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May 3, 2007

The Honorable Eric Solomon
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Mark W. Everson (or successor)
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: New York City Bar Report Offering Proposed Guidance Regarding U.S. Federal Income Tax Treatment of Certain Lending Activities Conducted Within the U.S.

Dear Assistant Secretary Solomon and Commissioner Everson:

On behalf of the New York City Bar, as reported by the Committee on Taxation of Business Entities, I am pleased to submit our report offering proposed guidance on lending activities under Section 864 of the Code.

The report was prepared in light of the August 15, 2006 first-time inclusion of this very important topic in the 2006-2007 Treasury Department Priority Guidance Plan. Parts II and III of the report review the current somewhat uncertain state of the law concerning when a foreign person, not otherwise subject to U.S. tax on net income, should be treated as engaged in a trade or business in the United States for Federal income tax purposes as a result of certain lending activities. Part IV proposes certain safe harbors and guidelines for Treasury's consideration that could provide clarity and greater certainty to foreign persons.

In the first of our safe harbor recommendations, we analyze the sometimes fine line between writing a loan, which could give rise to engaging in a trade or business, or purchasing a security, which generally does not. In particular, we focus on a foreign person's commitment to acquire a loan in the U.S. from a lender before the loan is funded, a "forward purchase commitment". In making our recommendations, we recognize that there are situations involving forward purchase commitments that suggest the lender might be acting as agent for the foreign person (transactions with what we refer to broadly in this report as Lending Affiliates) and we

suggest additional requirements to assure that the foreign person's purchase is in the nature of a secondary market transaction. In the absence of a transaction involving a Lending Affiliate, we propose a safe harbor that would allow a foreign person to purchase a fully funded loan pursuant to a forward purchase commitment without being treated as engaging in a U.S. trade or business. Our proposed safe harbor would apply provided (i) the foreign person was not committed to purchase the loan until after the lender was contractually committed to provide applicable financing, (ii) the foreign person has no understanding with the borrower concerning the loan prior to purchase, (iii) the loan is neither purchased from nor made by an affiliate of the foreign person or of a person that makes investment decisions for the foreign person, (iv) the person making investment decisions for the foreign person in connection with the loan is not affiliated with the person making such decisions for the lender, (v) the loan was made by the lender in the ordinary course of business, and (vi) the loan is not purchased by the foreign person until 24 hours after the loan is closed.

We were unable to offer safe harbors in connection with a purchase of a revolving credit line and a purchase of a loan made by a Lending Affiliate. For these situations, we have proposed guidelines for Treasury consideration identifying the factors that we consider relevant in analyzing whether the transaction warrants treatment as a secondary market transaction.

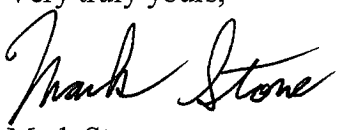
Our second safe harbor proposes that making a limited number of loans over a specified period should not by itself cause a foreign person to be treated as engaging in a U.S. trade or business. Review of the relevant authorities leads us to recommend that a foreign person can originate up to four loans a year, with a two year lookback, without giving rise to such status, so long as the foreign person does not hold itself out as a lender, and the loans are held for a minimum period of time.

Our third safe harbor recommendation addresses loans that are incidental to the acquisition of equity or equity rights, including a focus on PIPEs. We believe loans should be disregarded for trade or business status if, as part of the transaction, the foreign person acquires stock or related rights to stock in the borrower, there is a minimum holding period for the assets and, based on recognized and contemporaneous financial analysis that the foreign person would need to retain in its files and be able to produce on demand, the foreign person reasonably expects to earn more than 50% of its return from appreciation in the equity component of its investment unit.

Finally, we believe that where the dominant motive of a foreign person is to acquire, protect or enhance a pre-existing investment, whether that investment is debt or equity, the loan should not be considered in determining trade or business status. This is an intent based test that lacks the certainty of our other proposals, but which we believe reaches the correct result.

We are pleased to discuss any questions you may have. Please feel free to contact the undersigned at (212) 513-3577 or via e-mail at mark.stone@hklaw.com, or Jill Darrow, Esq. at (212) 940-7113 or via e-mail at jill.darrow@kattenlaw.com.

Very truly yours,



Mark Stone
Chair

Enclosure

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NEW YORK CITY BAR

REPORT OFFERING PROPOSED GUIDANCE REGARDING U.S. FEDERAL INCOME TAX TREATMENT OF CERTAIN LENDING ACTIVITIES CONDUCTED WITHIN THE UNITED STATES

As Reported By The Committee On Taxation Of Business Entities

May 3, 2007

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REPORT OFFERING PROPOSED GUIDANCE REGARDING U.S. FEDERAL INCOME TAX TREATMENT OF CERTAIN LENDING ACTIVITIES CONDUCTED WITHIN THE UNITED STATES

As Reported By The Committee On Taxation Of Business Entities

This report, which is submitted on behalf of the New York City Bar by its Committee on Taxation of Business Entities, considers certain U.S. federal income tax issues arising out of certain lending activities conducted within the United States by foreign persons and recommends guidance to provide greater certainty to such persons.[1]

I. Introduction

On August 15, 2006, the United States Department of the Treasury ("Treasury") published its 2006-2007 Priority Guidance Plan which for the first time included "guidance on lending activities under Section 864."[2] We believe that there is a need for guidance in determining when a nonresident alien individual or foreign corporation (each, a "Foreign Person") that is not otherwise subject to U.S. taxation on a net income basis should be treated as engaged in a trade or business within the United States for U.S. federal income tax purposes ("ETB") as a result of certain lending activities conducted within the U.S. by or on behalf of that Foreign Person. We propose that Treasury provide guidance (including certain limited safe harbors) concerning Foreign Persons' U.S. lending activities. The discussion below provides a general overview of current law concerning U.S. lending activities by foreign persons, identifies areas with respect to which guidance is absent or lacking clarity, identifies certain policy considerations that Treasury might consider in developing guidance, and proposes various safe harbors for Treasury's consideration that could provide clarity to Foreign Persons, practitioners and relevant tax officials.

II. Current Law Regarding General U.S. Federal Income Taxation of Foreign Persons

Foreign Persons are generally subject to U.S. federal income tax with respect to two types of income: (i) income that is "effectively connected" with the conduct of a "trade or business within the United States" ("ECI"); and (ii) so-called "fixed, determinable, annual or periodical income" ("FDAP") from U.S. sources that is not ECI.

Foreign Persons are subject, however, to a distinct tax regime in respect of each of these types of income. Specifically, ECI generally is taxed by the United States on a net basis at the regular graduated income tax rates that apply to U.S. persons and, when includable in income by

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[1] This report was prepared by an ad hoc committee of the Committee on Taxation of Business Entities of the New York City Bar. The authors of the report are Jill Darrow, Zvi Hahn, David Richardson, Mark Stone and Marc Teitelbaum. Substantial assistance was provided by Peter Blessing and William Lu. Helpful comments were provided by Gary Gartner and Stuart Leblang. Editing assistance was provided by Saleem Moghal.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations promulgated thereunder (the "Regulations") unless otherwise indicated.

a foreign corporation, might also be subject to "branch profits tax."[3] A Foreign Person's U.S.-source FDAP, on the other hand, is subject to U.S. federal income taxation on a gross basis at a flat rate of 30 percent (which may be reduced or eliminated pursuant to an applicable income tax treaty), which tax is generally collected through a withholding mechanism.[4] Importantly, Foreign Persons which are not ETB generally are not subject to U.S. federal income tax with respect to capital gains and interest income qualifying as "portfolio interest."[5]

The framework for taxing a Foreign Person with respect to an item of income, therefore, principally depends on first, whether the Foreign Person is considered to be ETB and second, whether the income is ECI or FDAP. Although the U.S. federal income tax consequences of such determinations are significantly different, it can be difficult under current law to determine when a Foreign Person is ETB. This report focuses on the circumstances under which certain U.S. lending activities carried on by or on behalf of a Foreign Person should cause the Foreign Person to be treated as ETB under Section 864.

A. Trade Or Business Within the United States

Neither the Code nor the Regulations thereunder provide a comprehensive definition of the term "trade or business within the United States" for purposes of Section 864. Rather, the only statutory and regulatory guidance regarding when a Foreign Person is ETB relates to the performance of personal services within the United States, specific exclusions from the scope of such term for certain trading in stock, securities, commodities and derivatives, and the scope of the phrase "active conduct of a banking, financing, or similar business."[6]

The courts and the Internal Revenue Service (the "Service") have adopted a facts and circumstances test for determining whether an activity constitutes a U.S. trade or business.[7] The analysis is both qualitative and quantitative, i.e., both the type and the frequency of the activity conducted by the Foreign Person in the United States are taken into account in determining whether the Foreign Person is ETB. In general, a Foreign Person must be significantly and actively involved in a profit-oriented activity in order to be deemed to be ETB.[8] The activities

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[3] *See* Section 871(b) (for foreign individuals) and Section 882 (for foreign corporations); *see also* Section 884. Branch profits tax generally applies at a flat rate of 30 percent (which may be reduced or eliminated pursuant to an applicable income tax treaty). The net effective rate of U.S. federal income and branch profits taxes is generally 54.5 percent (i.e., 35 percent + (30 percent x (100 percent – 35 percent))).

[4] *See* Sections 871(a) (for foreign individuals) and 881 (for foreign corporations); *see also* Sections 1441 and 1442.

[5] *See, however,* Section 871(a)(2) (imposing U.S. federal income tax on nonresident individuals who are present in the United States for a period or periods aggregating 183 days or more during the taxable year with respect to their net U.S. source capital gains). The "portfolio interest exemption" does not apply, however, if the interest is received by a "10 percent shareholder," by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business or by a controlled foreign corporation from a related person (Section 881(c)(3)), nor does it apply to certain contingent interest (Section 881(c)(4)).

[6] *See* Regulations Section 1.864-4(c)(5).

[7] *See* Rev. Rul. 88-3, 1988-1 C.B. 268, and *de Amodio v. Comm'r*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962).

[8] *See* Joseph Isenbergh, 2 *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income* ¶ 20:51 (3d. ed. 2002); *see also Snell v. Comm'r*, 97 F.2d 891, 892 (5th Cir. 1938) ("The word ['business'], notwithstanding

also must be "considerable, continuous, and regular" to constitute a trade or business.[9] Engaging in two isolated transactions without "sustained activity" has been held not to constitute a U.S. trade or business.[10] Ministerial and clerical activities that occur in the United States for a business that is otherwise foreign will not cause the Foreign Person to be ETB.[11] Finally, the "mere management of investments and the collection of rents, interest and dividends" has been held to be insufficient to cause a Foreign Person to be ETB.[12]

B. The Activities of Others Can Be Imputed to A Foreign Person

Under certain circumstances, the activities of others can be imputed to a Foreign Person and, if those activities rise to the level of a U.S. trade or business, the Foreign Person will be treated as ETB. For example, the activities of employees of, and persons acting exclusively or almost exclusively for, a Foreign Person are likely to be imputed to the Foreign Person.[13] However, "agency" may be found to exist in other circumstances as well.[14] A Foreign Person is considered to be ETB if a partnership, estate or trust of which the Foreign Person is a partner or beneficiary is engaged in a U.S. trade or business.[15]

III. Current Law Regarding United States Lending Activities

A. Case Law Under Section 864

There is limited authority addressing when lending constitutes a U.S. trade or business for purposes of Section 864. There have been two revenue rulings, the second revoking the first, but they are unhelpful, since no analysis is given in either.[16] In *Pasquel v. Commissioner*,[17] a foreign individual made an advance to a U.S. corporation. The Tax Court, which concluded that the Foreign Person was not ETB, focused on the number of loans (one) and the extent of other

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disguise in spelling and pronunciation, means busyness; it implies that one is kept more or less busy, that the activity is an occupation.").

[9] *See, e.g., Pinchot v. Comm'r.*, 113 F.2d 718, 719 (2nd Cir. 1940); *de Amodio, supra* n. 7; *Spermacet Whaling & Shipping Co. v. Comm'r*, 30 T.C. 618, 634 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

[10] *See Linen Thread Co v. Comm'r*, 14 T.C. 725 (1950); *compare United States v. Balanovski*, 236 F.2d 298 (2d Cir. 1956), *cert. denied*, 352 U.S. 986 (1957).

[11] *See Scottish American Investment Co. v. Comm'r*, 12 T.C. 49 (1949); *Spermacet Whaling & Shipping Co., supra* n. 9.

[12] *See Higgins v. Comm'r*, 312 U.S. 212 (1941); *Continental Trading, Inc. v. Comm'r*, 265 F.2d 40 (9th Cir. 1959).

[13] *See, e.g., Lewenhaupt v. Comm'r*, 20 T.C. 151 (1953); *Adda v. Comm'r*, 10 T.C. 273 (1948), *aff'd*, 171 F.2d 457 (4th Cir. 1948), *cert. denied* 336 U.S. 952 (1949); Isenbergh, *supra* n. 8 at ¶ 20:45.

[14] *See, e.g., de Amodio, supra* n. 7; *The Investor's Mortgage Security Company, Limited. v. Comm'r*, 4 T.C.M. 45 (1945); *Handfield v. Comm'r*, 23 T.C. 633 (1955). A Foreign Person also would be treated as engaging in the activities of a third party acting as its "nominee" and may be treated as engaging in the activities of a third party whose transitory involvement makes it appear that it is acting as a "conduit."

[15] Section 875.

[16] *See* Rev. Rul. 73-227, 1973-1 C.B. 338; Rev. Rul. 88-3, *supra* n. 7.

[17] 12 T.C.M. 1431 (1953).

U.S. activities entered into by the Foreign Person.[18] The case offers limited guidance, however, since the Foreign Person had made only one loan.

In *InverWorld, Inc. v. Commissioner,*[19] the Tax Court concluded that Regulations Section 1.864-4(c)(5)(i) provides a "useful framework" for determining whether a Foreign Person is ETB. Under that Section, a nonresident alien individual and a foreign corporation are considered to be engaged in the "active conduct of a banking, financing, or similar business in the United States" if (1) "at some time during the taxable year" the Foreign Person is engaged in business in the United States, and (2) the activities of such business consist of any one or more of the following activities carried on, in whole or in part, in the United States: (a) receiving deposits of funds from the public; (b) making personal, mortgage, industrial, or other loans to the public; (c) purchasing, selling, discounting, or negotiating notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness, for the public on a regular basis; (d) issuing letters of credit to the public and negotiating drafts drawn thereunder; (e) providing trust services for the public; or (f) financing foreign exchange transactions for the public.

By its own terms, Regulations Section 1.864-4 applies only to a Foreign Person that is ETB; it does not determine whether a Foreign Person is ETB. However, the Tax Court concluded that the Foreign Person in *InverWorld* was ETB because its U.S. activities satisfied four of the six factors listed in the Regulations.[20] The Tax Court's reliance on Regulations Section 1.864-4 was criticized by some commentators[21] and endorsed by others.[22]

B. Case Law Addressing Domestic Lending Activities For Purposes of Other Code Provisions

There are many cases addressing whether lending activities constitute a "trade or business" under other Code provisions, including Section 166,[23] which allows a deduction for bad debts of a trade or business, and Section 7704, which requires that certain partnerships be

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[18] *Id.* at 1433.

[19] 71 T.C.M. 3231 (1996).

[20] *Id.* at 3237-18-19.

[21] *See, e.g.*, Stuart Leblang & Rebecca Rosenberg, *Toward an Active Finance Standard for Inbound Lenders*, 31 TAX MGMT. INT'L J. 131, 142-44 (2002).

[22] *See, e.g.*, Lee A. Sheppard, *Neither a Dealer Nor a Lender Be: Hedge Fund Lending*, 108 TAX NOTES 729, 737-39 (Aug.15, 2005).

[23] The authority under Section 166 should be considered in determining whether a corporate or noncorporate Foreign Person should be treated as engaged in the business of lending. It may be assumed in the domestic context that a corporation is engaged in a trade or business. *See, e.g., Arkansas Best Corp. v. Comm'r,* 83 T.C. 640, 651 (1986) ("[t]he failure of Congress to include a corporation in the coverage of [Code Section 212] gives rise to a negative implication that all corporations necessarily have a trade or business and, accordingly, do not require the aid of Section 212 in order to deduct expenses incurred for the production of income"), *rev'd on other grounds,* 800 F. 2d 215 (8th Cir. 1986), *aff'd,* 485 U.S. 212 (1988). However, that assumption does not apply to foreign corporations. Under Section 864(a), a corporate Foreign Person is not assumed to be engaged in a trade or business. Instead, the activities of the foreign corporation and their connection to the United States determine whether the foreign corporation is ETB. *See* Regulations Section 1.864-3(a), Ex. 2 (stating that the foreign corporation's activity of supervising its investments is not a trade or business).

treated as corporations. In the cases addressing lending activities for purposes of provisions other than Section 864, the courts and Service have focused on the extent, scope, and context of the Foreign Person's lending activities. The factors identified by commentators[24] as relevant for such determination include the number and amount of the loans made over the years,[25] the amount of time and effort devoted to lending activities,[26] maintenance of an office for the lending activity,[27] the presence of employees or other dependent agents,[28] maintenance of books and records for the lending activity,[29] direct dealings with unrelated borrowers,[30] and promoting oneself as a money lender.[31]

The authorities suggest that Foreign Persons should be able to make a few loans and not be ETB. For example, in a case involving Section 166, a taxpayer that made eight or nine loans over a four-year period was not deemed to be engaged in a trade or business.[32] In a private letter ruling involving Section 7704(d)(2), a partnership that represented it would originate on average no more than 5 new mortgages a year over any five-year period was deemed not to be engaged in a trade or business.[33] On the other hand, a taxpayer that made 21 loans over a two-year period was deemed to be engaged in a trade or business.[34]

Based on *Whipple v. Commissioner*[35] and its progeny, there is also authority to the effect that a loan made to acquire, protect or enhance an equity investment where the taxpayer's

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[24] *See, e.g.*, David R. Sicular, Emma Q. Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 36 TAX LAW 719, 751.

[25] *See Sales v. Comm'r*, 37 T.C. 576, 580 (1961); *Serot v. Comm'r,* 68 T.C.M. 1015, 1022 (1994); *McCrackin v. Comm'r*, 48 T.C.M. 248, 251 (1984); *Jessup v. Comm'r,* 36 T.C.M. 1145, 1146-47 (1977); *Minkoff v. Comm'r*, 15 T.C.M. 1404, 1407-08 (1956); *Cushman v. United States*, 148 F.Supp. 880, 886-87 (D.C. AZ. 1956).

[26] *See United States v. Henderson,* 375 F.2d 36, 41 (5th Cir. 1967); *Ruppel v. Comm'r*, 53 T.C.M. 829, 833-34 (1987); *Jessup, supra* n. 25 at 1150.

[27] *Henderson, supra* n. 26 at 41; *Baker v. Comm'r*, 70 T.C.M. 387, 392 (1995); *Estate of Bounds v. Comm'r*, 46 T.C.M. 1209, 1213 (1983); *Cushman, supra* n. 25 at 886-87.

[28] *See Kushel v. Comm'r*, 15 T.C. 958, 960-61 (1950); *Cushman, supra* n. 25 at 886-87.

[29] *Henderson, supra n. 26* at 41; *Carraway v. Comm'r*, 67 T.C.M. 3139, 3139-5 (1994); *Bounds, supra* n. 27 at 1213; *Serot, supra* n. 25 at 1022; *Ruppel, supra* n. *26* at 834.

[30] Isenbergh, *supra* n. 8 at ¶35:22.

[31] *Id*; see *also Henderson, supra* n. 26 at 41; *Kushel, supra* n. 28 at 960-61; *Baker, supra* n. 27 at 392; *Magee v. Comm'r*, 66 T.C.M. 105, 112 (1993).

[32] *Imel v. Comm'r,* 61 T.C. 318 (1973).

[33] PLR 9701006 (Sept. 24. 1996)

[34] *Ruppel, supra* n. 26.

[35] 373 U.S. 193 (1963). In *Whipple*, the Supreme Court recognized three ways in which a shareholder-lender can be considered to have a trade or business: (1) as a consultant/promoter in exchange for a fee or a commission; (2) as a developer/promoter of companies that seeks to restructure the company's equity and then sell the restructured shares to customers; or (3) as a financier or money lender but only if it has a purpose of earning income from holding the debt instrument itself (in the nature of interest) and not from holding stock (in the nature of investment appreciation). The discussion herein focuses on the third category, namely, the standards to be treated as engaged in a lending business rather than being treated as a consultant or a promoter. *See also Eberhart v. Comm'r*, 36 T.C.M. 660 (1977); *German v. Comm'r*, 77 T.C.M. 1738 (1999).

dominant motive is to earn a return from the equity investment cannot be a business bad debt, because the loan is not related to a lending business conducted by the taxpayer but rather the taxpayer's investing activities. In this line of cases, no matter how extensive the lending activities were, the taxpayer generally was not be treated as engaged in the business of lending as a result of making such loans.[36] The determination of whether a taxpayer's dominant motivation in making an advance is to acquire, protect or enhance his equity investment has been based on the taxpayer's intent as evidenced by the facts and circumstances. In most of the *Whipple*-type cases, the taxpayer advanced funds to a corporation he directly or indirectly controlled. In one case, the taxpayer asserted that he had a right to a business bad debt deduction because his motive for the advances was to earn interest income as evidenced by the fact that his advances exceeded his initial investment in its stock by 60 times.[37] The Tax Court did not find for the taxpayer, noting he had owned 60 percent of the stock of the borrower. In another case, *German v. Commissioner*,[38] the taxpayer simultaneously made advances to several corporations and acquired a 20 percent equity interest in each one. The Tax Court held that the taxpayer was not in the trade or business of making loans, noting that "the determinative factor is [the taxpayer's] dominant motivation" in making the loan.[39]

In addition, in *Higgins v. Commissioner*,[40] the Supreme Court made it clear that mere ownership of U.S. stocks, securities or commodities for investment purposes does not amount to being ETB even if the Foreign Person conducts significant ministerial and maintenance tasks in the United States in connection with its investments.

The Tax Court, in a memorandum decision citing well-established authorities, held that the *Whipple* and *Higgins* line of cases is applicable to determine whether a Foreign Person is ETB under Section 864(b).[41] However, the Service has indicated, without supporting authority, that the rules under Section 864(b) "may differ in some respects" from the rules under other Code sections in determining whether a Foreign Person is ETB,[42] and that Section 864 is controlling on the issue of which activities amount to a U.S. trade or business. Where guidance

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[36] *Whipple, supra* n. 35 at 203; *see also Bodzy v. Comm'r*, 321 F.2d 331 (5th Cir. 1963).

[37] *Gubbini v. Comm'r*, 71 T.C.M. 2993 (1996).

[38] *Supra* n. 35.

[39] *Id.* at 1739, citing *U.S. v. Generes*, 405 U.S. 93 (1972).

[40] *Supra* n. 12.

[41] *deKrause v. Commissioner*, 33 T.C.M. 1362 (1974). The Foreign Person in this case was a beneficiary of a U.S. trust who sought to avoid 30% U.S. withholding tax on dividends and instead apply graduated income tax rates. The Foreign Person asserted that, under Section 875, she should be treated as ETB based on the trust's trading activities. The Foreign Person conceded that, under applicable case law, the trust's activities were not sufficient to be a trade or business, but nevertheless argued that a different (less onerous) standard applies for purposes of determining whether a Foreign Person is ETB. The Government prevailed. The Tax Court, citing *Liang v. Comm'r*, 23 T.C. 1040 (1955), and *Continental Trading, Inc*, *supra* n. 12, held that the phrase "trade or business" under Section 864(b) should be interpreted consistently with the general body of law interpreting "trade or business" under other Sections, and that the principles of *Higgins, supra* n. 12, and *Whipple, supra* n. 35, were therefore relevant to this analysis. That *deKrause* is a memorandum decision suggests that the Tax Court considered the case to involve the application of familiar legal principles to a relatively uncomplicated set of stipulated facts.

[42] Rev. Rul. 88-3, *supra* n. 7.

under Section 864 is lacking, we believe that it is both necessary and appropriate to look to the case law and rulings in other areas of the tax law for guidance concerning the issues discussed above.

C. Statutory Exceptions For Trading In Securities, Commodities and Derivatives

1. The Securities Trading Safe Harbors - Overview

Special rules exclude from the definition of a U.S. trade or business, (i) trading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent (the "Independent Agent Safe Harbor"), and (ii) trading in stocks or securities for the Foreign Person's own account (unless the Foreign Person is a dealer in stocks or securities) (the "Non-Dealer Safe Harbor").[43]

The securities trading safe harbors were enacted by Congress after a series of cases decided under an earlier provision that excluded from the definition of a U.S. trade or business, the "effecting, through a resident broker, commission agent, or custodian, of transactions in the United States in commodities . . . or in stocks or securities."[44] On the one hand, in *Higgins,* [45] the Supreme Court made it clear that mere ownership of U.S. stocks, securities, or commodities for investment purposes was not a U.S. trade or business, even if the Foreign Person conducted significant ministerial and maintenance tasks in the United States in connection with his investments. On the other hand, it was also clear that "dealing" in stocks, securities, or commodities did not qualify for the securities safe harbor.[46] Several cases concluded that a third type of activity -- trading -- also did not come within the safe harbor exceptions.[47] That led to uncertainty regarding when a Foreign Person's activities constituted "trading" rather than "investing." By adding the securities and commodities trading safe harbors, Congress eliminated the significance of the distinction between trading and investing in the context of stocks, securities and commodities.

a. Meaning of the Term "Securities"

The Regulations define the term "securities" to mean "any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing."[48] The Service has stated that the definition of security includes financial

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[43] Section 864(b)(2)(A). Similar rules exclude from the definition of a U.S. trade or business, (i) trading in certain commodities through a resident broker, commission agent, custodian or other independent agent and (ii) trading in such commodities for the Foreign Person's own account (unless the Foreign Person is a dealer in such commodities). Section 864(b)(2)(B).

[44] Former Section 871(c) (before the enactment of the Foreign Investors Tax Act of 1966).

[45] *Supra* n. *12*.

[46] *See* Sitrick, "U.S. Taxation of Stock and Securities Trading Income of Foreign Investors," 30 J. TAX'N 98, 98-99 (1969); Isenbergh, "The 'Trade or Business' of Foreign Persons in the United States," 61 TAXES 972 at 980 (1983).

[47] *See Liang, supra* n. 41; *Comm'r v. Nubar*, 185 F.2d 584 (4th Cir. 1950).

[48] Regulations Section 1.864-2(c)(2)(i).

futures (if they provide a holder a right to purchase the underlying financial instruments), Treasury bond futures, Treasury note futures, Treasury bill futures, and GNMA futures;[49] an "evidence of indebtedness" created in purchase funding agreements or sales funding agreements;[50] bankruptcy/trade creditor claims;[51] and futures contracts for 90-day domestic bank certificates of deposit.[52] Certain real estate mortgage investment conduits ("REMICs"), collateralized mortgage obligations ("CMOs"), and financial asset securitization investment trusts ("FASITs") also may be considered securities.[53] The term "security" should include regular interests in REMICs, as such interests are debt instruments under Section 860B(a). Residual interests in REMICs do not appear to be securities, since they are not debt instruments under Section 860F(e) (which provides, in part, that for purposes of subtitle F, a REMIC is a partnership and holders of residual interests in the REMIC are partners). Mortgage-backed securities, typically called CMOs, should be considered securities provided they are structured as debt instruments or otherwise are debt instruments under Section 860B. Lastly, under prior law, FASITs which qualified as "qualified debt instruments" and "permitted debt instruments" were considered securities, as they were debt instruments under Section 860H(b) (now repealed), but a "sole class of ownership interest" that is treated as a partnership interest under repealed Section 860H(d) most likely was not a security (by analogy to a residual interest in a REMIC as discussed above.)

b. Meaning of the Term "Trading"

The term "trading" is defined broadly under the Regulations to mean the "effecting of transactions" in stocks or securities, including "buying, selling . . ., or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, . . . and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading)."[54] The Service held that "trading" included securities lending transactions[55] and transactions in futures contracts for debt instruments (such as Treasury bonds and Treasury notes).[56]

It is therefore clear from the foregoing that trading in securities (or commodities) encompasses all sorts of active portfolio management. The Independent Agent Safe Harbor and the Non-Dealer Safe Harbor each apply regardless of the number of stock or securities

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[49] PLR 8807004 (Nov. 10, 1987).

[50] PLR 8652072 (Sept. 26, 1986).

[51] PLR 8704006 (Oct. 15, 1986).

[52] PLR 8527041 (Apr. 8, 1985).

[53] *See* Paul D. Schumann, *Section 864(b)(2) Safe Harbor Protects Foreign Investors in U.S. Markets*, 6 J. INT'L TAX'N 418, 1995 WL 713821 (W.G.&L.).

[54] Regulations Section 1.864-2(c)(2)(i).

[55] PLR 9041011 (Jul. 6, 1990).

[56] PLR 8527041, *supra* n. 52.

transactions undertaken by a Foreign Person, so long as the Foreign Person is not a dealer in stocks or securities (or commodities), as applicable.[57]

2. The Independent Agent Safe Harbor

Neither the Code nor the Regulations define the phrase "broker . . . or other independent agent" for purposes of the Independent Agent Safe Harbor. Furthermore, there is little authority interpreting the phrase. The legislative history of the Foreign Investors Tax Act of 1966 indicates that an agent may not be "independent" if the agent has discretionary authority to act on behalf of its foreign principal.[58]

In *InverWorld, Inc.*,[59] the Tax Court concluded that a foreign corporation's U.S. agent was dependent, principally because the agent acted almost exclusively for the foreign corporation, had few other clients, did not market its services to other clients, and earned substantially all of its income from the foreign corporation.

The concept of "independent agent" is also used in various other contexts, including U.S. income tax treaties. In *Taisei Fire & Marine Insurance Co. v. Commissioner,*[60] the Tax Court addressed whether a U.S. agent was independent for purposes of the permanent establishment determination under the United States-Japan Income Tax Convention. In concluding that the U.S. agent in that case was independent, the Tax Court emphasized that the foreign principals exercised no external control over the agent[61] and the agent bore entrepreneurial risk in its dealings with the foreign persons.[62]

The Independent Agent Safe Harbor does not apply if, at any time during the taxable year, the Foreign Person has an "office or other fixed place of business" in the U.S. through which, or by the direction of which, the transactions in stocks or securities are effected.[63] In *InverWorld, Inc.*,[64] the Regulations under Section 864(c)(4), which determine whether foreign source income is "effectively connected income," were applied to determine whether a foreign corporation has an office or other fixed place of business in the U.S.

3. The Non-Dealer Safe Harbor

The Non-Dealer Safe Harbor can apply irrespective of whether the U.S. trading is conducted in the United States by the Foreign Person itself, by employees of the Foreign Person, whether or not present in the United States, or by a broker, commission agent, custodian, or other

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[57] Regulations Sections 1.864-2(c)(1), -2(c)(2)(i), -2(d)(1), -2(d)(2)(i).

[58] *See* HR. Rep. No. 1450, 89th Cong., 2d Sess., 1966-2 C.B. 965, 975.

[59] *Supra* n. *19*.

[60] 104 T.C. 535 (1995).

[61] *Id.* at 550-55.

[62] *Id.* at 555-56.

[63] Section 864(b)(2)(C).

[64] *InverWorld, Inc., supra* n. 19 at 3237.

agent of the Foreign Person, whether dependent or independent, resident or nonresident, and present or not present in the United States, and irrespective of whether any employee or agent has discretionary authority to make decisions in effecting such transactions.[65] The safe harbor does not apply to Foreign Persons who are "dealers" in stocks or securities.[66]

Prior to the Taxpayer Relief Act of 1997, the Non-Dealer Safe Harbor did not apply to a foreign corporation whose principal business was trading in stocks or securities for its own account if its principal office was in the United States.[67] The Regulations provided rules (commonly referred to as the "Ten Commandments") for determining the location of a foreign person's "principal office."[68] In 1997, the prohibition on having a principal office in the United States was eliminated for tax years beginning after December 31, 1997.[69] The Regulations have not been amended to reflect the change in law.

4. Treatment of Derivatives

Under proposed regulations,[70] a Foreign Person which is an eligible nondealer is not considered to be ETB by reason of effecting transactions in derivatives for its own account, including hedging transactions within the meaning of Regulations Section 1.1221-2.[71] For these purposes, a derivative includes: (1) any interest rate, currency, equity, or commodity notional principal contract; and (2) any evidence of an interest, or a derivative financial instrument (including any option, forward contract, short position and any similar financial instrument), in any commodity, currency, share of stock, partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, note, bond, debenture, or other evidence of indebtedness, or notional principal contract.[72]

D. Business Development Companies and Section 871(k)

Generally, a business development company ("BDC") is a regulated investment company ("RIC") that is principally engaged in "furnishing capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes or products not previously generally available".[73] A BDC is exempted from certain limitations in the Code applicable to RICs.[74] A BDC is permitted to

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[65] Regulations Section 1.864-2(c)(2)(i).

[66] Section 864(b)(2)(A)(ii); Regulations Section 1.864-2(c)(iii).

[67] Former Section 864(b)(2)(A)(ii) (prior to the Taxpayer Relief Act of 1997).

[68] Regulations Section 1.864-2(c)(2)(iii).

[69] Taxpayer Relief Act of 1997, P.L. 105-34, Section 1162.

[70] Proposed regulations are considered authority for substantial authority purposes pursuant to Regulations Section 1.6662-4(d)(3)(iii).

[71] Proposed Regulations Section 1.864(b)-1(a).

[72] Proposed Regulations Section 1.864(b)-1(b)(2).

[73] Section 851(e)(1).

[74] Section 851(e).

originate loans to micro-cap companies and small issuers. BDCs generally acquire convertible loans and/or non-convertible loans plus warrants.[75]

Under Sections 851 to 855 (Subchapter M, Part I), a RIC and its shareholders are effectively subject to one level of taxation. Assuming that a RIC distributes all of its RIC taxable income, the RIC will obtain a deduction to fully offset its RIC taxable income and its shareholders will generally include the dividend as income, resulting in one level of taxation. Prior to the enactment of the American Jobs Creation Act of 2004, a RIC ordinary dividend paid to a Foreign Person was subject to a 30% withholding tax, subject to reduction under an applicable treaty. (The portion of the RIC dividend attributable to the RIC's long-term capital gain income is not treated as an ordinary dividend, but rather as a long-term capital gain that is not subject to U.S. income tax or withholding tax.[76]) Currently, under Section 871(k), the portions of a RIC regular dividend consisting of qualifying interest income and short-term capital gain are generally exempt from U.S. withholding tax.[77] This rule became effective for taxable years commencing after December 31, 2004 and terminates with the first taxable year commencing after December 31, 2007.

Until Section 871(k) sunsets, certain interest income of a RIC, including a BDC, may be paid to Foreign Persons without being subject to any U.S. tax.[78]

IV. Proposed Safe Harbors

Neither the Service nor Foreign Persons are well-served by tax laws that are susceptible to different outcomes when applied to substantially similar facts. Bringing a degree of clarity and certainty to this area of the tax law would promote taxpayer compliance and enhance the Service's ability to apply and enforce applicable tax law.

In response to the need for clarity and certainty in determining when a Foreign Person (that is not otherwise subject to U.S. taxation on a net income basis) will be treated as ETB by reason of its U.S. lending activities, we are proposing certain limited safe harbors and guidelines that are based on established principles derived from existing relevant or analogous authorities. Each section below provides a description of the pertinent issues raised by the applicable transaction, an analysis of relevant tax law authorities, and a proposed safe harbor or recommended guidelines for Treasury consideration. The premise of the recommendations below is that, based on existing authorities, it is possible to identify specific circumstances that should not be treated as a lending business. As such, the proposed safe harbors are intended to describe particular sets of circumstances which should allow a Foreign Person to safely assume that the described lending activities will not cause it to be ETB.

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[75] *See, e.g.,* Allied Capital Corporation, Form 10-K For F.Y.E. Dec. 31, 2006.

[76] Regulations Section 1.1441-3(c)(2)(i)(D).

[77] Section 871(k)(1)(A) and (2)(A).

[78] *See, e.g.,* Section 871(k)(1)(E)(iii), which treats as qualifying interest income, interest earned on deposits whether or not such income is effectively connected with a trade or business of the RIC.

Some of the proposed safe harbors are not strictly mechanical. We nevertheless believe that, by identifying and analyzing the most important elements of applicable or analogous areas of the tax law, the proposed safe harbors and recommended guidelines for guidance will provide greater certainty in the U.S. federal income tax classification of increasingly common investment activities by Foreign Persons, even if certain of our proposed safe harbors are not strictly mechanical.

We intend that a Foreign Person's failure to satisfy any of the proposed safe harbors would be disregarded in determining whether a Foreign Person is ETB, and that activities outside the safe harbors would continue to be analyzed on a facts and circumstances basis. We further intend that a Foreign Person can rely on one or more safe harbors in a given year and from year to year, as applicable.

A. Secondary Market Acquisitions

1. Description

Purchasing pre-existing, fully-funded loans made to U.S. borrowers ordinarily does not cause a Foreign Person (which is not a dealer) to be treated as engaged in a U.S. trade or business. Absent any facts suggesting that the Foreign Person was involved in arranging or making the loan, it seems relatively easy to conclude that the Foreign Person in these circumstances is merely purchasing securities.

There is less certainty that a Foreign Person is merely purchasing securities when the Foreign Person extends a commitment to acquire the loan from the lender before the loan is actually funded (a "forward purchase commitment"). The lack of any clear guidance in the tax law leads to undue (and sometimes misplaced) reliance on factors such as the length of time between the funding of the loan and its sale to the Foreign Person, and whether or not the Foreign Person participated in negotiating the terms of the loan, to establish that the Foreign Person is merely purchasing rather than lending. If the Foreign Person is considered to be making loans in these circumstances, then there is concern that the Foreign Person might be considered to be ETB.

2. Analysis

There is no direct authority concerning when a Foreign Person's forward purchase commitment should cause an ostensible purchase of a loan to be recharacterized as a lending activity. Nevertheless, based on case law in other analogous areas of the tax law, we believe that an appropriate starting point is to distinguish circumstances where the lender's commitment to the borrower to make the applicable loan precedes the Foreign Person's purchase commitment, from those where the Foreign Person's purchase commitment is given before the lender commits to make the loan.

Defining a Foreign Person's activity as "lending" or "purchasing" based, in part, on whether the Foreign Person's commitment to purchase is given to the seller before or after the lender is committed to provide financing to the borrower is consistent with long-standing case law and rulings characterizing the lender's agreement to make financing available to the

borrower, as a "service" provided to the borrower.[79] The essence of the service is arranging to make funds available to the borrower. Once there is a commitment to provide financing, the person making the commitment has assumed the risk of either providing its own funds or finding others to fund the loan. A Foreign Person which commits to purchase the loan after the loan commitment has been extended, is itself providing no services to the borrower but is merely committing to purchase a security.[80] Moreover, if the Foreign Person then purchases the loan after it has been funded, it is simply confirming the salability of the security.

We recognize that the existence of a forward purchase commitment raises the factual question of whether the person making the loan is acting as a "principal" in the transaction (such that the Foreign Person's purchase of the loan is consistent with a purchase of a security in a secondary market transaction), or whether the purported lender is committing to make the loan as an "agent" of the Foreign Person, in which event the Foreign Person's purchase is, in substance, a loan origination. In order to deny the benefit of the proposed safe harbor where circumstances suggest the presence of common ownership or control between the Foreign Person and the seller, and also to ensure that the Foreign Person's purchase is in the nature of a secondary market transaction, we believe that it is appropriate to impose, as part of the safe harbor proposed below, certain additional requirements intended to ensure that the Foreign Person's purchase is in the nature of a secondary market transaction. First, neither the seller nor the lender (if other than the seller) could be an affiliate of the Foreign Person, a person that makes investment decisions for the Foreign Person or a person whose lending decisions are made by the same person or persons who control the Foreign Person's investment decisions (in each case, a "Lending Affiliate").[81] Second, the Foreign Person could not have any understanding with the borrower prior to purchasing the loan, and the loan could not be made by the lender as an accommodation to the Foreign Person. Finally, the Foreign Person's purchase could not precede the funding of the loan.

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[79] See *Security State Bank v. Comm'r*, 111 T.C. 210 (1998), *aff'd*, 214 F.3d 1254 (10th Cir. 2000), *acq.*, 2001-1 C.B. xix, distinguishing (for purposes of determining whether Section 1281 applies) between loans "made" and loans "purchased" or "acquired." *See also* the predecessor case relied upon by the Tenth Circuit in *Security State Bank, Security Bank of Minnesota v. Comm'r*, 98 T.C. 33 (1992), *aff'd*, 994 F.2d 432 (8th Cir. 1993); Rev. Rul. 70-540, 1970-2 C.B. 101, 102 (a commitment fee "is a charge for agreeing to make funds available...rather than for the use or forbearance of money..."); Rev. Rul. 80-57, 1980-1 C.B. 157, 158 (a REIT's mortgage loans were not capital assets because they arose from the REIT's business, which included "the rendering of the services of originating and making loans"); and *Burbank Liquidating Corp v. Comm'r,* 39 T.C. 999 (1963), *acq. sub. nom. United Assoc., Inc.,* 1965-1 C.B. 3, *modified on other grounds*, 335 F.2d 125 (9th Cir. 1964) (one of the business activities of a savings and loan association is the "service" of providing funds as loans); *compare FNMA v. Comm'r,* 100 T.C. 541, 577-78 (1993) (the Service argued unsuccessfully that acquiring mortgages in the secondary mortgage market in order to provide liquidity to mortgage lenders was not a service to the borrower, such that the purchased mortgages did not come within Section 1221(a)(4)). Proposed Treasury Regulations would overturn these authorities' application of Section 1221(a)(4) to notes acquired by a creditor in a lending transaction, as well as notes purchased by a creditor in a secondary market transaction (REG 109367-06, Aug. 7, 2006), without regard to whether arranging for financing for the borrower constitutes a service.

[80] *FNMA v. Comm'r, supra* n. 79.

[81] For these purposes, affiliation or control could be found to exist irrespective of whether the Lending Affiliate and the Foreign Person are "related" within the meaning of Sections 267, 318 or 707.

3. Proposed Safe Harbor

A Foreign Person will not be treated as originating a loan (but instead as merely purchasing a security) and, therefore, will not be ETB solely by reason of purchasing a pre-existing (i.e., fully funded) loan from an unrelated person, provided that (1) the Foreign Person was not committed to purchase the loan until after the lender was contractually committed to provide the applicable financing to the borrower, (2) the Foreign Person has no understanding or arrangement with the borrower concerning the loan at any time prior to purchasing the loan, (3) the loan is neither purchased from nor made by a person that is an affiliate of the Foreign Person or of a person that makes investment decisions for the Foreign Person,[82] (4) the person that makes investment decisions for the Foreign Person with respect to the loan is not affiliated with the person that makes lending decisions for the lender, (5) the loan was made by the lender in the ordinary course of the lender's trade or business, and not as an accommodation to the Foreign Person, and (6) the loan is purchased by the Foreign Person not earlier than 24 hours after the later to occur of the closing of the loan and the date the loan was last materially modified. The safe harbor we are proposing would apply to a purchase of a loan notwithstanding that the purchase commitment was issued before the loan was funded, as long as the purchase commitment did not precede the lender's commitment to make the loan.

4. Related Considerations and Recommended Guidelines

a. Revolving Credit Lines

We considered whether the foregoing safe harbor should be extended to a purchase of a revolving credit or staged-payment loan. Depending on the circumstances, a purchase of such security implicates both purchasing a pre-existing loan and making a loan, and therefore does not come within the proposed safe harbor. We suggest that Treasury consider extending safe harbor protection to such a purchase in circumstances where it is clear that the Foreign Person's role is sufficiently passive to warrant treating the transaction as an "investment." For example, a revolving credit or staged-payment loan might be eligible to come within the safe harbor proposed above if (but only if) the following requirements are satisfied: (1) there is a specified cap on the total amount that the Foreign Person can be required to advance; (2) the outstanding loan balance, when the loan is purchased by the Foreign Person, is at least 10% of the maximum principal balance of the loan (once fully funded); (3) the Foreign Person will not own more than 25% of the loan (and related commitment); and (4) provided no default occurs, there is no discretion on the part of the Foreign Person as to whether to make further advances on the terms specified in the loan agreement.

b. Lending Affiliates

We considered whether the safe harbor proposed in Part IV.A.3 above or a modified safe harbor should apply to a Foreign Person's purchase of the loan in circumstances where the loan is originated by a person that is a Lending Affiliate with respect to the Foreign Person. The element of possible common control raised in loan purchase transactions between a Foreign

[82] See Part IV.A.4.b below for a discussion of the guidelines we propose to apply to a purchase of loans made by affiliates of the Foreign Person.

Person and a Lending Affiliate raises the factual issue of whether the origination of the loan and its subsequent sale to the Foreign Person should be accorded independent significance, or whether the Lending Affiliate is merely acting as an agent of the Foreign Person in making the loan.

The question raised by purchasing loans from a Lending Affiliate is whether it is possible to identify when a transaction of this type is properly treated as a transaction that does NOT involve loan origination by the Foreign Person. Rather than proposing any safe harbor for these transactions, we are instead recommending that guidance be provided identifying the factors that are relevant to determining when a Foreign Person's purchase of a loan from a Lending Affiliate will be respected as a "purchase" (as opposed to a loan origination). (If deemed appropriate, examples could also be provided of loan purchase transactions that will be presumptively treated as if the purchased loans were originated by the Foreign Person.) The factors proposed should be directed to determining whether the Lending Affiliate and the Foreign Person can be said to be conducting their respective lending and purchasing activities on an arm's-length basis, and ensuring that the loan was actually funded (before the Lending Affiliate sold it to the Foreign Person) with funds obtained by the Lending Affiliate from sources other than the Foreign Person. Such factors may include: (1) whether the Lending Affiliate funded the loans using either its own funds or funds provided by persons unrelated to the Foreign Person; (2) the length of time that passes between the Lending Affiliate's commitment to the borrower and the sale of the loan to the Foreign Person; (3) whether the Foreign Person raises funds in advance of when loans are made by the Lending Affiliate (which could be indicative of a lending activity); (4) whether the loans sold are of a type available for purchase in a secondary market; (5) whether the purchase price is an arm's-length price, as demonstrated by evidence such as the participation by third parties unrelated to the Lending Affiliate in reviewing and approving the Foreign Person's purchase; (6) whether the Lending Affiliate sells portions of the loan or substantially identical loans to third parties on substantially similar terms; and (7) whether the Foreign Person purchases loans and other securities from third parties and not just the Lending Affiliate.

B. Limited Number of Loans

1. Description

Based on the legal authorities discussed below, we believe that a Foreign Person can make a limited number of loans over a period of years without being considered to be ETB.

2. Analysis

Long standing case law concerning when a foreign person's U.S. activities rise to the level of a U.S. trade or business has consistently required that an activity must be engaged in with some regularity before it is properly characterized as a trade or business.[83] When the activity in question consists of investing or trading for the Foreign Person's own account, the

[83] *See Spermacet Whaling and Shipping Co., supra* n. 9, wherein the Tax Court stated that "before a taxpayer can be found to be engaged in trade or business within the United States, it must...have been regularly and continuously transacting a substantial portion of its business within this country." *See also Linen Thread Co., supra* n. 10, and *Pasquel, supra* n. 17.

level of activity that needs to be present before a trade or business is found appears to be higher than mere occasional or infrequent transactions.[84] This observation is consistent with the holdings in various cases pre-dating the introduction into the Code of the safe harbor of Section 864(b)(2), when it was necessary to determine whether securities trading by a nonresident alien for his own account rose to the level of a trade or business.[85]

Another element that appears to be at least relevant, if not essential, in distinguishing trading for a Foreign Person's own account, which is not a U.S. trade or business, from a "financing or similar business" is the presence of customers. The Regulations under Section 864 provide that a Foreign Person is ETB if its activities in the United States consist of, among others, "[m]aking personal, mortgage, industrial or other loans to the public," and expressly state that a foreign corporation acting as a financing vehicle for its parent or affiliates will not (solely by virtue of that activity) be considered to be engaging in a U.S. trade or business.[86] A Foreign Person which makes only a very limited number of loans over a long period is unlikely to have a "customer" relationship with the persons to which it makes loans because, in these circumstances, the Foreign Person is neither holding itself out as a source of credit nor making its credit generally available to potential borrowers.[87] In this regard, the Regulations provide that "in determining whether [a Foreign Person] is engaged in the active conduct of a banking, financing or similar business, the character of the business actually carried on during the taxable year in the United States shall determine whether the [Foreign Person] is actively conducting a banking, financing or similar business in the United States."[88] Even recognizing that this Regulation presupposes the existence of a trade or business, we nevertheless view the word "character" as suggesting that the factors normally considered indicative of a trade or business, namely, regularity and customers, are pertinent here as well.[89]

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[84] *See Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987) ("to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity...; a sporadic activity...does not qualify.")

[85] *See, e.g., Adda, supra* n. 13 ("extensive" commodities trading in the United States was held to be a trade or business); *Nubar, supra* n. 47 at 588 (4th Cir. 1950), *cert. denied*, 341 U.S. 925 (1951) ("...there can be no question but that the extensive trading in stocks and commodities constituted engaging in a trade or business..."); *Liang, supra* n. 41 (1955) (the absence of frequent short-term turnover in the taxpayer's portfolio over a 7-year period precluded finding that a nonresident alien individual was engaging in a U.S. trade or business by virtue of his securities investments).

[86] Regulations Section 1.864-4(c)(5).

[87] *See* G.C.M. 38456 (Jul. 25, 1980), setting forth the reasons for the interpretive division's disagreement with a proposed revenue ruling to the effect that any lending activity by a fixed investment trust would automatically cause it to be considered to be conducting a business, making it ineligible to be classified as a grantor trust. The GCM indicated that factors relevant to the determination of whether the trust's lending activity amounted to a business - - none of which were discussed - - would be "the number of loans that were made, the length of time over which loans were made, [and] the activity involved in making loans." It went on to conclude that "the total activity involved in making the one-time investment of the trust corpus would not suggest the conduct of a trade or business."

[88] Regulations Section 1.864-4(c)(5).

[89] *See also* Tech. Adv. Mem. 9611001 (Dec. 5, 1995), concluding that a foreign corporation the securities of which were acquired by U.S. multinational investors in a private placement did not receive deposits or make loans within the meaning of Regulations Section 1.864-4(c)(5). The ruling includes the following language: "We conclude that [the corporation] did not conduct its business in a customary business-like manner for a banking, financing or similar business entity. [Its] operating capital was derived almost exclusively from capital contributions by U.S.

Cases under Section 166 have consistently stated that a trade or business of lending money "is limited to those exceptional situations where the lending activities are so extensive and continuous as to elevate that activity to the status of a separate business."[90] Where the taxpayer held himself out (formally or informally) as a lender, the Tax Court has found a lending trade or business based on 31 loans over a 10-year period[91] and 66 loans over a 15-year period.[92] In the absence of a taxpayer's holding himself out as a lender, a lending trade or business was found to exist based on a somewhat higher level of activity, such as 21 loans over a period of two years[93] and more than 40 loans over a period of 5 years.[94] The Tax Court has declined to find a lending business when faced with less extensive and regular lending activity.[95]

A private letter ruling[96] concluded that a partnership which originated construction loans on a limited basis was not engaging in a financing or lending business for purposes of Section 7704(d)(2) (which defines the categories of income that a publicly traded partnership can earn while continuing to qualify for treatment as a partnership for U.S. federal income tax purposes), based on the following factual representations: (1) the partnership would not hold loans or any other assets for sale to customers in the ordinary course of business; (2) the partnership would hold the loans until maturity or refinancing, except in cases of default; (3) the partnership would originate on average not more than five loans per year; and (4) the partnership would not have more than two employees at any time. We believe that many of these factors are also relevant in analyzing whether limited lending by a Foreign Person amounts to a U.S. trade or business.

3. Proposed Safe Harbor

We recommend providing a safe harbor under which a Foreign Person's lending activity over a defined period would not be considered to be a U.S. trade or business, and therefore would not cause the Foreign Person to be ETB, if: (1) the Foreign Person does not hold itself out to others as a lender, and is not a dealer in securities; (2) the originated loans, unless incidental to the Foreign Person's investment or trading activities, are not disposed of (except in the case of default) prior to maturity or, if earlier, the second anniversary of the Foreign Person's commitment to lend; and (3) the Foreign Person does not originate more than four loans per year during the taxable year in question and each of the two immediately preceding taxable years (if

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multinational investors which were redeemable upon three months' demand...It did not have independent facilities (including a dedicated phone line) to receive deposits or process loans nor did it advertise to promote its services. It received no requests directly from the public to provide financing or other banking services. In order to be treated as engaged in the banking businesses in the international banking environment, [it] should have had some banking activity and customers [emphasis added]...."

[90] *Ruppel, .supra* n. 26 at 832, quoting *Imel, supra* n. 32 at 323.

[91] *Jessup, supra* n. 25.

[92] *McCrackin, supra* n. 25.

[93] *Ruppel, supra* n. 26.

[94] *Minkoff, supra* n. 25.

[95] *See, e.g., Barish v. Comm'r*, 31 T.C. 1280 (1959), involving 6 loans in one year and one loan the following year, and *Imel, supra* n. 32, involving 8 or 9 loans over a period of four years.

[96] PLR 97010006 (Sept. 4, 1996).

any). For these purposes, a revolving credit or staged-payment loan would count as only one loan if (but only if) the following requirements are satisfied: (1) there is a specified cap on the total amount that the Foreign Person can be required to advance; (2) the initial advance represents at least 20% of the maximum amount to be advanced under the loan agreement; and (3) provided no default occurs, there is no discretion on the part of the Foreign Person as to whether to make further advances on the terms specified in the commitment. It may be appropriate for the safe harbor to include an anti-avoidance rule, under which lending activities by beneficial owners in any tiered arrangement a principal purpose of which is to enable entities at different tiers to satisfy the safe harbor, would be attributed to the Foreign Person seeking to qualify for the safe harbor.

C. Loan Is Incidental to Equity Investment

1. Description

Lending transactions that are in the nature of private equity transactions (e.g., because they are coupled with the acquisition of rights to acquire equity in the issuer or a person related to the issuer) should not be treated as "lending."

2. Analysis

There is widespread agreement among tax practitioners that certain investments, such as private investments in public equity (PIPEs), do not implicate trade or business issues for a Foreign Person even though one of the components of the investment package might be a loan or a debt-like preferred stock. The distinguishing characteristic of PIPEs is the equity component of the economic returns. There are three principal types of PIPEs investments.[97] The first type is a short-term loan that will be paid solely in the issuer's stock.[98] The second type is a convertible note. The third type is a non-convertible note plus warrants. The issuers are generally non-investment-grade credits that cannot borrow from banks or other traditional lenders because they have neither a tangible net worth nor a history of consistent cash flows. The financial strategy of a PIPEs transaction is that the funds advanced will permit the issuer to use the funds to complete a business plan which will positively affect earnings, cash flows and stock values.

PIPEs investments are evaluated from an economic standpoint as an equity investment. PIPEs investors typically project potential future equity returns based on factors commonly applied in analyzing equity investments, such as the achievement of future earnings, price/earnings multiples, private to public company comparisons, and volatility factors. Hedge funds or private equity investors that specialize in PIPEs investments are not competing with traditional U.S. lenders, such as banks, finance companies or mezzanine funds. As noted above, the typical PIPEs issuer generally cannot obtain funds from a bank or finance company. Mezzanine lenders lending in today's market typically seek a 15% fixed return and obtain some

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[97] A fourth type does not implicate lending activities, namely, preferred stock that is convertible into equity of the issuer. The origination, holding and sale of convertible preferred stock is not a U.S. trade or business. See *Whipple, supra* n. 35.

[98] This investment should not be characterized as a debt instrument under Notice 94-47, 1994-1 C.B. 357, and Notice 94-48, 1994-1 C.B. 357.

equity to hopefully raise their returns to 17-18%, whereas PIPEs investors are generally seeking returns in excess of 25%. The debt component serves to protect the PIPEs investor from downside risk while its upside is preserved in the equity components. The primary reason for the Foreign Person's decision to participate in a PIPEs transaction is the equity component, without which the investment would not be made.

We believe that PIPEs transactions are more akin to investment transactions than a lending or financing business, and recommend that a safe harbor be provided under which making a loan as part of an investment in which deriving a return from the equity component is the Foreign Person's dominant motivation for making the investment would not constitute a USTB and also would not count as a "loan" for purposes of the other safe harbors proposed herein.

3. Proposed Safe Harbor

Our proposed safe harbor would allow a loan made to a U.S. borrower by a Foreign Person to be disregarded in determining whether the Foreign Person is ETB, and also to be disregarded as a "loan" for purposes of the other safe harbors proposed herein, if (1) the Foreign Person acquires stock or rights to acquire stock in the borrower (or its parent) in connection with making the loan, (2) the Foreign Person holds the loan and the related stock or stock rights (including any stock acquired by converting the loan or exercising the stock rights, as applicable) for a combined continuous holding period of more than 12 months, and (3) based on recognized methods of financial analysis, at the time of making the investment, the Foreign Person reasonably expects to earn more than 50% of its return (on a present value basis) from appreciation in the value of the equity components of the investment unit. The term "return" refers to all profits to be earned from interest income, dividends and gain on a sale of the stock after conversion of the convertible debt or exercise of the warrants. The term "appreciation" highlights that the return on the investment is from future equity growth. We contemplate that the proposed safe harbor would apply generally but not exclusively to PIPEs investments. A Foreign Person seeking to rely on the safe harbor would be expected to be able to furnish contemporaneous evidence of its financial analysis projecting that over 50% of the overall projected return from the applicable investment will be derived from the equity components.

D. Lending to Protect A Pre-Existing Investment

1. Description

Where a Foreign Person's dominant motivation in making a loan is to acquire, protect or enhance a pre-existing investment, the Foreign Person should be able to make the loan without being deemed to be ETB.

2. Analysis

In general, case law does not treat equity investing as a trade or business regardless of the level of the Foreign Person's involvement in originating and negotiating the terms of the

applicable equity instrument.[99] For example, a Foreign Person may widely advertise in the U.S. that it is seeking investment opportunities, and may originate and negotiate equity investments directly with the company in which it invests, without being considered to be ETB.[100]

The trade or business issue may become less clear, however, if, in addition to acquiring or holding an equity position, the Foreign Person subsequently makes a loan to the issuer. While there is no tax law directly on point, authority under Section 166 holds that loans made to enhance or protect an existing investment do not support a finding of a separate "lending" trade or business.[101] As an example of the latter, a Foreign Person may advance funds directly to an investee company experiencing financial distress as part of a workout or other debt restructuring in an attempt to protect an existing investment position. Moreover, loans made in these circumstances ordinarily would not be expected to involve any sort of "customer" relationships or regularity, which as discussed in Part IV.B, are factors typically used to distinguish a business from other non-business activities.[102] Accordingly, a Foreign Person should be able to advance funds to a company in which it has a pre-existing investment in an attempt to either enhance the value of or protect the prior investment without being deemed to be ETB.

3. Proposed Safe Harbor

A loan made by a Foreign Person primarily for the purpose of protecting or enhancing a pre-existing investment would not cause the Foreign Person to be treated as ETB, and also would not count as a "loan" for purposes of the other safe harbors proposed herein. We believe that, by limiting the safe harbor to loans made "primarily" for the purpose of enhancing or protecting an existing investment, Foreign Persons will be prevented from qualifying for the safe harbor by making "de minimis" investments in contemplation of making future loans. Some members of the Committee suggested that the safe harbor should require that the value (current or potential) of the earlier investment must be a certain minimum amount when compared to the loan being made, while other members of the Committee suggested that the value of the earlier investment in relation to the Foreign Person's portfolio is of even greater relevance in analyzing the Foreign Person's motive for making the loan. On balance, we believe that an intent-based test, while deficient from the standpoint of providing certainty to persons seeking to rely on it, has the advantage of taking the correct approach both as a policy matter and based on existing case law, without being unduly restrictive.[103]

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[99] *See, e.g., Higgins, supra* n. 12 at 218 (1941).

[100] *See Whipple, supra* n. 35.

[101] *Id.* (citing *J.F. German, supra* n. 35; *Gubbini, supra* n. 37; *M.J. Kelly v. Patterson*, 331 F.2d 753 (1964); *I.H. Millsap, Jr. v. Comm'r*, 46 T.C. 751 (1966).

[102] *See* Regulations Section 1.864-4(c)(5)(i), requiring that the enumerated activities be with "the public;" *see also,* as possible indirect additional authority, Section 864(c)(4)(D)(i), which excludes from ECI, interest earned by Foreign Persons on loans made to more than 50%-owned foreign corporations, and Regulations Section 1.864-4(c)(5), to the effect that a Foreign Person can make loans to domestic affiliates without such lending causing the Foreign Person to be ETB.

[103] Consistent with our conclusion above, our proposed safe harbor, in contrast to the safe harbor proposed in Part IV.C, does not require the Foreign Person to establish that its projected return from the prior investment exceeds its expected return on the loan at the time the loan is made.

We also considered, and rejected, the notion that the safe harbor should be limited to loans made primarily for the purpose of enhancing or protecting an existing *equity* investment. Instead, we believe that protecting a prior investment in a debt instrument is no less worthy of a safe harbor than protecting a prior equity investment. The key word, of course, is "investment," that is, the prior expenditure must not have been made in connection with a lending or financing business.

V. Conclusion

We appreciate Treasury's consideration of our recommendations, and would be pleased to discuss them with the appropriate persons.

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