# Attractive Enough to Be Forced?: The Implications of the Force of Attraction Rule for Certain Credit Funds

*By JoonBeom Pae**

## I. Introduction

The question of whether a foreign person's income would be treated as income "effectively connected" with a trade or business in the United States ("ECI") often invites significant confusion and challenges. The concept of "U.S. trade or business" is inherently ambiguous and fact dependent, unless a taxpayer can rely on certain statutory safe harbors. Once a foreign taxpayer is deemed engaged in a U.S. trade or business, it can be even more challenging to determine the exact scope of ECI, particularly in light of the potential application of the limited force of attraction rule under Code Sec. 864(c)(3) of the Internal Revenue Code (the "Code").

The origin of the force of attraction rule predates the codification of the ECI regime under Code Sec. 864 and the rule survived in a limited form as we see today. The current force of attraction rule can come into play in certain limited circumstances only, but when it does, it can unexpectedly amplify a foreign person's ECI. Certain U.S. source, ostensibly passive income, can be pulled into a foreign person's ECI even where there is no apparent relationship between such income and such foreign person's U.S. trade or business.

In this article, we will provide an overview of the statutory framework of the ECI rules (including the limited force of attraction rule and related provisions), the history relating to these rules, their interplay with the portfolio interest exemption, the implications of the recent court ruling in *YA Global Investments LP* ("*YA Global*")[1] on these rules, and the potential application of these rules in the context of certain credit fund structures.

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## II. Statutory Framework

A foreign taxpayer is generally subject to U.S. taxation on ECI, which is taxed on a net basis at graduated tax rates.[2] Although determining whether certain income qualifies as ECI requires a fact-intensive analysis, the framework generally examines (1) first, whether the taxpayer is engaged in a U.S. trade or business, and (2) if the answer to the first question is yes, whether a specific income item is "effectively connected" with such U.S. trade or business.

### A. "U.S. Trade or Business" Test

The U.S. trade or business test is governed by Code Sec. 864(b). Code Sec. 864(b) provides that the term "U.S. trade or business" includes the performance of personal services within the United States at any time within the taxable year, but no additional definition is provided in the Code or the Treasury regulations thereunder.[3]

Instead, case law provides additional color to determine the contours of a U.S. trade or business. Such cases generally hold that regular, substantial, and continuous profit-oriented activities in the United States, whether carried on by the taxpayer directly or through agents, constitute a U.S. trade or business.[4] In other words, mere ownership of U.S. real property, "quiescent" receipt of income therefrom, and customary acts incidental to ownership do not give rise to a U.S. trade or business.[5] In contrast, if a person "buys and sells real property, collects rents, pays operating expenses, taxes, and mortgage interest, makes alterations and repairs, employs labor, purchases materials, and makes contracts over a period of years," then the foreign owner of U.S. real property will be deemed engaged in a U.S. trade or business.[6] For this purpose, if a taxpayer is acting through an agent, the agent's activities are imputed to the taxpayer, regardless of whether the agent is independent or dependent.[7]

To encourage foreign investors to invest in the United States, however, Code Sec. 864(b)(2) was enacted to provide certain safe harbors related to trading in securities or commodities (collectively, the "Trading Safe Harbor"). If this Trading Safe Harbor applies, the taxpayer trading stock or securities will be deemed not to have a U.S. trade or business by reason of its trading activities, and therefore none of the taxpayer's income, gain, or loss from such trading activities will be treated as ECI.[8] If the Trading Safer Harbor does not apply, the taxpayer will have to assess its activities to determine whether it would be treated as engaged in a U.S. trade or business.[9]

Generally, the Trading Safe Harbor is available if a foreign person's activities are limited to (1) trading in stocks or securities through an independent agent or (2) if the foreign person is not a "dealer," trading in stocks or securities for its own account, whether by the foreign person or through a resident broker or other agent.[10] For this purpose, a "security" includes a note, bond, debenture, or other evidence of indebtedness.[11] A taxpayer can be treated as a "dealer" if such taxpayer regularly engaged in purchasing *and* selling securities with a view to making profits from such transactions.[12]

### B. "Effectively Connected" Test

If it is determined that a foreign person is treated as engaged in a U.S. trade or business, the next question is whether, and to what extent, the taxpayer's income would be treated as "effectively connected" with such U.S. trade or business. This "effectively connected" test is governed by Code Sec. 864(c). For this purpose, different tests apply depending on the type and source of income.

#### *1. FDAP Income and Gains*

For U.S.-source fixed, determinable, annual, periodic income and U.S.-source capital gains ("FDAP Income and Gains"), such income or gain will be treated as ECI only if either the "asset use" test or the "business activities" test is satisfied (collectively, the "General Rules").[13]

***a) General rules: asset use test and business activities test.*** The asset use test is satisfied if the income, gain, or loss is derived from assets used, or held for use, in the taxpayer's ordinary course of the trade or business. Certain FDAP Income and Gains may be considered ECI under the asset use test if it is derived from the working capital or inventory of a business.[14] For example, bank accounts, securities, and other investments are considered to be used in a U.S. trade or business if they are "held to meet the present needs" of the trade or business, such as working capital or inventory.[15] This test involves looking at current and past activities to determine whether the asset, prior to generating the applicable income, was used or held for use in the U.S. trade or business.[16] In order to satisfy this test, it is not necessary for the transaction generating such income or gain to have any connection with a U.S. trade or business.[17] Rather, it is sufficient to demonstrate that the assets in question were used or held for use in the relevant business.

The business activities test is satisfied if the activities of the trade or business were a "material factor" in realizing

the applicable income or gain.[18] In other words, if a business activity were a material factor in producing FDAP Income and Gains, such income can be treated as ECI even if the particular property generating such income or gain has not been used or held for use in a U.S. trade or business. This test, contrary to the asset use test, focuses on the transaction itself that generates the applicable income or gain and assesses whether such transaction was connected with the U.S. trade or business activities.[19] For example, the business activities test could be satisfied when dividends or interest are derived by a dealer in stocks or securities, capital gains are derived from the investments held by an investment company, or royalty income is derived by a taxpayer engaged in a licensing business.[20] Under this test, however, activities relating to the management of an investment portfolio shall not be treated as activities of a U.S. trade or business unless the maintenance of the investments constitutes the principal activity of that trade or business (as in the case of an investment company).[21]

***b) Banking rules.*** The Treasury regulations separately provide special rules (the "Banking Rules") applicable to FDAP Income and Gains generated by certain banking, finance, or similar business activities.[22] Under the Banking Rules, notwithstanding the "asset use" test and the "business activities" test under the General Rules, FDAP Income and Gains with respect to stock or securities will be treated as ECI only if (1) the stocks or securities giving rise to such income or gain are attributable to the "U.S. office" through which the business is carried on and (2) such stock or securities either (A) were acquired through specified financing activities (making loans to the public, distributing stocks or securities to the public, or satisfying reserve or other similar requirements imposed by U.S. banking authority) or (B) consist of other short-term or government-issued securities (or other securities subject to certain limitations).[23] The U.S. office for this purpose includes an U.S. office of an agent (including an independent agent).[24]

In order for the Banking Rules to apply, (1) the U.S. office must be a material factor in the realization of income, (2) the U.S. office must regularly carry on activities of the type for which such income is derived, and (3) the income shall be realized in the ordinary course of business that is carried on through that U.S. office. The material factor test would be met if the activities of the U.S. office constitute an essential economic element that provides a significant contribution to the income.[25] This requirement is similar to the material factor test used in the business activities test under the General Rules.

### *2. Other U.S.-Source Income*

In case of U.S. source income that is not FDAP Income and Gains, such income will be automatically treated as ECI under Code Sec. 864(c)(3) as long as the taxpayer is engaged in a U.S. trade or business. Under this rule, it is irrelevant whether such income is derived from or otherwise connected with the taxpayer's U.S. trade or business.[26] This rule is often referred to as the "limited force of attraction" rule, as it is a residue of the old force of attraction rules with a narrower application.[27] Under this rule, unless specific exceptions apply, all U.S.-source ordinary income or gains of a foreign person will be automatically treated as ECI to the extent such foreign person is engaged in a U.S. trade or business. No connection is required between such income and the foreign person's U.S. trade or business.

### *3. Foreign-Source Income*

Different rules apply for foreign-source income. Foreign-source income of a foreign person engaged in a U.S. trade or business is generally not treated as ECI, except for certain limited classes of income attributable to the taxpayer's U.S. office or other fixed place of business (a "U.S. Office").[28] Such income includes dividends, interest, or amounts received for the provision of guarantees of indebtedness that is derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account.[29] For this purpose, the U.S. Office of the taxpayer does not include the U.S. Office of its independent agent.[30] Generally, it would be more difficult for any foreign-source income to be treated as ECI as compared to U.S.-source income.

## III. History of Force of Attraction Rules

The "force of attraction" rule was first introduced in the Revenue Act of 1936.[31] Under this original force of attraction rule, if a foreign corporation had a U.S. trade or business, all of its U.S.-source income would become subject to U.S. taxation on net basis at the same rates applicable to a U.S. person. Conversely, if the foreign corporation did not have a U.S. trade or business, it would be subject to a 30% flat rate U.S. taxation that was applied on a gross basis with respect to limited classes of U.S.-source income, which typically included passive investment income.

The 1936 tax system has been described as the "force of attraction" regime because having a U.S. trade or business

would attract all of the taxpayer's U.S.-source income into the net-basis taxation in the United States, including even passive investment income that was completely unrelated to the taxpayer's U.S. trade or business. However, foreign persons were never taxed on foreign source income, even when such income was earned by a U.S. business.[32]

This original force of attraction rule remained in force until the Foreign Investors Tax Act of 1966 ("FITA") was enacted, which provided the current statutory framework for U.S. income taxation for foreign persons as discussed above. Under FITA, Congress narrowed the force of attraction rule and introduced the concept of a "U.S. trade or business" and an "effectively connected income" (collectively, the "ECI Rules") to differentiate the tax treatment between business and investment income.[33] Under the ECI Rules, a foreign person is subject to U.S. tax on a net basis at graduated rates for income that is "effectively connected" with a U.S. trade or business. Passive investment income, on the other hand, is generally not taxed on a net basis unless it meets certain specific requirements.

Before the portfolio interest exemption came into effect, non-ECI interest income was generally subject to 30% tax on a gross basis. Banking and financing businesses therefore generally found it more attractive to treat their interest income as ECI and deduct their expenses against it rather than facing a 30% flat rate tax applied on a gross basis.[34] In this historical context, the Banking Rules were promulgated in 1972. These rules generally restricted banks and financing businesses from deducting their funding costs and other expenses against FDAP Income and Gains.[35] So by its design, once a foreign person is determined to be engaged in a banking or financing business, specific requirements should be satisfied to treat its FDAP Income and Gains as ECI: (1) stocks or securities giving rise to such FDAP Income and Gains must be attributable to the U.S. office through which the foreign person's banking or financing business is carried on and (2) such stock or securities either (A) were acquired through specified financing activities (making loans to the public, distributing stocks or securities to the public, or satisfying reserve or other similar requirements imposed by U.S. banking authority) or (B) consist of other short-term or government-issued securities.

In light of the statutory wordings of the Banking Rules and their historical background, it seems reasonable to interpret that if a taxpayer is determined to be engaged in a banking and financing business, and such taxpayer's FDAP Income and Gains were determined not to be ECI under the Banking Rules, the same income and gains should not be retested as ECI under the General Rules.

However, the introduction of the portfolio interest exemption appears to have shifted dynamics between the Internal Revenue Service ("IRS") and taxpayers. With the portfolio interest exemption eliminating withholding tax on certain interest income, foreign persons engaged in banking and financing businesses may now find it more beneficial to classify their interest income as non-ECI (thereby avoiding tax on ECI), rather than reporting the same income as ECI and claiming associated deductions. In this context, it is notable that the IRS recently took the position in *YA Global* that even if any FDAP Income and Gains were determined to be non-ECI under the Banking Rules, such income can be treated as ECI if it satisfies the asset use test or the business activities test under the General Rules.[36]

## IV. *YA Global*

The recent decision by the U.S. Tax Court in *YA Global* introduces another layer of complexity to the ECI analysis. In this case, the court treated a taxpayer engaged in loan origination activities as a "dealer in securities" under Code Sec. 475, without specifying whether the same taxpayer would be treated as a "dealer in stock or securities" under Code Sec. 864(b)(2). This "dealer" classification can recharacterize a taxpayer's capital gains into ordinary gains, thereby letting the force of attraction rule apply, as further described below.

In broad strokes, YA Global Investments, LP (the "YA Global Fund") was an investment fund focusing on credit solutions investments, investing across a broad spectrum of the capital structure in various companies. Such investments included convertible loans. The court's determination that YA Global Fund was engaged in a U.S. trade or business was not a surprise, given its regular activities in loan origination and underwriting businesses. However, the court's conclusion that the YA Global Fund was a dealer in securities under Code Sec. 475 surprised many practitioners.[37] To reach this conclusion, the court relied on the finding that YA Global Fund "regularly [held] itself out as being willing and able" to purchase securities from the portfolio companies and that YA Global Fund in fact acquired such securities.

Under Code Sec. 475, a dealer in securities must regularly purchase *or* sell securities from or to "customers" in its ordinary course of business.[38] The court focused on the fact that YA Global Fund regularly acquired (*i.e.*, made) loans, but did not assess whether the borrowers were "customers" of YA Global Fund. Instead, the court simply deemed the "customer" status of the borrowers because YA Global Fund lent money to the borrowers as it publicly held itself out to be ready and willing to do so.

If the court's analysis were to be strictly applied, it could treat a typical credit fund as a dealer in securities under Code Sec. 475, as long as the fund or its manager publicly presents itself as ready and willing to make loans, and actually executes loans. This dealer characterization could pose several issues. Firstly, it might inflate or accelerate taxable income due to the mark-to-market requirement. Secondly, it could negate the favorable tax treatment applicable to long-term capital gains, as the fund's investments would no longer be treated as capital assets. Lastly, this non-capital asset treatment would trigger the limited force of attraction rule, thereby automatically treating the taxpayer's investment gains as ECI.

Taxpayers may be able to mitigate these issues by properly identifying each of its investments as being held for investment under Code Sec. 475(b)(1). However, many taxpayers did not anticipate this result and have not identified their investments as such yet.

## V. Application of the Force of Attraction Rule to Certain Credit Fund Structures

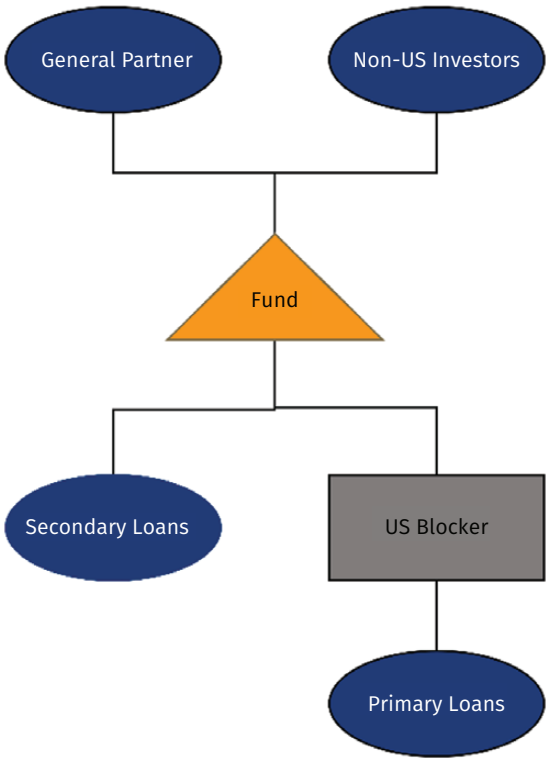
A credit fund is a managed pool of capital raised from investors to invest in credit products or programs. Typically structured as a partnership for U.S. federal income tax purposes, the fund's general partner or a manager sources, diligences, and manages the fund's investments. In light of their investment mandate and activities, credit funds tend to be more exposed to the U.S. trade or business risk compared to their private equity peers. This heightened exposure arises because the fund's loan origination activities resemble those of banking and other financial institutions.[39] As a result, for credit funds that regularly originate loans, it is typical to implement specific structures to address potential U.S. trade or business issues for their foreign investors. In this section, we explore and contrast two hypothetical credit fund structures to illustrate how the ECI analysis for each structure would change, particularly considering the potential application of the limited force of attraction rule.

### A. Structure I: "Below the Fund" Blocker Structure

This structure is generally designed to ringfence the loan origination activities by making primary loans through an entity that is treated as a U.S. corporation for federal income tax purposes (a "US Blocker"). Under this setup, the fund typically limits its direct investments to sufficiently seasoned secondary loans only, so that the fund



**STRUCTURE 1.**



can rely on the Trading Safe Harbor. The fund takes the position that such secondary loans qualify as "securities" for purposes of the Trading Safe Harbor, and the fund is not a "dealer" within the meaning of Code Sec. 864(b)(2)(A)(ii).

The US Blocker may be levered with shareholder loans provided by the fund to the extent desirable to mitigate the US Blocker's corporate income tax leakage. Even if the Trading Safe Harbor were not available, given the passive nature of the fund's assets and activities that are limited to holding secondary loans, stock in the US Blocker, and shareholder loans[40] to the US Blocker, the fund generally does not anticipate being deemed engaged in a U.S. trade or business.

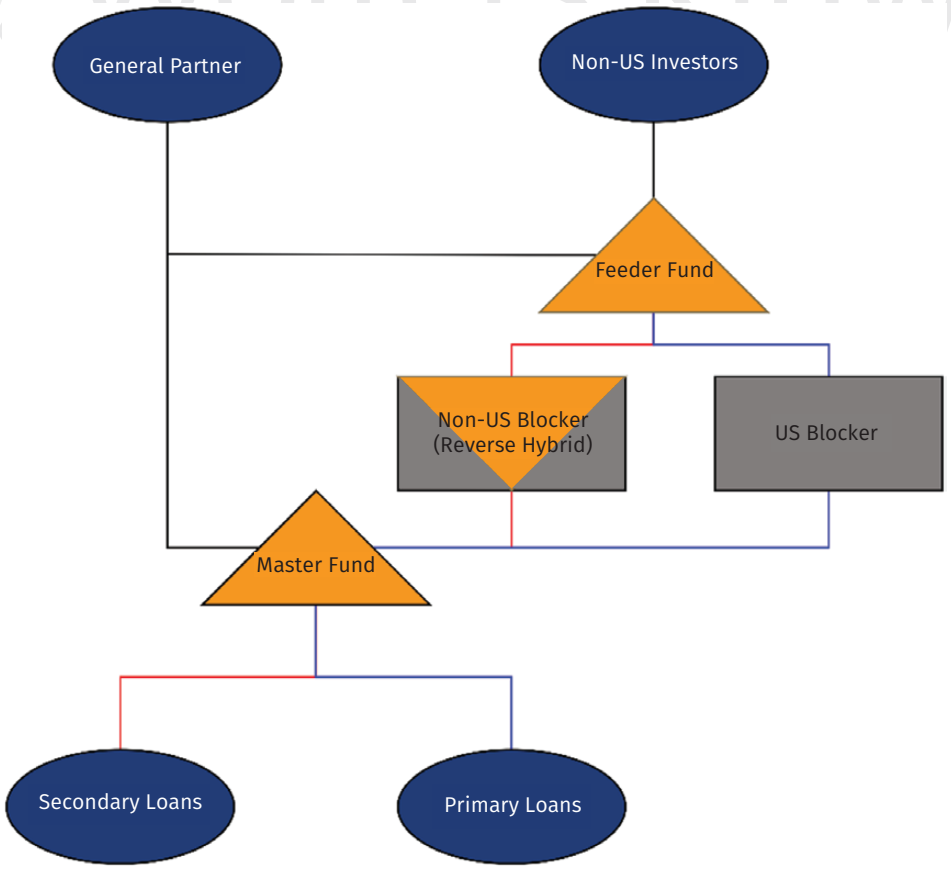
Under this structure, any income derived from primary loans will be subject to corporate income tax at the US Blocker level. Additional income or withholding tax may be imposed when the fund receives distributions from the US Blocker in the form of dividends or interest payments on shareholder loans. On the other hand, income from secondary loans is not expected to be subject to U.S. federal income tax as such income would not be characterized as ECI as long as the fund itself is not otherwise engaged in a U.S. trade or business.

## B. Structure II: "Above the Fund" Blocker Structure with Special Allocations

This second structure differs from the first in that the fund (the "Master Fund") directly holds both primary and secondary loans. In other words, there is no "blocking" entity under the Master Fund. Instead, blockers will be located above the Master Fund and the ECI-sensitive investors will be holding stock in such blockers *via* a feeder fund (the "Feeder Fund"). The Feeder Fund is typically set up and managed by the general partner or the manager.

This structure offers certain advantages over the first because non-ECI-sensitive investors, such as U.S. investors, can invest directly in the Master Fund without encountering additional tax leakage at the US Blocker level. The Master Fund often sets up two blockers: a US Blocker and a foreign entity treated as a corporation for U.S. federal income tax purposes (but treated

**STRUCTURE 2.**



as passthrough for local tax purposes in the investors' local jurisdictions) (a "Reverse Hybrid").[41] To mitigate tax leakage, the Master Fund may opt to specially allocate ECI solely to the US Blocker, while rerouting other income through the Reverse Hybrid.[42] Under this structure, the Master Fund would be considered engaged in a U.S. trade or business due to its loan origination activities related to its primary loan investments.

It is not difficult to anticipate that interest income derived from the Master Fund's primary loans would be treated as ECI, as such income looks akin to active business income from a banking or financing business. However, determining the ECI status for other types of income would involve a much more complex legal and factual analysis.

*The potential application of the force of attraction rule under Code Sec. 864(c)(3), as described in YA Global, provide valuable insights for certain credit funds and their foreign investors.*

Once the Master Fund is treated as engaged in a U.S. trade or business, we now enter the realm of the "effectively connected" test under Code Sec. 864(c). As discussed above, this test can yield different outcomes depending on the type and source of the applicable income. For example, under this structure, interest on U.S. secondary loans could first be tested under the Banking Rules. If the Banking Rules do not characterize such interest income as ECI, as illustrated in *YA Global*, such interest income can be retested using the asset use or business activities test under the General Rules. Both sets of rules rely heavily on factual determinations, although the Banking Rules are more formulated compared to the General Rules as discussed above.

Under the Banking Rules, interest income can be treated as ECI if two conditions are met: (1) the underlying loans are attributable to the "U.S. office" through which the business is carried on and (2) such loans were acquired as a result of, or in the course of, making loans to the public.[43]

The definition of U.S. office for this purpose includes the U.S. office of an agent (whether dependent or independent).[44] As such, due to the agency relationship with the investment manager, the Master Fund would likely be deemed to have a U.S. office. If the investment manager actively and materially participates in "soliciting, negotiating, or performing other activities required to arrange the acquisition of" the loans, these loans would be deemed attributable to the Master Fund's U.S. office, thereby satisfy the first prong described above.[45]

Therefore, in order to avoid ECI characterization, the Master Fund should successfully argue that the loans were not acquired as a result of or in the course of making loans to the "public." However, if the Master Fund makes loans to a broad, non-specific group of borrowers, this strategy can be an uphill battle.[46] Alternatively, the Master Fund can argue that the secondary loans are not acquired as "a result of" or "in the course of" making loans. But in order to make such an argument, the Master Fund should feel factually confident that none of those loans were acquired as part of making loans or in connection with refinancing primary loans. Furthermore, there is a possibility that at least a portion of such loans may be viewed as other short-term or government-issued securities under Reg. §1.864-4(c)(5)(ii) , thereby treating interest on such loans as ECI.[47]

In addition, as the IRS argued in *YA Global*, the same income might also need to be tested under the "asset use" or "business activities" test. Under the asset use test, could at least a portion of the secondary loans be considered assets held for use in the Master Fund's loan origination business? Additionally, under the business activities test, all or a portion of such income could be characterized as ECI if it is determined that such income is derived by a dealer or a person whose principal activity of its trade or business is maintaining its investments.[48] As discussed above, *YA Global* raises questions regarding the "dealer" status of the Master Fund, and it is also conceivable that the principal activities of the Master Fund's trade or business could be viewed as the maintenance of its investments. All these questions and uncertainties can add up, aggregately posing more than just a remote risk of ECI classification.

On top of this, following *YA Global*, certain capital gains derived from the Master Fund's secondary loan portfolio might be characterized as ECI. This potential characterization begins with determining the source of income for these capital gains.

Generally, capital gains of a foreign taxpayer are sourced to the taxpayer's residence.[49] Thus, when a foreign person recognizes capital gains, these gains are typically treated as foreign source income. However, capital gains on personal property attributable to a U.S. Office[50] of the taxpayer will be treated as U.S.-source income.[51]

The Master Fund in this structure would generally be deemed to have a U.S. Office through attribution. This is either because the investment manager's U.S. Office is attributed to the Master Fund as the investment manager is treated as a dependent agent of the Master Fund (following the rationale of the *YA Global* court) or because the investment manager's U.S. Office is attributed to its affiliate, the general partner, and then attributed to the Master Fund as the general partner of a partnership is generally deemed to be a dependent agent of the partnership.[52]

The Master Fund's U.S. Office would regularly carry on investment activities and presumably be a material factor in recognizing gains with respect to secondary loans. Therefore, capital gains on such investments would be attributed to the Master Fund's U.S. Office. As a result, these capital gains would be recharacterized as U.S.-source income, even if such gains are associated and allocable to a foreign taxpayer.

Should such U.S.-source capital gains be tested under the Banking Rules or the General Rules as FDAP Income and Gains? No if the Master Fund is treated as a dealer. The *YA Global* court suggests that if a taxpayer "regularly [held] itself out as being willing and able" to acquire loans and in fact acquired loans, such taxpayer would be treated as a dealer in securities.[53] Under this theory, the Master Fund could be treated as a dealer in securities under Code Sec. 475, if, for example, its manager discussed its investment programs at a public conference.

If the Master Fund is treated as a dealer in securities, its investments would be considered non-capital assets pursuant to *YA Global*, and any gains thereon would no longer be treated as capital gains under Code Sec. 475(d)(3)(A) (and Code Sec. 64 or 65). *YA Global* indicated that this characterization would apply to all other purposes of the Code. Thus, these gains, which are now treated as U.S.-source ordinary gains, would be forced to be treated as ECI under the limited force of attraction rule, because the Master Fund is engaged in a U.S. trade or business.

The discussion above suggests that the Master Fund would need to navigate multiple layers of complex factual and legal analyses to determine the exact scope of ECI. As discussed above, there is a possibility that a portion of the Master Fund's income that we normally expect to be treated as non-ECI income could be recharacterized as ECI. To mitigate this risk, the Master Fund may find it preferable to hold secondary loans through a separate foreign blocker beneath the Master Fund,[54] or to set up a separate and parallel investment sleeve to ringfence U.S. trade or business activities from tainting the Master Fund.

## VI. Conclusion

The potential application of the force of attraction rule under Code Sec. 864(c)(3), as described in *YA Global*, provide valuable insights for certain credit funds and their foreign investors. Although more limited in scope today, the force of attraction rule can still unexpectedly recharacterize certain U.S.-source passive income and capital gains as ECI, resulting in a broader U.S. tax exposure than typically anticipated.

This may be particularly pertinent for credit funds that engage in loan origination and other financing activities. Understanding and navigating ECI issues has always been crucial in structuring a credit fund, but with additional uncertainties and challenges imposed by *YA Global*, it has become even more important to carefully consider these issues.

### ENDNOTES

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1 161 TC No. 11, Dec. 62,306 (2023).

2 Code Secs. 871(b) and 882.

3 *See generally*, Kingson, *Taxing Foreign Corporations on U.S. Business Income*, 118 TAX NOTES 1143 (Mar. 10, 2008).

4 *See I. Balanovski*, CA-2, 56-2 USTC ¶9832, 236 F2d 298, *cert. denied*, SCt, 352 US 968, 77 SCt 357, *reh'g denied*, 352 US 1019 (1957) (partnership had U.S. trade or business, even though its U.S. activities were limited to purchasing and exporting goods for sale abroad); *Northumberland Ins. Co.*, DC-NJ, 82-2 USTC ¶16,383, 521 FSupp 70, 78 (foreign insurance company, which "occupied office space, hired agents and employees, and maintained assets and bank accounts in the United States," had U.S. trade or business, even though it was not "authorized to do business" in United States); *J. Pasquel*, 12 TCM 1431, Dec. 20,047(M) (1953) (purchase and sale of two ships in three-month period not trade or business).

5 *I. de Amodio*, 34 TC 894, Dec. 24,315 (1960), *aff'd*, CA-3, 62-1 USTC ¶9283, 299 F2d 623 (ownership of U.S. real property, receipt of rentals, and payment of taxes, mortgage principal and interest, and insurance premiums was not U.S. trade or business because activities "beyond the scope of mere ownership of real property, or the receipt of income from real property" were "sporadic rather than 'continuous,'... irregular rather than 'regular,' and ... minimal rather than 'considerable'"); *E. Herbert*, 30 TC 26, Dec. 22,928 (1958); *E.M.L. Neill*, 46 BTA 197,

Dec. 12,251 (1942) (taxpayer's ownership of U.S. real property and collection of rents was "no more a business activity carried on within the United States than her ownership of stocks or bonds of American companies held for her by an American agent").

[6] *Taiyo Hawaii Co.*, 108 TC 27, 611, Dec. 52,114 (1997) (citing *A.R.E. Pinchot, Exr.*, CA-2, 40-2 USTC ¶9592, 113 F2d 718; *see also I. de Amodio*, 34 TC 894, Dec. 24,315, 1960 WL 1317 (1960) (active management of rental property on a "regular and continuous" basis is a U.S. trade or business), *aff'd*, CA-3, 62-1 USTC ¶9283, 229 F2d 623; *E. Herbert*, 30 TC 26, Dec. 22,928, 1958 WL 961 (1958); *J.C. Lewenhaupt*, 20 TC 151, Dec. 19,606, 1953 WL 256 (1953), *aff'd*, CA-9, 55-1 USTC ¶9339, 221 F2d 227).

[7] *See* Rev. Rul. 80-225, 1980-2 CB 318 (foreign person may "be engaged in a trade or business in the United States as a result of activities performed on its behalf by an independent agent of the taxpayer in the United States"). *See also YA Global Invs., LP*, 161 TC No. 11, Dec. 62,306 (2023) (finding that adviser's activities on partnership's behalf were attributed to partnership); *A. Zaffaroni*, 65 TC 982, Dec. 33,662 (1976) (nonresident aliens had community property income earned in United States by active spouse; held, inactive spouse was engaged in U.S. trade or business by activities of active spouse as "agent or manager of that community").)

[8] Code Sec. 864(c)(1)(B).

[9] *InverWorld, Inc.*, 71 TCM 3231, 3237-26, Dec. 51,428(M), TC Memo. 1996-301. The court concluded that the Trading Safe Harbor was not available to the taxpayer and therefore conducted an intensive analysis of the facts to determine that the taxpayer was engaged in a U.S. trade or business.

[10] Code Secs. 864(b)(2)(A)(i) and 864(b)(2)(A)(ii).

[11] Reg. §1.864-2(c)(2)(i).

[12] Reg. §1.864-2(c)(2)(iv).

[13] Reg. §1.864-4(c).

[14] Reg. §1.864-4(c)(2)(ii).

[15] Reg. §1.864-4(c)(2)(iv)(a).

[16] Robert P. Rothman, *Gain from Property Sales as Effectively Connected Income*, J. Int'l Tax'n, available at *www.akingump.com/a/web/1495/Rothman-July-2009.pdf*.

[17] *Id.*

[18] Reg. §1.864-4(c)(3)(ii).

[19] Robert P. Rothman, *Gain from Property Sales as Effectively Connected Income*, J. Int'l Tax'n, available at *www.akingump.com/a/web/1495/Rothman-July-2009.pdf*.

[20] Reg. §1.864-4(c)(3).

[21] *Id.*

[22] Reg. §1.864-4(c)(5). Under the Banking Rules, a banking or financing business is a business involving activities including (1) receiving deposits of funds from the public, (2) making personal, mortgage, industrial, or other loans to the public, (3) purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness, (4) issuing letters of credit to the public and negotiating drafts drawn thereunder, (5) providing trust services for the public, or (6) financing foreign exchange transactions for the public. *See* Reg. §1.864-4(c)(5)(i).

[23] Reg. §§1.864-4(c)(5)(i) and 1.864-4(c)(5)(ii).

[24] Reg. §1.864-4(c)(5)(iii)(a). AM 2009-010 (Sep. 22, 2009). *See also* Moldenauer, *The Foreign Lender Memorandum and the Definition of a U.S. Office*, Tax Notes (Dec. 14, 2009).

[25] Reg. §1.864-6(b)(1).

[26] Reg. §1.864-4(b).

[27] To the contrary, the old form of the force of attractions rules brought virtually all of U.S. source income under U.S. taxation, regardless of whether such income was actually generated by or otherwise connected with, a U.S. trade or business.

[28] Code Secs. 864(c)(4)(A) and 864(c)(4)(B).

[29] Code Sec. 864(c)(4)(B)(ii).

[30] Reg. §1.864-6.

[31] Pub. L. No. 74-740, §231(a).

[32] *See generally* Roberts, *The Force of Attraction Doctrine in the United States Tax Law Today*, 21 Bull. Int'l Fiscal Documentation 487 (1967).

[33] Rev. Rul. 81-78; 1981-1 CB 604 (citing Pub. L. 89-809, §102).

[34] Moldenauer, *The Foreign Lender Memorandum and the Definition of a U.S. Office*, Tax Notes (Dec. 14, 2009).

[35] The intention of the IRS to apply the Banking Rules narrowly is reflected in Rev. Rul. 75-253, 1975 CB 203 ("Section 1.864-4(c)(5)(iii)(a)(2) provides a standard for determining whether U.S. source interest income received by foreign banks or financing companies through the efforts of their U.S. offices will be taxed at a flat rate under section 881 of the Code or at graduated rates under section 882 in order to enable such taxpayers to conduct business within the United States with some certainty as to the tax consequences of their activities.").

[36] *YA Global*, at 57. "Respondent contends that, "[i]f some portion of YA Global's U.S. source income is not effectively connected under Reg. §1.864-4(c)(5), it would be tested under the general effectively connected income rules for U.S.-source income."

[37] *See* The YA Global Tax Court Decision: Non-US Private Fund is Engaged in a US Trade or Business as a Result of Fund Manager's Activities US, available at *www.mayerbrown.com/en/insights/publications/2023/12/the-ya-global-tax-court-decision-non-us-private-fund-is-engaged-in-a-us-trade-or-business-as-a-result-of-fund-managers-activities-us*. *See also* What's A U.S. Trade Or Business? Analyzing The U.S. Tax Court's Decision In YA Global, *Forbes* (Apr 2., 2024), available at *www.forbes.com/sites/taxnotes/2024/04/02/whats-a-us-trade-or-business-analyzing-the-us-tax-courts-decision-in-ya-global/?sh=5b68620c56d5*.

[38] Reg. §1.475(c)-1(a)(2).

[39] Key attributes indicative of a lending trade or business encompass interaction and negotiation with borrowers or issuers, customer solicitation, fee receipt for lending services (*e.g.*, origination fees), provision of ancillary services, and sustained, routine engagement in the activity.

[40] A fund lending money to its own blocker is generally not treated as engaged in a lending business, as long as the number of loans are limited and the fund does not hold itself out to the public as a lending institution. *See* BNA Portfolio 735-3rd Private Equity Funds, Detailed Analysis, VIII. Tax Planning for Foreign and Tax-Exempt Investors. "... a fund should not be deemed to be engaged in a financial lending business in any of these cases. First a portfolio company is neither a "customer" of the fund nor a part of the "public" at large. Funds do not make these loans to unrelated parties and do not hold themselves out to public ... They make these loans because they have a pre-existing relationship with the borrower, usually as the controlling shareholder."

[41] A "reverse hybrid" entity (*i.e.*, a foreign limited partnership that elects to be treated as a corporation for U.S. federal income tax purposes) is preferred over a foreign corporation or company to preserve any potential treaty benefits that may be available to certain investors from certain eligible treaty jurisdictions.

[42] These special allocations raise interesting issues and considerations but those are not the focus of this article.

[43] Reg. §1.864-4(c)(5)(ii).

[44] Reg. §1.864-4(c)(5)(iii)(a).

[45] *Id.*

[46] *But see* Rev. Rul. 73-227, 1973-1 CB 338, revoked by Rev. Rul. 88-3, 1988-1 CB 268 (lending by foreign subsidiary to its parent was not a banking, financing, or similar business); LTR 9111061, (Dec. 20, 1990) (corporation that loaned funds only to qualified recipients described in Reg. §1.936-10(c)(9) was not making loans to the public).

[47] *See* the flush language in Reg. §1.864-4(c)(5)(ii).

[48] Reg. §1.864-4(c)(3).

[49] Code Sec. 865(a).

[50] The defined term "U.S. Office" is used here to differentiate from the U.S. office used in the Banking Rules. *See* the discussion in 'II. Statutory Framework—2. "Effectively Connected" Test—iii. Foreign Source Income").

[51] Code Sec. 865(e)(2).

[52] *See Donroy, Ltd.*, CA-9, 62-1 USTC ¶9373, 301 F2d 200 (1962) (the court held that the general partner in a United States limited partnership was the general agent of the limited partners in the partnership, and that the office or permanent establishment of the partnership was the office of each of the partners). *See also* Rev. Rul. 90-80, 1990-2 CB 170.

[53] *See YA Global*, at 46.

[54] This structure, however, could raise "passive foreign investment company" concerns for U.S. investors in the Master Fund.