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Safe harbour eligibility

For decades, taxpayers have been bedeviled by the distinction between trading in stocks and securities (eligible for a safe harbour) and lending (generally a taxable business).

In a recent chief counsel advice, the Internal Revenue Service (IRS) concluded that the fund (a foreign partnership) and the foreign feeder (a foreign corporation and partner of the fund) engaged in lending and stock distribution activities that qualified as a taxable trade or business within the US and that did not constitute trading in stock or securities under trading safe harbours

Through an office in the US, the fund manager conducted extensive lending and stock distribution and underwriting activities on behalf of the fund. The fund argued that the activities constituted investment activity and therefore did not constitute a taxable trade or business within the US. The fund argued to the contrary – that the activities fell within the trading safe harbours.

First, the IRS concluded that the fund was engaged in a trade or business within the US. A foreign corporation that engages in a trade or business within the US is taxable on its income that is effectively connected with such trade or business within the US. Activities performed by an agent on behalf of a foreign person are considered to be performed by the foreign person. The IRS concluded that the fund's activities were considerable, continuous, and regular because it dedicated significant time, energy, and resources to making numerous loans to borrowers and entering into dozens of stock distribution agreements with issuers.

Second, the IRS concluded that the fund's activities did not constitute trading in stocks or securities.Therefore, they did not fall within the trading safe harbour for which certain trading activities performed by or on behalf of a foreign person that would otherwise constitute a trade or business within the US are exempt.

The IRS concluded that neither the fund's lending nor underwriting activities constitute trading in stock or securities. The IRS concluded that lending is not trading in stock or securities because a foreign person who makes a loan in the US engages in the active conduct of banking or financing within the US. Courts have defined trading as profiting from fluctuations in the price of assets as opposed to profiting from services provided. The IRS determined the fund's activities were not trading because it profited not from a change in the value of securities, but from earning fees, a spread, and interest on its lending and underwriting activities.

The IRS also concluded that even if the fund's lending and stock distribution activities were trading in stock and securities, it could not have used the trading safe harbour because its management agreement provided discretionary authority to the fund manager and because its underwriting activities fit within the definition of a dealer in stock or securities.

In sum, the IRS determined that the fund and foreign feeder, as a partner of the fund, were engaged in a trade or business within the US. The fund's lending and stock distribution activities were considerable, continuous, and regular, and did not constitute trading in stock and securities under the trading safe harbour.

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