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Neither a Dealer Nor a Lender *Nor a Promoter* Be[1]

Stuart Leblang, Robert Rothman, and Daniel Paulos

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[1] For title inspiration, see Sheppard, "Neither a Dealer Nor a Lender Be: Collateralized Debt Obligations Raise New Questions," 22 Tax Notes Int'l 2685 (May 2001). *See also* Hamlet Act 1, scene 3, 75–77 ("Neither a borrower nor a lender be, For loan oft loses both itself and friend, And borrowing dulls the edge of husbandry").

This article explores the scope of the effective exemption from U.S. net income taxation generally applicable to foreign investment funds and other foreign investors that invest or trade in stock and securities from the United States. In particular, the article considers various scenarios where a foreign person who effects transactions in stock and securities from the United States might be treated as engaged in a U.S. trade or business, even though such person is not a dealer.

Conventionally, the U.S. federal income tax consequences of stock and securities activities of foreign persons are broadly categorized as either (i) passive investing or active trading activities not involving sales to customers, which generally do not give rise to a U.S. trade or business or U.S. net income taxation, or (ii) certain types of "dealer" activities involving customers, which may give rise to a U.S. trade or business and U.S. net income taxation.

A fundamental concept of U.S. tax law is the distinction between an "investor," a "trader" and a "dealer." These concepts are crucial to the issue of whether a foreign person who is engaged in the activity of selling property will be treated as being engaged in a "trade or business" as a result of such activity. If so, and if that "trade or business" has a sufficient connection with the United States, the foreign person will be subject to regular "net-basis" taxation on income which is treated as "effectively connected" with such trade or business.[2]

The concepts of "investor," "trader" and "dealer" (or close analogs of such concepts) also are relevant in other areas of the tax law. These include:

[2] Or when income from the sale of property is treated as "effectively connected," *see* Rothman, "Gain from Property Sales as Effectively Connected Income ─ a Roadmap," 20 J. International Tax. 30 (July, 2009).

- The character (ordinary *vs.* capital) of gain or loss recognized on the sale of the property;[3]
- Whether expenses relating to the activity are, in the case of a non-corporate taxpayer, deductible as a trade or business expense under Section 162 or as an expense for the production of income under Section 212.[4]
- Whether a taxpayer is required, or may elect, to mark its securities (including certain loans and financial products) held at year-end to market.[5]
- Whether a loss sustained by a lender on non-payment of a loan will be deductible as a business bad debt or under the more restrictive rules governing non-business bad debt.[6]

In fact, as discussed below, much of the law which is generally applied in the context of characterizing a foreign taxpayer as a dealer, a trader or an investor for purposes of determining whether he is engaged in a U.S. trade or business derives from those other contexts.

Significantly, however, a body of law, developed in the context of certain domestic stock and securities transactions, suggests that the three basic categories of "investor," "trader" and "dealer" may not be all-inclusive. For example, there is a body of case law dealing with "promoters" — a class which may be outside the three traditional pigeonholes.

In the context of transactions in stock and securities, the law seems to have a strong bias towards treating such activities as investment. This reflects the inherent passivity of most

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[3] Section 1221(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). Except where otherwise specified, all section references herein are to the Code.

[4] This distinction is of great importance today because Section 212 deductions, unlike trade or business expenses deductible under Section 162, are treated as "miscellaneous itemized deductions" and hence are subject to a "floor" under which they are only deductible to the extent they exceed 2% of adjusted gross income. Section 67.

[5] *See* Section 475.

[6] *See* Section 166.

securities-related activity, as well as a concern about the potential for domestic taxpayers who might try to claim ordinary losses and deductions.[7] However, the possibility exists that securities-related activities might be treated as outside the categories of investor or trader if the expectation of profit derives to a large enough extent from the things that the taxpayer does to enhance the value of a position (as opposed to simply receiving a passive return on invested capital or profiting from short term market fluctuations).

This article explores the scope of doctrines, such as the "promoter" doctrine, under which taxpayers engaged in stock and securities transactions that involve significant enhancement activities may fall into a category other than investor, dealer or trader, and the possibility that such doctrines, if applied expansively to foreign persons, could result in such persons being subject to U.S. tax even without being a "dealer."

I. BACKGROUND

A. The Statutory and Regulatory Framework

The conclusion that investing in stock and securities is not a trade or business originates in the case law,[8] while the conclusion that trading in stock and securities (and, in some cases, commodities) for one's own account will not, in itself, cause a non-U.S. person to be treated as engaged in a U.S. trade or business is based on a statutory Safe Harbor (the "**Trading Safe Harbor**").[9]

1. Investors. "Investing" generally includes a person's mere holding and managing of passive investments in stocks, bonds and other instruments, even if the holdings are extensive

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[7] We note that case law generally has applied the same standards for distinguishing between business and non-business activity in domestic context and in the international context. *See* text accompanying note 53, *infra*.

[8] *See* Higgins v. Commissioner, 312 U.S. 212, 217 (1941). *See also* DeKrause v. Comm'r, 33 T.C.M. 1362 (1974) (holding that the *Higgins* line of cases is applicable to determine whether a foreign person is engaged in trade or business under Section 864(b)).

[9] *See* Sections 864(b)(2)(A)(ii); 864(b)(d)(B)(ii).

and the activity associated with the management of such investments is substantial. The seminal case is *Higgins*, in which the Supreme Court, noting that the taxpayer "merely kept records and collected interest and dividends from his securities, through managerial attention for his investments," declined to conclude that the taxpayer was engaged in a trade or business.[10] An investor may devote "a considerable portion of time" to the oversight of "extensive investments" in stocks and bonds, and hire others to assist in offices rented for that purpose.[11]

If a taxpayer is an "investor" (under the standard of *Higgins* and its progeny), the taxpayer is not treated as being engaged in business at all. This has a number of consequences. For example, in the case of a foreign taxpayer, it means that, *per se*, he is not treated as engaged in a U.S. trade or business (without the need to rely on the Trading Safe Harbor). In the case of a domestic taxpayer, expenses associated with the activity would be deductible, if at all, under Section 212.

2. Dealers. Section 1221(a) provides that the term "capital asset" means any asset other than those specifically enumerated as exceptions.[12] Among the exceptions is that for

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[10] Note 8, *supra*, at 218. *Higgins* arose in the context of determining whether expenses incurred in connection with the investment activity were deductible; under the law in effect at the time, there was no counterpart to Section 212, so absent a trade or business no deduction was allowed to an individual taxpayer. *See also* Wilson v. United States, 376 F.2d 280, 293, 179 Ct. Cl. 725 (Ct. Cl. 1967) ("managing one's own investments … is not the carrying on of a trade or business, irrespective of the extent of the investments or the amount of time required to perform the managerial functions"); Continental Trading, Inc. v. Comm'r, 265 F.2d 40 (1959) ("the mere management of investments and the collection of [passive income streams] is insufficient to constitute the carrying on of a trade or business."); Evelyn M. L. Neill, 46 B.T.A. 197 (1942) ("We think that the rule is settled that the mere ownership of property from which income is drawn does not constitute the carrying on of business."); *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 34 (2d Cir. 1989) (taxpayer who initiated more than 2000 securities transactions over a two year period was considered to be an investor); *Neuman de Vegvar v. Comm'r*, 28 T.C. 1055 (1957) (holding period of more than 2.5 years; investor); *Chang Hsiao Liang .v. Comm'r*, 23 T.C. 1040 (1955), *acq. in result*, 1955-2 C.B. 3.

[11] *Higgins*, 312 U.S. at 218.

[12] One exception that is not often discussed but that is tangentially related to the topic of this article is that of Section 1221(a)(4), which applies to "notes receivable acquired…for services rendered…." One case has held that mortgages originated by a bank or other financial institution may be considered to fall under this exception. *See* Burbank Liquidating Corp. v. Comm'r., 39 TC 999 (1963) (acq.), modified on other grounds, 335 F2d 125 (9th Cir. 1964); *see also* Rev. Rul. 80-57, 1980-1 CB 157. More recently, the IRS has announced that it will not challenge a

"stock in trade of the taxpayer or other property of a kind which would properly be included in inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Although the term "dealer" is nowhere used in Section 1221, taxpayers who own assets which are excluded from the definition of capital asset under Section 1221(a)(1) are generally referred to as "dealers" in such property.[13] The concept of a "dealer" under Section 1221(a)(1) has been interpreted somewhat more narrowly where the property involved is stock or securities than in other contexts. It appears that, in the securities context, the "stock in trade" and "inventory" categories of excluded property are subsumed in the "property held primarily for sale to customers" category,[14] with the result that the determination of whether a taxpayer is a dealer in stock and securities centers on whether or not such taxpayer sells property to customers in the ordinary course of such taxpayer's trade or business.

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taxpayer who consistently follows this case. *See* Preamble to Proposed Regulations, Fed. Reg. Vol. 73, No. 79, p. 21861 (4/23/2008). Although a taxpayer who recognizes ordinary income or loss under Section 1221(a)(4) (as interpreted by *Burbank*) is not generally considered to be a "dealer," as discussed below, a foreign person who regularly engages in the business of originating loans is probably considered to be engaged in a U.S. trade or business (*see* text accompanying notes 37 and 38, *infra*). The consequences of Section 1221(a)(4) and *Burbank* is that such foreign taxpayer (like a U.S. person in the lending business) can generally choose to treat such activities as giving rise to ordinary gain or loss.

[13] *See* Bittker & Lokken: Federal Taxation of Income, Estates, and Gifts, *Property Held for Sale to Customers* ¶47.2.2 (citing Swartz v. Comm'r., 876 F2d 657 (8th Cir. 1989) and Marrin v. Comm'r., 147 F3d 147, 151 (2d Cir. 1998).

We note that the definition of dealer under Section 1221(a)(1) is slightly different than those used for purposes of Section 475 and the Trading Safe Harbor. Under Section 475, a dealer is "a taxpayer who (i) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business or (ii) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business." In contrast, for purposes of the Trading Safe Harbor, a dealers is a "merchant…, with an established place of business, regularly engaged as a merchant in" both buying securities (apparently from anybody) and selling them to customers. *See* Treas. Reg. § 1.864-2(c)(iv)(a).

For a discussion of the effect of the different formulations, *see* Thomas A. Humphreys, "The Way (Securitization) Things Ought to Be," Tax Forum No. 561, at 37 (Nov. 4, 2002); David R. Sicular, "Selected Current Effectively Connected Income Issues For Investment Funds," 56 Tax Law. 719 at 60, Summer, 2003; Jack B. Siegel, "Investor, Trader, or Dealer?" American Bar association – Section of Taxation, May, 2000.

[14] *See* Bielfeldt v. Comm'r., 231 F.3d 1035 (7th Cir. 2000), cert. denied, 122 S. Ct. 38 (2001); Marrin v. Commr., 147 F.3d 147 (2d Cir. 1998); Wood v. Comm'r., 16 T.C. 213 (1951). *See also* BNA Portfolio 561: Capital Assets Chapter I, Section A.

Specifically, with regard to transactions in stock and securities, courts have typically applied a "merchant analogy" to determine whether a taxpayer meets the required threshold of selling securities *to customers*.[15] The oft-quoted *Kemon* case described the merchant function as follows:[16]

> In determining whether a seller of securities sells to "customers," the merchant analogy has been employed.… Those who sell "to customers" are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods… Such sellers are known as "dealers."

Although the merchant analogy equates, to a certain extent, the existence of customers with the pursuit of remunerations for labor as a middleman, other cases have interpreted the customer requirement more literally. For example, in *Stephen Marrin v. Comm'r*, 147 F. 3d 147 (2nd Cir 1998) the Second Circuit suggested that, generally, customers would be known to a

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[15] *See* Kemon v. Comm'r., 16 TC 1026, (1951) and Bradford v. United States, 444 F.2d 1133 (Ct. Cl. 1971). *See also,* Bradford, 444 F.2d at 1140; Currie v. Comm'r, 53 T.C. 185, 199 (1969); Frankel v. Comm'r, 56 T.C.M. (CCH) 1156 (1989).

[16] *See Kemon* at 1032–1033.

dealer.[17] In similar circumstances, the Second Circuit found that a broker may be regarded as a customer of a taxpayer where such taxpayer has an established place of business or holds himself out to the general public as a securities dealer (*i.e.*, where the dealer is known to the customers).[18] The *Marrin* and *Stevens* cases seem to look past the merchant analogy to focus on the relationship between dealer and customer. Along these lines, dealer status appears more likely if the people from whom the taxpayer buys have different characteristics than the people to whom the taxpayer sells, based on the findings of another Second Circuit case.[19]

In other words, where the property involved consists of stock or securities, the case law has generally limited "dealers" to those who sell to *customers* in the ordinary course of business; the notion of "stock in trade" or "inventory," in the hands of a taxpayer who does not sell to "customers," has generally not been applied in this context.

On the other hand, courts analyzing the dealer issue in contexts other than securities (for example, real estate) have effectively eliminated any customer requirement,[20] focusing instead on the intent of the taxpayer,[21] the number and frequency of sales,[22] and whether subdivisions or improvements were made.[23] Thus, for example, a real estate developer who adds value to a

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[17] In *Marrin* the Second Circuit declined to extend the merchant analogy to find customers where a taxpayer sought to earn short-term profits by narrowing the bid/ask spread in securities trades executed for his own account. The court noted that "generally, where a taxpayer trades for his own account and sells securities to persons he does not know, [he is not a dealer]." The court also distinguished *Stevens* (discussed below) on the basis that Marrin did not have an established place of business or hold himself out to the public as a dealer in securities.

[18] *See* Stevens v. Comm'r, 78 F.2d 713 (2d Cir. 1935).

[19] *See* Seeley v. Helvering, 77 F. 2d 323 (2nd Cir. 1935). In *Seely*, the taxpayer bought and sold securities on behalf of the customers of the firm with which he was associated. The Second Circuit concluded that Seeley was not a dealer because he did not act as a merchant, noting that "a merchant, ordinarily at least, does not resell to the same class of persons from whom he buys."

[20] *See e.g.,* Black v. Comm'r., 45 BTA 204 (1941) and Farr v. Comm'r., 44 BTA 683 (1941).

[21] *See* Biedenharn Realty Co. v. US, 526 F.2d 409 (5th Cir.), cert. denied, 429 US 819 (1976). *See also* Lomas & Nettleton Fin. Corp. v. US, 486 F.Supp. 652 (ND Tex. 1980).

[22] *See* S&H, Inc. v. Comm'r., 78 TC 234 (1982).

[23] *See* Jersey Land & Dev. Co v. US, 539 F.2d 311 (3rd Cir. 1976); Brady v. Comm'r., 25 TC 682 (1995). *See*, *also* Bush v. Commissioner, 610 F.2d 426 (6th Cir. 1979); Harder v. Commissioner, T.C. Memo 1990-371; Gates v.

parcel of real estate (either by undertaking physical construction or by undertaking the legal steps necessary to subdivide it), and whose intention is to profit from such added value, can be a dealer regardless of whether he sells to customers (in the traditional sense) and regardless of the volume and frequency of sales.[24]

Similarly, the few cases that have addressed the distinction between a dealer and an investor in contexts other than securities or real estate generally have adopted the same factors used in the real estate context,[25] with the result that it is relatively clear that a person who acquires tangible or intangible property (other than securities) on a serial basis with a view to a quick resale at a profit can effectively be treated as a dealer regardless of the existence of any "customer" relationships. Likewise, it is clear that a person that creates, develops or materially enhances property with a view to the resale of that property for profit (rather than to hold and personally exploit through self-use, rental or lease of the property) will likewise be effectively treated as a selling inventory (*i.e.*, ordinary income property) regardless of the scope and regularity of the activity.

The significantly different standard applicable to taxpayers in the real estate context (and other contexts) as compared to the securities context has its origins in early court cases[26] that

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Commissioner, 52 T.C. 898 (1969); Bynum v. Commissioner, 46 T.C. 295 (1966). These cases addressed improvements and development in the context of real property where making improvements suggests that the taxpayer's economic profit derives not from long-term changes in market conditions, but rather from the value added by the taxpayer's own activities.

[24] *See* Black v. Comm'r., 45 BTA 204 (1941); Jersey Land & Dev. Co v. US, 539 F.2d 311 (3rd Cir. 1976); Winthrop v. US, 417 F2d 905 (5th Cir. 1969); Bynum v. Commissioner, 46 T.C. 295 (1966). See Brady v. Comm'r., 25 TC 682, 689 (1955) (acq.).

[25] *See*, *e.g.*, Graham D. Williford, T.C. Memo 1992-450 (Aug. 10, 1992) (finding that the taxpayer was an investor in fine art); David Taylor Enterprises, Inc. & Subs. v. Commissioner, T.C. Memo 2005-127 (May 31, 2005) (finding that the taxpayer was a dealer in classic cars).

[26] *See* Black v. Comm'r., 45 BTA 204 (1941) (acq.). *See also* Bush v. Comm'r., 36 TCM (CCH) 340 (1977), aff'd, 610 F2d 426 (6th Cir. 1979); Guardian Indus. Corp. v. Comm'r., 97 TC 308 (1991) ; Morley v. Comm'r., 87 TC 1206 (1986).

declined to apply the "to customer" rule, which was added to the predecessor of Code section 1221(a)(1) in 1934 for the specific purpose of preventing traders in securities from deducting their market losses from ordinary income.[27] The change was intended to distinguish taxpayers who interact primarily with a class of recognizable clients from securities traders buying and selling anonymously on an exchange or in other non-customer transactions, denying ordinary losses to the later group.[28]

If a taxpayer is a dealer, it appears that he is, *per se*, engaged in a trade or business.[29] If he is a foreign person, he will be treated as engaged in a U.S. trade or business if his activities are conducted in the U.S.;[30] if he is a U.S. person, expenses associated with the activity should generally be deductible as trade or business expenses under Section 162, and gain or loss in the property would be ordinary.

3. Traders. As noted above, a special statutory rule provides that a foreign person will not be treated as engaged in a U.S. trade or business simply as a result of trading in stock and securities (and, in some cases, commodities) for his own account. The Regulations define "trading" as the "effecting of transactions in stock and securities," which includes "buying, selling (including by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stock and securities, on margin or otherwise, for the account of the taxpayer, and any other activity closely related thereto (such as obtaining credit for the purpose

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[27] *See* H.R. Rep. No. 1385, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 CB (pt. 2) 627, 632.

[28] Id.

[29] *See* Sitrick, "U.S. Taxation of Stock and Securities Trading Income of Foreign Investors," 30 J. Tax'n 98, 98–99 (1969); Isenbergh, "The 'Trade or Business' of Foreign Taxpayers in the United States," 61 TAXES 972 at 980 (1983).

[30] As discussed below, the definition of "dealer" for purposes of the carve-out from the Trading Safe Harbor may be narrower than the general definition of a "dealer" in securities.

of effectuating such buying, selling or trading)." The volume of the trading activity is not taken into account in determining whether the taxpayer is trading or effecting transactions.

Dealing in securities is specifically excluded from the Trading Safe Harbor.[31] Under the applicable Regulations, for purposes of the carve-out from the Trading Safe Harbor, a dealer in stock and securities is defined as a merchant in stock and securities, with an established place of business, regularly engaged as a merchant in purchasing stock and securities and selling them to customers with a view to the gains and profits that may be derived therefrom.[32] However, persons who, in their individual capacities, buy and sell, or hold, stock and securities for investment or speculation are not "dealers."[33]

The *Kemon* case[34] describes the distinction between a dealer and a trader as follows:

> Contrasted to "dealers" are those sellers of securities who perform no such merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as "traders."

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[31] *See* Section 864(b)(2)(A)(ii).

[32] *See* Regulations section 1.864-2(c)(2)(iv). Note, however, that in determining whether a person is a dealer, such person's transactions in stock and securities effected both in and outside the United States are taken into account. Interestingly, the definition of "dealer" for this purpose may be somewhat narrower than the general definition of "dealer" for purposes of Section 1221(a)(1), as discussed above.

[33] *See* Regulations section 1.864-2(c)(2)(iv)(a).

[34] Note 15, *supra*.

The concept of a "trader" only has *statutory* significance for purposes of the Trading Safe Harbor and Section 475,[35] and there is little authority directly interpreting the term.[36] As noted above, there is a fair amount of case authority distinguishing traders from investors and dealers. However, much of this authority arose in contexts (other than the Trading Safe Harbor and Section 475), where the significance of being a "trader" was simply that one was not an investor or a dealer, as the case may be.

In the context of the Trading Safe Harbor, on the other hand, the concept of a "trader" has independent significance ─ once it has been determined that a taxpayer is neither an investor nor a dealer, the questions remains as to whether such taxpayer is a "trader" who is eligible for the Trading Safe Harbor. Although it might be argued that the three categories of investor, trader or dealer are exhaustive ─ which would imply that a taxpayer who is neither an investor nor a dealer, is, by default, a "trader" ─ this does not appear to be the case. Most practitioners believe, for example, that there is a significant risk that a foreign taxpayer who regularly engages in the business of originating loans is not entitled to the Trading Safe Harbor (with the result that such taxpayer could become subject to net-basis U.S. taxation as a result of such activity) even though he does not sell to "customers" (and hence is not a dealer). Indeed, in a recently released Generic Legal Advice Memorandum[37] the Internal Revenue Service (the "IRS") seems to have presupposed that loan origination does not fall within the Trading Safe Harbor in ruling that a

[35] Section 475 generally imposes mandatory mark-to-market accounting for dealers in stock and securities, and allows elective mark-to-market treatment for traders in those types of property. Mark-to-market accounting is neither required nor permitted for taxpayers who are not dealers or traders.

[36] A corollary of this is that the concept of a trader, as distinct from either a dealer or an investor, has no statutory significance outside of the securities (and commodities) context, and in fact the case law has not extended the concept beyond this context.

[37] *See* Memorandum, dated September 22, from Steven A. Musher, IRS Associate Chief counsel (international) to Kathy Robbins, IRS director of field operations, Manhattan, Financial Services, AM 2009 2009-010, Doc 2009-21092, 2009 TNT 182-13.

foreign corporation that regularly originates loans in the United States via an agent is engaged in a U.S. trade or business .[38]

In order to develop an analytical framework for determining whether a particular non-investor, non-dealer activity falls within the scope of the Trading Safe Harbor, it is necessary to examine some case-law doctrines which have developed in other contexts.

II. BEYOND INVESTORS, TRADERS AND DEALERS

A. The Promoter Concept

Outside the context of the Trading Safe Harbor, there is a line of cases holding that, in certain circumstances, an owner of securities who is not a dealer in the conventional sense may nonetheless be subject to a tax regime typically applied to dealers. The case most frequently cited for this so-called "promoter" doctrine is *Whipple v. Commissioner*.[39] The taxpayer in *Whipple* claimed a business bad debt deduction on a loan to a corporation which he controlled, arguing that he was in the business of "organizing, promoting, managing or financing" corporations. The Tax Court found, as a factual matter, that he was not in that business, and hence denied the deduction; however, the case left open the possibility that a taxpayer could be

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[38] On the other hand, some practitioners have noted that the IRS stipulated that the foreign corporation made its loans *to customers,* potentially implying that it is such customer relationship that distinguishes the foreign corporation from a traditional investor and that, as a result of the customer relationship, the activities of such foreign corporation may resemble those a dealer that is statutorily excluded from the Trading Safe Harbor. *See* "The Importance of a 'Customer Relationship' in Loan Origination," Tax Notes (2/1/10), David Shapiro and Jeff Maddrey.

The commentators also catalog a few arguments as to why loan origination may fall within an expansive interpretation of the Trading Safe Harbor, including that (i) loan origination is not specifically excluded, (ii) the term "trading," is broadly defined as "effecting transactions in stocks or securities," and (iii) the Trading Safe Harbor is designed to encourage capital investment in the United States. We also note that although the term "trading" typically evokes thoughts of financial trading, the term may also have a broader colloquial interpretation more synonomous with "trade" or "tradesman." Moreover, it is clear that even new issue loans are "securities" for purposes of the Trading Safe Harbor.

See also "Toward an Active Finance Standard for Inbound Lenders," 31 Tax Mgmt Int'l J. 131 (2002), Leblang and Rosenberg.

[39] *See* Whipple v. Comm'r., 373 U.S. 193 (1963).

in such a "promoter" business. The Supreme Court confirmed that such a possibility exists, as a legal matter, though it declined to disturb the Tax Court's factual determinations.[40]

Under *Whipple* and its progeny, a taxpayer will not be regarded as a promoter where the taxpayer's activities are limited to the protection or enhancement of the taxpayer's existing investments in business enterprises. However, where the taxpayer's activities are sufficiently extensive and continuous and where a taxpayer seeks a return other than that of a typical investor, the taxpayer may be treated as a promoter. Based on the few decided cases, the type of non-investor-like returns that a taxpayer must seek in order to be a "promoter" include (i) fees or commissions or (ii) profits derived from "quick sales" of enterprises in the ordinary course of business.[41] Regarding the type of taxpayer activity that may transform an investment or other type of business activity (e.g., trading) into a promoting business, courts have typically focused on the provision of management or promotion (marketing or finance) services or the development of enterprises as going-concerns.

The Tax Court analyzed the development of enterprises as going-concerns as a promoter activity in *Katz,*[42] finding taxpayers, who did not earn a fee or commission for their services, to be ineligible for capital gains treatment where they serially created, promoted, and sold corporations owning luncheonettes. The issue in *Katz* was the character of income from the sale of equity securities. In concluding that the taxpayer recognized ordinary income — *i.e.*, that he should be taxed as a "dealer" even though he did not sell to customers (and hence was not a dealer under the standard usually applied in the securities context) — the *Katz* court considered

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[40] *See* Whipple, 373 U.S. at 202 (favorably citing Giblin v. Comm'r., 227 F.2d 692 (5th cir. 1995)).

[41] *See* Whipple at 202-203, Farrar v. Comm'r, 55 T.C.M. (CCH) 1628; Newman v. Comm'r, 56 T.C.M. (CCH) at 1235.

[42] *See* Katz v. Comm'r., 19 TCM (CCH) 1035 (1960).

the taxpayers' purpose in acquiring the property,[43] the number and frequency of sales,[44] the period the property was held before resale,[45] the scope of the taxpayer's activity with respect to the development and sale of the corporations,[46] and the type of return that the taxpayer expected.[47]

The Tax Court analyzed the provision of management and promotion services in a number of other cases following *Whipple*.[48] For example, in *Farrar*, the Tax Court found that the replacement of existing management with management supplied by the taxpayer and the associated expansion of product lines and service areas, along with the provision of necessary financing, was sufficient to warrant treating the taxpayer as a promoter. Similarly, in *Newman*, the Tax Court found a taxpayer that spent between 30 and 50 percent of his time over a period of fifteen years promoting, organizing, and financing various retail ventures was engaged in business as a promoter.[49] Moreover, based on this line of cases, it is clear that a taxpayer may be considered engaged in a trade or business on account of its promotional activities even if it does

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[43] The court found particular significance in the fact that the taxpayer sold most of the corporations before commencing any operations and that he did not organize any of them with sufficient capital to make operations possible.

[44] The taxpayers created and sold eight luncheonette-owning corporations.

[45] The court found that the taxpayer held the corporations for an average of 9.9 months before sale.

[46] The taxpayer's activity with respect to the development and sale of corporations holding luncheonette sites included the investigation of locations, the negotiation of leases on locations found to be favorable, the appraisal of plans drawn by the fixture company for each store, and the negotiation of the sale of the stock of the eight corporations.

[47] The Tax Court wrote "[The taxpayer had] the expectation of selling it at a profit, not because of a rise in value during the interval of time between organization and sale, but because [he] had hopes of finding a market of buyers who would purchase the stock from them in excess of their cost. The excess which the associates expected to receive over their cost was remuneration for their services not as retailers, wholesalers, or middlemen, but rather as promoters and creators of luncheonette businesses." *See Katz* at 60-1162. Note also that the Tax Court did not find it necessary to discuss the theory that the taxpayer's eight corporations were "collapsible corporations" within the meaning of section 117(m) of the Internal Revenue Code of 1939, instead relying on its finding that the stock of such corporations was not capital in nature.

[48] *See* Farrar v. Comm'r., TC Memo 1988-385 (1988); Newman v. Comm'r, TC Memo 1989-63 (1989); Bell v Comm'r., 200 F.3d 545 (8th Cir. 2000); Chamberlin v. Comm'r., 88 AFTR 2d 2001-5151 (2001).

[49] For a more in-depth discussion of the promoter cases, see David R. Sicular & Emma Q. Sobol, "Selected Current Effectively Connected Income Issues for Investment Funds," 56 TAX LAW. 719 (2003).

not earn any fees or commissions for such services as long as it has the "immediate purpose" of selling the enterprises at a profit (*i.e.*, so-called "quick sales").

For example, in *Farrar*,[50] the taxpayer owned thirty-one banks and insurance companies for periods ranging from less than 1 year to 14 years, sixteen of which were held for 5 years or less. The Tax Court thought significant the fact that the businesses held longest by the taxpayer were the ones that were unprofitable and, thus, unmarketable, writing that this fact "belies any suggestion that petitioner retained profitable ventures for the long-term appreciation or dividends that an investor seeks." In *Newman*,[51] another case where the Tax Court found an intention to profit from quick sales, the taxpayer sold his interest in various ventures within 18 months of becoming involved in and undertaking considerable efforts to improve such ventures.[52]

Whipple has been cited, in a case interpreting "trade or business" under Section 864, for the proposition that the term as used in this Section should be interpreted consistently with notions of what is a "business" under the tax law generally.[53] Although this case, *DeKrause,* did not directly address the issue, it suggests that the activity of "promoting" companies may, for purposes of Section 864, be considered another classification (in addition to investing, trading, and dealing) of taxpayer activity with respect to transactions in stock and securities. Thus, it is possible, though untested, that promoting, like loan origination or other financing activities that courts have clearly distinguished from investing or trading activities, is not within the scope of

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[50] *See* note 48, *supra*.

[51] *See* note 48, *supra*.

[52] Note, the taxpayer in *Newman* also initially arranged to receive commissions from his joint-venturer for his promotion activities (though it appears that such commissions were paid sporadically at best).

[53] *See* DeKrause v. Comm'r, 33 T.C.M. 1362 (1974).

the safe harbor for trading activities, and hence may rise to the level of a U.S. trade or business if such activities are sufficiently extensive and continuous.[54]

B. Possible Broad Applications of the Doctrine

Once one accepts the notion ─ which seems unavoidable ─ that merely avoiding dealer status is not itself sufficient to assure availability of the Trading Safe Harbor with respect to all transactions in stock and securities, the question arises as to just what categories of non-dealer activities can rise to the level of a trade or business. In this connection, a common theme flowing through many activities which are considered to be "business-like" is the expectation of profit not derived from a fixed return on capital or from changes in overall market conditions (as is the case for an investor) nor from clever (or lucky) choices as to what and when to buy or sell particular securities (as is the case for a trader), but rather from expected enhancements in the value of securities due to the taxpayer's own efforts.[55] Thus, for example, a real estate developer creates value by building or subdividing, and hence has ordinary income on sale of the property even if he does not sell to "customers" (and hence would not be technically considered a "dealer" under the standard applicable to securities).

If this theory were to be interpreted broadly so as to deny the Trading Safe Harbor in situations where the profit expectation is based on value added by the taxpayer (even beyond dealers, lenders, and promoters), a number of different types of transactions could be implicated. Possibilities include:

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[54] Note 38, *supra*. for a summary of arguments as to why loan origination may fall within an expansive interpretation of the Trading Safe Harbor.

[55] This would include the efforts of persons hired by the taxpayer (including independent contractors), just as a real estate developer can be treated as a dealer based on construction work even if he hires carpenters and never personally picks up a hammer. *See, e.g,* General Legal Advice Memorandum 2009-010, *supra,* note 37.

- A taxpayer who acquires a portfolio of non-performing loan securities with a plan to enhance the value of those securities through a massive collection effort in the United States employing hundreds of agents;
- A taxpayer who acquires a portfolio of non-performing loans with a plan to enhance their value by negotiating a restructuring of the issuing corporations' capital;
- A taxpayer who acquires a position in a company with the intention of taking an active position in management so as to enhance its value and selling (or having the company borrow and distribute proceeds) relatively quickly.

These and other possibilities are explored further in the examples in Part III.

Such an application of the existing law would create significant uncertainty regarding the tax consequences of certain relatively traditional investment fund strategies involving stock and securities, including strategies based on value created as a result of the investor's involvement in the restructuring or workout process with respect to a company or individual borrowers, the direct or indirect provision of services to a company by a shareholder or securities holder, serial venture capital, incubation and other private equity strategies involving relatively near term exit opportunities for the investor (including, in the private equity context, through the distribution of proceeds from a leveraging transaction soon after acquisition) where the investor provides operational and other support beyond that of a typical investor. Although such an interpretation would, in many situations, represent a significant expansion of current law, we have seen these issues raised by other practitioners and have come across certain fact patterns that could present some degree of tax risk in the event the existing law were interpreted broadly. In fact, the potential application of these doctrines in the context of restructuring and collections activities

recently prompted the Managed Funds Association to seek clarification from the IRS that such a narrow interpretation of the Trading Safe Harbor would not be applied in these contexts.[56]

We also note that if the law is applied in this way, it would not make sense (and would be poor policy) to have even a relatively insignificant amount of value added by the taxpayer's own efforts "taint" an activity which would otherwise constitutive investment activity or fall within the Trading Safe Harbor. Thus, the promoter and similar doctrines should apply, if at all, in the securities context only where the predominant character of an activity entails value added as a result of the taxpayer's efforts.[57]

III. EXAMPLES

The following examples illustrate several practical contexts in which the issues discussed above are likely to arise.

Example (1): Distressed Debt Fund (Workouts): Distressed Debt Fund, an offshore corporation managed by a U.S.-based investment manager, purchases distressed debt in secondary markets at deep discounts from face value. The U.S. manager of Distressed Debt Fund employees individuals to oversee bankruptcy and restructuring proceedings involving the issues of the debt. The express strategy of the Fund is to enhance value the Fund's securities positions through the fund's significant expected role in the workout process.

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[56] *See* Letter to the Commissioner of the IRS from the Managed Funds Association, 2008 TNT 75-33 (April 9, 2009). We note that it might be argues that restructuring and collections activities should be considered *investing* activities, with the result that a foreign person involved in such activities may not need to rely on the Trading Safe Harbor ─ an argument which the Managed Funds Association did not make in its Letter to the Commissioner. On the other hand, domestic taxpayers involved in such activities would likely seek trade or business deductions for the associated expenses, a position which is consistent with being a trader but not with being an investor. As noted above (*see* text accompanying Note 7, *supra*), the case law generally has applied the same standards for distinguishing between business and non-business activity in domestic context and in the international context.

[57] Adopting such a threshold for the amount of promoting activity necessary to render a foreign person engaged in a trade of business also would help minimize the disturbance to investment funds, especially private equity funds, that any such expansion of the law could cause, since most investment funds, including most private equity funds, do not predominantly engage in promoter type activities.

Several commentators have discussed the potential applicability of the *Whipple* promoter doctrine to investors such as Distressed Debt Fund.[58] One commentator recently noted that there are "superficial similarities" between the activities of distressed debt investors whose strategy is based on participation in significant restructuring activities and type of promoter activities described in *Whipple*.[59] The similarity arises because, like a promoter, a distressed debt fund may devote significant energies to participating in the affairs of issuers of their debt securities. The commentator noted a distinction, in his view fundamental, between these funds and W*hipple* promoters, namely, that distressed debt funds do not participate in the affairs of any underlying businesses but rather just participate in the restructuring of the securities of such business. According to this commentator, this "selfish" aspect of Distressed Debt Fund's work may strain the analogy to the *Whipple* line of cases since taxpayers in those cases typically engage in activities that benefit the businesses underlying their investments.

Nonetheless, the activities of such a fund do go beyond those of a traditional debt investor in one fundamental respect: the expectation of the Distressed Debt Fund is that it will have to *do* something in order to earn a profit.[60] On the other hand, the expectation of a "traditional" investor or trader is that once it has made a decision to buy a particular security, all it will have to do to earn a profit is sit back and watch the money come in and, ultimately, decide

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[58] *See* David R. Sicular & Emma Q. Sobol, *Selected Current Effectively Connected Income Issues for Investment Funds*, 56 TAX LAW. 719 (2003) *and* Peter A. Furci, *U.S. Trade or Business Implications of Distressed Debt Investing*, Tax Review Paper No. 264 (2009).

[59] *See* Furci*, supra,* note 58.

[60] The fact that an agent of the Distressed Debt Fund (i.e., the manager) will actually do things on its behalf does not appear to change this analysis. *See* Rev. Rul. 80-225, 1980-2 CB 318; Lewenhaupt v. Comm'r., 20 TC 151, 163 (1953) , aff'd per curiam, 221 F2d 227 (9th Cir. 1955). *See also* General Legal Advice Memorandum 2009-010, *supra,* note 37.

when it is time to sell.[61] It is possible to interpret “trading” so as to exclude the activities of the Distressed Debt Fund on this basis.[62]

Example (2): Distressed Debt Fund (Collections): Distressed Debt Collection Fund, an offshore corporation managed by a U.S.-based investment manager, purchases non-performing debt of individuals and businesses at deep discounts from face value. Unlike the Distressed Debt Fund in Example (1), which acquires debt with the intention of participating in a restructuring of the issuing company, the expectation of Distressed Debt Collection Fund is that it will earn its profit by engaging in collection activities (for example, sending letters or making phone calls to the debtors and threatening legal action).[63]

It would seem that Distressed Debt Collection Fund should be even less likely to be engaged in a U.S. trade business than the Distressed Debt Fund in Example (1). Its intended activity — acquiring debt securities and enforcing its rights thereunder — seems more like that of a traditional debt investor and less like a promoter than a Fund which intends, at the time it acquires a debt instrument, to become involved in restructuring the finances and operations of the issuer.

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[61] Of course, any holder of debt faces the possibility that he will have to take some action in the event of a default. However, the distinguishing features of the types of funds described in Examples (1) and (2) is that they acquire their positions with the specific intent of profiting from negotiating a restructuring (in the case of Example (1)) or engaging in collections activity (in the case of Example (2)).

[62] This is why the Managed Funds Association recently sought clarification from the IRS that such a narrow interpretation of the Trading Safe Harbor would not be applied to restructuring and collections activities. *See* note 36, *supra.*

[63] To be sure, this distinction is sometimes less than clear-cut. In both cases, the intention is ultimately to collect as much as possible, and even the collection-oriented Fund may have to settle a claim for less than face or agree to longer payment terms. Perhaps a useful way to characterize the distinction between the two types of funds is that the collection-oriented Fund’s primary emphasis is to try to collect a debt in accordance with its terms (although it may agree to change those terms if necessary). On the other hand, the workout-oriented Fund acquires debt in the expectation of being a participant in a more general restructuring of the issuing company’s capitalization (which may involve renegotiating the terms of other classes of debt and equity as well); the hope is that the value of the particular debt security owned by the Fund will be indirectly enhanced as a result of an improvement in the issuer’s overall financial strength.

Nonetheless, the source of the expected profit is something that the Fund (or persons it hires to act on its behalf) *does* (namely, collection activities) rather than just clipping coupons or waiting for market conditions to be favorable to sell.[64] A broad reading of the "promoter" concept (or, put another way, a narrow reading of "trader") could result in distressed Debt Collection Fund falling outside the Trading Safe Harbor.[65]

Example (3): Energy Fund: Energy Fund, an offshore corporation managed by a U.S.-based investment manager, regularly buys and sells certain types of environmental credits for its own account. Such credits are commodities that are traded on organized commodity exchanges. Energy Fund purchases bulk credits and typically sells them in smaller units, profiting from discrepancies in the prices of the different sized lots. In particular, they might sell credits in smaller lots that are more marketable, which may fetch a higher market price than standardized bulk units, to a purchaser who has an atypical need for credits.[66]

Energy Fund generally uses a broker to facilitate its transactions and source its bulk purchases of environmental credits from sellers who may or may not be considered customers of the fund. All sales of such credits by the Energy fund occur on established exchanges or otherwise to buyers that, based on traditional standards, would probably not be considered customers of the Energy Fund.

Energy Fund will not be a *dealer* in such credits for purposes of the commodities Trading Safe Harbor because the fund does not sell to customers and thus it may be possible for the fund

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[64] Most domestic taxpayers engaged in this type of activity would probably claim their operating expenses as Section 162 trade or business deductions.

[65] This is why the Managed Funds Association recently sought clarification from the IRS that such a narrow interpretation of the Trading Safe Harbor would not be applied to restructuring and collections activities. *See* note 36, *supra.*

[66] We note that this example, in particular, poses a purely hypothetical fact pattern for purposes of discussing legal issues which may be relevant in other contexts. No implication is intended as to the extent to which this fact pattern is consistent with real-world market conditions.

to qualify for the trading safe harbor.[67] However, the activities of the Energy Fund bear some similarities to those typically conducted by real estate developers, which in the real estate context, do cause developers to be treated as dealers (under the broader concept of a dealer, which does not require "customers," applicable outside the control of securities). Could the IRS successfully assert that the activity fails to qualify for the Trading Safe Harbor because the primary driver of profitability derives from what is, in effect, the "subdivision" of the bulk credit rather than speculative changes in the market price for the credit?

Embedded within this question are at least two issues. First, subdividing real estate entails more than first buying a large parcel and selling smaller pieces of it — typically, a fair amount of legal work is needed to divide the large parcel into the smaller lots which can be separately sold. On the other hand, subdivision of credits also bears similarities to the activities of an arbitrageur, who identifies and takes advantage of pricing differences that exist, but does not actually do anything to alter the relevant security to bring about those price differences. The issue is therefore raised as to whether the IRS could successfully argue that the Energy Fund's activities should be viewed as going beyond trading on the theory that, like the real estate developer, value is added by selling credits in more marketable lots.

Even if "re-sizing" is treated in this way, the issue is further complicated by the fact that Energy Fund may profit both from such "re-sizing" and from its clever choices as to what and when to buy or sell a particular environmental credit (*i.e.*, speculative changes in the market price for the credits), with the result that Energy Fund may not neatly fit within the "subdivision"

[67] See Section 864(b)(2)(B)(iii) and Rev. Proc. 2007-7 (the IRS will not ordinarily rule on whether item is "commodity" or whether commodity is of kind customarily dealt in on organized commodity exchange or whether transaction is of kind customarily consummated at such place).

construct. After all, an intent to earn a profit from correctly predicting changes in market conditions is the hallmark of an investor or a trader.

Ultimately, the inquiry may be very fact-specific, looking to the relative importance of the two components of profitability in the context of the particular taxpayer's activities.

Example (4): Private Equity Fund With Activist Flip Strategy: Private Equity Fund, an offshore corporation managed by a U.S.-based investment manager, purchases significant positions in operating companies for its own account. By virtue of its substantial equity stake in such companies, Private Equity Fund often exercises a great degree of control over the affairs of its portfolio companies, often replacing board members with its own representatives. Private Equity Fund employs a staff of individuals based in the United States to help manage its extensive portfolio of companies. Some of these employees provide direct operational assistance and advice to portfolio company officers and employees, and others work extensively with company management to optimize the capital structure of the portfolio companies. Private Equity Fund generally acquires a particular position with the intention of disposing of it (either by private sale or by an IPO) at a significant profit as soon as possible, but in the expectation that, in most cases, a period of at least several years will pass before such a disposition is economically feasible and sufficiently profitable.

Most Private Equity Funds take the position that they are not engaged in a trade or business even though, by virtue of the activist role they takes in the affairs of their portfolio companies, they are significantly more active than a typical investor.[68] The case law is clear that investment activity is not transformed into trade or business activity just because it is extensive

[68] Note that the risk of being engaged in a trade or business is likely to be greater if the Fund receives fees for services provided to the portfolio companies.

and continuous.[69] On the other hand, extensive and continuous *promotional* activity may rise to the level of a trade or business, and some practitioners have expressed concern as to whether activities like those performed by Private Equity Fund could be promotional in nature. The answer may be highly fact-specific. If the primary driver of returns of the Private Equity Fund strategy is the economic success of the acquired enterprise rather than the efforts of the Private Equity Fund or its agents, it would seem that the activity is more akin to investment of trading. However, there are certain funds that may employ an investing strategy that is more dependent on the post-acquisition efforts of the fund and its agents (including employment of specialized restructuring, or other similar expertise of the fund manager in creating relatively quick turn around opportunities) rather than the fundamental skill of the fund manager in identifying favorably priced investment opportunities that benefit more generally on a longer term basis from the association of the acquired company with the fund. These situations may raise greater concerns.

As discussed above, the promoter concept is rooted in the *Whipple* line of cases (and, in certain contexts, in the *Katz* case).[70] Under W*hipple*¸ a taxpayer engaged in business as a promoter generally must seek a return other than that of a typical investor. The two types of non-investor-like returns that a promoter must seek include (i) fees or commissions or (ii) profits derived from "quick sales" of enterprises in the ordinary course of business. Private Equity Fund does not typically earn fees or commissions for the service it provides to its portfolio companies in turning them around.[71] Certain funds may benefit indirectly under an arrangement in which

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[69] *Note* 8, *supra*, and accompanying text.

[70] *See* text accompanying Notes 42-47, *supra.*

[71] If a fund provides services to a portfolio company in which it owns a controlling position and does *not* get paid an arm's length fee for these services, there may be an issue as to whether such a fee could be imputed under Section 482. However, in the typical case, it is generally believed that the fund should not really be treated as providing

the management company provides services (for which it is paid a fee) directly to portfolio companies; under the contract between the management company and the fund, any such fees received by the management company may reduce the management fee otherwise payable to the fund. However, this indirect participation in fees or commissions arising from services to be provided to portfolio companies is typically a very small amount of the expected return connected to the investment in the portfolio company and is clearly ancillary to the return expected from the ultimate sale of the investment.

Even if the fund is not in a fee-generating business, could such a fund be considered to earn profits from quick sales of portfolio companies? The case law does not provide any bright-line rules regarding what constitutes return from quick sale where substantial investor assistance is provided, and there is no Safe Harbor holding period that, once achieved, would innoculate a taxpayer against the "promoter threat." Indeed, there are examples where courts have found taxpayers with substantial holding periods (e.g., sufficient to, say, qualify for long-term capital gains treatment) to be in the promotion trade or business.[72] The *Farrar* case is particularly instructive as the Tax Court found the taxpayer to have an intention to profit from quick sales, notwithstanding the significant length of his actual holding period. In *Farrar*, the Tax Court noted the fact that the businesses held longest by the taxpayer were the ones that were unprofitable and, thus, unmarketable, writing that this fact "belies any suggestion that petitioner retained profitable ventures for the long-term appreciation or dividends that an investor seeks."

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services to the portfolio company; instead, it should be viewed as seeking to enhance the value of its own investment by assisting management in improving the financial position of the portfolio company; while such improvement is an integral component of the strategy, the fund's primary motivation is not to help the portfolio company but to enhance the value of the securities that it owns.

[72] *See* text accompanying Notes 50-52, *supra.*

To the extent that Private Equity Fund can distinguish itself from *Farrar* (by showing that it intends to hold its profitable business) or can otherwise show that it does not purchase business with an intent to flip them after enhancing their value through special assistance, it may have a stronger argument than by just relying on the length of its holding period.

A variant on this is where the Private Equity Fund employs a strategy of quickly leveraging acquired companies and causing such companies to return both capital and profits to the fund in the form of distributions of the borrowing proceeds. Such quick leverage transactions could theoretically be likened to quick sales of investments,[73] and raise the same issues.

Example (5): IP Fund. IP Fund, an offshore corporation managed by a U.S.-based investment manager, purchases rights to intellectual property through U.S. corporate holding companies. IP Fund causes the offshore holding companies to engage various affiliated and unaffiliated entities to help develop their intellectual property (e.g., by pursuing regulatory approvals or engaging in research and development activities). IP Fund plans to liquidate its portfolio through private sales after a number of years (but before IP is commercially exploited through royalty arrangements or otherwise) through the sale of its various holding companies. Such sales are organized through an office of the fund or its management company in the United States.

Property development activities will not in their own right cause the fund or its IP holding companies to receive taxable income in the United States since development is not itself an income generating business activity. However, income of the IP Fund from the sale of its IP holding companies would need to be analyzed to see if such income is connected to a U.S. trade or business. Conventional wisdom would be that the IP Fund is not engaged in a trade or

[73] Note that for tax purposes, a distribution in excess of "earnings and profits" is treated essentially as though it were a sale of the stock. *See* Section 301(c).

business in the United States, based on the theory that the Fund is a passive investor in the shares of the IP holding companies and/or the fund should be eligible for the Securities Trading Safe Harbor. Nevertheless, elements of the promoter doctrine, including the principles elucidated in *Katz*, could potentially be applicable. The law is unclear but, as discussed above, it is possible that the serial sales of companies engaged in development activity may indicate that the IP Fund's activities go beyond passive investment activity or trading even though the strategy involves the sale of securities held for a significant period. The key issue is the serial nature of the development activity (and the fact that the holding companies are established with a view to ultimate sale of company shares before the commencement of the operation of the company) and the overall role of the IP Fund in organizing the IP holding companies with a view to serial sale.[74]

IV. CONCLUSION.

Traditionally, it has been assumed that most foreign taxpayers engaged in securities transactions are not subject to net-basis U.S. taxation unless they fall within the narrow category of dealers (or possibly lenders). However, certain non-traditional investment strategies involving a significant enhancement in value of securities positions by a foreign person carry certain risks not present with respect to more traditional trading and investment strategies. In particular, there may be a class of taxpayer activity with respect to securities that exists outside of the traditional investor, trader, dealer spectrum. Taxpayers whose activities fall within that category may face possible attacks on their reliance on the Trading Safe Harbor. While such attacks would require an extension of existing law, there are fact patterns under which these issues may present themselves.

[74] There would not likely be any U.S. trade or business issue if each IP Holding company were acquired with all relevant development contracts already in place or if the strategy were to sell the entire fund in a single transaction.