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## IRS Memo Addresses Loan Origination by Offshore Entities

**TO:** Clients and Friends<sup>1</sup>  
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In a memorandum issued by the IRS Office of Chief Counsel to IRS agents in Manhattan, dated September 22, 2009 (the “Memorandum”), the IRS concluded that a foreign corporation is engaged in a U.S. trade or business and subject to U.S. taxation on the net income generated by its lending activities to U.S. borrowers through an agent in the U.S.

The facts described in the Memorandum involve a foreign corporation (the “Foreign Corporation”), which has no office or employees in the U.S., that makes loans to U.S. borrowers using the services of a U.S. company (the “U.S. Agent”) to solicit U.S. borrowers, negotiate the terms of the loans, perform credit analyses, and undertake all other related activities, other than final approval and signing of the loan documents which are performed by the Foreign Corporation’s employees outside of the U.S. The U.S. Agent performs these services “on a considerable, continuous, and regular basis” from its U.S. office and is compensated on an arm’s length basis for the services pursuant to a service contract with the Foreign Corporation. No details are provided in the Memorandum concerning the relationship between the U.S. Agent and the Foreign Corporation or whether the U.S. Agent performs activities for clients other than the Foreign Corporation pursuant to its service contract. The IRS suggests, however, in the Memorandum that such details are irrelevant to its analysis of the matter.

The Memorandum concludes that the interest income that the Foreign Corporation earns from its loans constitutes income effectively connected with a U.S. trade or business (“ECI”) under the special “banking financing or similar business” rule of

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Treasury regulation section 1.864-4(c)(5) (the “U.S. Banking Regulation”) and is subject to net U.S. taxation. According to the IRS, the requirement of such regulation that income generated by a banking or finance business must be “attributable to the U.S. office through which such business is carried on” in order to constitute ECI is satisfied by the involvement of the office of the U.S. Agent in the U.S. on a regular basis in loan origination activities in the U.S., regardless of whether the U.S. Agent is acting as an independent or dependent agent or exercises a power to conclude contracts on the Foreign Corporation’s behalf.

In essence, the IRS is asserting that the general rule under U.S. income tax treaties and other ECI tax provisions that the activities of an office of an independent agent (or of a dependent agent that does not have the authority to negotiate and conclude contracts on behalf of the principal) are not attributed to its foreign principals is not applicable for purposes of the U.S. Banking Regulation. This position may be problematic for certain offshore funds and other foreign investors that have structured their U.S. lending activities through U.S. agents in reliance on the contention that the activities of their agents in the U.S. do not give rise to ECI under the Banking Regulation.

If the positions taken by the IRS in the Memorandum are read expansively, there could be wide reaching ECI-related implications for offshore funds and other foreign investors with lending activities in the U.S. or which transact business with (independent or dependent) U.S. agents. For example, the Memorandum could lead to further examination by the IRS into the fact-specific question of whether the services of a U.S. loan originator that pre-arranges to sell U.S. loans to offshore funds immediately after origination are services of an “agent” or of a principal. Such issues are more likely to come up where a U.S. originator is under common control, is a related party or regularly sells a significant portion of its loans to one or a limited group of offshore funds.

However, it is possible that the Memorandum is intended to be read more narrowly and that its analysis should be applicable solely to the particular facts discussed therein.

The Memorandum concludes with the following statement, indicating that we may expect future IRS activity in this area: “We understand that foreign corporations and non-resident aliens may have used other strategies to originate loans in the United States giving rise to effectively connected income. We encourage you to develop these cases, and we stand ready to assist you in the legal analysis.” It is not clear which structures that the IRS intends to investigate. The Memorandum discusses purchases by a foreign entity of loans on the date the loan is originated by a U.S. based agent. However, many offshore funds and other foreign investors do not purchase U.S. loans until a considerable period of time has elapsed after origination.

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