

## Season and Sweat? The IRS Adds Offshore Credit Funds to Their Active Audit Campaign

By Mark Leeds<sup>1</sup>

Tax advisors working with credit funds know that sometimes the line between a fund that is an investor in financial instruments and one that is considered to be engaged in the trade or business of originating loans can be pretty hazy. But this line has significant consequences for non-US investors in these funds. If the fund is an investor (or trader) in financial instruments, the interest on the loans held by the fund may qualify for the portfolio interest exemption and the gains from the dispositions of such instruments will generally not be subject to US federal income tax for non-US investors.<sup>2</sup> On the other hand, if the credit fund is engaged in the conduct of a US trade or business, all of the income and gains that are considered to be effectively connected to the conduct of such trade or business will generally be subject to net US federal income tax.<sup>3</sup>

Certain credit funds taxable as partnerships regularly purchase loans originated by companies that are related (through ownership) to the funds themselves or to the general partners managing such funds. Other credit funds purchase loans shortly after the loans have been originated by third parties. Offshore insurance companies sometimes face similar issues with respect to loans acquired as reserve assets. Concomitantly, stock trading funds that could be considered dealers in securities face a parallel risk.

In each of these cases, an issue arises as to whether the loan origination activities should be imputed to the credit fund that has purchased such loan.<sup>4</sup> In order to manage this risk, savvy credit funds adopt and adhere to guidelines that are intended to ensure that the fund itself is not considered to be the loan originator. Some of these guidelines include not making commitments or loans to the loan originator, waiting a reasonable time after the loan has been originated before it is purchased by the fund, not benefiting from loan origination fees and/or ensuring that the loan originator sells loans to more persons than just the credit fund. Generically, these guidelines are referred to as "season and sell" rules.

The IRS has had its eye on these transactions for some time.<sup>5</sup> On June 10, 2021, the IRS added the loan origination issue to its Large Business and International ("LB&I") Active Campaigns. In other cases, the IRS has heralded the addition of issues to these campaigns. In this case, however, the addition of this issue received virtually no fanfare and (to date) has been covered as a single line item in the tax press. Although the rollout was inconspicuous, its consequences are likely to be far-reaching.

The launch of a campaign is the culmination of an extensive effort to redefine IRS compliance work and build a supportive infrastructure. The campaign program allows LB&I to address significant compliance and resource challenges. Campaign development coordinates strategic IRS planning and deployment of resources, training and tools, metrics and feedback. Settlements with taxpayers on

issues that are the subjects of IRS audit campaigns often require the approval of the IRS National Office. This rule makes settlement of those issues included in the campaign significantly more difficult.

Credit funds facing the issue as to whether their loan acquisition activities constitute the conduct of a US trade or business may wish to review their existing policies in light of the enhanced audit risk posed by the fact that the IRS has added this issue to its audit campaign. This change in audit posture may also serve as a catalyst for reviewing loan acquisition activities conducted in prior years. The IRS has certainly turned up the heat with this announcement, even if it was a stealthy move.

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*For more information about the topics raised in this Legal Update, please contact the following lawyer.*

**Mark Leeds**

+1 212 506 2499

[mleeds@mayerbrown.com](mailto:mleeds@mayerbrown.com)

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## Endnotes

- <sup>1</sup> Mark Leeds ([mleeds@mayerbrown.com](mailto:mleeds@mayerbrown.com); (212) 506-2499) is a tax lawyer with the New York office of Mayer Brown. Mark's professional practice includes substantial work with offshore credit funds and hedge funds. Mark extends his thanks to Joon Beom Pae ([jpae@mayerbrown.com](mailto:jpae@mayerbrown.com); (212) 506-2194) for his comments and suggestions. Mistakes and omissions, however, remain the sole responsibility of the author.
- <sup>2</sup> See Section 864(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code") (neither trading nor investing in debt instruments is treated as the conduct of a US trade or business); Code § 871(h) (portfolio interest is not subject to US gross basis taxation).
- <sup>3</sup> Code § 871(b) (rules for non-US individuals); Code § 882 (rules for non-US corporations).
- <sup>4</sup> See Internal Revenue Service ("IRS") Advice Memorandum 2009-010 (Sept. 23, 2009). For stock trading funds, the issue is whether they are trading securities or acting as a dealer in securities.
- <sup>5</sup> *Id.*

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