IRS Internal Memorandum Concludes Offshore Fund Engaged in Lending and Underwriting Business in the United States

January 8, 2015

On January 2, the Internal Revenue Service (the "**IRS**") released a Chief Counsel Advice memorandum (the "**CCA**") that concludes that an offshore master fund and its offshore feeder fund were engaged in a trade or business in the United States as a consequence of the master fund's lending and stock distribution activities, which were conducted on behalf of the master fund by a fund manager based in the United States. A link to the CCA **is here**. Although the CCA does not constitute authority on which a taxpayer may rely, it does provide insight into the views of the IRS on these issues. The CCA states that other fact patterns may cause an offshore fund to be engaged in the conduct of a trade or business in the United States and encourages the "field" to contact the IRS national office to discuss factual development and legal analysis in these cases.

The master fund described in the CCA is treated as a partnership, and the feeder fund is treated as a corporation, for U.S. federal income tax purposes. Both the master fund and the feeder fund are organized in a jurisdiction (likely the Cayman Islands) that does not have an income tax treaty with the United States. Pursuant to a management agreement, the master fund appointed a U.S.-based investment manager (the "**Fund Manager**") to buy, sell and otherwise deal in securities and related contracts for the master fund's account on a fully discretionary basis.

As the CCA notes, because the Fund Manager acts as the agent of the master fund, its activities pursuant to the management agreement are attributed to the master fund.[1] The Internal Revenue Code of 1986, as amended (the "**Code**"), provides that a foreign corporation (such as the feeder fund) will be treated as engaged in a trade or business in the United States if it is a partner in a partnership (such as the master fund) that is engaged in a trade or business in the United States.[2] A foreign corporation that is engaged in a trade or business in the United States is subject to U.S. federal income tax, at the rates applicable to U.S. corporations, in respect of its net income that is treated as "effectively connected" with that trade or business. In addition, absent a reduction or exemption pursuant to a tax treaty, a foreign corporation will be subject to a U.S. branch profits tax at a flat rate of 30% on its "dividend equivalent amount" (generally, the after-tax amount of certain effectively connected income that is not treated as reinvested in the trade or business). Under current law, the maximum combined rate of U.S. federal income and branch profits tax is 54.5%. Although trading in stocks and securities generally constitutes the conduct of a trade or business under common law principles, the Code provides a safe harbor under which a foreign person will not be considered to be engaged in a trade or business in the United States

[1] An internal memorandum from the IRS Office of Chief Counsel to the Director of Field Operations in Manhattan (Financial Services), which was released in 2009, concludes that activities constituting a lending business conducted on behalf of a foreign corporation by an agent based in the United States will be attributable to the foreign corporation without regard to whether the agent is a dependent agent or an agent of independent status. *See* I.R.S. Chief Couns. Mem. AM2009-010 (Oct. 2, 2009).

[2] *See* I.R.C. §875(1).

as a consequence of trading in stocks or securities for its own account (the "**Trading Safe Harbor**").[3] The Trading Safe Harbor does not apply to a dealer in stocks or securities.

The Fund Manager described in the CCA caused the master fund to acquire a significant number of convertible debt instruments and promissory notes directly from the borrowers. It negotiated directly with borrowers concerning all key terms of these debt instruments; conducted extensive due diligence on potential borrowers and received various fees from borrowers.[4] When the master fund acquired convertible debt instruments, the conversion price was typically discounted from the trading price of the borrower's stock at the time of conversion. The master fund would convert these debt instruments into stock (typically within a year) and then promptly dispose of the stock at the prevailing trading price. In connection with its lending activities, the master fund often received warrants to purchase shares of the borrowers' stock.

The Fund Manager also caused the master fund to enter into "Distribution Agreements" with issuers of stock pursuant to which the master fund made a commitment to purchase newly issued shares from the issuer from time to time at a price that was discounted from the prevailing trading price at the time of purchase. The issuer was required to file a registration statement with the Securities and Exchange Commission registering the issuer's stock for resale by the master fund. The master fund generally succeeded in pre-selling shares, at the prevailing trading price, in an amount at least sufficient to cover the price that the master fund owed to the issuer. In general, an issuer paid fees to the master fund, including commitment, structuring and due diligence fees.

The Fund Manager held the master fund out to the markets as a lender and underwriter and its investment professionals used their extensive business and personal relationships to generate lending and stock distribution deals for the master fund. The CCA notes that the Fund Manager's investment professionals sponsored and attended industry conferences relating to deal origination.

The CCA concludes that these activities constituted a lending business and an underwriting business, respectively. Significant to the analysis were:

- the Fund Manager's interaction with borrowers/issuers, including negotiations of the terms of debt instruments and extensive due diligence;
- the Fund Manager's solicitation of lending and stock distribution transactions for the master fund;
- the fact that the master fund received fees and obtained a "spread" by selling stock that it had acquired for a discounted purchase price; and
- the fact that the master fund engaged in the relevant activities on a considerable, continuous and regular basis.

In rejecting the argument that the Trading Safe Harbor applied to the master fund, the CCA states that the master fund's lending and underwriting activities did not constitute trading in stocks and securities because traders earn a profit from fluctuations in the market value of the stocks and securities they purchase, rather than from fees or "spreads." The CCA also reasons that the nature of the master fund's

[3] *See* I.R.C. §864(b)(2)(A)(ii). Under another statutory safe harbor, a foreign person (including a dealer) will not be considered to be engaged in a trade or business in the United States as a consequence of trading in stocks or securities through a resident broker, commission agent, custodian or other independent agent. I.R.C. §864(b)(2)(A)(i). After analyzing the relevant legislative history, the CCA concludes that an agent will not be considered to be "independent" for purposes of this safe harbor if the principal has granted discretionary authority to it. The master fund's grant of discretionary authority to the Fund Manager therefore made it ineligible for this safe harbor.

[4] The CCA does not describe the nature of those fees.

activities, including its extensive interactions with "customers," were typical of a banking, financing or similar business, rather than a trading activity.[5] Moreover, the CCA concludes that the master fund would be unable to rely on the Trading Safe Harbor in any event because it acted as a merchant with a view to distributing stock in exchange for a middleman's mark-up and was therefore a dealer. As a consequence of its status as a dealer, the master fund would not be entitled to rely on the Trading Safe Harbor with respect to any of its income: thus, if the master fund were engaged in trading stocks and securities, in addition to the lending and underwriting activities addressed in the CCA, any income it derived from the trading would generally be treated as effectively connected income.

In general, given the facts, the CCA is not surprising and is consistent with standard guidelines provided by tax professionals to offshore funds. A number of features of the analysis are interesting, however, and may provide some insight into how the IRS would approach other fact patterns involving offshore funds.

- While the CCA contains an analysis of whether the master fund's activities pursuant to Distribution Agreements constituted trading in stocks and securities, it does not analyze at any length the distinction between a lending business and investing or trading in debt obligations.[6] It notes as indicative of a lending business the master fund's direct negotiation with borrowers and solicitation of lending transactions (*i.e.*, holding itself out as being willing to make loans), activities that tax professionals generally advise offshore hedge funds to avoid.[7] However, the CCA appears to give comparable weight to the master fund's conduct of extensive due diligence on potential borrowers, an activity that would be equally appropriate for a prudent investor and therefore would not appear to indicate that the master fund was engaged in a business.
- The master fund acquired convertible debt instruments and often received warrants to purchase the borrower's stock in connection with its lending agreements. An offshore fund's simultaneous acquisition of equity, or options to acquire equity, of the issuer of a debt obligation is generally considered by tax professionals to mitigate the risk that the acquisition of the debt obligation would be treated as a lending business, as opposed to an investment in the issuer. In concluding that the master fund was engaged in a lending business, the CCA does not treat the equity elements as providing any indication that the master fund was acting as an investor. While not stated in the CCA, it is possible that the IRS ignored the equity elements because it viewed the master fund as taking minimal equity price risk, given the conversions and sales discussed in the next bullet point.
- The CCA focuses on the master fund's acquisition of stock at discounted prices (in the case of the lending business, through the conversion of convertible debt instruments) and prompt sale of that stock for full fair market value. Indeed, it concludes that the master fund's exercise of the conversion feature of the debt instruments and sale of the stock caused it to be a dealer (and therefore ineligible to rely on the Trading Safe Harbor). Because of this aspect of its lending business, the CCA would therefore treat the master fund as a dealer even if it had not entered

[5] In discussing the master fund's lending activities, the CCA refers to Treasury Regulations Section 1.864-4(c)(5), which provides rules for determining whether income is effectively connected to a banking, financing or similar business, for a description of the types of activities (including "making personal, mortgage, industrial, or other loans to the public") that constitute a lending business, as opposed to trading in stocks or securities.

[6] As noted above, it does refer to Treasury Regulations Section 1.864-4(c)(5). In its analysis of whether the master fund was engaged in a lending business, the CCA also refers to cases addressing whether lending constitutes a business for purposes of the bad debt deduction under Section 166 of the Code, stating that those cases have considered a number of factors, including the total number of loans made, the amount of time and effort expended, whether the taxpayer made loans to unrelated persons and whether the taxpayer actively sought out lending business and solicited borrowers.

[7] Apparently, the master fund was also acquiring the entire issuance of the relevant debt, but the CCA does not explicitly state so.

into any Distribution Agreements. Moreover, the CCA states that, in other contexts, making loans may be sufficient to cause the lender to be treated as a dealer even if the lender holds the loans instead of selling them, but expresses no opinion on this point.[8]

- The CCA implies that it is possible that certain of the master fund's activities would constitute a trade or business without regard to whether the master fund engaged in them on a considerable, continuous and regular basis, but states that it is unnecessary to address this issue because of the volume of the master fund's lending and underwriting activities. On the basis of case law and at least one analogous IRS private letter ruling, tax professionals generally consider the occasional origination of loans in a manner otherwise typical of a financing business (*e.g.*, no more than once a year) not to constitute the conduct of a trade or business.

[8] For this proposition, the CCA cites a regulation under Section 475 of the Code, which provides an exception from dealer status, for purposes of that provision, for persons that engage in no more than negligible sales of acquired securities. *See* Treas. Reg. §1.475(c)-1(c)(i).

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Mary Conway	**212 450 4959**	**mary.conway@davispolk.com**
Lucy W. Farr	**212 450 4026**	**lucy.farr@davispolk.com**