisions and administrative interpretations of this term. In very general terms, this guidance indicates that a trade or business must be conducted for profit and requires some degree of continuity and regularity. In addition, several cases provide that the actions of U.S. agents, as opposed to U.S. service providers, may be attributed to a non-U.S. person in determining whether its activities rise to the level of a trade or business in the United States. Case law has also long held that mere investment activities do not amount to a trade or business.

In addition to common-law carveouts, the Code contains safe harbor exceptions for securities or commodities trading. These safe harbors apply even if the trading activity would otherwise constitute a trade or business but do not cover many activities that may take place in conjunction with trading, such as loan origination and loan workout activities.

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## YA Global's Structure and Business

YA Global Investments LP was a Cayman Islands partnership that acquired different types of interests in U.S. companies. During most of the relevant period (2006–2008), Yorkville Advisors LLC served as YA Global's investment manager and its general partner through an office in the United States. Yorkville was compensated through a management fee based on a percentage of YA Global's assets and received what the Tax Court referred to as a 20% incentive fee based on YA Global's profits (potentially a carried interest from YA Global).

Yorkville and YA Global's management agreement appointed Yorkville as YA Global's fund manager and designated it as YA Global's agent and irrevocable attorney-in-fact with full power to buy, sell, and otherwise deal in securities and related contracts for YA Global's account. The management agreement allowed YA Global to periodically notify Yorkville of revised investment restrictions and was amended to reflect that Yorkville's actions were subject to YA Global's policies and control. YA Global had direct U.S. and foreign partners and established YA Offshore Global Investments Ltd. to serve as a corporate "blocker" for non-U.S. investors that did not want to invest in YA Global directly. YA Global had no employees and instead relied on Yorkville and its many employees.

Yorkville performed numerous lending, investment, and stock distribution activities pursuant to the management agreement. These activities included direct negotiation with borrowers over loan terms and negotiations for standby equity distribution agreement (SEDA) terms with portfolio companies. These portfolio companies paid various amounts designated as "fees" to both Yorkville and YA Global. The opinion indicates that YA Global's reputation was such that many companies in need of funding would reach out to Yorkville directly to discuss their needs. During the years at issue, YA Global was either Yorkville's only client or its only significant client.

YA Global's primary activity was providing funding to portfolio companies using convertible debentures, SEDAs, promissory notes, warrants, and other securities. A SEDA is a commitment to purchase up to a specified dollar value of a company's stock over a fixed period, typically two years in YA Global's case. The SEDAs typically required portfolio companies to pay Yorkville and YA Global various amounts documented as fees. YA Global also invested extensively in convertible debt that allowed YA Global to purchase interests in a portfolio company at a discount. After conversion, YA Global typically sought to earn a spread by selling the discounted securities at a profit.

### CCA 201501013

Chief Counsel Advice Memorandum 201501013 (CCA), issued on January 2, 2015, analyzed whether certain lending and stock distribution activities constituted a trade or business within the United States. The CCA concluded that the fund (later confirmed in the opinion as YA Global) was engaged in a U.S. trade or business because of the nature and extent of its agent's (Yorkville's) lending and underwriting activities and the conclusion that the agent performed those activities as the fund's agent. The CCA further concluded that those activities did not qualify for the securities trading safe harbor and that even if they had, the fund itself would not qualify under the safe harbor because it was a dealer in stocks and securities. Ultimately, the Tax Court reached the same conclusions as the CCA, but the opinion provides additional context and a higher degree of specificity.

## The Tax Court's Decision

As YA Global had no employees, the Tax Court sought to examine the relationship between YA Global and Yorkville to determine whether Yorkville was considered YA Global's agent. The conclusion that Yorkville served as YA Global's agent is perhaps unsurprising given it performed minimal activities outside of those performed on YA Global's behalf and had extensive authority under the management agreement. YA Global did not challenge the notion that Yorkville's

activities could be attributed to it for purposes of determining whether it was engaged in a U.S. trade or business. Instead, YA Global asserted only that Yorkville was a service provider rather than its agent. In analyzing the distinction between a service provider and an agent, the Tax Court put significant weight on YA Global's right to issue interim instructions to Yorkville under the management agreement.

## Trade or Business Activities

The Tax Court next analyzed whether YA Global's activities, including those conducted by Yorkville on its behalf, constituted a U.S. trade or business. Despite the parties spending a great deal of effort attempting to delineate exactly what type of trade or business YA Global was engaged in, the Tax Court stated the determination was of "no moment" – whether YA Global was involved in lending, underwriting, or other general profit-making activities, it was necessarily involved in a trade or business if that activity was sufficiently regular and continuous, and no specific exception applied.

The Tax Court's analysis covered three questions.

### ***(1) Were the activities continuous, regular, and engaged in for the primary purpose of producing income or profit?***

As YA Global did not dispute this point at trial and considering the number of Yorkville employees and volume of activities involved, the Tax Court answered this question affirmatively after a brief analysis.

### ***(2) Did the activities merely constitute the management of investments?***

In exploring this second question, the Tax Court examined the extent to which YA Global and Yorkville's returns were derived from capital investments in portfolio companies. The analysis of YA Global's returns is somewhat muddled by the fact that the SEDAs, convertible debentures, and other transactions it entered into appeared to have varying terms, with some having a specified fee component but with the nomenclature varying in the fee descriptions.

The opinion reasons that when a provider of capital is otherwise receiving a market return, the presence of fees and similar amounts indicates that something more, in terms of value and services, is present. YA Global argued the Tax Court should view the designated fees from the portfolio companies' perspective, relying on testimony that they viewed the "fees" as part of the overall economics of the transactions regardless of their designation. In terms of structure, these fees were often paid to Yorkville rather than YA Global, and sometimes a portion was paid over to YA Global or applied to reduce its management fees payable to Yorkville.

The Tax Court found that the fees indicated that something beyond mere investment was occurring in the transaction and that they would have been paid entirely to YA Global if they merely constituted payments for the use of capital. The Tax Court's finding that Yorkville had some discretion on whether to remit these fees to YA Global beyond the operating expenses of Yorkville suggested these "fees" were potentially relevant to YA Global's investors in ultimately projecting their returns. The opinion further suggests that the role of Yorkville in identifying, sourcing, and negotiating transactions, conducting due diligence, and structuring and managing transactions went beyond that of an investor and thus, along with the agency analysis and apparent receipt of compensation for such activities, removed YA Global's activities from qualifying as mere investment activities as opposed to trade or business activities.

### ***(3) Were the activities covered by the securities trading safe harbors?***

The Tax Court's analysis of the securities trading safe harbors was brief. It determined that YA Global did not qualify for the securities trading safe harbor because its fee income from portfolio companies exceeded a return on invested capital, suggesting compensation for activities beyond mere buying and selling of securities.

## Key Takeaways

While the opinion may be appealed, the Tax Court's general approach to a review of the pertinent facts of YA Global's operations emphasizes the importance of ensuring the analysis of tax treatment of a transaction accurately takes into account all the direct and indirect economic and commercial circumstances among the parties. For instance, in light of the opinion's parsing of the specific terms of the management agreement at issue in YA Global, investment funds and their advisers should carefully review their investment management arrangements and agreements.

Similarly, while the opinion did not rely merely on the labeling of certain payments as fees, the presence of amounts designated as fees whose purpose was not readily explainable proved problematic. The opinion analyzed the structure of these fees, in part to determine their purpose, and found the party they were paid to and their treatment by the parties to be relevant. This inquiry suggests funds, investment managers, and others should carefully consider how any fees, including more complex arrangements such as fee offsets or other forms of reimbursement or remittance, are structured.

Overall, in evaluating how the IRS and courts may characterize their transactions, offshore investors and their advisers would be wise to review all the relevant materials and arrangements among the parties, including facts that may fall outside the scope of a typical tax analysis such as marketing materials and similar communications to ensure the economic expectations of all parties are fully taken into account.

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