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YA GLOBAL V. COMM'R: UNDERSTANDING ITS IMPLICATIONS FOR CREDIT FUNDS & SECURITIZATION VEHICLES

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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 worked at Weil Gotshal.

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Matthew serves as chair of the annual Practicing Law Institute program "Taxation of Financial Products and Transactions." He has served as chair of the Financial Transactions Committee of the Tax Section of the District of Columbia Bar, and as the chair of the Financial Transactions Committee of the Tax Section of the American Bar Association. He has co-taught the Georgetown University Law Center class entitled "United States Taxation of International Income – II." He has published a number of articles dealing with international aspects of U.S. income tax and with the taxation of financial products and transactions. Matthew is listed in Chambers USA: America's Leading Lawyers for Business. From 2002 to 2004, Matthew served as special counsel to the Chief Counsel for the Internal Revenue Service. There, he advised the Chief Counsel regarding published guidance on a wide range of tax issues involving financial products and cross border transactions.

Background: Overview of Applicable Tax Rules

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
- Trading securities on a regular and continuous basis in the US is treated as the conduct of a US trade or business
- Securities include all forms of debt instruments
- Code § 864(b)(2), however, provides that the conduct of such trade or business (whether conducted directly or through a partnership) does not result in net US federal income tax for non-US persons
- Code § 1446 requires a partnership (even if foreign) to withhold on effectively connected income (ECI) allocated to non-US partners

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.**
- **Merchant banking rises above investment activities**
- **The analysis turns on factors such as:**
  - **Whether services are provided to customers**
  - **time and effort devoted to lending and banking activities**
  - **Whether fees are charged to securities issuers**
  - **Whether the securities are purchased from issuers or in secondary market transactions**
  - **whether capital is directly provided to customers**
  - **whether the taxpayer advertises, solicits business, has a reputation as a capital provider**

Activities of Agents

- **Authorities attribute activities of agents to the foreign principals, but 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.**

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.**

The Facts of *YA Global*

YA Global: Background

- **4 tax years at issue: 2006, 2007, 2008 & 2009**
- **YA Global was a Cayman Islands company taxable as a partnership for US tax purposes**
- **Yorkville Advisors, a US partnership, served as the sole general partner of YA Global & its investment manager**
- **YA Global had the right to impose investment restrictions on Yorkville's activities undertaken on behalf of YA Global**
- **YA Global had no employees and acted solely through Yorkville**

YA Global: Off-Shore Investor Structure

- **YA Global had a several non-US limited partners, but YA Offshore was the largest investor**
- **YA Offshore was treated as a corporation for US tax purposes**
- **YA Offshore was a typical offshore feeder into which the non-US investors invested their money.**
- **YA Offshore contributed the capital contributions that it received to YA Global**
- **YA Offshore had substantial expenses ($12 million in 2007 & $22 million in 2008)**

YA Global: Activities

- **YA Global provided capital directly to microcap and low-priced public companies in the OTC public markets through "standby equity distribution agreements" ("SEDAs"), convertible securities & straight debt**
- **SEDAs & converts allowed YA Global to purchase securities at a discounted price (PIPES: public issuers, private equity securities)**
- **YA Global and/or Yorkville frequently received fees for capital structuring**
- **When Yorkville received fees in excess of its costs, such fees triggered a management fee offset provision in the YA Global partnership agreement or had to be remitted to YA Global. But in practice, fees did not exceed expenses by much**

YA Global Activities (Continued)

- When YA Global purchased securities under the SEDAs or exercised its conversion rights, it frequently did so in order to sell the equity securities that it received
- Investment horizon was usually 12 to 24 months
- Fees paid to Yorkville were for due diligence, structuring and providing commitments to make capital contributions and/or loans
- Yorkville received $33.4 million in 2006, $25.3 million in 2007 & $29.6 million in 2008
- 25 SEDA transactions in 2006, 19 in 2007 & 9 in 2008
- 202 convert deals in 2006, 116 in 2007 & 111 in 2008

Yorkville Advisors: Activities on Behalf of YA Global

- **Yorkville received market standard 2% fee/20% carried interest from YA Global**
- **Yorkville employed over 50 employees in each year**
- **Yorkville paid over $15 million in salaries**
- **Yorkville "devoted most of its activities to YA Global" in each year**
- **Yorkville's work on behalf of 3 other funds was *de minimis***

YA Global: Tax Reporting, IRS Audit & Issues Presented

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YA Global's Tax Reporting

- **YA Global filed a US Internal Revenue Service Form 1065 in each year**
- **YA Global did not treat any income it earned as ECI**
- **Income was treated as portfolio interest or non-taxable capital gains**
- **YA Global used accrual accounting & did not designate any securities as held for investment**
- **YA Global did not file IRS Forms 8804 because it took the position that it did not have ECI to allocate to non-US partners**

CCA 201501013: The IRS Audit

- **YA Global was audited & in 2015, the IRS released a Chief Counsel Memo stating its views**
- **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 trading safe harbor because its manager was not an independent agent and because the fund's "underwriting" activities made it a dealer.**

The Tax Court Addressed 7 Separate Tax Issues

- **Should Yorkville's activities be imputed to YA Global?**
- **Did Yorkville's activities cause YA Global to be engaged in a USTB?**
- **Was YA Global a dealer in securities required to use mark-to-market accounting under Code § 475?**
- **What income should be considered to be effectively connected with YA Global's USTB?**
- **Should YA Global's liability for purposes of § 1446 be adjusted by partner-level expenses?**
- **What is the statute of limitations on assessment?**
- **Should YA Global be subject to penalties for failure to file Forms 8804?**

Issue 1: The Agency Issue

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The Imputation of Yorkville's Activities to YA Global

- **Discussion is premised on conclusion that if Yorkville is an independent contractor, YA Global would not be attributed with Yorkville's activities and YA Global would not be considered to be engaged in a USTB**
- **Investment management agreement (IMA) specifically referred to Yorkville as YA Global's agent**
- **YA Global retained the right to specify investment restrictions**

The Agency Discussion

- **Court undertook analysis using general principles of agency law**
- **Activities of an agent will be imputed to its principal**
- **A service provider will be treated as an agent if service recipient can provide interim instructions**
- **Conversely, a service provider will not be treated as an agent if service recipient cannot give interim instructions**
- **Court held that YA Global retained the right to provide interim instructions to Yorkville after notice**
- **The fact that Yorkville's rights were "coupled with an interest" did not mean that Yorkville had unfettered right to act**

Implications of Agency Discussion

- **No mention in this discussion of Treasury Regulation § 1.864-7(d):**
  - **the office or other fixed place of business of a dependent agent is attributed to the principal if the agent has the authority to negotiate and conclude contracts in the name of the nonresident alien individual or foreign corporation, and regularly exercises that authority**
- **Does the holding open up the possibility of structuring management arrangements as independent contractor relationships?**

Issue 2: The US Trade or Business Issue

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Facts the Court Found Relevant to the USTB Issue

- SEDAs & converts provided YA Global with the right to buy stock at a discount to FMV
- Yorkville received fees for capital structuring services
- YA Global PPM called fees payable to YA as “banker’s fees” (YA clients testified that no services were provided)
- YA Global received compensatory warrants
- SEDAs and converts not exercised until YA Global was ready to sell
- Yorkville was heavily involved in negotiating transactions

Parties' Position on the USTB Issue

- **Court recognized that investment activities are not USTBs**
  - **Court found justification for rule to be "unclear"**
  - ***Higgins* did not establish a standard for what level of activity caused securities activities to rise above investment activity**
- **IRS argued YA Global was both a lender and an underwriter, resulting the conduct of a fee-for-services business**
- **Trading seeks to profit from the change in value of securities**
- **YA Global argued that FMV discounts in SEDAs should be treated as premiums for put options**

Tax Court Analysis of the USTB Issue

- **Court disaggregated question into 3 sub-questions:**
  - **1. Were activities regular and continuous and engaged in for the primary purpose of earning a profit?**
  - **2. Did the investment exception apply?**
  - **3. Did the Code § 864(b)(2) trading safe-harbor apply?**
- **Q1 answered itself in the affirmative**
- **Q2 was challenged by the receipt of fees even when capital had not been put at risk & the fact that fees were paid to Yorkville (who did not put capital at risk).**
- **Court found that Yorkville services had value to portfolio companies**

Tax Court Distinguishes Merchant Banking from Investing

- **Investors purchase outstanding securities**
- **Investors do not deal directly with the companies in which they invest**
- **The benefit from an investor's purchase to the issuer is negligible**
- **An issuer does not receive capital from an investor's purchase of securities**
- **Merchant bankers arrange and structure the transactions**

Tax Court Did Not Discuss the Bad Debt (Promoter) Authorities

- **Code § 166 distinguishes business bad debts from non-business bad debts**
- **Losses on business bad debts are ordinary and losses on non-business bad debts are capital**
- **Case law addresses when a taxpayer is a "promotor" so that his losses are treated as business bad debts**
- ***Giblin v. Comm'r*, the taxpayer, an attorney, devoted at least 50% of his working time to the development of at least eleven separate business ventures over a 20-year period. Taxpayer treated as promoter**

More on the Bad Debt (Promoter) Authorities

- ***Newman v. Commissioner*** **sets forth the requirements for promoter status:**

(1) compensation sought is other than the normal investor's return, and income received is the direct product of the taxpayer's services and not primarily from the deployment of capital;

(2) the activity is conducted for a fee or commission or with the immediate purpose of selling the securities at a profit in the ordinary course of the taxpayer's business; and

(3) the taxpayer had a reputation in the community for promoting, organizing, financing and selling businesses.

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 limits exclusion for agent activities to ministerial and clerical activities. (But ministerial & clerical activities should not constitute trade or business activities in any event.)**

Issue 3: The Mark-to-Market Issue

Overview of the Mark-to-Market Rules

- **Mark-to-market accounting results in all gains and losses being ordinary in character**
  - **The rate benefit of long-term capital gains to non-corporate taxpayers is lost**
- **Gains and losses are accelerated relative to accrual accounting**
- **Code § 475 mandates the use of mark-to-market accounting for dealers in securities and allows traders in securities to elect to use such accounting**
- **Code § 475(c)(1) defines a dealer as a person who buys from OR sells to customers (statute does not require customers on both sides of a transaction**

The Tax Court Holds YA Global is a Securities Dealer

- YA Global promotional materials stressed that firm's market reputation enabled it to work directly with securities issuers
- The Tax Court held that the portfolio companies from whom YA Global purchased securities were customers of YA Global
- YA Global was "willing and able" to provide capital to portfolio companies
- Although the SEDAs and other securities purchase agreements contained investment intent language, none of these agreements referenced Code § 475 (as required by IRS regulation)

The Code § 475 Conclusion Is Counterintuitive

- **The Tax Court's analysis on the USTB issue supports the conclusion that YA Global was a promoter, not a dealer in securities**
- **One would expect that purchasing securities from a customer means that the "dealer" is purchasing outstanding securities, not originating transactions**
- **A factor seems more likely to be treated as a dealer than a merchant banker, using buying as the sole criteria**

Issue 4: The Determination of What Income Should Be Treated as ECI

The Code § 1446 Withholding Obligation

- YA Global was liable to withhold on ECI allocated to the non-US limited partner/feeder under Code § 1446
- ECI is determined under an "asset use" test and the "material factor" test
  - Is the asset used in the conduct of a US trade or business?
  - Was the USTB a material factor in the earning of income from the asset?
  - Special rules apply to interest & dividends arising from securities held in a banking or financing business
- Special rules focus on the activities performed by a US office in originating the securities, complemented by the Code § 865 office rule
- Code § 865(i)(5) generally looks to the partner level to determine whether there is a US office but Treas. Reg. § 1.1446-2(a) determines withholdable ECI at the partnership level
- The US office of a dependent agent is attributed to the non-US principal

The Parties' Position on the ECI Items

- **IRS asserted that all income, including gain from the disposition of positions was ECI**
- **Court recites that the taxpayer did not provide an analysis as to whether any income and gains could be excluded from ECI**
- **If Yorkville was an independent agent, then foreign-source income (including capital gains) would not be ECI. Code § 864(c)(4)(B)**
- **Because Yorkville devoted virtually of its efforts towards the management of YA Global, the court held that Yorkville was a dependent agent & its office was attributed to YA Global**

The Court's Analysis of the Source of Income

- **Since the income was recognized under mark-to-market rules, Code § 64 denies capital asset status to the securities held by YA Global**
- **Code § 864(c)(3) other income rule treats income not specified encompassed by personal property dispositions as ECI**
- **Court was not required to determine whether special banking rules applied**
- **If Taxpayer had briefed a deeper dive into the ECI rules, it might have a basis for excluding certain interest, dividends and gains from its ECI amount**

Banking ECI Rules: A Missed Opportunity?

- **Taxpayers engaged in "banking, financing or [a] similar business" use special ECI rules under Treas. Reg. § 1.864-4(c)(5).**
- **These rules limit the amount of income that is treated as ECI**
- **Dividends received on stock are treated as stock only if derived in connection with distributing securities to the "public"**
- **The portfolio companies may not have been treated as the public, but this argument was not briefed by the taxpayer**

Issue 5: Should YA Global's withholding tax liability be reduced by partner-level expenses?

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YA Offshore Had Directly Incurred Expenses

- **YA Global argued its withholding tax liability should be reduced by the expenses incurred by YA Offshore**
- **Regulations allow a partnership's Code § 1446 withholding tax liability to be reduced by partner-level expenses to the extent the partners certify those expense to the partnership under Treasury Regulation § 1.1446-6, but YA Global conceded that no such certification was provided.**
- **YA Global argued that such expenses should be taken into account under Code § 1464 "as a back-door means of giving effect to [the foreign feeder's] non-partnership deductions despite [the feeder's] failure to have certified those deductions."**

The Code § 1446 Withholding Obligation

- **Code § 1464 provides that "Where there has been an overpayment of tax under this chapter, any refund or credit made under Chapter 65 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent."**
- **The Tax Court held that there would be no "overpayment" by the amount of the partner-level deductions, because the partnership's liability for withholding tax (as distinguished from the final tax liability of the partners) had to be computed without such deductions.**

Looking Forward: Mitigants to Code § 1446 Withholding

- **Limited partners can certify deductions**
- **Foreign partnership partners can certify US and non-US partners (look through certification)**
- **Protective return filing by off-shore feeders**

Issue 6: What is the statute of limitations on assessment of the tax imposed by § 1446?

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2006 & 2007 Statute of Limitations

- YA Global asserted that assessments for 2006 & 2007 were time barred by the statute of limitations
- At issue was whether IRS Form 1065 (which were filed) starts the statute of limitations or whether IRS form 8804 (which were not filed) starts the statute of limitations
- IRS Form 1065 is the partnership income tax return
- IRS Form 8804 shows the amount of ECI withheld on allocations to non-US partners

Statute of Limitations

- **The Court held that the Forms 1065 were insufficient to advise the IRS of the partnership's withholding tax liability.**
- **YA Global "implicitly denied that it was engaged in a trade or business by reporting no ordinary business income on its Forms 1065."**
- **Tax Court stated in dicta that a taxpayer might be able to start the running of the period of limitations by filing a Form 8804 showing zero liability, with a factual explanation.**
- **Execution of the Forms 872-P was sufficient to extent the period of limitations, because the tax imposed by section 1446 was an "income tax."**

Issue 7: Should YA Global be subject to penalties for failure to file Forms 8804?

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Penalties for Failure to File Forms 8804

- **Code § 6651 imposes an addition to tax for the failure to file certain returns.**
- **The Forms 1065 filed by YA Global did not meet the requirement of a "return."**
- **YA Global did not have reasonable cause for its failure to file the Forms 8804.**
    - **Law firm did not conclude that YA Global was not engaged in a trade or business.**
    - **Accounting firm did reach this conclusion, but YA Global sued the accounting firm in 2015, and did not establish when it became aware of the facts supporting the law suit.**

Disclaimer

- **These materials are provided by the presenters, do not necessarily reflect the views of their respective firms and reflect information as of the date of presentation.**
- **The contents are intended to provide a general guide to the subject matter only and should not be treated as a substitute for specific advice concerning individual situations.**
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