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IRS: Loan Origination by Foreign Entity Through U.S. Intermediary Subject to U.S. Tax

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On September 22, 2009, the Office of Chief Counsel of the Internal Revenue Service ("IRS") released a generic legal advice memorandum ("Memorandum"), concluding that interest income earned by a foreign corporation with respect to loans originated by an agent in the U.S., whether dependent or independent, is subject to net income tax in the U.S. as income "effectively connected" with the conduct of a U.S. trade or business. The Memorandum is significant in that it clearly indicates that the IRS is prepared to take an aggressive stance against strategies developed by offshore funds and lenders that use intermediaries to originate loans in the U.S. without subjecting income derived from those activities to tax in the U.S. An expansive view of the Memorandum indicates that the IRS might also challenge situations in which an intermediary acquires or services loans pursuant to a management agreement.

Facts

The Memorandum addresses the following fact pattern. Foreign Corporation ("FCo") is a corporation organized outside the U.S. in a country that does not have a bilateral income tax treaty with the U.S. and is wholly owned by shareholders who are not U.S. persons. FCo makes loans to U.S. borrowers within the U.S. FCo has no office or employees located in the U.S. To originate loans to U.S. borrowers, FCo outsources the origination activities to a U.S. corporation ("Origination Co"). Under a service agreement between FCo and Origination Co, the activities performed by Origination Co include the solicitation of U.S. borrowers, the negotiation of the terms of the loans, the performance of the credit analyses with respect to U.S. borrowers, and all other activities relating to loan origination other than the final approval and signing of the loan documents. Origination Co conducts these activities on a considerable, continuous, and regular basis. Under the terms of the service agreement, FCo pays Origination Co an arm's length fee for its services. Origination Co performs the origination activities from an office located in the U.S., and Origination Co is subject to U.S. federal net income taxation. Although Origination Co performs all of the origination activities on behalf of FCo, Origination Co is not authorized to conclude contracts on behalf of FCo. FCo's employees, who work in an office located outside of the U.S., give final approval for the loans and physically sign the loan documents on behalf of FCo.

Applicable Law

The U.S. federal income taxation of a foreign corporation depends on whether such foreign corporation is engaged in a trade or business and, if so, whether such a trade or business is carried on in the U.S. The existence of a trade or business in any given taxable year and the determination whether such trade or business is located in the U.S. is based upon all the facts and circumstances, including the presence or absence of a profit motive, the continuity, regularity, and substantiality of the activities, and the nature of the activities. If a foreign corporation is engaged in a U.S. trade or business, it will generally be subject to U.S. federal income tax on its net income that is "effectively connected" with its U.S. trade or business.

Whether income derived by a foreign corporation is treated as effectively connected with its U.S. trade or business depends on the nature of the corporation's activities and the source of the income derived. Under applicable law, any U.S. source interest income in respect of securities received by a foreign corporation during the taxable year in the active conduct of a "banking, financing, or similar business" in the U.S. is treated as effectively connected to the conduct of that business only if the stock or securities giving rise to such income, gain, or loss are "attributable to the U.S. office through which such business is carried on" and the securities were acquired in one of a number of specified manners enumerated under applicable U.S. Treasury regulations, which includes making loans to the public. A loan will be attributable to a U.S. office "only if such office actively and materially participated in soliciting, negotiating or performing other activities required" for the acquisition of such loan.

Memorandum

Applying these rules above to the fact pattern in the Memorandum, the IRS first concluded that FCo is engaged in a trade or business within the U.S. In arriving at this conclusion, the IRS found that Origination Co is an agent, the activities of which are attributable to FCo, the principal: [1]

> "Although Origination Co. acts on behalf of [FCo] pursuant to a service contract and does not have authority to conclude contracts, Origination Co. performs activities that are a component of [FCo]'s lending activities, such as the solicitation of customers, the negotiation of contractual terms and the performance of credit analyses. In similar circumstances, courts have found an agency relationship to exist in fact and have attributed the activities of the U.S. agent to the foreign principal in determining whether the foreign principal conducted considerable, continuous, and regular activity within the United States. […] Because the lending activities of [FCo], which were carried on by Origination Co., were considerable, continuous, and regular, [FCo] is engaged in a U.S. trade or business."

Second, the IRS concluded that FCo is engaged in a banking, financing or similar business activity within the U.S. because its business, through the activities of Origination Co, includes making loans to the public. Third, the IRS concluded that the "U.S. office" requirement can be met without the existence of an "office or other fixed place of business" in the U.S. This conclusion is significant, because in testing whether a taxpayer has an office or other fixed place of business, the existence of an independent agent or an agent that lacks the authority to conclude contracts on behalf of the taxpayer is disregarded under regulations. In distinguishing the two terms, the IRS significantly expands the arrangements under which the activities of an intermediary – whether "agent" (in the traditionally accepted meaning of the word) or not – may be viewed as resulting in a US office attributable to a taxpayer. Finally, the IRS concluded that the active and material participation in soliciting, negotiating or performing other activities required for the acquisition of a loan by the office of an agent was sufficient to cause such loan to be attributable to such office. On the basis of the foregoing, the IRS concluded that the interest on the loans to the U.S. borrowers were effectively connected with FCo's U.S. trade or business and therefore subject to U.S. federal net income tax, notwithstanding the fact that FCo concluded the loans outside the U.S.

Observations

In coming to its conclusions in the Memorandum, the Memorandum does not indicate whether Origination Co is related to FCo, nor does it state whether Origination Co acts only on behalf of FCo or acts in the ordinary course on behalf of other unrelated parties. It provides no indication that it would regard the status of an agent as dependent or independent as affecting whether the acts of the agent should be attributed to an offshore taxpayer.[2] Furthermore, it does not indicate whether FCo had any tax avoidance motives. In light of these omissions, an expansive view of the Memorandum would conclude that the IRS is prepared to take the stance that these distinctions do not matter. A more tailored reading of the Memorandum is also possible. On a literal reading of the Memorandum, the conclusion that Origination Co is an agent appears to be based on the theory that it "performs activities that are a

component of FCo's lending activities." Those words imply that the activities performed by Origination Co are not severable from other activities of FCo and therefore the separate entity, management agreement, arms length pricing, and lack of contractual authority, are not to be respected as creating a separate legal entity acting as a principal on its own behalf. In addition, the Memorandum ignores the general rule under tax treaties that the office of an independent agent or of a dependent agent that does not have the authority to conclude contracts on behalf of its principal is not attributable to the principal.

The conclusion of the Memorandum is particularly troubling for funds which may have foreign corporations as partners and that are formed to acquire and hold debt obligations of U.S. persons. In that case, the fund will want to conduct its activities so as not to cause its foreign partners to be engaged in a U.S. trade or business. Normally, Origination Co would function in a manner similar to that described in the Memorandum. Even if Origination Co purchased the loans rather than originated the loans, the rationale of the Memorandum could affect the performance of certain services by Origination Co to cause the fund to be engaged in a U.S. trade or business. There are many other factual issues other than those addressed by the Memorandum which are relevant in determining whether or not Origination Co should be treated as an agent. Thus, for example, if Origination Co has sufficient capital to hold the originated loans rather than sell them to the fund, it would be more difficult to classify Origination Co as the mere agent of the fund. However, the Memorandum provides no comfort that the IRS may be willing consider any such distinctions as being material to the analysis.

Final Word

We note that the Memorandum is generic legal advice issued by the Office of the Associate Chief Counsel (International). Generic legal advice is not binding on the IRS and is not taxpayer specific. Rather, it is intended to provide assistance to IRS field agents administering industry wide programs or programs that give rise to issues that apply across classes of taxpayers. For the reasons discussed above, the Memorandum is nonetheless significant. It clearly indicates that the IRS stands ready to challenge foreign persons that in the IRS' view have originated loans in the U.S. through the strategy described in the Memorandum as well as "other strategies," leaving open the scope of any future guidance in this area. Furthermore, an expansive reading of the Memorandum could cast doubt on the tax status of arrangements not involving the origination of loans but the mere acquisition or servicing of acquired loans by an unrelated intermediary.

Footnotes

[1] The IRS bases its conclusion on *Inverworld, Inc., v. Commissioner*, T.C. Memo. 196-301 ("Inverworld").

[2] The Tax Court in Inverworld held that the U.S. subsidiary of a Cayman parent company that acted exclusively on behalf of the Cayman parent and not on behalf of unrelated parties had the authority to negotiate and conclude contracts in the name of its parent company, with the result that the U.S. subsidiary was considered a dependent agent of its parent company the activities of which could be attributed to its parent. The Tax Court in Inverworld, however, did not conclude, as the Memorandum seems to suggest, that the actions of an agent that does not have the authority to conclude contracts on behalf of its principal can cause a foreign corporation to be engaged in a trade or business within the U.S.