

CLIENT ALERT

IRS Victory in *YA Global v. Commissioner*: A Cautionary Tale

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On November 15, 2023, the Tax Court released its opinion^[1] in *YA Global v. Commissioner* and, among other conclusions, held that YA Global Investments LP, a Cayman Islands limited partnership (YA Global), was engaged in a U.S. trade or business for purposes of Code Section 864.

I. FACTUAL BACKGROUND

YA Global was a hedge fund that focused on equity-related lending transactions with convertible instruments and standby equity distribution arrangements (SEDAs). In 2001, YA Global was initially formed as a Delaware limited partnership. In early 2007, YA Global registered as a Cayman Islands limited partnership. From YA Global's formation until early 2007, Yorkville Advisors, LLC, a Delaware limited liability company (Yorkville), was YA Global's sole general partner. Yorkville Advisors GP, LLC was then YA Global's sole general partner from 2007 until 2011. YA Global had two feeder funds: YA Offshore, a Cayman Islands corporation (for YA Global's non-U.S. and tax-exempt investors), and YA Onshore, a Delaware partnership (for YA Global's U.S. investors).

YA Global entered into certain management agreements with Yorkville (the "Management Agreements") whereby Yorkville agreed to act as the agent of YA Global with the authority to buy and sell securities. Importantly, YA Global retained the right to give certain interim investment advice to Yorkville during the terms of the Management Agreements. Yorkville also conducted an extensive lending and stock underwriting business for YA Global, primarily through Yorkville's U.S. office.

Specifically, with respect to YA Global's lending business, Yorkville (on behalf of YA Global) negotiated directly with borrowers with respect to all key terms of the loans, lent borrowers money in return for debt instruments that were convertible into the borrower's stock at a future date, and sought to earn a spread on the transactions by quickly disposing of the stock once the relevant debt instrument had been converted at a discount.

With respect to YA Global's stock underwriting business, Yorkville entered into, and negotiated the terms of, certain distribution agreements with unrelated issuers. Pursuant to a distribution agreement, an issuer was entitled to periodically issue and sell to YA Global (at a discounted price) shares of stock on which YA Global could, through a series of mechanisms, earn a spread. In addition, YA Global directly and indirectly (through Yorkville) received significant commitment, structuring, and due diligence fees paid by the issuers.

From 2006 until 2008, YA Global took the position that it was not engaged in a U.S. trade or business.

II. CHIEF COUNSEL ADVICE (CCA) 201501013

The issues considered by the Tax Court were first assessed by the Internal Revenue Service (IRS) in Chief Counsel Advice (CCA) 201501013.^[2] In that memorandum, the IRS concluded:

- YA Global was engaged in a U.S. trade or business because Yorkville was an agent of YA Global. Accordingly, Yorkville's engagement in the lending and underwriting businesses was attributable to YA Global.
- YA Global's activities (conducted by Yorkville) did not qualify for the "trading in stocks or securities" exception under Code Section 864(b)(2)(A) because, rather than profiting from taking on risks or identifying advantageous purchases, YA Global received compensation (in the form of fees, discounted property, and spreads) in exchange for performing certain lending and underwriting activities.
- Even if YA Global's activities qualified as "trading in stocks or securities," YA Global did not meet the safe-harbor exception under Code Section 864(b)(2)(A)(i). The Code Section 864(b)(2)(A)(i) safe harbor only applies to taxpayers with no office or other fixed place of business in the United States that trade securities through an independent agent. The IRS concluded that Yorkville was not an independent agent because it had discretionary authority to conduct the lending and stock distribution and underwriting activities on behalf of YA Global.
- Even if YA Global's activities qualified as "trading in stocks or securities," YA Global did not meet the safe harbor exception to having a U.S. trade or business under Code Section 864(b)(2)(A)(ii). The Code Section 864(b)(2)(A)(ii) safe harbor only applies to taxpayers that are not dealers in securities and that trade for their own account, regardless of whether such trading is done through an independent agent. The IRS concluded that YA Global was not covered by the safe harbor because YA Global was a dealer—through its underwriting activity, YA Global regularly purchased and sold stocks to customers with an intent to earn gains and profits from those transactions.

III. TAX COURT'S DECISION

Consistent with the IRS's conclusions in CCA 201501013, the Tax Court ruled that YA Global was engaged in a U.S. trade or business. The decision addresses a number of matters, but the following aspects of the decision are particularly relevant to the asset management industry.

ATTRIBUTION

The Tax Court assessed the Management Agreements and concluded that Yorkville's activities were attributable to YA Global because Yorkville was an agent of YA Global under agency law principles. The Tax Court viewed this issue as particularly significant since YA Global had no employees and could have only engaged in a U.S. trade or business through an agent.

Specifically, after first rejecting the IRS's proposal that attribution should turn on "whether the putative agent was acting on behalf of or for the benefit of" a foreign person, the Tax Court determined that Yorkville was nonetheless an agent of YA Global and not, as argued by the taxpayer, merely a service provider. The Tax Court cited the Restatement (Third) of Agency in support of its conclusion that an agency relationship exists when the principal has the ability to give the agent interim instructions after the principal-agent relationship has been established. Accordingly, the Tax Court found Yorkville to be an agent of YA Global because the Management Agreements allowed YA Global to give Yorkville interim instructions by both requiring YA Global to "promptly advise" Yorkville "of any specific investment restrictions related to the account" and allowing the relevant investment restrictions to be changed from time to time.

The Tax Court further clarified that Yorkville was an agent even though Yorkville's power of attorney was "coupled with an interest" and, under agency law principles, "[a] power given as security does not create a relationship of agency." Specifically, the Tax Court equated Yorkville's interest to a commission and emphasized that Yorkville did not otherwise have a distinct interest in YA Global.

Finally, while not dispositive, the Tax Court highlighted that the Management Agreements between YA Global and Yorkville referred to Yorkville as YA Global's "agent."

Contrast with Existing Law

Asset managers can benefit by comparing the Tax Court's analysis of the agency relationship in *YA Global* with its analysis of the agency relationship in *InverWorld Inc. v. Commissioner*.^[3] In *InverWorld*, an investment and financial services company in the Cayman Islands ("Cayman Ltd.") entered into an agreement with an indirectly owned Delaware subsidiary corporation ("Subsidiary Inc.") whereby Subsidiary Inc. both provided research and investment recommendations and invested cash and purchased securities at the instruction of Cayman Ltd. The agreement contained a general disclaimer stating that Subsidiary Inc. was to be treated as an independent contractor and not as an agent and Subsidiary Inc. The agreement also stipulated that it did not provide Subsidiary Inc. with the authority to legally bind Cayman Ltd. However, despite this language, the Tax Court interpreted the agreement as granting Subsidiary Inc. with broad authority, including the ability to negotiate and conclude contracts on behalf of Cayman Ltd. The Tax Court ultimately concluded that this grant of authority overrode the general disclaimer and, because Subsidiary Inc. regularly exercised such authority, Subsidiary Inc. was an agent of Cayman Ltd.

Accordingly, when viewed together, *YA Global* and *InverWorld* show that the Tax Court may find an agency relationship based on both the language in the underlying agreements and the course of conduct of the parties.

U.S. TRADE OR BUSINESS

The Tax Court summarized the U.S. trade or business inquiry by explaining that YA Global was engaged in a trade or business because the activities that Yorkville conducted on behalf of YA Global (i) were continuous, regular, and directed at earning income or profit; (ii) went beyond the management of investments; and (iii) were not within the statutory safe harbor for securities trading. YA Global did not dispute that Yorkville's activities were continuous, regular, and directed at earning income or profit, so the Tax Court's decision focused upon the remaining two issues.

Management of Investments

The Tax Court held that YA Global was not simply an investor because YA Global's and Yorkville's profits were not limited to the returns on the capital invested in their portfolio companies. Specifically, even though a portfolio company agreement was typically structured such that YA Global and Yorkville were not paid until the transaction was consummated, certain commitment fees under the terms of the SEDAs were payable upon execution (i.e., before the portfolio company sought any advances). The Tax Court also emphasized that Yorkville received cash fees from the portfolio companies even though Yorkville did not contribute capital to the portfolio companies. Specifically, the Tax Court adopted a wide lens in its examination of Yorkville's activities and explained that "concluding that the fees paid by portfolio companies were for benefits other than their receipt of capital does not depend on identifying specific services that the relevant agreements required [Yorkville] to provide."

Trading Safe Harbors

The Tax Court relied upon its prior analysis and succinctly found that YA Global did not meet either safe-harbor exception to having a U.S. trade or business under Code Section 864(b)(2)(A). Specifically, (i) YA Global did not meet the Code Section 864(b)(2)(A)(i) safe harbor because the activities conducted by Yorkville on behalf of YA Global were not limited to the management of YA Global's investments and (ii) YA Global did not meet the Code Section 864(b)(2)(A)(ii) safe harbor because the income that YA Global earned from the portfolio companies was distinguishable from mere returns on invested capital.

IV. ADDITIONAL TAKEAWAYS

The uniqueness of the underlying facts and circumstances of the *YA Global* decision cast doubt upon the decision's precedential value for taxpayers concerned about realizing effectively connected income as a result of being engaged in a U.S. trade or business. However, there are several notable takeaways:

- In June 2021, the Large Business and International Division of the IRS announced a compliance campaign seeking to determine whether foreign investors are subject to tax on effectively connected income from their lending

activities conducted via a U.S. trade or business. The IRS's favorable result here may reinforce its decision to pursue these audits.

- Offshore funds that attempt to avoid being engaged in a U.S. trade or business via the independence of their onshore managers should carefully examine their management agreements in light of the attribution standard set forth in this decision.
- The Tax Court routinely cited YA Global's and Yorkville's own publications to the taxpayers' detriment. Funds and asset managers should review their marketing materials to avoid obvious pitfalls.

Please contact a member of the Winston & Strawn Tax Practice Group or your Winston relationship attorney for further information.

[1] 161 T.C. No. 11 (November 15, 2023), available [here](#).

[2] Chief Counsel Advice (CCA) 201501013 (January 2, 2015), available [here](#).

[3] T.C. Memo. 1996-301 (June 27, 1996), available [here](#).

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