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Activities of Fund Manager Cause Fund to Be Engaged in U.S. Trade or Business

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The United States taxes non-residents on income that is considered "effectively connected" to a trade or business carried on in the United States. Canada and most other countries adopt a similar approach. But pursuant to a safe harbour provided in the U.S. Code, trading in stocks and securities is generally not considered the conduct of a trade or business in the United States. The trading safe harbour applies where a non-resident is either trading for its own account or trading through an independent agent. The safe harbour is generally not available to dealers.

In a recent advice memorandum, CCA 201501013, the IRS considered the position of a fund that was acting as an underwriter of stocks and an originator of loans. The IRS concluded that the fund was ineligible for the trading safe harbour due to the U.S. activities of the fund manager as agent for the fund. While not particularly surprising given the facts, the memorandum provides some insight into how the IRS views the scope of the trading safe harbour.

The memorandum involved a fund that had a U.S.-based fund manager that was appointed the fund's agent with authority to buy and sell securities and enter into binding contracts on behalf of the fund.[1] No tax treaty applied to the partners of the fund. The fund manager held the fund out as a lender and underwriter of stocks. With respect to its underwriting activities, the fund participated in underwriting stocks for a variety of issuers and would typically buy stocks at a fixed price from the issuer and then sell them at a mark-up in the underwriting transaction to investors, earning a spread on the difference in price and typically also earning a fee. With respect to the fund's lending activities, the fund manager negotiated all the terms of the loans, conducted due diligence and typically received a fee on behalf of the fund.

The IRS concluded that the fund, through the fund manager as its agent, was engaged in a U.S. trade or business and was not eligible for the trading safe harbour as a result of its activities being considered more than "trading". Even if the activities could be considered "trading", the IRS concluded that the safe harbour would nevertheless have been unavailable because the fund was considered a dealer. The IRS also concluded that the fund was ineligible for an additional aspect of the safe harbour that might have been available if the fund had conducted its activities through an independent agent. The IRS ruled that this aspect of the safe harbour was unavailable because the fund manager was granted discretionary authority. This ruling appears to reflect the IRS's view that an agent with discretionary authority can never be "independent", at least for the purposes of the trading safe harbour. The IRS also concluded that the fund's lending activities were themselves sufficient to cause the fund to be considered engaged in a trade or business of originating loans rather than trading in securities. The IRS followed the precedent set by the tax court in *InverWorld* to look to Treasury Regulation Section 1.864-4(c)(5) to determine when a taxpayer would be considered to be engaged in a lending business, even though the regulation is not directly applicable to this question.

On the basis of the fact pattern presented, in which the fund's activities went considerably beyond those of the typical fund that wishes to stay within the trading safe harbour, the conclusion in the advice memorandum is not surprising. However, it does highlight the need to exercise caution when investing in a fund that invests in stocks, securities or loans in the United States, particularly when the fund manager is based in the United States and is given discretionary authority to act on behalf of the fund. It also highlights that the IRS continues to broadly attribute the activity of agents for purposes of determining whether a taxpayer is engaged in a trade or business in the United States. In Advice Memorandum 2009-010, issued in 2009, the IRS attributed the activities of an agent that lacked discretionary authority to find that a foreign corporation was engaged in a trade or business in the United States by virtue of loans originated by the agent. While the agency question in CCA 201501013 was more straightforward, given that the fund manager did possess discretionary authority, the fact that the fund manager also managed other funds and no employees worked exclusively for the fund did not sway the IRS from attributing the manager's activities to the fund. Thus, particularly if no treaty applies, the activities of agents must be closely monitored if a foreign investor desires to take advantage of the trading safe harbour to avoid being treated as engaged in a U.S. trade or business.

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[1] The fund was originally formed as a U.S. partnership and subsequently converted to a non-U.S. partnership. This was not relevant to the analysis or conclusion.

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