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New IRS Audit Campaign Targets Credit Fund Loan Origination

Key Issues for Funds & Non-US Taxpayers

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Today's Speakers

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Mark is a tax partner at the law firm of Mayer Brown. Mark's professional practice focuses on the tax consequences of a variety of capital markets products and strategies, including over-the-counter derivative transactions, swaps, tax-exempt derivatives and working with credit funds, offshore insurance companies and hedge funds. Prior to joining Mayer Brown, Mark was a partner at another International law firm, served as a Managing Director at Deutsche Bank, general counsel of a credit derivative company and, prior to that, Mark was a partner at Deloitte, where he led the Capital Markets Tax Practice. Mark began his legal practice at Skadden Arps and then at Weil Gotshal.

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Russell Nance's practice covers a wide range of federal income tax related matters. As a partner in our New York office, he focuses primarily on structured finance transactions and financial products. In addition, he has extensive experience representing clients in public and private, taxable and nontaxable M&A transactions. In particular, Russell has represented sponsors, managers, and underwriters in collateralized bond, loan, and debt obligation transactions and issuers and underwriters in various asset-backed and insurance related transactions, including mortgage-backed CP conduits; credit card, auto loan, and life insurance securitizations; full company securitizations; and catastrophe "sidecar" transactions. He also frequently advises on the issuance of equity-linked notes, swap transactions, and other derivative instruments.

What's Going on in the Private Loan Market?

- Regulatory considerations have substantially reduced the appetite of regulated financial institutions, such as banks, for originating and holding loans
  - Corporate loans
  - Loans to subprime lenders, who the lend out the capital in retail transactions
- Private credit funds and CLOs have become significant participants in originating, servicing and holding loans
- Non-US investors have become a regular source of capital for the private credit funds and CLOs to fund loans
- Non-US investors are subject to tax in their home jurisdictions (or not), and do not desire to incur US tax on their share of the income earned by the credit funds in which they invest

Overview of Statutory Scheme

US Trade or Business Activities of Non-US Persons

- A non-US person is subject to tax on its income that is effectively connected with the conduct of a US trade or business under rules that are substantially similar to those applicable to a US person
  - Treas. Reg. § 1.882-5
  - Imputation of agent activities
- Lending money on a regular and continuous basis in the US will be treated as the conduct of a US trade or business
- Buying loans in secondary and tertiary market transactions should not be treated as trade or business activities

Overview of Portfolio Interest Rules

- Interest on "straight" debt held by a non-US person (directly or through an entity taxable as a partnership generally qualifies as portfolio interest.
  - Certain contingent interest is not portfolio interest
  - Interest paid to a 10% shareholder is not portfolio interest
  - Interest paid to a bank pursuant to an ordinary course of business loan agreement is not portfolio interest
- Portfolio interest in the hands of a non-US person not earned in connection with the conduct of a US trade or business is not subject to US federal income tax.
- Interest earned in connection with the conduct of a US trade or business (directly or through a partnership) is subject to net US federal income under a tax scheme that generally follows the rules for US taxpayers.

Trading for One's Own Account Safe-Harbor

- US tax rules treat traders in securities as being engaged in the conduct of a trade or business.
- Securities include all forms of debt instruments
- Code § 864(b)(2) overrides the general rule for non-US persons who trade securities (directly or through a partnership) and exempt trading gains from being considered income effectively connected to the conduct of a US trade or business.
  - Trading may be conducted from within the US and still not be treated as a trade or business for non-US persons.

Activities of Agents

- Authorities attribute activities of agents to the foreign person, when this imputation will occur is uncertain.
- If the agent is an independent agent, it is less likely that the agent's activities will be imputed to the non-US principal.
  - There have been instances in which the Internal Revenue Service has been successful in imputing an independent agent's activities to a principal. De Amodio v. Comm'r, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3rd Cir. 1962).
- If the agent is a dependent agent, its activities will be imputed to the non-US principal.

Investment Activities Are Not a Trade or Business

- Management of investments in the US is not a USTB even though it may involve substantial time and activity.
- Little direct authority addresses loan origination activity.
- Making a single loan is not a USTB.
- The analysis turns on factors such as:
  - the number and frequency of loans
  - time and effort devoted to lending activities
  - whether the loans are made to customers
  - whether the taxpayer advertises, solicits business, has a reputation as a lender
  - whether the taxpayer provides services.

Authorities on Distinguishing Loan Originations from Secondary Market Activity

Some Authorities Addressing When a Person is in the Money Lending Business

- FSA 199911003. Additional factors distinguishing investment from trade or business activity:
  - whether taxpayer held itself out to the public to be in the money lending business,
  - whether the taxpayer advertised its loan services,
  - whether taxpayer had a reputation in the community for making loans,
  - the amount of income the taxpayer derived from its money lending activities, and
  - whether the taxpayer indicated that it was in the money lending business on its tax return.
- In FSA 199911003, the taxpayer's lending business encompassed the purchase of notes from third parties, as well as direct loans.

A Lender Has Continuity and Regularity to the Lending Activities

- **Higgins**, 312 US 212 (1941). Loans of large amounts of money, occasionally made, is not a trade or business.
- **Eberhart**, TC Mem. 1977-155. Isolated loans, even coupled with record maintenance, is not a trade or business.
- **Mayo**, TC Mem. 1957-9. Lending to a number of businesses not a trade or business where lending lacked continuity and frequency.
- **Hudson**, 31 TC 574 (1958). Lending attendant to stock investing shows investment motive, not a trade or business of lending.
- **Serot**, TC Mem.1994-532. 55 loans over 10 years, devotion of 40-50 hrs per week on lending and absence of relationships to borrowers established trade or business. Txp. Did not advertise.

Recent IRS Guidance

- Two non-binding authorities issued to date:
  - Generic Legal Advice Memorandum 2009-010 (Sept. 22, 2009) (the "GLAM")
  - Internal Legal Memorandum 201501013 (Sept. 5, 2014) (the "ILM")
- In the GLAM, the IRS determined that a foreign corporation was engaged in a USTB and recognized ECI as a result of lending activities (solicitation, due diligence, and negotiation with borrowers) attributed to the foreign corporation through an independent agent in the U.S.
- In the ILM, the IRS concluded that a foreign fund engaged in "lending" and "underwriting" activities that constituted a USTB not covered by the trading safe harbors.

AM 2009-010

- FC is not resident in a treaty country.
- US Corp. originates US loans pursuant to a service agreement. Services include solicitation of borrowers, negotiation of loan terms, credit analysis & other functions, but not final approval & signing of loan documentation.
- US Corp. performs these activities on a considerable, continuous & regular basis in the US.
- FC pays an arm's length fee to US Corp.
- US Corp. may not conclude contracts on behalf of FC.

AM 2009-010 Analysis of the Trade or Business Issue

- IRS concludes that relationship with US Corp. causes FC to be engaged in the conduct of a trade or business in the US.
- US Corp.'s activities are a component of FC's lending activities. These activities are "considerable, continuous & regular."
- US Corp. is only nominally an independent agent.
- IRS disavows Treasury Regulation § 1.864-7(d)(2) which does not attribute the activities of an independent agent to a principal.
- IRS limits exclusion for agent activities to ministerial and clerical activities. (But ministerial & clerical activities should constitute trade or business activities in any event.)

AM 2009-010 Analysis of the Trading Safe-Harbor in Code § 864(b)(2)

- Lending is not trading, so Code § 864(b)(2) safe-harbor is inapplicable.
- FC is engaged in a banking or financing business within the US. It is making loans to the public.
- This trade or business test requires that FC maintain an office in the US. The IRS strains to hold that US Corp.'s office should be attributed to FC.
- Interest income received by FC is trade or business income, even though US Corp. is an independent agent as to FC.

ILM Background

- The ILM involved a foreign hedge fund investing in “PIPE” transactions including promissory notes, convertible debt, warrants and common stock.
- The fund purchased convertible debt and notes with warrants.
- The ILM says that the issuers also paid commitment, structuring and due diligence fees to the fund.
- The fund manager spent extensive time engaging in negotiation, due diligence, soliciting, sourcing and originating these transactions.

ILM Analysis of the Trade or Business Issue

- The IRS concluded that the fund's "lending" and "underwriting" activities were a USTB that did not constitute "trading in stocks and securities" for purposes of the section 864(b)(2)(A) safe harbors.
  - The IRS looked to Treas. Reg. §1.864-4(c)(5)(i)(b) and section 166 factors to determine whether loan origination was a USTB.
  - The IRS indicated the fund primarily looked to profit from earning fees, a spread and interest payments.
- The IRS alternatively concluded that even if the fund's activities did constitute "trading in stocks and securities," the fund did not qualify for the first safe harbor because its manager was not an independent agent and did not qualify for the second safe harbor because the fund's "underwriting" activities made it a dealer.
- The taxpayer has filed a petition challenging IRS notices of deficiency, and the case is currently pending in the U.S. Tax Court.

Guidelines Used by Funds with Non-US Taxpayers to Prevent Secondary Market Activity from Being Treated as Lending

Guidelines for Loan Acquisitions

- Minimum waiting period (e.g., 24-48 hours) following original lender's funding/ commitment before foreign person purchases, or commits to purchase (e.g., pursuant to a forward commitment), the loan.
- Special rules for loans that require later fundings and revolving loans
- Risks inherent in "vertical structures," in which the loan purchaser owns the loan originator
- No significant negotiation or other communication with borrower or lender.
- No fees should be payable to the loan purchaser (directly or through pricing)
- No relationship with original lender; offshore fund should not provide capital to the originator.
  - Additional restrictions apply if loans are originated by affiliates ("season and sell") in order to preclude agency attribution.

Guidelines for Loan Acquisitions

- Originator sells participations to a significant number of investors (not selling the entire position to one off-shore fund).
- Originator has the ability hold the loan on its balance sheet.
- Price at which loan is sold reflects fair market value; sales do not occur at par value.
- Broad offering of loan participations.
- Distressed at purchase transactions
- Rules for loan extensions and amendments
  - Do substantial modifications constitute loan originations?
  - Do extensions constitute origination activities (roll-overs)?
  - Work-out considerations

The IRS Adds Offshore Lending to its Audit Campaign

The IRS Adds Offshore Lending to Audit Campaign

- On June 10, 2021, the IRS added the acquisition of loans by non-US persons to its audit campaign stating:
  - This campaign addresses whether foreign investors were subject to U.S. tax on effectively connected income from lending transactions engaged in through a U.S. trade or business. In general, foreign investors who only trade stocks and securities for their own account are not engaged in a U.S. trade or business under the safe harbor rule set forth in 26 USC 864(b)(2). The safe harbor rule, however, is not available to dealers in stocks or securities, or to entities engaged in a lending business, or to foreign investors in partnerships engaged in such activities.

What We Know About the Campaign So Far

- IRS has stated that the USTB issue for credit funds is “an admitted agency blind spot.” – Cindy Kim (LB&I Attorney)
- Campaign is exploratory.
- IRS is reviewing tax returns “to decide which ones will be audited.”
- Training of audit personnel to begin this autumn.
- IRS wants to see what standards are being used by taxpayers.
- IRS may seek input from tax practitioners

IRS Audit Campaigns

- IRS introduced audit "campaigns" in January 2017 as an alternative approach to "traditional" IRS audits
- **Purpose.** IRS budget reductions and attrition resulted in it having to focus its enforcement efforts on particular issues with risk of noncompliance
- **Selection.** Each "campaign" targets a particular tax issue
- **Procedures**. Treatment streams vary depending on the campaign issue, but could include issue-based examinations, soft letters, and outreach
  - Soft letters are sent to taxpayers to encourage voluntary compliance, but are not technically an IRS audit (although they signal an audit may be coming)
- **Statute of Limitations** (same as traditional audit)

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How We Can Help Clients Prepare for IRS Scrutiny

Proactive Steps to Prepare for an IRS Audit

- Review Guidelines and update to reflect current best practices
- Consider the filing of protective returns for non-US taxpayers to start running of statute of limitations
  - Form 1065
  - Form 8804
  - Form 1040-NR/1120-F
- Consider Treasury Regulation § 1.882-4 – deductions are permitted only if a tax return is timely filed (but see 18-month and good faith rules).
  - Voluntary compliance program

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