

2016

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Alan Appel

New York Law School, alan.appel@nyls.edu

Leonard Schneidman

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CHAPTER 2

The Trade or Business Issue for Foreign Portfolio Investors: From Safe Harbors to Troubled Waters

ALAN I. APPEL, ESQ.

LEONARD SCHNEIDMAN, ESQ.

Alan I Appel, Esq. is a Professor of Law and the Director of the International Tax Program at New York Law School, 185 West Broadway, New York, NY 10013. Tel No. 212-324-6554; email alan.appel@nyls.edu.

Leonard Schneidman, Esq. is a Managing Director at Andersen Tax LLC, 16th Floor, 125 High Street, Boston, MA 02110. Tel No. 617-292-8422; email: len.schneidman@andersentax.com.

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§ 2.01. INTRODUCTION

This article will examine the trade of business issue in the context of foreign “portfolio” (as distinguished from “direct”) investment.¹ These types of investments are passive: the investor exercises no control over the issuer or obligor of the investment. Direct investment, on the other hand, indicates situations where the investor influences or controls the investment and raises significantly different tax issues than portfolio investments.²

A central touchstone of the U.S. taxability of nonresident aliens and foreign corporations (collectively, “foreign investors”) is the existence of a trade or business in the U.S.³ If such a trade or business exists, income effectively connected to it is taxed at full graduated rates on a net basis. The enactment of the branch profits tax (Code section 884) has created an additional risk to foreign corporations whose investment activities are determined to rise to the level of being engaged in a trade or business. In such a case, the effectively connected income of the foreign corporation may be subject to the branch profits tax, as well as to the tax under Code section 881.

A further tax risk for nonresident aliens and foreign corporations whose investment activities constitute a trade or business is represented by the regulations concerning untimely filing of income tax returns by foreign taxpayers. Under the regulations,⁴ nonresident aliens and foreign corporations will not be entitled to otherwise-allowable deductions (or certain types of credits) for a taxable year unless they file a true and accurate return for the taxable year within the time-limits as set forth in those regulations. For example, if the current year is the first year for which a return is required under Code sections 874(a) or 882(c)(2), the current year’s return must have been filed no later than the earlier of the date which is one year after the extended due date for filing that return or the date the IRS notifies the taxpayer that a return has not been filed. In most instances, the determination that a foreign investor has engaged in a trade or business by virtue of its investment activities will not be made on an audit until *later* than one year after the due date for filing a return for that year. As a result, the foreign taxpayer will be effectively denied all its otherwise allowable deductions.

The foreign taxpayer may, however, request a waiver by the Service of the regulatory time limit conditioned on establishing, based on all the facts and circumstances, that it acted reasonably and in good faith in failing to file the return within 18 months of the due date.⁵

On the other hand, income that is not connected with the conduct of a trade or business is taxed, if at all, at a flat rate of 30% without deductions. This is generally done by withholding at the source. For example dividends and some interest from U.S. sources paid to a foreign investor are taxable at a flat 30% rate (subject to reduction by tax treaty, if available) so long as the foreign investor is not engaged in a trade or business in the U.S. Capital gains, income of foreign investors not engaged in a trade or business in the U.S. are generally not subject to U.S. taxation.

Although the phrase “trade or business” (or its slightly larger relations “engaging in” or “carrying on” a trade or business) appears in literally hundreds of sections or subsections of the Code, the Code offers no comprehensive definition of these phrases. And, in fact, the Supreme Court concluded in *Commissioner v. Groetzinger*⁶ that because of its wide utilization in various contexts, any judicial attempt “to formulate and impose a test for all situations would be counterproductive [and] unhelpful”.

In the context of foreign investors, the trade or business concept is further overlaid with specific statutory rules governing certain activities and types of investors. These rules act, in effect, as safe harbors for those activities falling within their boundaries.

Footnotes — § 2.01:

¹ The usual line of demarcation for a direct investment is 10 percent or more of voting power or voting securities.

² See, for example, Schneidman, “Tax Planning for U.S. Business Operations of French-Owned Enterprises”, Tax Notes Intl, March 17, 2014 (p. 1017).

³ For a complete discussion of this topic, including activities other than portfolio investment (for example, real estate, mineral interests, etc.), see J. Isenbergh, *The “Trade or Business” of Foreign Taxpayers in the United States*, 65 *Taxes* 972 (1983); D.S. Shapiro, *Private Securities Partnerships—The Trade or Business Issue Examined* 56 *Tax Notes* 85 (1992).

⁴ *Treas Reg* § 1.874-1; *Treas Reg* § 1.882-4. See *Swallows Holding Ltd. v. Commissioner*, 515 F3d 162 (CA-3) (2008), upholding the validity of the regulation.

⁵ *Treas Reg* § 1.882-4(a)(3).

⁶ *S Ct*, 87-1 USTC ¶9191, 480 US 23 (1987).

§ 2.02. PASSIVE INVESTMENT COMPARISON

[1] Background Cases

Ever since the case of *Higgins v. Commissioner*,⁷ the courts (and the IRS) have drawn a distinction between passive investing on the one hand and engaging in a trade or business on the other. As stated by the Supreme Court in *Groetzinger*:⁸ “The [*Higgins*] opinion, therefore,—although devoid of analysis and not setting forth what elements, if any, in addition to profit motive and regularity, were required to render an activity a trade or business—must stand for the proposition that full-time market activity in managing and preserving one’s own estate is not embraced within the phrase ‘carrying on business’”.

In light of this distinction, which is now firmly embedded in tax jurisprudence, the activities of foreign investors relating to holding of portfolio stocks or securities typically will not engage the foreign investor in a trade or business in the U.S. A critical, if blurry, distinction exists, however, between an ‘investor’ and a “trader” in stocks and securities. As discussed at Section 2.03, the Code provides statutory enclaves relating to certain trading activities of foreign investors. To the extent, however, that a foreign investor falls outside these statutory safe harbors, trading, as distinguished from investing, will give to trade or business status.⁹

A line of older cases (preceding the enactment of the Foreign Investors Tax Act of 1966) dealt in some detail with whether nonresident alien individuals who buy and sell stocks and commodities in the U.S. are engaging in a trade or business by virtue of their activities.¹⁰ While most of those cases, if they were to arise today, would fall within the safe harbors of the statutory provisions (as expanded by the Foreign Investors Tax Act of 1966), the Supreme Court in *Groetzinger*¹¹ may have added new vitality to the reasoning contained in these cases by its citation of *Commissioner v. Nubar*.¹²

In *Nubar*, the taxpayer was a citizen of Egypt who was forced to remain in the U.S. from 1939 through 1945 due to the outbreak of World War II. During his prolonged stay, he occupied a good deal of his time by trading profitably in stocks and commodities in the U.S. The Tax Court concluded that Nubar met the literal definition of the exclusionary language then contained in the Code for trading activities of nonresident aliens.¹³ In reversing, the Fourth Circuit determined that the statutory exclusion did not apply in the circumstances where the trading in securities would otherwise constitute engaging in a trade or business and the trading transactions were effected while the nonresident alien was present in the U.S. While the result of this case was effectively overruled by the 1966 statutory changes, the Fourth Circuit’s analysis of the issue of trade or business status appears to have been embraced by the Supreme Court in *Groetzinger*, wherein *Nubar* is described as involving a “full-time trader”.¹⁴

[2] Investor Versus Trader

In order to distinguish between an investor and a trader, the nature and extent of the taxpayer’s activities must be examined. Whereas an investor seeks long-term appreciation due to an objective increase in value of the corporate enterprise, a trader seeks profit in the shorter-term fluctuations of value as reflected in the marketplace. The nature of the investment and the volume of the transactions, as well as the degree to which the taxpayer commits his time to the activity, would be relevant inquiries in making this distinction. Thus, for example, the ownership of dividend-paying stocks or interest-bearing bonds that are held for a period of years

without any hedging, short sales or margin activity is likely to be considered an investment. On the other hand, dealings in commodities are more likely to be considered trading since, by their nature, they are usually held for a short period of time with frequent turnover.¹⁵

Comparing *Nubar* with *Higgins* and its progeny can be helpful in making the distinction between investor and trader. The cases involving domestic taxpayers are, to some extent, irreconcilable with the line of cases relating to foreign taxpayers. Clearly, the opinion in *Nubar* focused on the extensive nature of the taxpayer's activities in concluding that a trade or business existed, while the opinion in *Higgins* held that, despite the wide scope of the taxpayer's activities, he was not engaged in trade or business. In contrast to *Nubar*, however, in applying the tests of the statutory safe harbors, the volume of transactions by taxpayers coming within those provisions is irrelevant.¹⁶

[3] Effect of Deduction Limitations

Although *Groetzinger* confirmed the historical distinction between investment and business, certain limitations placed on individual deductions in the Code create an increasing tension in making this determination. For example, Code section 469 provides for the limited deductibility of passive activity losses. Thus, taxpayers may be expected to put great pressure on the tax laws to characterize various activities as active, rather than passive, in order to avoid the passive loss limitations. In addition, with the elimination of a number of miscellaneous itemized deductions previously available to individuals regardless of whether they were engaged in a trade or business (for example, investment advisory fees), individual taxpayers again will be led to characterize their investing activities as constituting a trade or business in order to obtain these deductions.¹⁷ The IRS will, of course, be taking the opposite side of these issues and arguing for a narrow definition of trade or business, at least in these contexts. In any event, as *Groetzinger* made clear, the determination of whether a taxpayer is engaged in a trade or business depends on the particular Code section under which the question arises. Thus, other parts of the Code will not necessarily control the resolution of the issue in the context of foreign investors.

Footnotes — § 2.02:

⁷ S Ct, 41-1 USTC ¶ 9233, 312 US 212 (1941).

⁸ *Supra*, footnote 7.

⁹ A similar distinction exists under the tax laws of the U.K., where realizing income derived from a trade, as distinct from an investment in shares, can affect a fund's tax exemption for its capital gain income.

¹⁰ *Commissioner v. Nubar*, CA-4, 51-1 USTC ¶ 9111, 185 F2d 584 (1950); *Fernand C.A. Adda*, 10 TC 273, Dec. 16,244, *aff'd*, 171 F2d 457; *Chang Hsiao Liang*, 23 TC 1040, Dec. 20,917 (1955); *Edward A. Neuman De Vegvar*, 28 TC 1055, Dec. 22,540 (1957). See also Gareleck, *What Constitutes Doing Business Within the United States by a Non-resident Alien Individual or Foreign Corporation*, 18 Tax L Rev 423, at 430-42 (1963).

¹¹ *Supra*, footnote 7.

¹² *Supra*, footnote 8.

¹³ 13 TC 566 (1949).

¹⁴ *Supra*, footnote 7.

¹⁵ For a detailed discussion of whether a commodities trading partnership is engaged in a trade or business, see Rudnick, Schenck, *Commodity Trading Partnerships After TRA '86*, 5 J Taxation of Investments 92 (1988).

¹⁶ See generally, the Committee Reports on the Foreign Investors Tax Act of 1966 (HR No 1450, 89th Cong, 2nd Session, p. 56; and HR No 1707, 89th Cong, 2nd Session, p. 16).

¹⁷ See, for example, Auster, *Tax Advantage “Traders Over Investors” in Securities*, 71 *Taxes* 46 (1993); Bond, Chaffin, *Can Securities Trading Be a Trade or Business*, 65 *Taxes* 727 (1987).

§ 2.03. IMPUTATION OF TRADE OR BUSINESS STATUS—GENERALLY

[1] Imputation From Partnership to Partners

Under principles of agency law, the trade or business of a taxpayer may arise from the activities of his agent or employee, rather than from the taxpayer’s direct activities. The statutory safe harbors discussed at Section 2.04[2], however, recognize this fact but provide exclusion from trade or business status to the foreign taxpayer regardless, so long as the statutory requirements are met. Thus, for example, a nonresident alien individual trading for his own account can utilize employees or agents (including an agent with discretionary authority) without being deemed to be engaged in a trade or business.

Subchapter N of the Code, however, contains two specific statutory rules creating the imputation of trade or business status to certain foreign taxpayers. Code section 875 provides that where a partnership engages in a trade or business, each partner is considered similarly engaged and where a trust or estate engages in a trade or business, each beneficiary is considered similarly engaged. No provision similar to Code section 875, however, applies to a nonresident alien shareholder of a corporation engaged in a U.S. trade or business. A nonresident alien who has no interest in a U.S. corporation, other than as a shareholder or creditor, is not considered engaged in that trade or business regardless of the corporation’s activities.¹⁸

It is important to note that Code section 875 cannot be used to impute a trade or business to a foreign partner or foreign beneficiary if the Code section 864(b)(2) statutory exclusion applies. Although not expressly stated in the Code, Code section 864(b)(2) was intended to eliminate the impact of the application of Code section 875. Thus, for example, if a partner is excluded from trade or business status under Code section 864(b)(2), no U.S. trade or business exists for purposes of Code section 875.¹⁹

Under Code section 875(1), a nonresident alien individual or foreign corporation is considered engaged in a trade or business in the U.S. if the individual or corporation is a partner in a partnership that is so engaged. In the case of a general partnership, this would probably arise under partnership law, since general partners are typically agents of each other. With regard to limited partners, however, the Code imposes a *per se* rule that can produce surprising results, since in that case a partner’s investment and control in the partnership are, by definition, limited.²⁰

This imputation of a partnership’s trade or business to its partners can be quite significant in the context of portfolio investment; there the partnership (both general and limited) is a common investment vehicle. As discussed at Section 2.04[2], under certain circumstances foreign taxpayers are not considered engaged in a U.S. trade or business, regardless of the imputation of the partnership’s trading activities to its partners. If, however, the particular activities do not fall under the statutory exclusion, the general rule of Code section 875(1) would apply.

*Robert Unger v. Commissioner*²¹ represents the judicial parallel of the imputation principle in the context of U.S. income tax treaties. In that case, the Tax Court applied the aggregate theory of partnership and relied on *Donroy, Ltd. v. United States*²² to hold that a partner in a limited partnership is considered to have a permanent establishment in the U.S. if the partnership has a permanent establishment.²³

Effect of Branch Profits Tax

The interplay of the branch profits tax and the imputation rule of Code section 875(1) results in a curious potential double tax. Code section 884 imposes a branch profits tax (in addition to the tax under Code section 882 on effectively connected income) equal to 30% of the “dividend equivalent amount” for the year.²⁴ The effect of Code sections 875(1) and 884, with respect to the earnings of a foreign corporate partner of a partnership having a U.S. trade or business, is to treat the partnership interest as if it were a U.S. branch of the

foreign corporation. The result is that the foreign corporate partner may be subject to the branch profits tax, as well as the tax under Code section 882, on its distributive share of the partnership's earnings. This result—whether or not intended by the drafters of Code section 884—nevertheless must be taken into consideration by foreign corporate partners.

[2] Imputation from a Trust or Estate to Each Beneficiary

Code section 875(2) provides that a nonresident alien individual or foreign corporation that is a beneficiary of an estate or trust engaged in a trade or business in the U.S. will be treated as being engaged in such trade or business in the U.S. Absent explicit statutory authority, the imputation of trade or business status to beneficiaries of trusts and estates would not necessarily result. Nevertheless, the Code clearly provides for such imputation and it must be taken into account.²⁵

Footnotes — § 2.03:

¹⁸ Edward A. Neuman de Vegvar *supra*, footnote 11.

¹⁹ PLR 8721079, February 25, 1987; see also TD 6948, 1968-1 CB 327.

²⁰ See Rev Rul 75-23, 1975-1 CB 290, in which the real estate business of a domestic limited partnership was imputed to its foreign limited partner. This ruling was declared obsolete in Rev Rul 87-80, 1987-2 CB 292 for reasons unrelated to the imputation of the limited partnership's trade or business to its foreign limited partner.

²¹ 58 TCM 1157, TC Memo 1990-15.

²² 301 F2d 200 (9th Cir 1962), *affg*, 196 F Supp 54 (ND Cal 1961).

²³ See H.M. Weinman, *Partnership Permanent Establishments: Unger v. Commissioner*, 19 Tax Mgmt Intl J 30 (1990).

²⁴ The dividend equivalent amount is the foreign corporation's effectively connected earnings and profits for the year, as adjusted for increases and decreases in U.S. assets, net of U.S. liabilities of the corporation.

²⁵ Rev Rul 85-60, 1985-1 CB 187. In the ruling, income was received by a nonresident alien beneficiary as a partner in a domestic partnership that had a permanent establishment in the U.S. The beneficiary was determined not to be exempt from tax under the provisions of the particular tax treaty involved, since he was considered to be in receipt of business profits attributable to the partnership's permanent establishment, which was imputed to him under principles of Code section 875(2).

§ 2.04. SECURITIES AND COMMODITIES TRADING—STATUTORY EXCLUSIONS

[1] Background

As early as 1936, the Code provided that engaging in a trade or business does not include certain specified securities and commodities trading activities of foreign taxpayers. This early provision was, however, construed narrowly by the courts. For example, the provision was interpreted as not protecting a nonresident alien in the circumstances where trading in securities would otherwise constitute engaging in a trade or business, and the trading transaction was effected while the nonresident alien was present in the U.S.²⁶

Similarly, no statutory protection was afforded where the nonresident alien's trading in securities was otherwise sufficient to constitute a trade or business and such transactions were effected by a resident agent who exercised discretionary authority with respect to such trading.²⁷ In addition, the judicial attempts to define the boundaries between investors (no trade or business) and traders (trade or business) for taxpayers who fell out from under the statutory protection created (and continue to create) no small degree of confusion.

With this background, the Foreign Investors Tax Act of 1966 was enacted. It included the expansion and clarification of the statutory exclusions for foreign taxpayers conducting securities and commodities trading

activities in the U.S. As amended, Code section 864(b)(2) and the regulations thereunder present a complex and often inconsistent series of rules keyed to, among other factors:

1. The type of investment (for example, stocks and securities or commodities);
2. The class of foreign taxpayer (for example, broker/dealer or investor);
3. The nature of the foreign taxpayer (for example, corporation or individual);
4. The status of the U.S. agent (independent or not); and
5. The location of the taxpayer's office or fixed place of business.

[2] Statutory Exclusions

[a] Exclusions (or "Safe Harbors")

There are several statutory exclusions allowing a person to trade in securities or commodities and not be considered "engaged in a trade or a business within the U.S." This section will discuss these exclusions in detail.

Code sections 864(b)(2) provides that "engaged in a trade or business within the U.S." does not include trading in stocks, securities or commodities under the following conditions:

1. *Trading through an independent agent.* Trading in stocks, securities or commodities through an independent agent (for example, a resident broker, commission agent or custodian), is excluded, *provided* the taxpayer does not have an office or other fixed place of business in the U.S. at any time during the taxable year through which, or at the direction of which, these transactions are effected.

Thus, foreign investors can grant discretionary authority to an independent U.S. agent without being engaged in a trade or business in the U.S. The rule applies to brokers or dealers, as well as to those who trade for their own account. For example, the rule would apply to a foreign broker who traded on behalf of a client through a U.S. broker.

2. *Trading for the taxpayer's own account.*²⁸ Generally, trading stocks, securities or commodities in the U.S. for the taxpayer's own account is also excluded, even if the transactions are consummated directly by the taxpayer, an employee of the taxpayer or an agent (including an agent with discretionary authority). This exclusion does not apply to brokers (since they are not trading for their own account) or dealers (specifically by the statute).

IRS letter Ruling 8721079, February 25, 1987, presents an unusual application of this exclusion. In that ruling, a foreign pension plan (P) invested in a bank common trust fund (Trust) established to invest in a portfolio of common stocks intended to approximate the Standard & Poors 500 Composite Stock Price Index (Fund B). The ruling concluded that P's participation in Fund B, through the Trust, was sufficient to consider P to be effecting transactions in the U.S. in stocks and securities under the safe harbor provided by Treasury regulation 1.864-2(c)(2).²⁹

3. *Special rules for partnerships trading for their own account.* The regulations under Code section 864 provide special rules governing when a foreign taxpayer will be considered to be engaged in a trade or business solely because the foreign taxpayer is a member of a domestic or foreign partnership that has been granted discretionary authority by such taxpayer to effect transactions in the U. S. in stocks, securities or commodities for the partnership's own account.³⁰ Absent these rules, the general imputation of the partnership's trade or business to its partners—as provided in Code section 875(1)³¹—might engage the foreign partner in a U.S. trade or business. These special rules do not apply, however, if the partnership is a dealer in stocks, securities or commodities.

It is important to note that, in applying these various statutory exclusions, the volume of transactions by taxpayers coming within their provisions is irrelevant.³² However, as noted previously, if a taxpayer falls outside the protection of the statutory safe harbors, the volume of trading activity may be crucial in determining whether the taxpayer is engaged in a trade or business in the U.S.

[b] Definitions of Stock, Securities or Commodities

As the above discussion clearly indicates, the result in any particular case may hinge on whether the trading is in stocks and securities, as distinguished from commodities. In IRS Letter Ruling 8807004, November 10, 1987, however, the IRS ruled that where an instrument is both a security and a commodity, the commodity safe-harbor test of Code section 864(b)(2)(B) will be applied in determining whether the foreign taxpayer is engaged in a U.S. trade or business. In so doing, the IRS relied upon the clear Congressional intent that engaging in certain commodity trading activities will not create a U.S. trade or business.

[c] Stock or Securities

The meaning of “stock” must have been considered self-evident since it is not defined in the regulations. The Code section 864 regulations do, however, define “securities” as “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.”³³ The regulations go on to define the “effecting of transactions in stocks and securities” to include buying, selling (whether or not by entering into short sales), or trading in stocks, securities or contracts or options to buy or sell stocks or securities, on margin or otherwise, for the account and risk of the taxpayer and any other activity closely related thereto (such as obtaining credit for the purpose of effecting such buying, selling or trading).³⁴

[d] Commodities

The regulations under Code section 864³⁵ state that the term “commodities” does not include goods or merchandise in the ordinary channels of commerce. The IRS, however, defines the word “commodity” broadly, taking the position that the word should be used in its ordinary financial sense.³⁶ Nevertheless, this line is not always easy to draw.³⁷ For example, the IRS treats spot, forward and futures contracts in precious metals and foreign currencies as commodities, while futures contracts for debt instruments on an organized market are treated as securities.³⁸ Additionally, the IRS considers futures contracts on financial indexes and commodity exchanges as commodities, even though settlement may be made only in cash.³⁹

The safe harbor for trading in commodities⁴⁰ only applies if the commodities “are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place.”⁴¹ In IRS Letter Ruling 8527041 (April 9, 1985), however, the IRS concluded that there is no requirement that the commodities transactions be consummated on an organized commodity exchange. Rather, the transactions need only be *similar* to transactions carried out on an organized exchange. The statute is unclear, however, as to how similar a product, traded off-exchange, must be to a commodity traded on an exchange, in order for the product to be a commodity “of a kind” customarily dealt in on an organized commodity exchange.

In IRS Letter Ruling 8813012 (December 23, 1987), the IRS shed some light on this issue. In that ruling, a foreign corporation was engaged in the business of entering into various crude oil forward and futures contracts and options on such contracts. The transactions entered into by the taxpayer were in a type of unidentified crude oil. The ruling indicated the crude oil futures in a second unidentified type of oil were traded on an organized commodity exchange in the U.S. The ruling held, without discussing the similarity or dissimilarity of two types of oil, that the taxpayer’s forward contracts were commodities for the purposes of the safe harbor of Code section 864(b)(2)(B). The implication of the ruling is that the off-exchange traded product need not be of exactly the same type as the exchange traded product. The ruling, however, does not indicate how much the off-exchange traded product can vary from the exchange traded product and still fit under the safe harbor.

Additional relaxation of the IRS's early restrictive interpretation of the scope of the commodity trading safe harbor is reflected in IRS Letter Ruling 8850041 (September 19, 1988), concerning a taxpayer whose activities consisted solely of trading futures contracts, index futures contracts, forward contracts, options on futures contracts, options on physical currencies, and transactions in spot contracts on currencies, all for the taxpayer's own account. Unlike the currencies or currency contracts at issue in prior rulings, not all of the items in Letter Ruling 8850041 were traded on an exchange regulated by the Commodity Futures Trading Commission; rather they were traded in the interbank market. Nonetheless, the IRS ruled that these items constituted "commodities of a kind customarily dealt in on an organized commodity exchange", so that they qualified for the commodity trading safe harbor.⁴²

The IRS's current position has been summarized by one commentator,⁴³ as follows:

Transactions in a commodity satisfy the commodity trading safe harbor if both of the following are met:

1. The commodity is a member of a set or class of commodities customarily dealt in on an organized U.S. commodity exchange.
2. The transaction is sufficiently analogous to transactions customarily consummated on an organized U.S. commodity exchange.

Among the still unanswered questions relating to the commodities trading safe harbor are whether either of the following will qualify: a commodity that is a member of a class of commodities that is dealt in solely on an organized foreign exchange, or a transaction customarily consummated on a foreign exchange but not sufficiently analogous to one customarily consummated on a U.S. exchange. Finally, it should be noted that many products traded on commodity exchanges, such as interest-rate sensitive indices,⁴⁴ have no underlying goods available for delivery. Nevertheless, they should qualify for safe harbor by virtue of constituting a commodity of a kind customarily dealt in on an organized commodity exchange.

[e] Dealers

The "trading for the taxpayer's own account" (unlike the "trading through an independent agent") safe harbor specifically excludes dealers from its application. Thus, a foreign corporation, or a nonresident alien that is a dealer in stocks or securities, would be considered engaged in a U.S. trade or business. The same holds for a dealer partnership with non-U.S. partners.⁴⁵

A "dealer" is a merchant of stocks or securities, with an established place of business, regularly engaged in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom.⁴⁶ A foreign person will not be considered a dealer solely because the foreign person acts as an underwriter, or a selling group member, for the purpose of making a distribution of stocks or securities of U.S. issuers to *foreign* purchasers of such stocks or securities (without regard to whether other members of the selling group distribute such stocks or securities to U.S. purchasers).⁴⁷ A foreign person will not be considered a dealer solely because he acts as a dealer in transactions other than those in connection with which discretion is given by him to a U.S. agent to trade in stocks or securities for the foreign person's account.⁴⁸

In effect, a foreign dealer is given a limited exclusion under the Code. That is, a foreign dealer will only be exempt from U.S. tax on gains from trading in U.S. stocks or securities if it conducts such trading activities through an independent agent, and it does not maintain an office or other fixed place of business in the U.S. through which transactions in stocks or securities are effected.⁴⁹ As a practical matter, any foreign dealer can make use of any safe harbor by establishing a separate subsidiary to carry out its U.S. trading activities.

[f] *InverWorld*—A Cautionary Tale

In *InverWorld v. Commissioner*,⁵⁰ the Tax Court, in a lengthy and methodical memorandum opinion, turned its judicial eye on the world of foreign taxpayers engaging (or not) in a U.S. trade or business by virtue of financial operations both inside and outside the U.S. In this case, *InverWorld, Ltd.* (LTD.) was an investment

management and financial services firm formed in the Cayman Islands and owned by non-U.S. persons. It owned all the shares of the InverWorld Holdings, Inc. (Holdings), a domestic corporation, which in turn owned all the shares of InverWorld, Inc. (INC.), an investment adviser registered with the Securities and Exchange Commission. INC. was formally engaged by LTD. to provide back-room services and investment advice and to manage the portfolio maintained on behalf of LTD.'s clients on a fully discretionary basis. In return for the services, INC. was paid a monthly fee by LTD.⁵¹

Among the court's determinations relating to the "engaged in trade or business" issue, were that:

- LTD. was engaged in the banking business in the U.S.
- LTD. engaged in that business in the U.S. by virtue of its trading of stocks and securities through INC.
- INC. was not an independent agent of LTD.
- LTD. maintained an office in the U.S. by virtue of the activities that were carried on at the premises of INC.
- INC. was not only a dependent agent of LTD., but also had the authority to negotiate and conclude contracts on behalf of LTD.
- After review of the judicial authority (much of it more than 50 years old at the time of the opinion), LTD.'s activities in the U.S. constituted a U.S. trade or business.
- LTD.'s service to its clients were performed in the U.S. and, therefore, gave rise to effectively connected income.

The court, to add insult to injury, confirmed a multimillion dollar deficiency, refused to allow LTD. a correlative Code section 482 adjustment for the allocation of income to INC. (with the result that both LTD. and INC. were taxed on the same income), and imposed substantial penalties.

The case presents a rare glimpse at a court's view of the Code's trading safe harbors and stands as a cautionary tale for foreign taxpayers and their U.S. tax advisors.

[g] Functional Analysis

It is helpful to examine the application of the exclusions described in Section 2.04[2] to various categories of foreign taxpayers:

1. *Dealers in stocks, securities or commodities.* A dealer in stocks, securities or commodities cannot grant discretionary authority to a dependent agent or maintain an office through which or by the direction of which the transactions are effected. The dealer can, however, trade through or grant discretionary authority to an independent agent in the U.S.
2. *Brokers in stocks, securities or commodities.* Similarly, a broker cannot grant discretionary authority to a dependent agent or maintain an office that effects or directs the transactions. Brokers can, however, trade through or grant discretionary authority to an independent agent in the U.S.
3. *Individual investors.* A nonresident alien investor can grant discretionary authority and have an office in the U.S. so long as he is trading for his own account. Trading volume is irrelevant. Such an investor can also maintain his principal place of business within the U.S. without losing his exclusion, at least insofar as his trading activities are concerned.
4. *Foreign investment companies.* A foreign investment company trading for its own account can grant discretionary authority and have an office in the U.S. that effects or directs its trading transactions.

5. *Partners in partnerships*.⁵² A foreign investor who is a partner in a non-dealer partnership (foreign or domestic) trading stocks, securities or commodities for its own account (either directly or through discretionary agents) in the U.S. will not be considered to be engaged in a trade or business in the U.S.
6. *Trusts and estates*. No special rules (such as described above) are provided for foreign trusts and estates. Rather, a foreign trust or estate may trade in stocks or securities for its own account under the same rules that apply to nonresident aliens.⁵³

Footnotes — § 2.04:

²⁶ *Commissioner v. Nubar*, *supra*, footnote 11.

²⁷ *Fernand C.A. Adda*, *supra*, footnote 11.

²⁸ Prior to the Tax Relief Act of 1997 (Pub L No 105-34), a foreign corporation or partnership that was engaged in the U.S. in the business of trading stocks or securities for its own account was not deemed to be engaged in a U.S. trade or business by virtue of that activity so long as its principal office was not in the U.S. The location of the principal office was determined by the application of the so-called “10 Commandments”: 10 specified functions all, or a substantial portion, of which had to be performed from an office located abroad. Although the statutory change itself appears to relate only to foreign corporations, the legislative history makes clear that “the bill modifies the stock and securities trading safe harbor by eliminating the requirement of both *partnerships* and foreign corporations that trade stocks or securities for their own account that the entity’s principal office not be within the United States”: House Rept., Taxpayer Relief Act of 1997 [emphasis added].

²⁹ In PLR 9041011, October 12, 1990, the IRS held that securities-lending transactions entered into by an offshore investment fund are the “effecting of transactions in the United States in stocks or securities” within the meaning of Treas Reg § 1.864-2(c)(2). In so holding, the ruling traces the term “effecting transactions” back to its inception in the Revenue Act of 1936 and concludes that for purposes of Treas Reg § 1.864-2(c)(2), the word “sale” includes an “exchange”, including an exchange under IRC § 1058.

³⁰ Treas Reg § 1.864-2(c)(2)(ii).

³¹ See the discussion at § 2.03[1].

³² Treas Reg § 1.864-2(c), (d).

³³ Treas Reg § 1.864-2(c), (2). The IRS has ruled that trade creditor claims arising out of bankruptcy proceedings in Chapter 11 of the Bankruptcy Code are securities: PLR 8704006, October 15, 1986.

³⁴ Treas Reg § 1.864-2(c)(2)(i)(c). In PLR 9204015, October 24, 1991, the ruling was that trading interest rate swaps was considered “effecting transactions in securities”.

³⁵ Treas Reg § 1.864-2(d)(3).

³⁶ Rev Rul 73-158, 1973-1 CB 337 (raw sugar sold to unrelated brokers is a commodity and not goods or merchandise in the ordinary channels of commerce).

³⁷ To aid in this line-drawing, the IRS issued a series of public rulings between 1977 and 1988 addressing various financial instruments, some of which are discussed below. No further guidance has been forthcoming, however, since the IRS adopted a no-rule policy in the area in 1991.

³⁸ See PLR 8527041, April 9, 1985.

³⁹ See PLR 8540033, June 21, 1985.

⁴⁰ For a complete discussion of the commodity trading safe harbor, see Carlisle, Helvie, *The Commodity Trading Safe Harbor for Foreign Investors*, 7 J of Taxation of Investments 146 (Winter, 1990); Rubble, *U.S. Income Taxation of Commodity Funds for Foreign Investors*, 16 Intl Tax J 263 (Fall, 1990).

⁴¹ IRC § 864(b)(2)(B)(iii).

⁴² The preamble to the proposed derivative trading safe harbor suggests, however, that the IRS no longer subscribes to the broad reading of the term “commodity” adopted in this ruling. See, E.W. Nijenhuis, *The § 864(b)(2) “Trading in Derivatives” Safe Harbor*, 39 Tax Mgmt Mem 371 (1998).

⁴³ Carlisle, Helvie, *supra*, footnote 41, at p. 154.

⁴⁴ For example, 30-day interest-rate futures contracts.

⁴⁵ The application of the dealer exception appears to apply only at the entity level so that a dealer would be able to avail itself of the trading safe harbor if it invests in a non-dealer partnership. See Y.Z. Reich, *Taxing Foreign Investors’ Portfolio Investments: Developments and Discontinuities*, 79 Tax Notes 1465 (1998).

⁴⁶ Treas Reg § 1.864-2(c)(2)(iv)(a).

⁴⁷ Treas Reg § 1.864-2(c)(2)(iv)(c), Example (1).

⁴⁸ *Id.*, Example (2).

⁴⁹ IRC § 864(b)(2)(c).

⁵⁰ 71 TCM 3231 (1996).

⁵¹ For a complete discussion of the facts and tax issues in the case, see Toan, Gold, Connors and Patten, *Foreign Broker Was Engaged in U.S. Trade or Business Through the Activities of an Agent: InverWorld, Inc. v. Comr.*, 25 Tax Mgmt Intl 655 (1996).

⁵² The possible effects of IRC § 7704(b), which taxes certain types of publicly traded partnerships as corporations, must be considered. Such corporate characterization would frustrate the intended tax result to the foreign partners from the use of a partnership, *that is*, pass-through tax treatment.

⁵³ See [PLR 8721079](#), February 25, 1987.

§ 2.05. PROPOSED DERIVATIVE TRADING SAFE HARBOR

For many years there was no clear guidance in determining whether modern financial products not actively traded in the U.S.—such as equity or credit swaps or other notional principal contracts—qualified as “stock”, “securities” or “commodities” for purposes of the stock, securities or commodities safe harbors. In response to this situation, the IRS issued proposed regulations that, if adopted as final regulations, would extend the trading safe harbor for certain foreign taxpayers trading in derivative financial instruments for their own account.⁵⁴ Under these proposed regulations, foreign taxpayers who are not dealers with respect to any derivative transactions, who are not otherwise dealers in stocks, securities or commodities, and who enter into derivative transactions for their own account, would not be treated as engaged in the conduct of a trade or business within the U.S. solely by reason of the derivative trading transactions.⁵⁵ These proposed regulations define “derivative” for this purpose as an interest rate, currency, equity or commodity, notional principal contract or an evidence of an interest in, or derivative financial instrument in, any commodity, currency, or any of the items described in Code sections 475(c)(2)(A) through 475(c)(2)(D).⁵⁶ For this purpose, proposed Treasury regulation 1.864(b)-1(b)(3) limits the term “currency” to “currencies of a kind customarily dealt in or on an organized commodity exchange”.

In a departure from its usual practice of providing only prospective effective dates for regulations, the preamble to the proposed regulations states that for periods prior to the effective date, taxpayers engaged in derivative transactions may take any reasonable position with regard to the “trading for the taxpayer’s own account” safe harbors and that positions consistent with the proposed regulations will be considered reasonable. The proposed regulations, for practical purposes, therefore, have an immediate—or perhaps even retroactive—effective date.

Functionally, the proposed regulations provide that a foreign person will not be treated as engaged in a U.S. trade or business solely by reason of trading in derivatives in the U.S. so long as the person:

1. Is not a dealer with respect to any derivative transactions;
2. Is not otherwise a dealer in stocks, securities or commodities; and
3. Enters into derivative transactions for its own account.

The preamble to the proposed regulations raises a number of questions and solicits comments on, *inter alia*, the following issues:

1. With regard to the terms “securities” and “commodities”, what is the proper scope of these terms and how to deal with the overlap between them, principally in the context of dealers.
2. The definition of “dealer”, and whether it is appropriate to allow derivative dealers to utilize the independent agent safe harbors.

Footnotes — § 2.05:

⁵⁴ REG-106031-98, 1998-1 CB 1322, corrected by [Announcement 98-74](#), 1998-2 CB 121. For commentary on these proposed regulations, see R.D. Lorence, *Treasury’s Grudging Assistance to Foreign Participants in U.S. Securities Markets*, 9 J. Intl Taxn 12 (1998); Nijenhuis, *supra*, footnote 33; Sheppard, *Implications of Trading Safe Harbor Rules for Equity Swap*, 79 Tax Notes 1546 (1998); Stratton, *Defining “Derivatives” for Safe Harbor Purposes: No Easy Task*, 80 Tax Notes 1255 (1998).

⁵⁵ Prop Treas Reg § 1.864(b)-1(b)(2). This safe harbor would encompass hedging transactions within the meaning of Treas Reg § 1.1221-2: Prop Treas Reg § 1.864(b)-1(a).

⁵⁶ Prop Treas Reg § 1.864(b)-1(b)(2). See discussion in REG-106031-98, *supra*, footnote 55.

§ 2.06. LENDING BUSINESS VERSUS EFFECTING SECURITIES TRANSACTIONS

[1] Background

If a foreign corporation or a partnership with foreign partners engages in transactions involving debt instruments, those transactions could be characterized as either carrying on a financing or lending business, or effecting securities trading transactions. The tax consequences of these two characterizations are dramatically different. If the foreign corporation or partnership is determined to be carrying on a U.S. trade or business, the effectively connected gains therefrom would be subject to net income taxation. In addition, portfolio interest otherwise not taxable to a foreign investor pursuant to either Section 871(h) (foreign individuals) or Section 881(c) (foreign corporations), does not include income that is effectively connected to a U.S. trade or business. If the transactions are characterized as trading in securities, in most likelihood the “trading for the taxpayer’s own account” safe harbor will be available to prevent U.S. taxability on the gains and any portfolio interest received on the security. The greatly increased activities of offshore hedge funds in the U.S. debt markets⁵⁷ has dramatically elevated the importance of the “trade or business” status issue.

[2] Lending or Finance Business Defined

The critical distinction in the current law relating to the existence *vel non* of a trade or business is that of passive lending and the conduct of a lending or finance business.⁵⁸ As stated by one commentator, “[c]urrent law fails to provide clear, predictable standards to determine whether U.S. lending activities of a foreign person constitute a trade or business in the U.S.”⁵⁹ Direct judicial authority is scant and is represented by the cases of *Pasquel v. Commissioner*⁶⁰ and *InverWorld*,⁶¹ reflecting, in effect, the two extremes of the facts and circumstances spectrum. In *Pasquel*, the court held that a single transaction, whether characterized as a loan or joint venture, was not sufficient to engage the taxpayer in a U.S. trade or business. *InverWorld*, in contrast, involved a foreign financial institution regularly engaged in five of the six enumerated financing functions over a number of years, which—not surprisingly—led to the court’s holding that the taxpayer was engaged in a U.S.

trade or business. Of course, the real world resides primarily in the gray area between these two cases, as to which there is no existing tax authority.⁶²

A relevant question as to which extensive (if conflicting) authority exists, is whether lending constitutes a business for a domestic taxpayer. Many of the domestic lending “trade or business” cases consider the application of the worthless debt deduction under Code section 166. This deduction applies only to debts created or acquired in a trade or business. The domestic bad debt cases rely on a series of nondeterminative factors and do not provide a logical, predictable template that can be used in the context of foreign taxpayers.⁶³

It should also be noted that the regulations under Code section 864 provide special rules for determining whether income and gains are effectively connected with the “active conduct of a banking, financing or similar business.”⁶⁴ Under these regulations, however, the taxpayer must still determine whether it is engaged in a business in the U.S., which presumably takes the taxpayer back to the conflicting authorities discussed above.

In practice, advisors tend to focus on two key elements in making the difficult determination as to whether a foreign person is engaged in passive lending or in the conduct of a lending business:

1. The degree of involvement of the foreign person (or its agent) in the lending process, reflected principally in the initiation and negotiation of the loans; and
2. Whether the foreign person engages in regular and continuous lending activities.

The manner in which the taxpayer participates in the lending transaction is also relevant. Thus, a taxpayer with customers is far more likely to be considered to be engaged in a lending business. Finally, there is the question of whose activities are to be taken into account in making this determination: a difficult inquiry with no direct authority in the foreign-lending area.⁶⁵

The application of these considerations in the context of collateralized debt funds—as distinguished from distressed debt funds—may produce different answers to the lending business inquiry by virtue of the different nature of the funds activities in those two distinct types of investments.⁶⁶

[3] Making Loans Versus Trading in Securities

A foreign taxpayer limiting its activities to buying, selling and holding fully funded securities is likely to avoid net basis taxation either as an investor or as a trader as it is protected by the statutory trading safe harbors. However, to the extent that the foreign taxpayer conducts extensive loan origination or negotiation activities in the U.S., the risk of net basis taxation due to its engagement in a lending business arises. The key factors in determining whether the taxpayer is engaged in the lending business are the level of its engagement in the origination process and whether those activities are regular and continuous. In order to mitigate the trade or business risk, hedge funds often purchase loans in the secondary market and/or limit the extent and manner of the fund’s and its investment manager’s direct engagement with borrowers in the loan negotiation activities. Whether the fund or its investment manager plays an active or passive role in the loan initiation and negotiation process is a relevant factor in this analysis.

[4] Effective Connection: The “Active Finance Business” Exception

A foreign taxpayer is not automatically subject to tax because it is determined to be engaged in a trade or business. Rather, tax is only imposed on income that is effectively connected with a U.S. trade or business. Under a special tax rule relating to income earned in the active conduct of a banking, financing or similar business, such income is considered effectively connected (that is, taxable on a net basis) only if it is attributable to a U.S. office through which such business is carried on.⁶⁷ In the absence of a U.S. office, therefore, active finance business income is not taxable to a foreign taxpayer. For the typical foreign hedge fund investor, so long as the investment manager is an independent agent, the manager’s U.S. office should not be imputed to the fund.⁶⁸ Thus, if the active finance business standard is met, all the funds’ income (other than Code section 1441 withholding taxes) would escape U.S. tax.

[5] The Service Speaks ... Twice

[a] AM 2009-010

In two administrative pronouncements, the Service addressed some (but certainly not all) issues relating to the lending as a trade or business question.

In AM 2009-010, the Service concluded that a foreign lender received taxable effectively connected U.S. source interest income on loans generated in the United States by what appears to be an independent contractor without the power to bind the foreign lender. This conclusion appears contrary to the state of present law relating to the attribution of agents' activities to a foreign principal,⁶⁹ and the Service promptly backed away from the ruling, stating that its conclusion is limited to the particular facts and not meant to be of general application.

[b] CCA 201501013

Of greater significance is the Service's publication of [CCA 201501013](#) where the U.S. fund manager had discretionary authority to negotiate and conclude contracts on behalf of the foreign fund and is thus distinguishable from AM 2009-010.

The facts in [CCA 201501013](#) are, in summary, as follows:

- A foreign limited partnership, treated as a partnership for U.S. tax purposes (the "Fund") participated in the origination and underwriting of convertible debt and equity instruments. Foreign Feeder, a foreign entity treated as a corporation for U.S. tax purposes, was a limited partner in Fund. Foreign Feeder did not qualify for treaty benefits.
- Management of Fund was vested exclusively in an unrelated Fund Manager. Fund appointed Fund Manager as Fund's agent and irrevocable attorney-in-fact with full power to buy, sell and otherwise deal in securities and related contracts on behalf of Fund.
- Pursuant to its grant of authority, Fund Manager conducted extensive lending, involving "numerous" loans and "dozens" of stock distribution agreements, in the United States and earned placement fees.
- The Fund Manager solicited potential borrowers, engaged in extensive due diligence, negotiated the terms of the loans and equity distribution agreements.
- Under its equity distribution agreements, the Fund was obligated to buy U.S. stock and pre-sell those shares.
- Fund Manager provided similar services to other investment entities through its U.S. office, but no employee of Fund Manager worked exclusively for Fund.
- The Fund itself had no employees or office in the U.S., and probably no office abroad.

The CCA considered three issues:

1. Did the Fund engage in a lending "trade or business" in the United States?
2. If so, could its activities still be considered "trading in stocks or securities" for purposes of both safe harbors?
3. If the Fund's activities qualified as trading in stocks or securities for purposes of the safe harbors, did either one apply?

The CCA is noteworthy by virtue of its analysis of the application of the trading safe harbors in the context of a foreign lending transaction. Specifically, the CCA concluded that the first trading safe harbor cannot apply if discretionary authority was granted to Fund Manager. While logical and seemingly consistent with the

legislative history, the concept that an independent agent cannot have discretionary authority is directly contradicted by Code Section 864(c)(5)(A), Reg. § 1.864-7(d)(1)(i) (requiring even a dependent agent to have the authority to conclude contracts—or fill orders from inventory—in order to attribute its office to the principal), and U.S. tax treaties (permanent establishment article). The CCA did not directly determine that the first safe harbor could not apply because Fund Manager’s office would be considered Fund’s office for this purpose but the CCA did attribute Fund Manager’s office to the Fund in connection with finding the Fund a dealer.

The CCA then concluded that the second trading safe harbor did not apply to the Fund, because its activities do not constitute trading. Specifically, the CCA suggested that the Fund might be considered to be conducting an active banking, financing or similar business, which the CCA asserts would not constitute “trading”. A similar conclusion was reached by the Tax Court in *InverWorld*.

The CCA also concluded that the Fund should be considered a dealer, and thus not entitled to the second trading safe harbor. Reg. § 1.864-2(c)(2)(iv)(a) defines a dealer as a merchant with an established place of business, regularly engaged in the purchase and resale to customers. The CCA attributed the Fund Manager’s U.S. place of business to the Fund. The CCA (controversially) found the Fund’s buyers to be “customers” simply by virtue of the fact that they were providing market access to the issuers.

It appears that the taxpayer involved in the CCA has petitioned the Tax Court,⁷⁰ claiming that the resulting tax deficiency is incorrect since the Service’s determination that the foreign fund was engaged in a U.S. trade or business by reason of its direct lending and underwriting activities is erroneous. A judicial pronouncement in this highly contentious area of foreign lending (if forthcoming) would be most illuminating.

Footnotes — § 2.06:

⁵⁷ Hedge funds have been particularly active in the syndicated loan, collateralized debt obligation and distressed debt markets.

⁵⁸ The distinction between trading financial assets by foreign nondealers covered by the statutory safe harbors and making loans is dealt with in § 2.06 [3], *infra*.

⁵⁹ S.E. Leblang, R. Rosenberg, *Toward an Active Finance Standard for Inbound Lenders*, 31 Tax Mgmt Intl J (2002); C.D. Sicular, E. Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 Tax L 719, 735-759 (2003). For a somewhat more pointed discussion of these issues, see Sheppard, *Neither a Dealer nor a Lender Be, Part 2: Hedge Fund Lending*, 108 Tax Notes 729 (2005).

⁶⁰ 12 TCM 1431 (1953).

⁶¹ *Supra*, footnote 52.

⁶² Two older revenue rulings (Rev Rul 73-227, 1973-1 CB 338 and Rev Rul 88-3, 1985-1 CB 268, which revoked Rev Rul 73-227) addressed the trade or business issue in the direct lending context. The rulings, however, do not provide an analytical framework for making this determination, and leave the resolution of the question to a facts and circumstances test.

⁶³ For a detailed discussion of this topic, see S.E. Leblang, R. Rosenberg, *op. cit.*, footnote 60, at pp. 135-41.

⁶⁴ Treas Reg § 1.864-4(c)(5).

⁶⁵ See D. Sicular, E. Sobol, *supra*, footnote 61, at pp. 763-9.

⁶⁶ *Id.*, at pp. 759-72; G.M. Biondo, *Why the Origination of Loans by Foreign Distressed Debt Funds Should Not Be Subject to U.S. Tax*, J Taxn Fin Products, 45 (Spring, 2003).

⁶⁷ IRC § 864(c)(4)(B)(ii). The Treasury regulations (Treas Reg § 1.864-4(c)(5)(i)(a)-(f) require interaction with the public in order to constitute active finance business income.

⁶⁸ But see the discussion of AM2009-010 at § 2.06[5][a] *infra*.

⁶⁹ Cummings, IRS Memo on Foreign Lenders and Engagement in U.S. Trade or Business Stands on Shaky Authority, Demonstrates Need for Formal Published Guidance, BNA, Daily Tax Report, Oct. 21, 2009.

⁷⁰ *YA Global Investments LP et al. v. Commissioner*, No 14546-15.