

# Client Alert

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## IRS ISSUES IMPORTANT GUIDANCE ON FOREIGN LENDING ACTIVITIES

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The IRS has released a memorandum describing a hypothetical situation in which a foreign hedge fund uses a U.S. corporation to be its agent for originating loans in the U.S. The IRS concludes that the foreign corporation is itself engaged in a foreign lending business, even though it has no direct presence or activities in the U.S., because of the agent's activities. The fact pattern described is not atypical for foreign hedge funds and other lenders. This may be indicative of a more aggressive enforcement stance by the IRS with regards to foreign lenders.

Mezzanine funds who engage in loan type activities have historically sought to avoid "loan origination" for U.S. tax purposes because it results in U.S. effectively connected income (and 35% taxation). Funds have historically adopted a number of strategies, including:

- A "season and sell" strategy where they buy loans from related or unrelated funds
- A strategy where they limit the number of loans that they themselves will originate so that their activities are not deemed to be carried on as a regular business
- An independent agent strategy where they purchase loans from other parties, but the decision making (and for the well advised taxpayer, substantially all the negotiating) is done by off-shore persons
- Various hybrids of this strategy.

The IRS concluded that a foreign hedge fund that did not have a U.S. office, but used an exclusive independent agent, had a U.S. trade or business (and therefore, effectively connected income). They applied agency principles to treat the activities of the origination company as attributable to the foreign fund. In this case, the fund had a formal approval process outside of the United States; however, substantially all of the negotiating was done by the exclusive agent loan origination company.

There are many funds in the marketplace that have used exclusive origination companies and taken the position that the fund did not have a U.S. business because the funds themselves did not have a U.S. office and the independent agent did not have authority to bind the fund.

In addition, the IRS made a blanket statement that they are aware that other hedge funds may have used other loan origination strategies that may have resulted in ECI and they are standing by ready to analyze them (phrasing this positive, not negative).

Beyond the specific scope of this memorandum, it is indicative that the IRS may be taking a more aggressive stance with non-U.S. hedge funds and loan origination generally. It is possible that the IRS will issue similar guidance on "season and sell" strategies or other similar issues.