LOAN ORIGINATIONS: A SHOT ACROSS THE BOW?

September 22, 2009

To Our Clients and Friends:

In a generic legal advice memorandum dated today, September 22, the Internal Revenue Service ("IRS") concluded that interest income received by a foreign corporation with respect to loans originated to U.S. borrowers through an agent was income that was effectively connected with the conduct of a banking, financing or similar business in the United States, and was thus subject to U.S. tax.

Although the question of when and whether loan originations constitute a U.S. trade or business is often discussed by tax practitioners, and IRS and Treasury officials have commented on the issue on various panels, the memorandum reflects the first official pronouncement on the topic from the IRS in several decades.

In the assumed facts of the memorandum, a foreign corporation that has no office or employees in the United States engages a U.S. corporation ("Origination Co.") to solicit potential borrowers in the United States, negotiate loan terms and perform credit analyses. Origination Co. is not authorized to conclude contracts on behalf of the foreign corporation, and the final approval and execution of the loan documents occurs outside the United States. These activities are considerable, continuous and regular.

Based on these facts, the memorandum concludes that the foreign corporation is engaged in a banking, financing or similar business within the United States, and therefore any interest income received is subject to U.S. tax. Along the way, the memorandum concludes that (1) the safe harbor for trading in stocks and securities for one's own account does not apply to the foreign corporation's loan origination activities; (2) the activities of Origination Co. are imputed to the foreign corporation for purposes of determining whether the foreign corporation is engaged in a trade or business, whether Origination Co. is viewed as a dependent or independent agent; (3) the loan origination activities constitute "making loans to the public" for purposes of determining whether the foreign corporation is engaged in a banking, financing or similar business; and (4) the U.S. office of an independent agent will be imputed to a foreign taxpayer for purposes of determining whether interest income is attributable to such office, and thus treated as taxable in the United States, within the meaning of the regulations governing a U.S. banking, financing or similar business.

It is perhaps unsurprising that the foregoing would represent the IRS's view of the tax consequences arising from these facts. It is also not surprising that the memorandum does

not address the hardest questions in the area. For example, what level of lending activity is sufficient to give rise to a U.S. trade or business? The assumed facts in the memorandum simply recite that the lending activities are considerable, continuous and regular. Second, are there types of loan originations that are sufficiently equity flavored (for example, subordinated loans with equity kickers or convertible debt) that such activity should be viewed as investing for one's own account rather than the conduct of a banking business? Further, the memorandum does not shed any light on what exactly constitutes an "origination" for these purposes, or whether certain secondary purchases of debt occurring close in time to original issuance could be so viewed, or the IRS's view of the efficacy of "season and sell"-type structures. The memorandum also does not address the tax implications of debt investments in distressed situations.

The larger question is whether the release of this memorandum signals the beginning of increased IRS attention to the loan origination area, either through enforcement efforts or the release of additional guidance. The penultimate paragraph of the memorandum provides the following exhortation to the field: "We 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. We encourage you to develop these cases, and we stand ready to assist you in the legal analysis."

Until further guidance sheds light on the tax treatment of the factual variations present in the market, which are typically more complex than those described in the memorandum, taxpayers will need to rely on their advisors' best judgment and market practice in deciding whether their debt investment activities may constitute a U.S. trade or business.

Please feel free to contact us with any questions.

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