ARNOLD & PORTER LLP

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LOANS BY OFFSHORE ENTITIES TO UNITED STATES BORROWERS MAY CONSTITUTE EFFECTIVELY CONNECTED INCOME

On September 22, 2009, the Internal Revenue Service (IRS) issued guidance that may significantly impact the US federal tax treatment of offshore hedge funds and other non-US entities that are deemed to make loans to US borrowers. Such foreign entities generally have taken the position that their activities are not subject to US federal taxation because those activities are limited to trading or investing for their own account, and so fall within the scope of the trading safe harbor exception to US federal taxation provided for by the US Internal Revenue Code of 1986, as amended, and the regulations thereunder. While IRS has previously resisted issuing guidance in this area, its recent pronouncement suggests that IRS is looking to give greater scrutiny to the US federal taxation of such activities.

In a memorandum issued on September 22, 2009 (the Memorandum), the IRS Chief Counsel's Office concluded that interest income earned by a non-US corporation on loans made to US borrowers constitutes "effectively connected income" (ECI), where the loan origination activities are performed by an agent located in the United States on behalf of the non-US corporation. The fact that the agent was independent of the non-US corporation was irrelevant to the analysis.

The Memorandum addresses a situation in which a corporation, located in a country that is not party to a tax treaty with the United States, originates loans to borrowers in the United States through a US corporation acting as the agent of the non-US corporation. Pursuant to an arm's-length services contract with the non-US corporation, the US service provider conducts solicitation, negotiation, credit analysis, and other loan origination activities on the non-US corporation's behalf on a "considerable, continuous and regular basis" from the service provider's US offices. The non-US corporation's functions are limited to approving the loans and signing the loan documents.

The Memorandum concludes that interest income earned by the non-US corporation on loans to US borrowers pursuant to such an arrangement constitutes income that is effectively connected with the carrying on of a US trade or business, and thus subject to US federal income tax, under special rules applicable to banking, financing,

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or similar business activities and is not eligible for the trading safe harbor exception from US federal taxation for such activities. Of particular note is the fact that the non-US corporation need not have its own US office through which its activities are conducted. The activities of the US office of the US service provider, specifically the active participation in day-to-day loan origination, are sufficient to subject the non-US corporation to US federal taxation. Further, because the interest income generated on loans to US borrowers constitutes US source income, the Memorandum concludes that the special rules which limit situations in which the activities of an agent can be attributed to its principal with respect to non-US source income do not apply.

Officials at the IRS have indicated that the guidance in the Memorandum should not be read to apply to situations other than the fact pattern specifically described in the Memorandum. While the Memorandum is not intended to be treated as binding precedent, it does signal that the IRS intends to give greater scrutiny to US lending strategies utilized by non-US hedge funds and other non-US entities. In fact, the Memorandum encourages IRS field agents to challenge strategies used by non-US corporations and non-resident aliens to originate loans in the United States and indicates that the IRS Chief Counsel's Office "stand[s] ready to assist [agents] in the legal analysis." Notwithstanding this heightened scrutiny, we believe that non-US corporations and non-resident aliens that have no US office and originate a *de minimis* number of loans over an extended period of time can be distinguished from non-US corporations and non-resident aliens that engage in regular and continuous loan origination activities. Under current law, the limited activities of the former group—absent other relevant facts in any particular case—should not be brought within the scope of the Memorandum and should not rise to the level of a US trade or business.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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