

# TAMING THE DRAGON: DRAWING LINES— A CASE STUDY OF FOREIGN HEDGE FUND LENDING TO U.S. BORROWERS AND TRANSACTIONING IN U.S. DEBT SECURITIES

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*Legislators, judges, and administrative agencies often have to distinguish between similar transactions for tax purposes. To help, Congress has drawn some lines via certain categories. These categories, or “cubbyholes,” raise “line drawing” issues of whether seemingly similar benefits qualify as taxable under specific categories. One line drawing area where the stakes are high is in the taxation of foreign persons lending money to U.S. borrowers and transacting in U.S. debt securities. The relevant category that determines federal income tax consequences to those transactions is whether persons are “engaged in a U.S. trade or business.” The stakes are high in these situations because of the legal uncertainty in these transactions, which may create interconnectedness and credit channels, increase systemic risk, and make our system more fragile.*

*This Article analyzes the engaged in a U.S. trade or business cubbyhole in the context of foreign hedge fund lending to provide guidance to legislators who are faced with line drawing or cubbyhole issues. Part I examines the uncertainties created by recent developments. Part II questions whether academics can help legislators draw lines in general and with respect to the specific case of hedge fund lending. Part III asks what type of law should govern: a rule or a standard. This Article concludes by advocating for the implementation of a “white list” approach based on policy developed in the United Kingdom to ensure that tax policy related to the engaged in a U.S. trade or business cubbyhole keeps pace with financial innovation.*

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## INTRODUCTION

Legislators, judges, and administrative agencies often have to distinguish between similar transactions for tax purposes. For example, “an accession to wealth” is generally taxed,<sup>1</sup> but if your boss provides a single cup of coffee, is that taxed? Under theories of taxation a cup of coffee is an accession to wealth, but no one reports this solitary cup as taxable income. To help, Congress has drawn some lines via certain categories. The Internal Revenue Code (Code) provides that employer provided benefits are not taxable if they qualify, for example, as a “no additional cost service,” a “qualified employee discount,” or “de minimus.” These categories, or “cubbyholes” as one scholar calls them,<sup>2</sup> raise issues of whether seemingly similar benefits qualify as taxable under specific categories. Another scholar calls this approach “line drawing” and notes that line drawing issues are “pervasive in tax law.”<sup>3</sup> For example, is an instrument debt or equity? If an instrument is debt, interest paid on that debt can be deductible. Is someone an employee or an independent contractor? If an individual is classified as an employee, the employer has a host of withholding obligations. Is an entity a partnership or a corporation? These entities are taxed very differently. There are many such categories or cubbyholes in tax law.

Many doctrinal line drawing issues fall outside the discourse in academia.<sup>4</sup> The thought is to leave doctrinal conflicts to those in the private

<sup>1</sup> See *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

<sup>2</sup> Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1320 (1991).

<sup>3</sup> See David Weisbach, *Line Drawing Doctrine and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1627 (1999) (stating that “scholars view literally dozens of subjects within the tax law as being outside the scope of serious academic discourse” and characterizing tax policy decisions in which in between fixed points there were a range of transactions as “line drawing”).

<sup>4</sup> See *id.*

sector who deal with transactions on a daily basis. However, line drawing, and the broader implications of what laws should be, *must* remain in the realm of academic discourse when the issues are fundamental, such as when systemic risk is implicated. Academics are well equipped to guide legislators in determining what the laws should be—whether that be line drawing or line obliterating—because they are not beholden to clients’ interests and have academic freedom.

One line drawing area where the stakes are high is in the taxation of foreign persons lending money to U.S. borrowers and transacting in U.S. debt securities. The relevant category that determines federal income tax consequences to those transactions is whether persons are “engaged in a U.S. trade or business.”<sup>5</sup> As I suggested in *The Global Shadow Bank—Systemic Risk And Tax Policy Objectives: The Uncertain Case of Foreign Hedge Fund Lending To U.S. Borrowers and Transacting In U.S. Debt Securities (The Uncertain Case)*, the stakes are high in these situations because of the legal uncertainty in these transactions, which create interconnectedness and credit channels, increase systemic risk,<sup>6</sup> and make our system more fragile.<sup>7</sup> I further posited that uncertainty in this area frustrated the very international tax policy objectives our international taxation regime was enacted to promote: namely, increasing investments in the United States that allow persons access to financing abroad at a lower cost.<sup>8</sup> The law is *even more* uncertain now with (1) recent developments between the intersection of these federal

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<sup>5</sup> I.R.C. § 864 (2016).

<sup>6</sup> One way to define systemic risk is the risk of the collapse of an entire financial system or market serious enough to have an effect on the goods, services, and resources aspect of the economy. Julie Manasfi, *Systemic Risk and Dodd Frank’s Volcker Rule*, 4 WM. & MARY BUS. L. REV. 181, 188 (2013).

<sup>7</sup> Julie Manasfi, *The Global Shadow Bank—Systemic Risk And Tax Policy Objective: The Uncertain Case of Foreign Hedge Fund Lending To U.S. Borrowers and Transacting In U.S. Debt Securities*, 11 FLA. TAX REV. 643 (2011).

<sup>8</sup> *Id.* at 671. With respect to the exemption for a foreign persons capital gains on sales that are not connected with a U.S. trade or business Congress wanted to decrease collection difficulties and increase U.S. brokers revenue by encouraging foreign persons to make passive investments in the United States. See H.R. REP. NO. 74-2475, at 9 (1936). With respect to not taxing portfolio interest received by a foreign person that is not connected with a U.S. trade or business, Congress’ main rationale for this decision was to allow a U.S. person to continue financing abroad at a lower cost. Congress thought that if the exemption were not enacted, U.S. borrowers would be at a competitive disadvantage against borrowers from other countries. See STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 391-94 (Comm. Print 1984). Finally the tax policy behind the enactment of the safe harbor for trading in securities for one’s own account was to increase the flow of foreign capital. It was thought that earlier confusion may have acted to deter some foreign investment. See TASK FORCE ON PROMOTING INCREASED FOREIGN INVESTMENT IN UNITED STATES CORPORATE SECURITIES AND INCREASED FOREIGN INVESTMENT IN UNITED STATES CORPORATIONS OPERATING ABROAD, REPORT OF THE PRESIDENT 21 (1964) (Fowler Task Force Report).

tax rules and agency law<sup>9</sup> and (2) a recent Internal Revenue Service (IRS) memorandum.<sup>10</sup>

The “engaged in a U.S. trade or business” cubbyhole has grown into a dragon. Justice Oliver Wendell Holmes famously analogized the way in which law becomes shaped into an enormous dragon:

When you get the dragon out of his cave on to the plain and in the daylight, you can count his teeth and claws, and see just what is his strength. But to get him out is only the first step. The next is either to kill him, or to tame him and make him a useful animal.<sup>11</sup>

A foreign person’s interest income and profit on the sale of U.S. debt instruments are generally exempt from U.S. federal income tax if the income is not effectively connected to a trade or business in the United States.<sup>12</sup> If nonresident aliens or foreign corporations (collectively, foreign persons) have income that is connected with a U.S. business, that income will be taxed at the regular graduated tax rates applicable to U.S. persons and corporations.<sup>13</sup> A foreign person engaged in a U.S. business will also generally have to file a U.S. tax return.<sup>14</sup> The stakes are high for the proper characterization of what constitutes a U.S. trade or business, because if the foreign person is not engaged in a U.S. business, interest income and capital gains on the sale of a U.S. debt instrument are generally exempted from U.S. federal income tax.<sup>15</sup>

This Article analyzes the “engaged in a U.S. trade or business” cubbyhole in the context of foreign hedge fund lending as a case study to provide guidance to legislators that are faced with line drawing or cubbyhole issues. Applying Justice Holmes’ analogy, the first step in the case study is to pull the dragon out of cave and into the daylight, which is the work I began in *The Uncertain Case*. However, now the dragon must be further pulled out of the cave because developments in the law have made the landscape even more uncertain.

Part I analyzes the uncertainties created by recent developments. As Justice Holmes suggests, the dragon must then be killed or tamed into a useful animal. Taming this dragon, first requires asking on what basis legis-

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<sup>9</sup> See Jeremy Scott, *Sun Capital Might Be Bigger Than You Think*, FORBES, (Sept. 25, 2013) <http://www.forbes.com/sites/taxanalysts/2013/09/25/sun-capital-might-be-bigger-than-you-think/>.

<sup>10</sup> Memorandum 201501013 from the Office of Chief Counsel IRS (Jan. 2, 2015).

<sup>11</sup> Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

<sup>12</sup> This assumes that the portfolio interest exemption applies to the interest. See I.R.C. § 881(c)(1) (2016). Note, however, the portfolio interest exemption does not apply to a “bank.” I.R.C. § 881(c)(3)(A) (2016). A hedge fund should not be considered a “bank” for this purpose because it is not regulated as a bank under I.R.C. § 58. Priv. Ltr. Rul. 98-22-007 (Feb. 10, 1998). With respect to capital gains see *infra*, note 30.

<sup>13</sup> *Id.* Such business income may also be subject to a “branch profits tax” at a rate of 30 percent. I.R.C., 21 U.S.C. § 884. (2015).

<sup>14</sup> See I.R.C. § 6012. (2015).

<sup>15</sup> *Id.*

lators could or should draw lines within the existing cubbyholes. As with most cubbyholes, there are known points at the edges and a range of transactions in between. At the known end of the spectrum, frequent loan origination in the United States and lending to U.S. borrowers qualifies as being engaged in a U.S. trade or business.<sup>16</sup> At the other end, long-term holding of debt securities purchased on the secondary market constitutes passive investing. Passive investors are generally not treated as engaged in a trade or business.<sup>17</sup> However, there is a broad range of activities in between these two extremes, and precedent in the middle is quite uncertain and becoming more uncertain over time.

Part II questions whether academics can help legislators draw lines in general and with respect to the specific case of the engaged in a U.S. trade or business cubbyhole. Based on the case study and other similar line drawing cases, this section demonstrates the following: (1) statutory interpretation is unhelpful because the plain meaning of the cubbyhole and the general meanings do not provide regulators with adequate guidance; (2) congressional intent is unhelpful because even if Congress provides normative content to the cubbyhole category, that normative content is indeterminate at the boundaries; (3) the typical tax policy considerations of horizontal and vertical equity are unhelpful because both are indeterminate with regard to what transactions or persons are similar or different at the line drawing boundaries; and (4) the tax policy consideration of efficiency could be helpful, but only if deadweight loss is ascertained, a task which becomes nearly impossible when compliance costs are not transparent, as is the case in the hedge fund industry.

Part III examines what type of law should govern: a rule or a standard. In areas of potential systemic risk, this section shows that the virtue of certainty provided by a rule is preferable to the virtue of flexibility provided by a standard. However, a rule can be made less certain with exceptions, while standards can be made more certain by means of specific rules.

This Article concludes with a suggestion for taming the engaged in a U.S. trade or business dragon. The unhelpfulness of congressional intent and typical tax policy considerations illustrate that it does not matter where the line is drawn at the boundaries, as long as the line is drawn so that potential permissible transactions are not chilled to the point of creating systemic risk in narrowing credit channels. Similarly, because of potential systemic risk,

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<sup>16</sup> See *Serot v. Comm'r*, 68 T.C.M. (CCH) 1015, 1022–23 (1994); *McCrackin v. Comm'r*, 48 T.C.M. (CCH) 248, 251 (1984) (noting that taxpayer was engaged in lending trade or business, where taxpayer made sixty-six loans to twelve unrelated borrowers over fifteen years); *Jessup v. Comm'r*, 36 T.C.M. (CCH) 1145, 1150 (1977) (noting that trade or business of lending existed where taxpayer engaged in thirty-one loan, endorsement, or guarantee transactions with seventeen unrelated persons over ten years); *Cushman v. United States*, 148 F.Supp. 880 (D.C. Ariz. 1956); *Minkoff v. Comm'r*, 15 T.C.M. (CCH) 1404 (1956).

<sup>17</sup> *Continental Trading, Inc. v. Comm'r*, 16 T.C.M. (CCH) 724 (1957) *aff'd*, 265 F2d 40 (9th Cir. 1959) (“[M]erely [the] servicing of . . . investments in this country” does not constitute a U.S. trade or business).

legislators should, at a minimum, incorporate specific rules if they choose to adopt a standard. In cases which potentially create systemic risk, such as shadow bank transactions, the virtue of rule certainty outweighs the virtue of standard flexibility. For the engaged in a U.S. trade or business dragon, I propose adopting a policy similar to what the United Kingdom has implemented. One of the key components in the United Kingdom's continuing attraction for non-resident investors (including hedge funds) is the ability to appoint UK-based investment managers without creating a risk of UK taxation. Her Majesty's Revenue and Customs (HMRC) is committed to maintaining this benefit by offering the Investment Manager Exemption. Through a series of qualifying tests, the Investment Manager Exemption ensures that overseas investors are not charged UK tax in relation to investment transactions conducted on their behalf, but that any fees received by a UK resident investment manager for services performed for the non-resident are fully chargeable to UK tax. However, I advocate for the use of "white lists," which list transactions that clearly meet the exemption criteria. White lists are preferable because this approach not only offers the certainty benefits of a rule and the flexibility benefits of a standard, but also permits adding transactions to the lists to keep pace with financial innovation.

I. LOOKING AT THIS PARTICULAR DRAGON—THE ZONE OF  
UNCERTAINTY: A CURRENT LOOK AT THE TAXATION OF FOREIGN HEDGE  
FUND LENDING TO U.S. BORROWERS AND TRANSACTING  
IN U.S. DEBT SECURITIES

This section discusses taxing foreign persons using the current engaged in U.S. trade or business standard. As a case study, it looks at foreign hedge funds lending money into the United States by purchasing U.S. debt securities and participating in loan origination. Although this case study is only one example of the uncertainty in the taxation of foreign persons, it is an important example because foreign hedge fund lending traverses credit channels that may create systemic risk. Accordingly, it may be vital to address this problem in the context of the shadow banking system. This system refers to financial institutions outside the traditional banking system acting as intermediaries between investors and borrowers and increasingly undertaking roles traditionally played by banks, including lending capital to U.S. businesses. For example, the highest levels of government are discussing whether hedge funds are systemically important because of their interconnectedness to the financial system and credit channels.<sup>18</sup> As this section demonstrates, the government should also consider whether tax uncertainty in

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<sup>18</sup> Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (Dodd-Frank Act), the Financial Stability Oversight Council has been delegated the task of designating nonbank financial institutions that are systemically important.

the transactions that create the interconnectedness and credit channels increases systemic risk.

The crux of the uncertainty problem is that the IRS may enforce the mushy or non-existent U.S. trade or business precedent on shadow bank transactions that cause funds to recognize unexpected income for federal income tax purposes. Legislators should thus consider whether the potential imposition of tax at the highest tax rate, 35%, at any unexpected point, could increase the potential systemic risk of funds failing or chilling lending transactions, impeding credit markets. Currently, offshore hedge funds are gambling that the rules will be interpreted and applied according to the advice of their legal counsel. This gamble, however, is increasingly on shaky ground—in late 2009, the Office of Chief Counsel of the IRS issued a memo to the Director of Field Operations for Financial Services, stating, “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. . . .”<sup>19</sup> If the offshore hedge funds lose the gamble and are too interconnected to fail, will we all lose? This question is one that legislators must consider.

In addition to the potential economic impact, there is the current immeasurable economic impact of chilled behavior due to uncertainty. Uncertainty in the tax laws may frustrate the objective of encouraging foreign financial investment in the United States. The legislative history of the securities trading safe harbor suggests that the safe harbor “may have acted to deter some foreign investment in the United States.”<sup>20</sup> The confusion of the current rules may be having the same effect at a time when the United States desperately needs more liquidity. Clearly, a foreign person considering whether to invest in the United States must calculate the extent to which an investment would generate U.S. tax liability. If the foreign persons are subject to substantial income tax in their home countries, this inquiry may not be so important because their home countries may provide the investor a tax credit for U.S. taxes paid. However, many potential foreign investors are subject to minimal tax in their home countries on income from U.S. investments, which makes the determination of U.S. tax liability critical in deciding where to invest funds.

#### A. *General Overview of the Case Study—Certain Transactions*

Generally, hedge funds are private pools of capital that typically restrict their investors to high net worth individuals and institutions in order to escape the types of disclosure and regulations requirements that apply to banks

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<sup>19</sup> Memorandum from Steven A. Musher, Associate Chief Counsel of the IRS, to Kathy Robbins, Director of Field Operations (Sept. 22, 2009).

<sup>20</sup> See Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1689–90 (1976).

and mutual funds.<sup>21</sup> As discussed in *The Uncertain Case*, funds that solicit capital from foreign investors are increasingly using a “master-feeder” structure in which U.S. investors and foreign persons invest through feeder funds in the same master fund.<sup>22</sup> A foreign person often invests in parallel with a U.S. person. Since the master fund is also investing for a domestic feeder fund and U.S. investors, the master fund may invest in the United States to a point where the master fund could be considered to be engaged in a U.S. business.<sup>23</sup> Therefore, the increased use of the master-fund structure actually heightens the potential for these issues since there is one master fund investing for both U.S. and foreign persons.<sup>24</sup> If the master-fund were

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<sup>21</sup> This means that hedge funds have flexibility in the investment strategies and financial instruments that they employ. This also means they can be highly leveraged. The term “hedge” initially came from funds’ tendencies to hedge or reduce market risk on an investment. For example, holding offsetting positions so that if the market rose the funds profited from the increase in the long position over the decrease in the short position, and if the market fell the funds profited from the increase in the short position over the decrease in the long position. Hedge fund investment strategies vary widely. Hedge fund managers often receive a management fee of 2 percent of the net asset value of the fund and 20 percent of returns in excess of some benchmark. See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3 (2008). This may create an incentive for hedge fund managers to take on risk and leverage in order to maximize returns. See John Kambhu, Til Schuermann & Kevin J. Stiroh, *Hedge Funds, Financial Intermediation, and Systemic Risk*, 291 FED. RES. BANK OF NEW YORK STAFF REP. 1, 3 (2007). In general hedge funds are currently largely unregulated. Although investing money through a hedge fund is considered investing in a security under the Securities Act of 1933, registration is not required because there is no public offering and only accredited investors are permitted to invest. Regulation D of the Securities Act of 1933 governs what constitutes an accredited investor for that purpose. In addition a hedge fund is an investment company under the Investment Company Act of 1940 but is not required to register as such if an exemption applies. Many hedge funds attempt to meet the exemptions provided in either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. Section 3(c)(1) exempts any issuer of securities whose outstanding securities are not beneficially owned by more than 100 persons and is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) of the Investment Company Act of 1940 exempts issuers where each investor is a qualified purchaser and no public offering is made or contemplated. A qualified purchaser for this purpose is generally intended to be a sophisticated investor as determined by the amount of money such purchaser has in investments in general. See John Kambhu, Til Schuermann & Kevin J. Stiroh, *Hedge Funds, Financial Intermediation, and Systemic Risk*, 291 FED. RES. BANK OF NEW YORK STAFF REP. 1 (2007); see generally, Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX LAW. 133 (2004). In addition, hedge fund investment advisors generally do not register as such under the Investment Advisors Act of 1940 because they have fifteen or fewer clients (or funds).

<sup>22</sup> Alternatives to the master-feeder structure when a fund is soliciting capital from foreign investors include a parallel structure in which a foreign corporation for U.S. tax purposes invests in tandem with a domestic fund (although not through a master fund). In another variation, the foreign corporation could invest in a flow-through entity for U.S. federal income tax purposes with the investment advisor as the general partner of the flow-through entity such that the investment advisor could receive a profit allocation instead of a performance fee. The difference between this alternative and a master-feeder structure is that a domestic fund does not also invest in that lower tier flow-through entity.

<sup>23</sup> Many of the U.S. investors may even prefer the characterization of the master fund as engaging in a financing to deduct expenses under I.R.C. § 162 (2015).

<sup>24</sup> Many foreign hedge fund offering memoranda state that the fund or the investment advisor believes that the fund should not be considered to be in a U.S. trade or business of lending but that it cannot give complete assurance of that conclusion. In addition, many invest-



considered to be engaged in a U.S. business, the foreign feeder corporation would also be considered to be engaged in a U.S. business and thereby taxed like a U.S. person.<sup>25</sup>

Many foreign funds purchase debt securities, either from the secondary debt market (exchanges or over-the-counter) or on the primary market (where debt securities are first sold to the public) rather than lend directly to U.S. borrowers. Lending directly is called loan origination. If done frequently enough, loan origination may result in treatment as a U.S. lending business for U.S. federal income tax purposes.

When debt securities are first sold to the public, these purchases are often syndicated. In a typical syndication, a group of lenders will fund a very large loan. A lead lender in the position of the administrative agent typically negotiates the loan as an agent for the others in the syndicate. There are usually two tranches of money: one tranche immediately put up by the syndicate members and another tranche that is warehoused by the lead lender. For the warehoused tranche, the lead lender advances the funds to the borrowers and then finds investors later to take the credit risk and/or buy these loans. The lead lender may earn its primary return in the form of fees for arranging the loan and negotiating the terms.<sup>26</sup>

### B. General Overview of the Legal Landscape—Engaged in U.S. Trade or Business

A foreign person's interest income and profit on the sale of U.S. debt instruments are generally exempt from U.S. federal income tax if the income is not effectively connected to a trade or business in the United States.<sup>27</sup> The key is whether the foreign person is considered engaged in a U.S. trade or business.<sup>28</sup> If nonresident aliens or foreign corporations (collectively, foreign persons) have income that is connected with a U.S. business, that income will be taxed at the regular graduated tax rates applicable to U.S. persons and corporations.<sup>29</sup> A foreign person engaged in a U.S. business will also

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ment advisors leave themselves the room to attempt to structure around these issues by forming a U.S. corporation or a Limited Liability Company to hold the offending investment or to invest through affiliated or non-affiliated companies formed in the Caymans or elsewhere.

<sup>25</sup> I.R.C. § 875 (2015).

<sup>26</sup> See generally Victoria Ivashina & David Scharfstein, *Loan Syndication and Credit Cycles*, 100 AMER. ECON. REV. 57 (2010)

<sup>27</sup> See *supra*, note 12.

<sup>28</sup> The United States generally taxes nonresident aliens and foreign corporations on two types of income: (1) income that is effectively connected with the conduct of a trade or business in the United States (ECI) and (2) fixed, determinable, annual or periodical income from U.S. sources that is not ECI (FDAP). See I.R.C. §§ 871(b)-882(a) (2014). Capital gains are not FDAP, so if capital gains are not ECI they are not taxed. Interest *is* FDAP, but may be exempt from U.S. federal income tax if it qualifies as portfolio interest or if there is a reduction or elimination of the tax under a double taxation treaty.

<sup>29</sup> *Id.* Such business income may also be subject to a “branch profits tax” at a rate of thirty percent. I.R.C. § 884 (2007).

generally have to file a U.S. tax return.<sup>30</sup> The stakes are high for the proper characterization of what constitutes a U.S. trade or business, because if the foreign person is not engaged in a U.S. trade or business, interest income and capital gains on the sale of a U.S. debt instrument are generally exempted from U.S. federal income tax.<sup>31</sup>

The Code and Treasury Regulations do not provide a definition of what constitutes being engaged in a U.S. business for purposes of these transactions.<sup>32</sup> Frequent loan origination for U.S. borrowers will almost always rise to the level of a lending or financing business in the United States.<sup>33</sup> At the other end of the spectrum, long-term holding of debt securities purchased on the secondary market will almost always constitute passive investing. Passive investors are generally not treated as engaged in a trade or business.<sup>34</sup> However, there is a broad range of activities in between these two extremes, and precedent in the middle is quite uncertain.

What rises to the level of loan origination for engaging in a U.S. trade or business is unclear in this context. Although the foreign funds may not be lending directly to U.S. borrowers in form, in substance the foreign funds may drive the loan terms with forward commitments and pre-closing understandings with the syndicate members. To what extent can the foreign fund or its investment advisor participate in the original loan negotiations? Is it a problem if the foreign fund provides loan document comments to the borrower (or to the syndicate member)? There is no clear authority for distinguishing between an alleged old and cold debt security bought on the secondary market and what constitutes loan origination in this context.

Does a forward commitment to purchase a portion of the loan before the original loan transaction closes put a foreign fund in an origination position? Does a material adverse change (MAC) clause, a provision giving the foreign fund an escape if there is a MAC, make us feel more comfortable about the position that a forward commitment does not translate into an origination position? How long must the foreign hedge fund wait after the original loan closing to purchase debt securities on the secondary market without risk of being accused of loan origination? Many funds wait only twenty-four

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<sup>30</sup> See I.R.C. § 6012 (2010).

<sup>31</sup> See *supra*, note 28.

<sup>32</sup> See I.R.C. § 864(b) (2010) (noting that the definition of “trade or business in the United States” includes the performance of personal services within the United States).

<sup>33</sup> See *Serot v. Comm’r*, 68 T.C.M. (CCH) 1015, 1022–23 (1994), *aff’d* 74 F.3d 1227 (3d Cir. 1995); *McCrackin v. Comm’r*, 48 T.C.M. (CCH) 248, 251 (1984) (examining a situation in which a taxpayer was engaged in lending trade or business, where the taxpayer made sixty-six loans to twelve unrelated borrowers over fifteen years); *Jessup v. Comm’r*, 36 T.C.M. (CCH) 1145, 1150 (1977) (finding that trade or business of lending existed where taxpayer engaged in thirty-one loan, endorsement, or guarantee transactions with seventeen unrelated persons over ten years); *Cushman v. United States*, 148 F.Supp. 880 (D. Ariz. 1956); *Minkoff v. Comm’r*, 15 T.C.M. (CCH) 1404 (1956).

<sup>34</sup> *Cont’l Trading, Inc. v. Comm’r*, 16 T.C.M. (CCH) 724 (1957), *aff’d*, 265 F.2d 40 (9th Cir. 1959) (holding that “merely [the] servicing of . . . investments in this country” does not constitute a U.S. trade or business).

or forty-eight hours. Is this enough? What if there are equalizing trades between a U.S. affiliate who purchased the debt securities at closing and a foreign fund for any value shifts during that time?

Sometimes a U.S. affiliate does not sell debt securities to its foreign affiliate until after the U.S. affiliate has held the loan for a fixed period of time, often three months. This strategy is often called seasoning the debt securities. What if the affiliated funds invest in lockstep with the foreign funds and provide equalizing trades during the seasoning period?

Non-syndicate members, such as foreign hedge funds, acquire portions of the loan, in many cases within twenty-four or forty-eight hours of the original funding. These hedge funds may have even committed to purchasing the interest prior to the original funding (a forward commitment). This forward commitment may or may not contain a MAC clause, allowing the hedge fund to back out if there is a major change in the borrower's financial status. Foreign hedge funds typically do not provide the money directly to the borrower, but this becomes complicated when the loan itself is a revolving line of credit.

In addition, the hedge fund may or may not have been involved with the lead lender's negotiation with the borrower. In many cases, the fund will not negotiate terms with the borrower directly, but will keep tabs on those negotiations through the lead lender or syndicate member and indicate to the lead lender or syndicate member terms it will or will not be willing to accept. This oversight and delegation can influence or even dictate the deal terms with the borrower.

The foreign hedge fund may purchase from the syndicate a participation with the lead bank or syndicate member, whereby the lead bank or syndicate member remains involved and passes on interest and other payments from the borrower to the participant. The foreign hedge fund may also acquire a portion of the loan through an assignment, whereby the fund actually steps into the shoes of the lead bank or the syndicate member with respect to the loan documents for that portion of the loan.<sup>35</sup> A hedge fund may also enter into a derivative contract with a syndicate member.

Finally, if there is loan origination or deemed loan origination, the amount of loan origination required before the foreign fund will be considered engaged in a U.S. trade or business remains unclear in this context.<sup>36</sup>

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<sup>35</sup> Although outside the scope of this article, the "participation" versus "assignment" distinction can produce very different results with respect to the United States and other countries withholding taxes on foreign persons.

<sup>36</sup> See *Pasquel v. Comm'r*, 12 T.C.M. (CCH) 1431 (1953); see also *Pinchot v. Comm'r*, 113 F.2d 718, 719 (2d Cir. 1940) (a nonresident alien was engaged in a U.S. trade or business because real estate management required "regular and continuous" activity including purchasing materials and making contracts); *De Amodio v. Comm'r*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962) (the negotiation of leases, collection of rent, and payment of taxes and insurance amounted to a U.S. trade or business); *Spermacet Whaling & Shipping Co. S.A. v. Comm'r*, 30 T.C. 618, 634 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960); *Cont'l Trading, Inc. v. Comm'r*, 265 F.2d 40, 43 (9th Cir. 1959), *cert. denied*, 361 U.S. 827 (1959); I.R.S. Gen.

There is, however, a safe harbor for foreign persons trading (and not dealing) in stock and securities, including debt securities, for their own account.<sup>37</sup> It is important to note that the safe harbor applies even if the foreign person has U.S. employees or a U.S. dependent agent.<sup>38</sup> Situations that do not fall squarely within the limited statutory definition of a U.S. business or within a safe harbor are left to a facts and circumstances determination of the principles in the applicable Code and Treasury Regulations and varied case law.<sup>39</sup>

Many hedge funds with foreign investors and foreign funds structure their transactions to qualify for the trading in stocks and securities for your own account safe harbor described above. This safe harbor applies even if the trading is done in the United States by the taxpayer or its agents, independent or dependent, such as an investment manager.<sup>40</sup> It also applies when the agent can make decisions about the transaction and the taxpayer has a U.S. office.<sup>41</sup>

With respect to the securities safe harbor, the distinction between trading and dealing is unclear. Trading is defined in the Treasury Regulations merely as “effecting of transactions in stocks or securities,” which includes “buying, selling . . . , or trading in stocks, securities, . . . and any other activity closely related thereto (such as obtaining credit for the purpose of

Couns. Mem. 18,835, 1937-2 C.B. 141 (mere management of investments was insufficient to constitute carrying on a trade or business); *Neill v. Comm’r*, 46 B.T.A. 197 (1942) (mere ownership of property in the form of a single building did not constitute the carrying on of a business); *Higgins v. Comm’r of Internal Revenue*, 312 U.S. 212, 216 (1941) (finding that no amount of activity can convert investment into a trade or business).

<sup>37</sup> See I.R.C. § 864(b)(2)(A)(i) (2010). Note that Prop. Treas. Reg. § 1.864(b)-1 provides that the term “engaged in a trade or business in the United States” (ETB) does not include effecting transactions in derivatives (including certain hedging transactions) and does not apply, however, to any foreign person who is a dealer in stocks, securities, commodities, or derivatives. “Trading” is defined in Treasury Regulations (codified in *the Code of Federal Regulations*) as “effecting of transactions” in stocks or securities which includes “buying, selling . . . , or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise, . . . and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading).” 26 C.F.R. § 1.864-2(c)(1), (2)(i) (2015). The securities trading safe harbor does not apply to dealers. Treasury Regulations define a “dealer” for this purpose as “a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom.” 26 C.F.R. § 1.864-2(c)(2)(iii) (2015). This is distinguished from buying, selling, or holding stocks or securities for investment or speculation. In making this determination, all of the foreign persons’ stock and securities transactions will be taken into account, even those that occur outside of the United States. Being characterized as a “dealer” for this purpose means that the securities trading safe harbor will not apply and the foreign person is may be considered engaged in a U.S. business under common law principles unless another safe harbor applies. See 26 C.F.R. § 1.864-2(c)(2)(iv) (2015).

<sup>38</sup> See David S. Miller & Jean Bertrand, *The Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers*, 65.2 THE TAX LAWYER 309 (2012).

<sup>39</sup> See Rev. Rul. 88-3, 1988-1 C.B. 268 (must apply appropriate Treasury Regulations to the “facts and circumstances”); *Amodio v. Comm’r*, 299 F.2d 623, 625 (3d Cir. 1962).

<sup>40</sup> See *supra*, note 37.

<sup>41</sup> See 26 C.F.R. § 1.864-2(c)(2) (2015).

effectuating such buying, selling, or trading).<sup>42</sup> A dealer is defined in the Treasury Regulations for this purpose as “a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived there from.”<sup>43</sup> This is distinguished from buying, selling, or holding stocks or securities for investment or speculation.<sup>44</sup> Distinguishing between trading and dealing to determine whether the safe harbor applies has been elusive.

A Treasury Regulation lists factors for determining whether a foreign person’s income is effectively connected with a banking, finance, or similar U.S. business.<sup>45</sup> The Treasury Regulation factors include:

[r]eceiving deposits of funds from the public, [m]aking personal, mortgage, industrial, or other loans to the public, [p]urchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness, [i]ssuing letters of credit to the public and negotiating drafts drawn thereunder, [p]roviding trust services for the public, or [f]inancing foreign exchange transactions for the public.<sup>46</sup>

The Tax Court has said that these regulations provide a “useful framework” for determining whether a foreign person or corporation is engaged in a U.S. business,<sup>47</sup> but by its terms this regulation assumes that the foreign person is engaged in a U.S. business and applies regardless of whether the foreign person’s income is connected to that U.S. business.<sup>48</sup>

A few cases provide guidance on what constitutes an active lending business for this purpose. In 1953, the Tax Court looked at the issue in *Pasquel v. Commissioner*, but *Pasquel* provides limited guidance since the foreign person made only one loan.<sup>49</sup> Generally, for there to be a U.S. business the foreign person’s activities must go beyond simple passive investment or ownership of property.<sup>50</sup> Based on general case law, if the activities are

<sup>42</sup> 26 C.F.R. § 1.864-2(c)(2)(c) (2015).

<sup>43</sup> I.R.C. § 864(b)(2)(A)(ii); Treas. Reg. § 1.864-2(c)(2)(iii).

<sup>44</sup> In making this determination, all of the foreign persons’ stocks and securities transactions will be taken into account, even those that occur outside of the United States. Being characterized as a “dealer” for this purpose means that the securities trading safe harbor will not apply and the foreign person may be considered engaged in a U.S. business under common law principles unless another safe harbor applies. See 26 C.F.R. § 1.864-2(c)(2)(iv) (2015).

<sup>45</sup> See 26 C.F.R. § 1.864-4(c)(5) (2015).

<sup>46</sup> *Id.*

<sup>47</sup> See *InverWorld, Inc. v. Comm’r*, 71 T.C.M. (CCH) 3231 (1996).

<sup>48</sup> This makes sense since this regulation was promulgated under the authority of Code section 864(c) which addresses ECI not ETB.

<sup>49</sup> See *Pasquel*, *supra* note 36, at 2.

<sup>50</sup> See *Continental Trading, Inc. v. Comm’r*, 265 F.2d 40, 43 (9th Cir. 1959); see also Gen. Couns. Mem. 18, 835, 1937-2 C.B. 141 (stating that mere management of investments was insufficient to constitute carrying on a trade or business); *Neill v. Comm’r*, 46 B.T.A. 197 (1942) (holding that mere ownership of property in the form of a single building did not

“considerable, continuous, and regular,” a U.S. trade or business will exist.<sup>51</sup> In addition, the activities must relate to earning profit, although no profit need be generated.<sup>52</sup> Nevertheless, simply receiving profits is not enough to find that a foreign person is engaged in a U.S. business.<sup>53</sup> Isolated activity, without “sustained activity,” is generally not enough to find a trade or business.<sup>54</sup> Similarly, clerical and ministerial activity is generally not enough to find a trade or business.<sup>55</sup>

The Tax Court has held that the words “trade or business” for this purpose should be “interpreted consistently with the general body of law on this subject.”<sup>56</sup> This suggests that other contexts in the Code in which the business concept is used may be helpful. Analogous authorities suggest that the number and amount of loans is important in the determination of whether a lending trade or business exists.<sup>57</sup> These authorities seem to indicate that

constitute the carrying on of a business); *Higgins v. Comm’r*, 312 U.S. 475, 478 (1941) (holding that no amount of activity can convert investment into a trade or business).

<sup>51</sup> See *Pinchot v. Comm’r*, 113 F.2d 718, 719 (2d Cir. 1940) (holding that a nonresident alien was engaged in a U.S. trade or business because real estate management required “regular and continuous” activity including purchasing materials and making contracts); *De Amodio v. Comm’r*, 34 T.C. 894, 906 (1960), *aff’d*, 299 F.2d 623 (3d Cir. 1962) (holding that the negotiation of leases, collection of rent, and payment of taxes and insurance amounted to a U.S. trade or business); *Spermacet Whaling & Shipping Co. v. Comm’r*, 30 T.C. 618, 634 (1958), *aff’d*, 281 F.2d 646 (6th Cir. 1960).

<sup>52</sup> See, e.g., *Investors’ Mortg. Sec. Co. v. Comm’r*, 4 T.C.M. (CCH) 45, 47 (1945); *Pinchot*, 113 F.2d at 719; *Lewenhaupt v. Comm’r*, 20 T.C. 151, 162 (1953), *aff’d*, 221 F.2d 227 (9th Cir. 1955); Gen. Couns. Mem. 18,835, 1937-2 C.B. 141, 143 (finding that when the taxpayer, through his agent, executed leases, rented property, collected rents, kept books of account, supervised repairs, paid taxes and mortgage interest, insured property, and purchased and sold property, that these actions were “beyond the scope of mere ownership of real property, or the receipt of income from real property”).

<sup>53</sup> See *Snell v. Comm’r*, 97 F.2d 891, 892 (5th Cir. 1938).

<sup>54</sup> *Linen Thread Co. v. Comm’r of Internal Revenue*, 14 T.C. 725 (1950) (holding that two isolated sales in the United States did not constitute a trade or business in the United States); cf. *Johansson v. United States*, 336 F.2d 809 (5th Cir. 1964) (holding that a nonresident alien prize fighter in one world championship fight in the United States was engaged in a U.S. trade or business).

<sup>55</sup> See *Scottish Am. Inv. Co. v. Comm’r of Internal Revenue*, 12 T.C. 45, 59 (1949) (holding that activities of a U.S. office of foreign trusts did not constitute a trade or business, and finding that the U.S. office was merely a helpful adjunct to the foreign trusts); *Spermacet Whaling & Shipping Co.*, 30 T.C. at 633-34, 634 (receiving monthly statements and correspondence and making certain payments were “ministerial and clerical in nature” and involved little exercise of the discretion or business judgment “necessary to the production of the income in question”); *Linen Thread Co.*, 14 T.C. at 736 (finding that delivery of goods, handling of paperwork and collection of payment by the U.S. office were not enough to constitute a U.S. trade or business where the profit generating activities occurred abroad).

<sup>56</sup> *deKrause v. Comm’r of Internal Revenue*, 33 T.C.M. (CCH) 1362, 1364 (1974); *Whipple v. Comm’r of Internal Revenue*, 373 U.S. 193, 201 (1963); see also *Folker v. Johnson*, 230 F.2d 906 (2nd Cir. 1956). With respect to other areas of the Code, the IRS has recognized that rules in the ETB context 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.” Rev. Rul. 88-3, 1988-1 C.B. 268.

<sup>57</sup> See *Serot v. Comm’r of Internal Revenue*, 68 T.C.M. (CCH) 1015, 1022-23 (1994); *McCrackin v. Comm’r of Internal Revenue*, 48 T.C.M. (CCH) 248, 251 (1984) (holding that taxpayer was engaged in lending trade or business, where taxpayer made sixty-six loans to twelve unrelated borrowers over fifteen years); *Jessup v. Comm’r*, 36 T.C.M. (CCH) 1145,

foreign persons may be able to make a limited number of loans and still not be considered to be in an active lending business in the United States.<sup>58</sup> Analogous authorities have also looked at the time and effort devoted to lending activities,<sup>59</sup> the maintenance of an office for the lending activity,<sup>60</sup> promoting oneself as a lender,<sup>61</sup> maintenance of books and records for lending activities,<sup>62</sup> and the presence of employees or other dependent agents.<sup>63</sup>

In the context of writing off business debt, there is some authority for the proposition that a loan made to acquire, protect, or enhance an investment where the dominant motive is to earn a return from the investment cannot lead to a business debt because the loan is related to the investing activities rather than to a lending business.<sup>64</sup> Regarding business deductions, in *Higgins v. Commissioner*, the Supreme Court rejected the proposition that management of one's securities could constitute a business given "sufficient extent, continuity, variety and regularity."<sup>65</sup> The Court found that "no amount of personal investment management would turn those activities into a business."<sup>66</sup> Although *Higgins* dealt with business deductions, courts have consistently held that the *Higgins* reasoning applied to writing off business debt.<sup>67</sup>

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1150 (1977) (holding that trade or business of lending existed where taxpayer engaged in thirty-one loan, endorsement, or guarantee transactions with seventeen unrelated persons over ten years); *Cushman v. United States*, 148 F.Supp. 880, 880 (D.C. Ariz. 1956); *Minkoff v. Comm'r of Internal Revenue*, 15 T.C.M. (CCH) 1404 (1956).

<sup>58</sup> For example, in *Imel v. Comm'r of Internal Revenue*, 61 T.C. 318, (1973), the Tax Court held that eight or nine loans made over the course of four years was not a trade or business for purposes of allowing a deduction for business bad debts. The IRS also issued a private letter ruling holding that a partnership that represented that it would not originate on average more than five new mortgages a year over any five year period was deemed to not be engaged in a trade or business for purposes of treating the partnership as a corporation. PLR 1997-9701006 (Jan. 3, 1997). It should be noted that that Private Letter Rulings are taxpayer specific rulings furnished by the IRS in response to requests made by taxpayers and cannot be used as precedent. In addition this particular ruling was interpreting the legislative history specific to I.R.C. § 7704(d) (treating certain publicly traded partnerships as corporations). See also Stuart Leblang & Rebecca Rosenberg, *Toward an Active Finance Standard for Inbound Lenders*, 31 TAX MGMT INT'L J. 131, 141 (2002).

<sup>59</sup> See *United States v. Henderson*, 375 F.2d 36, 41 (5th Cir. 1967); *Ruppel v. Comm'r of Internal Revenue*, 53 T.C.M. (CCH) 829, 832, 834 (1987); *Jessup*, 36 T.C.M. (CCH) at 1150.

<sup>60</sup> See *Henderson*, 375 F.2d at 41; *Cushman*, 148 F. Supp. at 880.

<sup>61</sup> See *Henderson*, 375 F.2d at 41.

<sup>62</sup> See *id.*; see also *Ruppel*, 53 T.C.M. at 832; *Serot*, 68 T.C.M. (CCH) at 1022-23 (1994); *Carraway v. Comm'r of Internal Revenue*, 67 T.C.M. (CCH) 3139 (1994).

<sup>63</sup> See *Cushman*, 148 F. Supp. at 880.

<sup>64</sup> See *Whipple*, 373 U.S. at 197, 202 (1963); *German v. Comm'r*, 7 T.C.M. (CCH) 1738 (1999) (holding that petitioner was not entitled to a bad debt deduction because the petitioner was not engaged in the trade or business of lending money).

<sup>65</sup> *Higgins*, 312 U.S. at 218218216218 (finding that no amount of activity can convert investment into a trade or business).

<sup>66</sup> *Id.*

<sup>67</sup> *deKrause*, 33 T.C.M. (CCH) at 1364, 74-1290; *Liang v. Commissioner*, 23 T.C. 1040 (1955); *Cont'l Trading, Inc. v. Comm'r of Internal Revenue*, 265 F.2d 40, 43 (9th Cir. 1959), *cert. denied*, 361 (1959).

Rulings in this area have been unhelpful.<sup>68</sup> Further, the IRS will not “ordinarily” issue rulings or determination letters regarding whether a taxpayer is engaged in a trade or business within the United States and whether income is effectively connected with the conduct of a trade or business within the United States.<sup>69</sup>

Certain foreign hedge funds specialize in the debt securities of companies in financial trouble. These debt securities tend to be significantly discounted to reflect the default risk. As a result, a significant modification of the loan is treated as a redemption of the original loan and the origination of a new loan.<sup>70</sup> A modification will be significant when it alters the rights and obligations of the parties in a manner that is economically significant.<sup>71</sup> There are specific rules in Treasury Regulations that deal with whether certain modifications are significant, including a change in yield on the debt instrument, a change in the timing of the payments under the debt instrument, certain changes in the obligor or security, certain changes in the nature of the debt instrument such as recourse or nonrecourse, and changes relating to accounting or financial covenants.<sup>72</sup>

Most commentators believe that a foreign person who purchases a loan in the secondary market with the expectation that it will perform, will not be considered engaged in a U.S. trade or business if there is a modification to preserve the investment.<sup>73</sup> Tax lawyer Peter Furci states that the Treasury Regulation that treats a significant modification as an exchange did so for purposes of gain or loss and there is no indication that the policy consideration regarding the appropriate timing of gain or loss recognition should ap-

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<sup>68</sup> In Rev. Rul. 73-227, 1973-1 C.B. 338, the IRS determined that U.S. source interest income of a foreign subsidiary of a U.S. parent was effectively connected with a U.S. trade or business. Rev. Rul. 73-227 provided minimal analysis on the ETB issue and was subsequently revoked by Rev. Rul. 88-3, 1988-1 C.B. 268. The later ruling stated that the conclusion in Ruling 73-227 “may be unsound” because it simply concluded without discussion that the foreign person is ETB. The later ruling provides that this determination should be made applying the rules to the facts. Rev. Rul. 73-227, 1973-1 C.B. 338; Rev. Rul. 88-3, 1988-1 C.B. 268.

<sup>69</sup> See Rev. Proc. 2008-7, 2008-1 C.B. 229. “Areas In Which Ruling Or Determination Letters Will Not Ordinarily Be Issued: Whether a taxpayer is engaged in a trade or business within the United States, and whether income is effectively connected with the conduct of a trade or business within the United States; whether an instrument is a security as defined in [Reg.] § 1.864-2(c)(2); whether a taxpayer effects transactions in the United States in stocks or securities under [Reg.] § 1.864-2(c)(2); whether an instrument or item is a commodity as defined in [Reg.] § 1.864-2(d)(3); and for purposes of [Reg.] § 1.864-2(d)(1) and (2), whether a commodity is of a kind customarily dealt in on an organized commodity exchange, and whether a transaction is of a kind customarily consummated at such place.” *Id.*

<sup>70</sup> See generally 26 C.F.R. § 1.1001-3 (2015); see Miller & Bertrand, *supra* note 38, at 36.

<sup>71</sup> See 26 C.F.R. § 1.1001-3(e)(1) (2015).

<sup>72</sup> See 26 C.F.R. § 1.1001-3(ae)(2a)-(6) (2015).

<sup>73</sup> See Manafasi, *supra* note 7, at 655-57; see also Peter Furci, U.S. Trade or Business Implications of Distressed-Debt Investing, 63 TAX LAW. 527, 537 (2010) (“Although there is no authority on point, a deemed exchange resulting from a significant modification of a debt security not purchased at its original issuance should not be treated as the equivalent of a loan origination for purposes of analyzing whether the debt holder is engaged in a U.S. lending business.”).



ply to the U.S. trade or business analysis.<sup>74</sup> He also notes that under the proposed regulations under the now repealed Financial Asset Securitization Investment Trust (FASIT) rules a FASIT would not be treated as origination of a new loan received from a borrower in exchange for the old loan in the context of a workout.<sup>75</sup>

On the other hand, where a foreign person buys nonperforming loans with the intent to renegotiate and sell the performing loans at a profit, the foreign person could be engaged in a U.S. trade or business.<sup>76</sup> Foreign persons might also “loan to own” or seek to acquire an equity interest in a business by first acquiring the outstanding debt securities. Precedent in these contexts are unclear: perhaps these investment are passive investments, perhaps there is a U.S. trade or business that is not applicable because of the trading safe harbor, perhaps the foreign person is engaged in a U.S. business and the trading safe harbor is not applicable because the person is a dealer, and finally, perhaps the person is engaged in a U.S. trade or business by analogy to the promoter type cases.<sup>77</sup>

### C. Increasing Uncertainty: Agency

#### 1. Overview of Agency and “Engaged in U.S. Trade or Business”

Federal income tax law can be awkward. When applied in the context of various state and international laws and in the context of other bodies of law, it can produce unanticipated results. For example, if an individual buys a piano in 2015 and years later, in 2022, she finds a secret cache of money hidden in it,<sup>78</sup> federal tax law says that the money must be treated as income when it is reduced to undisputed possession.<sup>79</sup> The timeframe for when money is reduced to undisputed possession, however, turns on state property law. If the applicable state law provides that an individual must have title to the cash when found, the income will be recognized in 2022. On the other hand, if the applicable state law provides that title to the cash vested upon the purchase of the piano, the individual would have taxable income of the cash in 2015, even if the individual did not know that she had the cash in 2015 to report as income. In this case, the individual is expected to file an amended return for 2015, seven years later, to report income that she never

<sup>74</sup> See Furci, *supra* note 73, at 537.

<sup>75</sup> See *id.* (citing Prop. Reg. § 1.860L-1(a)(4), 57 Fed. Reg. 57034 (1992)).

<sup>76</sup> See, e.g., New York State Bar Association, Tax Section, Letter to Honorable Eric Solomon, Assistant Secretary (Tax Policy), and Honorable Douglas H. Shulman, Commissioner Internal Revenue Service, Guidance on Economic Downturn Issues (Aug. 19, 2008).

<sup>77</sup> See Furci, *supra* note 73, at 545.

<sup>78</sup> These facts are based on *Cesarini v. United States*, 296 F. Supp. 3 (N.D. Ohio 1969) in which the court ruled that a couple who purchased a piano for \$15 in 1957 and found \$4,467 seven years later in 1964 should include the cash in gross income for the tax year when it was discovered.

<sup>79</sup> See *id.* at 5 (citing Rev. Rul. 61, 1953-1 C.B. 17); see also 26 C.F.R. § 1.61-1(a) (2015).

knew she had until she found opened the secret cache. Was this awkwardness caused by the intersection between federal and state bodies of law, or was it intended by federal legislators? The intersection of federal tax law and other bodies of law can produce unintended results. These unintended results are tolerated because there are bound to be seams between federal tax law, states laws, contract law, and property laws. Legislators surely cannot think of all possible scenarios and legal intersections when drafting new laws. But in certain cases legislators need to look at unintended results and ask whether these results should be maintained. Perhaps certain originally unintended intersections are not awkward. They are even desirable and will further policy objectives, and in some areas legislators need to make these intersections purposeful because the stakes are too high to let organic intersections stand by chance.

Agency is the fiduciary relationship that arises when the one person (a principal) manifests assent to another person (an agent) that the agent shall act on the principal's behalf, subject to the principal's control and the agent manifests assent to so act.<sup>80</sup> Once that agency relationship is created a principal can be liable for an agent's contracts and even an agent's torts.<sup>81</sup> Similarly activities of an agent can be imputed to a foreign person for this purpose causing the principal, the foreign person, to be considered engaged in a trade or business within the United States, and thereby taxed like a U.S. person, due to the agent's actions.

The precedent in this regard is somewhat mixed with the IRS and courts taking aggressive positions on imputation at times and at other times being reluctant to impute the actions of an agent on the foreign person.<sup>82</sup> Courts have generally taken an expansive view on imputation when the relationship between the agent and the foreign person is "regular" or "continuous" rather than "casual" or "isolated."<sup>83</sup> One commentator summarized the mixed character of precedent in this area by stating that "questions of impu-

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<sup>80</sup> RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

<sup>81</sup> RESTATEMENT (THIRD) OF AGENCY § 6.01 (2006); RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006).

<sup>82</sup> See Tech. Adv. Mem. 80-29-005 (Mar. 27, 1980) (illustrating the IRS's imputation of the actions of an operator of oil property to the foreign owner of the properties on the basis of the foreign person's ownership of assets); see also Rev. Rul. 55-617 1955-2 C.B. 774 (stating that sales of an independent commission agent are imputable); *Amodio v. Comm'r*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962) (finding that the purchase and management of real estate by "independent" real estate agents cause the foreign taxpayer to be ETB); *cf.* Tech. Adv. Mem. 81-47-001 (Jan. 3, 1970) (stating that no U.S. trade or business could be found because an independent agent was used); *Amalgamated Dental Co. v. Comm'r*, 6 T.C. 1009 (1946) (holding the actions of a U.S. supplier cannot be imputed to a foreign corporation because of an independent agency relationship).

<sup>83</sup> See *Amodio*, 34 T.C. at 906 (finding that the purchase and management of real estate by "independent" real estate agents cause the foreign taxpayer to be ETB); *Handfield v. Comm'r*, 23 T.C. 633 (1955) (finding that sales by a U.S. distributor were attributable to a foreign person).

tation can be answered only with the help of considerable intuition.”<sup>84</sup> In a general legal advice memorandum, the IRS concluded that if a U.S. agent performed lending activities on behalf of a foreign corporation pursuant to a service contract—such as locating borrowers, performing credit analysis, and negotiating borrowing terms—the foreign corporation had a U.S. lending business even if the agent lacked authority to conclude contracts on behalf of the foreign corporation.<sup>85</sup>

For example, a loan originator or syndicate member could be considered an agent for a foreign fund and, therefore, imputation of the agent’s activities may put the foreign fund in a loan origination position. But is that loan originator’s action on behalf of and subject to the control of the foreign fund? Often the foreign hedge fund is on the syndicate member’s speed dial for transaction after transaction.

To complicate matters, foreign hedge funds may use related U.S. hedge funds, or hedge funds controlled by the same investment advisor, to get closer to the loan origination. A related U.S. hedge fund may acquire a larger portion of the loan than it actually plans to hold as a syndicate member or from a syndicate member, intending to warehouse the excess amount for future resale to a foreign affiliate. In fact, because of the fast moving nature of these investments and commitments some investment advisors initially commit to purchase these debt securities through a U.S. hedge fund or entity that never intends to hold the investment very long, and then these investment advisors later decide how to allocate the investment among their various managed or affiliated foreign funds.

In an attempt to circumvent the argument that such a U.S. hedge fund is merely an agent for the foreign funds, and to put some distance between the original loan origination and the foreign funds, some U.S. funds season the debt securities. This process means that the U.S. fund does not sell interest to its foreign affiliates until after it has held the loan for a fixed period of time, often for roughly three months. However, the offering memoranda of many of these parallel funds disclose that these affiliated funds intend to invest in lockstep. This approach means that the U.S. fund and affiliated foreign hedge fund intend to make the same or similar investments (perhaps in different proportions). In addition, sometimes these affiliated hedge funds perform equalizing trades of other securities during the seasoning period. A hedge fund may price such a seasoned sale based on the market conditions at the time of the sale (as opposed to the time of the origination or the time when U.S. affiliate purchased the debt security). Also, some foreign funds have the right to reject an assignment from a U.S. affiliate and some funds

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<sup>84</sup> See Joseph Isenbergh, *INTERNATIONAL TAXATION – U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME* 21:15 (1997).

<sup>85</sup> Memorandum from Steven A. Musher, Associate Chief Counsel of the IRS, to Kathy Robbins, Director of Field Operations (Sept. 22, 2009). The Memorandum notes that the U.S. corporation’s activities relating to loan origination were conducted on a considerable, continuous, and regular basis from its U.S. office.

occasionally exercise this right. Some affiliated funds are also completely under the control of a common investment advisor, while others intentionally vest the rejection right in someone not under the control of the investment advisor.

## 2. *The Sun Capital Decision*

The First Circuit United States Court of Appeals decided *Sun Capital Partners, III, LP et al. v New England Teamsters & Trucking Industry Pension Fund et al.* in July 24, 2013. The case involved two private equity investment funds which owned a portfolio company, Scott Brass, Inc., that went bankrupt and defaulted on its pension obligations to the Teamsters pension fund. The court found that one fund was a “trade or business” under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA)<sup>86</sup> as amended by the Multiemployer Pension Plan Amendment Act of 1980 (MPPAA)<sup>87</sup> for purposes of liability for unfunded pension obligations.

In so finding, the court noted that the management company or investment advisors activities may be imputed onto the foreign fund. “[I]t is clear,” declared the court, “that the general partner of Sun Fund IV, in providing management services to [Scott Brass], was acting as an agent of the Fund.”<sup>88</sup> Therefore, by applying agency principles the court held that Sun Fund IV itself was engaged in a trade or business for ERISA purposes.<sup>89</sup>

Although this matter was not a tax case, case law suggests that analogous authorities may be helpful in determining what constitutes a “trade or business” for this purpose.<sup>90</sup> The IRS has, however, recognized that rules in this context 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.”<sup>91</sup> Some commentators have suggested that the principles of the case could extend to the “trade or business” analysis in the tax area.<sup>92</sup>

*Sun Capital* can be distinguished from the issues discussed in the Article in that private equity funds engage in different investments than hedge funds. Investment professionals at private equity funds manage the businesses in which they invest. Law professor Victor Fleischer aptly states, “[T]he entire private equity business model is promised on the fund’s managers creating value through active management of portfolio companies,

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<sup>86</sup> 29 U.S.C. §1001 (1974).

<sup>87</sup> 29 U.S.C. § 1381(1980).

<sup>88</sup> *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129, 147 (1st Cir. 2013).

<sup>89</sup> *Id.* at 149.

<sup>90</sup> See *deKrause v. Commissioner*, 33 T.C.M. (CCH) 1362, 1364 (1974); *Whipple v. Commissioner*, 373 U.S. 193, 201 (1963); see also *Folker v. Johnson*, 230 F.2d 906 (2nd Cir. 1956). Rev. Rul. 88-3, 1988-1 C.B. 268.

<sup>91</sup> Rev. Rul. 88-3, 1988-1 C.B. 268.

<sup>92</sup> See Ivan, *Sun Capital: Trade of Business Armageddon Talk*, FUND TAXATION, Aug. 9, 2013; Lydia Beyond, *‘Sun Capital’ Could Affect Both Main Street, Wall Street, Analyst Says*, DAILY TAX REPORT, Oct. 2, 2013.

which then presumably leads to an increase in the portfolio company's value."<sup>93</sup> By contrast, the hedge fund activities examined in this Article involve investing in debt securities and even loan originations where profit comes from the interest on the use of money, not from adding value at the borrower's management level. Any fingers in the business of the portfolio company are presumably to ensure repayment of principal and interest not necessarily to increase the value of the company. In *Sun Capital*, Scott Brass, Inc.'s value was not measurably increased by firm value so the court relied on the management fee offset to show that the general partner was getting an economic benefit of more than that of an investor. While some commentators distinguish situations in which there is no offset, Fleischer notes that limited partners generally derive an economic benefit from the activities of the general partner, such as the value created through the dividend or sale of the company because there is nothing else that would justify the fees. His reasoning, if extended to tax in the private equity context, may make *Sun Capital's* investor plus standard using agency activities applicable even when there is no fee offset arrangement.

Nevertheless, in the context of debt securities and even loan origination, the considerations are different. First, even if investment advisors activities were attributed to funds based on agency analysis their activities certainly do not rise to the level of the portfolio company management seen in *Sun Capital*. Second, the policy goals in these two contexts are distinct. With respect to *Sun Capital*, the MPPAA was enacted by Congress to "protect the viability of defined pension benefit plans, to create a disincentive for employers to withdraw from multiemployer plans, and also to provide a means of recouping a fund's unfunded liabilities."<sup>94</sup> Congress has, therefore, illustrated its intention not to allow persons to carve up liability for unfunded liabilities by using the corporate structure. That same rationale does not apply to the taxation of foreign persons' debt securities. The policy with how foreign persons are taxed tends to be for the ease of collection and to increase the flow of foreign capital.<sup>95</sup> This is completely different than the

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<sup>93</sup> Victor Fleischer, *Sun Capital Court Ruling Threatens Structure of Private Equity*, N.Y. TIMES, Aug. 1, 2013.

<sup>94</sup> *Sun Capital*, 724 F.3d at 138.

<sup>95</sup> With respect to the exemption for a foreign persons capital gains on sales that are not connected with a U.S. trade or business, Congress wanted to decrease collection difficulties and increase U.S. brokers revenue by encouraging foreign persons to make passive investments. See H.R. REP. NO. 74-2475 at 9, 21 (1936). With respect to not taxing portfolio interest received by a foreign person that is not connected with a U.S. trade or business, Congress's main rationale was to allow U.S. persons access to financing abroad at a lower cost. It thought that if the exemption was not enacted, U.S. borrowers would be at a competitive disadvantage against borrowers from other countries. See STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 391-94 (Comm. Print 1984). Finally, the tax policy behind the enactment of the safe harbor for trading in securities for one's own account, discussed in Part II herein, was to increase the flow of foreign capital. It was thought that earlier confusion may have acted to deter some foreign investment. See TASK FORCE ON PROMOTING INCREASED FOREIGN INVESTMENT IN UNITED STATES CORPORATE SECURITIES AND INCREASED FOREIGN INVESTMENT IN

ERISA policy of holding closely held groups accountable to make up unfunded liabilities.

However, on September 20, 2013, the Treasury Office, indicated that the *Sun Capital* decision may enable the government to reevaluate its position. Its position has for the most part been silence. Craig Gerson, attorney-adviser in the Treasury Office of Tax Legislative Counsel, said soon after the case came down, “I think there’s a recognition that the court’s decision in the First Circuit may give us an opportunity to reassess what trade or business means.”<sup>96</sup> I posit that a high level of legal uncertainty in lending and debt securities transactions may increase systemic risk and frustrate the very international tax policy objectives the international taxation regime was enacted to promote. In fact, since I wrote *The Uncertain Case*, the situation has become more uncertain. The lack of legislative response to *Sun Capital* adds uncertainty with respect to agency issues—imputing another’s activities onto the fund for purposes of the trade business analysis in ERISA. This is so even though the First Circuit was very careful to note that the Supreme Court has stated that when it interprets the phrase “trade or business,” it “does not purport to construe the phrase where it appears in other places.” Nevertheless, because of the lack of clear precedent in the tax area, it is common to look to other areas defining “trade or business.”<sup>97</sup>

I propose that the facts, reasoning, and public policy behind the statute at issue in *Sun Capital* can all be distinguished from hedge funds transactions. However, the uncertainty created in the tax area adds to the silence and is inconsistent with the U.S. tax policy goal of encouraging foreign investment. Further, as I discussed in *The Uncertain Case*, an increase in the void may increase systemic risk.<sup>98</sup>

### 3. Chief Counsel Advice Memorandum 2015

In a Chief Counsel Advice memorandum released in January 2015, the IRS concluded that a foreign fund was engaged in a U.S. trade or business based on its lending and underwriting activity imputed from a U.S. fund manager under a management agreement. The fund was therefore subject to U.S. income tax on income effectively connected with its lending and underwriting business. The memorandum provided that the fund manager’s business activities were attributable to the foreign fund because the manager was the fund’s agent and acting on the funds behalf. The memorandum glosses over the issue of attribution from an agent creating even more uncertainty from the ad hoc pronouncement.

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UNITED STATES CORPORATIONS OPERATING ABROAD, REPORT OF THE PRESIDENT 21 (1964) (Fowler Task Force Report).

<sup>96</sup> Jeremy Scott, *Sun Capital Might Be Bigger Than You Think*, FORBES, Sept. 25, 2013.

<sup>97</sup> See Manafsi, *supra* note 7, at 657–658 (quotations omitted).

<sup>98</sup> See *id.* at 646.

*D. Industry Response to the Uncertainty*

Because of the uncertainties discussed above, many crucial taxation determinations are made by the investors themselves, practitioners, the IRS, and courts.<sup>99</sup> Many different practitioner and industry developed standards interpreting uncertainties have arisen.<sup>100</sup> Without further legislative guidance, these constantly shifting, non-uniform standards often become industry benchmarks for transaction after transaction.<sup>101</sup> Assuming that the funds want to invest in U.S. loans or debt securities, many funds either conduct all material activities outside the United States or adhere to tax counsel guidelines to ensure that such material activities either comply with the trading safe harbor or qualify under a tax treaty.

Within these strategies it is clear that taxpayers are modifying their behavior to guess at what falls outside U.S. taxation. Perhaps those that are risk-averse are entirely forgoing opportunities to invest in the United States when it is not necessary that they pass on such investments. This uncertainty is inefficient and leads to deadweight loss. In the legislative history for the trading safe harbor, Congress recognized that confusion in the safe harbor “may have acted to deter some foreign investment in the United States.”<sup>102</sup> On the other end of the spectrum, risk taking funds are still subject to huge compliance costs and must take into account the possibility that they took the wrong risks.

If all of the funds’ income will be foreign source income (i.e. none of the obligors are in the United States and no obligor is engaged in a U.S. trade or business) and the fund does not have an office or fixed place of business in the United States, the fund should not recognize income that is effectively connected to a U.S. trade or business.<sup>103</sup> That is true even if that fund has a U.S. investment manager, so long as the manager is an independen-

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<sup>99</sup> See David R. Sicular & Emma Q. Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 *TAX LAWYER* 719, 720 (2003) (noting the production of “practitioner-developed rules”); see also Joel Kuntz & Robert Peroni, U.S. INTERNATIONAL TAXATION 1.04 (1992) (stating that “all cases not governed by Section 864(b) are left to the courts and the Service.”); Miller & Bertrand, *supra* note 38, at 33 (stating that “many hedge funds adhere to investment guidelines provided by tax counsel to ensure that their activities fall within the trading safe harbor”).

<sup>100</sup> See Sicular & Sobol, *supra* note 99, at 721.

<sup>101</sup> It should also be noted that the IRS will not “ordinarily” issue private letter rulings or determination letters regarding much of the uncertainty that will be discussed below (regarding whether a taxpayer is engaged in U.S. business and whether income is effectively connected with the U.S. business). See Rev. Proc., *supra* note 69.

<sup>102</sup> See H.R. Rep. No. 89-1450, at 26 (1966); S. Rep. No. 89-1707, at 9–10 (1966).

<sup>103</sup> 26 C.F.R. § 1.864-6(a) (2015) (foreign source income, gain, or loss that is described in section 1.864-5(b) and received by a foreign person is treated as effectively connected income only if the income, gain or loss is attributable under section -6(b) or (c) to an office or other fixed place of business which the foreign person has in the United States at some time during the taxable year).

dent agent.<sup>104</sup> Should funds really be driven to this strategy? Implicitly are legislators saying do not buy U.S. debt securities or lend to U.S. borrowers? This is counter to U.S. foreign tax policy of encouraging foreign investment in the United States. While the United States might gain some advantages in housing the permitted U.S. manager, even this part of U.S. tax policy has its uncertainties because the U.S. manager's office or fixed place of business in the United States will be attributed to the fund itself if the fund is not considered an independent agent. No authority defines independent agent for this purpose; however, the term has been explored with respect to tax treaties. The Tax Court has said that for purposes of the U.S.-Japan Tax Treaty an independent agent is one that is "legally independent" and "economically independent."<sup>105</sup> Generally that means that the agent has discretion over the details of the work and bears the risk of loss of its operations.<sup>106</sup> Treasury Regulations state that whether an agent is independent is determined without regard to whether the agent is related to the principal, which suggests that a limited partner could be an independent agent. However, more than one court has held that the U.S. office of a partnership is attributed to the foreign partner for purposes of the U.S.-Canada tax treaty.<sup>107</sup> Even in situations where foreign persons are not investing in U.S. source income, the tax consequences based on agency are unclear.

Funds that do want to invest in U.S. source income, such as loans to U.S. borrowers and U.S. debt securities, typically try to either comply with the trading safe harbor to qualify for a treaty exemption or conduct all of their activities outside the United States. In order to qualify for the trading safe harbor funds limit origination and restructuring activity. Those that purchase debt securities on the secondary market limit their participation in the original negotiations, do not acquire a loan until at least forty-eight hours after funding, and carefully structure commitments to purchases that occur prior to the initial loan closing, such as requiring an out for the occurrence of a materially adverse event or subject closing to a satisfactory review of the documents. In addition, many funds only permit the acquisition of affiliate originated loans after a seasoning period, meaning that they purchase the loan from the affiliate after a particular time has passed, such as ninety days, and typically subject such acquisitions to arm's length pricing criteria.

In order to meet the trading safe harbor and not trigger a new loan origination in an amend and extend transaction, funds often take the position that an amendment of the loan was made to preserve the value of an existing

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<sup>104</sup> 26 C.F.R. § 1.864-7(d)(2) (2015) (the office or other fixed place of business of an independent agent is not treated as the office or other fixed place of business of a principal that is a foreign person).

<sup>105</sup> *Taisei Fire & Marine Ins. Co v. Comm'r*, 104 T.C. 535, 556 (1995).

<sup>106</sup> *Id.* at 555.

<sup>107</sup> *See Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Unger v. Comm'r*, 936 F.2d 1316 (D.C. Cir. 1991).



investment.<sup>108</sup> Typically the fund will look at whether the amendment is initiated by the borrower, whether the borrower is in financial distress, whether the funds interest would be adversely impacted if the fund does not consent to an amendment, and what the funds involvement would be in the amendment. Key considerations include whether the fund would be redeemed prior to the scheduled maturity date if the fund does not agree to amend and whether the funds debt securities would be less liquid. Uncertainty in this area certainly increases fund compliance costs, but it may also have a chilling effect on credit channels to U.S. borrowers that are desperately needed.

Even funds that originate loans and would otherwise pay tax like U.S. persons because they are considered to be in a U.S. trade or business may qualify for an exemption from U.S. income tax under an income tax treaty. If the fund qualifies for an exemption under a treaty then a U.S. manager can originate loans on behalf of the fund without U.S. tax liability as long as the fund does not have a permanent establishment in the United States. As long as the U.S. manager qualifies as an independent agent, the U.S. manager's permanent establishment will not be attributed to the fund. In certain countries, such as Luxembourg and Ireland, there are business entities that are subject to only nominal local tax and qualify for the relevant treaty with the United States.

Foreign funds that have U.S. source income but do not qualify for a treaty exemption or the trading safe harbor can still engage in origination with U.S. borrowers and restructuring activity if all of the investments managers live outside the United States and all substantive decision making occurs outside the United States. In essence, the investment managers typically have no employees in the United States to ensure that no substantive activities occur in the United States. In this strategy, the manager does not need to be an independent agent.

## II. TAMING OR KILLING THE DRAGON—HOW SHOULD LEGISLATORS DRAW THE LINES?

If we were to start from scratch in this area we could abolish the cubbyhole of “engaged in a U.S. trade or business” completely—we could either tax all of the foreign lending transactions uniformly or not tax any of these foreign lending transactions. However, the former may chill the influx of money into the United States by sending foreign money elsewhere. The latter may put U.S. lenders at a competitive disadvantage relative to foreign lenders. This tradeoff leaves policymakers with the difficult question of where to draw the line between what to tax and what not to tax. The current line is whether the foreign person is engaged in a U.S. trade or business, but the distinguishing factors are so unclear that it can hardly be called a line. Policymakers could abolish this particular standard and create a different

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<sup>108</sup> See Rev. Rul. 73-460, 1973-2 C.B. 424; Rev. Rul. 90-63, 1990-2 C.B. 270.

standard if they think it is unsupported. However much of the difficulties discussed above would likely follow from any standard. Thus, given this complex doctrinal case study, (1) can we make any broad generalizations to help legislators draw lines in general or (2) can we make any suggestions to legislators about this particular case?

The scope of the line, the “engaged in U.S. trade or business” standard, is elusive, but why? Is it tied to a legal or economic principal? Can Congressional intent behind the distinction be used to tell legislators where to draw and how to maintain the line? In *The Uncertain Case*, I argued that the uncertainty in the line actually frustrated original congressional intent. However, I now discuss a different inquiry. This inquiry is whether congressional intent can be used to shore up or redraw the line. The answers to this question in this case study may explain why similar doctrinal line drawing questions are trapped in a morass of perpetual uncertainty and ineffective reform.

#### A. *Statutory Interpretation Is Unhelpful*

Statutory interpretation is unhelpful in these cases because the plain language of applicable statutes do not provide guidance. The term “engaged” does not give an objective measurement standard. For example, if a standard that states that people may not drive at excessive speeds, what is the plain meaning of excessive? It is the standard itself that defines the permitted and unpermitted activity. All that the standard “excessive” tells us is that there is at point at which the speed will be unpermitted. It is similar with “engaged in a U.S. trade or business.” There is a level at which lending to U.S. borrowers and/or investing in U.S. debt securities will get taxed. However, the plain language itself is not helpful in determining that point because it requires, *ex post*, those that implement the law to determine what constitutes “excessive” or unpermitted behavior. As Justice Holmes put it, “[t]here is a concealed, half conscious battle on the question of legislative policy, and if anyone thinks that it can be settled deductively, or once for all, I only can say that I think he is theoretically wrong. . . .”<sup>109</sup>

The general meaning of the term “engaged in a U.S. trade or business” does not provide much guidance either. Such standards become meaningless because, as law professor David Weisbach notes, they lack normative content, or even if they have some normative content they are indeterminate at the boundaries.<sup>110</sup> Again, looking at the standard of excessive speed as a parallel example, the value that standard is intended to promote is safety. Yet, even if the standard excessive is tied to the value of safety, in that studies show that the faster people drive the more the people are hurt or injured in accidents, the standard is nevertheless indeterminate at the boundaries. Is excessive fifty-five miles per hour? Is excessive sixty-five miles per

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<sup>109</sup> Holmes, *supra* note 11.

<sup>110</sup> See *supra* note 3.

hour? Does the standard of “excessive” help draw that line? Rather, that line has to be drawn *ex post* once the harm may have already occurred. Similarly, the engaged in U.S. trade or business standard can be thought of as a standard requiring foreign persons to be taxed when they do too much business in the United States. In other words, if foreign persons start acting like U.S. persons. However, are three loans the equivalent of doing business in the United States? What about controlling loans behind the scenes with a syndicate intent on purchasing securities later on the secondary market? Does it matter that there is a commitment to purchase later on the secondary market? There is nothing in the meaning of the terms “engaged in a U.S. trade or business” that draws those lines. Similar to “excessive,” the standard is indeterminate at the boundaries. Frequent loan origination looks like a U.S. person doing business, whereas passive long term investing does not. In between the standard does not help. Essentially what the standard does is state that there is a point at which foreign persons will be taxed in these transactions. It does not determine where that point lies. The same, though, can be said about any standard. The distinction is not meaningless, in that it is tied to the idea that the closer a foreign person gets to doing business like a U.S. person the more likely it is that the foreign person will be taxed like a U.S. person. It does, however, lack normative content at the boundaries.

### B. Congressional Intent is Unhelpful

Normative content itself is unhelpful if it bears little relationship to the current law. With case law trying to interpret the plain meaning irrespective of the normative content the current law gets further and further away from that content. Congressional intent behind the international tax regime in general can be looked at to see how far the current law has gotten away from that normative content. The Revenue Act of 1936 (the 1936 Act) established that foreign persons selling their passive investments would not be taxed on the resulting capital gains.<sup>111</sup> The reasoning behind this exemption was two-fold. First, Congress determined that these capital gains were administratively difficult to collect.<sup>112</sup> Second, it was thought that the exemption would

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<sup>111</sup> Revenue Act of 1936, ch. 690, §§ 211, 231, 49 Stat. 1648, 1714-17 (creating an early version of the business versus passive distinction). Foreign persons not engaged in a U.S. trade or business that did not have an office or place of business in the United States were subject to a gross-basis withholding tax at a flat rate on certain passive income (not including capital gains from sales). However, foreign persons that *were* engaged in a U.S. business or had an office or place of business in the United States were subject to a net-basis income tax at rates that applied to U.S. persons on *all* of their U.S. source income. Immediately prior to the 1936 Act, foreign persons were generally subject to an annual tax on their net income received from all U.S. sources and a gross-basis withholding tax on certain U.S. source passive income with the possibility of deductions and credits if an income tax return was filed. See Revenue Act of 1916, ch. 463, §§ 1, 10, 39 Stat. 756, 756-66; Revenue Act of 1918, ch. 18, §§ 217, 221(a), 221(d), 237, 40 Stat. 1057, 1069-80. See also, Sicular & Sobol, *supra* note 99, at 722.

<sup>112</sup> H.R. REP. NO. 74-2475, at 9, 21 (1936).

result in additional revenue from taxes on U.S. brokers' income.<sup>113</sup> In other words, Congress wanted to decrease collection difficulties and increase revenue by encouraging foreign persons to make these passive investments in the United States.

In addition, generally a foreign person receiving "portfolio interest"<sup>114</sup> is not taxed on that interest if it is not effectively connected with a U.S. trade or business and certain other conditions are met.<sup>115</sup> Congress enacted the portfolio interest exemption in 1984<sup>116</sup> with the rationale to allow U.S. persons access to financing abroad at a lower cost.<sup>117</sup> It was thought that if the exemption were not enacted, U.S. borrowers would be at a competitive disadvantage against borrowers from other countries.<sup>118</sup> Congress was concerned with the Eurobond market in particular.<sup>119</sup> Before the portfolio interest exemption, U.S. borrowers often borrowed in the Eurobond market through finance subsidiaries organized in the Netherlands Antilles to avoid U.S. withholding taxes on interest payments.<sup>120</sup> The Netherlands Antilles imposed no taxes on interest paid by the subsidiary to the foreign lender, and this interest was assumed to be exempt from U.S. withholding tax as foreign source income. Interest paid by the U.S. borrower to the Netherlands Antilles subsidiary was exempt from U.S. tax under an income tax treaty.<sup>121</sup> These structures increased borrowing transaction costs to U.S. borrowers and likely provided incomplete access to the Eurobond market for U.S. borrowers because of the structural planning and because the IRS challenged some of these structures.<sup>122</sup> In addition, the legislative history provides that the portfolio interest exemption was enacted to achieve an overall gain to the economy by expanded investment, and improved U.S. balance of payments, the exemption would then result in expansion in earnings and employment because of stimulation to investment banks, brokerage firms, and commercial banks.<sup>123</sup> Congress thought the revenue lost would be minimal because the

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<sup>113</sup> *Id.*

<sup>114</sup> Portfolio interest for this purpose includes most interest received from unrelated borrowers by taxpayers other than banks. The exemption does not apply to foreign banks (except for U.S. government debt), to foreign corporations that are 10 percent shareholders of the U.S. debtor, or to interest received by certain foreign corporations from a related person. I.R.C. § 881(c) (2012).

<sup>115</sup> In addition to the exemption on certain portfolio interest, interest on bank deposits are also exempted from the withholding tax under the Code and many tax treaties exempt treaty country residents from U.S. tax on interest income not attributable to U.S. permanent establishments. *See* I.R.C. §§ 871(i)(2)(A) (2012), 871(i)(3) (2012), and 881(d) (2012).

<sup>116</sup> Deficit Restoration Act of 1984, Pub. L. No. 98-369, § 127, 98 Stat. 494 (1984).

<sup>117</sup> *See* STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 391-94 (Comm. Print 1984).

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

tax rate on interest payments made by U.S. borrowers to foreign lenders was often reduced by treaty and there would potentially be increased foreign investment and thereby increased revenue from the additional economic activity.<sup>124</sup> There was also a fear that if the exemption were not enacted, some foreign persons would not invest in debt securities in the United States.<sup>125</sup> Finally, the exemption was enacted because the costs of collecting taxes attributable to interest paid to foreign persons was thought to be high.<sup>126</sup>

As discussed above, there is a safe harbor for foreign persons trading and not dealing in stock and securities (including debt securities) for their own account.<sup>127</sup> If this safe harbor for trading in securities for one's account is met, certain trading in stock and securities will not be considered a U.S. trade or business for this purpose.<sup>128</sup> The legislative history is sparse on the reasons for enacting an early version of this safe harbor (providing that this provision was added to "clarify" what it meant to be "engaged in trade or business in the United States").<sup>129</sup> The early version of this safe harbor enacted in 1936 raised many questions. It seemed clear that owning stocks, securities, or commodities for investment was covered by the 1936 safe harbor and did not constitute a U.S. business.<sup>130</sup> It also seemed clear that "dealing" in stocks, securities, or commodities was not covered by the 1936 safe harbor.<sup>131</sup> However, the 1936 safe harbor resulted in considerable litigation over hazy distinctions between these two boundaries.<sup>132</sup>

Consequently, in 1966, the Foreign Investors Tax Act revised the 1936 safe harbor. In discussing the reasons for this revision, the House Report identifies that there was some confusion as to the application of the safe harbor under the 1936 Act and further states that "the confusion . . . may have acted to deter some foreign investment in the United States."<sup>133</sup> Further, in 1963, President John F. Kennedy appointed a task force on Promoting Increased Foreign Investments in U.S. Corporate Securities and

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> See I.R.C. § 864(b)(2)(A)(i) (2010).

<sup>128</sup> There is another safe harbor for trading in stocks or securities through an independent agent but not through an office of fixed place of business in the United States, hereinafter referred to as the independent agent safe harbor. Most foreign hedge funds would not be able to argue that they are trading through an independent agent since their investment advisors in the United States routinely take a twenty percent profit interest in the fund as a general partner. Since most foreign hedge funds argue that much of what they do with regard to debt transactions falls under the securities trading safe harbor, I will not focus on the independent agent safe harbor. I.R.C. § 864(b)(2)(C) (1993).

<sup>129</sup> S. REP. NO. 74-2156, at 21–22 (1936); see also, Sicular & Sobol, *supra* note 99, at 726.

<sup>130</sup> *Higgins v. Commissioner*, 312 U.S. 475, 478 (1941) (passive investment activity, including making deposits and keeping records, in relation to securities investments cannot convert investment into a trade or business).

<sup>131</sup> See James Sitrick, *U.S. Taxation of Stock and Securities Trading Income of Foreign Investors*, 30 J. TAX'N 98, 98–99 (1969); Joseph Isenbergh, *The "Trade or Business" of Foreign Taxpayers in the United States*, 61 TAXES 972, 980 (1983).

<sup>132</sup> See also Sicular & Sobol, *supra* note 99, at 726–27.

<sup>133</sup> *Id.*

Increased Foreign Financing for U.S. Corporations Operating Abroad.<sup>134</sup> The task force concluded that “the most immediate and productive ways to increase the flow of foreign capital” to the United States would be to adjust the laws concerning the taxation of foreign persons.<sup>135</sup> In describing the purpose and background of the bill, the legislative history cites both the task force report and the Treasury Department’s subsequent proposed tax legislation designed to increase foreign investment in the United States.<sup>136</sup> The legislation was proposed as part of President Kennedy’s “program to improve the U.S. balance of payments.”<sup>137</sup> The bill’s stated primary object was the “equitable tax treatment by the United States of nonresident aliens and foreign corporations” while recognizing that the initial bill proposed by the Treasury Department was designed primarily to stimulate investments by foreigners in the United States.<sup>138</sup>

The policy rationale for the three rules described above can be summarized by stating that they were enacted to encourage foreign financial investment in the United States and because collection of the corresponding taxes was difficult for the IRS.<sup>139</sup> Thus, while there is normative content for the applicable rules, the normative content is indeterminate at the boundaries of this line drawing problem. Collection difficulties and encouragement or discouragement of funds investing in the United States is similar in the range of transactions in between the two extremes. Does the engaged in U.S. trade or business standard create a regime that decreases collection difficulties and increases revenue on U.S. brokers and managers income? It seems that the uncertainty in the standard actually increases collection difficulties. It also seems that the intersection of agency law with respect to potentially treating U.S. persons as agents for purposes of this inquiry cannot serve the interest of increasing those transactions.

### C. *The Tax Policy Considerations of Horizontal and Vertical Equity Are Unhelpful*

Professor Weisbach points out that with this kind of messy doctrinal area the general meaning of the words fail, not only because the words are unclear just like the “excessive” standard, but also because the words are not tied to policies that legislators care about such as equity, efficiency or feasibility.<sup>140</sup> Is the engaged in U.S. trade or business standard tied to any

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<sup>134</sup> See H.R. REP. NO. 89-1450, at 26 (1966); S. REP. NO. 89-1707, at 9–10 (1966).

<sup>135</sup> TASK FORCE ON PROMOTING INCREASED FOREIGN INVESTMENT IN UNITED STATES CORPORATE SECURITIES AND INCREASED FOREIGN FINANCING FOR UNITED STATES CORPORATIONS OPERATING ABROAD, REPORT TO THE PRESIDENT OF THE UNITED STATES 21 (1964) (Fowler Task Force Report).

<sup>136</sup> See H.R. REP. NO. 89-1450, at 26.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> See *supra* Parts III(A)–(C).

<sup>140</sup> See *supra* note 3.

policies? Horizontal equity for example looks at whether we tax similarly situated persons similarly. For example, a foreign person's long-term passive holdings of debt instruments are not taxed, while frequent loan origination by the same foreign person is taxed. Yet what about the transactions in between? Are they similar to passive holdings or frequent loan origination? There is also an issue as to what persons and transactions are even similar. How is horizontal equity achieved? Should transactions in between be taxed like passive investing or frequent loan originating? The standard does not definitively identify an answer to this question. Similarly, with vertical equity, taxing different taxpayers differently, how can one decide whether the transactions in between are similar or different to the transactions at the extremes? In fact, line drawing causes inequity because it imposes different treatment on relatively similarly situated persons on either side of the line.

*D. The Tax Policy Consideration of Efficiency Could Be Helpful If Deadweight Loss Could Be Ascertained*

Efficiency generally refers to taxing all income as equally as possible. Assuming similar income is taxed differently, how do policymakers decide the lesser divergence? Efficiency can be measured by deadweight loss. Deadweight loss in this context refers to a loss to society due to change in behavior that is not captured by government revenue. Efficiency is concerned with the difference between consumers actual after tax behavior and behavior they would have engaged in because they have less revenue. An efficiency tax is the tax that causes the lowest deadweight loss. Professor Weisbach, for example, takes the position that "efficiency" is the appropriate criterion for line drawing.<sup>141</sup> However, many other scholars state that the focus on efficiency has a cost to other tax policy goals.<sup>142</sup> I agree that the tax policy consideration of efficiency could be helpful if deadweight loss could be ascertained, but this is relatively impossible where compliance costs are not transparent such as in the hedge fund industry.

Therefore, with this case and many line drawing cases similar in structure, I suggest that (1) statutory interpretation is unhelpful because the plain meaning of the cubbyhole and the general meanings do not provide regulators with adequate guidance; (2) congressional intent is unhelpful because even if Congress provides normative content to the cubbyhole category that normative content is indeterminate at the boundaries; (3) the typical tax policy considerations of horizontal and vertical equity are unhelpful because both are indeterminate with regard to what transactions or persons are simi-

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<sup>141</sup> *Id.*

<sup>142</sup> Neil H. Buchanan, *THE ROLE OF ECONOMICS IN TAX SCHOLARSHIP* 3 (Brennan, Karen B. Brown, and Darryl Jones, eds. 2013); Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 64 *TAX L. REV.* 229 (2011), Dennis J. Ventry Jr., *Equity versus Efficiency and the U.S. Tax System in Historical Perspective*, in *TAX JUSTICE; THE ONGOING DEBATE* 55 (Joseph J. Thorndike and Dennis Ventry Jr. eds., 2002).

lar or different at the line drawing boundaries; and (4) the tax policy consideration of efficiency could be helpful, but only if deadweight loss is ascertained, a task which becomes nearly impossible when compliance costs are not transparent, as is the case in the hedge fund industry.

My conclusion with respect to both the case study and line drawing issues where the structure of the morass is similar is that it does not matter where the line is drawn at the boundaries as seen by the unhelpfulness of congressional intent and typical tax policy considerations. In the next section, I argue that legislators should draw a line, any line, so that potential permissible transactions are not chilled to the point of creating systemic risk in narrowing credit channels.

### III. A RULE OR A STANDARD

Laws have triggers and responses. For example, the trigger of driving in excess of fifty-five miles per hour shall result in a \$55 fine as a response.<sup>143</sup> This is a quintessential example of a rule prescribing definite consequences when certain facts exist.<sup>144</sup> In this example, the trigger is empirical and the response is determined. A rule specifies what is permissible, leaving only questions of fact, such as at what speed the person was driving.

A standard typically has a soft evaluative trigger and a guided response. For example, "driving at an excessive speed" shall result in a fine. A standard might not specify exactly what is permissible, such as prohibiting "driving at an excessive speed." As a result, this leaves both the facts and what is permissible up to the implementation of the law, requiring application in view of the particular facts.<sup>145</sup> This is often described as an *ex post* evaluation, whereas a rule is often described as an *ex ante* evaluation.

If a foreign person is engaged in a trade or business in the United States, all income from sources within the United States connected with the conduct of that trade or business are taxed at graduated rates on a net basis.<sup>146</sup> The trigger then is being engaged in a U.S. trade or business. This is a soft evaluative trigger, a standard, with an *ex post* evaluation. The response is that certain income is taxed at graduated rates on a net basis. This is a definite consequence or a determined response.

Rules draw bright lines between what is allowed and what is not. Proponents of rules often cite virtues of certainty, stability, uniformity, and security. This allows for planning around the rules and means that permissible conduct will not be chilled. Rules encourage behavior right up to the line and allow persons to treat the deterrent as a fixed cost of doing business. The

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<sup>143</sup> Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, DUKE L.J., 557, 560 (1992).

<sup>144</sup> See George W. Paton, A TEXTBOOK OF JURISPRUDENCE 236-238 (David P. Derham, ed., 1972).

<sup>145</sup> See *id.*

<sup>146</sup> I.R.C. § 861 (2010).



flip side to this is rigidity, closure, and inflexibility.<sup>147</sup> Proponents of standards often tout flexibility, individualization, and open-endedness, while simultaneously being vulnerable to criticisms of manipulability, indeterminacy, and confusion.<sup>148</sup> Standards allow persons to make individualized judgments about whether the behavior is permitted. Because there is a gray area, persons may be deterred from borderline activities. Standards typically authorize a result proportionate to the gravity of the prohibited activity, assuring the strongest result is applied to the greatest threats. However, because standards do not draw a bright line, risk-averse persons may be chilled from engaging in permissible activities and risk-tolerant persons may engage in unpermitted activities. Also, judges at the borders may reach inconsistent results, causing confusion.

The decision between applying a rule or standard depends on weighing the advantages and disadvantages against each other. Therefore, embedded in the choice between a rule or a standard is a normative choice about which values are preferred in a given context.

In *The Uncertain Case*, I posited that the IRS might decide to enforce the mushy or non-existent U.S. trade or business precedent with respect to shadow bank transactions<sup>149</sup> in a way that causes funds to recognize unexpected income for federal income tax purposes. I then stated that we should consider whether the potential imposition of a tax, at any unexpected point, could increase the potential systemic risk<sup>150</sup> with respect to funds failing or

<sup>147</sup> See Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1689-90 (1976).

<sup>148</sup> See *id.*

<sup>149</sup> The term “shadow banking system” refers to the fact that financial institutions outside the traditional banking system have acted as intermediaries between investors and borrowers and have increasingly undertaken roles traditionally played by banks, including lending capital to U.S. businesses. *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008: Hearing before the H. Oversight Comm. on Hedge Funds*, 111th Cong. 4 (2008) (statement of Andrew Lo), <http://ssrn.com/abstract=1301217>. In the lending context, this role may consist of being an intermediary between investors and borrowers (i.e., funneling funds from the investor to the borrower). The non-bank institution will thereby profit from fees and/or the difference in interest rates that it pays the investors and what it receives from the borrowers. This role may also consist of purchasing debt securities on the secondary market. For further discussion specific to hedge funds see *infra* Part II. These non-bank institutions may include hedge funds, investment banks, structured investment vehicles, and other non-bank entities. These intermediaries have included investment banks, hedge funds, and others that have expanded liquidity in many global financial markets, arguably increasing market efficiency. (description of the financial intermediaries); see Roger Ferguson & David Laster, *FIN. STABILITY REV.*, Apr. 2007, at 45, 47–48 (hedge funds have contributed to market efficiency and financial stability by expanding liquidity and thereby lowering the cost of capital).

<sup>150</sup> There is no widely accepted uniform definition of systemic risk. See Steven L. Schwarcz and Imen Anabtawi, *Regulating Systemic Risk*, 85 NOTRE DAME L. REV. (forthcoming 2011) (recognizing that the “term ‘systemic risk’ has been used in various ways, sometimes inconsistently.”); see also Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 196–97, 247–48 (2008). Alan Greenspan stated that the “very definition [of systemic risk] is still somewhat unsettled.” George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulation*, 16 CATO J. 17, 21 n.5 (1996) (quoting Alan Greenspan, Remarks at a Conference on Risk Measurement and Systemic Risk, Board of Governors of the Federal Reserve System (Nov. 16, 1995)). One way to define systemic risk is that it is the risk of collapse of an entire

certain lending transactions being chilled, thereby impeding credit markets. These offshore hedge funds gamble that the rules will be interpreted and applied according to the advice of their legal counsel. However, if they lose that gamble and are too interconnected to fail, then everyone may lose. In fact, in late 2009 the Office of Chief Counsel of the IRS issued a memo to the Director of Field Operations for Financial Services and stated that “[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. We encourage you to develop these cases . . . .”<sup>151</sup>

With this systemic risk concern, the solution should be a rule in order to create greater certainty. Standards can become more certain by means of specific rules, and rules can be less certain via exceptions that appeal to

financial system or market “serious enough to quite probably have significant adverse effects on the real economy.” The 2001 G10 Report on Consolidation in the Financial Sector suggested a working definition: “Systemic financial risk is the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy.” *The G10 Report on Consolidation in the Financial Sector*, [http://www.oecd.org/document/60/0,3343,end\\_2649\\_34593\\_1895868\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/60/0,3343,end_2649_34593_1895868_1_1_1_1,00.html).

George Kaufman, & Kenneth Scott, *What is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?* 7 INDEP. REV. 371 (2003) (“Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by comovements (correlation) among most or all the parts.”).

The “real economy” simply refers to the goods, services, and resources aspects of the economy, as opposed to financial markets. FINANCIAL TIMES LEXICON, <http://lexicon.ft.com/term?term=real-economy> (last visited Sept. 9, 2011). Essentially systemic risk involves a potential cascading failure in a system or market due to interlinkages and interdependencies. See Steven Schwarcz, *Systemic Risk*, *supra* note 75; see also, *Monetary Policy and Systemic Risk Regulation: Hearing Before the Subcomm. On Domestic Monetary Policy and Technology of the H. Committee on Financial Services*, 111th Cong. (2009) (testimony of John Taylor) (“By definition a systemic risk in the financial sector is a risk that impacts the entire financial system and real economy, through cascading, contagion, and chain-reaction effects.”). This chain reaction is often likened to the quintessential example of a banking panic. See generally George G. Kaufman, *Banking and Currency Crisis and Systemic Risk: Lessons From Recent Events*, 3 ECON. PERSPECTIVES, FEDERAL RESERVE BANK OF CHICAGO 9, 9–28 (2000). Banking panics historically have occurred when customers withdrew their deposits from a bank in fear that the bank would become insolvent, causing a chain reaction of runs on other banks. Rajkamal Iyer & Manju Puri, *Understanding Bank Runs: The Importance of Depositor-Bank Relationships and Networks* (NBER Working Paper No. 14280, 2008, <http://www.nber.org/papers/w14280>); Gary Gorton, *Banking Panics and Business Cycles*, OXFORD ECON. PAPERS 40, 751–781 (1988). The chain reaction may have occurred because other banks were owed money by the troubled bank or simply because general populous fear spread. Gorton, *Banking Panics*, *supra* note 80, at 760. It is thought that much of the Great Depression’s economic damage was caused by bank runs. Benjamin Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 3 AM. ECON. REV. 73, 257–76 (1983). While regulators have typically looked at banks as sources of systemic risk, because of the shadow bank system, we must look at the linkages or connectedness of the entire financial system, including non-bank financial institutions, not only those of the traditional banking system. Some scholars contend that the recent economic crisis of 2007–2010 was a run by investors on the shadow banking system. Gary Gorton, *Questions and Answers about the Financial Crisis prepared for the U.S. Financial Crisis Inquiry Commission* (2010), WALL ST. J. ONLINE, <http://online.wsj.com/public/resources/documents/crisisqa0210.pdf>.

<sup>151</sup> Memorandum from Steven A. Musher, Associate Chief Counsel of the IRS, to Kathy Robbins, Director of Field Operations (Sept. 22, 2009).

other standards. In other words, the meaning of a general rule is often found in the standards that limit its application. The United Kingdom, for example, has an engaged in U.S. trade or business like standard that it has made more rule-like through white lists that identify specific certain transactions that will not be taxed. One of the key components in the United Kingdom's continuing attraction for non-resident investors (including hedge funds) is the ability to appoint UK-based investment managers without creating a risk of UK taxation for themselves.

Because adopting a standard may create systemic risk, any such taxation standard should, at minimum, incorporate specific rules. In cases that potentially create systemic risk, such as shadow bank transactions, the virtue of rule certainty outweighs the virtue of standard flexibility. For the engaged in U.S. trade or business dragon, I propose adopting a policy similar to that in the United Kingdom. HMRC offers the Investment Manager Exemption. Through a series of qualifying tests, the Investment Manager Exemption ensures that overseas investors are not charged UK tax in relation to investment transactions conducted on their behalf and that any fees received by a UK resident investment manager for services performed for the non-resident are fully chargeable to UK tax. However, the United Kingdom's use of white lists, lists of transactions that clearly meet this criteria, is the mechanism which I most strongly advocate. This concept of white lists has the certainty benefits of a rule with the flexibility benefits of a standard in that transactions can be added to white lists to keep pace with financial innovation. U.S. legislators could implement something similar to white lists by using a series of proposed regulations that would complement a more rule-like exemption in the Code. The benefit of proposed regulations is that they would be open to public comment where the industry participants, in a not so transparent industry, could help guide the process.

#### CONCLUSION

I have applied Justice Holmes' principles of analysis to the engaged in U.S. trade or business cubbyhole by taking the dragon out of the cave, and asking whether academics can help legislators draw lines in general and with respect to the specific case study of the engaged in a U.S. trade or business cubbyhole in the context of hedge fund lending. Based on the case study and other similar line drawing cases, this section concludes the following: (1) statutory interpretation is unhelpful because the plain meaning of the cubbyhole and the general meanings do not provide regulators with adequate guidance; (2) congressional intent is unhelpful because even if Congress provides normative content to the cubbyhole category that normative content is indeterminate at the boundaries; (3) the typical tax policy considerations of horizontal and vertical equity are unhelpful because both are indeterminate with regard to what transactions or persons are similar or different at the line drawing boundaries; and (4) the tax policy consideration of efficiency

could be helpful, but only if deadweight loss is ascertained, a task which becomes nearly impossible when compliance costs are not transparent, as is the case in the hedge fund industry. Therefore, although drawing a line is important, it does not really matter where you draw the line.

I conclude that in areas of potential systemic risk a rule's virtue of certainty is preferable to the flexibility virtue of a standard, *but* a rule can be made less certain with exception and standards can be made more certain by means of specific rules. My conclusions with respect to both the case study and line drawing issues where the structure of the morass is similar, are that it does not matter where legislators draw the line at the boundaries as seen by the unhelpfulness of congressional intent and typical tax policy considerations, just that a line is drawn so that potential permissible transactions are not chilled to the point of creating systemic risk in narrowing credit channels. Similarly because of potential systemic risk, if legislators adopt a standard, the standard should, at a minimum, incorporate specific rules. In cases that potentially create systemic risk, such as shadow bank transactions, the virtue of rule certainty outweighs the virtue of standard flexibility. For the engaged in a U.S. trade or business dragon, I propose adopting a white list policy similar to the United Kingdom's Investment Manager Exemption. By focusing on white lists, which incorporate rule certainty into the flexibility of a standard, U.S. legislators can add transactions to the lists to ensure that the "engaged in a U.S. trade or business" cubbyhole keeps pace with financial innovation.