

U.S. Loan Origination Under the Ireland-U.S. Tax Treaty

by Jason Schwartz

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In this article, Schwartz explores how direct lending funds can use the Ireland-U.S. income tax treaty to make loans in the United States without being subject to U.S. federal income tax.

Investor appetite for direct lending has remained consistently strong in recent years, with North American private debt funds reaching their highest level of fundraising on record in the first half of 2019, and 2018 marking the fourth consecutive year in which private debt funds raised more than \$100 billion.¹

However, foreign funds that are managed from within the United States and make loans directly to borrowers may be engaged in a U.S. trade or business and subject to U.S. tax. Accordingly, many foreign funds limit themselves to purchasing loans on the secondary market.

One way that a U.S. manager might be able to engage in primary loan origination on behalf of a foreign fund and still avoid causing the fund to be subject to U.S. tax is to organize the fund in Ireland and ensure that it qualifies for benefits under the 1997 Ireland-U.S. income tax treaty.² Structuring this kind of Irish treaty fund is not

without challenges — but for some managers and investors, the rewards justify the effort.

This article discusses the tax considerations applicable to Irish treaty funds.

I. Background

A. Tax Guidelines

The IRS has asserted that making loans to the public in the United States, whether directly or through a U.S. agent, constitutes a U.S. trade or business.³ Foreigners that engage in a U.S. trade or business are subject to U.S. federal income tax on any income that is effectively connected with that U.S. trade or business.⁴

By contrast, purchasing loans on the secondary market constitutes a protected activity under section 864(b)(2), which generally provides that a non-U.S. taxpayer is not treated as engaged in a U.S. trade or business solely because it trades in stocks or securities for its own account (whether directly or through an agent), as long as the taxpayer is not a dealer in stocks or securities.

Accordingly, most foreign funds that have U.S. managers and invest in loans comply with tax guidelines provided by their U.S. tax counsel to ensure they are not making loans to the public.

There is little authority that distinguishes between making loans (which the IRS has asserted constitutes a U.S. trade or business) and trading loans (which does not constitute a U.S. trade or business), and tax guidelines merely reflect tax

¹ See Kelsey Butler, “Direct Lending Funds Raise Record-Breaking Cash, and Concerns,” Bloomberg, July 1, 2019; and Hannah George and Butler, “Who Needs a Bank? Why Direct Lending Is Surging,” Bloomberg, Mar. 6, 2019. As of June 2018, private debt assets under management reached \$769 billion. Preqin, “Private Debt Industry Keeps Up Its Momentum” (Feb. 21, 2019).

² The United States has income tax treaties with many jurisdictions. See IRS, “United States Income Tax Treaties — A to Z.” However, Ireland is a popular jurisdiction for U.S.-managed direct lending funds because there are sophisticated English-speaking legal service providers in Ireland, and Irish treaty funds can be organized so as not to be subject to tax in Ireland.

³ See AM 2009-010; and reg. section 1.864-4(c)(5)(i)(b) (a banking, financing, or similar business includes “making personal, mortgage, industrial, or other loans to the public”).

⁴ See section 882 (corporate income tax on effectively connected income); section 884 (branch profits tax on some deemed dividends attributable to ECI); section 875 (attributing activities of a partnership that is engaged in a U.S. trade or business to its partners); and section 1446 (enforcing partner-level income tax on ECI through partnership-level withholding obligations).

practitioners' best judgment in this regard. That said, tax guidelines typically contain three overarching principles: The fund may not negotiate the terms of a loan, may not be an original lender, and may not be the first person to bear economic risk with respect to a loan. These principles are predicated on the traditional view of a lender as the party that negotiates the loan, funds the loan, bears first risk with respect to the loan, and holds itself out as the lender.⁵

B. Non-Treaty Fund Structures

1. Master-feeder structure.

U.S. managers commonly organize master-feeder structures to accommodate both U.S. and foreign investors. In a typical master-feeder structure, a master fund is organized in the Cayman Islands or another low-tax jurisdiction. The master fund is the main investing entity and is treated as a partnership for U.S. tax purposes. Its partners are a domestic feeder and a foreign feeder.⁶ U.S. taxable investors typically invest in the domestic feeder, which is treated as a domestic partnership for U.S. tax purposes, while foreign and tax-exempt investors typically invest in the foreign feeder, which is organized in the same low-tax jurisdiction as the master fund and is treated as a foreign corporation for U.S. tax purposes.⁷

If the master fund in a master-feeder structure were engaged in a U.S. trade or business, the foreign feeder would be subject to U.S. corporate tax, and potentially the branch profits tax, on its allocable share of the master fund's effectively

connected income. The master fund would be liable for failing to withhold on the foreign feeder, and investors in the domestic fund would indirectly bear their share of that liability. Accordingly, master-feeder structures are not appropriate as direct lending funds if they have U.S. managers.

2. Season and sell structure.

Some U.S. managers that want to originate loans but also want to accommodate both U.S. and foreign investors rely on "season and sell" structures, under which a standalone domestic fund generally originates loans. The domestic fund is treated as a domestic partnership for U.S. tax purposes, and its investor base is limited to U.S. persons (who are indifferent to being engaged in a U.S. trade or business). After the domestic fund holds an originated loan for a specified seasoning period (typically 30 to 90 days), it offers a portion of the loan for sale to a standalone foreign fund. The foreign fund is organized in the Cayman Islands or other low-tax jurisdiction, treated as a foreign corporation for U.S. tax purposes, and allowed to have foreign investors. The foreign fund's purchase of its portion of the loan generally may be at arm's-length pricing and requires the prior approval of an investment professional that has the skills to evaluate the loan as an investment on behalf of the foreign fund and is unaffiliated with the manager (other than as a passive investor). The foreign fund takes the position that because it makes its decisions independently of the domestic fund, the domestic fund is not making loans as its agent and all the foreign fund's loan purchases are secondary market acquisitions.

Because the foreign fund in a season and sell structure cannot be required to purchase loans from the domestic fund, the domestic fund is subject to the risk that the foreign fund may choose not to acquire its portion of a loan. As a result, the domestic fund must have sufficient financial capacity to hold each loan it makes, and the economic return to investors in each of the domestic and foreign funds could be materially different.

⁵ Cf. AM 2009-010 (a non-U.S. corporation whose U.S. agent's activities included "the solicitation of U.S. Borrowers, the negotiation of the terms of the loans, the performance of the credit analyses with respect to U.S. Borrowers, and all other activities relating to loan origination other than the final approval and signing of the loan documents" was engaged in a U.S. trade or business); and ILM 201501013 (fund was engaged in a U.S. trade or business when its U.S. manager actively solicited potential borrowers and issuers, negotiated directly with borrowers on all key loan terms, and conducted extensive due diligence on potential borrowers and issuers). Compare *Land O'Lakes Inc. v. United States*, 514 F.2d 134, 139 (8th Cir. 1975) (middleman with risk of loss and opportunity for gain was not an agent), cert. denied, 423 U.S. 926 (1975), with *Rupe Investment Corp. v. Commissioner*, 266 F.2d 624 (5th Cir. 1959) (middleman protected against risk of loss was an agent).

⁶ The manager or a related entity might hold a carried interest in the master fund, in which case it also would treat itself as a partner in the master fund.

⁷ See generally David S. Miller and Jean Bertrand, "Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers," 65 *Tax Lawyer* 309 (2012).

C. Irish Treaty Fund

The rules for calculating ECI are convoluted, making it difficult to confidently quantify the downside risk to a foreigner of being engaged in a U.S. trade or business. In the absence of clear guidance, many tax practitioners assume the worst: If a foreigner is engaged in a U.S. trade or business, all its income and gain from that business will be ECI.

By contrast, an entity that is engaged in a U.S. trade or business but qualifies for benefits under the Ireland-U.S. treaty is not subject to U.S. tax on its ECI. Instead, the entity is subject to U.S. tax only on income attributable to a U.S. permanent establishment.⁸ It generally is easier to avoid having a U.S. PE than to avoid having a U.S. trade or business. Accordingly, a foreign direct lending fund that has a U.S. manager can avoid U.S. tax, even if its lending activities constitute a U.S. trade or business, as long as it qualifies for benefits under the Ireland-U.S. treaty and does not have a U.S. PE.⁹

II. Qualifying for Treaty Benefits

Irish treaty funds typically are organized either as section 110 companies or as Irish collective asset management vehicles (ICAVs), and they invest in loans either directly or through entities that are fiscally transparent for Irish tax purposes.¹⁰

A section 110 company is an Irish entity that qualifies for a special tax regime under section 110 of Ireland's Taxes Consolidation Act, 1997 (Act No. 39/1997), as amended. Under that tax regime, although a section 110 company generally is subject to Irish corporate tax at 25 percent, it can issue profit participating notes that provide for interest equal to substantially all the company's

net profits (before interest). The interest on the profit participating notes is deductible for Irish tax purposes as it accrues (whether paid on a current basis) and can be paid in a manner that eliminates Irish withholding tax.¹¹ Accordingly, by issuing profit participating notes to its investors, a section 110 company can reduce its net income to a nominal amount and eliminate virtually all Irish corporate tax liability.¹²

ICAVs are organized in accordance with the Irish Collective Asset-Management Vehicles Act 2015 and are statutorily exempt from tax on profits.¹³ They may be organized as umbrella vehicles with multiple sub-funds whose respective assets and liabilities may be segregated. ICAVs are subject to much more regulation (and therefore tend to be more expensive to set up and maintain) than section 110 companies. Moreover, ICAVs are subject to restrictions on their ability to pledge collateral and make guarantees, and thus generally must exercise more care than section 110 companies when constructing collateral packages for any leverage they incur.

To qualify for benefits under the Ireland-U.S. treaty, a section 110 company or ICAV must be a resident of Ireland and satisfy the treaty's limitation on benefits article.

A. Residence

Under the Ireland-U.S. treaty, Irish residents include persons that are liable to tax in Ireland by reason of being organized there, and specific collective investment undertakings.

Even though as a practical matter a section 110 company that issues profit participating notes may not be subject to significant Irish corporate

⁸ See treaty articles 5 (permanent establishment), 11 (interest), and 22 (other income).

⁹ U.S. states and localities are not precluded from imposing taxes on a foreign fund that has a connection to them, even if the fund qualifies for treaty benefits and lacks a U.S. PE. A discussion of state and local taxes is beyond the scope of this article.

¹⁰ To claim treaty benefits for an item of income, an Irish treaty fund must beneficially own that item of income for Irish tax purposes. As a result, if a section 110 company or ICAV invests in loans through an entity that is treated as fiscally opaque for Irish tax purposes, then it cannot claim treaty benefits for interest income on those loans. See Ireland-U.S. treaty protocol, article 1. Limited partnerships generally are fiscally transparent for Irish tax purposes; limited liability companies generally are not.

¹¹ For example, under the quoted Eurobond exemption, interest on the profit participating notes generally will not be subject to Irish withholding tax if it is paid by a non-Irish agent, the notes are listed on a recognized stock exchange, and none of the noteholders controls or is a significant counterparty of the section 110 company. Alternative exemptions from withholding tax also may be available.

¹² The EU anti-tax-avoidance directive (2016/1164/EU) requires EU members to implement corporate tax reform measures that could affect the ability of a section 110 company to take deductions on profit participating notes. As of the date of this article, Ireland has not yet proposed any implementing legislation. ICAVs are less likely to be affected by the legislation because they do not rely on interest deductions to minimize entity-level tax.

¹³ ICAVs generally must withhold investment undertaking tax on taxable Irish resident investors, but non-Irish residents are exempt from the tax.

tax, section 110 companies are Irish residents under the Ireland-U.S. treaty because they are liable to tax in Ireland by reason of being organized there.¹⁴

ICAVs are Irish residents under the treaty because they are collective investment undertakings.

B. Limitation on Benefits

Article 23 of the Ireland-U.S. treaty is intended to prevent persons that are not intended treaty beneficiaries from using the treaty to reduce their aggregate tax liability. A simple example of treaty shopping would be if an investor who is a resident of Saudi Arabia (which does not have an income tax treaty with the United States) set up a wholly owned ICAV that claimed treaty benefits.

Article 23 describes several categories of intended treaty beneficiaries. The category most commonly used by Irish treaty funds (because it allows for the most diverse investor base) requires the satisfaction of an ownership test and a base erosion test.

1. Ownership test.

Under the ownership test, at least 50 percent of the aggregate vote and value of the Irish treaty fund's shares must be directly or indirectly owned by U.S. residents and other "good persons."¹⁵

a. Definition of shares.

i. Section 110 companies.

Article 3(2) of the Ireland-U.S. treaty generally provides that any term used but not defined in the treaty has the meaning it has under the law of the jurisdiction whose tax is being applied. This suggests that U.S. tax law should determine the definition of shares in this context.

A section 110 company typically is organized as a special purpose vehicle whose ordinary

shares are wholly owned by a charitable entity unrelated to the holders of the company's profit participating notes. Because ordinary shares have nominal value and do not in practice exercise voting rights, whereas profit participating notes are entitled to substantially all company profits through the payment of profit participating interest (and bear company losses), represent substantially all the company's value, and typically are conferred some voting rights, the ordinary shares should be disregarded under U.S. tax principles and the profit participating notes should be treated as the company's equity for U.S. tax purposes.¹⁶

That said, many tax practitioners err on the side of caution and require the ordinary shares of the section 110 company to be held by Irish share trustees in trust for a named Irish tax-exempt charity (a good person under the treaty). That way, the section 110 company will pass the ownership test even if the ordinary shares are treated as the company's shares instead of, or in addition to, the profit participating notes.

ii. ICAVs.

ICAVs do not issue profit participating notes to minimize their net taxable income; instead, as mentioned above, they are statutorily exempt from entity-level tax on profits. Accordingly, an ICAV's shares are entitled to the ICAV's net profits (and bear the ICAV's net losses) and represent all the ICAV's value.

ICAVs may be organized as umbrella vehicles with multiple sub-funds. If the assets and liabilities of each sub-fund are segregated, then each sub-fund can be treated as a separate entity for U.S. tax purposes.¹⁷ Even so, because Ireland views an ICAV as a single Irish resident for Irish

¹⁴ See Treasury Technical Explanation of the Convention between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Gains Signed at Dublin on July 28, 1997, and the Protocol Signed at Dublin on July 28, 1997, article 4(1) ("Certain entities that are nominally subject to tax but that in practice rarely pay tax also would generally be treated as residents and therefore accorded treaty benefits," because "they are taxable to the extent that they do not currently distribute their profits.").

¹⁵ Most U.S.-managed direct lending funds that are organized as Irish treaty funds rely on U.S. residents to satisfy both the ownership and base erosion tests.

¹⁶ See Notice 94-47, 1994-1 C.B. 357 ("instruments that contain a variety of equity features" may be treated as equity for U.S. tax purposes); and *Dobkin v. Commissioner*, 15 T.C. 31, 33 (1950) ("When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way, a strong inference arises that the entire amount paid in is a contribution to the corporation's capital and is placed at risk in the business."), *aff'd per curiam*, 192 F.2d 392 (2d Cir. 1951). See also *Ambassador Apartments Inc. v. Commissioner*, 406 F.2d 288 (2d Cir. 1969); *Northeastern Consolidated Co. v. United States*, 406 F.2d 76 (7th Cir. 1969), *cert. denied*, 396 U.S. 819 (1969); and *Tyler v. Tomlinson*, 414 F.2d 844 (5th Cir. 1969).

¹⁷ Cf. prop. reg. section 301.7701-1(a)(5) (each "series" of a foreign insurance company may be treated as a separate entity for U.S. tax purposes if the assets and liabilities of the series are segregated from the assets and liabilities of other series).

tax purposes — that is, the ICAV is the corporate entity, and the sub-funds do not have any legal personality separate from the ICAV as a matter of Irish law — it appears that the ownership test applies to the ICAV's shares on an aggregate basis, instead of to sub-funds individually.¹⁸

This conclusion could lead to seemingly inappropriate results. Assume, for example, that an ICAV has two sub-funds. One sub-fund represents 51 percent of the ICAV's vote and value, is owned exclusively by good persons, and conducts activities that do not generate ECI. The other sub-fund represents 49 percent of the ICAV's aggregate vote and value, is owned exclusively by Saudi Arabian investors, and makes loans through a U.S. management company that is treated as an independent agent. Testing the ICAV's shares on an aggregate basis causes the ICAV to pass the ownership test, even though the ICAV's U.S.-source business profits are allocated solely to bad persons.

Given the perceived possibility for abuse, some tax practitioners prefer to ensure that each ICAV sub-fund, if tested separately, would satisfy the ownership test in its own right. However, there are often nontax business reasons why investors might prefer to have their own sub-fund. For example, the operative documentation of some credit-focused investment vehicles prohibits them from making equity investments that could expose them to the liabilities of other shareholders, and thus allows them to invest in an ICAV only through a segregated sub-fund. Limiting an investor's ability to avail itself of a core ICAV benefit arguably undermines the policies behind the Ireland-U.S. treaty's designation of an ICAV as a valid Irish resident.

b. Ownership chains.

Ownership is a direct or indirect test. However, article 23(2)(c)(i) cryptically provides that the ownership test will not be satisfied in a chain of ownership unless it is satisfied by the last owners in the chain. Taken literally, this provision would have the effect of looking through all chains of ownership to natural persons, which

¹⁸ See article 23(2)(c)(i) (applying ownership test to a resident by reference to "the aggregate vote and value of the company's shares" for a resident that is a company).

would be administratively difficult or impossible to do.¹⁹

Treasury's technical explanation of the treaty and protocol suggests that this is not the intent of the provision; instead, it is intended to look through persons who would otherwise be good persons solely because they satisfy the ownership and base erosion tests.²⁰ Based on this reading, a treaty fund should satisfy the ownership test if more than 50 percent of its shares are ultimately owned by U.S. residents, even if those U.S. residents own the shares through feeder funds or other entities that are not themselves good persons. A U.S. resident includes both taxable U.S. corporations and U.S. tax-exempt organizations (in each case regardless of whether they would themselves satisfy the limitation on benefits provision).²¹

2. Base erosion test.

Under the base erosion test, amounts that the Irish treaty fund pays or accrues to bad persons and that are deductible for Irish tax purposes generally may not exceed 50 percent of the fund's gross income.

ICAVs are not subject to entity-level tax on profits in Ireland, so they do not make any payments that are treated as deductible for Irish tax purposes and do not have to worry about satisfying the base erosion test.²² By contrast, section 110 companies are generally subject to Irish corporate tax, and make deductible payments (including interest payments on profit participating notes) to minimize their taxes.

a. Deductible payments.

The most important deductible payments a treaty fund will make if it is organized as a section

¹⁹ Under the Ireland-U.S. treaty, a U.S. resident is a U.S. citizen or green card holder who has a substantial presence, permanent home, or habitual abode in the United States. See treaty article 4(1)(a) and section 7701(b). Accordingly, for article 23, a U.S. citizen is a good person even if she does not have a substantial presence, permanent home, or habitual abode in the United States.

²⁰ See also LTR 200409025 (ruling, in an analogous context, that a corporation did not have to be looked through for determining qualifying ownership under the Luxembourg-U.S. income tax treaty).

²¹ See technical explanation, *supra* note 14, at article 23(2)(c) (neither the United States nor Ireland is concerned about treaty shopping by U.S. residents).

²² This is a potentially huge benefit of using an ICAV instead of a section 110 company. However, as mentioned, ICAVs are subject to much more regulation than section 110 companies.

110 company are interest payments on its profit participating notes, interest payments on any other leverage that it incurs, and fees it pays its investment manager.

Unlike the ownership test, the base erosion test generally does not look through fiscally opaque entities to their ultimate owners. Instead, it looks to the “person” to whom a deductible amount is paid or accrued.

Article 3(1)(a) defines person to include partnerships, which are not good persons under the base erosion test. This could lead to a concern that payments on profit participating notes to an entity that is treated as a partnership for Irish tax purposes should be treated as being made to a bad person. However, for Irish tax purposes, payments made to a partnership are treated as paid or accrued to the partnership’s partners. Accordingly, the better view is that partnerships (and any other entities that are fiscally transparent for Irish tax purposes) are looked through for the base erosion test.

The base erosion test does not count arm’s-length payments in the ordinary course of business on a financial obligation to a bank, as long as the bank is a U.S. or Irish resident or the payments are made to a U.S. or Irish PE of the bank. Accordingly, Irish treaty funds that are organized as section 110 companies often sign credit facilities only with U.S. or Irish banks (or U.S. or Irish bank branches) and negotiate for provisions that limit or restrict the bank’s ability to assign or participate the loan to bad persons.²³

The base erosion test does not count arm’s-length services payments, and management fees should fall under that exclusion.

b. Definition of gross income.

Treaty article 23(8)(a) defines gross income to mean the greater of a treaty fund’s gross income in the preceding fiscal year and the average of its gross income in the preceding four fiscal years.²⁴

²³ If the bank preserves its right to assign or participate the loan to a bad person, the fund will typically insist on having a right to prepay the loan if the assignment or participation would cause the fund to fail the base erosion test.

²⁴ The technical explanation indicates that an Irish treaty fund’s gross income should be determined under U.S. tax principles (“in determining whether a person deriving income from United States sources is entitled to the benefits of the Convention, the United States will ascribe the meaning to the term that it has in the United States”).

The treaty does not describe how to calculate gross income for a fund’s first fiscal year.

The technical explanation describes article 23(8)(a) as an optional approach for calculating gross income. While reading the provision as an optional approach might help explain why the provision does not address a fund’s first fiscal year, the provision itself does not suggest optionality. Accordingly, many treaty funds organized as section 110 companies read the provision to mandatorily modify the base erosion test beginning in the fund’s second fiscal year.

This reading can create serious problems if a fund’s income in one year exceeds its income in one or more earlier years. Suppose, for example, that a fund earns \$100 of gross income in year 1 and \$103 of gross income in year 2 and that in each year, its only deductible payments are interest payments on its profit participating notes. If article 23(8)(a) is read as a mandatory definition and 49 percent of the fund’s profit participating notes are held by bad persons, the fund will fail the base erosion test in year 2 because it has made deductible payments of \$50.47 to bad persons (49 percent of \$103 gross income), which exceeds 50 percent of its year 1 gross income.

c. Forgoing deductions on notes.

As the preceding example illustrates, article 23 presents a binary proposition: An Irish treaty fund either satisfies the LOB tests and qualifies for treaty benefits or it does not. If it does not, the fund is potentially subject to U.S. tax on all its income.

Some funds mitigate this potential cliff effect by drafting their profit participating notes so that they are not entitled to a deduction on the notes if the deduction would cause them to fail the base erosion test.

d. Two-tier structures.

Another way that an Irish treaty fund might minimize its risk of treaty nonqualification is by organizing as a section 110 company whose profit participating notes and ordinary shares are wholly owned by an ICAV. As long as the ICAV itself satisfies the ownership test, the section 110 company should also satisfy the ownership test because its profit participating notes and ordinary shares are indirectly (through the ICAV) held by good persons, and the ICAV should be a good

person for the section 110 company's base erosion test.²⁵

Using this two-tiered structure could be beneficial for two reasons. First, as regulated entities, ICAVs are limited in their ability to engage in some activities, whereas section 110 companies are not subject to the same restrictions. Second, if an ICAV wants to carry on some activities that do not give rise to ECI, it might prefer to do this directly. If it wants to carry on some activities that could give rise to ECI, it might prefer to do this through a section 110 company that is treated as a foreign corporation for U.S. tax purposes. The section 110 company would file a U.S. tax return claiming treaty benefits and reporting zero taxable income;²⁶ however, if the IRS successfully challenges this position, the section 110 company effectively serves as a blocker so that its ECI does not potentially taint the ICAV's other income.

III. Avoiding a U.S. PE

As mentioned, a fund that qualifies for benefits under the Ireland-U.S. treaty is subject to U.S. tax only on profits that are attributable to a U.S. PE.

Irish treaty funds with U.S. investment managers do not themselves have a place of management, a branch, or an office in the United States. However, the manager has the authority to conclude contracts on behalf of the Irish treaty fund and habitually exercises that authority through an office in the United States. Unless the manager is treated as an independent agent of the fund, the fund could be treated as having a U.S. PE.²⁷

A. Independent Agency

The Ireland-U.S. treaty does not define the term "independent agent." However, Treasury's

technical explanation provides that an agent is treated as independent if the agent is both legally and economically independent of its principal.²⁸ Further, the Internal Revenue Manual lists 11 factors to determine whether an agent qualifies as an independent agent.²⁹

The independent agent concept appears intended to prevent a principal from being treated as having a PE in a jurisdiction merely by reason of using a service provider there if the service provider is compensated at arm's-length rates and pays taxes on its compensation, and any goodwill generated in connection with its activities inure to the service provider (and not to the principal).³⁰

1. Legal independence.

Treasury's technical explanation does not contain a comprehensive definition of legal independence, but it suggests that a legally independent agent is free in the manner by which it performs its duties for the principal. Similarly, in *Taisei Fire & Marine Insurance Co. v.*

²⁸ This definition is also in the OECD commentaries on the model tax convention.

²⁹ See IRM chapter 18.

³⁰ This apparent policy rationale is consistent with the Ireland-U.S. treaty's treatment of brokers and general commission agents as independent agents. See article 5(6). See also 1963 OECD commentaries, article 5(6). Cf. *Taisei Fire & Marine Insurance Co. v. Commissioner*, 104 T.C. 535, 556 (1995) (holding an agent to be independent in part because of its "relationships and reputation in the industry").

Analogously, a large body of commentary suggests that foreign investment funds that originate loans in the United States through third-party managers should not be treated as engaged in a U.S. trade or business because they lack a direct customer relationship with the borrowers. Unfortunately, the IRS has not explicitly agreed with this suggestion. See generally David H. Shapiro and Jeff Maddrey, "The Importance of a 'Customer Relationship' in Loan Origination," *Tax Notes*, Feb. 1, 2010, p. 659. See also Jason Schwartz and David S. Miller, "Collateralized Loan Obligations," Bloomberg Tax Management Portfolio No. 6585 (foreign investment funds that originate loans from within the United States "would not present unfair competition for U.S. lenders, because any goodwill generated in connection with their origination activities would inure to their U.S. collateral managers (and not to the [investment funds]). U.S. collateral managers are compensated for their services at arm's-length rates, and pay U.S. taxes on their compensation."); and David R. Sicular and Emma Q. Sobol, "Selected Current Effectively Connected Income Issues for Investment Funds," 56 *Tax Lawyer* 719, 764 (2003) ("Without customers, and without holding itself out or promoting itself . . . as a professional money lender, the [foreign investment fund] should not be found to engage in a lending trade or business."). In AM 2009-010, the IRS held that a foreign corporation was engaged in a U.S. trade or business because it loaned money to customers from within the United States. Similarly, the definition in reg. section 1.864-4(c)(5) of the term "active conduct of a banking, financing or similar business" refers to making loans to the public, which also might suggest that a customer relationship is required. In a context analogous to reg. section 1.864-4(c)(5), the IRS defined the public as "ordinary and unrelated customers of banking services as opposed to sources in some way connected with the bank." See also TAM 9611001 (addressing the definition of "banking, financing, or similar business" for the tax credit rules under section 904).

²⁵ In this case, the ICAV would be a good person because it satisfies the ownership and base erosion tests. As noted, unlike the ownership test, the base erosion test does not look through opaque entities and thus permits deductible payments to be made to good persons solely because they satisfy the ownership and base erosion tests.

²⁶ An Irish treaty fund that is treated as a corporation for U.S. tax purposes and is engaged in a U.S. trade or business generally files Form 1120-F and appends Form 8833 to the return. See reg. section 1.6012-2(g)(1)(i) (Form 1120-F); and reg. section 301.6114-1(b)(5)(i) (Form 8833).

²⁷ See treaty article 5.

Commissioner, 104 T.C. 535 (1995), the Tax Court concluded that the determinant for legal independence is whether the agent is under the comprehensive control of its principal.

In *Taisei*, Fortress Re Inc. underwrote reinsurance on behalf of four Japanese insurance companies over three years and regularly exercised its authority to conclude contracts on behalf of each insurance company from within the United States. The insurance companies took the position that they qualified for benefits under the Japan-U.S. income tax treaty and that Fortress was an independent agent (the provisions regarding independent agency in that treaty are identical to the language in the Ireland-U.S. treaty).

Ruling in favor of the insurance companies, the Tax Court concluded that Fortress was legally independent of the insurance companies because it had discretion over how it performed the activities it was hired to perform, subject only to broad guidelines in the management agreements.³¹

a. Termination of management agreement.

The court in *Taisei* noted that Fortress's management agreements could be terminated by either party with six months' notice, but it did not explicitly rely on this fact in concluding that Fortress was legally independent. Even so, many tax practitioners view a manager's ability to terminate its management agreement with a treaty fund as supporting legal independence because it is indicative of a separation of business enterprises.

b. Manager as sponsor.

In *Taisei*, the four Japanese insurance companies each negotiated a management agreement with Fortress, an unrelated U.S. agent. Because of their disparate ownership, the insurance companies and Fortress were clearly acting at arm's length, which is characteristic of separate business enterprises.

By contrast, Irish treaty funds often are organized by the very U.S. agent that the funds hire to manage their investments. Moreover,

investors in Irish treaty funds might include other funds or discretionary accounts that the same agent manages. Some tax practitioners have expressed concern that a manager of a treaty fund cannot be an independent agent because as a sponsor of the Irish treaty fund (and possibly as sponsor of several other funds or discretionary accounts that invest in the Irish treaty fund), it effectively hires itself, which is uncharacteristic of separate business enterprises.

However, a fund's execution of a management agreement represents a consensus among the fund's ultimate investors to entrust the manager as the fund's agent.³² The ultimate investors risk capital in the fund, and any capital contributions by the manager typically are small by comparison. The manager typically interacts directly with many of the ultimate investors by, for example, negotiating side letters for specially negotiated fee arrangements or arranging share classes with rights different from those of other share classes.

In this light, a manager's success at persuading investors to contribute capital to an Irish treaty fund (or to other funds and discretionary accounts that invest in the Irish treaty fund) and the Irish treaty fund to hire it merely underscores the distinction between its business of making and managing investments on behalf of customers and the fund's business of making proprietary investments through the manager. Accordingly, the manager's role as fund sponsor should not cause it and the fund to be treated as engaged in the same enterprise.

Moreover, when an Irish treaty fund is organized as an ICAV, it must be managed by a manager that is regulated in Ireland as an alternative investment fund manager (AIFM). The AIFM is responsible for providing investment management and risk management services to the ICAV and has a nontransferable fiduciary duty to the ICAV's shareholders. The AIFM delegates its investment management responsibilities to a U.S. manager but typically can fire the U.S. manager for cause. The AIFM's role arguably creates

³¹ The court also noted that the insurance companies did not own an interest in Fortress, but it cautioned that a principal's ownership or non-ownership of an agent is not itself determinative. The court's analysis is consistent with the first four independent agency factors in the IRM.

³² Cf. *Taisei*, 104 T.C. at 555 (suggesting that an agent that manages a mutual fund may look through the fund and treat the investors as its customers for determining whether the agent is independent).

further separation between the ICAV and the U.S. manager.

c. Manager as partner.

Section 110 companies and ICAVs are fiscally opaque entities under Irish law, and by default are treated as associations taxable as corporations under U.S. tax law. Still, they may elect to be treated as partnerships for U.S. tax purposes.³³ Moreover, Irish treaty funds organized as section 110 companies or ICAVs often pay their manager an incentive fee based on the fund's profits.

The Ninth Circuit has suggested that a general partner might fail to qualify as an independent agent or a partnership and its limited partners. In *Donroy v. United States*, 301 F.2d 200 (9th Cir. 1962), a Canadian corporation was a limited partner in a California partnership that had an office in the United States. The Canadian corporation claimed the benefits of the Canada-U.S. income tax treaty and asserted that it did not have a PE in the United States because the partnership's office should not be attributed to it, a limited partner, and because the general partner should be treated as an independent agent of the limited partners. The Ninth Circuit concluded that the U.S. office of a partnership is attributable to the limited partners and that a general partner does not qualify as an independent agent of the limited partners.³⁴

In light of *Donroy*, tax practitioners often prohibit treaty funds from investing in partnerships in which a U.S. person serves as the general partner.

However, there is no suggestion in *Donroy* or other authoritative guidance that a limited partner cannot serve as an independent agent of its partnership or that the offices of a limited partner are attributable to its partnership or the other partners. Accordingly, the U.S. PE of an Irish

treaty fund's manager should not be attributed to the fund merely because the manager receives an incentive fee, even if the fee is treated for U.S. tax purposes as a partnership interest in the Irish treaty fund.

2. Economic independence.

As with legal independence, Treasury's technical explanation does not contain a comprehensive definition of economic independence. However, it does provide two relevant factors for determining that an agent is economically independent: an economically independent agent typically bears entrepreneurial risk with respect to its own activities and typically has more than one principal. Both factors tend to establish that the agent's business is not integrated with, and dependent on, that of the principal.

Similarly, in *Taisei*, the Tax Court concluded that the determinant for economic independence is whether the agent bears its own entrepreneurial risk. It found that Fortress was economically independent of the insurance companies because "there was no guarantee of revenue to Fortress, nor was Fortress protected from loss in the event it had been unable to generate sufficient revenue."

Tax practitioners tend to focus on four factors when assessing whether a manager is economically independent of an Irish treaty fund. These factors are discussed below.

a. Multiplicity of clients.

A common rule of thumb is that the manager should have at least 10 clients, including the Irish treaty fund, for which it performs services requiring the same skill set,³⁵ a number that easily exceeds the four insurance companies for which Fortress acted in *Taisei*.³⁶

There is a strong argument that for this purpose, each of the manager's ultimate investors should be counted as a separate client. As noted

³³ An Irish treaty fund that is treated as a partnership for U.S. tax purposes and is engaged in a U.S. trade or business generally files Form 1065, and each of its investors generally is required to file a U.S. tax return as well. See reg. section 1.6031(a)-1(b)(1)(i) (Form 1065). The fund or the investor also generally appends Form 8833 to its tax return. See reg. section 301.6114-1(b)(5)(i) and (c)(4) (partners are excused from filing Form 8833 if the partnership files the form).

³⁴ Later, the D.C. Circuit held under substantially similar facts that the U.S. office of a limited partnership should be attributed to the limited partners. However, the court declined to hold that a general partner cannot qualify as an independent agent. *Unger v. Commissioner* 936 F.2d 1316, 1320 (D.C. Cir. 1991).

³⁵ In *Taisei*, Fortress engaged in substantially similar activities for each insurance company. Moreover, an agent cannot be independent unless it is acting in the ordinary course of its business. See treaty article 5(6).

Managers commonly represent that originating loans on the primary market requires substantially the same skill set as investing in loans on the secondary market.

³⁶ The Tax Court noted that Fortress had never had more than 10 active management agreements in a fiscal year. Fortress continued to have obligations (presumably more ministerial in nature) for previously underwritten insurance after a management agreement was terminated.

above, although there is a range of views on the matter, the ultimate investors arguably are the manager's true customers, because they typically have a high degree of interaction with the manager and can decide whether to risk capital in the fund. A more conservative view would count as separate clients only funds or managed accounts that lack identity of beneficial ownership and do not pool their investments.³⁷

b. Breadth of business.

The smaller an Irish treaty fund's role in a manager's aggregate business, the less likely the manager is economically dependent on the fund. To ensure a manager is not substantially dependent on an Irish treaty fund, many tax practitioners require that the manager's total projected compensation from the fund not exceed 10 to 15 percent of its total compensation from its other clients.

This guideline is far more conservative than the facts in *Taisei*. Fortress had only four active management agreements, and a single insurance company appears to have accounted for 40 to 45 percent of its entire business.

c. Growth potential.

In *Taisei*, the Tax Court noted that there were hundreds of insurance companies worldwide that could have been suitable clients for Fortress, and that Fortress's relationships, reputation, and experience would enable it to attract those insurance companies as clients if necessary.

Tax practitioners typically require managers of Irish treaty funds to similarly represent that they have the requisite expertise to engage in the activities for which they intend to claim independent agent status, that any additional hires would be to help manage their overall workload (and not because existing personnel lack some skill essential to performing those activities), and that they have the capability and opportunity to obtain new clients with minimal modifications to their business and with minimal or no harm to current profits.

³⁷ For example, some tax practitioners require the manager to manage at least nine funds and managed accounts (other than the treaty fund), none of which invests more than half its aggregate capital contributions in the treaty fund or is owned by the same beneficial owners in substantially similar proportions.

d. Arm's-length fees.

One of the hallmarks of economic independence is the need to generate sufficient business to cover operating expenses.³⁸ An economically independent agent negotiates its fees at arm's length; as a result, the fees reflect a competitive bid process and typically do not reference the agent's overhead expenses.

Accordingly, most tax practitioners require treaty fund managers to represent that they will receive an arm's-length fee for their services, that the formula for computing the compensation will not depend on their own overhead expenses, and that they will be responsible for their own overhead (and thus will bear losses if overhead exceeds compensation).³⁹

3. Key man provisions.

Some management agreements or side letters with ultimate investors contain key man provisions that preclude a fund from calling further capital or making new investments if a key member of the management personnel no longer works for the manager.

The existence of a key man provision suggests that the ultimate investors believe the key man has special expertise that other management personnel lack. If an Irish treaty fund's operative documents contain a key man provision, tax practitioners often will test independent agency for each key man. Similarly, if the operative documents of the manager's other funds or managed accounts contain key man provisions, tax practitioners often will not count those other funds or managed accounts as customers for testing economic independence from an Irish treaty fund unless the fund's operative documents contain the same key man provision.

³⁸ Cf. *Taisei*, 104 T.C. at 555 ("While the management agreements provided that Fortress earned a percentage of the gross premiums written which effectively covered Fortress' operating expenses, this did not mean that Fortress bore no risk. Fortress had to acquire sufficient business to produce the gross premiums. Further, it appears that this provision of the agreements is normal for an underwriting manager.").

³⁹ Exceptions sometimes are made for expenses that typically are reimbursed when made by investment managers, such as legal, auditing, and consulting fees, as well as for expenses associated with preparing financial statements and tax returns. Cf. *Taisei*, 104 T.C. at 555.

IV. Conduit Considerations

Even if an Irish treaty fund qualifies for benefits under the Ireland-U.S. treaty and derives income that is not attributable to a U.S. PE, the IRS can still assert that the fund or its investors are subject to U.S. tax if the fund is a conduit under common law or the conduit financing rules in reg. section 1.881-3. For the reasons discussed below, an Irish treaty fund should not be treated as a conduit under common law or under the conduit financing rules if the loans it makes are in registered form for U.S. tax purposes.

A. Common Law

In *Aiken Industries v. Commissioner*, 56 T.C. 925 (1971), a Bahamian parent corporation owned U.S. and Ecuadorian subsidiaries. The Ecuadorian subsidiary, in turn, owned a Honduran subsidiary. The Bahamian parent loaned funds to the Honduran subsidiary, which in turn loaned the funds to the U.S. subsidiary. The U.S. subsidiary paid interest to the Honduran subsidiary, which paid an equal amount of interest to the Bahamian parent. U.S. withholding tax would have applied to interest paid by the U.S. subsidiary to the Bahamian parent. A tax treaty between the United States and Honduras eliminated withholding tax on interest, but there was no treaty between the United States and the Bahamas. The Honduras-U.S. treaty did not contain an LOB provision.

The Tax Court held that because the Honduras-U.S. treaty defined a Honduran corporation, and because the Honduran subsidiary satisfied that definition, the subsidiary could not be disregarded. However, the treaty required that for interest to be exempt from U.S. tax, it must be received by the Honduran subsidiary. The treaty did not define the meaning of received, and provided that any terms not otherwise defined were to be given the meaning ascribed to them by the jurisdiction imposing the tax. Applying what it concluded were “the genuine shared expectations of the contracting parties,” the Tax Court held that because the Honduran subsidiary “was committed to pay out exactly what it collected, and it made no profit” on the transaction, and because there was no valid nontax economic or business purpose for the transaction other than to avoid U.S. tax, the

Honduran subsidiary did not receive the interest income under the Honduras-U.S. income tax treaty. Instead, the Honduran subsidiary was merely a collection agent acting for the benefit of the Bahamian parent with respect to the interest paid by the U.S. subsidiary. Accordingly, U.S. withholding tax was imposed on the interest payments.

An Irish treaty fund should not be treated as a conduit under *Aiken*. In contrast to the Honduran subsidiary in *Aiken*, the Irish treaty fund is not committed to pay out exactly what it collects on its investment portfolio and will not have the same inflow and outflow of funds. Instead, the fund is free to invest and reinvest its funds, and payments under any profit participating notes it issues (if organized as a section 110 company) are net of any fees it is required to pay the manager and other service providers, as well as any other expenses it incurs. Thus, the fund has dominion and control over its income.⁴⁰

Moreover, unlike the Honduran subsidiary in *Aiken*, which the Tax Court found served no purpose other than to avoid the U.S. withholding tax that would have applied to interest paid by the U.S. subsidiary directly to the Bahamian parent, if the fund is an investment vehicle for several investors, it arguably has a substantial nontax business purpose — namely, the pooling of investments.

Finally, the Tax Court in *Aiken* concluded that the Honduran and U.S. governments did not intend for an item of income to be treated as received by the Honduran subsidiary. By contrast, article 23 of the Ireland-U.S. treaty provides that an Irish company can qualify for treaty benefits even if some of its owners and creditors are not good persons. Accordingly, the ability of a company such as the fund to benefit from the treaty was specifically contemplated by the treaty’s drafters.

B. Conduit Financing Rules

The conduit financing rules are designed to prevent entities that ostensibly qualify for the U.S. withholding tax exemption for portfolio interest from entering into back-to-back arrangements

⁴⁰ See *Aiken*, 56 T.C. at 933.

with investors that do not qualify for the exemption to allow the investors to indirectly receive benefits.

Generally, under these rules, the IRS could disregard the existence of an Irish treaty fund and impose withholding tax on the fund's investors if the placement of the treaty fund between the investors and the underlying borrowers reduces the tax that would otherwise have been imposed under section 881. If the treaty fund is disregarded under the conduit financing rules, then it is disregarded for all purposes, including treaty purposes.

However, as long as the loans held by the fund are in registered form for U.S. tax purposes, the interposition of the fund between its investors and the borrowers does not reduce any tax imposed under section 881, either because the interest income on the loans is ECI or because the investors would themselves qualify for the portfolio interest exemption.

1. ECI.

Section 881(a) imposes a 30 percent withholding tax on U.S.-source interest income that is not ECI. If an Irish treaty fund is treated as engaged in a U.S. trade or business, the interest income it receives should be treated as ECI and therefore should not be subject to tax under section 881. Likewise, if an Irish treaty fund is disregarded, foreign investors would not be subject to tax under section 881 (because they would be subject to tax under section 882).

2. Portfolio interest exemption.

Under the portfolio interest exemption, section 881(c) exempts from U.S. withholding tax any interest:

- that is paid on an obligation in registered form for U.S. income tax purposes;
- that is not contingent interest described in section 871(h)(4);
- for which the paying agent receives a Form W-8;
- that is not paid to a bank on an extension of credit made under a loan agreement in the ordinary course of the bank's trade or business; and
- that is not received by a 10 percent shareholder of the obligor, or by a controlled foreign corporation from a related person.

An obligation (such as a loan held by an Irish treaty fund) is in registered form if the right to receive payments of principal and interest may be transferred only through a book entry system maintained by the obligor or its agent. Credit agreements often contain a requirement that the borrower or the administrative agent (acting for this purpose as an agent of the borrower) maintain a record of each lender and its assignees,⁴¹ and Irish treaty funds that invest in loans often can ensure that those loans contain this requirement.⁴²

If interest income is portfolio interest, then it would not be subject to tax under section 881 even if paid directly to an Irish treaty fund's investors, so the participation of the fund does not reduce the tax imposed by section 881.

V. Alternative Structures

This section summarizes two alternative tax structures that direct lending funds use. The first relies on an alternative test in the LOB article of the Ireland-U.S. treaty. The second does not rely on the Ireland-U.S. treaty at all.

A. Alternative LOB Test

The first alternative can be useful for an Irish treaty fund substantially all of whose ownership consists of a small group of European, Canadian, or Mexican residents. Under this alternative, two conditions must be met. First, at least 95 percent of the aggregate vote and value of all the fund's shares must be directly or indirectly owned by no more than seven persons who are either (a) residents of the EU, Canada, or Mexico and qualify for benefits under the treaty between the

⁴¹ See Loan Syndications and Trading Association, "LSTA Model Credit Agreement Provisions" (Aug. 8, 2014).

⁴² Under reg. section 1.871-14(d)(1), interest a beneficiary receives from a grantor trust is treated as interest received on an obligation in registered form if the trust certificate held by the beneficiary is in registered form, even if the underlying obligations are not themselves in registered form. Proposed regulations would expand this rule to entities treated as disregarded entities or partnerships for U.S. tax purposes. See reg. section 1.871-14(c) and prop. reg. section 1.163-5(a)(5)(iii). Accordingly, as an alternative to acquiring loans that are in registered form, an Irish treaty fund might be able to acquire loans through an entity treated as a domestic grantor trust or other domestic flow-through entity.

United States and their home country,⁴³ or (b) other good persons.⁴⁴ Second, the fund must satisfy the base erosion test, counting as good persons any residents of the EU, Canada, or Mexico who qualify for benefits under the treaty between the United States and their home jurisdiction.⁴⁵

B. Passthrough Qualification

The second alternative can be useful for a fund that is owned exclusively by U.S. persons and foreigners that qualify for treaty benefits in their own right. Under this alternative, the fund is not organized as a section 110 company or ICAV, but instead as a limited partnership or other entity that is fiscally transparent under the tax laws of each investor's home jurisdiction. The fund may be organized in any jurisdiction, but the United States and the Cayman Islands are commonly used.

The fund does not claim treaty benefits. Instead, each foreign investor claims benefits under the income tax treaty between the United States and its home jurisdiction. As long as the fund's U.S. investment manager is an independent agent, the foreign investors generally should not be subject to U.S. tax as a result of investing in the fund.

VI. Conclusion

Given the emergence of direct lending as a popular asset class for institutional investors, an Irish treaty fund could be a powerful tool for U.S. managers with access to foreign capital. ■

⁴³ See treaty article 23(8)(e)-(f). Further, if the applicable tax treaty does not contain a comprehensive LOB article, the resident must be a person who would qualify as a good person had that treaty contained an LOB article equivalent to the one in the Ireland-U.S. treaty.

The U.S. income tax treaties with Austria, Belgium, Canada, the Czech Republic, France, Germany, Ireland, Luxembourg, Mexico, the Netherlands, Switzerland, and the United Kingdom all have comprehensive LOB articles. (The United States does not have a tax treaty with Liechtenstein or Monaco.)

⁴⁴ Unlike the ownership test described in Section II.B, good persons do not include U.S. residents unless they are qualified persons under treaty article 23(2). Good persons do include all qualified persons, even if they are good persons solely because they satisfy the ownership and base erosion tests.

⁴⁵ Treaty article 23(5).

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