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CLIENT ALERT

No Reason for Treaty Investor's Right to Terminate Manager Without Cause

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One tax-efficient way for a non-United States person to invest in U.S.-based loan activities is to rely on the provisions of an applicable U.S. income tax treaty which allows the lending business income to avoid U.S. income taxation so long as the income-producing loan activities are not attributable to the non-U.S. investor's permanent establishment in the United States. For this purpose, a permanent establishment generally includes a place of management, a branch, or an office. However, the non-U.S. investor is also treated as having a permanent establishment in the United States if a dependent agent has the authority to conclude contracts on behalf of the non-U.S. investor and habitually exercises that authority through a permanent establishment in the United States. However, under most treaties, a non-U.S. investor is not treated as having a permanent establishment in the United States by reason of the activities of an independent agent in the United States that acts in the ordinary course of its business as an independent agent.

So, in virtually every treaty-based structure, to accommodate a non-U.S. investor's investment in a U.S.-based lending activity, it is essential to confirm that the investment manager (or similar service provider) engaging in the income-producing activities in the United States on behalf of the non-U.S. investor is acting as an independent agent.

The determination of whether a manager is an independent agent is, of course, not clearly defined by applicable U.S. tax law and is based on all of the relevant facts and circumstances. Tax counsel will typically focus on certain specific factors which the few available authorities suggest are relevant. For example, the greater the number of non-U.S. investors represented by a manager, the more likely the manager is acting as an independent agent.

The purpose of this briefing is to focus on one factor that is often thought to be essential to conclude that the manager is an independent agent that we believe is based on a misreading of the Tax Court case where it originated. Specifically, tax counsel tasked with creating a treaty-based structure may require that the non-U.S. investor have the right to terminate the agreement with the manager without cause. The perceived significance of that factor traces its roots to the decision of the Tax Court in *The Taisei Fire and Marine Insurance Co., Ltd. v. Commissioner*, 104 T.C. 535 (1995). In *Taisei*, the court concluded that the U.S. service provider (a reinsurance agent) was an independent agent and one of the facts described in the decision was that the non-U.S. persons had the right to terminate the U.S. service provider without cause (with six months' notice). However, a close reading of the *Taisei* decision discloses that the right to terminate the service provider without cause was not a significant factor supporting the Tax Court's favorable conclusion and, in fact, could have been viewed by the court as an adverse factor.

In *Taisei*, the Tax Court concluded that independent agent status requires both legal independence and economic independence. *Taisei*, 104 T.C. at 549–51.

In first addressing the concept of legal independence, the court saw "comprehensive control" as determinant. *Id.* at 551. The IRS pointed to the various restrictions on the insurance activities which the U.S. service provider was hired to undertake on behalf of the non-U.S. persons (e.g., limitations on acceptance and net premiums) as indicative that the service provider was subject to comprehensive control by the non-U.S. persons. The Tax Court disagreed and concluded:

> As an agent, [the service provider] had complete discretion over the details of its work. As an entity, [the service provider] was subject to no external control. In sum, [the service provider] was legally independent of [the non-U.S. persons].

Id. at 555. Although the argument was not presented to the court by the IRS, it seems clear that the ability of the non-U.S. persons to terminate the U.S. service provider without cause effectively eliminated, or at least seriously undermined, the U.S. service provider's control.

In our view, in the case of a treaty-based structure accommodating a non-U.S. investor's investment in a U.S. lending activity, allowing the non-U.S. investor to terminate the agreement with the U.S.-based manager would be inconsistent with establishing the legal independence of the manager. Without legal independence, the manager cannot be an independent agent. *See id.* at 549–51.

Although the Tax Court in *Taisei* did not discuss the relevance of the non-U.S. persons' termination right in the context of determining legal independence, it is recited as a fact in the separate part of the court's decision regarding economic independence. *Id.* at 555. The court viewed economic independence as determined by the existence of "entrepreneurial risk." *See id.* at 551, 551.

In concluding that the U.S. service provider bore entrepreneurial risk, the court focused on the need for the service provider to procure adequate client income to cover its expenses and to establish terms and conditions for its services consistent with the current market, and on the existence of a sufficiently large pool of potential clients from which the service provider could draw new clients. *See id.* at 555–556.

Although the Tax Court at the beginning of its discussion of economic independence refers to the right of the non-U.S. persons to terminate the agreement with the U.S. service provider, it does not rely on that fact in any of its subsequent analysis leading to the conclusion that the service provider had economic independence. *See id.* Rather, the court relied on the facts that the service provider had to bear its own expenses and the service provider was not dependent on a limited source of revenues.

In the context of a treaty-based structure accommodating a non-U.S. investor's investment in U.S. lending activities, the manager's economic independence should be able to be adequately demonstrated by the manager bearing responsibility for the payment of its own operating expenses and having a sufficient volume of business with enough clients to show that reliance on any one client is not essential to the manager's continued operations. This can be demonstrated by the manager's financial history and the market conditions for the manager's loan investment activities, as the Tax Court did in *Taisei*. It should not be necessary to show that any one client is not essential to the manager by giving to all clients who are not U.S. persons the right to terminate the manager without cause.
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