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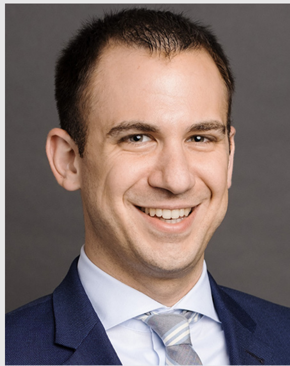

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In this article, Schwartz and Kalinowski examine lending as a U.S. trade or business and argue that loan purchases at initial issuance should be protected.

One of Jason's favorite restaurants is Queen's English in the Columbia Heights neighborhood of Washington, DC. He patronizes it often enough that the servers don't need to give him a menu; he is committed to consume whatever dishes chef Henji Cheung and his wife Sarah Thompson, who commands the front of the house, send his way.

The dining room accommodates fewer than 40 guests at a time, and Henji often orders ingredients with his regulars in mind. When he knows Jason is coming in for dinner, Henji tries to get a hold of a few sugar toads — small pufferfish native to the Chesapeake Bay — which he powders with spiced rice flower and lightly fries.

Even though Henji customizes his inventory for Jason and a pattern of past conduct establishes Jason's commitment to buying from Henji within a very short time frame, it would strain logic to suggest that Jason is engaged in the restaurant business. Henji (not Jason) selects the suppliers, solicits the ingredients, and negotiates the prices, and the price Jason pays includes a markup that reflects Henji's work.

But if Jason were a credit fund with foreign investors and Queen's English was selling him newly issued loans instead of sugar toads, Jason's U.S. tax advisers likely would fret that Jason is engaged in a U.S. lending business that subjects him or his foreign investors to U.S. net income tax.

That concern is reasonable in light of the IRS's historical saber rattling. In 2009 and in 2015 the IRS issued informal memoranda concluding that credit funds were engaged in a U.S. trade or business when their agents regularly loaned money on their behalf.[1] More recently, in 2019 and in 2020, the IRS is rumored to have sent information document requests asking asset managers about the season-and-sell strategies their credit funds use to avoid a U.S. trade or business.[2] Thus, like other tax practitioners in this space, we advise our non-U.S. clients that they risk being engaged in a U.S. trade or business if they buy loans at initial issuance, even if they don't hold themselves out as lenders to borrowers (that is, they don't "solicit" borrowers) or negotiate with the borrowers. However, as discussed below, this industry-wide concern may be rooted more in lore than in law.

This article examines the authorities on lending as a U.S. trade or business. We argue that the code and Treasury regulations appear to protect purchases of loans at initial issuance unless the purchaser or someone acting in the name of the purchaser solicits or negotiates with the borrowers, and we contend that the IRS's

[1] AM 2009-010; ILM 201501013.

[2] We discuss season-and-sell strategies *infra* in Section IV.C.

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informal guidance can be read consistently with this conclusion. We then provide several examples of tax guidelines that credit funds follow when purchasing loans to avoid a U.S. trade or business under a conservative interpretation of IRS guidance. The examples illustrate how the IRS's failure to clarify our reading inappropriately limits the availability of credit to prospective borrowers.

I. Background

Domestic corporations are subject to a 21 percent net income tax,[3] so most credit funds are structured as either partnerships or foreign corporations. If the fund is a partnership, non-U.S. investors typically invest through a foreign "feeder" corporation. If the fund is a foreign corporation, non-U.S. investors typically invest directly.

Under section 882(a), foreign corporations that are engaged in a U.S. trade or business are subject to U.S. federal income tax on any income that is "effectively connected" with the conduct of that trade or business. Under section 1446, partnerships (both domestic and foreign) that are engaged in a U.S. trade or business must withhold tax at the highest rate (now 21 percent for corporations and 37 percent for individuals)[4] on their foreign partners' distributive share of any income that is effectively connected with that U.S. trade or business.[5]

The rules for calculating effectively connected income are convoluted and difficult to apply. In the absence of clear guidance, asset managers generally assume the worst: If they are engaged in a U.S. trade or business, all their income and gain will be effectively connected and subject to U.S. tax. In light of the acute downside, they and their tax advisers often err on the side of caution in assessing whether lending activities constitute a U.S. trade or business.

II. Buying Loans at Initial Issuance

Under the securities trading safe harbor of section 864(b)(2)(A)(ii), trading in stocks or securities for one's own account, either directly or through a resident agent, isn't a U.S. trade or business unless one is a dealer in stocks or securities.

This section contends that "securities" include loans, "trading" includes buying at initial issuance, and "dealing" doesn't include buying at initial issuance.

A. Loans Are Securities

The IRS seems to accept that loans are securities under section 864(b)(2)(A)(ii). If they weren't, every U.S.-managed credit fund that trades loans would be engaged in a U.S. trade or business — that of trading property not described in the securities safe harbor — and either the credit fund or its foreign investors would be subject to U.S. tax. Here we briefly explain why loans are securities.

Reg. section 1.864-2(c)(2) defines securities to include "any note, bond, debenture, *or other evidence of indebtedness*."[6] A loan is evidence of indebtedness.

The regulatory definition of securities mimics statutory language from section 22(b)(9) of the Revenue Act of 1939 (the predecessor to section 108). That language was understood to include loans,[7] just as today's section 108 is understood to include loans.[8] Had the IRS wanted to exclude loans from the definition of securities under section 864(b)(2)(A)(ii), it could instead have modeled the definition on section 117(f) of the Revenue Act of 1934.[9]

An example in the section 864 regulations also explicitly refers to loans as securities,[10] and, in analogous contexts, the IRS has interpreted the

[3] Section 11(b).

[4] Section 1(j).

[5] Section 875.

[6] Reg. section 1.864-2(c)(2)(i) (emphasis added).

[7] Stanley S. Surrey, "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," 49 *Yale L.J.* 1153 (1940).

[8] *See, e.g.*, LTR 201328023.

[9] *See Gerard v. Commissioner*, 40 B.T.A. 64 (1939) (concluding that mortgage loans were not "other evidences of indebtedness . . . *with interest coupons or in registered form*" under section 117(f) of the Revenue Act of 1934 (emphasis added)). Section 22(b)(9) of the Revenue Act of 1939 doesn't include the language "with interest coupons or in registered form."

[10] Reg. section 1.864-4(c)(5)(vii), Example 1 (referring to "loans, bonds, notes, and bills" collectively as "securities").

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phrase "other evidence of indebtedness" to include loans.[11]

B. Trading Includes Buying

Reg. section 1.864-2(c)(2) defines trading to mean "the effecting of transactions," which includes buying, selling, and any other activity closely related thereto, without any carveout for buying at initial issuance. The same regulation defines securities to include the right to subscribe to or purchase a security, which appears to protect commitments to buy a security when issued. Buying stocks and bonds at initial issuance is widely understood to be a protected activity under section 864(b)(2)(A)(ii), and the IRS has never asserted otherwise. There is no indication in the regulations that a different rule might apply to loans.

Moreover, there was no secondary market in loans in 1967, when section 864(b)(2)(A)(ii) was enacted.[12] So if a foreigner held a loan, they probably bought it at initial issuance. As explained above, loans are securities under section 864(b)(2)(A)(ii). It stands to reason that when section 864(b)(2)(A)(ii) was enacted, Congress expected it to prevent purchasing loans at initial issuance from being a U.S. trade or business.

Indeed, before Congress enacted the "portfolio interest exemption" in 1984, foreigners were subject to 30 percent withholding tax on U.S.-source interest income. Foreign lenders lobbied Congress to instead subject that income to net basis tax.[13] Those lobbying efforts would have been unnecessary if Congress had believed that purchasing loans at initial issuance from within the United States already subjected foreigners to net income tax.

C. Buying Is Not Dealing

The securities trading safe harbor doesn't extend to dealers,[14] but buying a loan at initial issuance doesn't, in itself, constitute dealing for this purpose.[15] If the IRS had wanted dealing under section 864(b)(2)(A)(ii) to include buying loans at initial issuance, it could have issued regulations saying so, as it did under section 475.[16] It didn't, and the two sections have very different purposes.

There also is no suggestion that Congress intended buying loans at initial issuance to be treated as dealing under section 864(b)(2)(A)(ii). Congress's evident policy rationale for excluding dealers from the securities trading safe harbor was to prevent foreigners from unfairly competing with U.S. commercial banks.[17] Congress didn't express a similar concern about non-bank foreign lenders.[18]

Nor has Congress expressed concern about buying loans at initial issuance in analogous contexts. U.S. tax-exempt entities aren't subject to unrelated business income tax on interest they receive from loans they buy at initial issuance,[19] but they are subject to tax on gains from dealer activities. Real estate investment trusts aren't

[11] *See* FSA 199935017 (concluding that loans are securities described in section 475(c)(2)(C), which mimics reg. section 1.864-2(c)(2)); reg. section 1.892-3T(a)(3) ("The term 'other securities' includes any note or other evidence of indebtedness. Thus, an annuity contract, a mortgage, a banker's acceptance or a loan are securities for purposes of this section.").

[12] Blaise Gadanecz, "The Syndicated Loan Market: Structure, Development, and Implications," *Bank for Int'l Settlements Q. Rev.* 75, 76 (Dec. 2004) (secondary market for corporate loans began in 1990s); S&P Global Ratings, "A Guide to the Loan Market" (Sept. 2011) (secondary market for loans began in the 1980s).

[13] *See* "Foreign Investors Tax Act of 1966, Hearing on H.R. 13103 Before the S. Comm. on Finance, 89th Cong. 29," at 173 (Banco de Ponce's "net profit before taxes from all of its operations everywhere averages far less than 30 percent of its entire gross income.").

[14] Section 864(b)(2)(A)(ii).

[15] Reg. section 1.864-2(c)(2)(iv) (a dealer is "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" (emphasis added)).

[16] Reg. section 1.475(c)-1(c)(1).

[17] *See* ILM 201501013, citing IRS TAM, "Treasury Decision — Definition of 'Trade or Business Within the United States' as Applied to Nonresident Aliens and Foreign Corporations" 8 (Nov. 5, 1987) ("Dealers are in the business of trading stocks or securities for their own account. If they were artificially to be considered not engaged in a trade or business in the United States by virtue of their U.S. trading they would have a distinct competitive advantage vis a vis their U.S. counterparts.").

[18] *See, e.g.*, "Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad" (Apr. 27, 1964) ("Revision of U.S. taxation of foreign investors is one of the most immediate and productive ways to increase the flow of foreign capital to this country."); Hearing, *supra* note 13, at 117-118 ("As you know, European capital markets are poorly developed and very congested, and indigenous foreign banks are already unable to meet fully the needs of their own domestic customers." (Alfred W. Barth, executive vice president, the Chase Manhattan Bank)).

[19] Section 512(b)(1).

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subject to the 100 percent prohibited transactions tax on interest they receive from loans they buy at initial issuance,[20] but they are subject to tax on gains from dealer activities.

III. A Closer Look at the IRS Guidance

This section seeks to reconcile AM 2009-010 and ILM 201501013 with the above analysis. In short, we believe it is a stretch to read the IRS's informal guidance as treating the acquisition of loans at initial issuance, in itself, as a U.S. trade or business. Instead, we believe the message to be gleaned from these memoranda is that, in the IRS's view, substantive interactions with borrowers from within the United States could give rise to a U.S. trade or business. Under our reading, credit funds can acquire loans at initial issuance without becoming subject to U.S. net income tax as long as they don't solicit or negotiate with the borrowers.

A. AM 2009-010

The facts in AM 2009-010 are sparse. A foreign corporation entered into a "service agreement" with a U.S. corporation under which the U.S. corporation regularly solicited U.S. borrowers and negotiated the terms of the loans "on behalf of" the foreign corporation. The memorandum concludes that the foreign corporation was engaged in a U.S. trade or business because, through the U.S. corporation, it "lends money to customers on a considerable, regular and continuous basis with the intention of earning a profit." To support its conclusion, AM 2009-010 cites *InverWorld*,[21] a nonprecedential memorandum decision.

In *InverWorld*, a Cayman Islands financial services company (LTD) entered into a "consulting agreement" that authorized its wholly owned domestic subsidiary (INC) to regularly negotiate and conclude contracts "in the name of LTD."[22] The Tax Court held that INC was an agent of LTD. Because the contracts were concluded with "clients' funds, as attorney in fact for the clients, with a view to making commissions or other profits from such transactions," the Tax Court held that LTD was not trading in stocks and securities for its "own account" within the meaning of section 864(b)(2)(A)(ii) and that, in any event, it was a dealer.[23]

So *InverWorld* supports AM 2009-010's uncontroversial conclusion that an agent's activities are attributed to its principal when the agent acts "on behalf of" or "in the name of" the principal. However, *InverWorld* doesn't support the proposition that buying loans at initial issuance, in itself, is a U.S. trade or business; LTD couldn't rely on section 864(b)(2)(A)(ii) because it was a dealer.

B. ILM 201501013

ILM 201501013 considers whether a hedge fund was engaged in a U.S. trade or business as a result of an asset manager's activities on its behalf. The asset manager regularly solicited borrowers, negotiated loans directly with them, and acted as an underwriter in stock offerings. The memorandum concludes that the fund was engaged in a U.S. trade or business.

The most obvious reason that the fund was engaged in a U.S. trade or business is that its underwriting activities made it a dealer. Underwriting is a core dealer activity, so this conclusion is unremarkable.

The memo nevertheless goes to great lengths to explain why the fund, in any event, wasn't a trader under section 864(b)(2)(A)(ii). The memo's analysis is worth replicating in full:

> Certain activities may entail the "effecting of transactions in stocks and securities," but nonetheless exceed the scope of [section 864(b)(2)(A)(ii)]. These characteristics may include the conduct of

[20] *See* Rev. Rul. 80-57, 1980-1 C.B. 157 (the REIT was "engaged primarily in originating, making, and servicing short-term construction and development loans"); and GCM 35803 (May 3, 1974) (the REIT "makes conventional residential mortgage loans (Joint Loans) in cooperation with a commercial bank").

[21] *InverWorld Inc. v. Commissioner*, T.C. Memo. 1996-301.

[22] *Id.* at *34 (INC had "the authority for and in the name of LTD to carry out . . . purchasing, selling, and dealing in instruments or evidences of indebtedness by whomsoever issued" (internal quotations omitted)).

[23] *Id.* at *162.

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> one or more activities typical of a banking, financing, or similar business: interaction with customers; the attempt to generate profit from merchandising rather than market appreciation; or the extent of an underwriter's involvement in the U.S. markets. Fund's lending and underwriting activities demonstrate these characteristics. When Fund engaged in lending and underwriting, it did not profit from taking on risk or identifying advantageous purchases. Rather, in exchange for performing lending and underwriting activities, Fund received compensation in the form of fees, discounted property, and spreads. Both the activities performed and the compensation received by the Fund demonstrate that Fund's activities are not properly characterized as trading in stocks or securities.

So interacting directly with borrowers and seeking profits through fees and spreads instead of through market appreciation are unprotected under section 864(b)(2)(A)(ii), even if they aren't dealer activity. Conversely, the memo suggests that "taking on risk or identifying advantageous purchases" and attempting to generate profit from market appreciation *are* protected as long as the taxpayer is not a dealer, does not interact with customers, and does not earn dealer-like income such as fees and spreads.

C. The Takeaway

1. In general.

The best interpretation of the IRS's guidance is that non-dealer lending activities are protected unless the foreigner interacts substantively with borrowers by soliciting and negotiating with them. The IRS appears to believe that soliciting and negotiating with borrowers is a personal service. The regular performance of personal services within the United States generally is a U.S. trade or business.[24]

We support our interpretation with three key observations.

First, and most importantly, our interpretation doesn't undermine the statutory and regulatory protection accorded foreign non-dealers under section 864(b)(2)(A)(ii). Loans are still securities, trading still includes buying at initial issuance (as long as you don't solicit or negotiate with the borrower), and buying at initial issuance isn't dealing.

Second, in each of *InverWorld* (on which AM 2009-010 relies) and ILM 201501013, a foreigner earned fees for negotiating contracts. Although AM 2009-010 doesn't say whether the foreign corporation also earned negotiation fees, it would be fair to infer that it did; the foreign corporation paid an arm's-length fee to a U.S. corporation for soliciting and negotiating loans on its behalf, so any spread in excess of that fee presumably was passed on to the foreign corporation. Fees commonly are understood to compensate the recipient for the performance of personal services.

The regulations and case law provide some authority for treating solicitation and negotiation as activities that could cause loan acquisitions to fall outside the securities trading safe harbor. The definition under reg. section 1.864-4(c)(5) of the active conduct of a banking, financing, or similar business includes making loans "to the public."[25] In an analogous context, the IRS defined the public as "ordinary and unrelated customers," which suggests that making loans is a banking, financing, or similar business only if there is some preexisting relationship between the lender and the borrower — one that would have arisen from a history of solicitation and negotiation by the lender.[26] Notably, both memoranda refer to the foreigner's counterparties as customers.[27]

Similarly, outside the U.S. trade or business context, courts and the IRS have treated the acquisition of loans as a service only when the lender solicited or negotiated the loans with the

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[24] *See* reg. section 1.864-2(a) (the regular performance of personal services within the United States generally is a U.S. trade or business).

[25] Although reg. section 1.864-4(c)(5), by its terms, is only relevant to the determination of the amount of a foreigner's effectively connected income once the foreigner already is found to be engaged in a U.S. trade or business, the court in *InverWorld* found it to be a "useful framework" for determining whether the foreigner is engaged in a U.S. trade or business in the first place. *InverWorld*, T.C. Memo. 1996-301, at *126.

[26] *See* LTR 9611001 (addressing the definition under the section 904 tax credit rules).

[27] We are not the first to focus on AM 2009-010's use of the word "customer." *See generally* David H. Shapiro and Jeff Maddrey, "The Importance of a 'Customer Relationship' in Loan Origination," *Tax Notes*, Feb. 1, 2010, p. 659.

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borrowers.[28] The one exception was *Federal National Mortgage Association*,[29] in which the taxpayer's entire *raison d'être* was to provide liquidity in the secondary market for home mortgages.[30] As a quasi-governmental agency designed to relieve banks of their mortgage inventories so they can keep lending, Fannie Mae is easily distinguishable from a credit fund that acquires loans only if it believes they are good investments.

Third, our interpretation is consistent with the historical trend of imposing corporate tax on entities that generate goodwill, and not on those that don't (such as mutual funds, REITs, master limited partnerships, and real estate mortgage investment conduits).[31]

One might argue that, if our interpretation is correct, the memoranda give short shrift to the regulatory definition of trading under section 864(b)(2)(A)(ii), which (as mentioned above) includes buying at initial issuance and "any other activity closely related thereto." Reasonable minds can differ about whether solicitation and negotiation are closely related to loan acquisition. We don't need to resolve that question here because most credit funds don't actually solicit or negotiate.

2. Whither agency?

Credit funds rarely solicit or negotiate loans with borrowers. When they do, their interactions typically don't rise to the level of personal services, either because they are "workout" discussions intended to mitigate a previously unforeseen default[32] or because they are merely ministerial, clerical, or preparatory in nature (such as due diligence communications).[33]

Instead, credit funds ordinarily rely on a bank or similar party (such as a marketplace lender that runs an online lending platform)[34] to find borrowers and negotiate loans that conform to the credit funds' investment guidelines. The bank retains a fee (often called an origination fee) or a few days' worth of interest payments on the loan as compensation for performing these services. Under this framework, all goodwill inures to the bank, even if credit funds acquire the loan at initial issuance.

We don't believe there is any support in the memoranda or in *InverWorld* to impute a bank's solicitation and negotiation activities to a credit fund under the customary fact pattern described above. The memoranda and *InverWorld* explicitly describe a U.S. person soliciting and negotiating loans on behalf of a foreigner. Solicitation and negotiation in the foreigner's name created a customer relationship between the borrowers and the foreigner whereby (in contrast to the ordinary-course scenario) any goodwill inured to the foreigner instead of to the U.S. agent.

Moreover, in other contexts, courts and the IRS have declined to impute a service provider's (such as a bank's) customer relationships to a third party (such as a credit fund) if the service

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[28] *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963) (loans held by a U.S. savings and loan association were ordinary, not capital, assets because the association was "rendering the service" of making loans), *acq. sub. nom. United Associates Inc.*, 1965-1 C.B. 5; *see also* Rev. Rul. 73-558, 1973-2 C.B. 298 (bank); Rev. Rul. 72-238, 1972-1 C.B. 65 (savings and loan); Rev. Rul. 80-56, 1980-1 C.B. 154 (REIT); and Rev. Rul. 80-57, 1980-1 C.B. 157 (REIT).

[29] *Federal National Mortgage Association v. Commissioner*, 100 T.C. 541 (1993).

[30] *Id.* at 545 (taxpayer's statutory mandate was "to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing").

[31] *See generally* Robert Cassanos, "Single Taxation of Publicly Traded Entities," *Tax Notes*, June 16, 2003, p. 1663.

[32] *Compare Trent v. Commissioner*, 291 F.2d 669 (1961) (loans made by shareholder to corporation to enable it to continue paying his salary were business debts), *with Kelly v. Patterson*, 331 F.2d 753, 755 (5th Cir. 1964) (loans by shareholder to distressed corporation to protect shareholder's investment were not business debts); *German v. Commissioner*, T.C. Memo. 1999-104 (same); *Eberhart v. Commissioner*, T.C. Memo. 1977-155 (same); *Millsap v. Commissioner*, 387 F.2d 420 (8th Cir. 1968) (same); *cf.* Rev. Rul. 73-460, 1973-2 C.B. 424 (grantor trust did not impermissibly vary its investments by selling an obligation for which (1) the issuer was in default or (2) default in the reasonably foreseeable future was likely).

[33] *E.g.*, *Scottish American Investment Co. v. Commissioner*, 12 T.C. 49 (1949) (collection and transfers of funds, recordkeeping, and preparation of tax returns and periodic reports from within the United States were "routine and clerical functions" that did not give rise to a U.S. trade or business); *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960) (receipt of correspondence and arrangement of payments on behalf of foreign corporation from within the United States "were ministerial and clerical in nature, involving very little exercise of discretion or business judgment necessary to the production of the income in question," and thus did not give rise to a U.S. trade or business); *Linen Thread Co. Ltd. v. Commissioner*, 14 T.C. 725, 737 (1950) (delivery of goods, handling of paperwork, and collection of funds from within the United States did not give rise to a U.S. trade or business).

[34] We use the term "bank" for simplicity.

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provider was not doing business in the name of the third party. For example, in *Whipple*,[35] the Supreme Court held that a taxpayer's active management of a wholly owned corporation from within the United States didn't cause him to be engaged in a trade or business because his economic return "legally arises not from his own trade or business but from that of the corporation."[36] In Rev. Rul. 76-322, 1976-2 C.B. 487, the IRS ruled that a foreign parent corporation's consignment of merchandise to a domestic subsidiary doesn't cause the parent to be engaged in a U.S. trade or business when the subsidiary "sells in its own name to its own customers."[37] And in LTR 9822007 and LTR 9822008, the IRS concluded that syndicate members that acquired loans at initial issuance weren't in a banking business (and could qualify for the portfolio interest exemption) when the loans were negotiated by an international banking institution. Analogously, the tax code explicitly authorizes independent contractors and taxable REIT subsidiaries to perform services that would give rise to impermissible tenant services income if performed directly by a REIT.[38]

Thus, under our reading of the memoranda, a credit fund that acquires loans at initial issuance can claim protection under section 864(b)(2)(A)(ii) by establishing that it isn't a dealer and that someone else (such as a bank) solicited and negotiated the loans in its own name, instead of in the credit fund's name. The memoranda have sown confusion among asset managers and their tax advisers by cautioning against situations that rarely occur in practice, while failing to clarify that the mere acquisition of loans at initial issuance remains a protected activity. As discussed in greater detail in Section IV, by clumsily addressing loan solicitation, negotiation, and acquisition simultaneously, the memoranda have prompted tax advisers to craft tax guidelines for credit funds that are far more restrictive than necessary.

IV. Case Studies

A. Word Choice

Observant readers might notice that, until now, we have scrupulously refrained from using the term "loan origination." Loan origination is nonspecific and generally is understood to include (1) holding oneself out as a lender, (2) negotiating directly with the borrower, (3) bearing the first incidence of economic risk on the loan (for example, by committing to acquire the loan at initial issuance), (4) being a party to the loan agreement, and (5) advancing funds.[39]

Tax lore provides that loan origination is problematic for foreigners. The memoranda vindicate this lore by cautioning that the solicitation, negotiation, and acquisition of loans can be a U.S. trade or business while failing to note that the acquisition of loans at initial issuance, in itself, remains a protected activity. In response, to ensure that their credit fund clients are not engaged in loan origination, tax advisers impose restrictions on engaging in any of its component activities within the United States. These restrictions are overkill if, as we have argued, only the first two activities described above — soliciting and negotiating with borrowers — should ever cause a foreigner to be engaged in a U.S. trade or business.

This section gives several examples of how asset managers' meticulous efforts to avoid loan origination unnecessarily reduces the availability of credit to prospective borrowers.[40]

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[35] *Whipple v. Commissioner*, 373 U.S. 193 (1963).

[36] *Id.* at 202; *see also* reg. section 1.864-3(a), Example 2 (supervising subsidiary corporation from an office in the United States does not give rise to a U.S. trade or business); and *Centel Communications Co. Inc. v. Commissioner*, 92 T.C. 612 (1989) (warrants granted by a corporation to shareholders for guaranteeing the corporation's bank loans were not in connection with performance of services under section 83, even though the bank loans "supplied the capital [that the corporation] needed to turn profitable," because "the business of a corporation . . . is not also the trade or business of the shareholder").

[37] *See also* Rev. Rul. 75-454, 1975-2 C.B. 512 (Swiss insurance company not treated as having a U.S. permanent establishment by reason of the U.S. business activities of its parent and subsidiary).

[38] *See* section 856(d)(7)(C)(i) ("services furnished or rendered, or management or operation provided, through an independent contractor from whom the trust itself does not derive or receive any income or through a taxable REIT subsidiary of such trust shall not be treated as furnished, rendered, or provided by the trust").

[39] *See* AM 2009-010 (activities of "Origination Co." included "the solicitation of U.S. Borrowers" and "the negotiation of the terms of the loans").

[40] For a more detailed discussion of tax guidelines that many funds follow to avoid loan origination, see Jason Schwartz and David Miller, "Collateralized Loan Obligations," Tax Management Portfolio 6585 (2018).

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B. Forward Flow Arrangements

1. In general.

Credit funds commonly enter into forward flow arrangements with third-party lenders. Under a typical forward flow arrangement, the lender agrees to offer all or a portion of its inventory to the credit fund on a periodic basis. The fund can accept or reject the loans, but if it rejects too many loans, the lender usually has the right stop offering them. Often, the fund also is committed to purchase at least some percentage of all loans offered to it over the course of a specified period; some tax advisers call this a "soft commitment."

2. Tax guidelines.

Tax guidelines for forward flow arrangements focus on "breaking agency" between the lender and the credit fund by requiring the lender to bear economic risk on the loans it makes.[41]

If there is a soft commitment, credit funds often contractually limit the percentage of offered loans they can commit to acquire on the theory that the lender couldn't have agreed to make a loan as their agent if there was a meaningful possibility that they would not buy the loan. The amount of this limitation varies widely — some funds commit to purchase only up to 20 percent of loans offered to them, and others as much as 80 percent.

For the same reason, many credit funds require the lender to commit to make a loan before they commit to buy it. When there is no soft commitment, credit funds tend to be comfortable with a 48-hour waiting period that starts either when the lender is committed or when the lender advances funds to the borrower. Some credit funds commit even earlier in those situations, reasoning that a first-in-time commitment, in itself, establishes the lender's assumption of sufficient financial risk to be treated as having made the loan as principal instead of as agent.

When there is a soft commitment, credit funds tend to observe a longer waiting period. Some use 14 days based on the "5-14 representation" given in several leveraged spinoff private letter rulings.[42] Under those rulings, a parent corporation (1) issues debt to the capital markets, (2) contributes assets to a subsidiary in exchange for stock and securities, (3) distributes the stock to its shareholders, (4) engages a financial institution to acquire its debt, and (5) redeems the debt in exchange for securities of the spun-off subsidiary. The private letter rulings respect the financial institution as a creditor when it holds the debt for at least five days before committing to the debt-for-debt exchange and for at least 14 days before effectuating the exchange. However, Rev. Proc. 2018-53, 2018-43 IRB 667, eliminated the 5-14 representation.

Fourteen days isn't universal; some funds observe shorter waiting periods, and others longer. Some funds count days on a loan-by-loan basis, while others apply a rolling average.

Funds sometimes justify a shorter waiting period by including a clause that allows them to terminate their commitment to acquire a particular loan if there has been a material adverse change (MAC) in the condition of the borrower, the loan, or the market between the date of the commitment and the date of the fund's purchase. The "MAC-out" clause is intended to ensure that the lender continues to bear economic risk despite the fund's commitment.

3. Observations.

Loans made by forward flow lenders tend to be highly fungible, and most credit funds would be happy to buy all loans that satisfy their investment criteria. Thus, the parties to forward flow arrangements often automate the tax guidelines described above: A computer program randomly divvies up the lender's inventory among credit funds, and a computer program at each credit fund randomly rejects a specified percentage of loans and commits to acquire the rest. Industry-manufactured waiting periods retard the deal pace by delaying the lender's

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[41] *Compare 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 agent), *cert. denied*, 423 U.S. 926 (1975), *with Rupe Investment Corp. v. Commissioner*, 266 F.2d 624 (5th Cir. 1959) (middleman protected against risk of loss was agent).

[42] LTR 201613008; LTR 201601001; LTR 201308002; LTR 201232014; LTR 201216023; and LTR 200802009. *See generally* Shane Kiggen et al., "Report on Procedural Guidance for Private Letter Rulings on Divisive Reorganizations: Revenue Procedure 2018-53 and Plan of Reorganization Issues," New York State Bar Association Report No. 1436, at 22 n.63 (Mar. 13, 2020).

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ability to access new money, but they don't impose any significant financial risk on the lender if it lines up enough prospective buyers. Anecdotally, even during periods of significant market turmoil, buyers rarely, if ever, activate MAC-out clauses for fear of damaging their relationships.

Under our analysis, forward flow arrangements shouldn't cause a credit fund to be engaged in a U.S. trade or business. Thus, no waiting periods should be necessary. Borrowers apply to the lender (and not the fund) for loans, the fund doesn't interact with the borrowers, and the lender retains a spread that represents an arm's-length determination of the fair market value of its services. Ironically, it is much easier to conclude that a credit fund is a customer of a forward flow lender than to conclude that the underlying borrowers are customers of the credit fund.[43]

The IRS's failure to clarify its analysis in the memoranda merely reduces the availability of loans by increasing deal friction. This is particularly unfortunate given that forward flow lenders frequently serve borrowers who don't have sufficient credit to borrow from commercial banks. The availability of loans for those borrowers should be under the purview of consumer protection statutes and the agencies that enforce them, not the IRS.

C. Season and Sell

1. Vertical seasoning.

Some credit funds organize a U.S. "blocker" subsidiary that they capitalize with debt and equity. The blocker subsidiary solicits, negotiates, and makes loans in its own name, then holds the loans for a "seasoning period" before selling them at FMV to the credit fund. A common vertical seasoning period is 183 days. This is a significant amount of time in other contexts; it's the period that a non-U.S. individual would have to spend in the United States in one year to have a "substantial presence" here, and it's the threshold maturity date for chapter 3 withholding on debt. Some funds use shorter seasoning periods.

During the seasoning period, the U.S. blocker is subject to corporate tax on fees and interest and bears full economic risk on the loan. Credit funds hope that those factors break agency despite the common manager and the blocker's tax-driven purpose.

2. Horizontal seasoning.

Asset managers that have significant commitments from U.S. investors often use horizontal seasoning to break agency. Under horizontal seasoning, a domestic fund with only U.S. investors solicits, negotiates, and makes loans in its own name, then holds each loan for a seasoning period before offering to sell a portion of a loan to a credit fund with foreign investors. An "independent investment professional" acting on behalf of the foreign credit fund has discretion to accept or reject the loan and to negotiate the purchase price. Under the most conservative approaches, one or more third-party investors in the foreign credit fund act as the independent investment professional. Alternatively, the independent investment professional might consist of one or more individuals employed by the asset manager but not involved in negotiating the loans on behalf of the domestic fund, or a third-party valuation firm.

Horizontal seasoning periods vary widely, but common periods are 30 days, 60 days, and 90 days. During the seasoning period, the domestic fund's U.S. taxable investors are subject to tax on fees and interest and bear full economic risk on the loan. Credit funds hope that those factors break agency despite the common manager.

3. Observations.

The analysis for seasoning should be the same as for forward flow arrangements: The purchasing credit fund does not provide personal services because borrowers apply to the seller (that is, the blocker in vertical seasoning, or the domestic fund in horizontal seasoning) for loans, the purchaser doesn't interact with the borrowers, and the seller retains the origination fees and similar fees that represent an arm's-length determination of the FMV of its services. So after the seller makes a loan, it shouldn't have to retain it for any amount of time, let alone 30 to 183 days.

[43] *Cf.* Cassanos, "An Alternative Approach to the Offshore Lender's Dilemma," *Tax Notes*, Jan. 5, 2009, p. 111, 119 (Describing collateralized loan obligation issuers as having a relationship "with the bank, not the borrower. In other words, a CLO does not have customers; it is a customer.").

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Seasoning in a blocker results in a toll charge, unsanctioned by Congress, on income that simply isn't service income. Seasoning in a domestic fund delays the domestic fund's ability to access new money to make new loans. Both strategies hinder the flow of foreign capital into the U.S. market, undermining one of Congress's principal motivations for enacting section 864.[44]

D. Mezzanine Funds

1. In general.

What if the asset manager directly negotiates with borrowers instead of acquiring loans from another lender? This is the situation that mezzanine funds face. Typically, mezz funds buy a limited number of unsecured subordinated loans at initial issuance and simultaneously acquire governance rights, equity, or warrants in the borrowers.

2. Tax guidelines.

Because mezz funds acquire loans at initial issuance, they can't break agency. Instead, mezz fund tax guidelines typically limit the number of loans the fund can make and the frequency with which the fund makes them on the theory that sufficiently sporadic activity does not rise to the level of a trade or business.[45] Also, mezz funds try to structure their loans to look different from bank loans and more like long-term investments in the borrower's overall enterprise on the theory that the management of equity-like investments isn't a lending business.[46] Finally, the asset manager typically retains any origination fees, syndication fees, or similar service fees that it receives for negotiating the loans, although (consistent with private equity fund practice) some investors might negotiate to have those retained amounts offset their management fee expenses.[47]

3. Observations.

When an asset manager negotiates loans that are to be acquired by one or more mezz funds, the asset manager does so in its own name. Even if the mezz funds sign the loan, the borrower's customer relationship is with the manager. No more goodwill inures to the mezz funds from signing the loan at issuance than would have inured to them had they signed it 48 hours — or any other amount of time — later.[48] Moreover, as mentioned above, the asset manager retains any service fees, and those fees represent an arm's-length determination of the FMV of the services. So although the question is inherently factual, asset managers probably don't ordinarily negotiate loans "on behalf of" their mezz funds like INC did for LTD in *InverWorld*.

As in the forward flow and seasoning contexts, one unfortunate consequence of the IRS's lack of clarity in this area is a reduction of available loans to borrowers that commercial banks do not normally serve as mezz funds limit their lending activities to fend off the U.S. trade or business specter.

V. Conclusion

As noted above, tax lore posits that conducting any activities comprising loan origination from within the United States could cause foreigners to be engaged in a U.S. trade or

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[44] *See* Task Force, *supra* note 18 ("Revision of U.S. taxation of foreign investors is one of the most immediate and productive ways to increase the flow of foreign capital to this country."); and Hearing, *supra* note 13, at 29 ("A fundamental and enduring consequence of this revision will be increased interest on the part of foreign persons generally in investment by the United States. This proposed legislation therefore, is one of the important positive elements of our long-range balance of payments effort." (Statement of Henry H. Fowler, secretary of the Treasury)).

[45] *See Neuman de Vegvar v. Commissioner*, 28 T.C. 1055 (1957), *acq.*, 1958-1 C.B. 4, *acq.*, 1958-2 C.B. 5 (between 35 and 199 purchases and between four and 257 sales of stock during each of seven years didn't cause taxpayer to be engaged in a trade or business and subject to U.S. tax); *Liang v. Commissioner*, 23 T.C. 1040 (1955) (similar facts); and LTR 9701006 (partnership that "will originate on average no more than five new mortgages per year over any five-year period" and "will hold mortgage loans that it originates until maturity or refinancing, except in cases of default" isn't engaged in a "financial business" under section 7704).

[46] *See Whipple*, 373 U.S. at 202; *see also Wilson v. United States*, 376 F.2d 280, 293 (Ct. Cl. 1967) ("Managing one's own investments in securities is not the carrying on of a trade or business, irrespective of the extent of the investments or the amount of time required to perform the managerial functions."); *Continental Trading Inc. v. Commissioner*, T.C. Memo. 1957-164 ("merely servicing . . . investments in this country" does not cause an investor to be engaged in a trade or business); and LTR 9701006.

[47] Let's leave for another day the question of how fee offsets should be treated.

[48] *Cf.* GCM 38456 (July 25, 1980) (a trust did not engage in a lending business by acquiring loans at initial issuance because "if the trustee elects to invest in mortgage loans, it should make no difference whether he buys existing mortgages or makes new loans").

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business. We offer an alternative view, under which acquiring loans at initial issuance shouldn't cause a foreigner to be engaged in a U.S. trade or business unless, possibly, the foreigner renders personal services by soliciting or negotiating with the borrower or by having an agent solicit or negotiate with the borrower in their name. We believe that explicitly adopting this alternative view would be consistent with congressional intent and sound tax policy and would make credit more readily available to borrowers that cannot access it through commercial banks.

It arguably is unfair to lay all the blame at the IRS's feet, but the memoranda are not models of clarity. Asset managers can be forgiven for refusing to navigate muddy waters while holding their clients' money.

The IRS should issue guidance confirming our analysis. One straightforward way to do this would be to issue a revenue ruling concluding that a foreign corporation is not engaged in a U.S. trade or business even though its employees, while physically located within the United States, regularly (1) enter into commitments with domestic lenders to join a lending syndicate, (2) execute credit agreements, and (3) authorize funds to be advanced to borrowers, as long as no one solicits or negotiates with the borrowers in the foreign corporation's name. ■

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