Foreign fund’s activities conducted through US fund manager constitute US trade or business

On 2 January 2015, the IRS Office of Chief Counsel released CCA 201501013, advising that a fund was engaged in lending and stock underwriting activities in the US as a result of activities undertaken by its agent, a US-based management company, on its behalf. The CCA indicates that these lending and underwriting activities do not constitute “trading in stocks and securities” for purposes of the safe harbors under Section 864(b)(2)(A). Further, it concludes that even if the activities did constitute trading in stocks and securities, the fund was a dealer and would be unable to qualify for the safe harbors. Consequently the fund is engaged in a US trade or business for purposes of Sections 864(b) and 882.

Facts

Fund is an entity treated as a partnership for US tax purposes. Foreign Feeder, an entity treated as a corporation for US tax purposes, is a partner in the Fund and is resident in a country that does not have a tax treaty with the United States. Fund has no employees, but has engaged an unrelated US party, Fund Manager, to act as its agent with full power to buy, sell and otherwise deal in securities and related contracts for Fund’s account.

Acting on behalf of Fund, Fund Manager conducted due diligence on potential borrowers, negotiated the terms of loans, and caused Fund to extend financing, often in exchange for debt instruments convertible into stock of the borrowers. The Fund also received other property in connection with its lending activities, such as warrants to purchase borrowers’ shares. Fund Manager also conducted extensive underwriting activities on behalf of Fund, whereby Fund typically agreed to purchase stock from corporate issuers...
with the intent to re-sell such stock to customers, including US customers, at a profit. Fund earned interest income as well as structuring, due diligence and commitment fees in connection with these activities. Fund Manager provided similar services for other investment entities, and no employees of Fund Manager worked exclusively for Fund. Thus, although it seems that Fund Manager devoted extensive resources to managing Fund’s activities, Fund Manager did not act exclusively for Fund and would not necessarily be economically dependent on Fund.

**Background**

Absent an exception under an applicable income tax treaty, a foreign corporation engaged in a trade or business in the US is taxable on a net basis on income effectively connected with the conduct of that trade or business, and is also subject to a 30% “branch profits” tax on profits not retained in the US business. Similarly, under Section 875(1), a foreign corporation is considered to be engaged in a trade or business within the US if the foreign corporation is a partner in a partnership that is so engaged. For an entity to be engaged in a trade or business within the US, its profit-oriented activities in the US must be “considerable, continuous, and regular.” Merely holding or managing investments should not constitute a trade or business. However, trading in stocks and securities can constitute a trade or business.

Section 864(b)(2)(A) provides two safe harbors regarding trading in stocks of securities in the United States. Under Section 864(b)(2)(A)(i) (Safe Harbor I), the term “trade or business within the US” does not include trading in stocks or securities through a resident broker, commission agent, custodian or other independent agent. Safe Harbor I is available to all taxpayers, including dealers in stock and securities, provided that the foreign taxpayer does not have an office in the United States. Under Section 864(b)(2)(A)(ii) (Safe Harbor II), the term “trade or business within the US” does not include trading in stocks or securities for the taxpayer’s own account, whether by the taxpayer or his employees, or through a resident broker, commission agent, custodian or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions. Safe Harbor II is not available to taxpayers that are dealers in stocks or securities.

For purposes of the Safe Harbors, the regulations under Section 864 equate the term “trading in stocks or securities” to “the effecting of transactions in the US in stocks or securities,” which includes “buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise.” They define a dealer in stocks or securities as one who is a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom.

**Analysis in the CCA**

**US trade or business, before consideration of trading Safe Harbors**

The CCA first considers whether the lending and stock underwriting activities attributed to the Fund constitute mere investment activities or rise to the level of a trade or business, briefly reviewing the leading authorities in this area. In addition to cases on US trade or business per se, the CCA notes that with respect to Fund’s lending activities, authorities that address when a lending activity gives rise to a business for purposes of claiming the bad debt deduction permitted by Section 166 may be informative as to the requisite level and nature of activity. Not surprisingly, given the apparent extent of the lending and underwriting activities attributed to Fund, the CCA concludes that, before considering the possible application of the trading Safe Harbors, these activities caused Fund to be engaged in a trade or business within the United States.

In concluding that the activities performed by Fund Manager on behalf of Fund were attributable to Fund for purposes of Sections 864(b) and 882, the CCA takes the position that activities undertaken by an agent of a foreign person are considered to be performed by the foreign person, regardless of the degree of control the foreign person exercises over the
agent. The CCA relies, in part, on De Amodio v. Commissioner, 34 T.C. 894, 906 (1960), aff'd, 299 F.2d 623 (3d Cir. 1962), in which the Tax Court held that a nonresident alien was engaged in a trade or business when the nonresident alien acquired real property through a real estate agent and managed the properties through other local real estate agents. In De Amodio, the Tax Court did not describe as relevant the degree of control that the nonresident alien exercised over his agents, whether the agents had the power to bind the nonresident alien or whether the agents were “independent.”

This attribution of agent activity to a principal, regardless of the nature of the agency relationship or the powers of the agent, is consistent with the position previously taken by the IRS in a generic legal advice memorandum issued in September 2009 (the “2009 GLAM”), but is stated more unequivocally in the CCA.

Trading in stocks or securities
The Service next considers whether Fund’s activities constitute “trading in stocks or securities” for purposes of the trading Safe Harbors under Section 864(b)(2)(A). With respect to Fund’s lending activities, the CCA notes that Treas. Reg. Section 1.864-4(c)(5) provides that a foreign person is engaged in the active conduct of a banking, financing or similar business, the CCA takes the position that the regulation also demonstrates that such activities can be differentiated from, and do not qualify as, “trading in stocks or securities” for purposes of the trading Safe Harbors. This position is consistent with that articulated in the 2009 GLAM.

With respect to Fund’s underwriting activities, the CCA provides that distributing stocks or securities to US customers exceeds the level of underwriting activity permitted to qualify as “trading in stocks or securities.” It notes that this is consistent with the judicial determinations of the scope of trading activity for purposes of Section 1221(a)(1) and that in that context courts have described “trading” as purchasing and selling securities or commodities in secondary markets to generate profit based on fluctuations in the market value of such traded assets, rather than performing merchandising functions or any other service which warrants compensation by a price mark-up of the securities sold.

Trading Safe Harbor I
The CCA next considers whether either of the trading Safe Harbors would apply if Fund’s activities did in fact qualify as “trading in stocks or securities.”

Trading Safe Harbor I provides that trading in stocks or securities through a resident broker, commission agent, custodian or other independent agent does not constitute the conduct of a trade or business in the United States. The CCA concedes that neither the Code nor the regulations define the term “independent agent” for purposes of trading Safe Harbor I. However, the CCA concludes that for purpose of trading Safe Harbor I, an independent agent does not include an agent who has been granted discretionary authority by the principal. It supports this conclusion by examining the legislative history behind Section 864(b). The current statutory language was enacted as part of the Foreign Investors Tax Act of 1966 (FITA). Prior to amendment, the Code provided that the phrase “engaged in a trade or business within the United States” did not include “the effecting of transactions in the United States in stocks, securities, or commodities through a resident broker, commission agent, or custodian.” Under that definition, the Tax Court found, in 1948, that the trading safe harbor did not apply to a nonresident alien who granted discretionary authority to a US-based agent to trade for his account. FITA amended Section 864(b) to add trading Safe Harbor II, so that non-dealers could engage in trading through agents having discretionary authority. It also amended the pre-existing language, which became trading Safe Harbor I, to add the words “or other independent agent” to the permitted agent list of resident broker, commission agent, or custodian. The CCA concludes that in adding trading Safe Harbor II and permitting non-dealers to trade in the US through US-resident agents explicitly granted discretionary authority, but restricting dealers
to trading in the US through “independent agents,” Congress drew a distinction between the two terms, and that to read the statute otherwise would be to undermine the impact of excluding dealers from trading Safe Harbor II. The CCA does note, citing Taisei,\(^4\) that in the treaty context an independent agent may exercise discretionary authority on behalf of its principal, but believes this irrelevant to the meaning of the term for purposes of the trading Safe Harbor.

**Trading Safe Harbor II**

The second safe harbor under Section 864(b)(2)(A)(ii) permits trading through an agent with discretionary authority or through the foreign person’s US office but requires that the foreign person not be a “dealer in stocks or securities.” The regulations under Section 864 define a “dealer in stocks or securities” as a merchant, with an established place of business, regularly engaged in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom. The CCA concludes that Fund was ineligible for the second safe harbor because Fund’s underwriting activities involved regularly engaging in purchasing stocks and selling them to customers\(^5\) with an intention of earning gains and profits from those purchases and sales, and it had an established place of business (through Fund Manager). The CCA does not express an opinion as to whether Fund’s lending activities (e.g., originating loans, but not selling them) would have otherwise caused it to be a dealer for purposes of the trading Safe Harbors, but notes that in the context of Section 475 such activities could indicate dealer status.

**Implications**

The CCA is similar in many respects to the 2009 GLAM, which found that a foreign fund originating loans had income effectively connected with the conduct of a US trade or business as a result of activities conducted on its behalf by an unrelated party. In particular, both indicate that a foreign person will have a US trade or business if the activities conducted in the US by an agent on its behalf are sufficiently extensive, regardless of the nature of the agency relationship.

The CCA puts taxpayers on notice that the IRS may try to assert that taxpayers who originate loans but hold them to maturity rather than selling them should be treated as dealers for purposes of the trading Safe Harbor, although it remains uncertain whether this activity alone would be sufficient. The CCA makes clear that the IRS is encouraging agents to review taxpayers who may be found to have a US trade or business and may not be eligible for the trading Safe Harbors. Foreign persons without treaty protection (e.g., Hong Kong, Singapore, Brazil), should evaluate whether they could be impacted by the analyses in the CCA. In particular, such foreign persons should review whether they would be engaged in a US trade or business through the attribution of activities conducted by independent agents on their behalf.

---

**Endnotes**

1. These questions may not have been addressed because, as the CCA acknowledges, the Tax Court in *De Amodio* found that the real estate agents were independent agents and, as such, did not cause the nonresident alien to have a permanent establishment in the US under the applicable income tax treaty.

2. The term “independent agent” is defined in Treas. Reg. Section 1.864-7(d)(3) as a “general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity,” for purposes of determining whether the office of an agent may be attributed to a foreign principal.


5. Because the customers included US customers and the Fund was acting for its own account, the Fund was ineligible for the exceptions to dealer status provided in Treas. Reg. Section 1.864-2(c)(2)(iv)(b).
For additional information with respect to this Alert, please contact the following:

**Ernst & Young LLP, International Tax Services - Capital Markets, Washington, DC**

- David Golden +1 202 327 6526 david.golden@ey.com

**Ernst & Young LLP, International Tax Services - Capital Markets, New York**

- Karla Johnsen +1 212 773 5510 karla.johnsen@ey.com
- Colleen Zeller +1 212 773 6463 colleen.zeller@ey.com

**Ernst & Young LLP, Financial Services, Boston**

- Carter Vinson +1 617 859 6361 carter.vinson@ey.com

---

International Tax Services

- Global ITS, **Alex Postma**, London
- ITS Director, Americas, **Jeffrey Michalak**, Detroit
- National Director of ITS Technical Services, **Jose Murillo**, Washington

Member Firm Contacts, Ernst & Young LLP (US)

- Northeast
  - **Johnny Lindroos**, McLean, VA
- Financial Services
  - **Phil Green**, New York
- Central
  - **Mark Muktar**, Detroit
- Southeast
  - **Scott Shell**, Charlotte, NC
- Southwest
  - **Amy Ritchie**, Austin
- West
  - **Frederick Round**, San Jose, CA
- Canada - Ernst & Young LLP (Canada)
  - **Albert Anelli**, Montreal
- Kost Forer Gabbay & Kasierer (Israel)
  - **Sharon Shulman**, Tel Aviv
- Mancera, S.C. (Mexico)
  - **Koen Van 't Hek**, Mexico City
- South America
  - **Luiz Sergio Vieira**, São Paulo
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

International Tax Services
About Ernst & Young's International Tax Services practices

Our dedicated international tax professionals assist our clients with their cross-border tax structuring, planning, reporting and risk management. We work with you to build proactive and truly integrated global tax strategies that address the tax risks of today's businesses and achieve sustainable growth. It's how Ernst & Young makes a difference.

© 2015 EYGM Limited.
All Rights Reserved.

EYG No. CM5099

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com