Background on Tax Issues for Offshore “Bank Loan” Funds with US-Based Advisors

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I. Overview of Bank Loan Market²

A. What is the leveraged loan market?
   - Consists of loans made to speculative-grade borrowers
   - Accessed by borrowers for a variety of purposes but most commonly for leveraged buyouts, recapitalizations, and refinancings
   - Vast majority of loans are senior secured (usually first or second lien) floating-rate paper that the issuer can prepayment with little or no restrictions on fees
   - Loans range in size from $50mn to $10bn at the high end

B. Syndicated bank loans have been one of the fastest growing fixed income asset classes
   - Increased liquidity
   - Secondary trading volumes increased from $100bn in 2000 to current levels of $400-500mn
   - Concerns of rising inflation have made bank loans more attractive than bonds
   - Investors poured $13.8 billion into bank loan funds last quarter, according to an April 1 report from JPMorgan Chase & Co. That compares with $17.9 billion for all of last year

C. Structure of bank loans

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• Most bank loans are structured and syndicated to accommodate the two primary lender constituencies: banks (A-term loans) and institutional investors (B-term, C-term or D-term loans)

• Institutional investors include structured finance vehicles, hedge funds, mutual funds, and insurance companies

D. Loan trading dynamics

• Loan trading occurs among the major dealers, market makers and institutional investors

• While bank loans are not exchange-traded, most loans are priced and marked daily by two third pricing sources: MarkIt Partners and Loan Pricing Corporation (LPC), a subsidiary of Reuters plc

• Most bank loans are classified as Level 2 assets for financial reporting under FASB 157 (assets with observable trading levels)

• The number of loans priced daily by LPC has increased from 700 loans to over 2800 loans, and 82% of loans traded during 2Q2010 were executed within 100bps of their market price

II. Overview of Tax Rules.

A. Imposition of tax on a foreigner’s U.S. trade or business income.

Under Section 882, foreign corporations are subject to regular net-based income taxation on income that is effectively connected with the conduct of a U.S. trade of business (“ECI”).

Under Section 884, the “dividend equivalent amount” of that ECI is subject to a branch profits tax. If the foreign corporation does not file a true and accurate U.S. tax return, it is not entitled to deductions or credits in determining ECI. The return must be filed on a timely basis.

B. Section 864 “trading safe harbor.”

Under a safe harbor provided in Section 864(b)(2)(A), “trading in stocks or securities” generally is not a U.S. trade or business, except when the taxpayer is a dealer in stocks or

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3 Unless otherwise indicated, all “Section” and “Code” references are to the Internal Revenue Code of 1986, as amended.

4 I.R.C. § 882(c)(2).

5 Treasury Regulations require that the return be filed on a timely basis, which is generally defined for foreign corporations as no more than 18 months after due, unless no return was filed in the prior year in which case, if earlier, the return must be filed prior to the IRS mailing a notice that no return has been filed Treas. Reg. § 1.882-4(a)(3)(i). The Court of Appeals for the Third Circuit upheld this regulation, reversing the Tax Court. Swallows Holdings, Ltd. v. Commissioner, 515 F.3d 162 (3d Cir. 2008).
securities and effects the trades through its U.S. office directly or through the U.S. office of its agent other than an independent agent (the “Trading Safe Harbor”). Under Section 864(c)(1)(B), a foreign corporation will not be treated as recognizing ECI unless it has a U.S. trade or business.

C. ECI from a U.S.-based lending business.

There is little authority on the application of the Trading Safe Harbor to purchases and sales of bank loans. “Mere investing,” even if the resulting investments require significant oversight/management activity, is generally not a trade or business. Outside of Section 864, there is considerably more guidance on when a lending business constitutes a trade or business, as discussed below.

Treasury Regulations under Section 864 provide when ECI arises from the “active conduct of a banking, finance or similar business in the United States” (an “Active US Lending Business”). If the taxpayer’s only U.S. trade or business is the “active conduct of a banking, finance or similar business in the United States,” then the taxpayer’s income and gains from stocks and securities will be treated as ECI only if the stocks and securities are attributed to a U.S. office and certain other conditions are met. As discussed below, when this attribution would arise only as a result of the taxpayer’s agent having a U.S. office, there is a controversy about whether there are different rules for purposes of measuring ECI for U.S.-source as opposed to foreign-source income and gain.

III. Scope of the Trading Safe Harbor.

A. Statutory framework.


7 See, e.g., Higgins v. Commissioner, 312 U.S. 212 (1941) (mere management of investments and collection of rents, interest and dividends by a foreign person in the United States will not result in the person being in a US trade or business); Treas. Reg. § 1.864-3(a), Ex. 2 (a foreign corporation’s supervision of its investments is not a trade or business).

8 This activity is defined in Treas. Reg. § 1.864-4(c)(5)(i), though that regulation also provides that a foreign corporation acting merely as a financing vehicle for borrowing funds for its parent or other related corporations is not considered as engaged in the active conduct of banking, financing or similar business in the United States.

9 For U.S.-source income and gain, see Treas. Reg. § 1.864-4(c)(5), and for foreign-source income, see Section 864(c)(4)(B)(ii) and Treas. Reg. § 1.864-6(b)(2)(ii)(b).
1. The independent agent Trading Safe Harbor for dealers.

Under Section 864(b)(2)(A)(i), a U.S. trade or business does not include “trading stocks or securities through a resident broker, commission agent, custodian or other independent agent” provided that “at no time during the taxable year the taxpayer has an office or other fixed place of business through which or by the direction of which the trades are effected.” This part of the Trading Safe Harbor is available regardless of whether the taxpayer is a dealer in stocks or securities.

2. The general Trading Safe Harbor for non-dealers.

Under Section 864(b)(2)(A)(ii), for a taxpayer that is not a dealer in stocks or securities, a U.S. trade or business does not include “trading in stocks or securities for the taxpayer’s own account, whether 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.”

3. Implication of dealer status.

It is unclear when a lender might be treated as a dealer for this purpose. The IRS has ruled that a mortgage company that originated loans and sold them to customers that were institutional investors engaged in dealer activity. Another potential argument is that lending automatically results in dealer status without any subsequent sale being required. A dealer

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10 The regulations under Section 864 define a dealer 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. Persons who buy and sell, or hold, stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations, members of partnerships, or fiduciaries, who in their individual capacities buy and sell, or hold, stocks or securities for investment or speculation are not dealers in stocks or securities within the meaning of this subparagraph solely by reason of that activity. In determining under this subdivision whether a person is a dealer in stocks or securities such person’s transactions in stocks or securities effected both in and outside the United States shall be taken into account.” Treas. Reg. § 1.864-2(c)(2)(iv).


12 Under Section 475(c)(1)(A), a dealer include a taxpayer that “regularly purchases securities from... customers” with securities defined in Section 475(c)(2)(C) to include notes or “other evidence of indebtedness.” Under Treas. Reg. § 1.475(c)-1(c)(i) a “taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) ...” that engages in no more than negligible sales of the securities is not a dealer unless the taxpayer elects otherwise. These provisions may support that loan origination activity is dealer activity. See also Peaslee & Nirenberg, supra note 6, at Ch. 4. F.3.b. (§ 475’s definition “was aimed at banks or other finance companies that originate loans”); Lee A. Sheppard, Neither a Dealer Nor a Lender Be: Collateralized Debt Obligations Raise New Questions, Tax Notes Today 94-3 (May 15, 2001) (noting that a government official raised the possibility that CDO issuers may be considered dealers under § 475 at a NYSBA Tax Section meeting.); Sicular & Sobol, supra note 6 56 Tax. Law. at 762 (noting that commentators and the Service had indicated that CDOs may be treated as dealers under § 475). In a preamble to proposed regulations under Section 864, the IRS stated that it was considering conforming the Section 864 definition of dealer to the definition of dealer contained in Section 475. Preamble to Prop. Reg. § 1.864(b)-1, 63 Fed. Reg. 32,164 (June 12, 1998).
typically has customers and inventory, however.\textsuperscript{13} These factors arguably should be required to find dealer status for a taxpayer making a loan. As discussed in more detail below, providing capital to a borrower arguably does not by itself result in a customer relationship.

This question is important for many funds because it bears on whether a fund can rely on the Trading Safe Harbor for non-dealers for trading income. For example, imagine a fund that lends through foreign offices (and thus does not have a U.S.-based lending business) and trades through U.S. offices. Can the fund rely on the Trading Safe Harbor for its trading income or does dealer status preclude that?

4. Definition of “trading” and “securities”

In defining “trading” in stocks and securities the Treasury Regulations refer to “effecting a transaction in the United States in stocks or securities.”\textsuperscript{14} The term “effecting a transaction” in a security is a seemingly broad standard. The Treasury Regulations state further that the effecting of transactions in securities includes the following:

buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading).\textsuperscript{15}

The term “buying, selling… or trading” does not specify that the purchase cannot be from an issuer,\textsuperscript{16} and does not by its terms require that the purchase be in an established market. The volume of stock or security transactions is not taken into account in determining whether a taxpayer is investing or trading.\textsuperscript{17}

\textsuperscript{13} See, e.g., Kemon v. Commissioner, 16 T.C. 1026, 1032 (1951).

\textsuperscript{14} Treas. Reg. § 1.864-2(c)(2).

\textsuperscript{15} Id.

\textsuperscript{16} It is arguable, however, that a purchase from a borrower is “making a loan” rather than a “purchase.” See Security Bank Minnesota v. Commissioner, 994 F.2d 432 n. 7 (9th Cir. 1993) (“A review of the code demonstrates that Congress has consistently employed the terms "loan" and "made" to describe lending transactions.”), aff’g 98 T.C. 33 (1992) (“In the Code and in normal bank parlance, terms such as acquisition and issue commonly refer to third-party debt instruments; "loans" are "made" by a bank to its customers); but cf. Treas. Reg. § 1.475(c)-1(c)(i); G.C.M. 38456 (July 25, 1980) (“The making of loans is not necessarily different from other types of investments typically made by trustees” and so trust’s loan origination does not necessarily cause it to fail to be an investment trust).

\textsuperscript{17} Treas. Reg. § 1.864-2(c)(2).
Securities are defined as “any note, bond, debenture or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing...”

B. Authorities on origination activities under Section 864

In Pasquel v. Commissioner, a foreign person that made one loan (and conducted limited other U.S. activities) was found to be not in a U.S. trade or business. In InverWorld v. Commissioner, the Tax Court looked to Treasury Regulation § 1.864-4(c)(5)(i) for evaluating whether a foreign person was engaged in the “active conduct of a banking, finance, or similar business in the United States” (as defined in that regulation, an “Active US Lending Business”), and found that the taxpayer was so engaged as a result of having conducted four of those six activities identified in that regulation.

In a revoked Revenue Ruling 73-227, the IRS concluded that a foreign corporation (which seems to have had an office in the United States that made it ineligible for the Trading Safe Harbor under pre-1997 law) that made loans directly to its parent and affiliates was not trading in stocks and securities for its own account. Instead, it was engaged in a U.S. trade or business consisting of “the borrowing of funds and the relending of such funds” to its parent and affiliates. The ruling held that, although these activities were an active conduct of a trade or business, the trade or business was not a banking, finance, or similar business within the meaning of Treasury Regulation § 1.864-4(c)(5), nor was the foreign corporation’s principal business trading in stocks or securities for its own account.

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19 12 TCM (CCH) 1431 (1953).

20 71 TCM (CCH) 3231 (1996).

21 This regulation provides that a foreign person will be treated as engaged in an Active US Lending Business if (1) at some point during the taxable year the person is engaged in business in the United States and (2) the activities of such business consist of one or more of the following activities carried on in whole or part in the United States: (a) receiving deposits from the public, (b) making personal, mortgage, industrial, or other loans to the public, (c) purchasing, selling discounting or negotiating notes, drafts, bills of exchange, acceptances or other evidences of indebtedness or the public on a regular basis (d) issuing letters of credit to the public and negotiating drafts drawn thereunder, (e) providing trust services for the public or (f) financing foreign exchange transactions for the public.

22 Commentators have noted that the regulation by its terms applies only if a foreign person is in a U.S. trade or business and does not govern whether the person is in a trade or business. NYC 2007 Bar Report, supra note 6.


24 Rev. Rul. 73-227 noted the rule under Reg. § 1.865-4(c)(5) that a foreign corporation which acts merely as a financing vehicle for borrowing funds for its parent corporation is not considered to be engaged in the active conduct of a banking, financing, or similar business in the United States. It is not clear whether by
In revoking Revenue Ruling 73-227. Revenue Ruling 88-3 stated that the determination of whether a foreign corporation was engaged in a U.S. trade or business must be made by applying the rules under Section 864(b) to the facts, and the prior Revenue Ruling had failed to do so and reached its conclusion without discussing and applying the proper legal standards. Determining whether a taxpayer is engaged in a U.S. trade or business is “highly factual,” according to the Revenue Ruling and “not ordinarily made in advance rulings.” Revenue Ruling 88-3 also stated that the rules under Section 864(b) “may differ in some respects from those used in determining whether a taxpayer is engaged in a trade or business under other sections of the Code.”

In a 2009 general legal advice memorandum (“GLAM”), the IRS also held that loan origination by a taxpayer was a business not encompassed by the Trading Safe Harbor. In the GLAM 2009-010, released September 22, 2009, a Foreign Corporation outsourced loan origination activities to a U.S. corporation (“Origination Co.”) Under a service agreement between the Foreign Corporation and Origination Co., the activities performed by Origination Co. included soliciting U.S. borrowers, negotiating the terms of the loans, performance of the credit analyses with respect to the U.S. Borrowers, and all other activities relating to loan origination, except that the foreign corporation gave final approval and signed the loan documents.

After determining that Origination Co.’s activities should be attributed to the Foreign Corporation (discussed in more detail below), the GLAM held that “because Foreign Corporation regularly and continuously originates loans to customers, such activities constitute a lending trade or business and not trading and investing activities for the purpose of Section 864” and therefore Foreign Corporation did not qualify for the Trading Safe Harbor.

C. Factors considered by authorities on loan origination outside of Section 864

Whether a loan origination is a “business” has arisen outside the context of Section 864 with respect to U.S. taxpayers. For example, whether a loan origination “business” exists has frequently arisen in cases addressing Section 166’s bad debt deduction, in cases in which a taxpayer has argued that a debt is a “business” debt. Although the IRS has taken the position finding that the finance company was not in an Active US Lending Business under Treas. Reg. § 1.864-5(c)(5) the Revenue Ruling relied on the fact lending was made to related parties or some other factor.

25 But see deKrause v. Commissioner, 33 T.C.M. 1362 (1974) (the phrase “trade or business” under Section 864 should be interpreted consistently with the generally body of law interpreting “trade or business” under other Code sections).

26 One commentator has noted that the reference to soliciting loans may suggest that the Foreign Corporation was being held out to corporate borrowers as a ready source of funding for business loans but that the description in the GLAM was so “cursory” that the GLAM may potentially be read to have decided that merely negotiating the terms of the debt and directly advancing funds to the borrower resulted in an active lending business. Walker, supra note 6.

27 A “business” bad debt is defined as one that is created, acquired or incurred in connection with a taxpayer’s trade or business. I.R.C. § 166(d)(2). Therefore under Section 166 the taxpayer must be engaged in a trade or business and the debt must be proximately related to the trade or business.
that the test for business activity under Section 864 may be different than for other Code sections, this body of law is nevertheless relevant given the absence of guidance under Section 864.

1. Regular, continuous and substantive nature of activity

For a U.S. trade or business to exist the activities must be considerable, continuous and regular. As noted above, in the Pasquel case originating one loan did not constitute a U.S. trade or business. In Linen Thread v. Commissioner, two isolated sales by a United States office of a foreign corporation did not constitute a U.S. trade or business. There is a qualitative as well as quantitative aspect to this requirement, i.e., in addition to being “regular and continuous” the activity must be “considerable” and incidental, ministerial or clerical activities may be disregarded.

The number and amount of loans has also been considered in determining whether a business exists outside the context of Section 864, including the amount of time and effort devoted to the loan origination activity. In the context of rules applicable to publicly traded partnerships under Section 7704, the IRS has also indicated that an average of five loans a year, when the loans were held until maturity or refinancing, does not constitute a “business.” In P.L.R. 9701006 (Sept. 24, 1996), the IRS analyzed whether interest income from loans was “derived in the conduct of a financial… business” in determining whether there was qualifying income under Section 7704(d)(2). The taxpayer held commercial mortgage as investments, originated mortgages used in finance construction projects, and had no material level of debt to finance investments. It was anticipated the partnership would have two or fewer employees. In finding no financial business existed but only investment activity, the ruling noted that the partnership would originate on average no more than five mortgages per year and that the mortgaged would be held until maturity or refinancing.

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28 See, e.g., Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940); Spermacet Whaling & Shipping Co. v. Commissioner, 30 T.C. 618, 634 (1958).

29 14 T.C. 725, 736-37 (1959) (“[t]here is nothing of continuity or of sustained activity in these two small isolated transactions so as to warrant our regarding [the taxpayer] as engaged in a trade or business in the United States through its New York office on the strength of them.”)

30 Possibly also relevant in some cases is the foreign person’s U.S. activities when compared to total activities. See Sicular & Sobol, supra note 6, at 741.

31 See, e.g., Imel v. Commissioner, 61 T.C. 318, 323 (1973) (applying § 166); Ruppel v. Commissioner, 53 T.C.M. (CCH) 829, 833 (1987)(same); Eberhart v. Commissioner, 36 T.C.M. (CCH) 660,663 (1977)(same); P.L.R. 9701006 (Sept. 24, 1996) (applying § 7704); G.C.M. 38456 (July 25, 1980) (whether trust’s lending activity was a business for purposes of entity classification of trust depended on “the number of loans that were made, the length of time over which loans were made [and] the activity involved in making loans”); Sicular & Sobol, supra note 6, at 751 (discussing § 166 authorities); Stuart Leblang & Rebecca Rosenberg, Toward an Active Finance Standard for Inbound Lenders, 31 Tax Man. Int’l J. 131, 139-40 (2002).

32 Other factors also noted were that (i) the partnership would be owned by the union pension plans and would invest in projects that employ union labor, and (ii) the mortgages and other assets would not be held for sale in the ordinary course of business.
Cases addressing whether loan origination is a business under Section 166 have also examined the frequency of the lending activity. For example, making eight or nine loans over a four year period was held not to be a business under Section 166. Nor was making four loans over a four year period. In contrast, activity involving twenty seven loans to thirteen different borrowers over a four year period was found to be a business. No clearcut test has emerged from these authorities, however.

2. Activity undertaken to protect or enhance an existing investment

In *Whipple*, the Supreme Court determined that, where a shareholder made loans to an entity in which he had an equity investment and for which he had performed some services, a loan was not made in the course of a trade or business "[w]hen the only return is that of an investor" because the return was attributable to the corporation, not to the shareholder's trade or business, and because there were no additional fees paid in addition to the investment return. Thus under Whipple a loan made to acquire, protect or enhance an equity investment with a dominant motive to earn an equity investment return does not involve a lending "business" under Section 166.

3. Relevance of "customers" and the provision of "services"

The 2009 GLAM on loan origination referred to the foreign corporation as lending to "customers." The Treasury Regulations definition of the "active conduct of a banking, financing or similar business" refers to making loans "to the public." This may also

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36 *See, e.g.*, Sicular & Sobol, *supra* note 6, at 751; Leblang & Rosenberg, *supra* note 31, at 140.


38 *See also* Kelly v. Patterson 331 F.2d 753 (5th Cir. 1964) (money loaned by a corporation's majority shareholder was made to protect his investment, not his employment, and thus was not made in the course of a trade or business, making it deductible only as a non-business debt under Section 166); *Millsap v. Commissioner*, 46 T.C. 751 (1966), (taxpayer's loans to a corporation were not made in the course of a trade or business of lending because "[t]here is no evidence to suggest that the loans to companies were made for any reason other than to protect or enhance [the taxpayer's] investments therein"); *Eberhart v. Commissioner*, T.C. Memo 1977-155 (no trade or business when petitioner made infrequent loans, some of which were to corporations of which he was a shareholder); *German v. Commissioner*, T.C. Memo 1999-104 (no trade or business when taxpayer made advances to corporation in order to protect his initial investment); *Bush v. Commissioner*, T.C. Memo 1968-39 (no trade or business when loan was made by a majority shareholder to a "financially distressed corporation"); NYC 2007 Bar Report, *supra* note 6, at 5-6.
indicate a customer type of relationship was expected. In the context of Section 166, courts have also treated as relevant whether loans were made to “customers” or to the “public.” A customer relationship is arguably consistent with the provision of services by a lender and so necessary for loan origination to constitute a U.S. trade or business.

The 2009 GLAM provides no explanation as to the nature of the “customer” relationship. For example, borrowers typically approve lender lists when a loan is syndicated. Does this alone provide a customer relationship? A customer relationship may be understood as involving either a regular relationship between the parties or some regularity or standardization in the offer made to potential customers.

A reputation as a lender is also relevant. Under Section 166 authorities have also examined (a) whether the taxpayer holds itself out to the public as being in the money lending business, (b) whether the taxpayer advertises loans services, and (c) whether the taxpayer had a reputation in the community for making loans.

Related to the customer relationship is that provision of services by a lender. There is authority that has referred to a lender providing a loan to a borrower as involving the provision of a service. Such services by a financing business include, for example, standing

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39 A TAM addressing a Section 904 foreign tax credit rule applicable to corporations engaged in a banking, financing or similar business under a definition similar to the one set forth Treasury Regulation § 1.864-4(c)(5), including “making loans to the public” defined the “public” as “ordinary and unrelated customers of banking services as opposed to sources in some way connected with the bank.” T.A.M. 9611001 (Mar. 15, 1996) (emphasis added).

40 See, e.g., F.S.A. 199911003.

41 This argument has been made in much of the commentary on this subject. See e.g., Peaslee & Nirenberg, supra note 6, at Ch. 13.D.3.b. (“The key appears to be whether a lender stands ready to lend to a group of borrowers with which it has a customer relationship. A bank or finance company is a merchant of money, holding an inventory of funds available to lend. It will raise funds as needed to meet customer demand.”); David H. Shapiro & Jeff Maddrey, The Importance of a ‘Customer Relationship’ in Loan Origination, 126 Tax Notes 659 (Feb. 1, 2010); Sicular & Sobol, supra note 6, at 764 (“Without customers, and without holding itself out or promoting itself… as a professional money lender, the CDO issuer should not be found to engage in a lending trade or business.”).

42 Shapiro & Maddrey, supra note 41.

43 See, e.g., Gross v. Commissioner, 401 F.2d 600, 603 (9th Cir. 1968); Kushel v. Commissioner, 15 T.C. 958, 960 (1950); Magee v. Commissioner, 66 T.C.M. (CCH) 105, 112 (1993); F.S.A. 199911003, supra.


45 See Carpenter v. Erickson, 255 F. Supp. 613, 615 (D. Or. 1966); FSA 199911003, supra. See also Sicular & Sobol, supra note 6 at 754.

46 See, e.g., Burbank Liquidating Corp. v. Commissioner, 39 T.C. 999 (1963), modified on other grounds, 335 F.2d 12 (9th Cir. 1964) (saving and loan’s business of providing funds as loans referred to as a “service” and so subject to § 1221(a)(4)); Rev. Rul. 80-57, 1980-1 C.B. 157 (REITS loans were not capital assets
ready to provide credit to customers and extending such credit. The focus is on having funds available to meet the demand of customers for loans and charging for that availability as well as the use of money. An investor or trader may be distinguished as instead seeking a return on existing capital with the focus on choosing to invest in a borrower based on a favorable return - taking into account the risk profile of the borrower and market factors.

a. Marketability of loan

If there is a potential market in which to sell a loan, the existence of other potential investors also may separately support that the taxpayer in question is also investing rather than providing a financing service to a customer. The fact that capital is readily available to the borrower may support that no “customer” relationship necessarily exists with a particular lender.

D. Typical debt fund activities

1. Secondary purchases and the question of agency

Loan origination, potentially a “business” activity under Section 864 as discussed above, is factually distinguishable from a secondary market purchase of a security that is generally a “trading” or “investing” activity encompassed by the Trading Safe Harbor under Section 864. If a foreign person purchases a security shortly after origination, including entering into a forward sale agreement prior to the closing on the original funding of the loan, the question of whether in fact the foreign person is actually “originating” the loan arises. For example, if the original lender is viewed as acting as an agent of the foreign person, the foreign person may be viewed as in fact originating the loan through an agent.

a. The question of agency

Authorities have relied on an agency relationship to determine whether the U.S. activities of another party should be attributed to the foreign person to generate ECI. The case law

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47 See Peaslee & Nirenberg, supra note 6, at Ch. 4 F.3.b. (4th ed. 2011) (“The legislative history of section 7704 indicates that a significant factor in determining if an activity amounts to a financial business is whether it typically would be engaged in by a corporation or whether instead direct interests in the activity would be available to individual investors as well. With this in mind, the availability to investors of receivables of the type held by an [issuer in a securitization transaction] is a factor arguing against the existence of a financial business.”)

48 See, e.g., Lewenhaupt v. Commissioner, 221 F.2d 227 (9th Cir. 1955) (ECI due to agent managing real property), aff’g 20 T.C. 151 (1953); Adda v. Commissioner, 171 F.2d 457 (4th Cir. 1948), aff’g 10 T.C. 273; (ECI due to agent’s trading in commodities); Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940) (ECI due to agent’s activities of managing real estate in U.S.); Handfield v. Commissioner, 23 T.C. 633 (1955) (ECI due to distributor of post card being agent); Estate of Yerburg v. Commissioner, 4 T.C.M. (CCH) 1145 (1945) (ECI due to activities of real estate management firm); The Investors’ Mortgage Security Co. v. Commissioner 4 T.C.M. (CCH) 45 (1945) (ECI due to activities relating to leasing through agents or attorneys-in-fact of farms owned by taxpayer); GLAM 2009-010 (Sept. 22, 2009).
generally has examined the facts and circumstances of each case and no clearcut standard has
developed for determining whether an agency relationship exists.

The Supreme Court in *Commissioner v. Bollinger*, when examining whether a subsidiary
was an agent of a parent corporation, outlined the following factors as relevant: whether the
agent (1) operates in the name and for the account of the principal, (2) binds the principal by its
actions, (3) transmits assets received to the principal, (4) whether receipt of income is
attributable to the services of employees of the principal and to assets belonging to the principal,
(5) whether the agent subsidiary’s relations with the principal are not dependent on the fact that it
is owned by the principal, and (6) the agent’s business purpose must be the carrying on of the
normal duties of an agent.\(^{49}\)

In determining whether another’s U.S. trade or business activities should be attributed to
a foreign person, authorities have also referred to whether the alleged agent had ability to bind
the principal.\(^{50}\) Lack of authorization to act on a foreign person’s behalf has been held to be
inconsistent with a finding that activities in the U.S. by another related entity resulted in ECI.\(^{51}\)
The fact that parties are related is not enough by itself to create an agency relationship.\(^{52}\)

In the case of a purchase or sale of an asset, courts outside the context of Section 864
have generally looked to whether an intermediary has the risks and benefits of ownership in
determining whether an agency relationship exists with respect to purchased property in other
cases not involving ECI.\(^{53}\) Authorities under Section 864 generally also may be read as treating

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50 *See, e.g., Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (a U.S. agent managed properties of
himself and his sister in the United States “under broad powers of attorney” and the agent’s activities were
attributed to the non-U.S. person); *Adda v. Commissioner*, 10 T.C. 273, 278 (1948), *aff’d*, 171 F.2d 457
(4th Cir. 1948); *Rev. Rul. 80-255*, 1980-2 C.B. 318 (broker signs and countersigns insurance policies as
agent of foreign insurance company, foreign insurance company engaged in U.S. trade or business); *Rev.

51 *See European Naval Stores Co., v. Commissioner*, 11 T.C. 127 (1948).

T.C. 748 (1951).

53 *See, e.g., Land O’Lakes, Inc. v. United States*, 514 F.2d 134, 139 (8th Cir. 1975) (middleman with risk of
loss and opportunity for gain was not an agent of farmer’s cooperative), *cert. denied*, 423 U.S. 926 (1975);
*Rupe Inv. Corp. v. Commissioner*, 266 F.2d 624 (8th Cir. 1959) (middleman purchasing and selling stock
was agent - protected against risk of loss and not entitled to enhancement on value of stock); *Cohen v.
Commissioner*, 39 T.C. 1055 (1963) (purchaser of insurance policies not acting as agent when seller
retained incidents of ownership); 26 T.C. 191 (1956) (purchaser of short sale contracts acting as agent
where purchaser had no risk of loss or opportunity for gain); *J.H. Baird Publishing Co. v. Commissioner*, 9
T.C. 608, 616-17 (1962) (purchaser of property for fixed price was not acting as agent in like-kind
exchange); *Hilton v. Commissioner*, 13 T.C. 623 (1949) (bona fide purchaser of note was not acting as
agent of borrower), *acq.*, 1950-1 C.B. 3; *Clara M. Tully Trust v. Commissioner*, 1 T.C. 611, 620-23 (1943)
sale of stock to third party followed by redemption respected as real sale occurred), *acq.*, 1943 C.B. 23;
having the benefits and burdens of ownership as inconsistent with an agency relationship, although sometimes indicating this factor only implicitly.\textsuperscript{54}

Some authorities have treated a foreign person’s inability to control an agent as disfavoring attributing the agent’s activities to the foreign person.\textsuperscript{55} Other authorities, however, have disregarded whether there is control. For example, there are cases in which the activities of a U.S. agent with wide discretion acting on behalf of a foreign person during World War II were attributed to the foreign person even though effectively the foreign person had little control over the agent due to the inability to communicate during war time conditions.\textsuperscript{56} General partners have been considered agents of limited partners even though limited partners may have little control over the conduct of the partnership.\textsuperscript{57}

Also potentially relevant is whether an intermediary acts exclusively for the foreign person, including whether the intermediary was economically dependent on such person.\textsuperscript{58}

\textsuperscript{54} See, e.g., Handfield \textit{v. Commissioner}, 23 T.C. 633 (1955) (relying in part on the lack of indicia of the benefits and burdens of ownership by an intermediary selling postcards for a non-U.S. person as evidence that an agency relationship does exist resulting in ECI); \textit{Amalgamated Dental Co., Ltd. v. Commissioner}, 6 T.C. 1009 (1946) (a U.S. seller of goods was not a foreign purchaser’s agent for purposes of determining whether a U.S. trade or business existed even when the U.S. seller began to ship goods directly to the foreign person’s customers); \textit{Piedras Negras Broadcasting Co. v. Commissioner}, 43 B.T.A. 297 (1941) (foreign corporation not attributed activities of U.S. advertiser as no joint venture with U.S. advertiser since no sharing of risk). The IRS has also ruled that a U.S. company purchasing goods from a foreign company for sale in the United States is not an agent based on facts that indicated that the U.S. company had the benefits and burdens of ownership with respect to goods. See Rev. Rul. 76-322, 1976-2 C.B. 487; Rev. Rul. 63-113, 1963-1 C.B. 410; but see Rev. Rul. 70-424, 1970-2 C.B. 150 (U.S. party selling on commission basis held to be agent even though not fully protected against risk of loss).

\textsuperscript{55} See \textit{Di Portanova v. United States}, 690 F.2d 169 (Ct. Cl. 1982); \textit{Snell v. Commissioner}, 97 F.2d 891, 892-93 (5th Cir. 1938) ("one may carry on a business through agents whom he supervises."); \textit{Spermacet Whaling & Shipping Co. v. Commissioner}, 30 T.C. 618, 633 (1958) (corporation was not agent because it was “separate and independent entity”); \textit{European Naval Stores co. v. Commissioner}, 11 T.C. 127 (1948) (actions by U.S. company of purchasing goods held in the U.S. with profit going to related non-U.S. company characterized as gratuitous in determining no agency); \textit{Amalgamated Dental Co. v. Commissioner}, 6 T.C. 1009, 1014-15 (1946) (U.S. corporation that shipped foreign corporation’s products to its customers, billed customers retail and charged foreign corporation wholesale was not agent because U.S. corporation independently determined it would aid the foreign corporation in this manner); but see P.L.R.. 8029005 (Mar. 27, 1980) (in determining whether ECI exists it was “irrelevant” whether person acting in U.S. was an independent contractor or actual agent).

\textsuperscript{56} See \textit{Lewenhaupt v. Commissioner}, 20 T.C. 151 (1953), aff’d, 221 F.2d 227 (9th Cir. 1955); \textit{Adda v. Commissioner}, 10 T.C. 273, 278 (1948).

\textsuperscript{57} \textit{Donroy, Ltd. v. United States}, 301 F.2d 200 (9th Cir. 1962).

\textsuperscript{58} \textit{InverWorld Inc. v. Commissioner}, T.C. Memo 1996-301; Rev. Rul. 73-158, 1973-1 C.B. 337; Rev. Rul. 70-424, 1970-2 C.B. 150 (activities of exclusive agent for sale of products on commission attributed to non-U.S. corporation); P.L.R. 8147001 (Jan. 3, 1979) (lack of exclusivity specifically cited for no agency treatment -- exclusiveness implies an employment of agency, while with respect to an independent contractor or broker, there is a holding out of one’s self generally for employment in matters of trade or commerce.); cf. Treas. Reg. § 1.864-7(c)(3)(ii) (exclusivity evidence that agent dependent not independent).
Several of the authorities involving attribution of an agent’s activities under Section 864 have had facts indicating an exclusive relationship.\(^{59}\) On the other hand, there is authority that appears to have disregarded whether an agent was acting exclusively for a foreign person in determining whether there was ECI.\(^{50}\)

b. Publicly and quasi-publicly traded securities

The purchase of securities in a public offering or in a private placement under Rule 144A of the Securities Act of 1933, as amended has generally been viewed as encompassed by the Trading Safe Harbor.\(^{61}\) The bank underwriting such offerings generally are seen as not meeting the criteria for an agent under the factors described above. The purchaser of such a security in the initial offering also generally does not participate in negotiations of the terms of the security as would a lender in a financing business. The securities are marketed to investors and it is generally clear that the borrowers are not customers of the persons purchasing the securities.

This view is supported by Treasury Regulation section 1.864-4(c)(5)’s statement in the context of allocating income to the active conduct of a banking, financing or similar business: “A stock or security acquired on a stock exchange or organized over-the-counter market shall be considered not to have been acquired as a result of, or in the course of, making loans to the public” for purposes of determining whether the taxpayer is engaged in the “active conduct” of a U.S.-based lending business.\(^{62}\)

c. Loan syndications

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\(^{59}\) See Adda v. Commissioner, 171 F.2d 457 (4th Cir. 1948) (brother given “full discretion” to trade commodities for non-U.S. brother); Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940) (brother acting on behalf of himself and siblings); InverWorld Inc. v. Commissioner, T.C. Memo 1996-301 (U.S. subsidiary acting for Cayman parent corporation); Rev. Rul. 70-424, supra.

\(^{60}\) See de Amodio v. Commissioner, 34 T.C. 894 (1960), aff’d, 299 F.2d 623 (3d Cir. 1962) (the non-U.S. taxpayer employed a local real estate firms, with no evidence that the firms acted exclusively for the taxpayer); Lewenhaupt v. Commissioner supra (agent whose activities were attributed was a real estate broker engaged full time in the business of real estate brokerage and property management); Rev. Rul. 80-255, 1980-2 C.B. 318 (actions of a broker were attributed to a foreign insurance company -- IRS specifically stated that the actions of an independent agent may be attributed to a non-U.S. person in determining whether the non-U.S. person is engaged in a U.S. trade or business).

\(^{61}\) See, e.g., Beale et al, An Overview of the U.S. Federal Income Tax Treatment of Collateral Debt Obligation Transactions, 14 Tax’n Financial Inst. 27, 57 (July/Aug. 2001) (“By analogy to publicly-offered securities purchased at initial issuance, practitioners have also unanimously concluded that a CDO issuer is not excluded from the Section 864(b)(2)(A) safe harbors by reasons of purchasing Rule 144A or privately placed securities.”); Gina Biondo, Why the Origination of Loans by Foreign Distressed Debt Funds Should Not be Subject to U.S. Tax, Tax’n Fin. Products 45, 49 (Spring 2003) (“It seems very unlikely that a taxpayer could be engaged in a lending business due to the acquisition of public securities or private placements.”).

\(^{62}\) Treas. Reg. § 1.864-4(c)(5)(iv)(c). But see 2000 IRS NSAR 11236, n. 5 2000 W.L. 34423068 (Mar. 7, 2000) (“Some strong arguments can be made that privately placed debts are more similar to loans than publicly traded securities… For example, both bank loans and private placements are information sensitive, such that the lenders in both bank loan and private placement markets are financial intermediaries with expertise in evaluating and monitoring credit risks.”) (citation omitted).

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Groups of lenders may loan to a borrower where the loan is structured and arranged by a lead bank or lead banks, generally referred to as a syndicated loan. A fee is generally paid for this service. The question of whether an agency relationship exists often arises when such a loan is purchased by a foreign fund from an a syndicating bank or other initial lender. For example, a foreign fund may enter into a forward purchase agreement with a syndicating bank prior to the closing on the loan. If the syndicating bank is considered the agent of the foreign fund, and structures and arranges the loan in the United States, the foreign fund’s purchase may be considered loan origination that may give rise to business activity in the United States.\(^63\)

As described above, whether an intermediary has the benefits and burdens of ownership is a highly relevant factor in determining whether an agency relationship exists because it indicates whether the intermediary is acting on behalf of itself or another. If the syndicating bank is at risk with respect to the loan prior to the foreign fund’s purchase, this argues against the bank being an agent of the foreign fund, resulting in loan origination by the fund. Thus the fact that a loan is offered through a “firm commitment” underwriting arrangement rather than “best efforts” underwriting supports that no agency relationship exists. If the syndicating bank is committed to fund, this also supports that the lending “service” has been provided to the borrower.\(^64\)

The nature of the bank’s commitment is also of relevance. A full commitment involves the syndicating bank being legally obligated to fund the entire amount of a loan. For example, the significance of the bank’s commitment may be reduced by terms that reduce its potential risk of loss and arguably reduce its incentive to act on its own behalf rather than as an agent.

Foreign funds often adopt guidelines in order to mitigate the risk that purchasing loans will result in a U.S. trade or business. With respect to syndicated loans, these guidelines frequently require that a foreign fund entering into any forward purchase agreement to purchase a syndicated loan only enter into such an agreement after the syndicating bank has committed to fund the loan. The foreign fund is also generally required to close on the forward purchase agreement at least 48 hours after the loan has been funded.\(^65\) It had been previously been the practice to require material adverse effect (“MAE”) clauses in such a forward purchase agreement but that requirement has proven to be impracticable and is no longer typically required. Other restrictions are also generally contained in such guidelines, including limiting the percentage of the principal amount of the loan purchased, forbidding the foreign fund from negotiating the terms of the loan directly with the borrower or through the syndicating bank, and forbidding the receipt of fees by the foreign fund.

\(^{63}\) Cf. G.C.M. 38456 (July 25, 1980) (Indicating that making mortgage loans directly to a borrower, including through a broker, may be the equivalent of being a commercial lender resulting in a business. The GCM described the broker as being able to “readily find borrowers and handle the mechanics of making the loan.” The GCM later found that even if the broker was the trust’s agent “the total activity involved in making the one-time loans of the trust corpus would not suggest the conduct of a trade or business.”)

\(^{64}\) See NYC 2007 Bar Report, supra note 6 at 13 (“The essence of the service is arranging to make funds available to the borrower. Once there is a commitment to provide financing, the person making the commitment has assumed the risk of either providing its own funds or finding others to find the loan.”).

\(^{65}\) See, e.g., Cassanos, supra note 6; Sicular & Sobol, supra note 6 at 764.
Even if some of these guideline requirements are not met, however, it is not necessarily the case that the syndicating bank should be viewed as acting as an agent for the foreign fund, although the facts for each individual case would need to be examined. For example, even if a “best efforts” underwriting is involved there may be other factors supporting that no agency relationship exists. The syndicating bank will generally not have entered into an agency agreement with the fund and may also be unlikely to view itself as acting on the fund’s behalf, particularly if the purchaser is a relatively small investor.

The borrower arguably also will not have a customer relationship with the offshore fund. However, it is not clear to what extent a customer relationship between an agent and third party can be attributed to the principal. For example, if the syndicating bank is the agent of the offshore fund with respect to a particular loan, is its customer relationship attributed to the fund? The manager of the offshore fund may manage multiple funds and investment accounts and may have a reputation as a potential source of funds, including purchasing loans contemporaneously with the initial funding, i.e., in the primary offering market rather than the secondary offering market. Should these factors be attributed to an offshore fund, which has a more limited pool of capital, a shorter life and pays the manager a fee for its services?

One could argue that the syndicating bank in a best efforts underwriting is substance acting as an agent of the borrower. If that is the case, when interacting with the bank as the borrower’s agent the foreign fund will nevertheless generally not have a customer relationship with the borrower or provide any of the types of services to the borrower that arguably occur when a bank or similar financing company enters into a loan. Nevertheless, the absence of guidance in this area and the indeterminate authority regarding the existence of any agency relationship in the context of Section 864 creates uncertainty in this area.

2. Relevance of negotiations

As noted above, there is support for concluding that whether loan origination is a “business” depends on the existence of customers and the provision of services to the borrowers. Contact with the borrower in negotiating the terms of the loan, rather than passively accepting terms negotiated by another, may support that a customer relationship exists and that some service has been provided to the borrower. The type of due diligence that would also typically be performed by any secondary market purchaser should not be viewed as supporting the existence of a finance or similar lending business.

66 See Sicular & Sobol, supra, note 6 at 764 (“Merely participating in a large (or even medium sized) syndicate of lenders should not cause the CDO issuer to be found to have customers, and thus should not be viewed as constituting a trade or business within the United States for a CDO issuer, unless the CDO issuer itself actively participates in the negotiation of the loan (other than by simply providing comments to the lead bank) or otherwise has a customer relationship with the borrower or somehow solicited the borrower’s participation in the transaction.”)

67 See Sicular & Sobol, supra, note 6, at 766.

68 See Sicular & Sobol, supra note 6, at 753 (“Regular and substantial participation in loan negotiation activities increase the risk that a taxpayer will be deemed engaged in a lending business due, at least in part, to the greater likelihood that the taxpayer is thereby dealing with customers.”).
a. Delayed funding or revolving loans

This factor has some relevance in the context of delayed funding or revolving loans purchased in the secondary market followed by a subsequent draw down on the loan. If the purchaser was not involved in the original negotiations and has no customer relationship with the borrower, the fact that the purchaser provides capital directly to the borrower should not result in business activity. It may also be that the drawdown is not regular, continuous and substantive enough to arise to a level of a “business.” On the other hand, as noted above arguably standing ready to provide capital distinguishes a “financing” business from “investing.”

3. Deemed exchanges and workouts

A debt instrument held by a foreign fund may be subsequently modified, restructured or exchange and those events may also be relevant in determining whether a U.S. trade or business exists. For example, if the terms of a debt are significantly modified, the modification may cause a deemed exchange under Section 1001 resulting in a new debt instrument under the Code, even if no further capital is in fact transferred to the borrower. It may be argued that the deemed issuance of new debt must be examined to determine whether the origination of the new loan is a “business” activity. On the other hand, if the loan is purchased in the secondary market such an event may be viewed as simply part of being an investor. No customer relationship exists.

The extent of activities of the foreign fund may be of relevance in determining whether the activities related to the deemed exchange result in a business. For example, if the foreign fund was involved in directing the negotiations of the new debt instrument this would weigh in favor of an argument that the activities support a financing business. The types of modifications to the loan may be relevant, e.g., if additional funds are advanced or if the term of the loan is extended this may support an argument that the fund is acting as a financing business by in substance standing ready to extend additional credit, particularly if the modification was foreseeable when the loan was purchased by the fund.

a. Promoting as a separate business

In a bankruptcy context, lead creditors may become more actively involved in restructuring a financially troubled company, including funds that invest in distressed debt.

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70 In applying Treas. Reg. § 1.864-4(c)(5) to a foreign bank, the IRS has indicated in at least one unpublished advice that bonds received in a restructuring of existing debt would be reevaluated at the time of the Section 1001 exchange to determine if it gives rise to effectively connected income. FSA 5501 (Aug. 9, 1995) (“the debt received in the ‘exchange’ (the ‘restructured’ or ‘new’ debt) would be reevaluated at the time of the exchange to determine if it gives rise to ECI…. This restructured debt is considered a newly issued debt instrument.”); but see generally Peter A. Furci, U.S. Trade or Business Implications of Distressed-Debt Investing, 63 Tax Law. 527, 537 (Winter 2010) (discussing why deemed exchange should not be considered part of a lending business); Proposed Treas. Reg. § 1.860L-1(a)(4) (loan origination defined under FASIT rules to exclude the exchange of an old loan for a new loan of the same obligor; § 860L was subsequently repealed).

71 See Shapiro & Maddrey, supra note 71.
These activities raise the question of whether such activities result in a separate “business” as a promoter of the company, even if the fund purchased the distressed debt in the secondary market. For example, in Whipple v. Commissioner, 373 U.S. 193 (1963) when examining whether Section 166 applied to certain loan activities the Supreme Court indicated that the activity of regularly promoting a corporation or developing a corporation for sale may be a separate business activity. In determining whether a trade or business as a promoter exists, courts have looked at (1) whether compensation is other than the normal investor’s return and whether income received is the direct product of the taxpayer’s services and not indirectly produced from the successful operation of the corporate enterprise, (2) whether activity is conducted for a fee or commission or with the immediate purpose of selling the corporation at a profit in the ordinary course of business and (3) whether the taxpayer has a reputation in the community for promoting, organizing, financing and selling businesses.

b. DIP loans

A foreign fund may invest in debtor in possession (“DIP”) financing to a financially troubled company. Generally the issues raised would be similar to the issues for loan origination activity above, including the frequency of loans and whether a customer relationship may be viewed as existing. If the fund has previously issued debt of the borrower, a possible additional argument that no business results is that the DIP loan was made to protect an already existing investment.

4. “Mez” funds and equity-flavored debt

“Mezzanine” funds are funds that generally invest in subordinated debt with a longer maturity than the typical bank loan. A mezzanine fund may engage in loan origination directly with the borrower. Guidelines provided to offshore mezzanine funds typically limit the number of loans that may be originated so that the activities are not regular, continuous and substantive as required to be engaged in a “business.”

Further, the mezzanine loans often contain an equity stake, such as having the loan be convertible into equity or the issuance of warrants with the loan. There is authority that a loan with such a feature should be treated as primarily an investment activity due to the importance of the equity feature. As discussed above, the Supreme Court in Whipple v. Commissioner held that a loan made to as part of an equity investment did not result in a “business” for purposes of Section 166. Investing in stock does not constitute a “business” and if a significant motive is

72 See also Newman v. Commissioner, 56 T.C.M. (CCH) 1232, 1235 (1989); Farrar v. Commissioner, 55 T.C.M. (CCH) 1628, 1632 (1988); Siculan & Sobol, supra note 6, at 754-58. The Tax Court also recently held that managing venture capital funds was a business despite the capital nature of the carried interest received. Dagres v. Commissioner, 136 T.C. No. 12 (2011).

73 Newman v. Commissioner, 56 T.C.M. (CCH) 1232, 1235 (1989); Furci, supra note 70, at 545.

74 See Furci, supra note 70, citing United States v. Generes, 405 U.S. 93, 103 (1972); Garner v. Commissioner, 987 F.2d 267, 269 (5th Cir. 1993).

75 See, e.g., Cassanos, supra note 6.
entering into a stock investment, or protecting an existing equity investment, then a fund should not be viewed as engaged in a finance business.\textsuperscript{76}

IV. Measure of ECI from a U.S.-based lending business.

A. Potentially different rules for U.S.-source versus foreign-source income and gains.

1. Framework

If an offshore fund has a U.S.-based lending trade or business, whether any of its income is “effectively connected” with that U.S. trade or business is determined under Section 864(c), which makes this determination differently for U.S.-source versus foreign-source income and gain. Very generally, under Section 864(c)(4)(B), for foreign-source income and gain to be ECI, the taxpayer must have “an office or other fixed place of business within the United States,” and for this purposes the offices of its agents are disregarded if they are independent agents or do not have the authority to contractually bind the taxpayer. There is generally no office or fixed place of business requirement for U.S.-source income or gain to be ECI, except in the case of determining whether U.S. source-income and gain from stocks and securities are effectively connected with an Active US Lending Business. In such case, there is a U.S. office requirement.\textsuperscript{77} It is unclear whether lending activity can constitute a U.S. trade or business that results in ECI if the activity is not an Active US Lending Business.

2. Determining source

Interest or dividends on stocks or securities are generally sourced by reference to the issuer.\textsuperscript{78} Under Section 865, gain on the sale of personal property is generally sourced by the residence of the seller; provided, however, that gain on sales by a nonresident “attributable” to an “office or fixed place of business” maintained by the nonresident in the United States is U.S.-source. Under Section 864(c)(5) (as incorporated by Section 865(e)(3)), an agent’s office or

\textsuperscript{76} See also 2000 IRS NSAR 11236, 2000 W.L. 34423068 (Mar. 7, 2000) (When examining whether a fund’s activities in purchasing convertible debts and convertible preferred stock was sufficiently similar to a banking or financing business to result in ECI, stating that “another argument against concluding that [the fund] engaged in a U.S. banking or financing business arises from [the fund’s] focus on acquiring equities. In a case in which a partnership engaged in some lending transactions but had an overriding objective to profit from its appreciating stocks and warrants, it was held that the partnership was not engaged in a trade or business…” under § 166).

\textsuperscript{77} The rule in Treas. Reg. § 1.864-4(c)(5) requires that the U.S. source income from stocks or securities be attributable to a “U.S. office” only, there is no reference to “or other U.S. fixed place of business” as well, in contrast to the rules on allocating foreign source income in Section 864(c)(4)(B). One commentator has argued that by limiting the reference to the “U.S. office” only the drafter of the regulation may have intended to indicate a narrower approach than in Section 864(c)(4)(B). David T. Moldenhauer, The Foreign Lender Memorandum and the Definition of a U.S. Office, 125 Tax Notes 1200 (Dec. 14, 2009).

\textsuperscript{78} I.R.C. §§ 861 and 862.
fixed place of business is disregarded if the agent lacks the power to contractually bind the nonresident or if the agent is an independent agent.\footnote{79}

For an offshore fund in a lending business, this generally means that its only U.S.-source income is interest income from U.S. issuers unless it has agents, other than independent agents, in the U.S. with authority to negotiate and conclude contracts. Funds organized as corporations or limited companies that contract with an investment manager for their advisory services would typically have only independent agents. However, if a fund is organized as a partnership that acts through a U.S.-based general partner, there is a question as to whether the general partner is its dependent agent and thus whether the fund’s gains might be U.S. source.\footnote{80}

\section*{B. Measuring U.S.-source lending-related ECI.}

\subsection*{1. Statutory rules}

As a general rule, U.S. source income or capital gains from stock or securities is considered effectively connected to a U.S. trade or business under the following two criteria: (1) “whether the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business,” or (2) “the activities of such trade or business were a material factor in the realization of the income, gain, or loss” (the “Asset-Use” and “Business-Activities” Tests, respectively).\footnote{81} The statute does not require there to be a U.S. office or fixed place of business for a U.S. trade or business to exist and for any U.S. source income and gain from stocks and securities to be treated as ECI.

\subsection*{2. Regulatory rules.}

\subsubsection*{a. U.S.-source ECI from an Active US Lending Business.}

U.S.-source income and gain on stocks and securities, if “derived in the active conduct of a banking, financing or similar business” (again, an “Active US Lending Business”), is ECI only if the “stocks or securities” are “attributable to the U.S. office through which such business is carried on” and the stocks or securities either meet an acquisition test or consist of certain debt securities.

\footnote{79} This means that, for most offshore funds, any gain from sales of bank loans (even if inventory) will be foreign source (and only ECI under the rules discussed below) because the fund’s only arguable U.S. office or fixed place of business is that of its investment advisor, which is an independent agent. Note, however, that if the fund is a partnership with a general partner, the general partner may not be regarded as independent and thus its office could be attributed to the partnership and its foreign partners, causing the gain from the sale to be US source. \textit{See Donroy, Ltd. v. United States}, 301 F.2d 200 (9th Cir. 1962).

\footnote{80} \textit{See Donroy, Ltd. v. United States}, 301 F.2d 200 (9th Cir. 1962).

\footnote{81} I.R.C. § 864(c)(2); Treas. Reg. § 1.864-4(c).
The Active US Lending Business regulations were designed to provide relief to banks so as to be able to obtain full ECI treatment with respect to U.S. source interest income from customer loans and other banking-related activities, rather than U.S. withholding on the gross income.\(^{82}\) The Section 864 provisions applying to an Active US Lending Business were enacted prior to the 1984 enactment of the portfolio interest exemption to the 30% withholding tax on U.S. source interest.

i. Definition of an Active US Lending Business

An Active US Lending Business exists if

at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States in transactions with persons situated within or without the United States: (a) receiving deposits of funds from the public, (b) making personal, mortgage, industrial, or other loans to the public, (c) purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness, (d) issuing letter of credit to the public and negotiating drafts drawn thereunder, (e) providing trust services for the public, or (f) financing foreign exchange transactions for the public.\(^{83}\)

ii. Stocks and securities.

A security means “any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items.”\(^{84}\) U.S.-source income and gain from other assets that are not stocks or securities and are part of an Active US Lending Business (e.g., tangible personal property received in foreclosure from the loans) or another U.S. trade or business are determined to be ECI (or not ECI) under the Asset-Use Test or Business-Activities Tests.\(^{85}\)

iii. “Derived in the active conduct of.”

\(^{82}\) See, e.g., Rev. Rul. 75-253, 1975-1 C.B. 203; Moldenhauer, supra note 77; Peaslee & Nirenberg, supra note 6.

\(^{83}\) Treas. Reg. § 1.864-4(c)(5)(i). For this purpose, “making loans to the public” is clarified as follows: “A stock or security shall be considered to have been acquired in the course of making a loan to the public where, for example, such stock or security was acquired as additional consideration for the making of the loan. A stock or security shall be considered to have been acquired as a result of making a loan to the public if, for example, such stock or security was acquired by foreclosure upon a bona fide default of the loan and is held as an ordinary and necessary incident to the active conduct of the banking, financing, or similar business in the United States. A stock or security acquired on a stock exchange or organized over-the-counter market shall be considered not to have been acquired as a result of, or in the course of, making loans to the public.” Treas. Reg. § 1.864-4(c)(5)(iv).

\(^{84}\) Treas. Reg. § 1.864-4(c)(5)(v).

\(^{85}\) Treas. Reg. § 1.864-4(c)(5)(vi)(b).
The regulations do not discuss the meaning of “derived in the active conduct of” an Active Lending Business. This is particularly relevant to an offshore fund that holds bank loans (or other debt instruments) that the fund purchased on the secondary market and does not use as collateral or to create liquidity for the fund’s lending business. If the U.S.-source income from such loans is not treated as “derived in the active conduct” of its Active US Lending Business, then it is not ECI, but if it is so derived and the debt is attributable to the U.S. office through which the Active US Lending Business is conducted, then a portion of that income would be ECI, as explained below.

iv. The stocks or securities must be “attributable to a U.S. office.”

Notwithstanding the Asset-Use Test and the Business Activities Test that generally apply to allocate to ECI income, gain or loss from stocks and securities, if an Active US Lending Business exists U.S. source dividends, interest or gain or loss from the sale or exchange of stocks or securities which are capital assets derived by a foreign corporation in an Active US Lending Business is ECI with the conduct of that business “only if the stocks or securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on…” and meet certain other requirements.86

As noted above, Active US Lending Business regulations were promulgated prior to the 1984 enactment of the portfolio interest exception and were originally considered beneficial to banking, financing and similar business by taxing interest on a net basis rather than on a gross basis. The purpose of the U.S. office requirement in the Material Participation Test may have been to limit net taxation to those securities that are part of the banking or financing business rather than part of investment activity.87

(1) Standard for attribution

86 Treas. Reg. § 1.864-4(c)(5)(ii). Section 864(c)(2), which contains the Asset-Use and Business Activities Test, does not refer to a U.S. office or a separate rule for U.S. source income for an Active US Lending Business. See Moldenhauer, supra note 77. There is a reference to a U.S. office for the foreign source rules for an Active US Lending Business in Section 864(c)(4)(B)(ii) and 864(c)(5)(A).

87 See Moldenhauer, supra note 77 (“the objective of the U.S. office requirement was to require a connection with a U.S. office as a way of identifying with some clarity the loans, investment stocks, and securities acquired as part of the normal operations of a banking, financing, or similar business, rather than applying a more fluid test looking to the functional relationship of the stocks and securities to the taxpayer’s business operations’’); see also Technical Memorandum Re: Notice of Proposed Rule Making – Regulations Under Section 864(c) of the Code With Respect to Income Effectively Connected With the Conduct of a Banking, Financing, or Similar Business in the United States (Dec. 23, 1970), 1970 TM LEXIS 39, at 3-5 (“The basic objective of these special rules was…. to distinguish between banking income and nonbanking investment income of banks.”); Joseph Isenbergh, U.S. Taxation of Foreign Persons and Foreign Income, 38:14 (3d ed. 2004) (There is no self-revealing basis for determining whether the income of banks from financial assets … results day-to-day operations or long-term investments. Under the tax regime initially established by the 1966 Act (from 1966 to 1984), the Treasury had reason for concern that some taxpayers might be tempted to attach large investment holdings to active banking operations in the hope of avoiding flat rate taxation on their passive income.”).
This attribution requires that the U.S. office “actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security. The U.S. office need not have been the only active participant in arranging the acquisition of the stock or security.”\textsuperscript{88} (The “Material Participation Test”).

The following activities by themselves do not result in attribution: (1) collecting or accounting for the dividends, interest, gain, or loss from such stock or security, (2) exercising general supervision over the activities of the persons directly responsible for carrying on the activities of participating in the solicitation, negotiation, or performance of other services required to arrange the acquisition of the stock or security, (3) performing merely clerical functions incident to the acquisition of such stock or security, (4) exercising final approval over the execution of the acquisition of such stock or security, or (5) holding such stock or security in the United States or records such stock or security on its books or records as having been acquired by such office or for its account.\textsuperscript{89}

In Revenue Ruling 86-154, 1986-2 C.B. 103, the IRS has ruled that when U.S. offices of a foreign bank participated in funding a loan, negotiated the collateral for a loan and performed independent credit analysis and evaluation of the collateral prior to the granting of the loan, the U.S. offices met the Material Participation Test with respect to the security even though the foreign office of the bank solicited and negotiated the overall line of credit.\textsuperscript{90} The ruling also held that when a foreign bank’s U.S. office simply funded a U.S. subsidiary’s loan the U.S. office did not meet the Material Participation Test when all essential functions in connection with the loan were performed outside the United States.\textsuperscript{91} With respect to securities held by a partnership, the IRS has taken an “aggregate” approach to the partnership in applying the allocation rules under the Active US Lending Business rules.\textsuperscript{92}

(2) Whose “U.S. office”?

\textsuperscript{88} Treas. Reg. § 1.864-4(c)(5)(iii)(a).

\textsuperscript{89} Treas. Reg. § 1.864-4(c)(5)(iii)(b).

\textsuperscript{90} See also FSA 1998 WL 1984756 (Sept. 18, 1998) (to apply Material Participation Test, factors to be considered were whether the bank’s personnel from its U.S. office assisted in negotiating and soliciting the debt in question and whether U.S. office resources were used to investigate the debtor’s ability to make payments on the debt.)

\textsuperscript{91} In the context of a restructuring, an IRS field service advice involved loan terms being negotiated by a primary bank negotiating committee. The foreign taxpayer was not on the committee. The advice stated that preparation of the loan agreement and recommendation that the home office accept the terms negotiated by the committee did “not appear to rise to the level of material participation” but that more information was needed on the full extent of the rule of the U.S. branch and home office. FSA 5501 (Aug. 9, 1995).

\textsuperscript{92} When a partnership was not itself engaged in a U.S. trade or business but a partner was engaged in Active US Lending Business to which Treas. Reg. § 1.864-4(c)(5) applied, TAM 200811019 (Mar. 14, 2008) ruled that an “aggregate” approach to the partnership is taken in determining whether the Material Participation Test and other Treas. Reg. § 1.864-4(c)(5) rules regarding attributing income to an Active US Lending Business applied to the securities held by the partnership.
As mentioned above, on September 22, 2009 the IRS released GLAM 2009-010 that asserts that the U.S. office of an independent agent is attributed to a foreign corporation for purposes of allocating U.S. source income. The GLAM argues that the U.S. office requirement does not “require by its terms that the office be the office of the taxpayer. A U.S. office of an agent of the taxpayer is sufficient.” The GLAM stated that Origination Co. acted on behalf of the Foreign Corporation and performed activities that were a component of Foreign Corporation’s lending activities, such as the solicitation of customers, the negotiation of contractual terms and the performance of credit analyses. According to the GLAM, in similar circumstances courts have found an agency relationship to exist. The activities by Origination Co. on behalf of Foreign Corporation were more than ministerial and clerical, according to the GLAM, and the lending activities were considerable, continuous and regular. The Foreign Corporation loans to U.S. Borrowers were a trade or business “because Foreign Corporation lends money to customers on a considerable, regular and continuous basis with the intention of earning a profit.” Because the loan origination activities of Foreign Corporation were conducted through Origination Co. and occurred within the United States, there was a U.S. trade or business according to the GLAM.

After examining various relevant authorities, the GLAM then concludes that the loan origination activity is attributable to the agent’s U.S. office through which the origination activity is conducted and therefore U.S.-source interest on those loans are ECI. The GLAM examined the allocation rules under the Active US Lending Business regulations in Treasury Regulation § 1.865-4(c)(5) and noted that there was a requirement that income be attributable to a U.S. office.

The GLAM addressed the argument that the interest income is not ECI with respect to the Active US Lending Business because a U.S. office of an independent agent or an agent that does not have authority to conclude contract’s on the Foreign Corporation’s behalf is not attributable to the Foreign Corporation, after noting that some taxpayers were taking this position. According to the GLAM, this argument “misapplies both the statute and the regulations” because Section 864(c)(4)(B) and Treas. Reg. § 1.864-7 apply only for purposes of foreign source ECI.

In InverWorld v. Commissioner, the Tax Court relied on Treasury Regulation section 1.864-7 in applying Section 864(b)(2)(C). Section 864(b)(2)(C) states that the safe harbor for trading stock, securities or commodities through a resident broker, commission, agent, custodian or other independent does not apply if the taxpayer has an office or other fixed place of business in the United States through which the transactions in stocks, securities or commodities may be effected. The GLAM stated Section 864(b)(2)(C) and Treasury Regulation section 1.864-7 “are concerned with whether or not the taxpayer has a U.S. office (either directly or by attribution)” where as Treasury Regulation section 1.864-4(c)(5)(ii) of the Active US Lending Business exception “does not require that the taxpayer have a U.S. office.” According to the GLAM, Treasury Regulation section 1.864-4(c)(5)(ii) addresses a statutory provision that does not contain the same office or other fixed place of business requirement that is found in other sections and so does not import the same rule as Section 864(c)(4)(B). The GLAM noted that

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93 The GLAM cited InverWorld, Inc. v. Commissioner, T.C. Memo 1996-301, Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff’d, 221 F.2d 227 (9th Cir. 1955); T.A.M. 8029005 (Mar. 27, 1980).
the rule in Treas. Reg. section 1.864-4(c)(5)(ii) does not require that the office be that of the taxpayer, the office of an agent will suffice. The GLAM stated that if the regulations intended that interest income must be attributable to the taxpayer’s office to be ECI with the Active US Lending Business the regulation would have made this explicit.

The GLAM then held that for purposes of attributing Origination Co.’s origination activities in the United States, including soliciting borrowers and negotiating contractual terms, it was enough that Origination Co. was a dependent or independent agent. The GLAM concluded that Origination Co.’s U.S. office actively and materially participated in the origination of Foreign Corporation’s loans to U.S. borrowers and so U.S. source interest from the loans was ECI.

The GLAM has been criticized by commentators on various grounds. For example, commentators have argued that a uniform set of ECI rules was intended for foreign and U.S. source income and the fact that Treasury Regulation section 1.864-4(c)(5)(ii) refers in the passive voice to a U.S. office, and not to “the taxpayer’s” U.S. office, was inadvertent. As noted above, the original purpose behind the Active US Lending Business rules was to permit an exception to the withholding tax on gross interest income, and so arguably it makes more sense to apply the U.S. office test in this context narrowly, rather than expansively to cover any agent’s office. For example, if an expansive approach was taken to U.S. office, the original purpose of limiting net income treatment to banks and other financing businesses through the Material Participation Test could be avoided relatively easily by acquiring and holding stocks and securities through a U.S. broker or other independent agent. It has been argued that the rule for allocating a default classification encompassing investment securities that contains a formula (discussed in more detail below) that relies on the value of assets in the U.S. office as supporting this. A taxpayer would know the value of the assets in its own U.S. office, but not necessarily that of an agent. There has been disagreement with the GLAM’s assertion that InverWorld is distinguishable and the Tax Court’s application of Treasury Regulation section 1.864-7’s rules relation to an office or fixed place of business supports that it should also apply in allocating income under the regulations for an Active US Lending Business. The IRS has also previously cited Treasury Regulation section 1.864-7 in determining whether a bank had a U.S. office when applying the ECI rules for an Active US Lending Business in a prior unpublished ruling.

94 See Moldenhauer, supra note 77; Jonathan Zhu et al, U.S.-Source Interest Income from a Lending Business, 125 Tax Notes 785 (Nov. 16, 2009). The phrase “the” U.S. office also arguably suggests a focus on the foreign taxpayer rather than agents. Moldenhauer, supra note 77.

95 See Moldenhauer, supra (providing a detailed history of the enactment of the current regulations for Active US Lending Business and why the GLAM’s approach in the author’s opinion is inconsistent with the original intent of the regulation).

96 Id.

97 See Zhu et al, supra note 94.

98 F.S.A., 1998 W.L. 1984756 (Sept. 18, 1998) (The existence of a U.S. office through which a foreign corporation conducts a banking, financing, or similar business may be determined according to the rules of
If the GLAM’s analysis is accepted, it leaves unanswered the question of what other stocks and securities of the an offshore fund might be “attributable to” the U.S. office through which the Active US Lending Business is carried on. It seems to imply, however, that those acquired without the active participation of the agent conducting the Active US Lending Business would not be attributable to the agent’s U.S. office (and therefore would not give rise to ECI), since such attribution requires the active participation of that office. On the other hand, it might be argued that all of the U.S. activities of the offshore fund either directly or through agents should be aggregated and treated as conducted through a single office (even if it has multiple physical locations) and therefore that any stocks or securities acquired through activities in the United States (including by an agent other than the agent engaged in the Active US Lending Business) should be “attributable to” the U.S. office through which the Active US Lending Business is carried on.

What if the fund has in place guidelines that are part of its investment advisory agreement and prohibit the fund from buying from a syndicating bank unless prior to making the fund’s commitment to buy such loans the bank was committed to fund the loan without regard to its ability to syndicate it. Now suppose the advisory bought loans that it thought the selling bank had previously committed to make to the borrower but that in fact the bank had made no such commitment. Presumably, the fact that the activity is unauthorized would not prevent the bank’s activity from being attributed to the taxpayer and cause the taxpayer to be treated as having made loans directly to the borrower.

v. Treatment of specific types of stocks and securities

If a U.S. office meets the Material Participation test, the stock or securities giving rise to the income, gain or loss must be acquired for one of three purposes provided in Treasury Regulation section 1.864-4(c)(5)(ii)(a)(1)-(3) or consist of securities have one of three particular characteristics provided in Treasury Regulation section 1.864-4(c)(5)(ii)(b)(1)-(3). The purpose test set forth in subsection (a)(1)-(3) is met if the stock or securities meeting the Material Participation Test were acquired (1) as a result of, or in the course of making loans to the public, (2) in the course of distributing such stocks or securities to the public, or (3) for the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States. Otherwise income, gain or loss from securities meeting the Material Participation Test will be ECI if the securities are (1) payable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition, (2) issued by the United States, or any agency or instrumentality thereof, or (3) not otherwise describe and so in a default category with respect to which a formula approach is taken to determine ECI, described in more detail below.

The following focuses on categories that may be of particular interest to an offshore fund:

(1) Originated loans

§ 1.864-7.” -- however the FSA did not specifically address the independent agency question); see also Zhu et al, supra note94.
If the Material Participation Test is met, income, gain or loss from a security acquired “[a]s a result of, or in the course of making loans to the public” is considered ECI.  If the Material Participation Test is met at the inception of a loan origination, the income will be treated as ECI regardless of whether the loan is ever held in connection with the taxpayer’s U.S. trade or business or whether the U.S. trade or business continues to be a material factor in the realization of the income throughout the period the loan is held by the taxpayer.

(2) Stocks

If the Material Participation Test is met, stock acquired as a result of or in the course of making loans to the public, in the course of distributing the stock or securities to the public or for purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States.

(3) Short-term debt and U.S. government debt

As noted above, if the Material Participation Test is met, income, gain or loss from a security “[p]ayable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition” or a security “[i]ssued by the United States, or any agency or instrumentality thereof” is ECI.

(4) Other securities purchased for trading or investing

There is a default category for securities if the Material Participation Test is met but that do not otherwise meet the other categories described above (the “Investment Securities”). The other categories in Treasury Regulation section 1.864-4(c)(5)(ii)(a)(1)-(3), e.g., making loans to the public, and (b)(1)-(2), e.g., holding short term debt or U.S. government securities, were designed generally to encompass what was banking related activity. In contrast, the default category for Investment Securities in Treasury Regulation section 1.864-4(c)(5)(ii)(b)(3) was generally adopted to prevent ECI treatment for banks considered to have “excessive” investing within the United States through a U.S. office. As noted above, the provisions in Treasury Regulation section 1.865-4(c)(5), adopted in 1972, were enacted prior to the 1984 adoption of the portfolio interest exemption. At that time, interest income to a foreign bank that was

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100 T.A.M. 200811018 (Mar. 14, 2008).
101 Stock is considered to have been acquired in the course of making a loan to the public where, e.g., such stock was acquired as additional consideration for the making of the loan or such stock was acquired by foreclosure upon a bona fide default of the loan and is held as an ordinary and necessary incident to the active conduct of the banking, financing, or similar business in the United States. Treas. Reg. § 1.864-4(c)(5)(iv).
102 Reg. § 1.864-4(c)(5)(ii)(b)(1).
103 See T.A.M. 200811018 (Mar. 14, 2008). See also authorities cited supra note 87 and the accompanying text.
considered as part of ECI was generally treated more favorably because it is taxable on a net income basis, in contrast to the 30% U.S. withholding tax on gross interest income.

Investment Securities in this default category are subject to a special allocation formula. Generally under the formula, the volume of the Investment Securities in relation to the total assets of the U.S. office to which the Investment Securities are attributable under the Material Participation Test is measured. If this ratio is equal to less than 10%, all of the income, gain or loss from the default category of Investment Securities is treated as ECI. If the ratio is more than 10%, the formula allocates income, gain or loss in increasing proportions to non-ECI.\(^\text{104}\)

More specifically, U.S. source income from the Investment Securities is multiplied by a fraction the numerator of which is 10% and the denominator of which is the same percentage, determined on the basis of a monthly average for the tax year, as the book value of the total of such securities held by the U.S. office through which the U.S. trade or business is carried on bears to the book value of the total assets of such office.\(^\text{105}\)

As an example, assume foreign fund M has a U.S. branch B which is engaged in an Active US Lending Business. Assume during the tax year M derives through B’s activities in the U.S. $7.5 million U.S. source interest income from Investment Securities and $7.5 million gain from the sale or exchange of such Investment Securities. Assume the monthly average, determined as of the last day of each month in the tax year, of such Investment Securities held by B divided by the monthly average, as so determined, of the total assets held by B equals 15%. The amount of interest income from Investment Securities which is treated as ECI with respect to the Active US Lending Business is $5 million, calculated by multiplying $7.5 million of interest from the Investment Securities by 10%/15%. Similarly, the amount of gain from the sale or exchange of the Investment Securities that is treated as ECI with the US Active Lending Business is $5 million.\(^\text{106}\)

vi. Exclusivity of the Active US Lending Business test

U.S.-source income or gain from stocks or securities not treated as ECI under the Active US Lending Test is treated as ECI if it is effectively connected with another kind of U.S. trade or business under the Active-Use or Business-Activities Tests.\(^\text{107}\) This leaves open the question as to whether U.S.-source income and gain from stocks and securities derived from a lending business that is not an Active US Lending Business can be ECI under the Active-Use or Business-Activities Test. Further, at least one commentator has asserted that the Trading Safe

\(^{104}\) Id.

\(^{105}\) Treas. Reg. § 1.864-4(c)(5)(ii)(b).

\(^{106}\) Treas. Reg. § 1.865-4(c)(5)(ii).

\(^{107}\) Treas. Reg. § 1.864-4(c)(5)(vi)(a). This regulation contemplates, for example, this possibility for taxpayers engaged in a US manufacturing business.
Harbor is not available if an offshore fund is engaged in any business activity, including a financing business.108

b. Asset-Use and Business-Activities tests

As noted above, outside of the Active US Lending Business rules U.S. source income or capital gains from stock or securities is considered effectively connected to a U.S. trade or business under the Asset Use Test, i.e., “whether the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business,” or the Business Activities Test, i.e. whether “the activities of such trade or business were a material factor in the realization of the income, gain, or loss.”109

The Asset Use Test ordinarily applies to passive income, gain or loss where the trade or business activities as such do not give rise directly to the realization of the income, gain or loss.110 However, even in such case, any activities of the trade or business which materially contribute to such income, gain or loss is also taken into account as a factor in determining whether the income, gain or loss is ECI. Treasury Regulations state that the Asset Use Test is of primary significance where, for example, U.S. sourced interest income is derived by a nonresident individual or foreign corporation that is engaged in the business of manufacturing or selling goods in the United States.111

Ordinarily, the Asset Use Test is treated as met if the asset is (a) held for the principal purpose of promoting the present conduct of the U.S. trade or business, (b) acquired and held in the ordinary course of the U.S. trade or business, e.g., in the case of an account or note receivable arising from the trade or business, or (c) otherwise held in a direct relationship to the U.S. trade or business.112 In determining whether an asset is held in a direct relationship to the U.S. trade or business, principal consideration is given to whether the asset is needed in that trade or business.113 An asset is considered needed in a trade or business for this purpose only if it is held to meet the present needs of the trade and business and not its anticipated future needs.114 An

108 Lee Sheppard, News Analysis – Neither a Dealer Nor a Lender Be, Part 2: Hedge Fund Lending, reprinted in 2005 TNT 157-3 (Aug. 16, 2005) (“Well, why can’t a taxpayer have a lending business on one side and a securities trading safe harbor on the other? Because the safe harbor assumes that trading is the taxpayer’s only contact with the United States. Once the taxpayer is in some other business in the United States, like lending, the securities trading safe harbor goes out the window because the trading would be effectively connected with some other business. And the other business may well be securities trading – only securities trading standing alone is eligible for the safe harbor.”)

109 Section 864(c)(2); Treas. Reg. § 1.864-4(c).


111 Id.


114 Id.
asset is considered as needed in the U.S. trade or business if, for example, the asset is held to meet the operating expenses of that trade or business.\textsuperscript{115} Generally an asset is treated as held in a direct relationship to the trade or business if (1) the asset was acquired with funds generated by that trade or business, (2) the income from the asset is retained or reinvested in that trade or business, and (3) personnel who are present in the United States and are actively involved in the conduct of that trade or business exercise significant management and control over the investment of the asset.\textsuperscript{116}

The Business Activities Test ordinarily applies in making a determination with respect to income, gain, or loss which, even though generally of the passive type, arises directly from the active conduct of the taxpayer’s U.S. trade or business.\textsuperscript{117} As examples, the Treasury Regulations state that the Business Activities Test is of primary significance where dividends or interest are derived by a dealer in stocks or securities, gain or loss is derived from the sale or exchange of capital assets in the active conduct of a trade or business by an investment company,\textsuperscript{118} or service fees are derived in the active conduct of a servicing business.\textsuperscript{119} The Treasury Regulations state that in applying the Business Activities Test, activities relating to the management of investment portfolios are not treated as activities of the U.S. trade or business unless the maintenance of the investments constitutes the principal activity of that trade or business.\textsuperscript{120}

In applying the Asset Use Test or the Business Activities Test, consideration is given to whether or not the asset, or income, gain or loss, is accounted for through the U.S. trade or business, \textit{i.e.}, whether or not the asset, or the income, gain or loss, is carried on books of account separately kept for the trade or business.\textsuperscript{121} The accounting test is not controlling, however.\textsuperscript{122} Other factors considered are whether the accounting treatment of an item reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business and whether there is a consistent accounting treatment of that item from year to year by the taxpayer.\textsuperscript{123}

C. Measuring effectively connected foreign-source interest and dividend income.

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\textsuperscript{115} Id.

\textsuperscript{116} Treas. Reg. §1.864-4(c)(2)(iv)(b).

\textsuperscript{117} Treas. Reg. §1.864-4(c)(3).

\textsuperscript{118} These Treasury Regulations were adopted prior to the [1998] change to the Trading Safe Harbor eliminating the requirement that the principal office of the foreign corporation not be in the United States.

\textsuperscript{119} Treas. Reg. §1.864-4(c)(3).

\textsuperscript{120} Id.

\textsuperscript{121} Id.

\textsuperscript{122} Treas. Reg. §1.864-4(c)(4).

\textsuperscript{123} Id.
Under Section 864(b)(4)(B)(ii), foreign source interest or dividend income (and guarantee fees) of a foreign person is considered to be effectively connected with a U.S. trade or business if the foreign person has an office or other fixed place of business in the U.S. to which such income is attributable and the income is derived in the Active US Lending Business. 124

1. Must be “attributable to” a U.S. office or fixed place of business.
   a. Agents disregarded if independent or lack authority to bind.

   In determining whether a foreign person has an office or other fixed place of business, an office or other fixed place of business of an agent is disregarded unless the agent (i) has the authority to negotiate and conclude contracts in the name of the foreign person and regularly exercises that authority and (ii) is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of his business. 125

   b. Material-factor test.

   Income, gain or loss is not considered as “attributable” to an office or other fixed place of business within the United States unless the office or fixed place of business is a material factor in the production of the income, gain or loss and the office or fixed place of business regularly carries on activities of the type from which the income, gain or loss is derived. 126 The activities of the office or fixed place of business are not considered to be a material factor in the realization of income, gain or loss unless the activities provide a “significant contribution to, by being an essential economic element in, the realization of the income, gain or loss.” 127 The activities of the office or other fixed place of business in the United States do not have to be a major factor in the realization of income, gain or loss, however. 128

2. Foreign-source dividends or interest derived from an active U.S. finance business.

124 See also Treas. Reg. § 1.864-5(a), (b)(2).
125 I.R.C. § 864(c)(5)(A); Treas. Reg. § 1.864-7(d).
126 I.R.C. § 864(c)(5)(B).
127 Treas. Reg. § 1.864-6(b)(1).
128 Id.
Generally foreign source dividends and interest realized by a foreign person in a Active US Lending Business are only attributable to a U.S. office or fixed place if the Material Participation Test described above is met.\textsuperscript{129}

\textsuperscript{129} Treas. Reg. § 1.864-6(b)(2)(ii).