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THE GLOBAL SHADOW BANK--SYSTEMIC RISK AND TAX POLICY OBJECTIVES: THE UNCERTAIN CASE OF FOREIGN HEDGE FUND LENDING IN THE UNITED STATES

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ABSTRACT: THE GLOBAL SHADOW BANK--SYSTEMIC RISK AND TAX POLICY OBJECTIVES: THE UNCERTAIN CASE OF FOREIGN HEDGE FUND LENDING IN THE UNITED STATES

With the recent financial crisis in the U.S. starting in 2007, much attention has been drawn to the issue of whether and to what extent financial regulation should keep pace with financial innovation and the shadow banking system. However, often ignored is the Internal Revenue Code’s failure to adequately keep pace with this financial innovation. One example of how the tax laws lag behind financial innovation can be found in the taxation of lending into the U.S. by foreign persons. Most of the U.S. federal income tax law governing foreign lending into the U.S. was written before complex shadow banking transactions and sophisticated debt products were even contemplated. This leaves a great deal of uncertainty about how the tax laws should be interpreted and applied in this area. In order to analyze these uncertainties and their potential affects in more detail, I will concentrate on financial innovation in the hedge fund industry—focusing on transactions in which foreign hedge funds lend money into the U.S., either directly to U.S. borrowers or by purchasing debt securities.

First, Part II will identify how certain tax laws lag behind shadow bank transactions that are becoming more and more commonplace. I will explore typical foreign hedge fund lending transactions and demonstrate how the current law provides inadequate guidance as to how these transactions will be taxed. Part III will discuss why it may be absolutely vital to fix this problem--suggesting that we should consider the possibility that this kind of uncertainty in the taxation of certain shadow bank transactions may increase systemic risk making the U.S. financial system more fragile. Whether hedge funds are systemically important because of their interconnectedness to the financial system and credit channels is currently being discussed at the highest levels of our government. I posit that we should at the very least also consider whether tax uncertainty in the transactions that create the interconnectedness and credit channels increases systemic risk. Part IV will look at the tax policy reasons for the current law’s enactment and posits that the existing uncertainty frustrates these very tax policy goals.

Finally, Part V will contend that no matter what rules or standards policymakers adopt to fix the problem in this area, the rules or standards should get to the substance of the transactions and not merely the form. In order to adopt
a substantive approach, the IRS needs more information about foreign funds and

ABSTRACT (continued):

their transactions. It seems to me that we should at least consider the use of two disclosure regimes being fashioned as this is being written that will potentially already be applied to certain foreign persons for other purposes—(i) the FATCA provisions of the Hiring Incentives to Restore Employment Act of 2010 to capture U.S. persons attempting to evade U.S. tax via foreign vehicles and (ii) the disclosure and reporting provisions applied to certain nonbank financial institutions and investment advisors under the Dodd-Frank Wall Street Reform and Consumer Protection Act in the regulatory arena. In fact, these new tools, if applied in this area, may be instrumental not only to the implementation of rules or standards in this area but also to the issue of what the rules or standards should be based on what has the potential to be effectively implemented. It’s time to face the global shadow banking system—both with respect to how we want to regulate it and with respect to how we want to tax it.
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THE UNCERTAIN CASE OF FOREIGN HEDGE FUND LENDING IN THE UNITED STATES

Julie A.D. Manasfi*

I. INTRODUCTION.

The structure of the global financial system has drastically changed in the last few decades with the rise of what has been called a shadow banking system.¹

¹ See Paul Krugman, The Return of Depression Economics and the Crisis of 2008 163 (W.W. Norton & Company, Inc.) (2009) ("...the shadow banking system expanded to rival or even surpass conventional banking in importance..."); Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Hearing Before the H. Oversight Comm. On Hedge Funds, 111th CONG. (2008) (statement of Andrew Lo), http://ssrn.com/abstract=1301217 ("In particular, many financial institutions now provide some of the same services that banks have traditionally provided, but are outside of the banking system."); Bill Gross, Beware Our Shadow Banking System (2007), http://money.cnn.com/2007/11/27/news/newsmakers/gross_banking.fortune/ ("My Pimco colleague Paul McCulley has labeled it the "shadow banking system" because it has lain hidden for years ...); See Robin Blackburn, Subprime Crisis, NEW LEFT REVIEW, Mar.-Apr. 2008 at 50, 68-69 ("This ‘hidden’ system had expanded rapidly in the 1990s and 2000s as a consequence of deregulation, which allowed many financial institutions to take on banking functions and loosened the rules that govern borrowing and lending."); Gillian Tett and Paul Davies, Out of the Shadows: How Banking’s Secret System Broke Down, FINANCIAL TIMES, Dec. 2007, at 17 ("Yet while investors are scrutinizing some of the industry’s best-known names, a spectre will be silently haunting events: the state of the little-known, so-called “shadow” banking system. A plethora of opaque institutions and vehicles have sprung up in American and European markets this decade, and they have come to play an important role in providing credit across the financial system.").
Financial institutions outside the traditional banking system have acted as intermediaries between investors and borrowers and increasingly undertaken roles traditionally played by banks, including lending U.S. businesses capital. These intermediaries have included investment banks, hedge funds and others that have expanded the liquidity, arguably increasing market efficiency, in many global financial markets.

With the recent financial crisis in the U.S. starting in 2007, much attention has been drawn to the issue of whether and to what extent financial regulation should keep pace with financial innovation and the shadow banking system. However, often ignored is the Internal Revenue Code’s failure to adequately keep pace with this financial innovation. One example of how the tax laws lag behind financial innovation can be found in the taxation of lending into the U.S. by foreign persons. Most of the U.S. federal income tax law governing foreign lending into the U.S. was written before complex shadow banking transactions and sophisticated debt products were even contemplated.

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2 Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008: Hearing before the H. Oversight Comm. On Hedge Funds 4, 111th Cong. (2008)(statement of Andrew Lo), http://ssrn.com/abstract=1301217 In the lending context, this role may consist of being an intermediary between investors and borrowers (i.e., funneling funds from the investor to the borrower). The non-bank institution will thereby profit from fees and/or the difference in interest rates that it pays the investors and what it receives from the borrowers. This role may also consist of purchasing debt securities on the secondary market. For further discussion specific to hedge funds see Part II below. These non-bank institutions may include hedge funds, investment banks, structured investment vehicles, and other non-bank entities.

3 Id. (description of the financial intermediaries); See Roger Ferguson & David Laster, Fin. Stability Rev., Apr. 2007, at 45, 47-48 ( hedge funds have contributed to market efficiency and financial stability by expanding liquidity and thereby lowering the cost of capital).


5 E.g., the Revenue Act of 1936 created an early version of the business versus passive distinction that will be discussed in Part IV and established that foreign persons and corporations selling their passive investment would not be taxed on the resulting capital gains. Revenue Act of
deal of uncertainty about how the tax laws should be interpreted and applied in this area. Particularly problematic is that the taxation outcome depends on a mushy standard of whether a foreign person is engaged in a U.S. trade of business of lending. In order to analyze these uncertainties and their potential affects in more detail, I will concentrate on financial innovation in the hedge fund industry—focusing on transactions in which foreign hedge funds lend money into the U.S., either directly to U.S. borrowers or by purchasing debt securities.

Policymakers must choose where the boundaries of what rises to the level of a U.S. trade or business should be drawn, or re-drawn, given the growth of complex debt transactions. Any particular line drawn will be controversial. In fact, inefficiencies can arise when economically similar transactions are taxed differently. The taxpayer whose transactions fall on the business side of the line will argue that the distinctions are arbitrary and their transactions are economically similar to those transactions that just barely fall on the passive investment side of the line. My point is that there will undoubtedly be room for disagreement about any line drawn because there are competing tax policy considerations in this area. The goals of this article are not to propose where these lines should be drawn.

The goals of this article are much more fundamental.

- First, Part II will identify how certain tax laws lag behind shadow bank transactions that are becoming more and more commonplace. I will explore typical foreign hedge fund lending transactions and demonstrate how the current law provides inadequate guidance as to how these transactions will be taxed.

- Part III will discuss why it may be absolutely vital to fix this problem—suggesting that we should consider the possibility that this kind of uncertainty in the taxation of certain shadow bank transactions may increase systemic risk making the U.S. financial system more fragile. Whether hedge funds are systemically important because of their

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1936, ch. 690, §§ 211, 231, 49 Stat. 1648 (1936). An early version of the safe harbor for trading in stock or securities for one’s own account (which will also be discussed) was enacted in the 1936 Act and this safe harbor was revised in the 1966 Foreign Investors Tax Act. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1555 (1966).

interconnectedness to the financial system and credit channels is currently being discussed at the highest levels of our government. I posit that we should at the very least also consider whether tax uncertainty in the transactions that create the interconnectedness and credit channels increases systemic risk.

- Part IV will look at the tax policy reasons for the current law’s enactment and posits that the existing uncertainty frustrates these very tax policy goals.

- Finally, Part V will contend that no matter what rules or standards policymakers adopt to fix the problem in this area, the rules or standards should get to the substance of the transactions and not merely the form. In order to adopt a substantive approach, the IRS needs more information about foreign funds and their transactions. It seems to me that we should at least consider the use of two disclosure regimes being fashioned as this is being written that will potentially already be applied to certain foreign persons for other purposes—(i) the FATCA provisions of the Hiring Incentives to Restore Employment Act of 2010 (the “HIRE Act”) to capture U.S. persons attempting to evade U.S. tax via foreign vehicles and (ii) the disclosure and reporting provisions applied to certain nonbank financial institutions and investment advisors under the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter the “Dodd-Frank Act”) in the regulatory arena. In fact, these new tools, if applied in this area, may be instrumental not only to the implementation of rules or standards in this area but also to the issue of what the rules or standards should be based on what has the potential to be effectively implemented.

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7 Under the Dodd-Frank Act, infra note 10, the Financial Stability Oversight Council has been delegated the task of designating nonbank financial institutions that are systemically important.

8 FATCA refers to the Foreign Account Tax Compliance Act of 2009, H.R. 3933, 11th Cong. (1st Sess. 2009), which was never enacted. The provisions discussed in this article were introduced in FATCA but enacted as part of the HIRE Act, infra note 9.


10 Pub. L. No. 111-203, 124 Stat. 1376 (2010). This was signed into law by President Obama on July 21, 2010. The Dodd-Frank Act was passed in response to the financial crisis of 2007-2010 and generally, among other things, reforms the existing regulatory structure for financial institutions, increasing the oversight of certain nonbank financial institutions regarded as a systemically important.
II. THE CURRENT TAX LAWS IN THIS AREA LAG BEHIND FINANCIAL INNOVATION—A LOOK AT THE TAXATION OF FOREIGN HEDGE FUNDS LENDING MONEY INTO THE US.

A. Hedge Funds Generally.

“Hedge funds” are private pools of capital that typically restrict their investors to high net worth individuals and institutions in order to escape the types of disclosure and regulations requirements that currently apply to banks and mutual funds. This means that hedge funds have flexibility in the investment strategies and financial instruments that they employ. This also means they can be highly leveraged. The term “hedge” initially came from funds tendency to hedge or reduce market risk on an investment, i.e., holding offsetting positions so that if the market rose the fund profits from the increase in the long position over the decrease in the short position and if the market fell the fund profited from the increase in the short position over the decrease in the long position. Today’s hedge funds invest in varying ways and with varying strategies. Hedge fund managers often receive a management fee of 2% of the net asset value of the fund and 20% of returns in excess of some benchmark. This may create an incentive for hedge fund managers to take on risk and leverage in order to maximize returns.

B. Introduction to Hedge Fund Structures.

Funds that solicit capital from foreign investors are increasingly using a “master-feeder” structure. A “master-feeder” structure, although providing

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11 See John Kambhu, Til Schuermann & Kevin J. Stiroh, Hedge Funds, Financial Intermediation, and Systemic Risk, 291 FED. RES. BANK OF NEW YORK STAFF REP. 1 (2007); See generally, Alan L. Kennard, The Hedge Fund Versus the Mutual Fund, 57 TAX LAW. 133 (2004). Hedge funds are largely unregulated. Hedge funds generally do not register their shares under the Securities Act of 1933 because they do not hold public offerings. A hedge funds is also generally not “investment company” within the meaning of Investment Company Act of 1940 because they either have 100 or fewer investors or because their investors are sophisticated in that they qualify as “qualified purchasers.” In addition, hedge fund investment advisors generally do not register as such under the Investment Advisors Act of 1940 because they have 15 or fewer clients (or funds). Note that hedge funds can generally borrow in greater amounts than mutual funds because the Investment Company Act of 1940 limits the ability of mutual funds to borrow.


13 See Kambhu, Schuermann & Stiroh, supra note 11 at 3.

14 Alternatives to the master-feeder structure when a fund is soliciting capital from foreign
many tax and non-tax benefits, tends to amplify the uncertainties in the taxation of foreign funds lending into the U.S.

In a “master-feeder” structure, typically a U.S. limited partnership (See #1 in Figure 1 below, primarily an investment vehicle for U.S. taxable investors) and a foreign corporation (See #2 in Figure 1 below, primarily an investment vehicle for U.S. tax-exempt and non-U.S. investors) invest in parallel in another entity, the “master fund,” a pass-through entity for U.S. tax purposes (See #3 in Figure 1 below). The U.S. limited partnership and the foreign corporation are known as the feeder funds. See Figure 1 below.

Figure 1: Master-Feeder Structure

Because the master fund is taxed as a partnership for U.S. tax purposes, the investment advisor can be the general partner of the master fund. Therefore the investment advisor can receive a special profit allocation as a partner in lieu of all or a portion of a performance fee. A performance fee would be characterized as ordinary income which is taxed at a higher rate than a special profit allocation treated as capital gain, depending on the mix of income earned by the master investors include a parallel structure in which a foreign corporation for U.S. tax purposes invests in tandem with a domestic fund (although not through a master fund). In another variation, the foreign corporation could invest in a flow through entity for U.S. federal income tax purposes with the investment advisor as the general partner of the flow through entity such that the investment advisor could receive a profit allocation instead of a performance fee. The difference between this alternative and a “master-feeder” structure is that a domestic fund does not also invest in that lower tier flow through entity.
fund’s underlying investments.\textsuperscript{15} A special profit allocation, however, does not provide the same fee deferral options for federal income tax purposes.\textsuperscript{16}

The use of master-feeder structures is increasing because of the potential for the investment advisor to convert all or a portion of the performance fee into an incentive allocation and for other non-tax reasons. These non-tax reasons include (i) achieving a critical mass of assets in the master fund,\textsuperscript{17} (ii) reducing equalizing trades between foreign and domestic funds investing in parallel,\textsuperscript{18} (iii) improving operating efficiencies for the investment advisors,\textsuperscript{19} (iv) providing the flexibility to customize the feeder funds,\textsuperscript{20} and (v) providing a uniform performance record.\textsuperscript{21}

With the rise of the “master-feeder” structure, the U.S. federal income tax uncertainties as to whether or not the foreign master fund and thereby the foreign feeder fund is considered engaged in U.S. business for U.S. federal tax purposes are even more pronounced. Since the master fund also has a domestic feeder fund and thereby U.S. investors, the investment advisor may be tempted to have the master fund invest in the United States to a point which would cause the master fund to be engaged in a U.S. business.\textsuperscript{22} The increased use of the master-fund

\textsuperscript{15} I.R.C. §702 (2011).
\textsuperscript{17} Consolidating assets among the foreign and domestic funds into the master fund will give the master fund a larger asset base which, among other benefits, can be more attractive to lenders and investors. A single pool of assets may also make it easier for a fund to meet “qualified institutional buyer” or other similar asset-based qualifying status definitions allowing access to less regulations investments (such as the Rule 144A market—the private resales of securities to institutions) while the feeders may not qualify on their own.
\textsuperscript{18} In addition, trading is done at the master fund level, resulting in one portfolio. Therefore, the need to split tickets or engage in equalizing trades between funds of like strategy is avoided. This simplifies the day-to-day operations of the investment manager.
\textsuperscript{19} The total number of funds investing is consolidated since a foreign feeder fund and a domestic feeder fund invest in a master fund and the master fund procures the investments. This creates operating efficiencies for the investment advisor, such as simplifying and facilitating monitoring, risk management and the other investments strategy analyses performed by the investment advisor. It also avoids the need to enter into more than one set of documents with counterparties.
\textsuperscript{20} There is flexibility in customizing the feeder funds to the needs of specific groups of investors (e.g., feeder funds may have different term arrangements, fee structures, or they may accept subscriptions in different currencies).
\textsuperscript{21} Funds with the same strategies will have a uniform performance record in the master fund.
\textsuperscript{22} In fact, many of the U.S. investors may even prefer the characterization of the master fund as engaging in a financing business because then I.R.C § 162(2011) (which applies to trading but not investing) could apply instead of I.R.C. § 212 (2011)(whereby the general itemized deduction limits apply) to deduct relevant expenses.
structure actually heightens the potential for these issues since there is one master fund investing for both U.S. and foreign persons.\textsuperscript{23} If the master-fund were considered to be engaged in a U.S. business, the foreign feeder corporation would also be considered to be engaged in a U.S. business.\textsuperscript{24} The consequences of being considered to be engaged in a U.S. business for this purpose will be discussed below.

\textbf{C. Foreign Hedge Fund Lending In the U.S.}

Lending directly to borrowers is called loan origination. Frequent loan origination by foreign funds to U.S. borrowers is uncommon because these funds typically do not want to be considered to be engaged in a U.S. lending business for U.S. federal income tax purposes. Therefore, many foreign funds purchase debt securities—either from the secondary debt market (exchanges or on the over-the-counter market) or on the primary market (where debt securities are first sold to the public). A primary market debt securities purchase is often accomplished via a large loan “syndication.” In addition, debt securities may be packaged together.

In a typical syndication, a group of lenders will fund a very large loan. There will be a lead lender in the position of an administrative agent that typically negotiates the loan as an agent for the others in the syndicate. There are usually two tranches of money: (i) one tranche immediately put up by the syndicate members and (ii) another tranche that is “warehoused” by the lead lender, meaning the lead lender advances the funds and then finds investors later to take the credit risk and/or buy it. The lead lender may earn its primary return in the form of fees for arranging the loan and negotiating the terms. \textbf{See Figure 2 below.}\textsuperscript{25}

\textsuperscript{23} Many foreign hedge fund offering memoranda state that the fund or the investment advisor believes that the fund should not be considered to be in a U.S. trade or business of lending but that it cannot give complete assurance of that conclusion. In addition, many investment advisors leave themselves the room to attempt to structure around these issues by forming a United States corporation or a Limited Liability Company to hold the offending investment or to invest through affiliated or non affiliated companies formed in the Caymans or elsewhere.

\textsuperscript{24} I.R.C. § 875 (2011).

\textsuperscript{25} \textit{See generally,} Victoria Ivashina and David Scharfstein, AMER. ECON. REV., May 2010 at 57 (for a general description of loan syndication).
Non-syndicate members, such as foreign hedge funds, acquire portions of the loan, in many cases within 24 or 48 hours of the original funding. These hedge funds may have even committed to purchasing the interest prior to the original funding (a “forward commitment”). This forward commitment may or may not contain a material adverse change (MAC) clause allowing the hedge fund to back out if there is a major change in the borrower’s financial status. Foreign hedge funds typically do not fund the money to the borrower directly but this gets muddied when the loan itself is a revolving line of credit.

In addition, the hedge fund may or may not have been involved with lead lender’s negotiation with the borrower. In many cases the fund will not negotiate terms with the borrower directly but will keep tabs on those negotiations through the lead lender or syndicate member and indicate to the lead lender or syndicate member terms it will or will not be willing to accept. This in many cases drives or influences the deal terms with the borrower.

The foreign hedge fund may purchase from the syndicate a “participation” or by contract with the lead bank or syndicate member, whereby the lead bank or syndicate member remains involved and passes on interest and other payments from the borrower to the participant. The foreign hedge fund may also acquire a portion of the loan through an assignment, whereby the fund actually steps into the shoes of the lead bank or the syndicate member vis a vis the loan documents.
as to that portion of the loan. A hedge fund may also enter into a derivative contract with a syndicate member. A derivative contract is a contract between two parties that allows for the use of a derivative instrument to transfer credit risk from one party to another.

To complicate matters, foreign hedge funds may use related U.S. hedge funds, or hedge funds controlled by the same investment advisor, to get closer to the loan origination. The related U.S. hedge fund may acquire a larger portion of the loan, as a syndicate member or from a syndicate member, than it actually plans to hold, intending to “warehouse” the excess amount for future resale to the foreign affiliate. In fact, because of the fast moving nature of these investments and commitments some investment advisors initially commit to purchase these debt securities through a U.S. hedge fund or entity that never intends to hold the investment very long and then later decides how to allocate the investment amongst its various managed funds.

In an attempt to circumvent the argument that the affiliated U.S. hedge fund is merely an agent for the foreign fund and to put some distance between the original loan origination and the foreign fund, some funds “season” the debt securities. This means the U.S. affiliate does not sell to its foreign affiliate until after it has held the loan for a fixed period of time, often 3 months or so. However, the offering memoranda of many of these parallel funds disclose that many of these affiliated funds intend to invest in “lockstep.” This means the U.S. fund and affiliated foreign hedge fund intend to make the same or similar investments (perhaps in different proportions). In addition, sometimes these affiliated hedge funds perform equalizing trades of other securities during seasoning period. A hedge fund may or may not price such a seasoned sale based on the market conditions at the time of the sale (as opposed to at the time of the origination or when the U.S. affiliate purchased the debt security). In addition, some foreign funds have the right to reject an assignment from a U.S. affiliate and some occasionally do. Some affiliated funds are completely under the common control of an investment advisor, while others intentionally vest the rejection right in someone not under the control of the investment advisor.

Another complicating factor is that hedge funds often invest in many different positions in the same borrower, which complicates things. Some invest in PIPES
(private investment in public equity) in the form of short-term loans paid in stock, notes convertible into stock and non-convertible notes or warrants for stock. The idea is that the debt component will protect the downside while the equity component gives the fund the upside.

Certain foreign hedge funds specialize in the debt securities of companies in financial trouble. These debt securities tend to be significantly discounted to reflect the significant default risk. This type of debt is thought of as “loaning to own,” or seeking to acquire an equity interest in a business by first acquiring the outstanding debt securities.

**D. U.S. taxation of foreign lending into the U.S.**

The U.S. taxes foreign lending into the U.S in a manner that, at first blush, may seem very generous. A foreign person’s interest income and profit on the sale of U.S. debt instruments are generally exempt from U.S. federal income tax if the income is not effectively connected to a trade or business in the U.S. The key to unlocking this “generosity” is for the income to be characterized as passive investment income instead of income connected with a U.S. business. If nonresident aliens or foreign corporations, hereinafter foreign persons, have income that is connected with a U.S. business, that income will be taxed at the regular graduated tax rates applicable to U.S. persons and corporations. A foreign persons engaged in a U.S. business will also generally have to file a United States tax return.

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29 This assumes that with respect to the interest, the portfolio interest exemption applies. See I.R.C § 881(c)(1)(2011). Note however the portfolio interest exception does not apply to a “bank.” I.R.C. § 881(c)(3)(A) (2011). A hedge fund should not be considered a “bank for this purpose since it is not regulated as a bank under I.R.C. § 58 (2011). I.R.S. Priv. Ltr. Rul. 98-22-007 (Feb. 10, 1998). With respect to capital gains see infra note 30.

30 The United States generally taxes nonresident aliens and foreign corporations on two types of income: (1) income that is effectively connected with the conduct of a trade or business in the United States (“ECI”) and (2) fixed, determinable, annual or periodical income from United States sources that is not ECI (“FDAP”). I.R.C. §§ 871(b) and 882(a)(2011). Capital gains are not FDAP so if it is not ECI then it is not taxed. Interest is FDAP but may be exempt from U.S. federal income tax if it qualifies as “portfolio interest” or if there is a reduction or elimination of the tax under a double taxation treaty.

31 Id. Such business income may also be subject to a “branch profits tax” at a rate a 30%. I.R.C. §884 (2011).

Certain lending activities will certainly rise to the level of a lending or financing business in the U.S., such as a frequent loan origination to U.S. borrowers. Other lending activities seem to clearly constitute passive investing, such as the long-term holding of debt securities purchased on the secondary market. However, there is a broad range of activities in between these two extremes and precedent in the middle is quite uncertain. The stakes are high for the proper characterization of what constitutes a U.S. trade or business since if the foreign person is not engaged in a U.S. business, interest income and capital gains on sale of a U.S. debt instrument are generally exempted from U.S. federal income tax.\textsuperscript{33}

The Code and Treasury Regulations do not provide a thorough definition of what constitutes being engaged in a U.S. business for this purpose.\textsuperscript{34} However, there is a safe harbor for foreign persons trading and not dealing in stock and securities (including debt securities) for their own account.\textsuperscript{35} Situations that do not fall squarely within the limited statutory definition of a U.S. business or within a safe harbor are left to the principles in the applicable Code and Treasury Regulation sections and varied case law.\textsuperscript{36}

\textsuperscript{33} Supra note 30.

\textsuperscript{34} See I.R.C. § 864(b) (2011) (the definition of “trade or business in the United States” includes the performance of personal services within the United States).

\textsuperscript{35} I.R.C. § 864(b)(2)(A)(i), (ii) (2011). Note that proposed Treasury Regulations §1.864(b)-1 provides that the term “engaged in a trade or business in the United States” does not include effecting transactions in derivatives (including certain hedging transactions) and does not apply, however, to any foreign person who is a dealer in stocks, securities, commodities, or derivatives. “Trading” is defined in Treasury Regulations as “effecting of transactions” in stocks or securities which includes “buying, selling..., or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise..., and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading).” Treas. Reg. 1.864-2(c)(1), (2)(i) (1966). The securities trading safe harbor does not apply to dealers. Treasury Regulations define a “dealer” for this purpose as “a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom.” I.R.C. § 864(b)(2)(A)(ii) (2009); Treas. Reg. § 1.864-2(c)(2)(iii) (1966). This is distinguished from buying, selling, or holding stocks or securities for investment or speculation. In making this determination, all of the foreign persons’ stock and securities transactions will be taken into account, even those that occur outside of the U.S. Being characterized as a “dealer” for this purpose means that the securities trading safe harbor will not apply and the foreign person is may be considered engaged in a U.S. business under common law principles unless another safe harbor applies. Treas. Reg. § 1.864-2(c)(2)(iv) (1966).

\textsuperscript{36} See Rev. Rul. 88-3, 1988-1 C.B. 268 (must apply applicable Treasury Regulations to the “facts and circumstances”).
There is a Treasury Regulation that lists factors for determining whether or not a foreign person’s income is effectively connected with a banking, finance or similar U.S. business. The Treasury Regulation factors include: receiving deposits of funds from the public; making personal, mortgage, industrial, or other loans to the public; purchasing, selling, discounting or negotiating for the public on a regular basis notes, drafts, checks, bills of exchange, acceptances or other evidences of indebtedness, issuing letter of credit to the public and negotiating drafts drawn thereunder; providing trust services for the public; or financing foreign exchange transactions for the public. By its terms this Treasury Regulation assumes the foreign person is engaged in a U.S. business and applies to whether or not income is connected to that U.S. business. The Tax Court has said that these factors also provide a “useful framework” for determining whether a foreign person or corporation is engaged in a U.S. business.

There are few cases that provide clarity on what constitutes an active lending business for this purpose. The Tax Court looked at the issue in 1953 in Pasquel v. Commissioner but Pasquel provides limited guidance since the foreign person made only one loan. Also, based on general case law, if the activities are “considerable, continuous, and regular” a U.S. trade or business will exist. In order for there to be a U.S. business, the foreign person’s activities generally must exceed simple passive investment or ownership of property. In addition, the activities must relate to earning profit although no profit need be generated.

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38 Id.
39 Id. This makes sense since this regulation was promulgated under the authority of Code section 864(c) which addresses ECI not ETB.
40 Pasquel v. Comm’r, 12 T.C.M. (CCH) 1431 (1953).
41 Id.
42 See Pinchot v. Comm’r, 113 F.2d 718, 719 (2d Cir.1940) (a nonresident alien was engaged in a U.S. trade or business because real estate management required “regular and continuous” activity including purchasing materials and making contracts); De Amodio v. Comm’r, 34 T.C. 894, 906 (1960), aff’d, 299 F.2d 623 (3d Cir.1962) ( the negotiation of leases, collection of rent, and payment of taxes and insurance amounted to a U.S. trade or business); Spermacet Whaling & Shipping Co. v. Comm’r, 30 T.C. 618, 634 (1958), aff’d, 281 F.2d 646 (6th Cir.1960).
43 See Continental Trading, Inc. v. Comm’r., 265 F.2d 40, 43 (9th Cir.1959), cert. denied, 361 U.S. 827 (1959); See also, I.R.S. Gen. Couns. Mem. 18,835, 1937-2 C.B. 141 (mere management of investments was insufficient to constitute carrying on a trade or business), Neill v. Comm’r, 46 B.T.A. 197 (1942) (mere ownership of property in the form of a single building did not constitute the carrying on of a business), Higgins v. Comm’r, 312 U.S. 475, 478 (1941) (no amount of activity can convert investment into a trade or business).
44 See, e.g., Investors’ Mortgage Security Co. v. Comm’r., 4 T.C.M. 45, 47 (1945); Pinchot v. Comm’r, 113 F.2d 718, 719 (2d Cir.1940); Lewenhaupt v. Comm’r, 20 T.C. 151, 162 (1953), aff’d, 221 F.2d 227 (9th Cir.1955); I.R.S. Gen. Couns. Mem. 18,835, 1937-2 C.B. 141, 143 (the
Nevertheless, simply receiving profits is not enough to find that a foreign person engaged in a U.S. business.\footnote{See, Snell v. Comm’r, 97 F.2d 891, 892 (5th Cir.1938).} Isolated activity, without “sustained activity,” is also generally not enough to find a trade or business.\footnote{Linen Thread Co., Ltd. v. Comm’r, 14 T.C. 725 (1950) (two isolated sales in the United States did not constitute a trade or business in the United States); cf. Johansson v. United States, 336 F.2d 809 (5th Cir.1964) (a nonresident alien prize fighter in one world championship fight in the United States was held to be a U.S. trade or business).} Similarly, clerical and ministerial activity is generally not enough to find a trade or business.\footnote{Scottish American Investment Co., Ltd. v. Comm’r, 12 T.C. 45, 59 (1949) (activities of U.S. office of foreign trusts did not constitute a trade or business and the U.S. office was merely a helpful adjunct to the foreign trusts); Spermacet Whaling & Shipping Co. v. Comm’r, 30 T.C. 618, 634 (1958), aff’d, 281 F.2d 646 (6th Cir.1960) (receiving monthly statements and correspondence and making certain payments were ‘ministerial and clerical in nature’ and involved little exercise of the discretion or business judgment ‘necessary to the production of the income in question.’); Linen Thread Co., Ltd. v. Comm’r, 14 T.C. 725 (1950) (delivery of goods, handling of paperwork and collection of payment by the U.S. office was not enough to constitute a U.S. trade or business where the profit generating activity occurred abroad).}

The Tax Court has held that the words “trade or business” for this purpose should be “interpreted consistently with the general body of law on this subject.”\footnote{deKrause v. Comm’r, 33 T.C.M. (CCH) 1362 (1974); Folker v. Johnson, 230 F.2d 906, (2nd Cir. 1956); Whipple v. Comm’r, 373 U.S. 193, 201 (1963). With respect to other areas of the Code, the IRS has recognized that rules in the ETB context may “differ in some respects from those used in determining whether a taxpayer is engaged in a trade or business under other sections of the Code.” Rev. Rul. 88-3, 1988-1 C.B. 268.} This suggests that other contexts in the Code in which the business concept is used may be helpful. Analogous authorities suggest that the number and amount of loans is important in the determination of whether or not a lending trade or business exists.\footnote{See, Serot v. Comm’r, 68 T.C.M. (CCH) 1015, 1022-23 (1994); McCrackin v. Comm’r, 48 T.C.M. (CCH) 248, 251 (1984) (taxpayer was engaged in lending trade or business, where taxpayer made 66 loans to 12 unrelated borrowers over 15 years); Jessup v. Comm’r, 36 T.C.M. (CCH) 1145, 1150 (1977) (trade or business of lending existed where taxpayer engaged in 31 loan, endorsement, or guarantee transactions with 17 unrelated persons over 10 years); Cushman v. U.S., 148 F.Supp. 880 (D.C. Ariz. 1956); Minkoff v. Comm’r, 15 T.C.M. (CCH) 1404 (1956).} These authorities seem to indicate that foreign persons should be able to make a limited number of loans and not be considered to be in an active lending business in the United States.\footnote{For example, the IRS issued a Private Letter Ruling holding that a partnership that represented that it would not originate on average more than 5 new mortgages a year over any five year period was not deemed to be engaged in a trade or business for purposes of I.R.C. 7704(d).} Analogous authorities have also
looked at the time and effort devoted to lending activities,\(^{51}\) the maintenance of an office for the lending activity,\(^{52}\) promoting oneself as a lender,\(^{53}\) maintenance of books and records for lending activities\(^{54}\) and the presence of employees or other dependent agents.\(^{55}\)

In the context of bad debt deductions, there is some authority for the proposition that a loan made to acquire, protect or enhance an investment where the dominant motive is to earn a return from the investment cannot lead to a “business” bad debt because the loan is related to the investing activities rather than a lending business.\(^{56}\) In the context of business deductions, the Supreme Court in Higgins v. Commissioner failed to accept the proposition that management of one’s own securities could constitute a business given “sufficient extent, continuity, variety and regularity” finding that “no amount of personal investment management would turn those activities into a business.”\(^{57}\) Although Higgins dealt with business deductions, Courts have consistently held that the Higgins reasoning applied in this context.\(^{58}\)

Rulings in this area have been unhelpful.\(^{59}\) Further, the IRS will not

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The tax court held in Imel v. Comm’r that 8 or 9 loans over a four year period was not a trade or business for purposes of allowing a deduction for bad debts of a trade or business. Imel v. Comm’r, 61 T.C. 318, 323 (1973). The Tax Court also held that 21 loans made over a two year period constituted a trade or business for purposes of determining whether a partnership had to be treated as a corporation.\(^{51}\) U.S. v. Henderson, 375 F.2d 36, 41 (5th Cir. 1967); Ruppel v. Comm’r, 53 T.C.M. 829, 832, 834 (1987); Jessup v. Comm’r, 36 T.C.M. (CCH) 1145, 1150 (1977).


\(^{53}\) Henderson, 375 F.2d at 41; Cushman, 148 F. Supp. At 880.

\(^{54}\) See Whipple v. Comm’r, 373 U.S. 193, 197, 202 (1963); German v. Comm’r, 7 T.C.M. (CCH) 1738 (1999) (petitioner was not entitled to a bad debt deduction because the petitioner was not engaged in the trade or business of lending money).

\(^{55}\) Higgins v. Comm’r, 312 U.S. 212 (1941) (no amount of activity can convert investment into a trade or business).


\(^{57}\) In Revenue Ruling 73-227 the IRS held that U.S. source interest income of a foreign subsidiary of a U.S. parent was effectively connected with a U.S. trade or business. Revenue Ruling 73-227 provided minimal analysis on the ETB issue and was subsequently revoked by a later ruling. Rev. Rul. 73-227, 1973-1 C.B. 338. The later ruling stated that the conclusion in Ruling 73-227 “may be unsound” because it simply concluded without discussion that the foreign person is ETB. Rev. Rul. 88-3, 1988-1 C.B. 268. The later ruling provides that this determination
“ordinarily” issue rulings or determination letters regarding whether a taxpayer is engaged in a trade or business within the United States and whether income is effectively connected with the conduct of a trade or business within the United States.\textsuperscript{60}

Agency issues further complicate this area. Activities of agents can be imputed to foreign persons. The precedent in this regard is somewhat mixed with the IRS and courts taking aggressive positions on imputation at times and other times being reluctant to impute actions of an agent to a foreign person.\textsuperscript{61} Courts have generally taken an expansive view on imputation when the relationship between the agent and the foreign person is “regular” or “continuous” rather than “casual” or “isolated.”\textsuperscript{62} One commentator summed up the mixed character of the precedent in this area by stating “questions of imputation can be answered only with the help of considerable intuition.”\textsuperscript{63} In a general legal advice memorandum, non-binding authority, the IRS concluded that if a U.S. agent performed lending activities on behalf of a foreign corporation pursuant to a service contract—such as locating borrowers, performing credit analysis and negotiating borrowing terms, the foreign corporation had a U.S. lending business even if the agent lacked

\textsuperscript{60} Rev. Proc. 2008-7, 2008-1 IRB 229, 230 (Listed as “Areas In Which Ruling Or Determination Letters Will Not Ordinarily Be Issued: Whether a taxpayer is engaged in a trade or business within the United States, and whether income is effectively connected with the conduct of a trade or business within the United States; whether an instrument is a security as defined in §1.864-2(c)(2); whether a taxpayer effects transactions in the United States in stocks or securities under §1.864-2(c)(2); whether an instrument or item is a commodity as defined in §1.864-2(d)(3); and for purposes of §1.864-2(d)(1) and (2), whether a commodity is of a kind customarily dealt in on an organized commodity exchange, and whether a transaction is of a kind customarily consummated at such place.”)

\textsuperscript{61} See I.R.S. Tech. Adv. Mem. 80-29-005 (Mar. 27, 1980) (the IRS imputed the actions of an operator of oil property to the foreign owner of the properties on the basis of the foreign person’s ownership of assets); See also, Rev. Rul. 55-617 (holding that sales of an independent commission agent were imputable); See also, de Amadio v. Comm’r, 34 T.C. 894, 906 (1960), aff’d, 299 F.2d 623 (3d Cir.1962) (the purchase and management of real estate by “independent” real estate agents cause the foreign taxpayer to be ETB); cf. TAM 8147001 (no U.S. trade or business found because independent agent used); cf. Amalgamated Dental Co. v. Comr., 6 T.C. 1009 (1946) (actions of a U.S. supplier not imputed to a foreign corporation because of an independent agency relationship).

\textsuperscript{62} See de Amadio v. Comm’r, 34 T.C. 894, 906 (1960), aff’d, 299 F.2d 623 (3d Cir.1962) (the purchase and management of real estate by “independent” real estate agents cause the foreign taxpayer to be ETB); Handfield v. Comm’r, 23 T.C. 633 (1955) (sales by a U.S. distributor were attributable to a foreign person).

authority to conclude contracts on behalf of the foreign corporation.64

In practice, these determinations are made by the investors themselves, practitioners, the IRS and courts.65 Many different practitioner and industry-developed standards interpreting uncertainties have arisen.66 Lawyers, accountants and other service providers advise of particular applications of uncertainties in order to reach a “should” or “will” opinion (i.e., this should work or this will work). Without further legislative guidance, these constantly shifting, un-uniform standards often quickly become industry benchmarks for transaction after transaction.67

E. Some examples of how the current law is ill-equipped to deal with these shadow banking transactions.

Many Investment advisors argue that most of the debt-related transactions described above fall within the securities trading safe harbor and/or that the foreign hedge fund is not engaged in an active financing business. Imbedded in these positions are the following contentions: (i) the relevant activities constitute trading and not dealing in debt securities thereby the securities trading safe harbor applies; (ii) the relevant activities do not rise to the level of an active financing business in that either (A) there is no loan origination so these activities are not thrown out of the securities trading safe harbor; or (B) in the alternative, limited loan origination does not rise to the level of an active financing business; and (iii)

64 I.R.S. Chief Couns. Mem. AM 2009-010 (Sept. 22, 2009); I.R.C. 6110(k)(3). The Memorandum notes that the U.S. corporation’s activities relating to loan origination were conducted on a considerable, continuous, and regular basis from its U.S. office.

65 David R. Sicular & Emma Q. Sobol, Selected Current Effectively Connected Income Issues for Investment Funds, 56 Tax Law. 719 (2003)(practitioner developed standards”); See also, Joel Kuntz and Robert Peroni, U.S. International Taxation (Warren, Gorham & Lamont, Loose-Leaf), Chapter 1.04 (“All cases not governed by Section 864(b) are left to the courts and the Service”).

66 See Sicular & Sobol, supra note 65, at 722.

67 It should also be noted that the IRS will not “ordinarily” issue private letter rulings or determination letters regarding much of the uncertainty that will be discussed below (regarding whether a taxpayer is engaged in U.S. business and whether income is effectively connected with the U.S. business. Rev. Proc. 2008-7, 2008-1 I.R.B 229, 230(Listed as “Areas In Which Ruling Or Determination Letters Will Not Ordinarily Be Issued: Whether a taxpayer is engaged in a trade or business within the United States, and whether income is effectively connected with the conduct of a trade or business within the United States; whether an instrument is a security as defined in § 1.864-2(c)(2); whether a taxpayer effects transactions in the United States in stocks or securities under Treas. Reg. § 1.864-2(c)(2); whether an instrument or item is a commodity as defined in Treas. Reg. § 1.864-2(d)(3); and for purposes of Treas. Reg. § 1.864-2(d)(1) and (2), whether a commodity is of a kind customarily dealt in on an organized commodity exchange, and whether a transaction is of a kind customarily consummated at such place.”)
even if certain hedge funds are engaged in an active financing business, income from other securities trading activities are not connected to such financing business (in other words securities trading can be segregated and still fall under the securities trading safe harbor even if a foreign hedge fund is otherwise engaged in an active financing business). 68 I will explore below merely some of the uncertainty that relates to these positions.

With respect to the securities safe harbor, the distinction between trading and dealing is unclear. “Trading” is defined in Treasury Regulations merely as “effecting of transactions” in stocks or securities which includes "buying, selling..., or trading in stocks, securities,... and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading).” 69 A “dealer” is defined in Treasury Regulations for this purpose as “a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom.” 70 This is distinguished from buying, selling, or holding stocks or securities for investment or speculation. 71 Distinguishing between trading and dealing to determine whether or not the safe harbor applies has been as elusive as the trade or business concept itself.

What rises to the level of “loan origination” is also unclear in this context. Although the foreign funds may not be lending directly to U.S. borrowers in form, in substance the foreign funds may be driving the loan deal terms with forward commitments and pre-closing understandings with the syndicate members. There is no clear authority for distinguishing between an alleged “old and cold” debt security bought on the secondary market and what constitutes loan origination in this context.

Does a forward commitment to purchase a portion of the loan before the original loan transaction closes put a foreign fund in an origination position? Does a MAC clause, a provision giving the foreign fund an out if there is a material

68 Note that there substantial issues concerning whether activities related to restructuring distressed debt amount to loan origination which are outside the scope of this article.


71 In making this determination, all of the foreign persons’ stock and securities transactions will be taken into account, even those that occur outside of the U.S. Being characterized as a “dealer” for this purpose means that the securities trading safe harbor will not apply and the foreign person is may be considered engaged in a U.S. business under common law principles unless another safe harbor applies. Treas. Reg. § 1.864-2(c)(2)(iv) (1966).
adverse change, make us feel more comfortable about the position that a forward commitment does not translate into an origination position? How long must foreign hedge fund wait after the original loan closing to purchase debt securities on the secondary market without risk of being accused of loan origination? Many funds wait only 24 or 48 hours. Is this enough? What if there are equalizing trades between a U.S. affiliate who purchased the debt securities at closing and a foreign fund for any value shifts during that time?

Sometimes a U.S. affiliate does not sell debt securities to its foreign affiliate until after the U.S. affiliate has held the loan for a fixed period of time, often 3 months or so. This strategy is often called “seasoning” the debt securities. What if the affiliated funds invest in “lockstep” with the foreign funds and provide equalizing trades during the seasoning period?

Agency issues further complicate matters. Perhaps the lead lender or syndicate member is an agent for the foreign fund. Often times the foreign hedge fund is on the syndicate member’s speed dial for transaction after transaction. In addition, to what extent can the foreign fund or its investment advisor formally or informally participate in the original loan negotiations? Is it a problem if the foreign fund provides loan document comments to the borrower (or to the syndicate member)?

Finally, if there is loan origination or deemed loan origination, how much loan origination is required before the foreign fund will be considered engaged in a U.S. trade or business is unclear in this context.\footnote{Pasquel v. Comm’r, 12 T.C.M. (CCH) 1431 (1953), See Pinchot v. Comm’r, 113 F.2d 718, 719 (2d Cir.1940) (a nonresident alien was engaged in a U.S. trade or business because real estate management required “regular and continuous” activity including purchasing materials and making contracts); De Amodio v. Comm’r, 34 T.C. 894, 906 (1960), aff’d, 299 F.2d 623 (3d Cir.1962) (the negotiation of leases, collection of rent, and payment of taxes and insurance amounted to a U.S. trade or business); Spermacet Whaling & Shipping Co. v. Comm’r, 30 T.C. 618, 634 (1958), aff’d, 281 F.2d 646 (6th Cir.1960), See, Continental Trading, Inc. v. Comm’r., 265 F.2d 40, 43 (9th Cir.1959), cert. denied, 361 U.S. 827 (1959), See also, I.R.S. Gen. Couns. Mem. 18,835, 1937-2 C.B. 141 (mere management of investments was insufficient to constitute carrying on a trade or business), Neill v. Comm’r, 46 B.T.A. 197 (1942) (mere ownership of property in the form of a single building did not constitute the carrying on of a business), Higgins v. Comm’r, 312 U.S. 475, 478 (1941) (no amount of activity can convert investment into a trade or business).}

Whether or not the securities trading safe harbor can apply to segregate securities trading from an active financing business is unclear in this context. At least one commentator, Lee Shephard, contends that the safe harbor itself
assumes that trading is the taxpayer’s only contact with the U.S. Shepphard argues that once the taxpayer is in some other business in the U.S. (i.e. lending) then the securities trading income would be effectively connected with that other business. In other words, only securities trading standing alone is eligible for the securities trading safe harbor. But even Shepphard calls for guidance on this point. Other commentators contend segregation is possible.

III. WE SHOULD CONSIDER WHETHER THE CURRENT UNCERTAINTY INCREASES SYSTEMIC RISK.

What is “systemic risk?”

“But I know it when I see it….”--Justice Potter Stewart, concurring opinion in Jacobellis v. Ohio 378 U.S. 184 (1964)(regarding possible obscenity in the The Lovers.)

There is no widely accepted uniform definition of systemic risk. One way to define systemic risk is that it is the risk of collapse of an entire financial system or market “serious enough to quite probably have significant adverse effects on the real economy.” The “real economy” simply refers to the goods, services and resources aspects of the economy as opposed to buying and selling on the financial markets. Essentially systemic risk involves a potential

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74 Id.
77 The 2001 G10 Report on Consolidation in the Financial Sector suggested a working definition: “Systemic financial risk is the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy.” The G10 Report on Consolidation in the Financial Sector, http://www.oecd.org/document/60/0,3343,end_2649_34593_1895868_1_1_1_1,00.html. George Kaufman, & Kenneth Scott, What is systemic risk, and do bank regulators retard or contribute to it? 7 INDEP. REV. 371 (“Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by comovements (correlation) among most or all the parts”).
cascading failure in a system or market due to interlinkages and interdependencies.\textsuperscript{79} This chain reaction is often likened to the quintessential example of a banking panic.\textsuperscript{80} Banking panics historically have occurred when customers withdrew their deposits from a bank in fear that the bank would become insolvent causing a chain reaction of runs on other banks.\textsuperscript{81} The chain reaction may have occurred because other banks were owed money by the bank in trouble or simply because general populous fear spread.\textsuperscript{82} It is thought that much of the Great Depression’s economic damage was caused by bank runs.\textsuperscript{83} While regulators have typically looked at banks as sources of systemic risk, because of the shadow bank system, we must look at the linkages or connectedness of the entire financial system, including non-bank financial institutions, not only those of the traditional banking system. The recent economic crisis of 2007-2010 was a run by investors, not on banks, but on shadow banking system.\textsuperscript{84}

Folks in the hedge fund industry have long argued against hedge funds systemic importance on the grounds that their transactions are only a small piece of the overall market.\textsuperscript{85} However, systemic risk does not only stem from being

\textsuperscript{79} See Steven Schwarcz, Systemic Risk, 97 GEO. L. J. 1 (2008); See also, Monetary Policy and Systemic Risk Regulation: Hearing Before the Subcomm. On Domestic Monetary Policy and Technology of the H. Committee on Financial Services, 111\textsuperscript{th} Cong. (2009)(testimony of John Taylor) (“By definition a systemic risk in the financial sector is a risk that impacts the entire financial system and real economy, through cascading, contagion, and chain-reaction effects.”).

\textsuperscript{80} See generally George G. Kaufman, Banking and currency crisis and systemic risk: lessons from recent events, ECON. PERSPECTIVES, FEDERAL RESERVE BANK OF CHICAGO, issue Q III at 9-28 (2000).


\textsuperscript{82} Gorton supra note 81 at 760.

\textsuperscript{83} Benjamin Bernanke, Nonmonetary effects of the financial crisis in the propagation of the Great Depression, 3 AM. ECON. REV. 73, 257-276 (1983).


\textsuperscript{85} Gregory Brown, Jeremiah Green & John Hand, Are Hedge Funds Systemically Important? (2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1689079 (“The claims against hedge funds have been disputed by portfolio managers and industry representatives on the grounds that their market transactions were relatively small compared to total trading activity.”); Laurence Fletcher, No Hedge Fund Now Poses Systemic Risk: LTCM partner, Thompson Reuters (2009), http://www.reuters.com/assets/print?aid=USTRE5505402009060 (quoting Hans Hufschmid, chief executive at a fund servicing firm and former Long Term Capital Management Partner “I find it hard to believe—I don’t think a hedge fund today is big enough to pose a systemic risk.”);
“too big to fail” in terms of market share. The Dodd-Frank Act recently created the Financial Stability Oversight Council (the “FSOC”), in part to identify, monitor and respond to risks to the financial stability of the U.S. The FSOC is to designate certain nonbank financial companies to be supervised by the Federal Reserve’s board of governors, considering among other things “the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies,” “the important of the company as a source of credit…and as a source of liquidity for the United States financial system,” and the “interconnectedness of the company.” Clearly Congress felt that there were other factors in determining systemic risk besides the size and scale of the activities of the company. The International Monetary Fund also determined, in a recent G-20 commissioned study, that institutions that were interconnected, not just the largest institutions, could impair financial markets. Professor Hal Scott stated in his testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs about proposed rules that would prohibit certain holdings and proprietary trading by bank or bank owners, that “the absolute size of an institution is not the predicate for systemic risk; it is rather the size of its debt, its derivatives positions, and the

86 E.g., Anne Rivière, The Future of Hedge Fund Regulation: A Comparative Approach: United State, United Kingdom, France, Italy and Germany 35 (2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1663553 citing Rama Cont, Amal Moussa & Andrea Minca, Too Interconnected to Fail: Contagion and Systemic Risk in Financial Networks, Working paper, Columbia Center on Fin. Engineering (2009) (“Indeed, the failure of LTCM, a hedge fund worth $4 billion posed a systemic risk because of its exposure to banks, while the failure of Amaranth, which was worth more than the double ($9.5 billion) had no systemic impact”).


88 Id. at §113(a)(2)(C).

89 Id. at §113(a)(2)(D).

90 Id. at §113(a)(2)(G).

91 This is evidenced by the multi faceted approach to defining “nonbank financial companies” that will be supervised and regulated by the Federal Reserve Board of Governors. It should be noted that clearly size and scale of the activities of a company are also relevant in this determination as evidenced by Congress’s inclusion of this as a factor as well. See Id. at §113(a)(2)(G).

scope and complexity of many other financial relationships running between the firm, other institutions, and the wider financial system.”

A draft report by the FSOC that has not yet been publicly released as this article is being written allegedly states that hedge funds and private equity firms could pose a systemic risk to the financial system. Since the collapse of Long Term Capital Management’s master fund (LTCM) in 1998, scholars have also alleged that hedge funds may have a role in systemic risk. LTCM was a hedge fund that failed financially following the Russian financial crisis in 1998. [The Federal Reserve Bank of New York organized a “bailout” of $3.625 billion by the major creditors to avoid a wider collapse in the financial market.] FRB NY President McDonough, in his 1998 congressional testimony after the LTCM collapse, stated: “there was a likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer...Most importantly, this would have led to further increases in the cost of capital to American businesses.”

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93 Prepared written testimony: Hearing Before the U.S. H. Comm. On Banking, Housing, and Urban Affairs, 111th Cong. (2010) (testimony of Hal Scott). Professor Hal Scott was testifying about the implications of the Volcker Rules for Financial Stability (Volcker Rules) and proposed size limitations on banks. The proposed Volcker Rules provide that “no bank or financial institution that contains a bank will own, invest in or sponsor a hedge fund or a private equity fund, or proprietary trading operations unrelated to serving customers for its own profit.” White House Press Release dated Jan. 21, 2010 “President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers.)

94 Rebecca Christie and Ian Katz, Hedge Fund May pose systemic Risk in Crisis, U.S. Report Says, Bloomberg (2011), http://www.bloomberg.com/news/2011-02-17/hedge-funds-may-cause-systemic-risk-in-crisis-u-s-report-says.html This is pivotal finding because, as discussed, the FSOC has been designated the task of defining nonbank financial institutions that will be subject to supervision and oversight by the Federal Reserve Board of governors.

95 See Nicholas Chan, Mila Getmansky, Shane M. Haas & Andrew Lo, Systemic Risk and Hedge Funds, in RISKS OF FINANCIAL INSTITUTIONS 235 (Mark Carey & Rene Stulz, ed., 2007).


fact a study by the Bank of France estimated that “17 banks would have collectively lost 3 to 5 billion dollars if LTCM hadn’t been bailed out.”

If systemic risk is the collapse of an entire financial system that has effects on the real economy, what are some of the potential linkages between hedge funds and the real economy? One link is credit channels or banks’ direct exposure to hedge funds. Bank lending affects the real economy and hedge funds have a symbiotic relationship with banks. For example, banks may be exposed to hedge funds by selling various financial products to hedge funds. Banks may also sell various prime brokerage services to hedge funds. As result


100 See supra note 77.


102 Adam Ashcraft, Are Banks Really Special? New Evidence from the FDIC Induced Failure of Healthy Banks, AM. ECON. REV., Dec. 2005 at 1712, 1728 (“This paper has developed evidence that healthy-bank failures have significant and apparently permanent effects on real economic activity. While there are important caveats to keep in mind concerning the interpretation of pro forma failed bank balance sheets, much of this effect can be explained by a severe contraction of bank lending.”); See also Kambhu, Schuermann & Stiroh supra note 11 at 10 (citing Ashcraft, Id.)

103 Nicholas Chan, Mila Getmansky, Shane M. Haas & Andrew Lo supra note 95 at 309.

104 Traditional banks could, for example, sell loan portfolios as bonds to securitization vehicles (securitizations, conduits, structured investment vehicles (SIVs), limited purpose finance corporations (LPFCs), collateralized loan obligations (CLOs), collateralized bond obligations (CBOs), collateralized debt obligations (CDOs), and specialist credit managers) that are in turn financed by investors (including hedge funds). Gorton supra note 84 at 9.

105 Id. Prime brokerage is a term used for a bundled package of services offered which may include lending securities, hedge fund start up services, clearance and custody of assets, portfolio reporting, branding and marketing, compliance, risk management and financing through margin
there may be ramifications of hedge funds’ failures on interconnected banks with respect to credit channels.\textsuperscript{106} The idea is that if a hedge fund fails, a bank with significant exposure to that hedge fund may not be willing or able to extend credit to borrowers that otherwise would be qualified for such credit.\textsuperscript{107} Further, affected banks could fail themselves or reduce liquidity they provide to other funds or to other banks, further disrupting financial markets and credit channels.\textsuperscript{108}

In addition to banks’ direct exposure to hedge funds, scholars are also considering whether hedge fund difficulties could disrupt the broad financial activity, affecting the capital markets and credit channels.\textsuperscript{109} Some scholars suggest that hedge funds management incentive structure may lead managers to be risk preferring and to provide inflated valuations which lead to distorted risk calculations by counterparties.\textsuperscript{110} The fact that many hedge funds are highly leveraged is also a potential concern.\textsuperscript{111} If these highly leveraged funds fail, they

\textsuperscript{106} Nicholas Chan, Mila Getmansky, Shane M. Haas & Andrew Lo supra note 95 at 309; Rivière supra note 86 at 35-36; Kambhu, Schuermann & Stiroh supra note 11 at 11-12.

\textsuperscript{107} Kambhu, Schuermann & Stiroh supra note 11 at 11-12 (discussing that collateralizing these exposures may not be enough to mitigate against this risk because collateral values may fall. However, recognizing that banks’ current exposures are heavily collateralized and each bank has some interest in mitigating these risks). \textit{Cf.} Rivière supra note 86 at 36 (stating the failure of Amaranth didn’t have a “destabilizing effect because counterparties to these funds held sufficient collateral).


\textsuperscript{109} Kambhu, Schuermann & Stiroh supra note 11 at 13.

\textsuperscript{110} Rivière supra note 86 at 37 (“The first one that needs to be mentioned is this inherent the conflict of interests that is posed by valuation. There is indeed a natural incentive to provide inaccurate, inflated valuation of the portfolio because the compensation of hedge fund managers are directly calculated based on this value. This can lead to distorted assessments by counterparties and clients and generate risk”).

\textsuperscript{111} Robert E. Rubin, Arthur Levitt, Alan Greenspan & Brooksley Born (The President’s Working Group on Financial Markets), \textit{Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management 23} (1999), http://www.treasury.gov/resource-center/fmks/Documents/hedgfund.pdf (“Leverage allows an investor to take on higher risks, including those risks that are shed by others. Thus, the leveraged exposure of investors with higher risk appetites can be a vehicle that allows a larger number of risk-averse investors to reduce their risks. While the leverage that supports the reallocation of risk provides benefits, it can be fragile. In a volatile market, high levels of leverage increase the likelihood that a leveraged entity will fail, in part because the size of potential losses can seriously deplete and even wipe out the entity’s net worth”); Nicholas Chan, Mila Getmansky, Shane M. Haas & Andrew Lo supra note 95 at 331 (“The use of leverage by hedge funds, however, raises the specter of financial market contagion
may be forced to sell positions at a fire sale, potentially causing losses to counterparties.\textsuperscript{112} In addition, these losses could lead to additional defaults and market participants who were not counterparties might be affected through price adjustments and increased market uncertainty if the failed fund held a large enough position in a particular market.\textsuperscript{113} The lack of transparency and complexity of certain financial instrument could make understanding who actually bears what risk more difficult, impeding an attempted workout.\textsuperscript{114} Finally, it is also currently being debated whether hedge funds may amplify the effects of a crisis in the ways that they respond to a crisis, i.e. short selling transactions,\textsuperscript{115} and in the way their investors redeem their interests in the funds only after a lock-up period, potentially \textit{en masse}.\textsuperscript{116}

It is by no means settled whether or not hedge funds create or increase systemic risk since such a determination would require data that has been compiled about foreign hedge funds, namely revealing counterparty credit exposures, the net leverage of hedge funds, the interconnectedness to banks, etc. Nevertheless, certainly the potential for hedge funds to have a systemic impact is there. And if this is so, we should also be considering whether uncertainty in the federal income tax consequences of hedge fund lending transactions makes these funds more susceptible to failure or whether the uncertainty of the taxation of certain transactions could impede credit markets.

\textsuperscript{113} \textit{Id}.
\textsuperscript{114} Kambhu, Schuermann & Stiroh \textit{supra} note 11 at 3.
\textsuperscript{115} Gregory Brown, Jeremiah Green & John Hand \textit{supra} note 85 at 19 (“\textit{O}ur findings suggest that the real risk posed by hedge funds more likely concerns their ability to increase the severity or duration of a crisis, as opposed to initiating it.”); Issing Comm. of the Group of Twenty Finance Ministers and Central Bank Governors, \textit{New Financial Order Recommendation 5} (2009) (The Issing Committee in charge of preparing the London G20 meeting noted that “hedge funds played a role in crisis transmission, due to their strong reliance on bank financing and maturity mismatch. In the crisis, these characteristics contributed to pro-cyclical behaviors, in particular to deleveraging and asset sales, which had a negative impact on market liquidity”); \textit{Cf}. High-Level Group on Financial Supervision, \textit{De Larosière Report} 24 (2009), http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf (The report concludes financial stability was not affected by the hedge fund industry).
\textsuperscript{116} Rivière \textit{supra} note 86 at 37.
The idea is that, potentially, a low level IRS employee could decide to enforce the mushy or non-existent U.S. trade or business precedent with respect to shadow bank transactions in a certain way causing funds to recognize unexpected income for federal income tax purposes. We should then consider whether the potential imposition of tax at potentially the highest tax rate, 35%, at any unexpected point, could increase the potential systemic risk with respect to funds failing or certain lending transactions being chilled impeding credit markets. These offshore hedge funds gamble that the rules will be interpreted and applied in the way that their legal advisors think they will be. If they lose that gamble and are too interconnected to fail, will we all lose? This is something that we must at least consider. In fact, in late 2009 the Office of Chief Counsel of the IRS issued a memo to the Director of Field Operations for Financial Services and stated: “We understand that foreign corporations and non-resident aliens may have used other strategies to originate loans in the United States giving rise to effectively connected income. We encourage you to develop these cases…”

IV. THE CURRENT UNCERTAINTY FRUSTRATES THE VERY INTERNATIONAL TAX POLICY OBJECTIVES THAT THIS REGIME WAS ENACTED TO PROMOTE.

If a U.S. person buys a debt instrument originally issued by a U.S. borrower, the U.S. person will generally have to pay federal income tax on the interest received on that debt instrument and on any gain realized upon sale.\(^{117}\) If a foreign person buys that same debt instrument, assuming certain conditions are met, the foreign person may not have to pay federal income tax on the interest received or on the gain realized upon sale.\(^{118}\) Why does the U.S. tax a foreign person’s interest income and gain from the sale of a passive investment in the U.S. less than it taxes the same investment made by a U.S. person? This Part will explore the tax policy reasons behind three seemingly generous provisions to foreign persons in the context of lending in the U.S: 1) the exemption for a foreign person’s capital gains on sales that are not connected with a U.S. trade or business;\(^{119}\) 2) the exemption for “portfolio interest” received by foreign persons...
that are not connected with a U.S. trade or business; and 3) the safe harbor which allows foreign persons trading in debt securities for their own account to be eligible for items 1) and 2) above by treating the trading as a passive investment instead of an active U.S. business. The current uncertainty in whether a foreign person is engaged in a U.S. trade or business frustrates these very tax policy objectives.

A. The policy behind the exemption for a foreign person’s capital gains on sale that are not connected with a U.S. trade or business.

The 1936 Act established that foreign persons selling their passive investments would not be taxed on the resulting capital gains.\textsuperscript{120} The reasoning behind this exemption was essentially two-fold. First, Congress determined that these capital gains were administratively difficult to collect.\textsuperscript{121} Second, it was thought that the exemption would result in additional revenue from taxes on U.S. brokers’ income.\textsuperscript{122} In other words, Congress wanted to decrease collection difficulties and increase revenue by encouraging foreign persons to make these passive investments in the U.S. and the line that was drawn was that if these investments rose to the level of a U.S. trade or business, then the foreign person would be taxed like a U.S. person.

B. The tax policy behind the enactment of the exemption for “portfolio interest” received by foreign persons that is not connected with a U.S. trade or business.

Generally a foreign person receiving “portfolio interest”\textsuperscript{123} is not taxed on

\textsuperscript{120} The Revenue Act of 1936 supra note 5 at §§ 211, 231 (creating an early version of the business versus passive distinction). Foreign persons not engaged in a U.S. trade or business that did not have an office or place of business in the U.S. were subject to a gross-basis withholding tax at a flat rate on certain passive income (not including capital gains from sales). However, foreign persons that were engaged in a U.S. business or had an office or place of business in the U.S. were subject to a net-basis income tax at rates that applied to U.S. persons on all of their U.S. source income. Immediately prior to the 1936 Act, foreign persons were generally subject to an annual tax on their net income received from all U.S. sources and a gross basis withholding tax on certain U.S. source passive income with the possibility of deductions and credits if an income tax return was filed. See, Revenue Act of 1916, ch. 463, §§1, 10, 39, Stat. 756, 765; See also, Revenue Act of 1918, ch. 18, §§ 217, 221(a), 221(d), 237, 40 Stat., 1057, 1069-1073, 1080; See also, Sicular & Sobol, supra note 65, at 722.

\textsuperscript{121} H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9, 21 (1936)

\textsuperscript{122} Id.

\textsuperscript{123} Portfolio interest for this purpose includes most interest received from unrelated borrowers
that interest if it is not effectively connected with a U.S. trade or business and certain other conditions are met.\textsuperscript{124} Congress enacted the portfolio interest exemption in 1984.\textsuperscript{125} Its main rationale was to allow U.S. persons access to financing abroad at a lower cost.\textsuperscript{126} It was thought that if the exemption were not enacted that U.S. borrowers would be at a competitive disadvantage of borrowers of other countries.\textsuperscript{127}

Congress was concerned with the Eurobond market in particular; a network of underwriters and financial institutions that market bonds issued by private parties and other borrowers.\textsuperscript{128} A U.S. borrower’s borrowing cost is typically higher to the extent that foreign lenders require that payments be grossed up for the lender’s U.S. withholding tax.\textsuperscript{129} Before the portfolio interest exemption, U.S. borrowers often borrowed in the Eurobond market though finance subsidiaries organized in the Netherlands Antilles to avoid U.S. withholding taxes on interest payments.\textsuperscript{130} The Netherlands Antilles imposed no taxes on interest paid by the subsidiary to the foreign lender, and this interest was assumed to be exempt from U.S. withholding tax as foreign source income. Interest paid by the U.S. borrower to the Netherlands Antilles subsidiary was exempt from U.S. tax under an income tax treaty.\textsuperscript{131} These structures increased borrowing transaction costs to U.S. borrowers and probably provided incomplete access for U.S. borrowers to Eurobond market because of the structural planning and because the IRS challenged some of these structures.\textsuperscript{132}

In addition, the legislative history provides that the portfolio interest exemption was enacted in order to achieve an overall gain to the economy by

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\textsuperscript{124} Id.
\textsuperscript{126} Staff of the Joint Comm. on Tax’n, 98th CONG., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 391-394.
\textsuperscript{127} Id.
\textsuperscript{128} Id.
\textsuperscript{129} Id.
\textsuperscript{130} Id.
\textsuperscript{131} Id.
\textsuperscript{132} Id.
expanded investment, US balance of payments, resulting expansion in earnings and employment because of stimulation to the Investment banks, brokerage firms and commercial banks. In addition, congress thought the revenue lost would be minimal since the tax rate on interest payments made by U.S. borrowers to foreign lenders was often reduced by treaty and there would potentially be increased foreign investment and thereby increased revenue via the additional economic activity. There was a fear that if the exemption were not enacted, some foreign persons would just not invest in debt securities in the U.S. Finally, the costs of collecting tax attributable to interest paid to foreign persons was thought to be high.

C. The tax policy behind the enactment of the safe harbor for trading in securities for one’s own account.

If this safe harbor for trading in securities for one’s own account is met, certain trading in stock and securities will not be considered a U.S. trade or business for this purpose. The legislative history is sparse on the reasons for enacting an early version of the safe harbor (providing that this provision was added to “clarify” what it meant to be “engaged in trade or business in the U.S.”). The early version of the safe harbor enacted in 1936 raised many questions. It seemed clear that owning stocks, securities or commodities for investment was covered by the 1936 safe harbor and did not constitute a U.S. business. It also seemed clear that “dealing” in stocks, securities or commodities was not covered by the 1936 safe harbor. However, the 1936 safe

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133 Id.
134 Id.
135 Id.
136 Id.
137 There is another safe harbor for trading in stocks or securities through an independent agent but not through an office of fixed place of business in the U.S., hereinafter referred to as the independent agent safe harbor. Most foreign hedge funds’ would not be able to argue that they are trading through an independent agent since their investment advisors in the U.S. routinely take a twenty percent profit interest in the fund as a general partner. Since most foreign hedge funds argue that much of what they do with regard to debt transactions falls under the securities trading safe harbor, I will not focus on the independent agent safe harbor. I.R.C. §864(b)(2)(C)(2011).
138 S. REP. NO. 74-2156, at 9-10 (1936); See also, Sicular & Sobol, supra note 65, at 726.
139 Higgins v. Comm’r, 312 U.S. 475, 478 (1941) (passive investment activity, including making deposits and keeping records, in relation to securities investments cannot convert investment into a trade or business).
harbor resulted in considerable litigation over hazy distinctions in between these two boundaries.\textsuperscript{141}

In 1966, the Foreign Investors Tax Act revised the safe harbor enacted in the 1936 Act. In specifically discussing the reasons for the provision, the House Report identifies that there was some confusion as to the application of the safe harbor under the 1936 Act and further states that “the confusion….may have acted to deter some foreign investment in the United States.”\textsuperscript{142} Further in 1963, President Kennedy appointed a task force on “Promoting Increased Foreign Investments in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad.”\textsuperscript{143} The task force concluded “the most immediate and productive ways to increase the flow of foreign capital” to the United States would be to adjust the laws concerning the taxation of foreign persons.\textsuperscript{144} In describing the purpose and background of the bill, the legislative history cites both the task force report and Treasury Department’s subsequent proposed tax legislation designed to increase foreign investment in the United States.\textsuperscript{145} The legislation was proposed as part of President Kennedy’s “program to improve the U.S. balance of payments.”\textsuperscript{146} The bill’s stated primary object was the “equitable tax treatment by the United States of nonresident aliens and foreign corporations” while recognizing that the initial bill proposed by the Treasury Department was designed primarily to stimulate investments by foreigners in the United States.\textsuperscript{147}

\textbf{D. The current uncertainty is economically inefficient, adds to the deadweight loss of taxation and frustrates the very tax policy objectives the regime was enacted to implement.}

Perhaps some level of certainty is desirable for taxpayers to be able to structure their affairs. I do not weigh in on whether a rule (i.e., Louis Kaplow’s example of a rule: “driving in excess of 55mph” is prohibited) or a standard (i.e., Louis Kaplow’s example of a standard “driving at an excessive speed” is prohibited) would be more beneficial in this area. What I do contend is that whether policymakers go with a rule or a standard such rules or standards should be written with today’s complex shadow banking transactions in mind. In other

\textsuperscript{141} See also, Sicular & Sobol, supra note 65, at 726-727.
\textsuperscript{142} Id.
\textsuperscript{144} Fowler Task Force Report, at 21 (1964).
\textsuperscript{145} See H.R. Rep, No 89-1450, at 26.
\textsuperscript{146} Id.
\textsuperscript{147} Id.
words, uncertainty, to the extent there is any, should not stem from the fact that the laws are too old to keep up with society’s financial innovation. Since most of the relevant law was written before these complex shadow banking and debt transactions were contemplated, practitioner-developed rules have arisen in response to the uncertainty in the area.\textsuperscript{148} These rules are constantly shifting and not uniform because each practitioner has different standards to get to the “should” or “will” opinion that their client seeks and each client is willing to accept varying levels of risk on where the lines are or will be drawn.\textsuperscript{149} Some foreign hedge funds live with, so to speak, this uncertainty—spending tremendous amounts of time and money to poll various practitioners and those in the industry for a consensus of how far to go before crossing the line. Others restrict their own activities, potentially affecting the extent to which foreign capital is invested in the U.S.

These constantly changing, not uniform, standards are economically inefficient. In other words, hedge funds that would have more actual marginal benefit than marginal cost may not be purchasing debt securities because they are risk averse to the tax uncertainty while hedge funds that have more actual marginal cost than marginal benefit may still be buying the debt securities because of a willingness to take risks with respect to the tax uncertainty. This occurs because their marginal cost in terms of U.S. federal income taxes payable is somewhat of a gamble in terms of how much activity will constitute a U.S. lending business and thereby lead to a hefty tax bill.

Society loses with respect to this market inefficiency tweaking the supply and demand of these debt products. There is deadweight loss in this context or a loss to society due to the reduction in the sales of the debt securities because of the tax uncertainty that is not captured by government revenue. There is also the risk that those hedge funds that are risk taking with respect to the tax uncertainty will subsequently find an unexpected tax liability which leads us to again ask the questions about systemic risk if these risk takers are interconnected enough. In addition, society loses with respect to the time and money hedge funds spend in procuring practitioner driven standards could be used in a more economically productive way.

The policy rationale for the three rules described above can be summed up in stating that they were generally enacted because collection of the

\begin{footnotes}
\item[149] See, Sicular & Sobol, \textit{supra} note 65, at 778.
\end{footnotes}
corresponding taxes was difficult and to encourage foreign financial investment in the United States.\footnote{See Parts IV(A)-(C) herein.} Uncertainty in these tax laws may frustrate the objective of encouraging foreign financial investment in the U.S. The legislative history of the securities trading safe harbor specifically discusses that the confusion in the application of the early version of the safe harbor “may have acted to deter some foreign investment in the United States.”\footnote{Supra note 142.} The confusion of the current rules may be doing the same thing here at a time in which the U.S. desperately needs more liquidity.

Clearly a foreign person considering whether or not to invest in the United States must calculate the extent to which an investment would generate United States tax liability. If the foreign person is subject to substantial income tax in its home country, this inquiry may not be so important since its home country may allow the investor a tax credit for United States taxes paid. However, many potential foreign investors are subject to minimal tax in their home country on income from United States investments which makes the determination of United States tax liability key in deciding where to invest funds.

\section*{V. CONCLUSIONS, SUGGESTIONS AND MOVING FORWARD.}

The issue of where to draw the trade or business in the U.S. line is and always has been a difficult one because of competing tax policy considerations.\footnote{See generally David A. Weisbach, \textit{Line Drawing, Doctrine, and Efficiency in the Tax Law}, 84 Cornell L. Rev. 1627, 1649-51 (1999).} Proponents for a US trade or business rule or standard more generous to foreign persons may argue, among other things:

\begin{itemize}
  \item The U.S. should attract foreign investment to keep the U.S. productive and help with the unemployment rate.
  \item Revenue loss would be small because tax rates get reduced via treaties anyway and an increase in foreign investment will increase economic activity and thereby overall U.S. tax revenue.
  \item There are considerable costs to collection from foreign funds and a strict standard would just lead to the behavioral response of foreign funds not investing in debt securities in the U.S.
\end{itemize}
• U.S. borrowers would be at a competitive disadvantage of borrowers of other countries.

Proponents for a US trade or business rule or standard less generous to foreign persons argue, among other things:

• U.S. investors are subject to higher U.S. taxes on the same passive investments,

• U.S. bargaining power in taxation treaties would be diminished if we were generous with all.

• The U.S. could become a tax haven.

• Foreign investment will not necessarily increase if there is a race between countries to the most generous or if foreign persons are merely paying the foregone U.S. tax to their home countries.

In addition there may be special considerations that policymakers want to consider given the current need for liquidity in the U.S. following the recent financial crisis.153

Irrespective of which direction policymakers decide to go on the substantive question of what rises to the level of a U.S. trade or business or for that matter if that should even be the relevant inquiry, I posit that given the complex form of shadow bank transactions between foreign persons and their U.S. affiliates/ lead lenders, whatever standards or rules are adopted should get to the substance and not merely the form of the transactions.

In other words, if the relevant inquiry is to what extent a foreign person originated loans, the inquiry should not be centered on how close foreign persons get to loan origination in form but how close a foreign person gets to loan origination in substance—perhaps focusing on who actually bears the risk of making these loans at origination. For example, perhaps the following deal terms would be relevant in such an inquiry: whether there was a forward commitment allowing the foreign fund to get out if the borrower collapsed financially; the extent to which the foreign person drives the original loans via negotiations the

153 E.g., John G. Gaine, Managed Funds Group Suggests Ways to Alleviate Liquidity Crisis in U.S. Capital Markets, 2008 TNT 75-33 (Apr. 9, 2008).
borrower or with the lead lender; the extent of oversight by the foreign fund over the syndicate negotiating with the borrower; whether there seems to be an established “seasoning” period and who bears the risk of market fluctuations during that period (i.e. during that seasoning period there are any equalizing trades between US funds and foreign funds and at the end of the seasoning period is the purchase price is based on the FMV at the time of the original loan or at the end of the seasoning period).

I acknowledge that any approach that gets to the substance of these deals would be difficult, if not impossible, to implement and enforce with the current lack of transparency of these transactions and foreign funds. That is precisely why I suggest that before we get into the line drawing exercise of where the U.S. trade or business line should be or even what the relevant inquiry should be, we need to look at what information the IRS has access to about these foreign funds and their transactions and to perhaps additional or new information gathering tools needed to appropriately tax these shadow bank transactions. Currently, foreign hedge funds that receive interest from U.S. borrowers on debt securities merely provide U.S. person’s with a form certifying their foreign status and claiming the portfolio interest exemption described above.\(^\text{154}\) Foreign persons who do not have income that is effectively connected with a U.S. trade or business do not generally have to file a U.S. tax return.\(^\text{155}\) Clearly without more information from the foreign funds, investment advisors or counterparties to the transactions, any potential approach that gets to the substance of these deals would be impossible.

Given recent legislative developments both in tax and in the regulation of nonbank financial institutions, there are a few new options to consider with respect to giving the IRS the tools it needs to even contemplate implementing any kind of substantive approach in this area.

First, perhaps we should look to the FATCA provisions of the HIRE Act as an example of an information gathering mechanism from foreign funds.\(^\text{156}\) Starting on January 1, 2013, a “foreign financial institution” must enter into an agreement with the US. Department of Treasury or they will be subject to a 30% withholding tax that will be imposed on payments to them of, among other things, U.S. source interest and the proceeds from the sale of property that produces U.S.


\(^{155}\) Upon receipt of interest payments from U.S. borrowers they would merely need to submit Form W-8BEN essentially stating they are a foreign person. Id.

\(^{156}\) Supra note 9.
source interest or dividends. The objective behind this is to track down U.S. persons who are attempting to evade U.S. taxes by using offshore accounts and vehicles. Most foreign hedge funds (i.e., #3 in Figure 1 herein) and foreign blocker corporations (i.e., #2 in Figure 1 herein) would have to disclose certain information about any U.S. beneficial owners or face a withholding tax on certain U.S. source income.

Historically it is difficult to collect taxes from foreign persons. The mechanism that the FATCA provisions use is withholding—i.e., U.S. borrowers that pay interest to a foreign fund would have to retain 30% of that interest and pay it over to the IRS if the foreign fund had not complied with the FATCA provisions. The U.S. withholding agent has a strong incentive to comply with its withholding obligation because if it wrongfully fails to withhold, it is itself on the hook for this amount. This means that a foreign fund could face a 30% withholding tax even if the portfolio interest exemption or another exemption applied to the income in question! In other words, foreign funds who continue to invest in the U.S. must jump through this hoop for their transactions to be profitable enough to enter into. I posit that we should consider whether it makes

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157 This is not an additional tax, however, if a foreign financial institution fails to provide the agreement with the U.S. Treasury and gets withheld against, such institution would not be entitled to a refund of this amount even if the income qualified for an exemption from general withholding (i.e., the portfolio interest exception).

158 Supra note 9.

159 I.R.C. §1472(d)(2011) broadly defines a “foreign financial institution” to include any foreign entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) holds financial assets for the account of others as a substantial portion of its business, or (iii) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in financial assets (including securities, partnership interests, commodities, or any interest in such securities, partnership interests or commodities). Notice 2010-60 provides guidance on this statutory definition and indicates that a “business” for FATCA purposes is much broader than generally for federal income tax purposes. Therefore, in addition to foreign investment and commercial banks and foreign insurance companies, most foreign hedge funds, foreign “blocker corporations,” foreign collateral debt obligation issuers, foreign private equity funds, and other foreign securitization vehicles that are mere “investors” in securities or commodities are likely to be treated as engaged in a business for purposes of FATCA and may be treated as “foreign financial institutions” that must enter into an agreement with the U.S. Treasury Department or be subject to the withholding provisions. Any foreign financial institution that is more than 50% owned by a foreign financial institution or is greater than 50% commonly owned with the financial institution is considered part of the same “expanded affiliate group” as the foreign financial institution and is subject to the same reporting and withholding requirements. Thus, if a foreign financial institution enters into an agreement with the U.S. Treasury Department, all other foreign financial institutions that are also members of the expanded affiliate group are required to comply with the agreement.

160 See Parts IV(A) – (C) herein.
sense to also, potentially in these very same agreements with the U.S. Treasury, obtain information that could help implement and enforce substantive rules or standards in the taxation of the foreign funds themselves and not just in attempt to corral U.S. investors in these funds.

The second avenue to consider is that investment advisors and foreign funds may already be facing additional disclosures in another arena as well—regulation reporting and disclosures under the Dodd-Frank Act. Yes, the long awaited and feared heightened regulation of the hedge fund industry is potentially upon us with the passage of the Dodd-Frank Act. The Private Fund Investment Advisors Registration portion of the Act [161] requires investment advisors to maintain and be subject to Securities and Exchange Commission inspection of the following records for each private fund it advises: including assets under management, use of leverage, counterparty credit risk exposure, trading and investment positions, valuation policies and practices, types of assets held and any other information deemed necessary by the SEC, in consultation with the Financial Stability Oversight Council. [162] While these disclosures may not get to all of the foreign persons that the IRS would need to look at to implement substantive rules or standards in this area because of the definition of “private fund” and a limited exemption for “foreign private advisers,” it is worth considering whether there is now, and whether by design there should be, any overlap in the usage of these reports and disclosures. The Dodd-Frank Act requires that the SEC and FSOC maintain confidentiality of any private fund information they collect, however, such information may be disclosed to “any government agency or self-regulatory organization requesting the information for purposes within the scope of its jurisdiction.” [163]

If we, as a nation, are potentially requiring investment advisors (and for that matter, systemically significant nonbank financial institutions) to report and disclose information about foreign funds, I think it is worth considering whether these disclosures could help fix other harmful ambiguities in dealing with global shadow bank transactions—such as how these transactions by foreign funds should be taxed in the U.S. And in fact, if the taxing uncertainty in this area potentially increases systemic risk, a proposition I contend should be considered in Section III, perhaps using Dodd-Frank related disclosures to help fix this area of the tax law actually does go hand in hand with the Dodd Frank Act’s stated purpose “[t]o promote the financial stability of the United States by improving

161 Supra note 10 at §401 et al.
162 Supra note 10 at §404(b)(3).
163 Supra note 10 at §404(c).
accountability and transparency in the financial system.164 Much of the rulemaking and implementation of the ideas in the Dodd Frank Act are still being fashioned by regulators (the SEC, FSOC, the Commodity Futures Trading Commission and the Board of Governors of the Federal Reserve System) as this is being written. I do not weigh in, at least in this article, on the very important issues of the extent and degree of financial regulation. I merely suggest that we should consider whether systemic risk to the U.S. financial system can be increased via tax uncertainty within the interconnected web of global shadow bank transactions and thereby whether the disclosure and reporting regimes currently being fashioned to “promote financial stability” could or should be utilized help fix this area of the tax law.

There are competing policy considerations with either of these avenues that clearly need more study. With respect to both using the FATCA provisions and the Dodd-Frank Act disclosure and reporting regime we must consider whether requiring information for this purpose could chill investment and liquidity creation in the U.S. Nevertheless it seems that our policymakers are surging ahead in requiring certain disclosures from certain foreign financial institutions for the purposes of financial stability generally and tracking down U.S. (as opposed to foreign) evaders of U.S. tax. With respect to the Dodd-Frank Act disclosure and reporting, another consideration is whether using information disclosed for taxation purposes would hamper the candidness of information disclosed for systemic risk purposes. These issues clearly need more study and consideration.

Foreign funds would prefer to stay off of regulator’s and the IRS’s radar entirely. Obviously after the HIRE and Dodd-Frank Acts this is not likely. We are entering a new era of regulation and disclosure. It’s time to face the global shadow banking system—both with respect to how we want to regulate it and with respect to how we want to tax it.

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164 Supra note 10 at Preamble.