NOTES

WHOSE OFFICE IS THIS ANYWAY? A LOOK AT THE IRS'S NEW POSITION ON OFFSHORE LENDING

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I. INTRODUCTION

"Banks don't lend anymore. Hedge funds have stepped in."[1] Lee Sheppard wrote these words in 2005, but the financial crisis starting in 2008 has shone a spotlight on this significant change in the reality of modern finance. What role hedge funds may have played in causing the financial crisis is debatable,[2] but few will dispute that U.S. businesses have had trouble finding capital even as the economy, on the whole, has started to recover.[3]

There are many possible contributors to the onset of the capital crunch. Among them are banks, which had difficulties meeting capital requirements, in part because their balance sheets were weighed down by mortgage-backed securities that proved to be less valuable than initially thought,[4] and in part because of changes in accounting rules,[5] as well as increases in minimum capital reserve requirements.[6] The U.S. government and the Federal Reserve responded by combining to invest trillions of dollars to purchase "toxic" securities, guarantee loans, provide additional loans, and make direct capital injections into troubled financial institutions.[7]

1. Lee A. Sheppard, *Forthcoming Guidance for Financial Intermediaries and Hedge Funds*, TAX NOTES TODAY, Jan. 19, 2005, *available at* 2005 TNT 12-3 (LEXIS).

2. *See, e.g.*, Mine Aysen Doyran, *Hedge Funds, Systemic Risk and Lessons for the Sub-Prime Financial Crisis*, BUS. REV., CAMBRIDGE, Dec. 2009, at 26 (discussing hedge funds and "systemic risk").

3. *See, e.g.*, DELOITTE, A TALE OF TWO CAPITAL MARKETS 4–14 (2011), *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/CFO_Center_FT/us_cfo_ATaleofTwoCapitalMarkets_030711.pdf.

4. Leslie Scism & Maurice Tamman, *Small Banks Say a Cure Hurts*, WALL ST. J., Jan. 7, 2010, at C1.

5. *See, e.g.*, Brian S. Wesbury & Robert Stein, *Why Mark-to-Market Accounting Rules Must Die*, FORBES.COM (Feb. 24, 2009, 12:01 AM), http://www.forbes.com/2009/02/23/mark-to-market-opinions-columnists_recovery_stimulus.html.

6. Scism & Tamman, *supra* note 4.

7. An early estimate by the inspector general for the Troubled Asset Relief Program ("TARP") suggested that the total U.S. government liability for the various financial bailout efforts could reach \$23.7 trillion. Dawn Kopecki & Catherine Dodge, *U.S. Rescue May Reach \$23.7 Trillion, Barofsky*

While banks have suffered large losses, hedge funds have been rapidly expanding what the Internal Revenue Service ("IRS") considers to be lending. Current hedge fund loans have been estimated to exceed $1 trillion.[8] Hedge funds are now competing with traditional banks in many areas of lending and are dominant players in lending to troubled companies in particular.[9] Although the issue of offshore[10] lending has been brought to the forefront by the financial crisis, the phenomenon is not new.[11] Moreover, countries all around the world have to contend with issues raised by these hedge funds.[12]

Lending hedge funds are organized as partnerships that, for tax purposes, are considered foreign. There is nothing particularly foreign about them, however. They are managed out of offices in the United States, typically New York or Connecticut.[13] What makes them "foreign" is that they are organized in countries other than the United States.[14] The countries

Says, BLOOMBERG.COM (July 20, 2009, 15:01), http://www.bloomberg.com/apps/news?pid=20601087&sid=aY0tX8UysIaM. This worst case scenario, however, appears to have been avoided. More recent estimates peg total government net losses at around $140–$380 billion. *See* Jim Puzzanghera, *Bailout Not So Costly After All*, L.A. TIMES, Feb. 28, 2011, at A1.

8. *See* Ryan J. Donmoyer, *IRS Tells Auditors to Look at Loans by Offshore Funds*, BLOOMBERG.COM (Sept. 24, 2009, 16:11), http://www.bloomberg.com/apps/news?pid=20601087&sid=aAF8XAUBYSdY.

9. *See* Gina M. Biondo, *Why the Origination of Loans by Foreign Distressed Debt Funds Should Not Be Subject to U.S. Tax*, 4 J. TAX'N FIN. PRODUCTS 37, 38 (2003); Lee A. Sheppard, *Neither a Dealer nor a Lender Be, Part 2: Hedge Fund Lending*, 108 TAX NOTES 729, 731–32 (2005).

10. The term "offshore" may evoke thoughts of islands, and, in fact, the tax haven jurisdictions most often used by hedge funds are islands. In 2006, over half of all hedge fund assets worldwide were domiciled in the Bahamas, Bermuda, the British Virgin Islands, and the Cayman Islands. *See* Martin A. Sullivan, *Offshore Explorations: Caribbean Hedge Funds, Part 2*, 118 TAX NOTES 255 (2008). Nevertheless, the analysis of this Note does not depend on the use of islands; any tax haven will do.

11. Indeed, commentators have been discussing such matters at least as far back as 2001. *See* Lee A. Sheppard, *Neither a Dealer nor a Lender Be: Collateralized Debt Obligations Raise New Questions*, 91 TAX NOTES 1038, 1038–39 (2001).

12. *See* STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART I, JCX-62-07, at 10–23 (2007) [hereinafter JCX-62-07] (discussing the history, characteristics, and trends of such funds); STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS AND RELATED ISSUES, PART II, JCX-63-07, at 8–9 (2007) [hereinafter JCX-63-07] (discussing the geographic distribution of such funds).

13. Lee A. Sheppard, *Offshore Investments: Don't Ask, Don't Tell*, 108 TAX NOTES 171, 171 (2005).

14. For purposes of U.S. tax law, foreign partnerships and corporations are those partnerships and corporations that are not "created or organized in the United States or under the law of the United States or of any State." I.R.C. § 7701(a)(2)–(5) (2006). *See also* Treas. Reg. § 301.7701-5(a) (as

of choice are tax havens, generally Caribbean islands.[15] These hedge funds are typically highly leveraged,[16] as are U.S. banks,[17] and have managers who apparently do enough work in the United States to "take lavish compensation,"[18] similar to managers of some infamous U.S. banks.[19] Conversely, however, hedge funds are unregulated—unlike U.S. banks, which are "highly regulated,"[20] and soon may be even more regulated.[21]

Partnerships, of course, do not pay taxes, although their partners and employees do. This Note is not concerned with the taxation of the U.S. partners or managers of these funds.[22] These individuals are taxed comprehensively on their income.[23] The issue, rather, is with the taxation of foreign persons who invest in a hedge fund. These foreign investors generally are not partners in the hedge fund partnership; rather, the partner is a foreign "feeder" corporation organized in a tax haven jurisdiction, with the foreign investors as its shareholders.[24] The United States can tax U.S.-

amended in 2006) (providing that an entity created or organized under both domestic and foreign laws is considered domestic). For comparison, under U.K. law, a company that is not incorporated in the United Kingdom is resident in the country "where the central management and control actually abides." *See* De Beers Consol. Mines Ltd. v. Howe, [1906] A.C. 455 (H.L.) 458 (appeal taken from Eng.); *INTMI20030: Company Residence: Overview*, HM REVENUE & CUSTOMS, http://www.hmrc.gov.uk/manuals/intmanual/INTM120030.htm (last visited Aug. 29, 2011).

15. *See supra* note 10.

16. *See* JCX-62-07, *supra* note 12, at 14–15; Sheppard, *supra* note 13, at 171–72.

17. Edward D. Kleinbard, *Competitive Convergence in the Financial Services Markets*, 81 TAXES 225, 230 (2003).

18. *See* Lee A. Sheppard, *European Countries Chase Hedge Fund Capital*, TAX NOTES TODAY, Mar. 17, 2004, *available at* 2004 TNT 52-6 (LEXIS).

19. *See, e.g.*, Stephen Labaton, *Fed to Monitor Pay of Bankers to Curtail Risk*, N.Y. TIMES, Oct. 23, 2009, at A1.

20. *See* Lee A. Sheppard, *Treasury's Froberg on the Hot Seat About Hedge Fund Lending*, TAX NOTES TODAY, May 8, 2006, *available at* 2006 TNT 88-13 (LEXIS).

21. *See* David Wessel, *For Banks, Change Is Coming*, WALL ST. J., Mar. 18, 2010, at A2.

22. In most cases, if a U.S. person invests directly in a hedge fund's foreign feeder corporation, rather than becoming a partner, the person will be subject to the passive foreign investment company ("PFIC") regime, I.R.C. §§ 1291–1298, which is rarely preferable to partnership taxation. JCX-63-07, *supra* note 12, at 38; Martin A. Sullivan & Lee A. Sheppard, *Offshore Explorations: Caribbean Hedge Funds, Part 1*, 118 TAX NOTES 95, 98–99 (2008). *See also* Philip S. Gross, *Tax Planning for Offshore Hedge Funds—The Potential Benefits of Investing in a PFIC*, 21 J. TAX'N INVESTMENTS, 187 (2004) (discussing the merits of investing in a PFIC).

23. *See, e.g.*, I.R.C. §§ 1, 61 (2006). There may be some concern that these U.S. managers and investors do not actually report all the income they are required to by law, *see generally* Sullivan & Sheppard, *supra* note 22 (discussing tax evasion by U.S. individuals), but this issue is beyond the scope of this Note.

24. *See* JCX-62-07, *supra* note 12, at 2–6 (describing hedge fund structures); Sullivan & Sheppard, *supra* note 22, at 98 ("Foreign investors prefer to invest in the United States through

source income at its source (through withholding), and it can tax a foreign corporation directly (or a foreign investor who invests directly in the hedge fund partnership).[25] Under what circumstances, if any, should the United States tax these corporations?

U.S. tax law classifies foreign persons into two general categories: those that are engaged in a U.S. trade or business ("USTB"), and those that are not.[26] The differentiator is what this Note calls "nexus": whether the foreign person has a sufficient connection to business in the United States such that it should be taxed on par with U.S. businesses, rather than as merely an investor.

To illustrate the application of the nexus rules in practice, consider the following four scenarios:

Scenario 1. *A foreign bank opens a branch in the United States and originates loans to U.S. borrowers from this branch.* The foreign bank is engaged in a USTB, and the United States taxes the bank on the earnings of its branch in much the same way as it taxes a U.S. bank on its earnings from U.S. operations.[27]

Scenario 2. *A hedge fund opens an office in the United States and originates loans to U.S. borrowers from this office.* The hedge fund also is engaged in a USTB and is taxed on its earnings in essentially the same way as the foreign bank is in Scenario 1, meaning that the hedge fund's foreign investors are taxed indirectly.[28]

Scenario 3. *A foreign bank acquires loans to U.S. borrowers that were originated by a third party in the United States.* The foreign bank may or may not be engaged in a USTB (for the same reasons given in Scenario 4 below), but it will likely be taxed (although not necessarily by the United States) regardless. If it is engaged in a USTB, the result is the same as in Scenario 1. If it is not, then the interest likely will be subject to little or no

corporations because their anonymity is preserved and because they are not required to file a U.S. tax return unless they have something else going on.").

25. *See* Sullivan & Sheppard, *supra* note 22, at 98.

26. *See infra* Part II.B.

27. Some important differences exist, however, including rules on how much interest expense can be deducted against the earnings of the branch. *See* JESSICA L. KATZ, CHARLES T. PLAMBECK & DIANE M. RING, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS, at A-45 to -55 (Bureau of Nat'l Affairs, Tax Management Portfolio No. 908-2nd, rev. 2010) (describing and illustrating these rules).

28. The feeder corporation pays the tax on its income from the hedge fund partnership, reducing the funds available for distribution to the foreign investors.

withholding tax by the United States because of the benefits of a tax treaty[29] or may be exempt entirely under the portfolio interest exemption.[30] If the foreign bank can claim the benefits of a tax treaty, however, its earnings are inevitably taxed in the bank's home jurisdiction.[31]

Scenario 4. *A hedge fund acquires loans to U.S. borrowers that were originated by an unrelated party in the United States.* A hedge fund in this scenario takes the position that it is not engaged in a USTB because the activities it is conducting are eligible for the securities trading safe harbors.[32] Furthermore, although hedge funds organized in tax havens cannot claim the benefits of tax treaties,[33] the hedge fund takes the position that the interest on the loans is exempt from withholding taxes under the portfolio interest exemption.[34] Thus, the hedge fund argues that its foreign investors' share of the interest income should not be taxed by the United States at all.

Does the result in Scenario 4 make sense? The securities trading safe harbors and the portfolio interest exemption were added to the law in an effort to attract more mobile foreign capital to the United States.[35] Yet, here hedge funds appear to be using these tools to gain a tax advantage in competition with domestic banks over U.S. customers. The IRS does not seem to think this result makes sense. In late 2009 it released an internal Chief Counsel Memorandum (the "CCM") adopting a new position on the

29. As of 2010, the United States had treaties in effect generally imposing a 0 percent withholding rate with many of the major financial powers of the world, including Canada, Denmark, Finland, France, Germany, Ireland, Luxembourg, Norway, Sweden, and the United Kingdom. I.R.S. Publication 901, tbl.1 (Mar. 31, 2010). Treaties with Japan, China, Spain, and Italy, however, set the rate at 10 percent. *Id.*

30. *See infra* notes 66–69.

31. Tax havens and the United States have not negotiated treaties that lower withholding rates. *See* Sullivan & Sheppard, *supra* note 22, at 98.

32. *See infra* Part III.A.

33. *See supra* note 31.

34. *See infra* Part III.A.

35. *See infra* Part IV.A.

taxation of offshore lending,[36] apparently designed to deal specifically with Scenario 4.[37]

The CCM attempts to tax the foreign investors of Scenario 4 on their U.S.-source income by treating the hedge fund as engaged in a USTB through the activities of the unrelated party that originated the loans.[38] Thus, the CCM potentially gives all four scenarios the same result: U.S. net income taxation at graduated rates. Problematically, however, these scenarios are not the only ones that could be affected by the CCM's reasoning. The CCM essentially has announced a revolutionary and expansive theory of attributive nexus unlike anything that has been seen in U.S. tax law. Under the CCM, a taxpayer apparently can be considered engaged in a USTB because of little more than market penetration, solely through the actions of a third party that cannot bind the taxpayer to contracts and over which the taxpayer exercises little, if any, control.[39]

The CCM's approach is not the only way to address the apparent inequity of Scenario 4. This Note proposes a customer nexus approach to determine whether a foreign person is engaged in a USTB in this context of offshore lending. The goal of this approach is to focus on what matters under current foreign tax policy: whether a foreign person is competing with U.S. businesses for U.S. customers. The CCM, by contrast, is focused on the activities of third parties that, at best, only indirectly show whether a foreign person is competing with U.S. businesses for U.S. customers. The key feature that differentiates a bank or a bank's competitor from a mere investor is the existence of customer relationships. Thus, by focusing on customer relationships, the United States should be able to tax hedge funds

36. I.R.S. Chief Couns. Mem. AM2009-010 (Sept. 22, 2009) [hereinafter CCM], *available at* http://www.irs.gov/pub/irs-utl/am2009010.pdf. This Note calls the position "new" because, until the CCM, the IRS had simply avoided the issue. *See* Lee A. Sheppard, *The IRS's Alternative Reality*, TAX NOTES TODAY, Oct. 22, 2009, *available at* 2009 TNT 202-1 (LEXIS) (observing that the IRS had "ignor[ed] the question . . . for the past decade"). Note that this CCM may not be cited as precedent. I.R.C. § 6110(b)(1)(A), (i)(1)(A), (k)(3) (2006).

37. The CCM itself makes no mention of hedge funds, but commentators are quick to point out that its facts accurately describe a common hedge fund arrangement. *See, e.g.*, Kevin Cunningham & Douglas Poms, *IRS Issues Generic Legal Advice Memorandum on Lending by Non-U.S. Firms*, TAXNEWSFLASH (KPMG, U.S.), Oct. 26, 2009, at 1, *available at* http://us.kpmg.com/microsite/taxnewsflash/2009/Oct/Fund_Lending.pdf (characterizing the CCM as involving a hedge fund); Donmoyer, *supra* note 8 (same).

38. The details of the CCM are discussed in Part III, *infra*.

39. *See infra* notes 215–21 and accompanying text.

that compete with U.S. banks while not needlessly taxing (and driving away) the mobile capital of mere foreign investors.

Part II of this Note first looks at the evolution of the importance of nexus in U.S. foreign tax law. Part II then discusses the modern rules applicable to the taxation of foreign investors in hedge funds and the significance of being engaged in a USTB.

Next, Part III summarizes lending hedge funds' arguments for why their foreign investors should not be taxed on U.S.-source interest income. Part III then discusses the IRS's new position, finding that it has questionable legal support and leaves much uncertainty in the taxation of offshore lending.

In Part IV, this Note addresses the question of how offshore lending should be taxed under current U.S. foreign tax policy. First, Part IV finds that current U.S. policy is to tax the income of foreign taxpayers that compete with U.S. businesses for U.S. customers, while burdening mere foreign investment as little as possible. Second, Part IV discusses the shortcomings of the IRS's new position at achieving both policy goals. Finally, this Note concludes in Part V by arguing that a customer nexus approach to offshore lending could better achieve these goals.

II. THE NEXUS REQUIREMENT

A. A HISTORY

In the absence of tax treaties, the United States has not always differentiated among foreign persons on the basis of nexus. The first U.S. foreign tax rules, beginning in 1909, used a blanket rule, taxing foreign corporations on net income "from business transacted and capital invested within the United States."[40] Later, the country switched to another blanket rule, taxing foreign corporations on all "income from sources within the United States" regardless of a connection to a U.S. business.[41] This system, however, "was complicated, drove away business, caused much resented annoyance to foreigners and involved large refunds."[42]

40. Act of Oct. 3, 1913, ch. 16, § II.G, 38 Stat. 114, 172–77; Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 112–17. *See generally* KATZ, PLAMBECK & RING, *supra* note 27, at A-1 to -2 (describing the history of U.S. income taxation of foreign corporations).

41. *See, e.g.*, Revenue Act of 1934, Pub. L. No. 73-216, §§ 231–36, 48 Stat. 680, 737–38.

42. Mitchell B. Carroll et al., Am. Bar Ass'n, *International Double Taxation—A.B.A. Report*, 14 TAX MAG. 611, 612 (1936).

In 1936, the United States adopted a nexus approach in which foreign corporations were taxed differently depending on whether they were engaged in a USTB.[43] Supposedly, the rationale for this change was simply to replace the old, impractical system with one that was easier to administer"[44] (although, coincidentally, the new regime adopted some of the same principles negotiated in the then-recently concluded tax treaty with France).[45] Importantly, however, the USTB rules shifted the focus of the U.S. international taxing regime. The focus shifted from whether the country could impose a tax on foreign corporations to whether a corporation's contacts were such that it made sense to tax it as if it were a U.S. business, rather than a mere foreign investor.[46]

This 1936 system also proved problematic because under it investment income, as well as business income, was taxed under the business income regime if a foreign corporation were engaged in a USTB, but not otherwise. This was known as the "force of attraction" principle.[47] For example, if a foreign corporation without a USTB had $1 million of interest income from U.S. corporate bonds, and incurred $750,000 of interest expense to earn it,[48] the full $1 million of income would be subject to withholding tax. Using the 15 percent withholding rate of the day,[49] the tax withheld would be $150,000, resulting in a profit of $100,000 on the investment (minus any taxes imposed by the corporation's home jurisdiction). If that corporation opened a U.S. office that manufactured a small number of widgets for a net loss of $50,000, however, it would then have a USTB.[50] The $1 million of interest would be "attracted" to the USTB and no longer subject to withholding. The corporation would be able to deduct its loss on the manufacture of widgets and its interest expense against this income,[51]

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43. KATZ, PLAMBECK & RING, *supra* note 27, at A-1 to -2.

44. *See* H.R. REP. No. 74-2475, at 10 (1936); Andrew Walker, *The Submerged Logic of "Doing Business" and Attribution: Diving Below the Surface of the Offshore Lending "GLAM"* 23 (N.Y. Univ. Sch. of Law, Colloq. on Tax Policy & Pub. Fin., Tax Forum, No. 621, 2010), *available at* http://www.law.nyu.edu/ecm_dlv3/groups/public/@nyu_law_website__academics__colloquia__tax_policy/documents/documents/ecm_pro_064381.pdf.

45. *See* Caroll et al., *supra* note 42, at 611.

46. *See* Walker, *supra* note 44, at 22–24.

47. KATZ, PLAMBECK & RING, *supra* note 27, at A-2.

48. This corporation, we might say, is highly leveraged.

49. Revenue Act of 1936, ch. 690, § 231(a), 49 Stat. 1648, 1717.

50. Let us assume, for now, that this manufacturing activity would amount to a USTB. As explained more thoroughly below in Part II.B, whether a foreign corporation is engaged in a USTB is not always a clear-cut determination today (nor was it in 1936).

51. *See id.* §§ 119, 232(a), 49 Stat. at 1693–95, 1717.

resulting in taxable income of $200,000 on which it would pay taxes at a rate of 22 percent,[52] or $44,000. The corporation thus could save $56,000 by creating a money-losing widget business to go along with its bond investment.[53]

By the 1960s, the United States became concerned about its balance of payments because not enough capital was flowing into the country.[54] In an effort to convince more foreign investors to invest in the United States, the Foreign Investors Tax Act of 1966[55] ("1966 Act") was enacted, thereby mostly eliminating the force of attraction principle, installing in its stead the modern nexus dichotomy that distinguishes between business income and investment income.[56]

Part IV.A will discuss the original and current policy justifications for the 1966 Act and subsequent developments in more detail. First, this Note will establish how the current law works in practice to tax the income of foreign feeder corporations used by foreign investors to invest in hedge funds, and how the IRS has attempted to change the law through the CCM.

B. NEXUS UNDER CURRENT LAW

1. Overview

"[I]ncome from sources within the United States"[57] ("U.S.-source income") earned by a foreign taxpayer has three possible fates: it is taxed on a net basis, it is taxed on a gross basis through withholding, or it is not taxed at all. First, if a taxpayer has a sufficient nexus to be considered engaged in a USTB, and the income "is effectively connected with the

52. *Id.* § 231(b), 49 Stat. at 1717.

53. The $250,000 gross profit from the bond investment, less the $50,000 loss on the widget manufacturing and the $44,000 of tax, is $156,000, which is $56,000 more than the $100,000 after-tax profit the corporation would have received from the bond investment alone.

54. *See* Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689, 690–91 (1987).

55. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539 (codified as amended in scattered sections of 26 U.S.C).

56. *See* KATZ, PLAMBECK & RING, *supra* note 27, at A-2; Dale, *supra* note 54, at 692–93. In addition to attempting to encourage foreign investment, a purpose of the 1966 Act was to prevent the United States from being seen as a tax haven. Thus, while the 1966 Act provided for certain foreign-source income to be ECI, such income was limited to certain narrow categories—income likely not to be taxed in its country of origin. Walker, *supra* note 44, at 25–26.

57. I.R.C. § 861(a) (2006). Today, whether income is U.S. source or foreign source is determined primarily under the rules of §§ 861 and 862. This Note is principally concerned with interest income, which is generally U.S. source if paid by a U.S. resident or domestic corporation, and foreign source if not. *See id.* §§ 861(a)(1), 862(a)(2).

conduct of" that USTB, the income is what this Note calls "ECI."[58] ECI is taxed on a net basis at graduated rates, essentially mirroring the way a U.S. taxpayer would be taxed on the same income.[59] In the case of a foreign corporation, the corporation is taxed at up to the 35 percent regular corporate tax rate and in addition is subject to a branch profits tax of an additional 30 percent (subject to reduction by treaty), for an effective maximum rate of 54.5 percent.[60] If a foreign corporation has a U.S. subsidiary, dividends paid by that subsidiary ordinarily will be subject to a 30 percent withholding tax (again subject to reduction by treaty);[61] the branch profits tax is designed to mirror this result in the case of a foreign corporation that is itself engaged in a USTB.[62]

Second, if the U.S.-source income is not ECI but is "fixed or determinable annual or periodical . . . income" ("FDAP"), then the income ordinarily is subject to tax on a gross basis, collected through withholding, at a base flat rate of 30 percent[63] (unless reduced by treaty).[64] FDAP includes U.S.-source interest and dividends, among other items, but does not include most capital gains.[65] Importantly, however, a massive statutory exception exists for interest income: in many cases, it is entirely exempt from tax under the "portfolio interest" exemption.[66] One potential

58. *See id.* §§ 864(c), 871(b)(1), 882(a)(1).

59. *See id.* §§ 871(b), 882(a).

60. *See id.* §§ 11, 882(a), 884; Mark Stone, *NYC Bar Addresses U.S. Tax Treatment of Lending Activities by Foreign Persons*, TAX NOTES TODAY, May 7, 2007, *available at* 2007 TNT 88-51 (LEXIS).

61. I.R.C. § 881(a). Most major U.S. trading partners have negotiated reduced treaty rates of 5 to 15 percent for dividends, *see* I.R.S. Publication 901, tbl.1 (Mar. 31, 2010), and similar rates for the branch profits tax, *see* PETER J. CONNORS, THE BRANCH-RELATED TAXES OF SECTION 884, at A-56 to -58 (Bureau of Nat'l Affairs, Tax Management Portfolio No. 909-3rd, rev. 2010).

62. 2 BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 15.04[2] (7th ed. 2006 & Supp. 2010).

63. *See* I.R.C. §§ 871(a)(1), 881(a), 1441, 1442. If the foreign taxpayer is not engaged in a USTB, no income will be ECI. Thus, the definition's requirement that income not be ECI will always be met.

64. For a discussion of treaty rates, see *supra* note 31.

65. *See* I.R.C. §§ 871(a)(1)(A)–(D), 881(a)(1)–(4) (defining what is, and by implication what is not, included in FDAP). For simplicity, this Note refers to all types of income listed in §§ 871(a)(1) and 881(a) as FDAP, although technically only the items of §§ 871(a)(1)(A) and 881(a)(1)—including interest, dividends, and rents—are "fixed or determinable annual or periodical . . . income." The scope of items included in FDAP is theoretically quite broad. *See* KATZ, PLAMBECK & RING, *supra* note 27, at A-62.

66. *See id.* §§ 871(h), 881(c). *See also* KATZ, PLAMBECK & RING, *supra* note 27, at A-63 to -70 (discussing the intricacies of the portfolio interest exemption); Yaron Z. Reich, *Taxing Foreign Investors' Portfolio Investments: Developments and Discontinuities*, 79 TAX NOTES 1465, 1474–76

impediment is that, in the case of a foreign corporation that is a "bank," the exemption does not cover interest received "on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of [the bank's] trade or business."[67] What qualifies as an "extension of credit" or a "loan agreement" is not clear,[68] but given that any interest income that might be eligible is by prerequisite not effectively connected with a USTB, a bank at least has a plausible argument that the income does not result from "the ordinary course of . . . business."[69] Because a hedge fund almost certainly is not a "bank" in any case,[70] U.S.-source interest income earned by a hedge fund should be tax-free to its foreign investors unless it is ECI (in which case the full 54.5 percent rate will likely apply).

If a foreign taxpayer is engaged in a USTB and earns U.S.-source income that otherwise would be FDAP (or capital gain or loss), various tests are applied to determine whether that income is closely enough connected with the USTB to be taxed as ECI.[71] Any other U.S.-source income automatically is taxed as ECI, regardless of its connection to the USTB, under the "residual force of attraction" principle.[72] In contrast, if the taxpayer is not engaged in a USTB, any non-FDAP income (such as capital gain) ordinarily will not be taxed by the United States.

The consequences of incorrectly guessing whether a taxpayer has ECI can be severe. For example, if a foreign corporation believes that it is not engaged in a USTB and, accordingly, does not file U.S. income tax returns,[73] and then the IRS later reaches the opposite conclusion, the corporation may be taxed multiple times on the same income (which is now

(1998) (same).

67. I.R.C. §§ 871, 881(c)(3)(A).

68. KATZ, PLAMBECK & RING, *supra* note 27, at A-68.

69. *See* JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C1.03[2][c][vii] (rev. 2009) (suggesting that this exception to the exemption does not apply to notes purchased on a secondary market); Reich, *supra* note 66, at 1475 ("[T]he bank loan exception should not apply to a bank's acquisition of a conventional Eurobond.").

70. In the absence of any regulations on the matter, the IRS has interpreted "bank" as having the meaning given that term under I.R.C. § 581. *See* I.R.S. Tech. Adv. Mem. 98-22-007 (May 29, 1998). Among other things, this definition exempts from its scope an entity that is not a regulated deposit-taking institution. I.R.C. § 581.

71. *See infra* Part II.B.3. If the income is not taxed as ECI, it may be subject to withholding (possibly at a 0 percent rate under a treaty) if it is FDAP, or exempt from tax if it is "portfolio interest" or capital gain. *See supra* notes 63–70 and accompanying text.

72. KATZ, PLAMBECK & RING, *supra* note 27, at A-16. *See* I.R.C. § 864(c)(3).

73. A foreign corporation might be wise to file protective tax returns, but some may be reluctant to for fear of triggering audits. Biondo, *supra* note 9, at 50–51.

ECI). The corporation will also be without the benefit of deductions because a corporation must file a return to claim deductions.[74] This result may be especially punitive in the case of a highly leveraged hedge fund that has a substantial amount of interest expense.[75]

2. U.S. Trade or Business

Before any income earned by a taxpayer can be classified as ECI, the taxpayer must be engaged in a USTB. Although many provisions of the Internal Revenue Code of 1986 ("Code") employ the term "trade or business," there is "no single comprehensive definition."[76] Whether a taxpayer is engaged in a USTB is generally determined under the common law.[77]

The principal question that courts ask is whether the nature and extent of the economic activities conducted in the United States are "considerable, continuous, and regular."[78] This is a "highly factual" inquiry[79] that "can be difficult to predict and to apply," especially in the context of financial activities.[80] As the Staff of the Joint Committee on Taxation has demurred,

74. *See* I.R.C. § 882(c)(2); KATZ, PLAMBECK & RING, *supra* note 27, at A-16. *But cf.* Biondo, *supra* note 9, at 51 (suggesting that a taxpayer may still be able "to claim benefits attributable to capital losses" without having filed a return). KATZ, PLAMBECK & RING, *supra* note 27, at A-16 & n.153, mentions the taxpayer in *InverWorld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231, *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996), as an example of such a corporation faced with this "seemingly punitive result[]."

75. For example, if a hedge fund has $10 million of interest income and $9 million of interest expense, it could have a tax liability of $5.45 million if it is unable to deduct the interest expense—an effective tax rate of 545 percent.

76. KATZ, PLAMBECK & RING, *supra* note 27, at A-13; Anthony P. Polito, *Trade or Business Within the United States as an Interpretive Problem Under The Internal Revenue Code: Five Propositions*, 4 HASTINGS BUS. L.J. 251, 258 (2008). Rev. Rul. 88-3, 1988-1 C.B. 268 (revoking Rev. Rul. 73-227, 1973-1 C.B. 338), notes that the rules for determining whether a taxpayer is engaged in a trade or business within the United States "may differ in some respects from those used in determining whether a taxpayer is engaged in a trade or business under other sections of the Code."

77. *See* KATZ, PLAMBECK & RING, *supra* note 27, at A-13. One statutory exception is that "the performance of personal services within the United States at any time" constitutes a USTB. I.R.C. § 864(b).

78. *See* de Amodio v. Comm'r, 34 T.C. 894, 905 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962) (citing Pinchot v. Comm'r, 113 F.2d 718 (2d Cir. 1940)); KATZ, PLAMBECK & RING, *supra* note 27, at A-13. *See also* Polito, *supra* note 76, at 258–60.

79. Rev. Rul. 88-3, 1988-1 C.B. 268.

80. *See* Stuart Leblang & Rebecca Rosenberg, *Toward an Active Finance Standard for Inbound Lenders*, 31 TAX MGM'T INT'L J. 131, 135 (2002).

"As a practical matter, it is sometimes not possible to differentiate passive investment from bona fide financial services activity."[81]

There are very few cases and administrative decisions dealing with the issue of when cross-border financing activities rise to the level of a USTB.[82] One is left to try to draw analogies to cases deciding the trade or business issue in different contexts. Many of these cases are of at least questionable current validity. These cases include cases about securities trading decided before the securities trading safe harbors were enacted,[83] about bad debt deductions,[84] and about other activities even less relevant to lending or financing.[85]

Nevertheless, it appears that some common criteria have been developed for determining whether activities performed in the United States satisfy the "considerable, continuous, and regular" test. First, the activities must be "active,"[86] meaning the entity performing them must be "involved to a significant degree in the underlying activity."[87] Second, the

81. STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, at 863 (Comm. Print 1987). This statement was used as justification for eliminating a prior separate foreign tax credit limitation "for interest derived in the conduct of a banking, financing, or similar business." *See id.*

82. *See* Leblang & Rosenberg, *supra* note 80, at 136; Jonathan Zhu, Myra Sutanto Shen & Brett R. Dick, *U.S.-Source Interest Income from a Lending Business*, 125 TAX NOTES 785, 789 (2009) ("*InverWorld* is the only published case addressing the ECI rules involving a lending business."). Perhaps the closest decision available—other than the CCM—is an administrative advisory in which the IRS decided not to argue that a company that merely factored receivables of related U.S. corporations was engaged in a USTB. I.R.S. Field Serv. Advisory 2002-24-003 (June 14, 2002). According to the advisory, the factor assumed only a portion of the credit risk of the accounts receivable, while the U.S. corporations continued to make all credit decisions and managed and collected the accounts. *Id.* The apparent lack of customer relationships between the U.S. customers and the factor seems to have been decisive.

83. *See infra* note 130.

84. *See, e.g.*, United States v. Generes, 405 U.S. 93 (1972); Whipple v. Comm'r, 373 U.S. 193 (1963). *See also* Leblang & Rosenberg, *supra* note 80, at 140 ("The domestic bad debt cases can be very difficult to reconcile with each other, and do not provide a logical, predictable template that can be used to make the trade or business of lending determination for purposes of §882 or §871."). Note also that, since bad debt cases involve loan losses, "there may have been a bias against a finding that the taxpayer was a lender." Sheppard, *supra* note 11, at 1042.

85. *See, e.g.*, Johansson v. United States, 336 F.2d 809 (5th Cir. 1964) (personal services); Lewenhaupt v. Comm'r, 20 T.C. 151 (1953) (real property transactions), *aff'd*, 221 F.2d 227 (9th Cir. 1955).

86. KATZ, PLAMBECK & RING, *supra* note 27, at A-13.

87. 2 JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 35.20 (3d ed. 2004).

activities must be "closely and directly related to the derivation of profit,"[88] rather than, for example, merely "[m]inisterial, clerical, or collection-related activities,"[89] activities involved in the investigation of business opportunities,[90] the purchasing of products for resale abroad,[91] or promotional work[92] (yet active solicitation can qualify).[93] Finally, the activities generally must be "fairly extensive"[94] or "numerous,"[95] or else must comprise a "major portion" of a company's business.[96]

While certain activities must be performed in the United States in order for a USTB to be found, courts have not required that all associated activities be conducted within the country's borders.[97] In addition, a USTB does not necessarily require an extended physical presence in the country.[98] For example, engaging in a single horse race in the United States may be sufficient.[99] In contrast, tax treaties (which are not the focus of this Note) commonly allow a host state to tax a foreign business only if that business is conducted in the host state "through a permanent establishment situated therein";[100] a single horse race probably is insufficient.[101]

An added complication in the case of lending and financing activities is that the ECI rules, discussed in Part II.B.3 below, create a particular type

88. KATZ, PLAMBECK & RING, *supra* note 27, at A-13.

89. *Id.* at A-14.

90. Abegg v. Comm'r, 50 T.C. 145, 153–54 (1968), *aff'd*, 429 F.2d 1209 (2d Cir. 1970), *overruled on other grounds by* Lessinger v. Comm'r, 85 T.C. 824 (1985), *rev'd*, 872 F.2d 519 (2d Cir. 1989).

91. *See, e.g.*, European Naval Stores Co. v. Comm'r, 11 T.C. 127, 132–34 (1948), *acq.*, 1948-2 C.B. 2; Amalgamated Dental Co. v. Comm'r, 6 T.C. 1009, 1014 (1946).

92. KATZ, PLAMBECK & RING, *supra* note 27, at A-14 to -15.

93. *See* Rev. Rul. 56-165, 1956-1 C.B. 849 (construing a tax treaty).

94. *See* KATZ, PLAMBECK & RING, *supra* note 27, at A-15.

95. *See* United States v. Belanovski, 236 F.2d 298, 301, 304 (2d Cir. 1956).

96. *See id.* at 303. *But cf.* Scottish Am. Inv. Co. v. Comm'r, 12 T.C. 49, 59 (1949) ("It is not so much the volume of the activities of the [U.S.] office, although volume of activities may, in some cases, be a factor, but rather their character and . . . purpose . . . that we believe are determinative.").

97. Walker, *supra* note 44, at 3.

98. Yaron Z. Reich, *U.S. Federal Income Taxation of U.S. Branches of Foreign Banks: Selected Issues and Perspectives*, 2 FLA. TAX REV. 1, 66 (1994).

99. *See* Rev. Rul. 58-63, 1958-1 C.B. 624.

100. *See, e.g.*, Org. for Econ. Cooperation & Dev. [OECD], *Model Tax Convention on Income and on Capital: Condensed Version*, art. 7, para. 1 (July 22, 2010) [hereinafter OECD Model Convention], *available at* http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en. *See generally* KATZ, PLAMBECK & RING, *supra* note 27, at A-103 to -123 (detailing many of the intricacies of the permanent establishment rules).

101. *See* Rev. Rul. 58-63, 1958-1 C.B. 624.

of USTB called "a banking, financing, or similar business in the United States" ("BFSB").[102] If a taxpayer is engaged in a USTB, the BFSB test is whether the taxpayer's activities consist of one or more of six listed activities,[103] including "[m]aking personal, mortgage, industrial, or other loans to the public."[104] Although this rule might appear to require that a corporation first meet the standard USTB test before any consideration can be given to whether the corporation also meets the BFSB test, the Tax Court in *InverWorld* took a different approach. In *InverWorld*, the court stated that the BFSB test "provides a useful framework . . . for analyzing whether [a taxpayer is] engaged in" a USTB in the first place.[105] Commentators, however, have split over whether this approach is desirable.[106] Nevertheless, *InverWorld* has yet to be challenged by other courts.

Two other Code sections deal with related concepts of banking or financing businesses, albeit not in a cross-border setting.[107] It is not clear to what extent interpretations of these sections might affect the meaning of a BFSB.[108]

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102. *See* Treas. Reg. § 1.864-4(c)(5)(i) (as amended in 2005).

103. *Id.*

104. *Id.* § 1.864-4(c)(5)(i)(b). The complete list of activities is as follows:

> (a) Receiving deposits of funds from the public,
> (b) Making personal, mortgage, industrial, or other loans to the public,
> (c) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,
> (d) Issuing letters of credit to the public and negotiating drafts drawn thereunder,
> (e) Providing trust services for the public, or
> (f) Financing foreign exchange transactions for the public.

Id. § 1.864-4(c)(5)(i)(a)–(f).

105. InverWorld, Inc. v. Comm'r, 71 T.C.M. (CCH) 3231, 3237-18, *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996). But the court also concluded that the foreign corporation was engaged in a USTB using the normal tests. *See* Sheppard, *supra* note 9, at 737–38.

106. *Compare* Leblang & Rosenberg, *supra* note 80, at 142–44 (arguing that one must first determine that a taxpayer is engaged in a USTB before applying the BFSB test), *with* Sheppard, *supra* note 9, at 738 (dismissing the argument that this holding in *InverWorld* is dictum).

107. I.R.C. § 542(d) (2006) (defining a "lending or finance business" for purposes of personal holding companies); *id.* § 7704(d)(2)(A) (using the term "financial or insurance business" in the context of publicly traded partnerships).

108. The personal holding company rules tax certain types of corporations that earn large amounts of passive investment income—an effort by Congress to keep shareholders from avoiding the corporate double tax. *See* 1 BITTKER & EUSTICE, *supra* note 62, ¶ 7.20. Perhaps recognizing that not all income from lending activities is passive investment income, however, Congress has carved out an exception for a "lending or finance business," which includes a business of "making loans" or "purchasing or discounting accounts receivable, notes, or installment obligations." I.R.C. § 542(d)(1). This exception is strictly limited. For example, eligible debts generally must not have remaining maturities of more than twelve years. *See id. See also* Pac. Sec. Cos. v. Comm'r, 59 T.C. 744, 751 (1973) ("[T]he statute does

Even if a taxpayer's activities have all the indicia of a USTB, however, they will not be treated as a USTB if they fit within either one of two statutory securities trading safe harbors.[109] This Note calls these safe harbors the "general trading safe harbor" and the "proprietary trading safe harbor." The general trading safe harbor allows a taxpayer to trade "in stocks or securities through a resident broker, commission agent, custodian, or other independent agent," provided that the taxpayer does not perform the trading through "an office or other fixed place of business in the United States" ("OFPB").[110] The proprietary trading safe harbor uses broader language, allowing the taxpayer to trade directly, or through an employee or dependent agent as well as through an independent agent, and to use an OFPB.[111] The proprietary trading safe harbor, however, is specifically limited in scope to trading "for the taxpayer's own account," and it does "not apply in the case of a dealer in stocks or securities."[112]

If a taxpayer is not engaged in any USTB under the traditional test, the taxpayer does not have ECI regardless of whether the activities fit within—or abjectly fail—the safe harbors.[113] Less certain, and far more important, is the case in which a taxpayer is engaged not only in activities described by the safe harbors, but also in activities that would independently qualify as a USTB. May the taxpayer nevertheless invoke the safe harbors with respect to securities trading activities? Commentators are split.[114] In any case, the safe harbors apply only for purposes of USTB classification.[115] If

not look to the net result. The statute carefully and specifically defines what is the lending or finance business. While there may be no difference in end result between a direct chattel lease and a nonrecourse loan secured by a chattel lease in the 'market place,' the statute clearly makes the distinction in delineating the activities which constitute the lending or finance business as defined in section 542(d)(1).").

The IRS interpreted § 7704(d)(2) in I.R.S. Priv. Ltr. Rul. 97-01-006 (Jan. 3, 1997), finding that a taxpayer with no more than two employees, and that originated an average of no more than five loans per year, was not a "financial business." Some have argued that, because of this ruling, a company must originate more than five loans per year to be a BFSB, although other scholars are not so sure. *See, e.g.*, Leblang & Rosenberg, *supra* note 80, at 141 (arguing that all the facts and circumstances, including the number of employees, are also relevant).

109. *See* I.R.C. § 864(b)(2)(A). There are two other closely analogous safe harbors for trading in commodities. *See id.* § 864(b)(2)(B).

110. *Id.* § 864(b)(2)(A)(i), (C).

111. *See id.* § 864(b)(2)(A)(ii), (C).

112. *Id.* § 864(b)(2)(A)(ii).

113. Treas. Reg. § 1.864-2(e) (as amended in 1975).

114. *See, e.g.*, Sheppard, *supra* note 11, at 1043–44 (presenting, and then countering, an argument by David Miller that the safe harbors may be invoked).

115. *Compare* I.R.C. § 864(b) (defining USTB), *with id.* § 864(c) (defining ECI).

a taxpayer has a USTB for any other reason, the ECI rules may result in ECI treatment for a broad range of U.S.-source income, including many kinds of securities income if the taxpayer is engaged in a BFSB.[116]

The safe harbors contain several terms worth exploring in more detail. Both safe harbors are limited to "securities," which is defined quite broadly to encompass "any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing."[117]

It is not so clear, however, what the safe harbors mean by "resident broker" and the like. This language is seemingly borrowed from the Organisation for Economic Co-operation and Development ("OECD") model treaties.[118] The treaties use the terms "broker" and "general commission agent,"[119] both of which are almost certainly terms of art from U.K. tax law.[120] What bearing this background may have on the United States' interpretation of its own terms (coupled with the addition of

116. *See infra* Part II.B.3.

117. Treas. Reg. § 1.864-2(c)(2)(i)(c). The IRS has also interpreted "securities" liberally. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 87-04-006 (Oct. 15, 1986) (ruling that trade creditor claims arising out of bankruptcy proceedings were securities). *See also* Biondo, *supra* note 9, at 39 (discussing the IRS's interpretations of securities).

118. *See* John F. Avery Jones & David A. Ward, *Agents as Permanent Establishments Under the OECD Model Tax Convention*, 33 EUR. TAX'N 154, 168 (1993). A similar phrase is used in Treas. Reg. § 1.864-7(d)(1)(i) (1972), the OFPB regulation, which is discussed below in Part II.B.4. The relevant part of the 2010 edition of the OECD model treaty has essentially the same text as the 1992 edition analyzed at great length by John Jones and David Ward. It reads as follows:

> 5. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 6 applies—is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.
>
> 6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

OECD Model Convention, *supra* note 100, art. 5, paras. 5–6. *Cf.* Jones & Ward, *supra*, at 155. *See also* Lee A. Sheppard, *Tweaking the Permanent Establishment Concept*, 125 TAX NOTES 1255 (2009) (discussing later developments). The U.S. Model Income Tax Convention mirrors the OECD treaty. *See* UNITED STATES MODEL INCOME TAX CONVENTION OF SEPTEMBER 20, 1996, art. 5, paras. 5–6 (1996) [hereinafter U.S. MODEL CONVENTION], *available at* http://www.irs.gov/pub/irs-trty/usmodel.pdf.

119. OECD Model Convention, *supra* note 100, art. 5, para. 6. *Cf.* U.S. MODEL CONVENTION, *supra* note 118, art. 5, para. 6.

120. *See* Jones & Ward, *supra* note 118, at 163–66.

"resident" before "broker" and the deletion of "general" before "commission agent") is not clear.[121] *InverWorld*, however, did interpret the "other independent agent" language as requiring that the resident broker, commission agent, or custodian also be "independent."[122]

Independence, in turn, is another term given scant content by the Code and regulations.[123] More useful guidance probably comes from the treaty context. Independence for treaty purposes is defined as both legal independence (using a "comprehensive control" test) and economic independence (using an "entrepreneurial risk" test).[124] If an agent has discretion over whom it works for, and how it performs the details of its work, and if it bears economic risk of loss, it is likely independent.[125]

The general trading safe harbor can apply to a taxpayer that is a dealer in securities,[126] while the proprietary trading safe harbor excludes dealers.[127] If a foreign entity wants to fit within the proprietary trading safe harbor (perhaps because the entity has an OFPB that would cause it to fail the general trading safe harbor),[128] the entity must engage only in "trading"

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121. *See id.* at 175.

122. InverWorld, Inc. v. Comm'r, 71 T.C.M. (CCH) 3231, 3237-19, *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996). John Jones and David Ward reach essentially the same conclusion in interpreting comparable language found in treaties. *See* Jones & Ward, *supra* note 118, at 169–70 ("It can be assumed from the use of the word 'other agent' that brokers and *commissionaires* are always independent.").

123. The Code does not define "independent agent" for purposes of the general trading safe harbor. *See* I.R.C. § 864(b)(2)(A)(i) (2006). Although the Tax Court grafted on the definition of "independent agent" found in the OFPB regulation, s*ee InverWorld*, 71 T.C.M. (CCH) at 3237-19 to -20, *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996), this definition too is bare, simply providing that "the term 'independent agent' means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity." Treas. Reg. § 1.864-7(d)(3)(i) (1972). *See also* Richard Crawford Pugh, *Policy Issues Relating to the U.S. Taxation of Foreign Persons Engaged in Business in the United States Through Agents: Some Proposals for Reform*, 1 SAN DIEGO INT'L L.J. 1, 29 (2000) (calling this regulation's definition "frustratingly blurred"). The regulation, however, does provide a helpful hint: related parties and exclusive agents can still be independent. *See* Treas. Reg. § 1.864-7(d)(3)(ii), (iii).

124. *See* OECD Model Convention, *supra* note 100, art. 5, para. 6 cmts. 37–38; Pugh, *supra* note 123, at 31–32.

125. A seminal case on the matter is *Taisei Fire & Marine Insurance Co. v. Commissioner*, 104 T.C. 535, 552–56 (1995), *acq.*, 1995-2 C.B. 1, which found an agent to be legally independent because the agent had "complete discretion" to perform designated duties and worked for multiple principals, and economically independent because the agent had no guaranteed revenue or protection from loss.

126. *See* Treas. Reg. § 1.864-2(c)(1) (as amended in 1975).

127. I.R.C. § 864(b)(2)(A)(ii).

128. *See id.* § 864(b)(2)(C).

without being a dealer anywhere in the world.[129] Trading is an inherently murky concept; its contours lie somewhere between the two poles of "investing" (which is ordinarily not a business activity) and "dealing."[130] Dealing is defined as "regularly" selling stocks or securities "to customers."[131]

Can lending qualify as trading? In a technical sense, the answer must be yes. If an investor purchases U.S. government bonds, that investor is a lender to the U.S. government, and such bonds qualify as securities that can be traded.[132] Interestingly, a "note" also qualifies as a security under the definitional regulation, and at the time the regulation was written, there was no secondary market for notes—implying that at least some origination activities must be within the scope of securities trading.[133] But nowhere do the regulations mention "lending" as being within the scope of securities trading,[134] so a taxpayer that wishes to argue that an activity should be covered by the safe harbors probably will not benefit by phrasing the activity as a kind of lending.[135]

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129. Treas. Reg. 1.864-2(c)(2)(iv)(a). As a practical matter, the solution for a company with a dealer business is to segregate that business into a separate corporation so that dealer status does not taint trading activities. *See* Reich, *supra* note 66, at 1473.

130. *See* KATZ, PLAMBECK & RING, *supra* note 27, at A-17. This murkiness is exemplified by the plethora of cases on the subject decided before the enactment of the securities trading safe harbors. *See, e.g.*, Higgins v. Comm'r, 312 U.S. 212 (1941); de Vegvar v. Comm'r, 28 T.C. 1055 (1957), *acq.*, 1958-2 C.B. 5; Chang Hsiao Liang v. Comm'r, 23 T.C. 1040 (1955), *acq.*, 1955-2 C.B. 4; Kemon v. Comm'r, 16 T.C. 1026 (1951). The securities and commodities trading safe harbors were enacted in 1966. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, sec. 102(d), § 864(b)(2), 80 Stat. 1539, 1544–45.

131. Treas. Reg. § 1.864-2(c)(2)(iv)(a); *Kemon*, 16 T.C. at 1032–34 (distinguishing dealing, which requires selling to customers, from trading, which does not). *Cf.* I.R.C. § 475(c)(1) (defining a "dealer in securities" as including one who "regularly . . . sells securities to customers in the ordinary course of a trade or business").

132. I.R.S. Priv. Ltr. Rul. 88-07-004 (Nov. 10, 1987).

133. *See* Treas. Reg. § 1.864-2(c)(2)(i)(c); Lee A. Sheppard, *Neither a Dealer nor a Lender Be, Part 4—Vulture Fund Self-Help*, TAX NOTES TODAY, Nov. 13, 2008, *available at* 2008 TNT 220-5 (LEXIS).

134. *See* Treas. Reg. § 1.864-2(c)(2); Prop. Treas. Reg. § 1.864(b)-1, 63 Fed. Reg. 32,164, 32,166 (June 12, 1998). *See also* Sheppard, *supra* note 11, at 1040 (concluding that trading does not include lending).

135. *See* Biondo, *supra* note 9, at 40–45 (arguing that lending might fit within the scope of trading, but acknowledging the concern that lending may be too active to qualify).

3. The "Effectively Connected" Requirement

If a foreign taxpayer is engaged in a USTB (as a partner in a hedge fund), then income "effectively connected with" that trade or business is subject to taxation at graduated U.S. rates on a net basis.[136] As explained above, U.S.-source income that would not otherwise (in the absence of a USTB) be FDAP or capital gain is automatically classified as ECI.[137] For U.S.-source interest and other FDAP-like income or capital gain, however, certain rules determine whether the income is treated as ECI. Under the standard rules, it is ECI if it satisfies either the "asset-use" or "business-activities" test.[138] If a foreign taxpayer is engaged not simply in a USTB, but in a BFSB, then a different test must be used, and a higher threshold met, before certain income can constitute ECI.[139]

Under the asset-use test, income derived from assets is ECI if the assets are "used in or held for use in" a USTB.[140] For example, interest earned by a taxpayer engaged in the manufacture or sale of goods in the United States (such as interest charged on unpaid receivables) may qualify as ECI under this test.[141]

The business-activities test classifies income as ECI if the activities of a USTB are "a material factor in the realization of the income."[142] For example, this test may operate to classify interest earned by a dealer in securities as ECI.[143]

In the case of a BFSB, a different test applies to U.S.-source "dividends or interest from stocks or securities, or . . . gain or loss from the

136. *See* I.R.C. §§ 871(b), 882(a). Note that if a partnership is engaged in a USTB, then so are its partners, *id.* § 875(1), and if a partnership has ECI, that ECI flows through to the partners, *see id.* § 702.

137. *See supra* note 72 and accompanying text.

138. *See* I.R.C. § 864(c)(2); Treas. Reg. § 1.864-4(c)(2)–(3) (as amended in 2006). ECI also includes certain other categories of income. *See* I.R.C. § 864(c).

139. *See* Treas. Reg. § 1.864-4(c)(5)(ii); *infra* note 242 and accompanying text.

140. I.R.C. § 864(c)(2)(A).

141. Treas. Reg. § 1.864-4(c)(2)(i).

142. I.R.C. § 864(c)(2)(B).

143. Treas. Reg. § 1.864-4(c)(3)(i). For additional discussion of the asset-use and business-activities tests, see KATZ, PLAMBECK & RING, *supra* note 27, at A-24 to -26. In addition to these tests, "due regard shall be given to" the accounting treatment of the item in question in determining whether it is effectively connected. I.R.C. § 864(c)(2) (flush language); Treas. Reg. § 1.864-4(c)(4). Also, § 864(c)(2) uses inclusive, rather than exclusive, language in phrasing these tests, suggesting that other factors may be relevant as well. *But cf.* Dale, *supra* note 54, at 702 (arguing that "all available authorities deal exclusively with the" asset-use and business-activities tests).

sale or exchange of stocks or securities which are capital assets."[144] Under this test, the income is ECI if the underlying stock or security is "attributable to the U.S. office through which such business is carried on"[145] (the "BFSB office" requirement), subject to a few limitations.[146] Because eligible securities include ones acquired "[a]s a result of, or in the course of making loans to the public,"[147] interest on a foreign bank's loans to U.S. customers would seem to be ECI under this provision, provided that the BFSB office requirement is met.

4. Imputation of U.S. Activities and Offices

The final requirement before a foreign taxpayer can have ECI is that the activities performed in the United States that constitute a USTB, and the BFSB office to which income is attributable (in the case of a BFSB), must somehow be attributed to the taxpayer. An easy case is if the taxpayer itself performs the activities or manages the office: no attribution is necessary. But, if the taxpayer is a corporation, attribution of some kind is a logical necessity. In one sense, a corporation cannot ever itself engage in a business—its activities are the activities of its agents.[148] Unfortunately, the tax law provides little guidance as to whether and when the activities of one party will be attributed to a foreign corporation.[149]

One clear rule of attribution is that the activities of a partnership are attributed to its foreign partners, corporate and noncorporate.[150] In addition,

144. Treas. Reg. § 1.864-4(c)(5)(ii). Loans made in the ordinary course of business should be classified as noncapital assets, *see* I.R.C. § 1221(a)(4), so gain or loss from their sale or exchange appears to be outside the scope of the BFSB test, *see* KATZ, PLAMBECK& RING, *supra* note 27, at A-27 n.300; Reich, *supra* note 98, at 7 n.13.

145. Treas. Reg. § 1.864-4(c)(5)(ii). To be attributable to a U.S. office, the office must "actively and materially participate[] in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security." *Id.* § 1.864-4(c)(5)(iii)(a). Mere clerical, managerial, and similar activities are not sufficient to meet this test. *See id.* § 1.864-4(c)(5)(iii)(b).

146. *See id.* § 1.864-4(c)(5)(ii)(a)–(b).

147. *Id.* § 1.864-4(c)(5)(ii)(a)(1).

148. Felix Cohen might have called any attempt to ascribe activities to a corporation an exercise in "transcendental nonsense." *See* Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 809–14 (1935). *But cf.* Jones & Ward, *supra* note 118, at 160 ("In many civil law countries [officers and partners] are not regarded as agents acting on behalf of the body, but as the body itself entering into . . . contracts . . . ."). For a discussion of modern theories underlying imputation, see Walker, *supra* note 44, at 42–56.

149. *See* Steven R. Lainoff, Stephen Bates & Chris Bowers, *Attributing the Activities of Corporate Agents Under U.S. Tax Law: A Fresh Look from an Old Perspective*, 38 GA. L. REV. 143, 163 (2003).

150. *See* I.R.C. § 875(1) (2006). It does not matter whether the partnership is general or limited. *See, e.g.*, United States v. Balanovski, 236 F.2d 298, 304 (2d Cir. 1956) (imputing the activities of a

the activities of a corporation's employees are imputed to the corporation.[151] There also is little doubt that activities of a "dependent" agent—one "subject to a high degree of control by the corporation"—are imputed.[152] Activities of a shareholder, however, are not imputed to the underlying corporation merely because of the shareholder's ownership.[153]

Under what circumstances can the activities of an independent agent[154] be imputed to a foreign corporation? As a practical matter, both the courts and the IRS have at times "taken an expansive view" in finding a sufficient agency relationship, but at other times have not.[155] It appears to be that when the agency relationship is "regular" or "continuous," activities will be imputed rather broadly, while a more "casual" relationship will generally not give rise to imputation.[156]

general partnership); Vitale v. Comm'r, 72 T.C. 386, 389–90 (1979) (imputing the activities of a limited partnership).

151. KATZ, PLAMBECK & RING, *supra* note 27, at A-15 to -16.

152. *Id.* Presumably, dependent agent is a broader construct than employee, but how much broader is unclear. The only example of a dependent agent provided in the regulations is an employee. Treas. Reg. § 1.864-7(e) (1972). Note that under U.S. tax law, for purposes of the distinction between an employee and an independent contractor, the test for control includes aspects of economic control as well as the legal control considered by the general rules of agency at common law. *See* Lainoff, Bates & Bowers, *supra* note 149, at 151–52. "[T]he employee versus independent contractor analogy," however, "is of limited use" in the context of interpreting tax treaties. *See* Taisei Fire & Marine Ins. Co. v. Comm'r, 104 T.C. 535, 551 (1995), *acq.*, 1995-2 C.B. 1.

153. KATZ, PLAMBECK & RING, *supra* note 27, at A-15 to -16. Thus, if U.S. individuals invest in a foreign feeder corporation of a hedge fund partnership, and the same individuals carry on a USTB, that fact alone will not mean the hedge fund is engaged in a USTB. The activities of a partnership, however, can be imputed to foreign partners under some circumstances. I.R.C. § 875(1). *See also* KATZ, PLAMBECK & RING, *supra* note 27, at A-16 to -17 (discussing some issues related to imputation of activities with partnerships, trusts, and estates); Lawrence Lokken, *Income Effectively Connected with U.S. Trade or Business: A Survey and Appraisal*, TAXES, Mar. 2008, at 57, 61 (same).

154. For a discussion of the meaning of "independent agent," see *supra* notes 118–24 and accompanying text.

155. KATZ, PLAMBECK & RING, *supra* note 27, at A-16.

156. *See id.* For cases involving successful imputation, see, for example, *Lewenhaupt v. Commissioner*, 20 T.C. 151, 162–63 (1953) (involving a principal who "employed" an agent who had "a broad power of attorney" and performed many tasks in managing and leasing real estate), *aff'd*, 221 F.2d 227 (9th Cir. 1955), and *Adda v. Commissioner*, 10 T.C. 273, 277 (1948) (involving an agent who was the principal's brother and had broad discretion to conduct the principal's trading activities), *aff'd*, 171 F.2d 457 (4th Cir. 1948). The IRS has also imputed activities when an agent had an exclusive agreement with the principal to sell the principal's products, subject to the principal's control. Rev. Rul. 70-424, 1970-2 C.B. 150. In contrast, courts have not imputed activities when the relationships are more ad hoc. *See, e.g.*, Spermacet Whaling & Shipping Co. v. Comm'r, 30 T.C. 618 (1958) (involving, inter alia, a purported foreign principal that conferred upon its U.S. lawyer the title of "assistant secretary," but "only as a matter of convenience and to enable him to perform certain ministerial acts"), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

An important separate issue arises regarding a foreign taxpayer engaged in a BFSB: Can an agent's U.S. office be imputed in order to satisfy the BFSB office requirement?[157] The only related office attribution rule provided by the Code concerns certain foreign-source income from sales of personal property.[158] Under this rule, an agent's "office or other fixed place of business in the United States" (again, "OFPB")[159] can be imputed only if the agent is (1) dependent and (2) has and "regularly exercises" authority to negotiate and conclude contracts on the principal's behalf.[160] The accompanying regulation confirms that an independent agent's OFPB never can be imputed.[161] The remainder of this Note will refer to this rule as the "OFPB attribution rule."

Interestingly, the OFPB attribution rule employs the same "OFPB" language as found in the general trading safe harbor, which exempts trading through an OFPB from the protection of the safe harbor.[162] Because of the identity of language, the Tax Court in *InverWorld* decided to apply the accompanying regulation for this attribution rule to the general trading safe harbor.[163] Whether the regulation should also be applied to the BFSB rules is taken up in Part III, below.

Regardless whether the regulation should apply, there is an argument that the underlying attribution rule should apply in any case. In common

157. *See supra* notes 144–47 and accompanying text (explaining the BFSB rules).

158. *See* I.R.C. § 864(c)(5). Such sales now appear to be governed by the income resourcing rules of § 865(e). *See* 2 BITTKER & EUSTICE, *supra* note 62, ¶ 15.02[1][c]. Section 864(c)(5) would still appear to have force, however, because it is incorporated by reference under the income resourcing rules and because Congress decided to amend it in 2010. *See* I.R.C. § 865(e)(3); Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2122(c), 2010 U.S.C.C.A.N. (124 Stat.) 2504, 2567–68 (to be codified at I.R.C. § 864(c)(4)(B)(ii)).

159. The reader may notice that this language is identical to the language found in the general trading safe harbor. *See supra* note 110 and accompanying text. In light of *InverWorld*, this Note will refer to both instances of this phrase as "OFPB." *See infra* note 163 and accompanying text.

160. I.R.C. § 864(c)(5)(A).

161. Treas. Reg. § 1.864-7(d)(2) (1972). Under this regulation, the general rule is that an OFPB "is a fixed facility." *Id.* § 1.864-7(b)(1). The legislative history suggests an OFPB should have a similar meaning to that of the "permanent establishment" term used in many treaties. *See* S. REP. NO. 89-1707, at 20–21 (1966), *reprinted in* 1966-2 C.B. 1059, 1072–73; KATZ, PLAMBECK & RING, *supra* note 27, at A-29 n.324; Dale, *supra* note 54, at 734. This regulation also defines "independent agent" as "a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity." Treas. Reg. § 1.864-7(d)(3)(i). Compare this definition with the one found in § 864(b)(2)(A)(i), quoted in text accompanying note 110, *supra*.

162. *See supra* note 110 and accompanying text.

163. *See* InverWorld, Inc. v. Comm'r, 71 T.C.M. (CCH) 3231, 3237-19 to -24, *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996).

law countries today, agents, whether dependent or independent, generally can bind their principals to contracts. The same is not true, however, in many civil law countries, nor was it true under the common law (for purposes of binding foreign principals) at the turn of the twentieth century—the time when the first model treaty was crafted.[164] Therefore, if an agent, for whatever reason, cannot bind its principal, there is an argument that the agent's activities should not be imputed to its foreign principal as a matter of tax common law.[165]

III. NEXUS AT A CROSSROADS: OFFSHORE LENDING

As described above, in the case of a foreign hedge fund that lends money to U.S. borrowers—or does something very similar to lending money—the tax treatment is, in practice, all or nothing for the hedge fund's foreign investors. If the interest income from the loans is ECI, the effective tax rate is as high as 54.5 percent. If it is not ECI, the portfolio interest exemption exempts the interest from U.S. tax altogether, resulting in an effective tax rate of 0 percent.[166] Needless to say, hedge funds have gone to some lengths to argue that their interest income is not ECI, while the IRS has fought back with its CCM.

Before we can debate the merits of each side's position, we must first establish a set of baseline facts. The CCM essentially uses these: A foreign corporation ("Foreign Corporation"), owned entirely by non-U.S. persons, does business with an unrelated U.S. corporation ("Origination Co.") through an arm's-length "service agreement."[167] Origination Co. originates loans to U.S. borrowers "on a considerable, continuous, and regular basis."[168] Other than the service agreement, the two corporations are not

164. *See* Jones & Ward, *supra* note 118, at 156–58.

165. *See id.* at 158. U.S. cases have, at times, attributed agents' activities to foreign corporations despite an apparent lack of authority to bind the foreign corporation to contracts. *See, e.g.*, de Amodio v. Comm'r, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); Handfield v. Comm'r, 23 T.C. 633 (1955); Lainoff, Bates & Bowers, *supra* note 149, at 163–64 (discussing these cases). But the issue is not whether an agent has the authority to bind its principal; rather, it is whether the agent can bind its principal, and under the common law, agents generally can, even if they lack actual authority. *See* RESTATEMENT (THIRD) OF AGENCY §§ 2.03, 2.06 (2006); Jones & Ward, *supra* note 118, at 158. *See also InverWorld*, 71 T.C.M. (CCH) at 3237-22 to -24 (holding that an agent's activities could be attributed to its foreign principal because the agent, in fact, had the power to bind the principal to contracts even though the parties' agreement specifically said otherwise).

166. *See supra* Part II.B.1.

167. CCM, *supra* note 36, at 2.

168. *Id.* The activities performed by Origination Co. include "the solicitation of customers, the

related,[169] and "Origination Co. is not authorized to conclude contracts on behalf of Foreign Corporation."[170] Origination Co. operates out of a U.S. office, but Foreign Corporation maintains no office of its own in the United States.[171] The CCM does not specify how much discretion Origination Co. has, how regularly Origination Co. and Foreign Corporation deal with each other, or whether Origination Co. performs similar services for any other party.[172]

A. HEDGE FUNDS' POSITIONS

Perhaps the strongest argument advanced by the hedge funds is that they are not "lending" because they are not "[m]aking personal, mortgage, industrial, or other loans to the public."[173] Rather, hedge funds argue that they are merely buying existing loans in a secondary market,[174] or in any case are only investors.

If a hedge fund buys existing loans in a secondary market, arguably the securities trading safe harbors apply, precluding USTB status and thus ECI.[175] As a result, the argument continues, the interest income is also not subject to withholding taxes because of the portfolio interest exemption.[176]

negotiation of contractual terms and the performance of credit analyses." *Id.* at 5.

169. *See* Sheppard, *supra* note 36 (calling the two corporations "unrelated"). If the corporations were related, an agency relationship may be easier to establish. For example, a partner may be an agent of a partnership. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c. Note that *InverWorld* involved a parent-subsidiary relationship, but the Tax Court disregarded this relationship in determining whether the purported agent was independent, ultimately finding that it was not. *InverWorld*, 71 T.C.M. (CCH) at 3237-20.

170. CCM, *supra* note 36, at 2.

171. *Id.*

172. Kimberly S. Blanchard, *The Foreign Lender Memorandum: Just the Facts, Ma'am*, 39 TAX MGMT. INT'L J. 163, 163–64 (2010).

173. This quoted language comes from the definition of a BFSB. *See supra* notes 103–04 and accompanying text.

174. *See* Leeds, *supra* note 169, at 236–37; Sheppard, *supra* note 11, at 1040–41. This argument may be somewhat tenuous, however, because in a different context the Treasury has equated "regularly purchas[ing] securities from customers in the ordinary course of a trade or business" with "regularly making loans to customers in the ordinary course of a trade or business of making loans." *See* Treas. Reg. § 1.475(c)-1(c)(1)(i) (1996).

175. *See* Leeds, *supra* note 169, at 236–37. Bank loans today often are not held by the banks that originated them. As one example, consider the infamous mortgage-backed securities, which are still being sold over the market even after the financial crisis. *Prospect Mortgage Offering Jumbo Loans on Secondary Market*, YAHOO! FIN. (Mar. 9, 2011, 7:36 PM), http://finance.yahoo.com/news/Prospect-Mortgage-Offering-prnews-1672101396.html?x=0&.v=1.

176. Leeds, *supra* note 169, at 236.

Hedge funds argue that the general trading safe harbor is met because no OFPB can be imputed.[177] In our example, Origination Co.'s office probably should not be imputed to Foreign Corporation because Origination Co. cannot conclude contracts on Foreign Corporation's behalf.[178] Hedge funds also argue that the proprietary trading safe harbor is met because the hedge funds are not dealers in securities because they do not regularly engage in business with "customers."[179] In our example, however, there is no mention of a secondary market. Moreover, the activities may be too much like lending to qualify as trading for either safe harbor.[180]

Assuming the securities trading safe harbors do not apply, a hedge fund may still be able to argue that it is not engaged in a USTB because it is a mere investor, as is one who acquires securities from an underwriter in a private placement.[181] Even if the investing activities are extensive, investing is not a business under *Higgins v. Commissioner*.[182]

177. *Id.*

178. *See supra* notes 158–61 and accompanying text.

179. *See* Leeds, *supra* note 169, at 237. *Cf.* Biondo, *supra* note 9, at 41 ("Even if the definition of dealer under the mark-to-market rules should apply for purposes of determining whether a fund can rely on the trading safe harbor, many funds would satisfy the negligible sales exception.").

180. *See supra* notes 132–35 and accompanying text. Because the CCM postulates that Origination Co. engages specifically in loan origination activities "includ[ing] the solicitation of U.S. Borrowers, the negotiation of the terms of the loans, [and] the performance of the credit analyses with respect to U.S. Borrowers," CCM, *supra* note 36, at 2, this argument is unlikely to have success if Origination Co.'s activities are imputed to Foreign Corporation.

181. *Compare* Pasquel v. Comm'r, 12 T.C.M. (CCH) 1431 (1953) (finding no USTB where the taxpayer engaged in only one financing transaction), *and* I.R.S. Field Serv. Advisory Mem. 2002-24-003 (June 14, 2002) (finding no USTB where the taxpayer merely factored receivables of a related party), *with* InverWorld, Inc. v. Comm'r, 71 T.C.M. (CCH) 3231 (finding a USTB where the taxpayer regularly engaged in financing transactions), *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996).

182. Higgins v. Comm'r, 312 U.S. 212, 217–18 (1941). *Higgins*, however, involved the question of whether a taxpayer was permitted a deduction as a business expense, and deduction provisions are generally narrowly construed. *See id.* at 213; David M. Garelik, *What Constitutes Doing Business Within the United States by a Non-Resident Alien Individual or a Foreign Corporation*, 18 TAX L. REV. 423, 457 (1962–1963) (discussing *Higgins*).

To strengthen their case that they are merely investing in, and not originating, loans, hedge funds sometimes shy away from handling the actual loan securities and instead will only "acquire[] synthetic exposure" to loans through derivative swap agreements. Leeds, *supra* note 169, at 232–33. Derivative swap income may also qualify as foreign source, which means that, if the income is not ECI, it will not be taxed at all as long as the income is not classified as a dividend. *See id.* at 235; Lee A. Sheppard, *How to Fix Withholding on Securities Loans and Swaps*, 120 TAX NOTES 1248, 1249–51 (2008) (explaining how one might structure derivative swaps to avoid dividend treatment).

Even if a hedge fund is engaged in a USTB, however, it may still be able to argue that loan interest is not ECI.[183] The key to this argument is that if the hedge fund is engaging in lending activities that are sufficient to constitute a USTB, but are outside the scope of the safe harbors, then the hedge fund almost certainly is a BFSB.[184] As a BFSB, the asset-use and business-activities tests do not apply for determining ECI; instead, the applicable test is whether the income is "attributable to the U.S. office through which such business is carried on."[185] Accordingly, the hedge fund will argue that the BFSB office requirement is not met, so the interest is not ECI.[186] Of course, Origination Co. has a U.S. office. The question is whether this office can be attributed to Foreign Corporation. If the OFPB attribution rule applies, then the office cannot be attributed if Origination Co. is merely an independent agent or cannot conclude contracts on behalf of Foreign Corporation.[187] The fact is that Origination Co. cannot conclude contracts on behalf of Foreign Corporation, so interest income earned by Foreign Corporation should not be ECI—if the attribution rule applies.

B. THE IRS'S NEW POSITION

The CCM takes the position that Foreign Corporation is engaged in a USTB and interest income earned on its loans is ECI. Its reasoning is as follows: First, Foreign Corporation is engaged in a USTB because Origination Co.'s activities, which meet the "considerable, continuous, and regular" test, are attributable to Foreign Corporation.[188] Second, Foreign Corporation is engaged in a BFSB "because its business . . . includes making loans to the public."[189] Finally, interest income is ECI under the special BFSB rule because Origination Co. maintained a BFSB office to which the income is attributable.[190]

183. Sheppard, *supra* note 11, at 1043.

184. *Id.*

185. *See supra* notes 145–46 and accompanying text.

186. *See* CCM, *supra* note 36, at 7–8; Sheppard, *supra* note 11, at 1044.

187. *See supra* notes 158–61 and accompanying text. There is also the argument that the common law would prevent attribution if Origination Co. cannot bind Foreign Corporation to a contract. *See supra* notes 164–65 and accompanying text.

188. CCM, *supra* note 36, at 5–6. The facts assume this test is met: "Origination Co. conducts these activities on a considerable, continuous, and regular basis." *Id.* at 2.

189. *Id.* at 7.

190. *Id.* at 7–9.

As a preliminary matter, some have questioned whether the CCM asserts sufficient facts to attribute Origination Co.'s activities to Foreign Corporation under existing law. We do not know how independent Origination Co. is from Foreign Corporation.[191] What we do know is that Origination Co. cannot conclude contracts on Foreign Corporation's behalf.[192] The CCM asserts that it does not matter whether Origination Co. is dependent or independent[193] and cites several authorities for the proposition that an inability to conclude contracts does not prevent attribution of activities.[194] It is doubtful that these authorities actually support the CCM's conclusion, however, because they all involved dependent agents or agents who could conclude contracts on behalf of their foreign principals.[195]

If we assume Origination Co.'s activities can be attributed to Foreign Corporation, however, the CCM's analysis faces another hurdle: if Foreign Corporation were merely engaged in activities that could constitute a USTB but not a BFSB, then the securities trading safe harbors may apply.[196] Rather, the CCM concludes that Foreign Corporation is engaged in a BFSB "and not trading or investing activities."[197] In support, the CCM likens its facts to those of *InverWorld*.[198] That case, however, involved a corporation that did extensive business with public customers as a

191. *See* Blanchard, *supra* note 172; Jasper L. Cummings Jr., *IRS Memo on Foreign Lenders and Engagement in U.S. Trade or Business Stands on Shaky Authority, Demonstrates Need for Formal Published Guidance*, DAILY TAX REP., Oct. 19, 2009, *available at* 199 DTR J-1 (BNA).

192. CCM, *supra* note 36, at 2.

193. *See id.* at 1, 9.

194. The cited authorities include, in particular, *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940); *InverWorld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231, *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955); and I.R.S. Tech. Adv. Mem. 80-29-005 (Mar. 27, 1980). *See* CCM, *supra* note 36, at 5–6.

195. While I.R.S. Tech. Adv. Mem. 80-29-005 (Mar. 27, 1980) declares that "it is irrelevant whether [an agent] is an independent contractor of . . . or the actual agent," the agent apparently was able to bind its principal to contracts. Similarly, the agent in *Lewenhaupt* had "a broad power of attorney which included the power to buy, sell, lease, and mortgage real estate for and in the name of the" principal. *Lewenhaupt*, 20 T.C. at 163. *Pinchot* also involved an agent with "broad powers of attorney." *Pinchot*, 113 F.2d 718, 719. Finally, the agent in *InverWorld* had the power to bind its principal to contracts. *InverWorld*, 71 T.C.M. (CCH) at 3237-23 to -24. *See* Cummings, *supra* note 191 (arguing that the CCM's cited authorities do not support its position); Walker, *supra* note 44, at 9–10 (same). Kimberly Blanchard adds that the lack of factual specificity in the CCM makes it impossible to compare its facts to those of the cited authorities. Blanchard, *supra* note 191.

196. *See* Walker, *supra* note 44, at 8.

197. CCM, *supra* note 36, at 6.

198. *See id.*

securities dealer.[199] Although the CCM concludes that Foreign Corporation's loans are made "to the public," the only fact appearing to support this conclusion is the unelaborated statement that Origination Co. "solicit[s]" U.S. borrowers.[200]

In addition to activity attribution, there is the matter of office attribution. If we assume that Foreign Corporation is engaged in a BFSB,[201] for interest income to be ECI it must be "attributable to the U.S. office through which such business is carried on."[202] The CCM concludes that this test is met because the interest is attributable to Origination Co.'s U.S. office, which in turn need not be imputed to Foreign Corporation.[203] This last step is crucial because, as discussed in Part II.B.4, office attribution is not permitted under the OFPB attribution rule if, as in the CCM, the agent is not allowed to conclude contracts on behalf of the foreign corporate principal. The IRS has said that this key issue is the only issue the CCM was intended to address.[204] But if the IRS's reasoning is correct, the BFSB office requirement is effectively moot: in reality, it will almost always be satisfied irrespective of whether a foreign person is doing anything more than passive investing activities.

The Tax Court in *InverWorld* adopted the OFPB attribution rule for purposes of the general trading safe harbor,[205] and the IRS itself has previously applied this rule in administrative advisories in the context of both U.S.-source and foreign-source ECI.[206] The CCM distinguishes *InverWorld* on the basis that the court drew an analogy to the OFPB attribution rule's regulation because of the need to interpret the OFPB language found in the statutory general trading safe harbor. Because the

199. *See InverWorld*, 71 T.C.M. (CCH) at 3237-18 to -19 (finding specifically that the foreign corporate taxpayer in question "engaged in four of the six activities listed in" Treas. Reg. § 1.864-4(c)(5)(i)), *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996).

200. *See* CCM, *supra* note 36, at 2, 5, 9; Walker, *supra* note 44, at 8.

201. One pair of commentators calls this assumption a "relatively noncontroversial" conclusion. Cunningham & Poms, *supra* note 37, at 2.

202. Treas. Reg. § 1.864-4(c)(5)(ii) (as amended in 2005). *See also supra* notes 145–46 and accompanying text.

203. *See* CCM, *supra* note 36, at 7–8.

204. Kristen A. Parillo, *Memo on Foreign Corporation's U.S. Lending Activity Is Not Major Guidance, IRS Official Says*, 125 TAX NOTES 386 (2009).

205. InverWorld, Inc. v. Comm'r, 71 T.C.M. (CCH) 3231, 3237-19 to -20, *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996).

206. *See* I.R.S. Field Serv. Advisory (Sept. 18, 1998), 1998 FSA LEXIS 270; I.R.S. Field Serv. Advisory (July 29, 1996), 1996 FSA LEXIS 259; Zhu, Shen & Dick, *supra* note 82, at 789–90.

statutory language underlying the BFSB regulation does not contain any such language, the CCM reasons, there is no need to resort to the OFPB attribution rule.[207]

Some argue that the Tax Court would have had an easier time applying the OFPB attribution rule to the BFSB regulation, had the court the occasion to do so, than it did applying the rule to the general trading safe harbor.[208] A key reason is that the BFSB rules are a creation of the regulations and do not have any real statutory foundation.[209] Accordingly, the argument goes, the correct place to look for interpretive guidance is the regulations themselves, whose structure and history show that the OFPB attribution rule should apply to the BFSB regulation as well.[210]

In any case, the CCM takes the position that office attribution is not necessary for ECI purposes because the BFSB office requirement refers only to "the U.S. office" and "a U.S. office," not the foreign corporation's U.S. office.[211] This distinction defies common sense and the natural reading of the regulation. The use of the passive voice and the lack of a possessive noun or pronoun, by themselves, should not be enough to support the CCM's interpretation—not when they are consistent with an alternative meaning that is better supported for the reasons given above.[212] Indeed, practitioners long seem to have taken for granted that the BFSB office is the foreign corporation's office, not someone else's.[213]

Even if the CCM is correct in making the above distinction, however, its conclusion that no attribution is necessary seems to be logically impossible: there must be some kind of nexus linking Origination Co.'s

207. *See* CCM, *supra* note 36, at 8; Walker, *supra* note 44, at 10–11.

208. Zhu, Shen & Dick, *supra* note 82, at 789.

209. *Id.*

210. *Id.* In particular, the OFPB attribution rules clearly apply to the foreign-source ECI rules of Treas. Reg. § 1.864-5. *See* Treas. Reg. § 1.864-5(a) (as amended in 1997). In addition, the definition of a BFSB explicitly applies to these same foreign-source ECI rules. *Id.* § 1.864-4(c)(5)(i) (as amended in 2005). The fact that no cross-reference is made to apply the OFPB attribution rules to the BFSB test would appear to be more of a historical oversight than an intentional policy decision. *See* Zhu, Shen & Dick, *supra* note 82, at 788. *See also* David T. Moldenhauer, *The Foreign Lender Memorandum and the Definition of a U.S. Office*, 125 TAX NOTES 1200 (2009) (discussing the structure, history, and purpose of the regulations and concluding that the CCM's "retrospective interpretation" is unwarranted).

211. *See* CCM, *supra* note 36, at 7–8.

212. *See* Zhu, Shen & Dick, *supra* note 82, at 787–90; Moldenhauer, *supra* note 210, at 1207–10.

213. For example, Yaron Reich has described the BFSB ECI rule as follows: "interest income and gain or loss from a debt security are ECI if the security is 'attributable' to the U.S. *branch* and the other requirements . . . are satisfied." Reich, *supra* note 98, at 7 (emphasis added).

office to Foreign Corporation.[214] Thus, by distinguishing the OFPB attribution rules, the CCM appears implicitly to have adopted an expansive new "tax common law" attribution rule in its stead that allows attribution of an office without a dependent agent to bind its principal to contracts.[215] This new rule seems more akin to aggressive modern state tax attribution standards than anything used in the international tax arena or intended by Congress.[216] Specifically, it looks like a theory of economic nexus that requires little more than market penetration to trigger ECI.[217] Such a rule could have profound implications in many areas of tax law.[218]

The CCM's approach to office attribution, as a matter of policy, can be criticized on many fronts. Logically, many kinds of "weak" economic relationships could result in attribution, undermining the concept of the firm[219] and the concept of a corporation as a taxable entity separate from its shareholders.[220] In addition, even such an expansive theory of attribution might be circumvented rather easily through extensive subcontracting. There may be no administrable solution to this problem.[221]

The IRS has countered that bowing to practitioners' arguments about BFSB office attribution in this case would have the effect of giving the benefits of the more taxpayer-friendly permanent establishment standards from treaties to taxpayers in nontreaty (tax haven) jurisdictions.[222] Congress, however, may have intended just that effect when it enacted the statute employing the OFPB language—that is, there might not be a substantial difference between the permanent establishment and OFPB concepts.[223] Moreover, the IRS, in creating the BFSB rules, deliberately set

214. *See* Walker, *supra* note 44, at 10.

215. *See id*. at 1–2, 19 (internal quotation marks omitted).

216. *See* Cummings, *supra* note 191; Walker, *supra* note 44, at 20–21, 57.

217. *See* Walker, *supra* note 44, at 54–56.

218. *Id.* at 11 ("The analysis outlined in the [CCM] thus has implications in contexts well beyond offshore lending.").

219. *See id.* at 55.

220. *Id.* at 57–59.

221. *Id.* at 59–62.

222. *See* Lee A. Sheppard, *ABA Tax Section Ponders Unanswered Financial Questions*, TAX NOTES TODAY, Jan. 25, 2010, *available at* 2010 TNT 15-2 (LEXIS).

223. *See* Dale, *supra* note 54, at 734–44 (comparing and contrasting the permanent establishment and OFPB concepts, and concluding that they are similar but not identical). The modern ECI rules might be seen as veering away from this history by taxing certain foreign-source income, but their purported rationale was to keep the United States from becoming a tax haven, not to refocus the USTB rules in general. *See* Walker, *supra* note 44, at 24–27.

a higher threshold for interest income to be ECI when it is earned by a BFSB rather than by a regular USTB.[224]

In sum, it is little wonder that commentators have called the CCM's reasoning both "strained"[225] and "incorrect."[226]

C. Implications Going Forward

Practitioners have been concerned about how far reaching the effects of the IRS's new position could be. "[T]he activities of any person who is on the ground in the United States can be attributed to a nonresident . . . simply by virtue of the domestic activities being regular and continuous and carried out on behalf of the nonresident."[227] If so, will a foreign entity earn ECI merely because it created a contractual relationship with a U.S. person? The IRS has attempted to assuage taxpayers by repeatedly (albeit informally) saying that the CCM is limited to its facts.[228] Nevertheless, the reasoning employed by the CCM could potentially have broad implications, not just in the taxation of offshore lending, but in other areas as well.[229]

Will taxpayers change their filing positions because of the CCM? The CCM is not binding authority,[230] and if the IRS adopts it in a dispute, the targeted taxpayer might forcefully argue that the court should not follow

224. *See infra* notes 242–45 and accompanying text.

225. *I.R.C. Chief Counsel Memo on Loan Origination by Foreign Entities*, ALERT MEMO (Cleary Gottlieb Steen & Hamilton LLP), Sept. 23, 2009, at 2, *available at* http://www.cgsh.com/files/News/9f9842df-0a0c-4562-9d7d-5db43fbfab36/Presentation/NewsAttachment/99e4dec9-722e-4bd7-99e6-5e8cdf7f47e2/CGSH%20Alert%20-%20IRS%20Chief%20Counsel%20Memo%20on%20Loan%20Origination%20by%20Foreign%20Entities.pdf.

226. Zhu, Shen & Dick, *supra* note 82, at 790.

227. Cummings, *supra* note 191. Roger Lorence added, "Anything that doesn't involve buying a loan in the secondary market is arguably affected by this IRS action." Donmoyer, *supra* note 8 (internal quotation marks omitted). Arguably, however, even secondary market sales are affected because the CCM assumed Origination Co. and Foreign Corporation were related only through an arm's-length agreement. *See* CCM, *supra* note 36, at 2.

228. *See, e.g.*, Parillo, *supra* note 204; Sheppard, *supra* note 222. Ironically, if the CCM is indeed limited to its facts, then does it actually say anything at all? One of its facts is that "Foreign Corporation makes loans to U.S. persons . . . *within the United States*." CCM, *supra* note 36, at 2 (emphasis added). This declaration would appear to prejudge the subsequent analysis, although more likely it is merely a drafting mistake. *See* Cummings, *supra* note 191; Walker, *supra* note 44, at 7 & n.28.

229. *See supra* note 218 and accompanying text. *See also* Letter to the Editor, *Memo Would Adversely Affect Hedge Funds, Pools of Capital*, 127 TAX NOTES 1399 (2010) (suggesting possible tax planning opportunities created by the CCM).

230. *See supra* note 36.

the CCM for the reasons described above.[231] Regardless, "[a]s a matter of future tax planning, prudent taxpayers are likely to follow the CCM until further judicial or administrative guidance becomes available."[232]

Uncertainties remain in the taxation of offshore lending. Disregarding uncertainty over the validity of the CCM's interpretation of the law, there are still questions regarding where the line should be drawn between what is ECI and what is not. Is interest income from a loan ECI if anyone originated the loan from a U.S. office, and a hedge fund later buys it in a secondary market—even much later?[233] What if a hedge fund participates in the restructuring of loans?[234] If the interest income is ECI, then is gain from a sale of the underlying security also ECI?[235] The questions are numerous.

Nevertheless, if these uncertainties were reduced through bright-line rules, as have been proposed,[236] and if the CCM's conclusion were endorsed by the courts or embodied in future regulations so that taxpayers could rely on it as precedent, the potentially far-reaching implications of the CCM's new approach to attribution would still remain. Is such an approach necessary to reach the current goals of the U.S. tax system? The answer, this Note proposes, is no.

IV. HOW SHOULD OFFSHORE LENDING BE TAXED?

A. THE POLICY OF NEXUS REVISITED

The ECI rules do not automatically exempt FDAP-like income from net-basis taxation. Instead, the asset-use and business-activities tests are used to determine whether the FDAP-like income should nevertheless be considered business income rather than investment income.[237] In addition, the 1966 Act added the proprietary trading safe harbor[238] with the stated

231. *See supra* Part III.B.

232. Zhu, Shen & Dick, *supra* note 82, at 790.

233. Andrew Walker argues that a market-availment standard is not a textually implausible interpretation of the law, but suggests that the answer is no. *See* Walker, *supra* note 44, at 3, 14–15.

234. The Association of the Bar of the City of New York proposed a safe harbor for restructuring loans. *See* Stone, *supra* note 60. But the existence of this proposal suggests that, without it, the result is at best unclear. The CCM did nothing to clarify the matter. *See* CCM, *supra* note 36.

235. Again, the answer is arguably no. Zhu, Shen & Dick, *supra* note 82, at 787.

236. *See* Stone, *supra* note 60.

237. *See supra* Part II.B.3.

238. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, sec. 102(d)(2), § 864(b)(2)(A)(ii), 80

goal being to facilitate and encourage foreign investment in the United States without compromising the taxation of actual U.S. businesses conducted by foreign taxpayers.[239]

From the beginning, however, the Treasury Department ("Treasury") felt that BFSBs should have a special test to determine when income is ECI.[240] The exact reasons for doing so are not known.[241] Nevertheless, the effect of the rule, in both its original and current forms, is to exempt some FDAP-like income that otherwise would be ECI from being classified as such and, at least before the enactment of the portfolio interest exemption, to expose more interest to gross-basis withholding—generally a punitive result for a highly leveraged company.[242]

Why would the Treasury want to increase the threshold for treating interest and certain other income as ECI in the case of banks? Purportedly, the rule was created "to distinguish between banking income and nonbanking investment income of banks."[243] But the Treasury was probably primarily concerned with the ability of foreign banks to avoid taxes by treating large amounts of FDAP-like income as ECI, thus allowing them to take deductions associated with that income against their other business profits.[244] Yet, not all commentators agree.[245]

Stat. 1539, 1544. The securities trading safe harbors are described *supra* Part II.B.2.

239. *See* H.R. REP. NO. 89-1450, at 12–13 (1966); S. REP. NO. 89-1707, at 16–17 (1966). *But cf.* Sheppard, *supra* note 9, at 730 ("The legislative history of the [proprietary] trading safe harbor shows that Congress, rather than wanting to attract foreign capital, had simply given up on collecting tax on capital gains realized by foreign investors, and had decided that making brokers rich would be a good way to make up the lost revenue.").

240. Although the text of § 864(c)(2) refers to only the first two tests, Treas. Reg. § 1.864-4(c)(5) has included the special BFSB rule from the regulation's inception. *See* T.D. 7216, 1972-2 C.B. 415.

241. *See* T.D. 7216, 1972-2 C.B. 415; Moldenhauer, *supra* note 210, at 1203–04.

242. *See* Alfred C. Groff & James F. Hoch, *Selected Issues in U.S. Taxation of U.S. Branches of Foreign Banks*, 1988 U. ILL. L. REV. 343, 349–50; Moldenhauer, *supra* note 210, at 1204. To illustrate, consider again a foreign corporation that leverages its capital, incurring $750,000 of interest expense, to earn $1 million in interest income from U.S. corporate bonds. If the income is taxed on a gross basis using a 30 percent withholding rate, the corporation will be left with only $700,000 of after-tax income to pay its $750,000 of expenses—an effective tax rate of 120 percent of net income. Thus, taxation on a net basis (even at a current rate of 54.5 percent) is preferable for a highly leveraged company.

243. I.R.S. Tech. Mem. (Dec. 23, 1970), 1970 TM LEXIS 39 at *4.

244. *See* Moldenhauer, *supra* note 210, at 1203–05. Before 1977, the regulations were liberal in allowing a corporation to allocate interest deductions according to its own books, giving management much discretion. *See* T.D. 6258, 1957-2 C.B. 368, 375–76; KATZ, PLAMBECK & RING, *supra* note 27, at A-46.

245. Sheppard describes the BFSB rules as having been created at the behest of Canadian banks to protect their U.S.-source interest income from withholding taxes. Accordingly, she argues, to maximize

The initial version of the BFSB regulation the Treasury promulgated effectively let banks decide whether to treat banking income as ECI, simply by adjusting their accounting treatment—the infamous "booking rule." In brief, this rule let a bank avoid ECI treatment for interest income if the underlying loan were "booked" or physically held in a foreign country.[246] This rule soon proved unworkable because of the effect of tax treaties that reduced or eliminated the withholding tax on non-ECI interest and other income.[247] Thus, this regulation was amended.[248]

Treaties today are not the only source of rules exempting non-ECI interest from tax altogether. The portfolio interest exemption was added in 1984[249] to allow U.S. companies to compete directly as borrowers in the Eurobond market, which required that interest be exempt from withholding.[250] While the portfolio interest exemption has some restrictions regarding its use by banks, hedge funds almost certainly qualify as nonbanks.[251] Thus, the IRS finds itself in a predicament in which the BFSB rule that limits the reach of ECI works to the government's detriment in the case of offshore lending hedge funds.

The business environment has also changed significantly from what it was at the time of the 1966 Act. In 1966, a congressional study "describe[d] U.S. and foreign banks as generally having a symbiotic relationship with little direct competition."[252] Accordingly, the legislative history of the 1966 Act does not mention protecting U.S. banks from foreign competition as a reason for enactment.[253] Rather, the focus was on

the favorable ECI treatment, the rules impose "a very low threshold of activity" for characterizing interest as ECI. Sheppard, *supra* note 9, at 733–34. Sheppard's position seems untenable in light of the fact that the BFSB rules impose a higher threshold than the asset-use and business-activities tests, and this higher threshold makes sense given the IRS's expressed concerns with allowing foreign banks to obtain ECI treatment on investment income. *See* Moldenhauer, *supra* note 210, at 1203–05.

246. *See* Groff & Hoch, *supra* note 242, at 349–50.

247. *See id.* at 350; KATZ, PLAMBECK & RING, *supra* note 27, at A-6.

248. T.D. 7958, 1984-1 C.B. 174.

249. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127, 98 Stat. 494, 648–53 (codified as amended in I.R.C. §§ 871(h), 881(c)).

250. STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-81, at 391–94 (Comm. Print 1984); James P. Holden, Jr., Note & Comment, *Repeal of the Withholding Tax on Portfolio Debt Interest Paid to Foreigners: Tax and Fiscal Policies in the Context of Eurobond Financing*, 5 VA. TAX REV. 375, 383, 393–94, 404 (1985).

251. *See supra* notes 67–70 and accompanying text.

252. Moldenhauer, *supra* note 210, at 1209 n.49.

253. *See* H.R. REP. NO. 89-1450 (1966); S. REP. NO. 89-1707 (1966).

creating a better environment for foreign investment in the United States.[254] Today, however, hedge funds have arrived at the lending scene. Although U.S. banks have been supportive of hedge funds in their opposition of ECI treatment for U.S.-source interest income,[255] the reason for this support may have more to do with banks' need for hedge funds as prime brokerage clients and less to do with the belief that hedge funds are not competitors.[256]

The United States' world economic position has also changed over the last century. While the country became the world's largest capital exporter soon after World War II,[257] more recently, the United States has become the world's largest net capital importer.[258] Thus, the country's efforts to attract foreign capital seem to have been successful. Sheppard, for one, says foreign investors today are "quite comfortable."[259] But they need to be if the United States is going to continue its position as a dominant destination for foreign capital.

Moreover, products and services in the financial services industries today are converging.[260] The traditional boundary lines among banks, insurers, and security dealers have been eroding for some time.[261] In addition, the advent of derivative instruments, among other devices, has essentially allowed companies to create customized securities with whatever mix of financial, economic, and tax characteristics the companies want.[262]

In short, capital is mobile and sophisticated investors are not about to slow down their efforts to structure instruments and transactions such that income is earned subject to the least tax possible. In this country,

254. *See supra* notes 54–56 and accompanying text.

255. *See* Sheppard, *supra* note 9, at 734–35.

256. *See id.* at 735 ("Hedge funds are the best customers of commercial banks and investment banks. They borrow heavily and pay a lot of fees for prime brokerage as they churn their portfolios. More important, they stand ready to buy loans that banks want to get rid of."). *See also supra* note 9 and accompanying text.

257. Holden, *supra* note 250, at 379.

258. COUNCIL OF ECON. ADVISORS, THE ANNUAL REPORT OF THE COUNCIL OF ECONOMIC ADVISORS, *in* ECONOMIC REPORT OF THE PRESIDENT 7, 130–32 (2006).

259. *See* Sheppard, *supra* note 9, at 744.

260. *See* Kleinbard, *supra* note 17, at 225–27.

261. *See id.* at 232–43.

262. *See* Leeds, *supra* note 169 (describing the use of total return swaps as a substitute for bank lending). *See generally* Kleinbard, *supra* note 17 (exploring a range of characteristics that can be included in derivatives).

withholding taxes essentially "function as on-off switches": if a tax is imposed, investors will take their funds elsewhere.[263] Arguably, the United States does not use withholding taxes to collect revenue; rather, it uses them "mostly as a bargaining chip for treaty negotiations."[264] As found by the Staff of the Joint Committee on Taxation:

> Policies that impede cross border investment can lead to inefficient investment decisions and potentially reduced aggregate investment. Reduced aggregate investment and an inefficient allocation of investment dollars reduces future growth compared to that achievable in the absence of restrictions. Reduced growth means that per capita income will be lower in the future than it might otherwise be.[265]

Thus, one can argue that the United States should not tax foreign investment at all, and trying to differentiate among different kinds of foreign investment would seem to serve no useful purpose because capital income is interchangeable. An argument that foreign investors should be taxed differently depending on whether their income is earned from an "active" business versus a "passive" investment[266] seems to fall flat: the investors' income is capital income either way.

While there is a difference between active businesses and passive investment, this difference is already captured by the tax law. If a foreign corporation actively engages in a U.S. business by hiring U.S. employees to solicit customers and originate loans, those employees' salaries show up as income on their individual tax returns. What remains—corporate profit—is no more active or passive to its eventual recipients (the foreign investors) than if the corporation's sole activities consisted of buying U.S. government bonds and holding them until maturity.

Importantly, however, there is a practical reason not only to tax certain foreign investments but also to tax different foreign investments differently: the United States taxes its own corporations' profits.[267] Thus, if a U.S. corporation has to pay taxes on its profits, but its foreign competitor does not, the U.S. corporation will be at a competitive disadvantage

263. Kleinbard, *supra* note 17, at 246.

264. *See* Sheppard, *supra* note 182, at 1249.

265. STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE UNITED STATES, JCX-49-08, at 73 (2008) [hereinafter JCX-49-08].

266. *See, e.g.*, Leblang & Rosenberg, *supra* note 80 (arguing that the United States should use an "active finance standard" to decide whether lending income is ECI).

267. I.R.C. § 11 (2006).

because of the tax law. In other words, the government could exempt hedge funds from tax altogether and might thereby increase future growth and per capita income in the United States, but then we would have to deal with the prospect of having U.S. banks go out of business (and all accompanying effects on the economy).

Therefore, the nexus requirement, complete with the trading safe harbors and the portfolio interest exemption, seems to make sense in light of current policy goals. In general, foreign investors should be taxed as little as possible on U.S.-source income in order to encourage them to invest in the United States, but if a foreign investor competes with U.S. businesses, it should be taxed as a U.S. business in order to prevent unfair competition.[268] The question then becomes: How best can this goal be accomplished in the case of offshore lending?

B. THE IRS'S SOLUTION: A RESULT IN SEARCH OF A JUSTIFICATION

There is little doubt that hedge funds are competing with U.S. banks.[269] Merely imposing a tax on "hedge funds," however, would hardly be effective at stopping this competition. Financial services are converging; if one form of doing business, or one technique, or one product is taxed unfavorably, we can count on industrious companies to devise new schemes to achieve the most favorable tax treatment available.[270]

It is apparent that the existing (pre-CCM) law of nexus is inadequate to achieve the desired result of taxing foreign hedge funds that compete with U.S. banks, as hedge funds have argued that their income is not taxable to their foreign investors.[271] Allowing the trading safe harbors and portfolio interest exemption to apply together to the same income may have the laudable effect of encouraging foreign investment,[272] but if hedge funds

268. *See* Leblang & Rosenberg, *supra* note 80, at 145. Walker takes a contrary view: "USTB was originally and remains primarily an administrative construct to identify income that is administratively sensible to tax on a net income basis under the self-assessment regime," rather than through withholding. Walker, *supra* note 44, at 27. Considering that withholding essentially acts as an "on-off switch[]," Kleinbard, *supra* note 17, at 246, and has primarily been used "as a bargaining chip for treaty negotiations" rather than a tax collection device, Sheppard, *supra* note 182, at 1249, one would hope that the USTB nexus rule continues to exist for more than merely the ease of tax administration.

269. *See supra* notes 9, 255–56 and accompanying text.

270. *See supra* notes 260–62 and accompanying text.

271. *See supra* Part III.A.

272. *See supra* Part IV.A.

are able to use these rules to avoid taxes on outright competition with U.S. businesses, there seems to be a problem.

The IRS has responded by attempting to move a lending hedge fund's income away from the realm of trading and to treat it as ECI from a BFSB.[273] This approach obviates the effect of the trading safe harbors and portfolio interest exemption, as the income is now ECI. Yet, to achieve this result the IRS apparently has proposed a vastly more expansive theory of nexus in order to attribute the BFSB office of an unrelated third party to the hedge fund. As explained above, the net cast by this approach might be much broader than intended while simultaneously not being fine enough to snare all lending hedge funds.[274]

The problem with the IRS's approach is apparent when one focuses on what current policy goals are rather than the wording of the BFSB regulation. The IRS's approach, in essence, creates a fiction to fit the lending hedge fund's peg into the BFSB rule's hole. Because the rule asks for a "U.S. office," the CCM makes it look as though the hedge fund has one. But the goal is not to tax hedge funds that have—or almost have—U.S. offices; the goal is to tax hedge funds that compete with U.S. businesses over U.S. customers.

Some individual states in the United States have adopted expansive theories of nexus that are similar to the one apparently adopted by the CCM, allowing for activities of unrelated third parties to be attributed to out-of-state corporations for state tax purposes.[275] States have pursued this route out of an abundance of aggression, seeking to collect as much in taxes as they can.[276] Congress has noticed, with legislation being proposed (and reproposed) to curb the ability of states to use a nexus concept that abolishes the need for physical presence.[277] Walker criticizes the use of such a broad nexus construct for U.S. foreign tax purposes because of the administrative difficulties posed by collecting taxes from foreign taxpayers

273. *See supra* Part III.B.

274. *See supra* notes 214–21 and accompanying text.

275. *See* Walker, *supra* note 44, at 20–22. The CCM does not bother to cite state law, however. *See* CCM, *supra* note 36.

276. *See* Bartlett Cleland, *Business Activity Taxes: The New Internet Tax*, IPI IDEAS (Inst. for Policy Innovation, Louisville, Tex.), Mar. 2003, *available at* http://ipi.org/IPI/IPIPublications.nsf/PublicationLookupFullTextPDF/228DA5F53A7A1CBE86256CEE007BA972/$File/II18-BAT.pdf?OpenElement.

277. *See* Troy Flanagan, *The Business Activity Tax Simplification Act*, FRANCHISING WORLD, Apr. 2009, at 76.

when the threshold nexus between a foreign corporation and the United States is so slight.[278] More fundamentally, the problem with adopting a rule along the lines of the state tax regimes for foreign tax purposes is that such a system, as does the CCM's approach, only indirectly—and crudely—achieves the policy goal of taxing competing businesses while not taxing mere investment.

With its focus off center, it is only natural that the CCM's approach will fail at the margins. And with the malleability and interchangeability of financial services, the margins are what matter in the case of offshore lending. Therefore, this Note proposes a different approach, one that is designed to be focused on the goal: a customer nexus approach.[279]

C. AN ALTERNATIVE SOLUTION: A CUSTOMER NEXUS APPROACH

1. The Centrality of Customer Relationships

Fundamentally, attribution of activities to corporate entities is necessary for us to reach the conclusion that a corporation is engaged in business anywhere.[280] And, at least the way the laws are currently phrased, some physical presence is necessary if the question is whether a corporation is engaged in business within the United States as opposed to with the United States.[281] But to require that a BFSB office be attributed through agency to meet this physical presence requirement for purposes of the BFSB rules seems to be an indirect and inaccurate way to solve the real problem: determining whether a foreign corporation is competing with U.S. businesses for U.S. customers, rather than merely investing in the market. This Note argues that a more direct and accurate approach to distinguish between traders eligible for the trading safe harbors and lenders would be

278. *See* Walker, *supra* note 44, at 27–30.

279. David Shapiro and Jeff Maddrey suggest that the CCM's approach is, in fact, a focus on whether a "customer relationship" exists. David H. Shapiro & Jeff Maddrey, *The Importance of a "Customer Relationship" in Loan Origination*, 126 TAX NOTES 659, 660 (2010). They criticize this approach as likely to have a chilling effect on foreign investment in U.S. debt that has been originated in the United States, for fear that the relationship between the customer and the loan originator will taint the debt with the requisite customer relationship triggering ECI. *See id.* at 664. Regardless whether this description befits the CCM, my proposition is inherently different, as we will see in the next section. Rather than considering whether the loan originator and underlying customer had the requisite customer relationship, I propose looking to see if there is a sufficient nexus between the foreign holder of the debt and the customer.

280. Some civil law societies might beg to differ. *See supra* note 148.

281. *See* Walker, *supra* note 44, at 43.

to identify when a foreign taxpayer has a sufficient nexus to U.S. customers.[282]

An important assumption underlying this customer nexus theory is that customer relationships are a necessary incident of a lending business. Although there may be some basis for concluding that the key differentiator between activities that should be taxed as businesses and activities that should be taxed as investments is the existence of customer relationships,[283] we need not reach such a sweeping conclusion. For our purposes, it is sufficient that what differentiates financial services businesses, such as lenders, from various other financial activities that the tax law has traditionally treated as investing, is the existence of customer relationships.[284] Indeed, the Treasury has at least implicitly acknowledged this identity in the definition of a BFSB.[285]

Congress has also explicitly recognized the need for customer relationships in the analogous area of Subpart F. The policy concerns under Subpart F are very similar to the concerns underlying the taxation of inbound transactions, but viewed from the opposite direction. Subpart F is designed to limit the ability of U.S. shareholders to defer U.S. taxation of passive investment income earned by foreign corporations, while simultaneously not overburdening active foreign businesses conducted by U.S. taxpayers,[286] and these active businesses now include "banking, financing, or similar businesses."[287] Because Congress did not want to open

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282. In a sense, one could say that a foreign corporation has a physical presence if it is competing with U.S. businesses for U.S. customers, both of which businesses and customers are in the United States. More practically, however, any such requirement makes sense only if it contributes to identifying which corporations should be subject to U.S. tax. Physical presence is not necessary as a matter of taxing jurisdiction, as has been recognized at least since 1936. *See supra* notes 43–46.

283. *See* Kemon v. Comm'r, 16 T.C. 1026, 1032–34 (1951) (distinguishing dealing, which requires customers, from investing, which does not).

284. *See* Kleinbard, *supra* note 17, at 230–31. Note, however, that "[t]he principal exception to the centrality of customer relationships seems to be some parts of the insurance industry." *Id.* at 231.

285. The BFSB regulation uses the terms "to the public," "from the public," and "for the public" in defining the activities that can constitute a BFSB. Treas. Reg. § 1.864-4(c)(5)(i) (as amended in 2005).

286. *See* H.R. REP. NO. 87-1447 (1962), at 57–58; S. REP. NO. 87-1881 (1962), at 78–79.

287. *See* I.R.C. § 954(h) (2006). This exception in its permanent form was enacted by the Tax and Trade Relief Extension Act of 1998, Pub. L. No. 105-277, § 1005, 112 Stat. 2681-886, 2681-890 to -900. *See also* LaBrenda Garrett-Nelson, *New Definition of "Lending or Finance Business" Levels Playing Field for Financial Services Industry*, TAX NOTES TODAY, Nov. 16, 1998, *available at* 98 TNT 220-100 (LEXIS) ("[T]ax policymakers determined that the line between a finance and credit company and portfolio investors is in fact susceptible to delineation. Having drawn that line, there was then no

a spigot allowing all sorts of investment income to be converted into "banking" income, it tailored this exception to apply only if a sufficient portion of income is derived "from transactions with *customers*" (subject to many detailed requirements).[288]

Even if customer relationships were not an absolute requirement for a lending business, however, their existence is certainly more indicative of such a business than is the existence of an office. If a corporation opens an office[289] in a country, there is a good chance that the corporation is running a business at that location; but it does not follow that every activity conducted there is actually a business with which the tax law is concerned. Indeed, the special BFSB ECI rule deals with the specific situation in which a corporation may operate an office in the United States but receive U.S.-source income that is not "attributable to the" office and, thus, is treated as investing income, not ECI.[290] The fact that a corporation operates an office in the United States is certainly a relevant factor, but it alone is hardly a sufficient factor for the differentiation between a lending business and mere investing activities.

Nor is the existence of a BFSB office a necessary fact for a corporation to conduct a lending business at a particular location. Indeed, the CCM was concerned specifically with a case in which a foreign corporation with no U.S. office was nevertheless engaging in a U.S. lending business.[291] Of course, in the CCM there was a U.S. office that was involved in originating loans—it just was not the foreign corporation's office.[292] Nevertheless, with the advent of online banking, it is not hard to imagine facts in which a physical building and staff are completely absent in a country, yet the competition is every bit as real.

tax policy reason to deny deferral to cross-border income (that is, income from customers located outside the home country) earned by finance and credit companies.").

288. *See* I.R.C. § 954(h) (emphasis added); STAFF OF THE JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1998, JCS-6-98, at 248–55 (Comm. Print 1998) (discussing the background of § 954(h)); Garrett-Nelson, *supra* note 287 (same).

289. One could suppose, instead, that a company opens an OFPB as that term is defined in the tax law. But to use the term "fixed place of *business*" would seem to prejudice the subsequent inquiry into whether the company is conducting business at that location, so the discussion here merely uses the term "office."

290. *See supra* notes 144–46 and accompanying text.

291. *See* CCM, *supra* note 36, at 2.

292. *Id.*

For purposes of taxing e-commerce, some have proposed eliminating the need for a permanent establishment and moving to more of a source-based taxation scheme.[293] This proposal may work well in the context of Internet sales, but it does little to address the issue of differentiating business activities from investing that so permeates financial services. Perhaps such an approach is nevertheless necessary to preserve tax revenues,[294] but at least one commentator has proposed doing essentially the opposite with regard to financial products by exempting them from source-based taxation.[295] The customer nexus approach proposed in this Note might achieve the best of both worlds: taxing income that is derived from competing business activities while exempting (or subjecting to gross-basis withholding) income derived from investing activities.

A change in the taxation of foreign corporations to reflect a changing reality would not be unprecedented.[296] To implement a customer nexus approach for BFSBs, however, would not necessitate congressional action, as the only rule requiring that income be connected to a BFSB office in order to be treated as ECI is an administrative creation.[297] Thus, a new regulation—or a radically new interpretation of the existing one—is all that would be needed. To give taxpayers stronger assurance that a new rule would be enforced, however, legislation would be preferable.

2. Application of a Customer Nexus Approach

Whether a customer nexus approach would lead to the conclusion that U.S.-source interest income earned by a foreign corporation is ECI would depend on the facts and circumstances of the particular case. Of course, policymakers could adopt bright-line rules to apply to particular fact patterns, and they could list factors that would tend to move taxpayers closer to the ECI realm and factors that would tend to move them farther away.

293. *See, e.g.*, Aldo Forgione, *Clicks and Mortar: Taxing Multinational Business Profits in the Digital Age*, 26 SEATTLE U. L. REV. 719, 776–80 (2003).

294. *See id.* at 727 ("So as long as tax authorities place great emphasis on the residency of the taxpayer, there will be a gradual diminution of the tax base of many industrialized countries and the loss of significant tax revenues.").

295. *See* Jeffrey M. Colón, *Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads*, 1999 U. ILL. L. REV. 775.

296. *See supra* Parts II.A, IV.A.

297. *See supra* note 240 and accompanying text.

In most cases imaginable, the results reached using a customer nexus system should be no different from those reached using the current system. This symmetry makes sense when one considers that the current system uses factors that are essentially proxies for the existence of a customer relationship. Where the results might differ under a customer nexus approach, however, are in precisely the kinds of cases that commentators (and presumably the CCM) are concerned with: cases in which hedge funds use sophisticated schemes to convert income from lending activities into tax-exempt portfolio interest.[298]

To illustrate that this system works in easy cases, consider the following two scenarios. If a foreign corporation has its own office in the United States run by its own employees, and it originates a residential mortgage loan to a U.S. resident through that office, it is clear that any interest income earned on that loan would be ECI to the foreign corporation because there is a customer relationship between the U.S. resident and the foreign corporation. In contrast, if an identical corporation, through an identical office, buys a bond in a public bond offering by a U.S. telecommunications company and holds the bond to maturity, any such interest earned by the foreign corporation on its bondholding should not be ECI. The reason is that the telecommunications company is not the foreign corporation's customer.[299]

How does this analysis work if an unrelated party (we will call it "U.S. Bank") originates loans to U.S. residential mortgage borrowers and transfers the loans to the foreign corporation? The mortgage borrowers are clearly customers. The question is whether they have sufficient customer relationships with the foreign corporation.[300] Several factors could be considered, including whether the foreign corporation structures covenants in the loans, solicits customers, reviews customer credit histories, or approves loan applications. In addition, one could consider whether the usual indicia of agency exist between U.S. Bank and the foreign corporation (such as legal control and a lack of entrepreneurial risk).[301] One

298. *See, e.g.*, Leeds, *supra* note 169.

299. *See* Kemon v. Comm'r, 16 T.C. 1026, 1032 (1951) ("Those who sell 'to customers' are comparable to a merchant in that they purchase their stock in trade . . . with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost.").

300. *Cf.* discussion *supra* note 279.

301. *See supra* notes 124–25 and accompanying text.

could also consider the degree to which the foreign corporation manages the risk of a default[302] and, in a similar vein, the extent to which the foreign corporation assumes the credit risk of the mortgage borrowers (rather than the credit risk of U.S. Bank).[303] For example, if U.S. Bank has an exclusive agreement to sell its loans directly to the foreign corporation and receives a flat fee in exchange, one might think U.S. Bank is only an agent in fact. The foreign corporation might be seen as effectively stepping into the shoes of U.S. Bank to assume any customer relationship created by it. In contrast, if U.S. Bank securitizes its loans and transfers interests in them to the highest bidders in the open market, and the foreign corporation buys some of these securities, we may reach a different conclusion. In this latter case, it may seem that the foreign corporation is little more than a customer of U.S. Bank, not the individual borrowers. If, however, additional facts show that the foreign corporation is more of a conduit through which to funnel interest income offshore (perhaps as part of a prearranged loan syndicate),[304] ECI treatment may be appropriate.

Clearly, where one should draw the line between lending activities and mere investing activities will not always (and may never) be easy. But considering the malleability of financial transactions,[305] it seems inevitable that hedge funds will try to arrange their facts so that they fall on the investing side of the line. Devising a system of taxation that reaches the right answer in every situation would be impractical if not impossible. But by focusing on the existence or absence of customer relationships, we should at least be able to limit our errors.

V. CONCLUSION

Hedge funds are increasingly competing with U.S. banks for U.S. customers while not paying the same U.S. income taxes that U.S. banks are required to pay. As long as the objective of U.S. foreign tax policy is to protect U.S. businesses from foreign competitors that might gain an unfair advantage from the tax law, while simultaneously encouraging foreign

302. *See* Kleinbard, *supra* note 17, at 244–45 (explaining that "financial institutions acting in the capacity of financial services firms dealing with customers" have an "agenda . . . to *manage* the risk of a . . . default, not simply to accept it").

303. *See id.* at 226–28 (describing how credit risk exposure can be transferred among various kinds of financial instruments).

304. *See* Sheppard, *supra* note 9, at 731–32 (discussing various lending arrangements hedge funds have devised).

305. *See* Kleinbard, *supra* note 17, at 225–26.

investment in the United States, we will face difficult issues regarding the proper taxation of hedge fund offshore lending activities. The malleability of financial instruments means that income that, under current law, looks like investment income might actually be business income in disguise.

The IRS's recent proposed solution, adopted in its CCM, is arguably not legally supportable under current law and may have unintended and far-reaching implications beyond offshore lending. Furthermore, it might not actually stop offshore lending hedge funds from escaping U.S. taxation while competing with U.S. financial institutions for U.S. customers.

This Note proposes that current U.S. policy goals might be better served by changing the focus of the inquiry from whether a BFSB office is attributable to a foreign corporation to whether a foreign corporation has a sufficient customer relationship with U.S. borrowers. The existence or absence of a BFSB office at some level that can be attributed to a foreign corporation is only an imprecise proxy for whether a hedge fund is actually competing with U.S. banks. Because customer relationships are a necessary part of a lending business, it makes sense to look directly at whether such relationships exist. By doing so, a customer nexus approach should allow the tax law to discriminate between competing business activities and mere investing activities regardless of the forms used to engage in those activities.