

Tax

Implications of Recent IRS Memorandum on Loan Origination Activities for Offshore Hedge Funds that Invest in U.S. Debt

By Cara Griffith

On September 22, 2009, the Internal Revenue Service (IRS) Office of Chief Counsel issued a memorandum concluding that “interest income received by a foreign corporation with respect to loans that it originated to U.S. borrowers constitutes income effectively connected” with the conduct of a U.S. trade or business and is subject to net income tax in the U.S. Some hedge fund managers – especially those with funds focused on credit or lending – are concerned that the memo presages more focused attention by the IRS on investments by offshore hedge funds in U.S.-based debt. Other managers think the memo’s effect on hedge funds may be limited because it addresses a narrow fact pattern that differs in important ways from the typical approach taken by offshore funds to investments in U.S. debt. However, even those that distinguish the memo on its facts concede that, at a broader level, the memo may indicate a disposition on the part of the IRS to take a harder look at lending activities by offshore entities in general. The concern here is that even if this memo does not capture typical hedge fund investments within its purview, another memo that does may be in the offing.

This article details the fact pattern and legal conclusions of the memo, then analyzes the potential implications of the memo for offshore hedge funds. In particular, the article explores: the extent to which the fact pattern in the memo resembles and departs from the typical structure of

investments by offshore hedge funds in U.S. debt; efforts by offshore funds to structure debt investments to fit within the securities trading safe harbor; the components of lending activities that typically are and are not carried on by offshore hedge funds; secondary market purchases of U.S. debt by offshore hedge funds; whether the memo applies with greater or lesser force to the purchase by offshore hedge funds of loan portfolios; the leveling effect of the memo on the difference between independent and dependent agents; the effect of the memo on the tax concept of an “office” in the U.S.; and how the memo has already and is likely to, going forward, affect the structuring of offshore hedge funds.

IRS Memo Fact Pattern

The fact pattern in the memo involves a situation in which a foreign corporation, organized in a non-treaty jurisdiction, makes loans to U.S. persons within the U.S. The foreign corporation has no office or employees in the U.S. To originate loans to U.S. borrowers, the foreign corporation outsources the origination activities to a U.S. corporation (origination company). The origination company is located in the U.S. and is subject to U.S. federal income taxation. Under the terms of a service agreement between the foreign corporation and the origination company, the activities performed by the origination company include solicitation of U.S. borrowers, negotiation of the terms of loans,

performance of credit analysis of the U.S. borrowers, and other activities relating to loan origination, other than final approval and execution of loan documents. The origination company is not authorized to conclude contracts on behalf of the foreign corporation.

Applicable Law

Pursuant to Internal Revenue Code (IRC) Section 882(a)(1), a foreign corporation that is engaged in a trade or business in the U.S. during the taxable year is subject to U.S. federal income tax on taxable income that is effectively connected with the conduct of that trade or business. The phrase “trade or business” includes “the performance of personal services within the United States,” but does not, pursuant to IRC Section 864(b)(2)(A)(i), include “[t]rading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent.” Also, under the “securities trading” safe harbor, a U.S. trade or business does not include “[t]rading in stocks or securities for the taxpayer’s own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other independent agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transaction.” IRC Section 864(b)(2)(A)(ii). For more on the securities trading safe harbor, see “MFA Presses for Guidance on Securities Trading Safe Harbor,” *The Hedge Fund Law Report*, Vol. 1, No. 11 (May 13, 2008).

If a foreign corporation is determined to be engaged in a trade or business, its income is taxable only if it is “effectively connected” with the U.S. trade or business. Treas. Reg. Sec. 1.864-4(c)(5) provides that U.S. source income received by a foreign corporation that is engaged in banking, financing or a

similar business in the U.S. is treated as effectively connected to the conduct of that business if the stock or securities giving rise to the income, gain or loss are attributable to a U.S. office and the securities were acquired in a specified manner, including making loans to the public. A loan will be deemed attributable to a U.S. office only if that office “actively and materially participates in soliciting, negotiating, or performing other activities” required to arrange the loan.

Although foreign source interest income is generally not treated as effectively connected with the conduct of a U.S. trade or business, such income will be treated as effectively connected income “if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable.” IRC Section 864(c)(4)(B). The office or other fixed place of business of an agent will be disregarded in determining whether a foreign corporation has an office in the U.S. unless the agent “(i) has the authority to negotiate or conclude contracts in the name of the foreign corporation and regularly exercises such authority and (ii) is not a general commission agent, broker or other independent agent acting in the ordinary course of business.”

Legal Conclusions in IRS Memo

The IRS concluded that the foreign corporation in the fact pattern in its memo is engaged in a trade or business within the U.S. pursuant to IRC Section 864(b)(2). The memo stated that although the origination company acts on behalf of the foreign corporation pursuant to a service agreement and lacks the authority to conclude contracts, the origination company “performs activities that are a component of [the foreign corporation’s] lending activities, such as the solicitation of customers, the negotiation of contractual

terms and the performance of credit analyses.” As further support, the memo concluded that the foreign corporation’s loans to U.S. borrowers were “on a considerable, regular and continuous basis with the intention of earning a profit,” and because the loan origination activities were conducted through the origination company, the IRS determined that the activities occurred within the U.S. Regarding the securities trading safe harbor of IRC Section 864(b)(2), the memo noted that because the foreign corporation regularly and continuously originates loans to U.S. borrowers, those activities constitute a lending trade or business and are not trading or investing activities.

After concluding that the foreign corporation is engaged in a U.S. trade or business, the IRS then determined that the foreign corporation has income effectively connected with that business because it “is engaged in a banking business and such interest income is attributable to an office in the United States.” Pursuant to Treas. Reg. Sec. 1.864-4(c)(5), the IRS concluded that because the foreign corporation’s U.S. source interest income was “attributable to the U.S. office through which such business is carried on,” the income will be treated as effectively connected income. The memo noted that the regulation does not specify that the U.S. office must belong to the taxpayer. Rather, a “U.S. office of an agent of the taxpayer is sufficient.” As such, the origination company’s office satisfies the office requirement. And because that U.S. office actively and materially participated in the day-to-day origination activities, the foreign corporation’s U.S. source interest income is attributable to a U.S. office, even though the foreign corporation concluded the loans outside of the U.S.

Implications for Hedge Funds

Although the IRS memo does not specify what type of institution the foreign corporation is, the memo suggests that

the IRS focus more squarely on loan origination activities of offshore entities, including offshore hedge funds, said Michele Gibbs, a Partner at Tannenbaum Helpert Syracuse & Hirschtritt LLP. The memo, while not an IRS ruling and therefore not binding precedent, is one of the first instances of written guidance from the IRS that may be applicable to loan origination activities conducted by offshore hedge funds in recent years, noted Adam Gunnerson, a Senior Associate at Withers Bergman LLP. The legal framework regarding the taxation of foreign persons with activities in the U.S. was drafted in the 1960s and has not been amended to address hedge fund investments. In addition, no case has squarely dealt with the loan origination activities of hedge funds, and recent caselaw in similar contexts is not particularly relevant, Gunnerson noted.

Lending activities by hedge funds are not uncommon. Many offshore hedge funds lend money in the U.S. and have taken the position that they are not subject to U.S. tax, said Shahzad Malik, a Partner at TroyGould LLP. In general, “entities that originate loans and are in a U.S. trade or business are subject to tax on their foreign source interest income. However, “entities that buy debt are generally exempt from tax on the interest because of the ‘portfolio interest’ exception,” Malik noted. Most debt investments by offshore hedge funds are structured to prevent the funds from being construed as engaged in a U.S. trade or business, and/or to ensure that the fund’s activities qualify as trading in stocks or securities, an activity that falls under the securities trading safe harbor, explained Gunnerson.

Secondary Market Purchases

Hedge funds have been able to keep their activities within the securities trading safe harbor because they do not

typically deal in primary market debt. Rather, they generally deal in secondary market debt, where debt is not purchased directly from the issuer, but from another holder. Maury Cartine, a Partner at independent public accounting firm Marcum LLP, said that “if an offshore fund buys bonds as investments in the secondary market, the income from those loans would generally not be treated as income effectively connected with a U.S. trade or business.”

The IRS memo is unlikely to change that analysis. Edward Lemanowicz, a Partner at Dechert LLP and head of the firm’s International and Domestic tax practice, noted that the memo resolves a relatively narrow issue, and that there is a significant difference between the fact pattern presented in the memo and the manner in which most offshore hedge funds operate and invest. Although the foreign corporation in the memo was performing most of the requisite loan origination activities outside the U.S., it took a more active role in funding loans at closing – something that most offshore hedge funds do not do. In essence, said Michael Rufkahr, also a Partner with Dechert LLP, the specific conclusions in the memo will not affect most hedge funds. “The memo does not represent a new direction or a bigger problem in the area of loan origination,” said Rufkahr. Most funds that are taking an aggressive position like the foreign corporation in the memo are already aware of the potential for adverse tax implications and most practitioners would not advocate that type of aggressive position, noted Rufkahr.

Loan Portfolios

However, Cartine suggested that “the purchase and servicing of a loan portfolio by an offshore fund is more problematic. At some point, these activities might be regarded as a business activity within the United States.” While the

purchase by an offshore fund of outstanding loans and notes on a nonrecurring basis would not likely be treated as a business activity within the United States, Cartine said that “the recurring purchase of a non-securitized loan portfolio comprised of many different borrowers that requires servicing” could be regarded as a trade or business activity in the U.S.

Dependent and Independent Agents

Prior to the recent memo, the general consensus was that if a U.S. loan originator was a dependent agent of an offshore fund, the activities of the originator would be attributed to the principal, the offshore fund. A dependent agent lacks the authority to negotiate and conclude contracts on behalf of the principal. On the other hand, if the loan originator was an independent agent, then the activities would not be attributed to the principal, explained Gunnerson. However, the memo has thrown these propositions into doubt. The memo indicates, Gunnerson suggested, that if the loan origination activities are outside of the securities safe harbor and an offshore fund has an agent acting on its behalf in the U.S., the activities will be attributed to the principal, regardless of whether the agent is dependent or independent.

According to Robert Cudd, a Partner with Morrison Forrester LLP, the memo can be read broadly to suggest that, in the view of the IRS, the performance of vital services can create an agency relationship without any formal agreement or arrangement for purposes of attributing the acts of an agent to an offshore fund. Further, the stance taken by the IRS in the memo appears to disregard the general rule under tax treaties and relevant provisions of the IRC regarding dependent (those that cannot bind the principal) and independent agents (those that can bind the principal), said

Cudd. In particular, the memo disregarded the fact that the fund had no U.S. office through which its activities were conducted. Rather, the IRS imputed the activities and the office of the agent to the fund to conclude that the income of the fund was effectively connected U.S. source income.

An Office in the United States

If an offshore hedge fund is determined to be engaged in a lending trade or business in the U.S. by virtue of its loan origination activities, interest income from that business will be effectively connected if it is attributable to “an office in the United States.” Distinguishing between a “U.S. office” and an “office or other fixed place of business” in the U.S. is significant, said Cudd. The securities trading exemption could also be jeopardized if the activities and office of the managers were attributed to the fund. The IRS essentially concluded that the requirement of a “U.S. office” can be met without the actual existence of an office. This means that the IRS has expanded the arrangements under which the activities of an agent can result in creating a U.S. office attributable to an offshore fund, noted Cudd.

Affect on Structuring of Offshore Funds

While practitioners that spoke with The Hedge Fund Law Report were quick to note that the IRS memo is not binding precedent, but simply the “first shot across the bow” on loan origination, they also noted that the memo is already affecting structuring of offshore funds. Cudd noted that offshore funds that have foreign corporations as partners

and that were formed to acquire and hold debt obligations of U.S. persons may also be concerned that activities of the management company could cause the foreign partners to be engaged in a U.S. trade or business. Accordingly, Cudd said that such funds are more concerned about separating manager functions from the limited activities of the general partner and the activities of the fund in holding securities.

Kenneth Werner, a Partner at Richards Kibbe & Orbe LLP also suggested that the final paragraph in the memo could indicate possible future activity by the IRS in this area. In that paragraph, the IRS stated that it is aware that other strategies may have been used by foreign corporations to originate loans that may have given rise to effectively connected income. The IRS encouraged the development of those cases and stands “ready to assist . . . in the legal analysis.” Werner suggested that there are two situations where the IRS might pay more attention. First is the situation where an agent bank is organizing a syndicated loan and a hedge fund wants to buy debt directly from the bank. If done properly and the offshore fund does not fund the loan itself, this type of transaction seems acceptable, Werner said. A second situation is where a domestic fund is making loans, waiting a period of time, generally, at least 90 days, and selling the loan to a related offshore fund. Although both transactions can be done properly and then would likely withstand scrutiny from the IRS, Werner suggested that if funds are pushing the envelope with these types of transactions, that may put up a red flag for the IRS.