



IRS Rules Offshore Loan Activities Subject to U.S. Tax

In a legal memorandum issued by the Office of the Chief Counsel, the Internal Revenue Service (“IRS”) has concluded that a foreign corporation’s income attributable to certain loan activities was effectively connected with the conduct of an active trade or business within the United States and, therefore, was subject to U.S. income tax. However, the activities of the foreign corporation in the memorandum were significantly different than typical offshore fund investment activities and the adverse conclusion under the facts in the memorandum is not particularly surprising. The troublesome analysis and conclusion in the memorandum should not be applicable in most cases, and certain portions of the analysis may in fact be supportive of favorable tax treatment for typical offshore investment funds.

In the memorandum, a foreign corporation with no office or employees located in the United States entered into a “service agreement” with a U.S. person (referred to in the memorandum as “Origination Co.”) pursuant to which Origination Co. solicited borrowers in the U.S., negotiated the terms of the loans, and performed credit analyses and all other activities relating to loan origination, other than the final approval and signing of the loan documents. As consideration for these services, the foreign corporation paid Origination Co. an arms-length fee. The only activities of the foreign corporation’s employees with respect to the loans, which was performed in an office located outside of the United States, was to give final approval for each loan and physically sign the loan documents on behalf of the foreign corporation.

Under these facts, the IRS concluded that, pursuant to the service agreement, Origination Co. was an agent acting on behalf of the foreign corporation. Therefore, the loan activities performed by Origination Co. were attributable to the foreign corporation for purposes of determining whether the foreign corporation engaged in a trade or business within the United States. According to the memorandum, courts have found a U.S. trade or business where a taxpayer’s U.S. activities, either directly or through an agent, are considerable, continuous, and regular. In the facts at issue in the memorandum, the IRS notes that Origination Co.’s activities on behalf of the foreign corporation were more than ministerial or clerical in nature. Therefore, according to the IRS, the lending activities of the foreign corporation (through its agent, Origination Co.) were considerable, continuous, and regular causing the foreign corporation to be engaged in an active lending business in the United States. Furthermore, the IRS ruled, contrary to the taxpayer’s assertion, that it was not necessary for the foreign corporation to have its own office in the U.S. through which the lending business was carried on. The U.S. office of Origination Co., the foreign corporation’s agent, was sufficient because interest on loans to U.S. borrowers is U.S. source income, not foreign source income.

CHARLOTTE

CHICAGO

GENEVA

HONG KONG

LONDON

LOS ANGELES

MOSCOW

NEW YORK

NEWARK

PARIS

SAN FRANCISCO

WASHINGTON, D.C.

The arrangement between the foreign corporation and Origination Co. in the memorandum is significantly different than typical offshore investment fund activities with respect to loan acquisitions. Generally, loan acquisitions by offshore investment funds are subject to a set of tax-related investment guidelines that limit the direct or indirect participation of the offshore fund in loan origination activities by U.S. persons. As a result, it is expected that most offshore investment funds will not be treated as engaged in a U.S. trade or business because they qualify for a safe harbor for foreign persons that trade in loans (or other securities) for their own account.

It is important to note that in the memorandum, the IRS specifically concludes that the safe harbor for trading in loans for one's own account is unavailable to the foreign corporation because it engaged in an active lending business through its agent Origination Co. This conclusion is consistent with what has long been understood as the position of the IRS, although some commentators have expressed the view that a foreign person's origination of loans to hold in its own investment portfolio should qualify for the safe harbor.

Although the conclusion in the memorandum was certainly adverse to the taxpayer involved, there are portions of the analysis that are supportive of the position that most offshore investment funds are structured so as to not be subject to U.S. tax. The memorandum repeatedly states that Origination Co.'s loan activities on behalf of the foreign corporation were "considerable, continuous and regular." The implication is that inconsistent or irregular loan-related activities by an offshore fund would not

be sufficient to cause the fund to be treated as engaging in an active lending business in the U.S. This conclusion is consistent with the IRS's position in Private Letter Ruling 9701006 that the origination of five or fewer loans during the course of a year, with the intention of holding the loans to maturity, is not sufficiently regular and continuous to constitute the active conduct of a finance business for purposes of the regulations relevant to the taxation of "publicly traded partnerships."

Although the memorandum seems clearly distinguishable from the way most offshore investment funds are structured and operated, and in some ways the IRS's analysis in the memorandum is supportive of the favorable tax treatment for those funds, the author of the memorandum concludes somewhat ominously as follows:

We understand that foreign corporations and non-resident aliens may have used other strategies to originate loans in the United States giving rise to effectively connected income. We encourage you [IRS personnel] to develop these cases, and we stand ready to assist you in the legal analysis.

The IRS has for a few years had on its business plan the release of interpretative authorities with respect to the safe harbors relied on by most investment funds for concluding that they are not engaged in a U.S. trade or business. However, prior to this Chief Counsel memorandum, no guidance in the area of offshore loan activities has been issued by the IRS.

We will continue to monitor further developments in this area. In the meantime, if you have any questions or concerns, please call any of the following partners in our tax group:

Chicago Office

Dennis J. Kelly	312-558-5986
Roger S. Lucas	312-558-5225
Andrew W. Ratts	312-558-5991
Louis J. Weber	312-558-5627

dkelly@winston.com
rlucas@winston.com
aratts@winston.com
lweber@winston.com

New York Office

Edmund S. Cohen	212-294-2634
Susan F. Klein	212-294-6879

ecohen@winston.com
sklein@winston.com

These materials have been prepared by Winston & Strawn LLP for informational purposes only. These materials do not constitute legal advice and cannot be relied upon by any taxpayer for the purpose of avoiding penalties imposed under the Internal Revenue Code. Receipt of this information does not create an attorney-client relationship. No reproduction or redistribution without written permission of Winston & Strawn LLP.