

IRS Issues Guidance On U.S. Lending Activities By Non-U.S. Investor

A major U.S. tax issue for off-shore funds and other non-U.S. holders of U.S.-source debt is whether the income (interest and any gains on sale) from such debt will be treated as “effectively connected income” (“ECI”) subject to U.S. income tax, as opposed to non-ECI, *i.e.*, investment income exempt from U.S. tax. The answer depends on whether the fund or other holder is deemed to be engaged in a banking, finance or similar business (in such case subject to full U.S. tax) or viewed as simply an investor in debt securities (no U.S. tax). Unfortunately, there is limited case law or other authority as to when the line is crossed from mere investment to the active conduct of a finance business.

It is largely because of this paucity of authority that a recent memorandum issued by the U.S. Internal Revenue Service (the “IRS”) generated a degree of interest among tax professionals advising off-shore investors in U.S. debt. In the memorandum, which is a generic pronouncement without binding effect on any specific taxpayer, the IRS concluded that interest income received by a non-U.S. corporation (the “Non-U.S. Co.”) from U.S. loans originated on its behalf by an agent (the “Origination Co.”) was ECI, taxable to the Non-U.S. Co.

Under the facts set forth in the memorandum, the Non-U.S. Co. had no office or employees in the United States. Rather, the Origination Co., a third party acting pursuant to a service agreement for which it was paid an arm’s-length fee, solicited loans from U.S. borrowers, negotiated the terms of loans, performed credit analysis with respect to the U.S. borrowers, and undertook all other activities relating to loan origination other than the final approval and signing of loan documents. This approval and signing was done by the Non-U.S. Co. employees in a non-U.S. office.

The activities addressed in the memorandum clearly evidence a lending business, *i.e.*, solicitation, origination, and negotiation of multiple loans to multiple borrowers. As such, the pronouncement is not terribly helpful to many hedge funds or other investors whose activities are more nuanced, such as buyers of distressed debt engaged in workouts where the modified debt is treated for tax purposes as having been newly originated or investors lending only to a limited number of borrowers.

A more significant point in the memorandum is the imputation by the IRS of the U.S. activities of the Origination Co., as agent, to the Non-U.S. Co. The memorandum specifically states that the Origination Co. acts on behalf of the Non-U.S. Co. pursuant to a service contract and does not have authority to conclude contracts on behalf of the Non-U.S. Co. Nevertheless, the IRS finds that the Origination Co. performs activities that are a “component of Non-U.S. Co.’s lending activities,” and, accordingly, the Origination Co.’s activities and office are imputed to the Non-U.S. Co., resulting in a finding that Non-U.S. Co. is engaged in a U.S. trade or business. In what represents an expansive reading of existing relevant case law, and a restrictive reading of certain regulations, each of which could be interpreted to prevent this result, the fact that the Origination Co. has no power to conclude contracts on behalf of the Non-U.S. Co. and/or may be viewed as an independent, as opposed to a dependent, agent of the Non-U.S. Co. — factors that might have given certain non-U.S. investors comfort in the past — do not prevent the finding of ECI.

This memorandum indicates that the IRS is taking a hard look at off-shore entities investing in U.S. loans. Whether this attention will expand, for example, to non-U.S. funds that purchase portfolios of distressed debt or newly originated loans remains to be seen.

Chicago Office
+1.312.583.2300

Los Angeles Office
+1.310.788.1000

Frankfurt Office
+49.69.25494.0

New York Office
+1.212.836.8000

London Office
+44.20.7105.0500

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1.202.682.3500

West Palm Beach Office
+1.561.802.3230

Copyright ©2009 by Kaye Scholer LLP. All Rights Reserved. This publication is intended as a general guide only. It does not contain a general legal analysis or constitute an opinion of Kaye Scholer LLP or any member of the firm on the legal issues described. It is recommended that readers not rely on this general guide but that professional advice be sought in connection with individual matters. References herein to "Kaye Scholer LLP & Affiliates," "Kaye Scholer," "Kaye Scholer LLP," "the firm" and terms of similar import refer to Kaye Scholer LLP and its affiliates operating in various jurisdictions.