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TOWARD AN ACTIVE FINANCE STANDARD FOR INBOUND LENDERS

by

Stuart E. Leblang , Akin, Gump, Strauss, Hauer & Feld, L.L.P.
and Rebecca Rosenberg, Caplin & Drysdale

This article examines the distinction in U.S. federal tax law between "active" lending activities (of non-bank foreign persons) that constitute the conduct of a lending or finance business and "passive" lending activities (of nonbank foreign persons) that do not constitute a trade or business.[i] The distinction, which is unclear and difficult to apply, is an important component of the overall U.S. tax regime applicable to foreign persons that direct all or a portion of their global financial dealings from the United States. The article considers the application of the distinction in light of recent trends in global finance and argues (based on important U.S. tax policy considerations) that significant modification and clarification of the distinction are warranted.[ii]

Background And Summary

Although the United States is generally perceived as a moderate or high tax jurisdiction, it actually functions as a tax haven of sorts in respect to certain important financial activities of foreign persons .[iii] In particular, U.S. tax rules that exist in part by design and in part as a result of the historic development of basic U.S. tax principles generally permit foreign persons to conduct their global financial management activities (directly or through agents) from U.S. soil at little or no U.S. tax cost.[iv] These activities include private and capital markets investing, as well as stocks, securities, and commodities trading.[v] As a result of these favorable rules (certain of which are unique among developed nations), the United States is a preferred locale for financial management activities of sophisticated global investors such as foreign investment funds (including so-called foreign hedge funds that cater to high net worth foreign individuals and foreign institutions), large foreign pension funds, and global financial institutions.[vi]

The U.S. tax rules governing financial management activities of foreign persons are, in part, specifically designed to encourage foreign investment in U.S. financial markets and the growth of the U.S. money management industry.[vii] The rules implicitly assume that global financial investment and money management activities are relatively mobile functions that can be shifted easily among jurisdictions, and that incentives encouraging the conduct of such activities in the United States ultimately favor development of U.S. capital markets and the flow of foreign financial investment into the United States. Similar assumptions regarding the relative mobility of financial activities underlie the economic policy goals implemented in other U.S. international tax rules.[viii] The outbound rules, in particular, generally restrict deferral and U.S. foreign tax credit benefits for income arising from foreign financial management activities (such as passive debt and equity investing and securities and commodities trading) of U.S. persons based on concerns that the relative mobility of such activities could lead to an erosion of the U.S. income tax base.[ix]

Because the favorable rules governing the taxation of U.S. financial management activities of foreign persons are a product of U.S. internal law rather than U.S. tax treaties, foreign persons that reside in jurisdictions that do not have a currently effective tax treaty with the United States (including tax haven jurisdictions) are also entitled to the benefits of these rules. Accordingly, beneficiaries of these rules include investors that are subject to low or zero tax in other jurisdictions, and the rules therefore encourage, to a certain degree, global nontaxation of income such as investment and securities trading income arising from financial management activities. This result may itself raise concerns related to an increased focus by governments on tax competition and cross-border tax arbitrage.[x]

Although the U.S. tax rules seem to have achieved their intended effects of promoting foreign investment in the United States and fostering the growth of the U.S. financial management industry, the rules contain an important weakness relating to the distinction between passive lending activities of foreign persons and lending activities of foreign persons that are conducted as part of a lending, financing or similar business. For these purposes, lending activities refer to activities associated with the negotiation and origination of loans (including participations in loan syndications) but do not include activities related to the acquisition of loans or debt securities from an original lender or subsequent loan purchaser, or in the capital markets.[xi] Income from lending activities includes interest and gains as well as other related income such as loan commitment fees, guarantee fees, and income from finance leases. While gains and interest of nonresident foreigners associated with passive lending activities are effectively exempt from U.S. taxation, income associated with the conduct of an active lending, finance, or similar business generally *is* subject to U.S. net income taxation.[xii]

The distinction between passive lending and the conduct of a lending business requires application of the general common law distinction between passive investment activities and activities that represent the conduct of a trade or business. In the context of lending activities engaged in by foreign persons in the United States, however, this generally applicable distinction raises especially difficult issues.[xiii] Under current law, the distinction is rather unclear and thus has the potential to create both significant tax uncertainty and irrational tax results for foreign persons that enter into lending transactions in the United States.[xiv] General shifts in global finance, including recent financial market trends emphasizing the importance of private cross-border financing transactions, have increased the potential for negative and inappropriate tax consequences.[xv] Ultimately, the risk of such tax consequences could lead foreign persons to avoid the conduct of lending-related and other financial activities in the United States, thereby possibly undermining an important policy goal of encouraging the conduct of financial management activities in the United States. Of course, this policy goal must be weighed against other important considerations including general fairness principles and the importance of preventing foreign persons operating in the United States from achieving an unfair competitive advantage (based on preferential tax status) over U.S.-owned businesses that operate in the United States.[xvi]

The general distinction in U.S. tax law between passive investment and the conduct of a trade or business can be viewed as a subcategory of an even broader set of distinctions between various types of active and passive activities which permeate the Internal Revenue Code. As demonstrated in the next part of this article, these passive/active distinctions are typically employed as mechanisms to limit specific tax preferences granted under the Code and thus to preserve the U.S. tax base. In the international context generally, and in the outbound lending context in particular, these active/passive distinctions have evolved to reflect to a significant degree issues relating to the relative mobility of financial activities.

In particular, there seems to be significant precedent in other contexts for rules that make it more difficult to characterize lending activities as "active" (rather than "passive"), including provisions that use the concept of an "active conduct of a finance or similar business" (often referred to as an "active finance" standard) in contrast to the lesser "trade or business standard" discussed above. An "active finance" standard is incorporated into a variety of Code sections, including rules governing the definition of effectively connected income of foreign persons,[xvii] the definition in §542 of personal holding company income of U.S. persons, and the definition in §904(d) of financial services income under the foreign tax credit rules. Most recently, an "active finance" standard has been reincorporated into rules governing the definition of subpart F income. The active finance standard contained in §954(h) of subpart F, like several other active finance standards in the Code and regulations, provides detailed and relatively demanding requirements for treating finance income as "active."

This article aims to support the notion that the tax principles traditionally applied to make this distinction between "passive" lending activities and conduct of a U.S. lending business by a foreign person are inadequate in that they are difficult to apply and do not adequately reflect important considerations relating to the relative "mobility" of financial activities and capital that have been broadly incorporated into other international tax rules. The article also seeks to illustrate that the traditional principles governing the distinction are in certain cases incapable of creating sufficiently clear and rational distinctions between passive lending and the conduct of a finance business. Any remedy for these shortcomings in the current rules would need to balance issues relating to nexus and fair competition with the policy goal of encouraging the conduct of financial management activities in the United States. Ideally, any remedy would be designed to treat as passive the finance or lending activities of a foreign person that are not connected with a true financial intermediation business (*i.e.*, a business conducted to earn a fee or a "spread" between income from loans and the lender's own borrowing or funding costs).[xviii]

One solution might be to incorporate in this trade or business test a heightened and more detailed "active finance" standard, such as the standards that exist elsewhere in the Code and regulations. Alternatively, the test could be clarified to emphasize the type of income earned by the taxpayer, for example whether the taxpayer profits primarily from fees or fee-type income (including income from spread lending) or, alternatively, from interest earned on capital investment. However, these solutions might not provide sufficient clarification or relief given the growth of private financing transactions and the overall importance of encouraging the conduct of financial management activities in the United States. Accordingly, the article also considers the possible development of a trade or business safe harbor for U.S. lending activities conducted by foreign persons that are not regulated financial entities (or affiliates of such entities), where the lending activities are entirely unrelated to the conduct by the foreign person (or a related party) of a consumer finance business (relating to the financing of the purchase of consumer goods).

The next part of this article discusses the current law distinction between passive lending and the conduct of a lending or finance business in light of other types of trade or business distinctions in the Code, including other types of distinctions involving lending activities. The article then describes certain business and economic developments that may be relevant for purposes of interpreting, or recommending revisions to, the current rules. The next part sets forth a series of examples designed to illustrate that the current rules may be underdeveloped in light of current conditions. Lastly, the article considers several alternative approaches for modernizing the current rules.

Current Law Standards Regarding The Conduct Of A Lending Or Finance Business

Overview

With a few regulatory exceptions, the U.S. tax law's trade or business concept is based on a facts and circumstances test, and thus can be difficult to predict and to apply.[xix] As a result, it is often difficult to ascertain the level of U.S. activity of a foreign person that will give rise to a trade or business in the United States and thus subject income connected with such activities to the U.S. net income tax system. Of course, all U.S. activities of foreign persons, including service, rental, sales, financial, and manufacturing activities, must be analyzed to determine whether such activities give rise to a trade or business. However, the trade or business threshold arguably is most difficult to apply in connection with the conduct by a foreign person in the United States of unregulated financial activities, including lending and financial trading activities. The difficulty in distinguishing between financial activities that are undertaken solely for investment and those undertaken as part of a trade or business can be attributed to the fact that all lending and finance activities have some passive characteristics.

The enactment by Congress in 1966 of the stock, securities, and commodities trading safe harbors essentially eliminated the need to conduct a trade or business analysis with respect to most types of financial trading activities of foreign persons (*i.e.*, activities involving the purchase and sale of financial assets by nondealers) in the United States, including the trading of loans or other debt securities in the United States. Prior to the enactment of these safe harbors, considerable uncertainty existed regarding the distinction between nontaxable investment activities and taxable financial trading activities.[xx] As of yet, no equivalent safe harbor or other interpretive assistance has emerged to alleviate the difficulties associated with ascertaining the distinction between loan originations (and other direct lending activities) that represent passive investment activities and those that represent the conduct of a lending or finance business.

As stated above, the trading safe harbors and other U.S. tax provisions (including the portfolio interest rules and certain aspects of the effectively connected income rules) were enacted to encourage the conduct by foreign persons of financial management activities in the United States and the flow of capital to the United States. In enacting these rules, Congress specifically recognized that both investment and trading activities tend to be mobile, and therefore that U.S. taxation of these activities could induce foreign persons to conduct such activities outside the United States and reduce U.S. access to capital.[xxi]

This section analyzes the current law definition of a U.S. finance or lending business, and considers whether it might be appropriate, based on capital mobility and other concerns, to clarify (or to raise) the threshold level of activities that are necessary to characterize a foreign taxpayer as engaged in a U.S. finance or lending business. Of course, any thoughtful modification to the definition would necessitate consideration of countervailing concerns, including issues relating to the U.S. tax base and the extent to which any particular taxpayer-favorable change to the definition would provide foreign lenders with an unfair competitive advantage over U.S. lenders. This section also discusses the manner in which the U.S. tax law's definition of a finance or lending business relates generally to other passive/active distinctions in the Code and considers, in particular, the possibility of employing a fairly detailed, relatively taxpayer-favorable "active finance" standard to determine whether a foreign lender will be treated as engaged in a trade or business in the United States. The "active finance" standard generally denotes a higher level of activity than the straightforward "lending or finance business" concept, and has emerged in various other contexts of the Code where the relative mobility of passive investment activities and capital is of concern.

Relevant Authority

Current law fails to provide clear, predictable standards to determine whether the U.S. lending activities of a foreign person constitute a trade or business in the United States. The determination is critical because U.S. net income tax generally applies to income of a foreign person only to the extent that such income is effectively connected with the taxpayer's conduct of a U.S. trade or business.[xxii] Neither the Code nor the regulations defines the term "trade or business" for this purpose. This section attempts to ascertain the legal standards that are most likely to apply to determine when lending activities constitute a trade or business for purposes of §882 or §871. This section, therefore, examines: (i) the very limited judicial and administrative guidance that has considered the trade or business implications of cross-border loans, (ii) analogous authorities that address whether lending activities constitute a trade or business for other Code sections, (iii) authorities that have considered the circumstances in which non-lending financial activities, such as securities trading, give rise to a trade or business for purposes of §881 or §871, and (iv) finally, the authorities that address whether nonfinancial activities, such as real estate development and retail product sales, give rise to a trade or business for purposes of other Code sections.

There is very little authority, in administrative pronouncements or case law, that interprets the trade or business standard with respect to cross-border financing activities. Two revenue rulings address this issue for cross-border lending activities without shedding much light on the subject.[xxiii] The more recent ruling, Rev. Rul. 883, which revoked the earlier ruling, stated that the question of whether a foreign financing subsidiary of a U.S. parent was engaged in a U.S. trade or business was a highly factual determination that must be made by applying the rules of §864(b) and the regulations thereunder. However, neither §864(b) nor the regulations thereunder provide rules for determining when a taxpayer will be treated as engaged in a trade or business (other than in the context of certain personal services).[xxiv]

The most directly applicable court case is *Pasquel v Comr*.[xxv] Without ruling on the taxpayer's contention that his U.S. financing activity constituted a loan, the Tax Court held that one isolated financing transaction was not sufficient to establish a trade or business because a trade or business requires sustained and continuous activity. The *Pasquel* opinion seems to stand only for the principle that the number of loans a foreign person makes in the United States and the extent of its U.S. finance activities (*e.g.*, cross-border., active, sustained involvement or passive, infrequent transmittal of funds) are important factors in the trade or business determination. The case thus establishes a point of reference (one loan regarding which the foreign person shows very little activity does not create a trade or business) and two factors (number of loans and amount of activity) but does not provide an analytical framework that can be applied to divergent fact patterns (*e.g.*, to a foreign, taxpayer with four U.S.-connected loans, two of which the taxpayer actively monitors).[xxvi]

A significant number of cases have addressed whether other types of financial activities of foreign persons in the United States, such as securities trading, give rise to the level of a trade or business under prior law.[xxvii] These securities trading cases, which have much less relevance since enactment of the stocks and securities safe harbor, distinguish between traders, who use relatively rapid, short-term transactions to profit from market fluctuations, and investors, who hold securities for longer periods to benefit from increases in the underlying company's value or to generate income while protecting their principal. Whether the taxpayer is engaged in a trade or business of trading securities is determined using a facts and circumstances analysis. The cases emphasize such factors as the length of the taxpayer's holding periods, the frequency, regularity, and extent of the taxpayer's buying and selling activity, and the taxpayer's intent to profit from short-term turnover of securities.

These cases are loosely related to lending fact patterns, in that the cases involve the conduct by foreign persons of financial management activities in the United States,[xxviii] but their usefulness is limited due to the fact that trading and lending activities are quite different. The securities trading cases do, however, establish that the trade or business determination will not turn solely on the amount of the foreign persons' activities in the United States, and that the type and quality of the activity conducted ultimately will be determinative.[xxix]

A number of other court cases have addressed the U.S. trade or business issue in the context of foreign persons engaged in U.S. real property, wholesale, trading, and service activities.[xxx] These cases, which generally establish that a trade or business involves continuous and regular activities, provide relatively little guidance regarding the application of the trade or business definition to inbound financing or lending activities because such activities are so different (and have so many more inherently passive characteristics) than the activities examined in the court cases.

In addition, the generic concept of a "trade or business" is used in more than 200 Code sections, and there have been a significant number of cases outside the inbound finance or lending context that specifically address whether lending or finance activities constitute a trade or business. While these cases are clearly useful in establishing factors the courts are likely to consider in analyzing the definition of a lending or finance business in the inbound finance context, standards from §166 and other Code sections are not necessarily applicable to §882 or §871.[xxxi] In addition, the cases reinforce the conclusion that there are no clear, predictable standards for ascertaining the existence of a lending or finance business and the legal analysis of the issue is highly fact-specific.

Many of the domestic lending trade or business cases concern application of the worthless debt deduction under § 166, which applies only to debt created or acquired (or loss incurred) in connection with a trade or business of the taxpayer. The cases clearly hold that not all profit-motivated finance and lending activities rise to the level of a trade or business.[xxxii] In reaching their conclusions, the cases rely on a series of non-determinative factors as indicia of the existence of a lending or finance business, including the following: whether the taxpayer engaged regularly and continuously in lending activities,[xxxiii] the number and amount of the loans concluded, whether the taxpayer actually collected interest, whether the loans were made to support equity investments or (instead) in anticipation of earning interest, whether the taxpayer represented itself to the public as engaged in a trade or business of lending,[xxxiv] whether the taxpayer had a reputation in the community as a lender, whether the taxpayer engaged in transactions with unrelated parties, whether the taxpayer advertised its services as a lender, and whether the taxpayer behaved in a businesslike manner (*e.g.*, using written, signed loan agreements, maintaining a business office for conducting lending activities, and keeping records of its transactions).[xxxv]

Other bad debt cases address the related question of whether debt is proximately connected to a trade or business other than lending money, because a worthless debt from any trade or business is eligible for deduction under §166.[xxxvi] With respect to this issue, the Supreme Court has established a "dominant motive" test to distinguish between loans concluded in connection with the taxpayer's business and loans that are investments.[xxxvii] This test looks specifically to the subjective motive of the taxpayer in making the loan, and draws a clear distinction between loans advanced to earn interest or otherwise further the taxpayer's trade or business and loans advanced to achieve other, non-business purposes (*e.g.*, to protect an equity investment).[xxxviii]

The domestic bad debt cases can be very difficult to reconcile with each other, and do not provide a logical, predictable template that can be used to make the trade or business of lending determination for purposes of §882 or §871. These cases rest first on a facts and circumstances evaluation of the taxpayer's activities and, next, on an analysis of whether the loan was primarily intended to generate or protect trade or business income (interest, the taxpayer's employment, etc.) or whether it was instead intended to protect an equity interest or family relationship.[xxxix] The cases do suggest some useful, meaningful factors for evaluating whether a lender has engaged in a trade or business, such as the number of loans made by the taxpayer, whether the borrowers are related to the lender, the percentage of the taxpayer's time spent on the lending or securities activity,[xl] and whether the taxpayer holds itself out to the public as a lender. However, little meaningful guidance exists for applying those factors, especially in the cross-border lending context. For example, there is no guidance regarding the relative weight of the case law factors and which (if any) factors are determinative.

Other Code provisions that incorporate the concept of an explicit lending or finance trade or business (other than in a purely cross-border context) include §§542(d) (relating to personal holding companies) and 7704(d)(2) (relating to publicly traded partnerships). The Service interpreted §7704(d)(2)(A)'s reference to "interest . . . derived in the conduct of a financial or insurance business" in PLR 9701006.[xli] The private letter ruling concerned a partnership formed as the successor to an existing corporation. It was expected that the partnership would have two or fewer employees, would "hold mortgage loans that it originates until maturity or refinancing, except in cases of default," would "not hold loans or other assets for sale to customers in the ordinary course of business . . ., with the possible exception of the sale of foreclosure property," and would "originate on average no more than five new mortgages per year over any five-year period." Like its predecessor corporation, the partnership would be owned primarily by the pension plans of several labor unions, and the mortgages originated by the partnership would finance construction projects that employed union labor.

The Service began its analysis in the ruling with an examination of the legislative intent behind §7704's reference to interest derived in a finance business, concluding that Congress intended to distinguish between active business transactions ordinarily carried out in corporate form and passive investments.[xlii] The Service then stated that whether a publicly traded partnership is engaged in a financial business is determined by "the facts and circumstances surrounding the conduct of the entity's business." Based on all of the facts discussed above, the Service concluded that the partnership would not be engaged in a finance business.

The ruling's analysis is consistent with the bad debt cases in several ways, but it provides little guidance for determining whether a foreign taxpayer's lending activities constitute a trade or business. Like the bad debt cases, the ruling applies a facts and circumstances analysis and considers factors including the number of the taxpayer's loans (five or fewer each year) and the extent of the taxpayer's activity (two or fewer employees). The emphasis of the ruling's facts and circumstances analysis on interpreting the legislative intent of §7704 prevents the ruling from being directly applicable to a determination under §882 of whether the taxpayer is engaged in a trade or business.

Some practitioners have suggested that the ruling strongly supports the notion that five or fewer loans per year will not constitute a trade or business for purposes of §882. However, several cases regarding bad debt deductions appear to contradict this conclusion. In addition, the ruling examines all of the facts and circumstances (including the lack of resale to customers in the ordinary course of business and the very low number of employees) rather than focusing solely on the number of loans, and specifically derives its "key question," relating to the type of business ordinarily carried on by a corporation (as opposed to an individual or partnership), from the purposes of §7704. More particularly, the ruling specifically focuses on the fact (in the list of factors supporting its conclusion) that the partnership will be owned primarily by labor union pension plans and will invest in construction projects that employ union members. The ruling therefore rests at least partially, and possibly largely, on the fact that the partnership's mortgage loans are intended not only to yield interest, but to promote and protect the employment of the primary partners (which are, ultimately, the labor union membership).[xliii]

In summary, it can be quite difficult to determine whether the U.S. finance or lending activities of foreign persons rise to the level of a trade or business. There are almost no authorities directly on point. Some guidance can be found in cases involving the trade or business status of securities trading activities of foreign persons, as well as cases involving the deductibility of losses from domestic lending activities. These cases, however, tend to be fact specific. In addition, the overwhelming majority of these cases concern individual taxpayers, and therefore the cases often involve relatively simple fact patterns. Taxpayers can attempt to draw analogies to other references in the Code to the trade or business of lending, but little guidance is available under these provisions.

Application of Trade or Business Standard in Practice

The trade or business standard is especially difficult to apply in the context of finance and lending activities because these activities necessarily have some passive characteristics which complicate the distinction between investment (passive-type) finance activities and finance activities undertaken as part of a trade or business. The existing rules applicable to cross-border lending by foreign persons fail to draw on basic and logical distinctions that would provide clarity and would limit the possible broad application of the trade or business concept, including distinctions designed to identify basic elements of a traditional lending business such as whether the lender is subject to licensing or other financial regulations and whether the lender employs leverage in connection with its lending activities.[xliv] Arguably, the analysis should also focus on traditional indicia of a financial intermediation business such as the nature of the expected returns (*i.e.*, whether the lending activities give rise to fees or spread-like returns). In the absence of significant legal or administrative precedent in support of this narrow approach, practitioners are left to focus primarily on the taxpayer's general level of activity, which is also an important factor in the bad debt cases. This approach is especially difficult in lending situations because, unlike retail, manufacturing, and land management activities, the extent of activity may not differ widely for lending transacted as an investment and lending that is part of a trade or business.

Accordingly, it is very difficult to derive a useful, predictable test for determining when lending activities constitute a trade or business. As the staff of the Joint Committee on Taxation acknowledged in the foreign tax credit context, "[a]s a practical matter, it is sometimes not possible to differentiate passive investment from bona fide financial services activity."[xlv]

Similarly, the Conference Committee for the Taxpayer Relief Act of 1997 stated, in discussing the cross-border finance activities of U.S. persons, that "the line between income derived in the active conduct of such businesses and income otherwise derived by entities so engaged can be difficult to draw."[xlvi]

In making the difficult determination of whether a foreign person is engaged in passive lending or in the conduct of a finance business, practitioners tend to focus most on the degree of involvement of the foreign person (or its agent) in the lending process (*e.g.*, initiation and negotiation of loans) and whether the taxpayer engages in regular and continuous lending activity. Pursuant to the general principles governing the trade or business determination, initiation and negotiation in the United States of one isolated long-term loan generally would not be considered to constitute the conduct of a financing business. In contrast, the initiation and negotiation of a series of short-term loans with customers on a regular and continuous basis would almost certainly be regarded as the conduct of a U.S. finance business. Intermediate fact patterns are far more difficult to evaluate.

The scant authority does not provide much if any comfort to any foreign person that may, alone or as part of a broader group, make direct loans in the United States. Many practitioners believe that the threshold for trade or business characterization of lending activity is low, and often urge caution because the consequences of wrongly predicting a lack of trade or business status (net U.S. tax on net interest and net gain from lending activities) can be severe. Some advisers mandate that no loan negotiations at all take place in the United States. Others prohibit foreign persons from engaging in any loan origination activities in the United States.

Interaction Between the Trade or Business Test and the Effectively Connected Income Test Applicable to the Active Conduct of a Banking, Financing, or Similar Business

The regulations under §864 provide special rules for determining whether income and gains are effectively connected with the active conduct of a banking, financing, or similar business. These rules, provide a limited safe harbor that prevents certain types of such income and gains from being treated as effectively connected with a U.S. banking, financing, or similar business. However, the safe harbor does not eliminate the need to apply the trade or business test and is not necessarily more taxpayer-favorable than the otherwise applicable rules for determining effectively connected income. These special rules therefore do not obviate the need for a heightened trade or business standard for U.S. lending activities of foreign persons.

Under Regs. §1.8644(c)(5), U.S. source interest, dividends, and gains from stocks and securities that are capital assets, derived by a nonresident in the active conduct of a banking, financing, or similar business, will be treated as effectively connected to such activities only if the taxpayer's U.S. office actively and materially participates in activities necessary to acquire the stock or security, and the stock or security meets at least one of six other requirements.[xlvii] One of the six requirements is met if the stock or security is acquired "[a]s a result of, or in the course of making loans to the public."[xlviii]

A taxpayer is engaged in the active conduct of a banking, financing, or similar business, for purposes of the regulations, if the taxpayer is engaged in a business in the United States and the activities of that business consist of lending to the public, accepting deposits from the public, buying, selling, discounting, or negotiating evidences of indebtedness for the public on a regular basis, issuing letters of credit to and providing trust services for the public, or financing foreign exchange transactions for the public.[xlix] Whether "the taxpayer is subjected to the banking and credit laws of another country" will be taken into account, but "the character of the business actually carried on . . . in the United States" is the ultimate determinant of whether the taxpayer is engaged in the active conduct of a banking, financing, or similar business.[l]

Thus, a taxpayer must first determine that it is indeed "engaged in a business," which presumably requires recourse to the case law tests for trade or business treatment. The additional requirement that the business "consist of" the listed activities adds an emphasis on transactions with the public.[li]

Once the taxpayer is treated as engaged in the active conduct of a banking, financing, or similar business for purposes of the regulations, it is unclear whether the regulatory test for determining whether income or gain from securities is effectively connected to that business is higher than the effectively connected income tests (the asset use test and the business activities test) applicable to other types of businesses.[lii] The special rule for banking, financing, and similar businesses treats income as effectively connected only if the U.S. trade or business has a U.S. office and at least one of the six regulatory requirements is met.[liii] Interest income from the active conduct of a banking, financing, or similar business that does not meet any of the six criteria will not be treated as effectively connected to the taxpayer's banking, financing, or similar business.[liv] In addition, the special rule for such businesses requires that the U.S. office *actively* and materially participate, in contrast to the "material" factor requirement of the business activities test.[lv] The regulations do not define the term "actively." Nor is it clear how a 'U.S. trade or business could be a material factor in the production of income, within the meaning of the business activities test, without actively participating in the generation of such income, except by the mere provision of funds.

The banking, financing, and similar activities rules are, however, slightly *more* likely to treat income as effectively connected (in contrast to the business activities test) in certain circumstances. If a taxpayer's U.S. office actively originated a loan but all further activities regarding the loan were conducted by the foreign home office, the banking, financing, and similar activities test would treat the entire income stream from the loan as effectively connected income.[lvi] The business activities test arguably would treat only the fees and other income associated with the origination (rather than the resulting interest payments) as effectively connected income, unless the U.S. business's participation in the loan origination was a material factor in generating all of the subsequent income from the loan. In addition, the banking, financing, and similar activities test arguably gives less weight to the booking point of loans, compared to the business activities test.[lvii] The former rules specifically state that the booking point of loans will not be a dispositive factor.[lviii] The business activities test gives "due regard" to whether the relevant income is accounted for on the books of the U.S. trade or business, although this factor will not be dispositive.[lix] To some extent, then, the business activities test might be less likely (compared to the special rules) to treat interest income as effectively connected if the underlying loan is accounted for on the books of a foreign entity.

A foreign taxpayer is not subject to net U.S. tax on income that is not effectively connected to a U.S. trade or business, and the special effectively connected income rules for banking, financing, and similar businesses can therefore be viewed as providing a safe harbor of sorts that at least assures some taxpayers that they are not subject to net U.S. tax. However, these rules do not eliminate the need for greater clarification of the trade or business rules for lending activities. Regs. §1.8644(c)(5) does not provide clear, quantifiable standards as to what constitutes a U.S. office's active involvement in a loan origination. Nor does it define "the public." More importantly, if the taxpayer's U.S. office actively and materially participates in the acquisition of a loan and one of the six criteria are met, taxpayers still need to determine, under the case law, whether they are engaged in a business in the United States.[lx]

Clearer standards, and greater predictability for foreign persons, would result if the law were changed to remove the need to resort to case law (for example if the Code or regulations provided a more detailed safe harbor with explicit factors). Other active finance standards in the Code and regulations contain more detailed, quantifiable requirements than the current banking, financing, and "similar business rule, including explicit "predominant activity" tests.[lxi] In addition, it would be useful to develop a trade or business test, for lending activities, that explicitly considered factors such as the extent of the taxpayer's customer transactions, the amount of the taxpayer's leverage, and whether the taxpayer generally profits from spread or fee-type income rather than interest or investment type income. These factors would help distinguish between business and investment activities.

Policy Considerations Underlying Finance Business Concept and Other Active/Passive Distinctions

The current law "trade or business" standard applicable to inbound lending or financing activities almost certainly reflects traditional notions of tax jurisdiction and tax "nexus."[lxii] The final section of this article advocates modification of the trade or business standard in the inbound financing context so as to take into account additional tax policy considerations, inc1uding considerations relating to the certainty of tax results, access to foreign capital, and fair competition between foreign and domestic lenders. An approach that balances these considerations would be consistent with the development of the trade or business standard in other contexts involving the conduct of financial activities in the United States, as well as the general development of other active/passive distinctions in the Code relating to the conduct of financial activities.

The mobility of financial activities (and related financial income) has emerged as an important policy consideration in a variety of U.S. international tax rules involving the taxation of foreign persons that engage in financial activities relating to the United States. For example, a specific desire to attract relatively mobile financial activities and capital prompted enactment of the trade or business safe harbors applicable to securities and commodities trading, aspects of the effectively connected income rules, and the exemption from withholding tax for portfolio interest.[lxiii] However, the goal of attracting foreign capital and activities to the United States has generally been balanced against the need to protect the competitiveness of U.S. businesses operating in the United States. For example, recent rules relating to eligibility for tax treaty benefits, and the rule excluding from the portfolio interest exception bank loans made in the ordinary course of a banking business, were designed to prevent foreign persons from gaining an unfair competitive advantage as a result of preferential tax treatment.[lxiv]

Generally, U.S. tax rules have viewed foreign persons as more likely to obtain an unfair competitive advantage regarding active endeavors, including trade or business activities, than with respect to passive or investment activities.[lxv] This article suggests that in applying the trade or business test to lending income of foreign persons, the goal of attracting foreign capital should be weighted heavily in relation to concerns about the competitiveness of U.S. lenders. Much of such lending activity is passive in nature, and thus raises fewer competitiveness concerns. In addition, other active/passive distinctions in the Code that provide beneficial tax treatment for passive investments have been specifically designed to attract mobile foreign capital and investment activities into the United States. Lending and finance activities are particularly mobile,[lxvi] and thus present an opportunity to attract foreign investment through beneficial tax treatment.

The trade or business standard applicable to inbound finance activities is but a small aspect of a broad set of distinctions found throughout the Code between the treatment of active and passive activities. A careful review of these distinctions tends to support modification of the trade or business standard applicable to inbound finance activities to reflect policy considerations associated with the relative mobility of finance and lending activities. The active/passive distinctions found throughout the Code fall into two distinct categories. The first category ("Category 1") includes rules designed to reserve certain tax benefits for "active" endeavors. The second category ("Category 2") includes rules designed to limit certain tax benefits reserved for "passive" endeavors. Ultimately, active/passive distinctions in both categories limit the scope of various tax preferences and therefore function in a manner that preserves the U.S. tax base.

Category 1 rules ensure that certain tax benefits and preferences apply only in the context of "active" endeavors. Such rules tend to employ an active/passive distinction as a surrogate for a business purpose test.[lxvii] Rules in this category include passive/active distinctions incorporated into §469 (passive activity loss rules), §162 (business expense deduction), §165 (bad debt deduction), §355 (prerequisites for a tax-free spin-off), §367 (outbound transfers of property), and §552 (personal holding company rules). Rules in Category 2, in contrast, include rules that provide tax benefits for certain passive activities and entities, and limit the scope of active business activities that may be conducted by persons receiving the tax benefits. Rules of this type include provisions restricting the amount of active conduct, or actively derived income, of tax-advantaged entities such as regulated investment companies (RICs), real estate mortgage investment conduits (REMICs), publicly traded partnerships (PTPs), real estate investment trusts (REITs), and financial asset securitization trusts (FASITs).

Each category contains rules employing passive/active distinctions in the cross-border context. Category 1 includes rules that use passive/active distinctions to limit benefits for U.S. investors with passive, mobile investments overseas, including rules limiting deferral for foreign source income and restricting the use of foreign tax credits, as well as rules limiting the tax-free transfer of assets to foreign corporations.[lxviii] Category 2 includes rules that use passive/active distinctions to determine the taxation of foreign persons, providing more beneficial treatment for the passive investment than the active business conduct of such persons. These rules include the general "trade or business" standard for purposes of determining whether a foreign person is subject to U.S. net income taxation, the trading safe harbors, and the portfolio interest exception.

It is important to note that passive/active distinctions of the Category 1 variety tend to employ relatively high thresholds for financial-type activities to be treated as "active" rather than passive. For example, the personal holding company rules, the subpart F rules and the foreign tax credit rules incorporate special "active" business standards in relation to financially oriented activities such as securities and commodities trading, rents, royalties, and finance and lending activities. These higher standards almost certainly reflect the fact that passive/active distinctions with respect to financial activities tend to be quite difficult. It is also logical for the government to incorporate higher activity thresholds in the context of Category 1 type rules in order to limit erosion of the U.S. tax base by limiting the U.S. tax benefits conferred to truly active income.

In contrast, it seems natural that passive/active distinctions relating to financial activities in the Category 2 context would incorporate lower "activity" requirements, classifying more endeavors as active and fewer as passive investments. A higher activity threshold for active categorization would tend to degrade the U.S. tax base (because "passive" activities are tax-advantaged under Category 2). In addition, treating more endeavors as passive could allow certain tax-advantaged persons (*e.g.*, foreign persons and persons operating through domestic tax-advantaged entities such as RICs and REITs) an unfair competitive advantage against non-tax-advantaged persons.

The trade or business standard applicable to the U.S. lending activities of foreign persons is a Category 2 rule, because passive activities generally receive more beneficial tax treatment than active business conduct under the rules for net tax of income effectively connected with a U.S. trade or business, the portfolio interest deduction, and associated provisions.[lxix] Based on the above comparison of historic Category 1 and Category 2 passive/active distinctions, the use of a relatively expansive "trade or business" test with respect to inbound lenders would seem logical. However, as previously discussed, a significant countervailing policy consideration has emerged in the inbound investment context relating to the U.S. goal of attracting relatively mobile financial activities and capital into the United States. This policy (essentially the flip side of the capital mobility concerns that arise in the outbound context) has emerged in a variety of Category 2 contexts involving inbound finance activities. In particular, capital mobility considerations were an important policy rationale for the stock, securities, and commodities trading safe harbors (which effectively provide that trading activities will be treated as per se passive) and certain aspects of the effectively connected income rules.

The policy is also evident in the relatively narrow concept of a loan made in the "ordinary course" of a bank's business, which is employed to distinguish between active and passive bank lending for purposes of the portfolio interest exception. This policy consideration regarding the attraction of foreign financial resources and activities was so important that it outweighed the natural and historic inclination of Congress to define "passive" activities narrowly in Category 2 rules (presumably based on concerns regarding both the tax base and the potential for unfair competition).

Active Financing Concepts in Other Contexts

The Code and regulations already apply an "active finance" standard, presumably more stringent than the usual trade or business test, for purposes of distinguishing between active and passive finance and lending activities in certain domestic and cross-border contexts.[lxx] Unfortunately, such active finance standards generally cannot be applied for purposes of the trade or business determination in the inbound lending context because these standards are operative only for specific Code sections.[lxxi] However, these standards may serve as useful precedents in formulating a new active/passive standard in the inbound finance context.

Although the various active finance standards that exist currently in the Code and regulations differ somewhat from each other, the standards share certain basic features. Active finance standards generally require that the taxpayer conduct lending, finance, or similar activities regularly and continuously, with customers, unrelated persons, or the public, in the ordinary course of business, in a substantial amount or as a predominant part of the entity's business, or a combination of these factors. Several provisions contain lists of the types of business activities that may give rise to an active finance business, if all other requirements are met.[lxxii]

The factors used in the existing active finance standards resemble the non-exhaustive list of factors employed by the courts to determine the existence of a lending business for purposes of determining eligibility for the bad debt deduction. However, no one factor under the case law is determinative, not all of the factors are examined in each case, and it can be difficult to predict, in any particular case, whether a taxpayer that possesses some factors, but not others, will be treated as engaged in a trade or business. In contrast, the regulation and Code sections that incorporate active finance standards often set out lists of exclusive, determinative factors, with specific guidance as to which factors are mandatory and the degree to which the factors must be satisfied. Some provisions, such as §954(h), even provide numerical thresholds for factors such as a minimum percentage of an entity's gross income that must be derived from finance and lending activities.

As discussed above, the active/passive distinction can be especially difficult with respect to lending and finance activities, which by their nature will have certain inherently passive characteristics. Certain active finance standards avoid this difficult inquiry with respect to banking entities by using U.S. or foreign licensing or regulation of banks as a surrogate for some or all of the factors described above.[lxxiii] Other provisions attempt to simplify the active/passive determination by focusing on the entity earning the income, rather than only the income itself. Such rules examine whether the income-earning entity as a whole is predominantly (or otherwise sufficiently) engaged in actively deriving finance income, rather than only on whether any particular income item is derived from active finance activities. For example, the regulations defining the financial services separate limitation category for purposes of the foreign tax credit analyze whether the taxpayer is a financial services entity predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.[lxxiv] The regulations then list types of income which are treated as "active financial services income," arguably without requiring that the income be, in fact, actively derived.[lxxv]

In contrast, other active finance standards such as the standard used in §954(h) examine both the entity's activities in general and the specific activities generating the particular interest or finance income at issue, requiring both to satisfy "active" standards. The latter approach recognizes that even entities engaged in an active finance or lending business can derive passive income and gains from certain lending activities. The portfolio interest exception reflects a similar recognition.

Market Developments

As discussed above, the rules governing the taxation of inbound non-bank lending and finance activities are vague, can lead to irrational results, and fail to take into account the relative mobility of lending and finance activities. Although these rules have persisted for many years without materially impairing the ability of the United States to maintain its status as a preferred location for global financial management activities, general shifts in global finance, including recent financial market trends emphasizing the importance of private non-bank cross-border financing transactions, suggest that the negative impact of the rules is likely to grow.

A significant amount of attention has been paid in recent years to the impact of the explosive growth in public capital markets[lxxvi] and the market instability attributable to the growing participation of non-regulated financial entities such as hedge funds in those markets.[lxxvii] Comparatively little attention has been paid to the recent growth of international private financing transactions, including privately negotiated equity and debt transactions, and the growing role of non-regulated financial entities in such activities.

Traditionally, the international market for private financings of startup and established companies was dominated by financial institutions such as commercial banks, merchant banks and domestic venture capital companies. Throughout the 1990s, however, the private financing market (which encompasses alternative non-market investments such as private debt, private equity and derivatives strategies) experienced a significant democratization with the entry of a myriad of non-regulated domestic and foreign non-bank financial institutions, including traditional hedge funds and newly formed private equity funds.[lxxviii]

Paradoxically, the rapid growth and success of international public capital markets may have fueled the expansion of the private finance market. The growing efficiencies in these markets, and a commensurate decrease in the ability of investors to earn arbitrage returns, may have prompted international investors to seek higher returns outside the confines of the traditional capital markets. In addition, because of changes in technology that permitted sophisticated investment strategies to be designed and implemented by nonfinancial institutions without the resources of traditional investment banks, there has been a tremendous growth in the number of nonfinancial institutions involved in more traditional investment banking activities. In fact, the transformation has been so complete that one commentator now views hedge funds "as the privatisation of the trading floor or investment bank.[lxxix]

The ability of nonfinancial institutions to engage in private financing transactions and to conduct other traditional banking functions suggests a convergence in the financial world.[lxxx] As financial convergence evolves, the special status of "regulated" entities will continue to be eroded and the mobility of financial management activities is likely to increase. In 1998 Congressional testimony, Alan Greenspan recognized the mobility of financial management activities in connection with traditional trading activities when he stated that "given the amazing communications facilities available around the globe, trades can be initiated from almost any location . . . Any direct U.S. regulation restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction."[lxxxi]

The increasing mobility and convergence of financing transactions and the institutions performing them highlights the importance of clarifying when exactly inbound lending activities will be subject to net U.S. tax.

Examples

As discussed above, the legal distinction between passive lending and the conduct of a lending or finance business is quite vague, and there is some risk that even a rather limited amount of lending activity in the United States could cause a foreign person to be treated as engaged in a U.S. lending or finance business. It is relatively clear from the existing case law that a person may be engaged in a trade or business of lending even though such person is not a traditional financial intermediary such as a bank, insurance company or other entity.

However, there are limits on the type of financing transactions that can give rise to a trade or business. There is essentially no risk under current law that a foreign person that enters into private *equity* transactions will be treated as engaged in a trade or business by virtue of such activities. Accordingly, foreign persons who engage in equity finance activities in the United States (including foreign venture capitalists) generally will not be engaged in a trade or business by virtue of their equity investment activities, even if the investments take the form of preferred stock and the foreign persons borrow money from financial markets (or customers, in the case of financial institutions) to fund all or a portion of such investments.[lxxxii]

It is difficult to reconcile this difference in tax treatment between debt financing and equity financing activities. Presumably, the distinction is based on the assumption that equity financing activities are inherently associated with speculative passive investment activities, while debt financings can be a fundamental aspect of financial intermediation business involving a relatively nonspeculative endeavor to generate fees (*e.g.*, in the form of a spread between borrowing (funding) costs and lending income) from customer transactions.[lxxxiii] Unfortunately, the relevant authority addressing the conduct of a lending or finance business does not explicitly look to the true nature of the lender for purposes of the analysis.

The examples listed below are designed to illustrate various shortcomings in the current active/passive distinction applicable to inbound finance activities.

Example 1. F is a private openend investment fund organized under the laws of a foreign tax haven jurisdiction and classified as a corporation for U.S. federal income tax purposes. F is owned by non-U.S. institutional and individual investors from a variety of jurisdictions (only some of which have a tax treaty with the United States) and the investments of F are managed by M, a U.S. based investment management company employed exclusively by F. Pursuant to the investment advisory agreement between M and F, M has sole discretion to select, enter into, and manage the investments of F. M also is charged with maintaining all financial accounting and other records on behalf of F, and is responsible for all communications with shareholders of F (including the furnishing of financial reports), including all investment solicitations relating to F. M conducts all of its activities on behalf of F from an office in New York City with approximately 50 employees, and does not maintain an office in any other jurisdiction. The board of directors of F are all U.S citizens. All shareholders and board of directors meetings of F are held in New York City.

In exchange for providing investment advisory services, M receives an annual fee calculated based on a percentage of the current aggregate net asset value of F as well as a separate contingent fee equal to a fixed percentage of the net income of F on an annual basis. F's offering documents indicate that the purpose of F is to deploy capital to trade debt and equity securities traded on U.S. or foreign capital markets. F may also enter into various exchange traded or private derivative contracts with U.S. or non-U.S. counterparties in order to take leveraged investment positions, or to effect hedges of some or all of the positions owned by F. Although F is permitted to acquire and sell corporate loans and other types of debt securities in private and capital market transactions, F is not permitted to enter into or negotiate the terms of any loans with any borrowers, or to participate directly, or indirectly (*i.e.*, through syndications or participations in original loans), in lending transactions with borrowers. F does not generally borrow money from any of its shareholders or from customers. F is permitted to borrow money from financial institutions or to issue debt securities in international capital markets.

Analysis of Example 1. Assuming that F limits its investment activities to those listed in F's offering documents, F will not be engaged in a trade or business in the United States because all the activities of F are shielded by the stock, securities, and commodities trading safe harbor. The fact that F may buy and sell debt securities in private or capital markets transactions should not alter this conclusion since such activities generally are considered trading rather than financing or lending activities. Because of 1997 statutory changes to the safe harbor, the fact that F maintains its principal and only office in New York does not affect its ability to avail itself of the trading safe harbor.

Because F will not be treated as engaged in a U.S. trade or business, all gains realized by F in connection with its trading and investment activities will be entirely free of U.S. federal income tax. In general, any interest payments. (whether U.S. or foreign source) received by F from unrelated third parties will also be free of U.S. withholding tax.[lxxxiv] Any U.S. source dividends received by F generally would be subject to a 30% withholding tax (or a reduced rate if the dividend qualifies for a lower rate under an applicable tax treaty). In general, the tax consequences described above would not be any different if F conducted regulated banking or other financing operations (other than those of a dealer) in a foreign jurisdiction, even if F used customer loans or deposits obtained in connection with those operations to finance all or some of its stock, securities, and commodities trading activities in the United States.

Example 2. The facts are the same as in ***Example 1***, except that M is also authorized to enter into so-called private equity transactions on behalf of F, including acquisitions in private placements of common shares and/or warrants to acquire shares in existing or startup companies incorporated in the United States or elsewhere. In cases where M enters into private equity transactions, M typically negotiates the acquisition of the securities directly with the issuing company. M, on behalf of F, widely advertises in the United States that F is looking for private equity investments and stands ready to negotiate such investments following a positive analysis of the issuing company. M sometimes arranges for an issuance of debt securities by F, or a borrowing by F from a bank, to fund some of F's private equity investments. In general, the issuing companies in which F will invest do not expect to pay any significant dividends.

Analysis of Example 2. In general, F will be subject to the same favorable U.S. tax rules as described in ***Example 1***. The fact that F may regularly enter into equity finance transactions with various corporations which F may solicit as investees generally will not alter the conclusion that F will not be treated as engaged in a trade or business. As stated above,[lxxxv] there is no concept of a foreign person being engaged in the conduct of an equity finance business since equity investments are per se deemed to be passive and speculative in nature. Of course, F would be subject to U.S. withholding tax with respect to any U.S. source dividends received in connection with its equity investments.

The fact that F may borrow to finance its private equity investments generally will not alter the conclusions above. In general, the tax consequences described above would not be any different if F (or any of the investors in F) conducted regulated banking or other financing operations outside the United States (but not dealer activities), even if F used customer deposits or other customer funds obtained in connection with those operations to finance some or all of its private equity investments.

Example 3. The facts are the same as in ***Example 2***, except that M also enters into private equity investments involving the issuance of fixed or floating rate preferred interests, including preferred interests convertible into common interests (with or without current pay coupons), by U.S. corporations. Certain of the preferred stock securities may have terms very similar to debt instruments but clearly constitute equity securities for U.S. federal income tax purposes. Accordingly, issuers of the preferred stock are not entitled to interest deductions.

In most cases, the issuers of the preferred shares are high technology startup companies that do not have current or accumulated earnings or profits, and are willing to forego the accumulation of net operating losses which would occur if the financings were structured as subordinated debt instruments. In certain cases, the preferred shares provide for current coupons which are funded from deferred payment loans or equity investments from other investors.

Analysis of Example 3. In general, F will be subject to the same favorable U.S. tax rules as described in ***Example 2*** because there is no current law concept of the conduct of an equity financing, business. Theoretically, a foreign person like F could conduct unlimited equity financing activities in the United States without being subject to net income taxation with respect to such activities. Of course, F would be subject to U.S. withholding tax on any dividends received in connection with such business. In many private equity transactions, however, the issuing company will not have current or accumulated earnings and profits such that payments on preferred shares will not be characterized as dividends. The fact that F may borrow to finance its preferred stock investments generally will not alter the conclusions above. Furthermore, the tax consequences described above generally would not be any different if F (or any of the investors in F) conducted regulated banking or other financing operations in a foreign jurisdiction (but not dealer activities), even if F used customer deposits or other customer funds obtained in connection with those operations to finance some of its private equity investments.

Example 4. The facts are the same as in ***Example 3***, except that F also makes a series of private equity investments in the form of privately negotiated loans that are convertible into shares of the issuer. F advertises the fact that it is interested in entering into convertible loans.

Analysis of Example 4. Even though the convertible loans will in many instances be economically similar to the convertible preferred shares described in ***Example 3***, there is a risk that M's activities on behalf of F in connection with such private convertible loans could cause F to be treated as engaged in the conduct of a U.S. financing, lending or similar business. Under the current law principles governing the notion of a trade or business, the fact that F is not generally engaged in a financing business in the United States and does not raise funds from customers (in the form of bank deposits or similar funding mechanisms) would not seem to preclude this result. The fact that the convertible loans have significant equity characteristics also does not seem to preclude this result.[lxxxvi]

In the event that F is engaged in the conduct of a U.S. finance business, F would be subject to U.S. net income tax imposed at the normal U.S. corporate rates (up to 35%) on income effectively connected with such business, and F would also be subject to a separate 30% branch profits tax on net amounts remitted from the business to F. In general, interest income and gains (including gains resulting from appreciation of the loan conversion feature) associated with loans made by F to U.S. persons would be effectively connected with the business, as would possibly certain interest and gains from any loans made to foreign issuers.[lxxxvii] F may be able to deduct at least a portion of F's interest and other expenses, if any, against its effectively connected income. It is important to note that all such deductions could be denied in calculating F's effectively connected income if F originally took the position that it was not engaged in a financing or lending business in the United States and failed to file a protective income tax return. In general, the conduct by F of a financing business in the United States should not affect the tax treatment of income associated with F's stock, securities, or commodities trading activities (including income from related derivative transactions) as such activities arguably would still be eligible for the benefits of the stock, securities, and commodities trading safe harbors.

Assuming that F is not a bank, and does not itself raise debt financing in the form of deposits or other consumer-like instruments, it seems difficult to rationalize subjecting income from F's lending activities to U.S. net income taxation, especially in light of the general exemptions for trading and equity financing activities. Under these exemptions, F could clearly acquire the same convertible loans in secondary market transactions, or structure the loans as convertible preferred equity transactions, without being treated as engaged in a U.S. trade or business. The result is especially troublesome given the existence of the speculative conversion feature.[lxxxviii]

Example 5. The facts are the same as in ***Example 4***, except that F also makes a series of long-term deeply subordinated loans (so-called "junk" loans) directly to U.S. issuers alone or together with equity investments in the issuers.

Analysis of Example 5. The analysis of ***Example 5*** is essentially the same as the analysis for ***Example 4***. However, it is important to note that subordinated loans are often more speculative than certain equity financings. The long-term nature of the subordinated loans also suggests that the loans may represent an investment activity rather than a trade or business.

Example 6. The facts are the same as in ***Example 5***, except that F also enters into short-term bridge loan financings most often in conjunction with equity investments in the issuers.

Analysis of Example 6. The analysis is essentially the same as the analysis for ***Example 5*** with the additional risk that the bridge loan financings could be viewed as part of the conduct of a financing business by F. Even though bridge financings by F seem more akin to the conduct of a traditional financing business, it may not be appropriate to view them as such when they are made in conjunction with equity investments.

Example 7. The facts are the same as in ***Example 6***, except that F also enters into long-term interest bearing loans (including secured loans) alone or in conjunction with equity investments in the issuers. F conducts the negotiation and origination, due diligence, and other activities necessary to issue the loans. In connection with these long-term loans, F often acts as a member of a lending syndicate that may or may not include banks.

Analysis of Example 7. The analysis is essentially the same as the analysis for ***Example 6***, with the added likelihood that secured debt financings could be viewed as part of the conduct, of a financing business by F. Although secured loans are traditionally associated with the conduct of a finance or lending business, there are strong arguments that F should not be subject to U.S. net income taxation. F has no real customer transactions and there is no indication of a spread business. If F raised customer money in the United States or other jurisdictions, or if F were owned by banks or insurance companies to whom its equity was traceable, there would be stronger arguments that F is engaged in a trade or business. In the absence of those facts, it is not clear whether it is appropriate to treat F's activities as constituting a lending business.

Example 8. The facts are the same as in ***Example 7***, except that F will typically borrow money in the capital markets or from banks specifically for the purpose of financing its lending activities.

Analysis of Example 8. In this case, F arguably is acting as a traditional finance company to the extent it is engaged in the business of earning the spread on the interest rate differential between amounts borrowed and loaned. This example raises a historic issue of whether a finance company should ever be viewed as engaged in an active business. As discussed above, this issue has been raised in connection with the subpart F rules and passive foreign investment company rules. Until recently, U.S. persons investing in foreign finance companies could not obtain the benefit of deferral. F's activities are presumably very mobile because there are no customers on the funding side of its transactions and because F is an unregulated lender, to the extent it serves the U.S. market.

Example 9. The facts are the same as in ***Example 8*** except that F, directly or through foreign subsidiaries, conducts traditional insurance and banking businesses in various jurisdictions outside the United States. Premiums from insureds and deposits from banking customers received in connection with the insurance and banking businesses are used to fund F's various U.S. lending activities.

Analysis of Example 9. This appears to be the most appropriate case for treating F as engaged in a U.S. finance or lending business, given the fact that funding for the loans made in the United States is traceable to regulated financial transactions with customers. F (or the F group) is engaged in a customer driven finance business that benefits from the traditional advantage of financial intermediaries (such as insurance companies) and banks to collect funds from the public (either in the form of insurance premiums or regulated bank deposits).

Alternative Models And Conclusion

As evident from the discussion above, it is this article's premise that the current law distinction between passive lending and the conduct of a finance or lending business in the inbound context fails to provide predictable, clear legal standards and is difficult to rationalize in light of both market developments and the general evolution of the U.S. international tax rules. Assuming this premise is correct, it is worth considering how the law could be improved.

The current law principles that govern the distinction between passive lending and the conduct of a finance or lending business look principally to the relative level of finance activities conducted by the lender. The principles arguably do not as clearly take into account such factors as the existence and type of customer relationships, whether the lender is heavily leveraged and intends to profit from a spread or other fees, or the general business characteristics of the lender. The "active financing" standards developed in the context of various U.S. international and domestic tax rules articulate clearer sets of principles that specifically look to customer relationships, the overall characteristics of the lender (including the extent of finance activities in comparison to the overall activities of the lender), and a variety of other factors for purposes of drawing an active/passive distinction. One possible improvement to the current law distinction in the inbound finance context would be to adopt (through legislative action or promulgation of regulations) an active finance standard modeled after one or more of the standards that already exist in the Code and regulations.[lxxxix]

The adoption of an active finance standard would significantly clarify the law because it would replace application of the vague facts and circumstances approach found in the case law with a clearer and more defined test. In particular, such a standard would clarify that only foreign persons that engage in finance or lending transactions with "customers" could be engaged in a U.S. lending business and thus provide an effective safe harbor for loans to non-customers.[xc]

Based on existing active finance standards, an active finance standard for inbound finance activities could be constructed to rely on a variety of specific factors, including whether the lender is subject to the banking or credit laws of any jurisdiction, whether lending is a predominant part of the lender's overall activities, the nature of the lending transactions (*e.g.*, the maturity of the loans), the extent of the deductions attributable to the lender's finance activities, whether the taxpayer's loans are contingent on the borrower's profits or on some other equity-like measure, and other factors.[xci] Any active financing standard adopted for this purpose could also incorporate new and unique factors, including an interest tracing or funding inquiry designed to identify lenders that function as financial intermediaries, employ minimal capital, and seek to earn an economic spread (who would be regarded as engaged in a finance business), as distinguished from lenders that do not engage in a fee or "spread" business (who would be treated as engaged only in passive investing). In the past, others have considered constructing such a test for purposes of the active finance standard in subpart F, but they were unable to solve difficult issues relating to the fungibility of money.

Adoption of one of the existing active finance standards (or a modified version of one or more of the existing standards) in the inbound lending context generally would not eliminate the need for taxpayers to analyze the nature of the lending activities at issue. An even more favorable clarification of the current law active/passive distinction in the inbound finance context might include adoption of a specific safe harbor rule for certain types of lending transactions. Such a safe harbor could provide that lending activities of non-regulated entities simply will not give rise to a U.S. trade or business and thus could operate in a manner similar to the safe harbor rule for securities trading activities.

Regulated institutions usually have relatively cheap access to funding in the form of insured bank deposits (in the case of banks) or regulated insurance contracts (in the case of insurance companies). Accordingly, a safe harbor rule that prevents a foreign person, other than a foreign person regulated as a financial entity anywhere in the world, from being treated as engaged in a trade or business as a consequence of basic finance or lending activities (*e.g.*, making of loans or loan commitments, issuances of letters of credit, granting of loan guarantees, etc.)[xcii] might strike a fair balance between the competitiveness concerns of U.S. financial institutions and the strong policy goal of attracting financial management activities and foreign capital to the United States.

Under this safe harbor approach, foreign persons such as banks, insurance companies, and finance companies that are regulated as financial institutions anywhere in the world would not be eligible for the favorable safe harbor rule and would be subject to the current law rule or a new active finance standard. Non-regulated entities that are in the consumer finance business (*i.e.*, are in the business of making loans designed to fund the purchase of specific goods by consumers) presumably would also be denied the benefit of the safe harbor. Also, in order to prevent abuse, the safe harbor could be constructed such that foreign persons that are related to regulated financial institutions (based on appropriate related party standards) would not be eligible for the safe harbor rule.

Under such a safe harbor rule, global institutions such as hedge funds, private equity funds, unregulated finance companies, and others could enter into transactions in the United States involving the lending of capital without fear that such activities would cause them to be treated as engaged in a U.S. finance business and thus potentially subject to net U.S. taxation. Alternatively, these companies could raise funds from the capital markets or other institutions and enter into transactions in the United States to lend these funds to U.S. issuers without being engaged in a U.S. finance business.

A safe harbor lending rule could also be drawn more narrowly by incorporating additional prerequisites such as a limit on the taxpayer's total number of annual loans, on loan maturities, on secured loans, or other factors.[xciii] Even a safe harbor with these types of restrictions would significantly clarify the current law tax treatment of international financial institutions (including hedge funds and private equity funds) that enter into lending transactions in the United States. Any such clarification could be expected to encourage foreign lending in the United States, by allowing foreign lenders to better predict whether they will subject to U.S. net taxation. A rule that not only clarified the legal standards, but also provided favorable tax treatment for many passive, investment-type lending activities, could maximize the attraction of foreign activities and capital to the United States without placing comparable U.S. lenders at a competitive disadvantage.

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BIOS: **Stuart E. Leblang** is a partner in the tax and technology practice groups of Akin, Gump, Strauss, Hauer & Feld, L.L.P. in New York. Mr. Leblang can be contacted at sleblang@akingmump.com.

Rebecca I. Rosenberg is a member in Caplin & Drysdale's Washington, D.C. office. Ms. Rosenberg can be contacted at rir@capdale.com

[i] Others have noted that the U.S. tax regime applicable to foreign persons effectively divides the income and activities of foreign persons into two broad categories of income: active and passive. *See* Reich, "Taxing Foreign Investors' Portfolio Investments: Developments and Discontinuities," 79 *Tax Notes* 1465 (1998). Reich describes active income as "earned income from the conduct of business activities. . ." and passive income as "investment income, such as interest, dividends and gains from the sale of stocks and securities that is not earned by the taxpayer in the ordinary course of business (for example, as a securities dealer or a bank)." Although the active/passive distinction can also be relevant with respect to U.S. lending activities of foreign banks, this article focuses on application of the distinction to foreign persons other than licensed banks.

[ii] Unless otherwise noted, all section references used herein are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

[iii] *See* Sonsino, "An Unlikely Tax Haven," 99 *Corp. Fin.* 30 (1994).

[iv] As a result of these rules, a foreign person can maintain literally hundreds of employees in the United States to conduct financial management activities on the foreign person's behalf without becoming subject to U.S. tax. Together, the portfolio interest rule that exempts most types of interest of foreign persons from gross basis tax, the general exemption from U.S. tax of capital gains of foreign persons, and the stock, securities, and commodities trading safe harbors under §864(b) (the "trading safe harbors") that treat certain trading activities as not constituting a trade or business, operate effectively to exempt income from most investment and trading activities of foreign persons from U.S. tax. U.S. source dividend income, in contrast, remains subject to tax but may be eligible for reduced withholding tax rates under U.S. tax treaties if it is not effectively connected with a U.S. trade or business. *See* Reich, "Taxing Foreign Investors' Portfolio Investments: Developments and Discontinuities," 79 *Tax Notes* 1465 (1998), which sets forth a convincing case that U.S. withholding tax on portfolio dividends should be eliminated. Reich notes that elimination of that tax "would remove the single substantive exception to the favorable tax environment that foreign investors in portfolio stock and securities already enjoy." This type of income has decreased in importance, however, as dividend yields on U.S. securities have fallen. In addition, as a practical matter, taxpayers may have developed strategies to avoid U.S. withholding tax on dividends. *See* Hariton, "Withholding on Cross-Border Stock Loans and Other Equity Derivatives," 72 *Taxes* 1050, 1050 (1994) (citing

Deputy Assistant Secretary Cynthia Beerbower as stating that Treasury is concerned that taxpayers are avoiding withholding tax on dividends through the use of derivatives).

[v] Derivatives transactions entered into by foreign persons from the United States can also be free of U.S. tax. In general, derivatives are subject to favorable sourcing rules. *See*, *e.g.*, Regs. §1.8637. Also, recent proposed regulations interpreting the trading safe harbors clarify that entering into swaps and other derivative transactions generally qualifies for the trading safe harbors. Prop. Regs. §1.864(b)1. Nevertheless, various issues relating to the scope of the safe harbors persist. For an excellent and comprehensive review of some of these issues, see Nijenhuis, "The: 'Trading in Derivatives' Safe Harbor," 39 *Tax Mgmt*. Memo. 371 (11/9/98).

[vi] Like certain other nations, the United States does not apply net income taxation to income (including interest, dividends, and gains) earned by a foreign person in connection with passive investment activities conducted by or on behalf of the foreign person on U.S. soil, unless the income is related to a U.S. trade or business. These activities include passive financial investments, including passive equity and debt financings of U.S. or foreign issuers that are analyzed, negotiated and concluded from the United States. Unlike other developed nations, however, the United States also effectively exempts from net income taxation the income and gains realized by a foreign person in connection with the conduct from the United States of an active stock, securities, or commodities trading business. Recently, other nations have begun to liberalize their own rules applicable to domestic trading and other financial activities of foreign persons in an effort to attract foreign financial management activities and capital. Certain other countries attempt to attract foreign capital and support local financial management activity through special domestic investment entities subject to favorable tax regimes.

[vii] For example, the stock and securities trading safe harbors under §864(b) are designed to attract foreign capital and activities into the United States. Legislation that enacted the safe harbors arose as a result of recommendations of a presidential task force on "Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad," and was intended to increase foreign investment in the United States. *See* Ways and Means Committee, Report on Foreign Investors Tax Act of 1966, H. Rep. No. 1450; 89th Cong., 2d Sess. (4/26/66). *See also* Staff of Joint Committee on Taxation, General *Explanation of Tax Legislation Enacted in 1997*, 105th Cong., 1st Sess., at 320 (12/17/97) ("The stock and securities trading safe harbor serves to promote foreign investment in the U.S. capital markets," discussed on the occasion of the repeal of the rule that denied the benefits of the safe harbors to foreign persons that maintained a principal office in the United States). It is also clear that the trading safe harbors are generally designed to increase the conduct of financial management activities in the United States. *See* Department of the Treasury, Taxpayer Bill of Rights 3 and Tax Simplification Proposals. April 1997, at 47 (proposing repeal of the rule denying certain trading safe harbor benefits to traders with a "principal office" in the United States, because the rule "shift[ed] certain administrative jobs from the United States to foreign tax haven jurisdictions and limit[ed] the business opportunities of U.S. investment managers"); *cf.* Jensen, Spikes, and Carter, "International Provisions of the Taxpayer Relief Act of 1997," 24 *Int'l Tax. J.* 1 (1998) (the principal office requirement caused foreign persons to move administrative functions outside the United States). Similarly, the portfolio interest exception was intended to improve U.S. taxpayers' access to foreign capital. In particular, it was intended to improve access of U.S. issuers to the Eurobond market as well as to remove any incentive for U.S. issuers to conduct foreign borrowings through subsidiaries incorporated in tax havens. *See* Staff of Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong., 1st Sess. (12/31/84); Senate Finance Committee, Explanation of Provisions Approved by the Committee on March 21, 1984, 98th Cong., 2d Sess. (4/2/84) (the 30% withholding tax "raise[d] the cost of foreign capital to U.S. borrowers"); *see also* Granwell, "Repeal of the 30 Percent Withholding Tax on Interest Paid to Foreigners," 13 *Tax Mgmt. Intl. J.* 306, 311 (1984); Wales, "Repeal of 30 Percent Withholding: A Case Study in Complexity," 12 *J. Corp. Tax'n* 352 (1986); *cf.* Staff of Joint Committee on Taxation, *Tax Treatment of Interest Paid to Foreign Investors*, 98th Cong., 2d Sess. (4/28/84) ("Some argue that repeal of the withholding tax would increase the inflow of capital to U.S. corporations. . . . [But] repeal of the withholding tax may cause foreign investors to substitute Eurobonds for other U.S. assets, rather than to increase their net holdings of U.S. assets. . . . Alternatively, the primary effect of repeal could be that some foreigners, who are now investing in dollar denominated bonds issued by non U.S. borrowers, would switch to U.S. corporate and Treasury securities . . . [resulting in a] net capital inflow").

[viii] Of course, inbound and outbound cross-border rules have different policy reasons for focusing on the mobility of financial activities. The outbound rules, such as the antideferral rules and the foreign tax credit provisions, reflect concerns that mobile activities of U.S. persons may leave the United States in response to foreign or U.S. tax

incentives or in an attempt to claim U.S. tax benefits inappropriately or otherwise to avoid U.S. tax. In contrast, the inbound cross-border rules, such as the portfolio interest exception and the trading safe harbors, attempt to attract mobile foreign capital and activities to the United States by providing for favorable tax treatment. Both sets of rules, however, attempt to maximize the amount of mobile capital and activities in the United States.

[ix] Section 954(h), (which only applied to taxable years beginning after 1998 and, before 2002, but is expected to be extended), allows deferral of income from certain financial activities, but only if such activities meet a series of complex requirements generally aimed at ensuring that the controlled foreign corporation is actively engaged in a financial business in its home country.

[x] *See generally* Leblang, "International Double Non-taxation," 79 *Tax Notes* 255 (1998). The focus on tax haven jurisdictions has intensified recently, and the Organization for Economic Cooperation and Development (OECD) continues to challenge preferential tax regimes. *See* OECD "Harmful Tax Competition: An Emerging Global Issue," (1998); "OECD Supports U.S. Government's Tax Haven Blacklist," *Doc 200010139 2000 TNT 665*.

[xi] As a result of the securities trading safe harbor, purchases and sales of existing debt instruments for a taxpayer's own account generally will not give rise to a U.S. trade or business. It is somewhat unclear whether income from such debt securities (including interest and gain) could be treated as effectively connected to another trade or business of the taxpayer under the principles of §864(c). Many practitioners believe, however, that this income would not be subject to net income tax based on the theory that the trading safe harbor overrides the effectively connected income rules.

[xii] If a foreign person is considered to be engaged in a U.S. lending or finance business, income and gains effectively connected to that business will be subject to U.S. net income tax at the usual rates applicable to U.S. individuals and corporations. §§871(b) and 882. A foreign corporation engaged in such a U.S. business can also be subject to an additional U.S. branch profits tax on the effectively connected income. §884. As discussed below, the effectively connected income rules in this area are complicated. The regulations apply a special set of rules to determine whether interest and dividends from stock and securities are effectively connected to the active conduct of a banking, financing, or similar business. Regs. §1.8644(c)(5).

[xiii] Making these distinctions is especially difficult with respect to finance activities in general, because all loans have inherently passive, investment-type characteristics. The difficult distinctions that continue to apply to inbound lending activities under current law were resolved for stock, securities, and commodities trading by the enactment of the trading safe harbors in §864(b).

[xiv] *See* examples at the end of this article.

[xv] The increased importance of cross-border private financing transactions is discussed below. The recent growth in these transactions highlights the potentially different tax treatment of cross-border private *equity* financings and private debt financings. A foreign person that engages in private equity financings is not likely to be treated as engaged in a U.S. trade or business because there is no current law concept of an equity financing business. Equity investments are considered to be per se passive, regardless of the amount of the taxpayer's involvement in structuring the terms of the investment, even if the taxpayer receives preferred stock. *cf. Higgins v. Comr.*, 312 U.S. 475, 478 (1941) (no amount of activity can convert investment into a trade or business). Under current law, private debt financings entered into by foreign persons raise a significant risk that the foreign person could be treated as engaged in a U.S. finance business. This distinction between the treatment of debt and equity investments seems difficult to justify in light of the economic equivalence of many types of debt and preferred stock investments. Although the finance business issue arises primarily with respect to investment-type vehicles managed in the United States, the issue also arises in connection with special offshore vehicles established for the purpose of securitizing U.S. debt obligations. In certain cases, these passive-type vehicles, which are heavily leveraged (because they issue various (tranches of debt and maintain as little equity as possible) may raise U.S. trade or business issues if the IRS contends that agents of such vehicles effectively originate loans on behalf of such vehicles.

[xvi] Recent legislative activity reveals that competitiveness concerns remain prominent. For example, in 1997, Congress enacted §894(c), which was designed to eliminate certain tax benefits obtained by foreign persons from the use of hybrid entities in certain cross-border financing: transactions. Section 894(c) prohibits the application of the reduced treaty withholding rate for payments related to such transactions. *See* H.R. Comm. Rep. on P.L.10534; Paron, "U.S. Financing LLC — It Was Good While It Lasted," 71 *CMA Mag*. 33 (Oct., 1997). More recently, competitiveness concerns have prompted several U.S.-owned insurers to lobby heavily for legislation that would reduce or eliminate perceived tax advantages obtained by foreign-owned U.S. insurers whose foreign parents are

located in Bermuda or other tax havens which impose no income tax. *See* Souter, "Bermuda Tax Status Under Fire: U.S. Insurers Protest that Loophole Gives Bermuda Companies Unfair Advantage," *Bus. Ins.*, Mar. 13, 2000.

[xvii] *See* Regs. §1.8645.

[xviii] Arguably, only true financial intermediaries (*i.e.*, highly leveraged financial entities) enter into loans in connection with a finance business. In contrast, it can be argued that lenders that deploy capital to earn interest and/or capital appreciation are acting in the nature of true investors. Of course, it will often be difficult to determine whether particular loans are attributable to capital or to leverage (*i.e.*, borrowed funds) of the lender.

[xix] *See generally* Boyle, "What is a Trade or Business?" 39 *Tax Lawyer* 737 (1986) (the trade or business test needs refinement); Lopez, "Defining 'Trade or Business' Under the Internal Revenue Code: A Survey of Relevant Cases," 11 *Fla. St. U. L. Rev.* 949 (1984); Bolling and Carper, "The Evolving Definition of 'Trade or Business': Ditunno and Beyond," *63 Taxes* 73 (1985).

[xx] Basic tax principles reveal that purchases and sales of assets that ordinarily generate passive income can, in certain circumstances, rise to the level of business conduct. *See* FSA 1999509, 1999 *TNT* 1589, and cases cited therein. In other words, the taxpayer's activities, rather than the type of asset, are determinative of whether the taxpayer is engaged in a trade or business. Before the enactment of the trading safe harbors, although there were no brightline rules regarding minimum holding periods, practitioners sometimes considered a two-year holding period' as significant evidence of an investment intent rather than the conduct of a trade or business. The lack of clear standards may have inhibited financial management activities in the United States, before the safe harbors, by deterring foreign investors from trading in stocks and securities through a resident U.S. agent. *See* Committee on Ways and Means, H.R. Report 1450, 89th Cong. 2d Session (regarding H.R. 13103, the Foreign Investors Tax Act of 1966) ("[T]he confusion regarding the status of a foreign investor who has granted discretionary authority to a U.S. agent may have acted to deter some foreign investment in the United States"). In order to encourage foreign investment in the United States, and to limit legal uncertainty under the traditional legal authorities, Congress enacted legislation to ensure that a foreign person would not be treated as engaged in a trade or business in the United States by virtue of trades effected in the United States for the person's own account. The safe harbor, as in effect today under §864(b)(2)(A), provides that the term "trade or business within the United States" does not include trading in stocks or securities for the taxpayer's own account whether by the taxpayer or his employees or agents and whether or not such employees or agents have discretionary authority to make decisions in effecting the transactions, provided the taxpayer is not a dealer in stocks or securities. Section 864(b)(2)(B) provides a similar safe harbor rule for commodities trading.

[xxi] *See* fn. 8, above.

[xxii] *See* §§882(a), 871(b). In general, the U.S. source income of foreign persons ("inbound" income) is subject to two distinct tax regimes. Fixed or determinable, annual or periodical income ("FDAP"), which includes interest and dividends, is subject to a gross basis withholding tax of 30% (or lower, based on applicable treaty rates) if the income is not effectively connected with a U.S. trade or business. §§871(a), 881(a). A foreign person's U.S. source income that is effectively connected with a U.S. trade or business is subject to net tax under the same rules (including graduated rates and applicable deductions) that apply to U.S. citizens and residents. U.S. source income of foreign persons that is not covered under either regime (such as capital gain that is not effectively connected with a U.S. trade or business) is not subject to U.S. tax. U.S. source interest that is not effectively connected with the conduct of a U.S. trade or business is generally exempted from U.S. tax under §§871(h) and 881(c), as long as the interest is not received by a bank in the ordinary course of its business and certain other requirements are met. Prior law, in effect until 1996, applied the "force of attraction doctrine," Which provided that if a taxpayer was engaged in a trade or business in the United States, all of the taxpayer's U.S. source income (whether or not connected with the trade or business) was subject to U.S. net income tax. Foreign source income of foreign persons is never subject to withholding tax, and is subject to net taxation only if it is effectively connected with a U.S. trade or business.

[xxiii] Rev. Rul. 73227, 19731 C.B. 338, concluded that the financing subsidiary's "business consists of the borrowing of funds and the relending of such funds to M (the parent) and M's domestic and foreign subsidiaries and affiliates. The activities incident to this trade or business are virtually all carried on in the United States through X's [the subsidiary's] United States office. Accordingly, X is engaged in the active conduct of a trade or business in the United States." Rev. Rul. 73227, 19731 C.B. at 339. The revenue ruling contains an extensive discussion of §864(c) and the regulations thereunder, concerning the determination of whether income is *effectively connected* with a trade or business. However, this effectively connected analysis becomes relevant only if the taxpayer is indeed engaged in a trade or business. As noted by Rev. Rul. 883, Rev. Rul. 73227 does not contain any discussion of authorities, or

much analysis (beyond the quoted sentences above) concerning the underlying determination of whether the taxpayer is engaged in a U.S. trade or business. Rev. Rul. 883, 19881 C.B. 268, revoked Rev. Rul. 73227 on the grounds that the latter ruling merely concluded that the foreign financing subsidiary was engaged in a trade or business in the United States "without discussion of the applicable statute and, regulations" and without applying those authorities to the facts in the ruling.

[xxiv] The regulations under §864(b) describe the safe harbors, but go so far as to state that "[t]he fact that a person is not determined by reason of this section to be *not* engaged in trade or business within the United States is not to be considered a determination that such person *is* engaged in trade or business within the United States. Whether or not such person is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case." Regs. §1.8642(e) (emphasis added).

[xxv] 12 T.C.M. 1431 (1953). The fact pattern in that case involved a U.S. business that purchased a surplus war ship, needed additional funding, and obtained $100,000 from Pasquel, a Mexican citizen. The principal of the U.S. business told Pasquel to expect the return of his $100,000, with at least an additional 25%. The principal felt a moral obligation to fulfill this representation, and entered into contracts in the United States, without Pasquel's knowledge, to protect Pasquel from loss in the event that the U.S. business failed. When the U.S. business sold the war ship, it immediately repaid Pasquel $100,000 and his share of the profits, even before the U.S. business finished refurbishing the ship (which was a condition of the sale). The opinion contains no details about Pasquel's activities in Mexico, and does not state whether he was in the business of lending in Mexico or elsewhere. Pasquel argued that his contribution was a loan, while the government claimed that Pasquel participated in a joint venture. The court stressed Pasquel's passive role in the ship transaction.

[xxvi] U.S. tax treaties also fail to provide detailed guidance for determining whether a foreign person's lending activities in the United States constitute a trade or business. Both the 1996 U.S. Model Income Tax Treaty and the OECD Model Treaty provide that income from a trade or business ("business profits") that is earned through a permanent establishment in one of the signatory countries can be taxed in that country. OECD Model Tax Convention on Income and Capital, Art. 7(l) (1992), U.S. Model Income Tax Convention of September 20, 1996, Art. 7(1). However, neither model treaty provides a significant definition of a "trade or business" for this purpose. The technical explanation to the U.S. model states that the term "trade or business" is not defined in the model treaty and that the term must therefore be interpreted using domestic U.S. law. Technical Explanation to the 1996 Treasury Department Model Income Tax Convention, 1 CCH Tax Treaties at 10,63335. It further explains that the regulations under §367(a) should be used to determine whether a taxpayer is engaged in an active trade or business, based on whether the taxpayer engaged in a "specific unified group of activities that constitute . . . an independent economic enterprise carried on for profit," and that require substantial managerial or operational activity by the taxpayer's officers or employees. *Id.*

The 1996 U.S. Model Treaty provides more detail in the context of the limitations on benefits article, which refers to an "active trade or business" as one of the criteria by which a person not otherwise eligible for treaty benefits can qualify for benefits under the treaty. U.S. Model Income Tax Convention of Sept. 20, 1996, Art. 22(3)(b). Under the treaty, such an active trade or business does not include making and managing investments unless "the activity is banking, insurance, or securities activity conducted by a bank, insurance company, or registered securities dealer." *Id.* This rule that managing investments cannot constitute an active trade or business (except for certain licensed entities) recognizes the difficulties in distinguishing between active and passive finance activities for nonbank taxpayers. Both model treaties discussed above attempt a modified version of such a distinction with respect to interest income, however, by allowing the source country to impose net tax on interest income that is sufficiently connected with a permanent establishment that carries on business, but allowing only a limited gross basis tax on other (presumably passive) interest income. OECD Model Tax Convention on Income and Capital, Art. 11(4) (1992), U.S. Model Income Tax Convention of September 20, 1996, Art. 11(3).

[xxvii] *See Higgins v. Comr.*, 312 U.S. 475, 478 (1941) (applying a facts and circumstances test and stating that no matter how extensive or continuous, taxpayer's activities were investment activities and could not constitute a trade or business); *Purvis v. Comr.*, 530 F.2d 1332 (9th Cir. 1976); *de Vegvar v. Comr.*, 28 T.C. 1055 (1957) (emphasizing extent of activity); *Liang v.Comr.*, 23 T.C. 1040 (1955) ("frequent, short term turnover" is the key factor). *See also Adda v. Comr.*, 10 T.C. 273 (1948) (trading in commodities can constitute a trade or business if sufficiently extensive; the key factors are the number of transactions and amounts of gain; and "infrequent" and "inconsequential" trades would not have constituted a trade or business); *Comr. v. Nubar*, 185 F.2d 584, 8889 (4th Cit. 1950) (*dicta*, extent of trading made activities a trade or business, "infrequent or inconsequential" activities

would not have constituted a trade or business). Some cases may also consider a taxpayer's trading on margin, hedging, borrowing to purchase securities, or purchasing derivatives as a sign that the taxpayer was engaged in a trade or business. See *Liang v. Comr.*, 23 T.C. 1040 (1955) (taking into account that taxpayer used no hedges, did not purchase on margin, did not borrow to buy stocks, and did not enter into short sales, puts, or calls); de *Vegvar v. Comr.*, 28 T.C. 1055 (1957) (same); *cf. Comr. v. Nubar*, 185 F.2d 584, 58586 (4th Cir. 1950) (describing taxpayer's margin activity, but not discussing this point in opinion).
Cases examining whether securities activities of domestic taxpayers constitute a trade or business similarly emphasize whether the taxpayer sought to profit from long-term appreciation or from short-term market movements, and the length of the taxpayer's holding periods. Such cases also examine the extent of the taxpayer's activities, but this "regular and continuous" factor is not determinative. *See, e.g., Moller v. U.S.*, 721 F.2d 810 (Fed. Cir. 1983) (denying home office deduction); *Yaeger's Est. v. Comr.*, 889 F.2d 29 (2d Cit. 1989) (denying worthless debt deduction).

[xxviii] For example, the cases treat shorter holding periods as a strong indicator that the taxpayer is engaged in a trade or business. See fn. 28, above. This emphasis on the length of the taxpayer's investment is consistent with practitioners' practices in applying the trade or business test to lending activities, and with §542(d)'s consideration of the remaining maturity periods of loans.

[xxix] *See Higgins v. Comr.*, 312 U.S. 475, 478 (1941) (extensive securities transactions; no amount of activity can convert investing into a trade or business). *cf. Groetzinger v. Comr.*, 771 F.2d 269, 27475 (7th Cir. 1985) (comparing high and low-volume investing with high and low-volume trading, stating that it is difficult to distinguish between high and low-volume investors), *aff'd*, 480 U.S. 23 (1987).

[xxx] It is relatively clear from cases involving the U.S. trade or business status of foreign persons that U.S. activities relating to the mere ownership of income-generating assets will not cause a foreign person to be treated as engaged in a trade or business in the United States. Accordingly, the activities associated with the mere custody and monitoring of securities, including stocks and bonds, and the mere right to receive rent or royalties, generally will not rise to the level of a trade or business. Occasional acquisitions and sales of such assets usually will not alter this conclusion. In contrast, ownership of assets coupled with "considerable, continuous and regular" management and other activities (such as the active management of rental real estate holdings) can result in the conduct of a trade or business. *See e.g.*, *Lewenhaupt v. Comr.*, 20 T.C. 151, 163 (1953) (taxpayer's U.S. real estate activities, conducted through an agent, were "considerable, continuous, and regular and . . . constituted engaging in a business"); *Johansson v. U.S.*, 336 F.2d 809 (5th Cir. 1964) (participation by a boxer in a championship fight in the United States constituted the performance of personal services and, therefore, the boxer was engaged in a trade or business in the United States); *Ingram v. Bowers*, 47 F.2d 925 (S.D.N.Y. 1931), *aff'd*, 57 F.2d 65 (2d Cir. N.Y 1932) (income from record sales constituted personal services income from recordings in the United States); *InverWorld, Inc. v. Comr.*, T.C. Memo 1996301 (Mexican brokerage firm's Cayman Islands company was engaged in business in the United States based on certain investment services performed by its U.S. subsidiary and attributed to the Cayman Islands company); Linen Thread Co., *Ltd. v. Comr.*, 14 T.C. 725 (1950) (two isolated sales in the United States did not constitute a trade or business in the United States); *Handheld v. Comr.*, 23 T.C. 633, 638 (1955) (an arrangement between a foreign post card manufacturer and a U.S. distributor was a consignment contract creating an agency relationship and, thus, the activities of the U.S. distributor were attributable to the foreign manufacturer, causing it to have a permanent establishment in the United States and to be engaged in business in the United States); *U.S. v. Balanovski*, 236 F.2d 298 (2d Cir. 1956) (foreign partnership was engaged in a trade or business in the United States based on the principal partner's activities in the United States, which went beyond the activities of a mere purchasing agent and included soliciting orders, inspecting merchandise, and making important business decisions); *Scottish American Investment Co., Ltd. v. Comr.*, 12 T.C. 45, 59 (1949) (activities of U.S. office of foreign trusts did not constitute a trade or business.

[xxxi] *See* Rev. Rul. 883, 19881 C.B. 268, (§864's standards "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."); *cf. Rev. Rul.* 75365, 19752 C.B. 471 (the terns "trade or business" may have different meanings for purposes of §6166, relating to estate taxes, than for other purposes); Rev. Rul. 75366, 19752 C.B. 472 (same); Rev. Rul. 75367, 19752 C.B. 472 (same).

[xxxii] *See Whipple v. Comr.*, 373 U.S. 193, 197, 202 (1963). A for profit motive is necessary, but not sufficient, to demonstrate that a taxpayer is engaged in a trade or business. *See* Boyle, "What is a Trade or Business?" *39 Tax*

Lawyer 737, 74345, 75859 (1986) (conceptualizing the trade or business test as including a for profit requirement similar to §183's requirements).

[xxxiii] *See e.g., Snell v. Comr.*, 97 F.2d 891, 892 (5th Cir. 1938) (business "means busyness").

[xxxiv] The examination of whether the taxpayer holds itself out to the public as engaged in a business appears in Justice Frankfurter's concurring opinion in *Deputy v. Dupont*, 308 U.S. 488, 499 (1940), and is also mentioned in *Snow v. Comr.*, 416 U.S. 500, 502 (1976). This test has been extensively questioned and examined in cases concerning whether professional gamblers, who do not have customers or offer goods or services to others, may be treated as engaged in a trade or business. *See*, *e.g.*, *Groetzinger v. Comr.*, 771 F.2d 269 (7th Cir. 1985) (holding oneself out to the public as providing goods and services to others is not a determinative factor), *aff'd* 480 U.S. 23 (1987); *Ditunno v. Comr.*, 80 T.C. 362 (1983)' (same); Boyle, "What is a Trade or Business?" 39 *Tax Lawyer* 737, 739, 74648, 762763 (1986) (grouping trade or business factors into four criteria, disapproving of the examination of whether the taxpayer holds itself out as providing goods or services, and, stating that the Tax Court generally does not view this criterion as determinative or as being adopted as a criterion by the U.S. Supreme Court); *cf. Gajewski v. Comr.*, 723 F.2d 1062 (2d Cir. 1983), cert. denied, 105 S. Ct. 88 (1984); PLR 8018017 (self-employment tax not applicable because gambler did not offer goods or services to others); Bolling and Carper, "The Evolving Definition of 'Trade or Business': Ditunno and Beyond," 63 *Taxes* 73 (1985).

The Service has stated that offering goods or services to only one customer may suffice for characterization as a trade or business under § 1402(c) (relating to self-employment tax), which generally defines trade or business by cross reference to §162. *See* Rev. Rul. 82210, 19822 C.B. 204; *see also* Boyle, "What is a Trade or Business?" 39 *Tax Lawyer* 737, 75052 (1986) (discussing case law conflicts as to whether a consultant contractually limited to serving, or actually serving, only one customer could be treated as engaged in a trade or business).

[xxxv] The Internal Revenue Service discussed the analyses found in the cases in a recent field service advice (FSA). *See* FSA 199911003 (Nov. 18, 1998), 1999 *TNT* 5462. The FSA concerned a U.S. person (taxpayer) who purchased a debt instrument that later became worthless. The FSA concluded that the taxpayer was in the trade or business of money lending, because he "has loaned money and purchased notes for many years, has a reputation in the community as a lender and purchaser of notes, and has been approached by borrowers and sellers of notes." *See also, e.g., Gross v. Comr.*, 401 F.2d 600 (9th Cir. 1968); *Carpenter v. Erickson*, 255 F. Supp. 613 (D. Or. 1966) (taxpayer who financed seven persons in eight years and was known in the community as financing businesses was engaged in the trade or business of financing or lending); *Carraway v. Comr*., T.C. Memo 1994295, 67 T.C.M. 3139; *McCrackin v. Comr*., T.C. Memo 1984293, 48 T.C.M. 248, 251 (taxpayer was engaged in lending trade or business, where taxpayer made 66 loans, totaling approximately $620,000, to 12 unrelated borrowers over 15 years); *Zivnuska v. Comr*., 33 T.C. 226 (1959) (*dicta*, because the Court held that the relevant amounts were equity investments rather than debt); *Ruppel v. Comr*., T.C. Memo 1987248, 53 T.C.M. 829, 83234 (no one factor is determinative); *Hoogerworf v. Comr*., T.C. Memo 1976186, 35 T.C.M. 811; *Serot v. Comr*., T.C. Memo 1994532, 68 T.C.M. 1015, 102223; *Hudson v. Comr*., 31 T.C. 574, 584 (1958) (loans were "too few and infrequent" to constitute a trade or business, although taxpayer loaned to at least four borrowers); *Jessup v. Comr*., T.C. Memo 1977289, 36 TCM 1145, 1150 (trade or business of lending existed where taxpayer engaged in 31 loan, endorsement, or guarantee transactions with 17 unrelated persons over 10 years); *U.S. v. Henderson*, 375 F.2d 36, 41 (5th Cir. 1967) (dicta, no lending trade or business despite the taxpayer making seven other loans, in addition to those at issue, where all borrowers were acquaintances, no office, no advertising, and activities did not absorb a significant portion of taxpayer's or agent's time, although taxpayer had a reputation in the community as a lender, maintained records, and collected interest); *Cone's Est. v. Comr*., T.C. Memo. 195456; *Cushman v. U.S*., 148 F. Supp. 880 (D. Ariz. 1956); *Minkoff v. Comr*., T.C. Memo. 1956269. These cases generally involved individual taxpayers.

The Tax Court has stated that a taxpayer will be treated as engaged in the trade or business of money lending, for these purposes, only in the exceptional circumstances in which the taxpayer's activities are so extensive and continuous as to rise to the level of a separate business. *See e.g.*, *Imel v. Comr*., 61 T.C. 318, 323 (1973); *Carraway v. Comr*., T.C. Memo 1994295, 67 T.C.M. 3139, 31395; *Rollins v. Comr*., 32 T.C. 604, 61213 (1959); *Ruppel v. Comr*., T.C. Memo 1987248,.53 T.C.M. 829, 832; *Serot v. Comr*., T.C. Memo 1994532, 68 T.C.M. 1015, 102223. The Tax Court appears to use this concept to determine whether a taxpayer-lender's activities constitute a trade or business separate from the *borrower's* activities, especially where the taxpayer's alleged trade or business is connected to the taxpayer's shareholder, client, or employee relationship with the borrower. *See Berwind v. Comr*., 20 T.C. 808, 815 (1953) (implying this interpretation). The "exceptional circumstances" language thus seems

merely to implement the oft-repeated rule that the business of a borrower, client, or employer, or of a corporation in which the taxpayer is a shareholder, is not treated as a business of the tax-payer-lender. *See id*.
The lending cases tend not to address whether the taxpayer conducts its activities directly or through an agent. Cross-border securities trading cases, however, demonstrate that the nature and extent of the activities rather than whether they are performed directly is the key to the trade or business analysis. See de *Vegvar v. Comr*., 28 T.C. 1055 (1957); *Adda v. Comr*., 171 F.2d 457 (4th Cir. 1948) (independent agent performing activities in United States, using his own discretion, had same effect as if taxpayer himself were in United States); *Liang v. Comr*., 23 T.C. 1040 (1955) (use of an agent, rather than principal acting directly in United States, is relevant but not determinative, more important is analysis of agent activities). This lack of emphasis on agency contrasts with the interpretation of the "active trade or business" standard in §§355 and 367, which requires that the taxpayer act directly, or through employees, rather than through independent contractors. *See e.g.*, Regs. §1.367(a)2T. The active finance standard in §954(h)(3)(A)(ii) also requires direct activity by the taxpayer.

[xxxvi] Debt will be characterized as connected with a trade or business, rather than as a nonbusiness debt, only if the debt is proximately connected with a trade or business (not necessarily the trade or business of lending). The typical case concerns an individual taxpayer who makes one loan, or several loans to one borrower, and attempts to deduct the resulting worthless debt. The taxpayer often argues that the loan was made to preserve a client relationship or otherwise protect the taxpayer's trade or business (for example, by saving an insolvent corporation that employs the taxpayer), while the government contends that the loan was an investment unrelated to the taxpayer's trade or business. *See e.g.*, *U.S. v. Geneses*, 405 U.S. 93, 103 (1972).

[xxxvii] *See U.S. v. Generes*, 405 U.S. 93, 103 (1972). This test requires that general business concerns rather than investment return be the dominant motive for the loan. *See also Burton v. Comr*., 549 F.2d 1111 (6th Cir. 1977).

[xxxviii] Presumably, this dominant motive analysis also would be relevant in determining whether lending activities rise to the level of a trade or business in the first instance as well as whether loans are proximately connected to a nonlending trade or business. The dominant motive test hinges on the type of income the debt would have generated (or the loan would have protected) if the debt had not become worthless. The cases therefore examine whether the lender was attempting to protect his salary (as the borrower's employee) or business relationship with the borrower, both of which would yield income connected with the lender's trade or business, or whether the lender was instead protecting his investment (for example, as a shareholder) in the borrower or helping a friend or family member, in which case the loan would not be proximately related to the taxpayer's trade or business. See, *e.g.*, *U.S. v. Generes*, 405 U.S. 93, 103 (1972); *Mann's Est. v. U.S.*, 731 F.2d 267 (5th Cir. 1984); *Kelly v. Patterson*, 331 F.2d,753 (5th Cir. 1964); *Tennessee Securities, Inc. v. Comr*., 674 F.2d'570, 57475 (6th Cir. 1982); *Alsobrook v. U.S.*, 566 F.2d 628 (8th Cir. 1977); *Lundgren v. Comr*., 376 F.2d 623 (9th Cir. 1967); *Gross v. Comr*., 401 F.2d 600 (9th Cir. 1968); *Hunsaker v. Comr*., 615 F.2d 1253 (9th Cir. 1980); *Hogue v. Comr*., 459 F.2d 932 (10th Cir. 1972); *Harsha v. U.S.*, 590 F.2d 884 (10th Cir. 1979); *Adelson v. U.S.*, 21 Cl. Ct. 231 (1987); *Levin v. U.S.*, 597 F.2d 760 (Ct. Cl. 1979); *Jones v. Comr*., T.C. Memo 1997368; *Osterbauer v. Comr*., T.C. Memo 1995490.

[xxxix] The latter inquiry often resembles the analysis of whether the transaction is debt or equity. *cf*. *German v. Comr*., T.C. Memo 1999104 (using the same analysis to state that the transactions resembled equity rather than debt and to hold that the petitioner was not entitled to a bad debt deduction, assuming the transaction was debt, because the petitioner was not engaged in the trade or business of lending money, although the government did not question the characterization of the transactions as debt); *Laidlaw Transportation, Inc. v. Comr*., T.C. Memo 1998232, and cases cited therein (discussing distinction between debt and equity).

[xl] *cf*. FSA 1999509, 199 TNT 1589 (stating that facts concerning the extent of the taxpayer's time and income attributable to lending activities would be relevant to the determination of whether the taxpayer was engaged in a trade or business of lending). This factor would suggest that a fund or corporation formed solely to make loans would be more likely to be characterized as a trade or business than a taxpayer that engaged in other activities and also issued loans. This does not seem to be a useful distinction if both taxpayers engage in the same lending activities.

[xli] Section 7704 generally provides that a publicly traded partnership will be treated as a corporation unless at least 90% of its gross income is qualifying income, which does not include interest derived in a financial business.

[xlii] Section 7704 is intended, in general, to treat as corporations any businesses of the type that would ordinarily operate in corporate form, in order to prevent taxpayers operating in public partnership form from obtaining tax advantages over other, similarly situated businesses that operate as corporations. *See* Ways and Means Committee, H. R. 100391, Omnibus Budget Reconciliation Act of 1987, 100th Cong., 2d Sess., at 1065.

[xliii] The ruling does not explain the significance of this factor, but under the reasoning of the bad debt cases, if the primary motive for issuing the mortgage loans is protection of the lender's employment, then the loan is proximately connected to a trade or business (the employment) but is not part of a lending trade or business. *See* above fns. 3639 and associated text. Under the bad debt cases, proximate connection to any trade or business is sufficient, but §7704 excludes interest from qualified income if the interest is derived in a *finance or insurance* business. Therefore, the private letter ruling can be interpreted as resting partly on a conclusion that the partnership is engaged in a trade or business but not in a finance trade or business, because its primary motive in issuing loans is furtherance of union members' employment.
[xliv] A similar factor was taken into account in at least one case examining whether a foreign person was engaged in the trade or business of securities trading. *See Liang v. Comr*., 23 T.C. 1040 (1955) (taking into account that taxpayer used no hedges, did not purchase on margin, did not borrow to buy stocks, and did not enter into short sales, puts, or calls).
[xlv] Staff of Joint Committee on Taxation, *General Explanation of the Tax Reform Act* of 1986, 863 (5/4/87). The financial services separate limitation category was created, in the foreign tax credit provisions, in part due to "the practical difficulty of distinguishing passive income of [an active financing business] . . . from its active income." *Id.* at 884.
[xlvi] Conference Report to Accompany H.R. 2014, 645 (7/30/97).
[xlvii] Regs. §1.8644(c)(5)(ii), (iii). Securities include evidences of indebtedness, and therefore include loans. Regs. §1.8644(c)(5)(v).
[xlviii] Regs. §1.8644(c)(5)(ii)(a). Under the sixth rule, a specified amount of the taxpayer's interest, gain, and loss from stocks and securities not meeting any of the other five requirements (but derived in the active conduct of such a business where the taxpayer's U.S. office actively participated in acquiring the stock or security) is also treated as effectively connected to the active conduct of such a business. Regs. §1.864(c)(5)(ii)(b)(3) and flush text.
[xlix] A taxpayer could, theoretically, be treated as engaged in a U.S. trade or business of lending for purposes of §882, but not as engaged in the active conduct of a banking, financing, or similar business under Regs. §1.8644(c)(5)(i) if the taxpayer were engaged in regular, continuous lending activity and showed other characteristics outlined in the case law, but did not have sufficient (or any) transactions with the "public." This result would depend partly on the meaning of the "public," for purposes of the regulations.
It is also possible for a taxpayer to be in a trade or business, under §882, but not fall within Regs. §1.8644(c)(5)(i) by reason of the special rule that financing entities that borrow funds for related persons are not treated as engaged in the active conduct of a banking, financing, or similar business. *See* Regs. §1.8644(c)(5)(i) (last sentence); *see also* Rev. Rul. 73227, 19731 C.B. 338, *revoked by*, Rev. Rul. 883, 19881 C.B. 268.
[l] Regs. §1.8644(c)(i).
[li] This is not a dispositive factor under the case law, but the existence of unrelated borrowers has been taken into account as a factor. *See e.g., McCrackin v. Comr.,* T .C. Memo 1984293, 48 TC.M. 248, 251; *Jessup v. Comr*., T.C. Memo 1977289, 36 TCM 1145, 1150; *U.S. v. Henderson*, 375 F.2d 36, 41 (5th Cir. 1967) (dicta).
[lii] The business activities test applies to income of a passive type that "arises directly from the active conduct of the taxpayer's trade or business," while the asset use test generally applies where the income does not directly arise from the trade or business activities as such (for example, where interest income is earned by a retail business). Regs. §1.8644(c)(3), 4(c)(2)(i). Therefore, the former test seems more applicable to lending income.
[liii] The regulations were drafted when effectively connected income characterization was generally preferable to gross basis tax (before the portfolio interest exception was enacted). The regulations were intended to prevent taxpayers from characterizing too much income (*i.e.*, income that was actually passive) as income effectively connected to a trade or business. *See* Isenbergh, *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income* 21:15 (1997).
[liv] However, the foreign person's income could be effectively connected to another trade or business of the taxpayer. Regs. §1.8644(c)(5)(vi)(a). In addition, if the taxpayer's activities were a trade or business under §882, but were not a banking, financing, or similar business under the regulations, the business activities, and asset use tests would apply to determine whether the income were effectively connected.
[lv] *See* Regs. § 1.8644(c)(5)(iii).
[lvi] Section 864(c)(6) provides a somewhat similar rule that would treat ongoing interest income that is attributable to a previous year's transaction as effectively connected income if it would have been treated as effectively connected if it were earned in the same year as the underlying transaction.

[lvii] The 10% rule of Regs. § 1.8644(c)(5)(ii) can be viewed as another instance in which the banking, financing, or similar activity rules are more likely than the business activities test to treat income as effectively connected. The percentage of interest that is treated as effectively connected varies inversely in relation to the percentage of the U.S. office's assets that consists of items other than certain stocks and securities. Such stocks and securities consist of stocks or securities acquired as a result of or in the course of making loans to the public, in the course of distributing such items to the public, or for the purpose of satisfying certain U.S. banking authority requirements, securities payable on demand or at a fixed date not later than one year from acquisition, and securities issued by the United States that generate income meeting one of the six criteria.
[lviii] Regs. § 1.8644(c)(5)(iii)(b)(5).
[lix] §864(c)(2), Regs. §1.8644(c)(4).
[lx] *cf. lnverworld v. Comr*., T.C. Memo 1996301 (examining both Regs. §1.864(c)(5) and the case law factors to determine whether the taxpayer was engaged in a business). In addition, Rev. Rul. 883, 19881 C.B. 268, indicates that the analysis of whether a taxpayer is engaged in a trade or business is distinct from the analysis of whether the taxpayer's income is effectively connected with a banking, financing, or similar business.
[lxi] *See e.g.*, §954(h).
[lxii] Such trade or business requirements in the Code resemble the provisions in tax treaties that allow the source country to tax active income only if the taxpayer operates a trade or business in the source country through a permanent establishment. For example, both the OECD Model Treaty and the U.S. Model Treaty provide that business profits of an enterprise are taxable only by the taxpayer's state of residence, except that the source country may tax such profits to the extent that the profits are attributable to a permanent establishment, in the source country, through which the taxpayer "carries on a business." OECD Model Tax Convention on Income and Capital, Art. 7 (1992); U.S. Model Income Tax Convention of Sept. 20, 1996, Art. 7. Both model treaties define "business profits" as income from a trade or business. *Id.*, Art. 7(7).
Treaties appear to use the operation of a trade or business through a permanent establishment as a surrogate for the distinction between active and passive income. The permanent establishment and double taxation articles of essentially all U.S. tax treaties reflect the international consensus that the source country has primary tax jurisdiction to tax "active" income (*i.e.*, income earned from the conduct of business activities in the source country). There is less consensus on the tax treatment of passive income (*i.e.*, income such as interest, dividends, and gains) that is not earned in the ordinary conduct of a business in the source country. See Reich, "Taxing Foreign Investor's Portfolio Investments: Developments and Discontinuities," 79 *Tax Notes* 1465 (1998). Most U.S. tax treaties eliminate or reduce source country tax on gains and reduce source country taxation of dividends. *See e.g.*, U.S. Model Income Tax Convention of Sept. 20, 1996.
[lxiii] *See* §§864(b), 864(c); and 881(c), Regs. §1.8645, and fn. 8, above (regarding rules enacted in order to attract foreign capital to the United States). In addition, the mobility of financial activities has been taken into account in the subpart F and foreign tax credit rules, which seek to remove tax incentives that might otherwise induce taxpayers to move financial income and activities offshore.
[lxiv] *See* Staff of Joint Committee on Taxation, General Explanation of the *Revenue Provisions of the Deficit Reduction Act of 1984* (12/31/84) (discussing the portfolio interest exception, "[I]n addition to addressing a Federal Reserve concern regarding reserve requirements, the foreign bank exception was intended to prevent U.S. banks, which are subject to U.S. tax on interest income, from suffering a competitive disadvantage vis-a-vis foreign banks that make loans to U.S. persons") *see also* fn. 17, above (discussing §894(c) and other competitiveness issues).
[lxv] *See e.g.*, the portfolio interest exception (which is not available for interest earned by banks in the ordinary course of their business) and the stock, securities, and commodities trading safe harbors, which are not available for dealers. *cf.* Ways and Means Committee, H. R. 100391, Omnibus Budget Reconciliation Act of 1987, 100th Cong., 2d Sess., at 1065 (stating that publicly traded partnerships have less of a competitive advantage over corporations with respect to passive income because, among other reasons, "investors could earn such income directly").
[lxvi] *See* Staff of Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 863 (5/4/87) ("Income earned in a financial services business, by its nature, is relatively movable; it may sometimes be shifted to low tax jurisdictions . . . . [P]rior law . . . gave manufacturing companies with substantial excess credits, for example, an incentive to establish or acquire banking (or other financial services) type entities in low tax jurisdictions"); *cf.* Conference Report to Accompany H.R. 2014; 645 (7/30/97) ("the potential mobility of the business activity and income recognition of insurance, banking, financing, and similar businesses require[s] further study").

[lxvii] *See e.g.*, Ways and Means Committee, H. Rep. 98432, Tax Reform Act of 1984, 98th Cong., 2d Sess. (3/5/84) (in discussing amendments to §367, the Ways and Means Committee stated that "[t]he bill generally replaces the principal purpose test of present law with an 'active trade or business' exception"); Conference Report on Tax Reform Act of 1986, H. Rep. 99841, 99th Cong., 2d Sess. (9/18/86) (discussing the material activities requirement of the passive activity loss rules, the legislative language "recognizes the substantial likelihood that, despite the difficulty in many circumstances of ascertaining whether the management services rendered by an individual are substantial and bona fide, such services are likely to be so when the individual is rendering them on a fulltime basis and the success of the activity depends in large part upon his exercise of business judgment").
[lxviii] *See* §§355, 904(d), and 954.
[lxix] Foreign lenders generally prefer to be eligible for the portfolio interest exception, which applies only if the interest income is not effectively connected with a U.S. trade or business. See §881(a), (c). However, if the taxpayer is not eligible, for that exception (or for beneficial treatment under a tax treaty, perhaps because the interest is earned through a permanent establishment carrying on a business in the United States or because the taxpayer's country has no tax treaty with the United States), the comparative results of net tax under §882 or gross basis tax under §881 depend on the amount of the deductions the taxpayer would be able to claim.
[lxx] Relevant cross-border provisions include §§904(d), 952(c)(1)(B)(iv), and 954(h). Relevant domestic provisions include §§42(k)(2)(A)(i) (for purposes of low income housing rules, whether financing from certain nonprofits is qualified financing is determined without regard to whether lender is actively and regularly engaged in lending money); 49(a)(1)(D)(iv) (active and regular requirement, qualified commercial financing for purposes of the at risk rules); 1202(e)(3)(A) and (B) (active business requirements for corporations issuing certain small business stock); 1361(c)(5)(B)(iii) (exception from the definition of straight debt, for purposes of S corporations); and 1362(d)(3)(C)(ii) (exception from passive income treatment, for, purposes of S corporation status).
[lxxi] *See* Rev. Rul. 883; 19881 C.B. 268 (rules under §864(b) for determining whether taxpayers are engaged in a U.S. trade or business "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"). *cf*. Ways and Means Committee of the House of Representatives, H. Rep. 100391, 100th Congress, lst Sess. (12/26187) (discussing passive income provisions in publicly traded partnership rules, and stating that the definition of passive income used in that context was specific to §7704 and was not the same as the concept used in the passive loss, S corporation, or other rules); *Groetzinger v. Comr*., 771 F.2d 269, 271 (7th Cir: 1985) *aff'd*, 480 U.S. 23 (1987) ("the precise meaning or connotation of the term ["trade or business"] appears to vary depending upon the provision in which it is used").
[lxxii] For example, §954(h)(4) and Regs. §1.9044(e) list activities such as lending, buying, and selling debt, and leasing (and, in the case of the §904 regulations, such other activities as providing underwriting and foreign exchange services and factoring evidences of indebtedness). *See also* Conference Report to Accompany H.R. 4328, 105th Cong., 2d Sess., 1562 (10/19/98) (listing more activities for purposes of §954(h) than are mentioned in the Code).
[lxxiii] *See e.g.*, §954(h)(2)(B) (using licensing as a substitute for entity-level requirement, but not for requirements regarding the kind of transactions and activities that generate financial income); *cf*. Regs. §1.12964 (relating to banking). The limitation of benefits article of the 1996 U.S. Model Income Tax Treaty takes a similar approach, stating that investment activities will not be treated as an active trade or business except in the case of banking, insurance, or securities activities carried on by a bank, insurance company, or licensed securities dealer. 1996 U.S. Model Income Tax Treaty, Art.22 (3)."
[lxxiv] Regs.§ 1.9044(e)(3).
[lxxv] Regs. §1.9044(e)(2).
[lxxvi] In his remarkable book on globalization; Thomas Friedman describes the emergence in the post *cold-war* era of an "Electronic Herd" of often anonymous stock, bond, currency and multinational investors, connected by screens and networks that dominate global capital markets. *See* Friedman, *The Lexus and The Olive Tree* (1999). The "Electronic Herd" refers to all persons who can move money among markets and among "an incredible diversity of financial products" on a very short-term basis, including currency traders, major mutual and pension funds, hedge funds, insurance companies, bank trading rooms, and individual investors.
[lxxvii] The spectacular 1998 collapse of Long Term Capital Management, a highly leveraged U.S.-based hedge fund; focused particular attention on the role of nonregulated financial entities in market instability. The collapse triggered significant debate regarding the need for financial regulation of nonregulated market participants

(including hedge funds) that operate under U.S. jurisdiction and elsewhere. See "Hedge Funds, Leverage, and the Lessons of Long Term Capital Management," Financial Market Trends (6/1/99).

[lxxviii] *See* "Debunking the Myths," *Private Banker Int'l* (Dec. 1998); *see also* "Number of Hedge Funds Increases for Tenth Consecutive Year; Growth Rate Slows; But Still Steady," *Business Wire* (9/21/99) (Based on report of George P. Van).

[lxxix] *Id.*

[lxxx] For example, in Europe the competition is so tough that "banks and investment firms are chasing more lucrative business away from the plain-vanilla traditional private placement sector." Robinson, "Private Market Feels the Squeeze," *Euroweek* (Nov. 1996).

[lxxxi] Elliott, "Coming Apart," *Newsweek* (10/12/98) (Congressional testimony related to potential regulation of hedge funds in the aftermath of the collapse of *Long-term* Capital Management).

[lxxxii] Of course, any dividends paid on preferred stock and other equity investments in U.S. issuers will attract U.S. withholding tax (assuming the dividends are not effectively connected with a U.S. trade or business), which may be reduced under tax treaties and may or may not be recoverable through a foreign tax credit mechanism in relevant foreign jurisdictions. Although the withholding tax may impede preferred stock investments in established companies, it is often of little relevance with respect to preferred share investments in high-technology or other startups that have no current or expected earnings and profits and that fund distributions on preferred shares through mechanisms other than earnings (including from subsequent financings).

[lxxxiii] Such an assumption is obviously a broad, generalization that becomes particularly strained with respect to hybrid financing transactions such as convertible debt and bridge loan facilities entered into in connection with related equity investments. Such hybrid financings are likely to be significantly more passive in nature than certain issuances of fixed or variable rate preferred shares.

[lxxxiv] In the case of U.S. source interest, the exemption for withholding tax assumes that the interest satisfies all the requirements of §881(c).

[lxxxv] *See* above text accompanying fn. 93.

[lxxxvi] Convertible loans often raise difficult issues under the portfolio interest exception. In general, there is a significant risk that interest on a convertible loan will be subject to U.S. withholding tax if the loan is convertible into 10% or more of the voting. stock of the issuer (or if a conversion option, together with other shares owned by the holder of the loan, causes the holder to be considered as owning 10% or more of the voting shares of the issuer).

[lxxxvii] It is unclear which, if any, of F's other income and gains (*i.e.*, income and gains from other investments) would be effectively connected with the lending business. In general, any income and gains derived in connection with activities that qualify for the trading safe harbors should not be treated as effectively connected.

[lxxxviii] In addition, it is difficult to see how F's private lending transactions impose unfair competition on U.S. regulated financial intermediaries. The loans could clearly be negotiated from outside the United States.

[lxxxix] A new standard for inbound lending might even base its description of non-trade-or-business activities on a reference to income that would not be described in §954(h) (applied as if the United States were the taxpayer's "home country," within the meaning of that section).

[xc] Of course, the definition of "customer" would continue to raise difficult issues.

[xci] In adopting anew standard, the United States would have to decide whether to take into account *all* of the taxpayer's activities (worldwide), or only its U.S. activities. The former approach seems to be required in order to protect the competitiveness of U.S. lenders operating in the United States.

[xcii] Ordinary consumer financial services such as trust services, foreign exchange services, collections services, and charge and credit card services would not be treated as basic finance activities for purposes of the safe harbor rule.

[xciii] In 1986, Boyle suggested a test based on the amount of skill and effort expended by the taxpayer. *See* Boyle, "What is a Trade or Business?" 39 *Tax Lawyer* 737, 76062 (1986) (suggesting that skill and effort may explain the case law results, and (even if not) should be adopted as the standard). However, this proposed test conflicts with cases such as *Higgins* and *Yaeger*, which concerned taxpayers who expended skill and effort but were nonetheless classified as investors. In addition, Boyle's proposed test is unappealing because investors, as well as traders, can certainly exercise considerable skill and knowledge, while dealers may routinely profit from relatively undemanding, unskilled matching of clients who wish to take offsetting positions from each other.