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Client Alert

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IRS RULING GUIDANCE ON LENDING ACTIVITIES OF FOREIGN ENTITIES IS A “SHOT ACROSS THE BOW”

On Wednesday, September 22, 2009, the Office of Chief Counsel of the Internal Revenue Service issued an internal memorandum encouraging auditors to focus on lending activities conducted by offshore entities that may give rise to a taxable U.S. trade or business.

The memorandum addresses a particular factual situation involving a foreign corporation (“Foreign Corp”) that regularly and systematically makes loans to U.S. borrowers. The origination of such U.S. loans is not carried out directly by Foreign Corp. Instead, Foreign Corp outsources the origination activity to a U.S. corporation (“U.S. Corp”). U.S. Corp conducts all of these activities for Foreign Corp in the United States and earns an arms-length fee for its services. In particular, U.S. Corp solicits U.S. borrowers and carries out all activities relating to the origination of the loans, other than approving the investment and signing the loan contracts on behalf of Foreign Corp; approval and execution of the loan is carried out by employees of Foreign Corp outside the United States.

The memorandum concludes that U.S. Corp’s activities in the United States are conducted on behalf of Foreign Corp, i.e., as an agent of Foreign Corp, and as a component of Foreign Corp’s lending business. The memorandum further concludes that U.S. Corp’s activities in the U.S. can be attributed to Foreign Corp. As a result, Foreign Corp’s income is connected to a U.S. trade or business and taxable by the United States at regular corporate rates. The memorandum specifically rejects the argument that such U.S. activities cannot be attributed to Foreign Corp if the U.S. service provider is an independent contractor and is not authorized to enter into contracts on behalf of the foreign entity. The memorandum cites various authorities that support this position but neglects certain other authorities that could support a contrary view.

Whether activities related to the acquisition of U.S. loans constitutes a taxable U.S. trade or business is an issue of significant concern to CLOs, hedge funds, and other foreign investors, which generally seek to characterize their activities involving loans or other debt as non-taxable passive investment or securities trading. The result reached on the specific, rather simplified factual situation in the memorandum is not entirely surprising given the mixed legal authority addressing the issue and the fact Foreign Corp simply “outsourced” origination activity it would likely have conducted directly absent tax considerations. However, few offshore funds likely present such a transparent factual pattern.

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The broader import of the memorandum is less than clear. In part because the IRS made the memorandum public immediately after issuing it, instead of allowing the memorandum to surface in due course pursuant to standing Freedom of Information Act requests, we view the memorandum to some degree as a “shot across the bow,” intended to deter foreign funds from taking particularly aggressive positions that tax nexus is lacking with regard to loan origination activities.

Significantly, the memorandum also notes that foreign funds and foreign investors often use other strategies to originate loans in the United States and, somewhat unusually, directs auditors to develop cases against such strategies. Read broadly, the logic of the memorandum conceivably could extend to standard syndicated lending and origination practices. For example, it is fairly typical for loans to be originated by an administrative agent who then syndicates the funded loan to funds and other lenders shortly after closing. If this origination were deemed to be conducted on behalf of the purchasers in an agency capacity (rather than being viewed as a secondary market sale of these loans), the same result reached by the memorandum might apply. Possibly, the memorandum prefigures a more general assault on practices in the syndicated loan market. It is also unclear what, if anything, the memorandum portends for foreign investors that make further loans to distressed companies in which the investor already holds debt. It should be noted that while it may indicate the position of the IRS with respect to the issues it addresses, an internal IRS memorandum is not binding legal authority.

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