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IRS Issues Guidance on When Lending Activity By A Non-U.S. Person May Subject It To U.S. Income Taxation

Foreign persons and their tax advisors have long questioned and considered how extensive lending activities in the U.S. by a foreign person have to be in order to give rise to U.S. taxation of the U.S. sourced interest. There has been little guidance from the IRS on the issue.

On September 22, 2009, the IRS Office of Chief Counsel issued a memorandum (the "Memorandum") to the IRS Director of Field Operations for Financial Services, in Manhattan, setting forth its position with respect to lending activities by a foreign corporation through a U.S. agent. The Memorandum concludes that a foreign lender with no U.S. office may still have U.S. taxable income resulting from U.S. source interest if the foreign lender has a U.S. agent – even if the agent cannot enter into contracts on behalf of the foreign lender. The Memorandum was issued to provide guidance to IRS agents auditing taxpayers, and is not binding precedent. However, it is significant because it is the first indication from the IRS that lending activities by a foreign person's U.S. agent, with no authority to bind, may give rise to net income taxation in the U.S.

IRS Chief Counsel Memorandum

By way of background, if a foreign person (an alien who does not reside in the U.S. or a foreign corporation) carries on a trade or business in the U.S., the person is taxed at regular income tax rates on taxable income that is effectively connected with the U.S. business, which taxable income is determined on a net basis, with deductions for all otherwise deductible items that are directly connected with the effectively connected income. If, on the other hand, a foreign person has U.S. source income that is not effectively connected with a U.S. business, the income is not taxed at regular income tax rates; rather, it is taxed at a flat 30% rate. As a practical matter, where the foreign person has U.S. source interest income and does not have a U.S. trade or business, such interest income often is not subject to U.S. taxation. This is because the 30% flat rate is often reduced or eliminated by an applicable tax treaty, or the interest is exempt from taxation under the "portfolio interest exemption" (which exempts from the 30% tax, interest from U.S. sources, excepting interest on some unregistered obligations and interest on bank loans and on obligations held by 10% or greater owners of the debtor).

The facts of the Memorandum are fairly narrow. A non-U.S. corporation ("Foreign Corporation") is 100% owned by shareholders that are not U.S. persons. Foreign Corporation has no office or employees located in the U.S. In order to originate loans to U.S. borrowers, Foreign Corporation outsources the origination activities to a U.S. corporation ("U.S. Origination Corporation"). Under a service agreement between U.S. Origination Corporation and Foreign Corporation, Foreign Corporation pays U.S. Origination Corporation a fee, and in return U.S. Origination Corporation performs loan origination activities, including soliciting U.S. Borrowers, negotiating the terms of loans, and performing the credit analyses with respect to the U.S. borrowers. U.S. Origination Corporation is not authorized to conclude contracts on behalf of Foreign Corporation, however. Foreign

Corporation's employees, who work in an office located outside of the U.S. give final approval of the loans and physically sign the loan documents on behalf of Foreign Corporation.

Generally, while the office and activities of an independent agent are not attributed to its non-U.S. principal, the activities of a dependant agent that regularly exercises the authority to conclude contracts that bind the non-U.S. principal may in fact create a U.S. trade or business and thus result in effectively connected income. Specifically, in the case of the conduct of a banking, financing, or similar business, when determining whether a foreign corporation has an office or other fixed place of business in the U.S., the Internal Revenue Code (the "Code") provides that that the office or other fixed place of business of an agent will be disregarded unless the agent (i) has the authority to negotiate and conclude contracts in the name of the foreign corporation and regularly exercises such authority and (ii) is not a general commission agent, broker or other independent agent acting in the ordinary course of business. Code Section 854(c)(5)(A).

The Memorandum notes that the "Service is aware that some taxpayers may have taken the position that interest income is not effectively connected with banking, financing or similar business activity because the income is not attributable to a U.S. office of the Foreign Corporation and that the office of Foreign Corporation's agent is not attributable to the Foreign Corporation . . . ." However, the IRS Chief Counsel concluded that on the set of facts addressed in the Memorandum, despite the fact that the U.S. Origination Corporation did not have authority to conclude contracts on behalf of Foreign Corporation, the interest income received by Foreign Corporation was effectively connected with such foreign corporation's U.S. banking, financing or similar business.

Why This Is A New Development

Until the issuance of this Memorandum, there was no guidance directly addressing whether lending activities such as those described would cause the non-U.S. lender to have U.S. taxable income. As suggested in the Memorandum, some non-U.S. taxpayers have been taking the position that since their U.S. agents did not have the ability to conclude binding contracts for the non-U.S. principals, their U.S. office could not be attributed to them. This Memorandum makes clear that the IRS Chief Counsel's office does not accept this position.

In addition to providing guidance as to the IRS's view of this particular set of facts, the Memorandum is noteworthy in that it states "[w]e understand that foreign corporations and non-resident aliens may have used other strategies to originate loans in the United States giving rise to effectively connected income . . . " and goes on to advise and assure the Director of Field Operations that "[w]e encourage you to develop these cases, and we stand ready to assist you in the legal analysis." This statement was seen by some as an encouragement to IRS agents to audit foreign corporations that engage in lending activities and have arrangements similar to the ones in the Memorandum.

Since the issuance of the Memorandum, IRS officials have reportedly cautioned against reading too much into the Memorandum and asserted that the Memorandum dealt with the very narrow question of whether only the office of the non-U.S. person should be looked at or the office of an agent as well. In response to a question as to the meaning of their statements that they encouraged IRS field agents to develop these cases, and that the IRS Chief Counsel's office stood ready to assist them in the legal analysis – the IRS official stated: "I think you can take from it that we're actively looking at cases and considering various issues that come up, including this one . . . . It's a statement to the field that we're there to help parse through some of these iterations." Kristen A.

Parillo, Memo on Foreign Corporation's U.S. Lending Activities Activity Is Not Major Guidance, IRS Official Says, 2009 TNT 185-4 (Sep. 28, 2009).

Implications for Future

Even if, as the IRS official stated, the Memorandum addressed only the very narrow question of whether the term "U.S. office" that could give rise to effectively connected taxable interest income from a banking, financing or similar activity meant only the taxpayer's office or an agent's office as well (even where such agent could not conclude contracts for the foreign person), given that the answer given was "yes," this is quite a significant question. Many have noted that the IRS's interpretation of the relevant statute to reach its conclusion may have been a questionable interpretation. While the Memorandum certainly provides useful guidance as to the IRS's view on the question, it likely is not the final word, and we may expect to hear further on the topic in the near future. In the meantime, offshore lenders — particularly those that took some level of comfort in taking the position that their interest income from U.S. borrowers was not subject to U.S. tax because they did not have any agent that could enter contracts on their behalf — would we well advised to revisit their positions and exposure.

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