

U.S.-Source Interest Income From a Lending Business

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A recent chief counsel memorandum held that U.S.-source income of a foreign corporation is income effectively connected with that corporation's lending business. After analyzing the memo, the authors conclude that the memo's position is incorrect under current law.

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A recent chief counsel memorandum¹ holds that U.S.-source interest income of a foreign corporation (FC) is income effectively connected with the FC's U.S. lending business by attributing the U.S. activities and, especially, the U.S. office of the FC's U.S. agent, whether or not a dependent agent, to the FC. We discuss the CCM's analysis regarding the office attribution and conclude that the CCM's position is incorrect under current law.

¹Chief counsel memorandum from Steven A. Musher, IRS associate chief counsel (international), to Kathy Robbins, director of field operations, Manhattan, financial services, AM 2009-010 (Sept. 22, 2009), *Doc 2009-21092*, 2009 TNT 182-13. Chief counsel advice does not set out official rulings or positions of the IRS and may not be used or cited as precedent. Section 6110(i)(1)(A) and 6110(k)(3); see also Mitchell Rogovin and Donald L. Korb, "The Four R's Revisited: Regulations, Rulings, Reliance and Retroactivity in the 21st Century: A View From Within," *Taxes* 21, 31 (Aug. 2009).

A. The CCM's Analysis

The CCM addresses the following fact pattern. An FC is incorporated in a foreign country without a treaty with the United States. The FC is owned entirely by non-U.S. persons. The FC does not have any office or employees in the United States. The FC makes loans to U.S. borrowers by outsourcing origination activities to a U.S. corporation (Origination Co.). Under a service agreement between the FC and Origination Co., Origination Co. solicits U.S. borrowers, negotiates the terms of the loans, and performs all activities relating to loan origination *except* the final approval and signing of the loan documents. Origination Co. performs these services from its U.S. office on a "considerable, continuous, and regular basis" and receives an arm's-length fee for them. Origination Co. is not authorized to conclude contracts on behalf of the FC. The FC gives final approval for the loans and signs the loan documents outside of the United States.

The CCM first determines that the FC is engaged in a trade or business within the United States under section 864(b)(2).² The CCM asserts that the activities Origination Co. performs on behalf of the FC are attributable to the FC for purposes of determining whether the FC is engaged in a trade or business within the United States, even when Origination Co. is an independent agent with no authority to bind the FC.³ Because Origination Co.'s

²In this article, "code" refers to the Internal Revenue Code of 1986, as amended. "Regulations" refers to the Treasury regulations promulgated under the code.

³CCM, *supra* note 1.

The principal authority cited by the CCM for this proposition is *InverWorld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231 (1996), *Doc 96-18802*, 96 TNT 127-14, supplemented on other grounds, 73 T.C.M. (CCH) 2777 (1997), *Doc 97-13052*, 97 TNT 92-24. However, in *InverWorld*, the Tax Court concluded that the agent was not an independent agent, *id.* at 3237-20, had the authority to negotiate and conclude contracts in the name of the principal, *id.* at 3237-23, and regularly exercised that authority, *id.* Because *InverWorld* concluded that the agent was a dependent agent with broad authorities, it cannot be used to support the CCM's proposition.

While beyond the scope of this article, a brief note is in order on the issue of agency attribution for purposes of determining whether an FC has a U.S. trade or business. Although a dependent agent's activities are likely to be attributed to its principal, the law is not clear on whether an independent agent's activities would also be attributed. The majority view is probably no, at least when the independent agent cannot bind the principal. See, e.g., Joseph Isenbergh, "The 'Trade or Business' of Foreign Taxpayers in the United States," *Taxes* 972, 982 (Dec. 1983) ("Relationships of lesser control — such as independent contractors or brokers — do not so readily give rise to imputation. The tendency of the courts to take matters of imputation for granted, however, leaves a number of questions still open.") (internal footnote omitted); David R. Sicular and

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U.S. activities are considerable, continuous, and regular, the FC is engaged in a U.S. trade or business.⁴ The securities trading safe harbor under section 864(b)(2) does not apply because the FC's lending activities do not constitute trading in stock and securities.⁵

The CCM then concludes that the FC's U.S.-source interest income is effectively connected income by applying the special ECI rules for a banking, financing, or similar business — the lending business.⁶ The FC is engaged in the lending business in the United States because its U.S. business includes making loans to the public.⁷ Reg. section 1.864-4(c)(5)(ii) provides the special ECI rules for the lending business. Under reg. section 1.864-4(c)(5)(ii), the FC's U.S.-source interest income will be treated as ECI only if the securities giving rise to such income are "attributable to the U.S. office through which such business is carried on."⁸

Emma Q. Sobol, "Selected Current Effectively Connected Income Issues for Investment Funds," 56 *Tax Law.* 719, 742 (2003):

Based on an analysis of the relevant judicial and administrative authorities, the courts and the Service generally seem to impute the U.S. activities of employees and dependent agents to a foreign principal. There is less clarity where the agent is an independent agent, and there is also uncertainty as to where to draw the line between dependent and independent agents or for that matter whether that is even the right question.

(internal footnotes omitted). See also Steven R. Lainoff, Stephen Bates, and Chris Bowers, "Attributing the Activities of Corporate Agents Under U.S. Tax Law: A Fresh Look from an Old Perspective," 38 *Ga. L. Rev.* 143, 162-168 (2004) (summarizing authorities but unable to reach any firm conclusion).

The lack of certainty is unfortunate, given the residual force-of-attraction principle which turns most U.S.-source income into effectively connected income if an FC has any U.S. trade or business to which the U.S.-source income may have little or no connection. Section 864(c)(3) (providing residual force-of-attraction principle but excluding income subject to gross-based withholding or capital gains from it). In this regard, the CCM's assertion exacerbates concerns for some foreign companies with contractual relationships with U.S. service providers and deriving U.S.-source income regardless of whether such income has anything to do with the U.S. service providers.

⁴CCM, *supra* note 1.

⁵Section 864(b)(2) (providing safe harbors for, among others, taxpayers trading in stocks or securities through a broker, commission agent, custodian, or other independent agent); CCM, *supra* note 1.

Musher, author of the CCM, has publicly commented that the CCM should not be used as guidance on "when lending rises to a U.S. trade or business and under what circumstances," noting that the CCM "involved none of those questions and addressed none of those issues." Kristen A. Parillo, "Memo on Foreign Corporation's U.S. Lending Activity Is Not Major Guidance, IRS Official Says," *Tax Notes*, Oct. 5, 2009, p. 55, *Doc 2009-21410*, 2009 *TNT* 185-4 (quoting Musher at the American Bar Association Section of Taxation meeting in Chicago (Sept. 25, 2009)).

⁶Reg. section 1.864-4(c)(5)(i) (defining lending business to include, among others, "making personal, mortgage, industrial, or other loans to the public").

⁷*Id.*

⁸Reg. section 1.864-4(c)(5)(ii):

(Footnote continued in next column.)

The crux of the CCM's analysis is its interpretation of the phrase "attributable to the U.S. office" in the context of an agency relationship. The CCM first notes that some taxpayers have applied reg. section 1.864-7(d) to the U.S. office requirement in reg. section 1.864-4(c)(5)(ii). Reg. section 1.864-7 defines "office or other fixed place of business" for purposes of determining when non-U.S.-source interest income is ECI under section 864(c)(4)(B). Reg. section 1.864-7(d) provides that when determining whether an FC has an office or other fixed place of business in the United States, (i) the office of an independent agent is not treated as the office or other fixed place of business of the FC, and (ii) the office of a dependent agent is also disregarded unless that agent has the authority to negotiate and conclude contracts in the name of the FC, and regularly exercises that authority.⁹

The CCM asserts reg. section 1.864-7 does not apply to U.S.-source interest income.¹⁰ The CCM observes that reg. section 1.864-7 applies only to non-U.S.-source interest income described in section 864(c)(4)(B), and concludes it cannot be used to interpret the U.S. office requirement of reg. section 1.864-4(c)(5)(ii) for U.S.-source interest income described in section 864(c)(2).¹¹ The CCM seeks to distinguish the Tax Court's reliance on reg. section 1.864-7 in interpreting section 864(b)(2) in *InverWorld, Inc. v. Commissioner*.¹² The CCM notes that section 864(b)(2)(C), like reg. section 1.864-7(a), requires that the taxpayer have a U.S. office,¹³ but reg. section 1.864-4(c)(5)(ii) only requires that the U.S.-source interest income be attributable to a "U.S. office," without specifying that it must be the taxpayer's U.S. office. The CCM concludes that the U.S. office of Origination Co. satisfies the U.S. office requirement for the FC's U.S.-source interest income to be treated as ECI.¹⁴

Any dividends or interest from stocks or securities . . . which is from sources within the United States and derived by . . . a foreign corporation in the active conduct during the taxable year of a banking, financing, or similar business in the United States shall be treated as effectively connected . . . only if [such] stocks or securities . . . are attributable to the U.S. office through which such business is carried on and . . . were acquired . . . as a result of, or in the course of making loans to the public.

⁹Reg. section 1.864-7(d)(1)(i) and (2). For this purpose, an independent agent means "a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity." Reg. section 1.864-7(d)(3). Also, maintenance of a stock of merchandise from which the agent regularly fills orders on behalf of the foreign principal could also give rise to office attribution. Reg. section 1.864-7(d)(1)(i).

¹⁰CCM, *supra* note 1.

¹¹*Id.*

¹²*InverWorld, Inc. v. Commissioner*, 71 T.C.M. (CCH) 3231 (1996), *Doc 96-18802*, 96 *TNT* 127-14, *supplemented on other grounds*, 73 T.C.M. (CCH) 2777 (1996), *Doc 96-21761*, 96 *TNT* 150-20.

¹³CCM, *supra* note 1.

¹⁴The CCM takes this position even if Origination Co. is an independent agent of the FC with no authority to bind the FC. This appears to be an aggressive position. See *supra* note 3

(Footnote continued on next page.)

Finally, the CCM concludes that, because Origination Co.'s U.S. office "actively and materially participated" in the origination activities, including soliciting and negotiating the loans, the FC's U.S.-source-interest income is attributable to Origination Co.'s U.S. office and thus is ECI regarding the FC's U.S. lending business under section 864(c)(2).¹⁵

B. The CCM's Flawed Office Attribution Analysis

We believe that, as to the office attribution, the CCM misinterprets the code and the regulations, far too narrowly construes the only judicial authority on point, and fails to account for prior administrative pronouncements, which are, like the CCM itself, of no precedential value. In misinterpreting the regulations, the CCM threatens to render incoherent the regulatory regime and may introduce intractable practical issues for an FC whose interest income may be ECI but whose gain from a sale of the underlying loans may not be.

1. The code. Section 864(c)(2) provides the general ECI rules for certain U.S.-source income including interest income. The CCM attaches too much weight to the fact that section 864(c)(2) does not contain a U.S. office requirement. The CCM states that because reg. section "1.864-4(c)(5)(ii) elaborates a statutory provision that does not contain the same 'office or other fixed place of business' requirements found in other sections . . . the [provision] cannot be read to import the same 'office or other fixed place of business' rule of section 864(c)(4)(B)."¹⁶

The statement misses the mark. Section 864(c)(2) does not contain any special ECI rules for the lending business and could not possibly provide any guidance, one way or the other, on the U.S. office requirement at issue. The

(discussing similarly aggressive position in activity attribution for purposes of determining existence of U.S. trade or business).

We speculate that the CCM may have taken this position for two reasons. *First*, because the CCM asserts that reg. section 1.864-7 has no application to U.S.-source interest income, the CCM may have felt that it lacks any textual basis for distinguishing between a dependent agent and an independent agent. Allowing such a distinction may begin the path down a slippery slope from which there is no basis to recover and thus lead to the conclusion that reg. section 1.864-7 applies to reg. section 1.864-4(c)(5)(ii). *Second*, the determination between a dependent agent and an independent agent is not always clear and, in the treaty context, has not always been in favor of finding a dependent agency relationship. See, e.g., *Taisei Fire & Marine Ins. Co. v. Commissioner*, 104 T.C. 535 (1995), *Doc 95-4474*, 95 TNT 86-21 (finding independent agency relationship in treaty context when agent acted for several unrelated principals); see also Harvey P. Dale, "Effectively Connected Income," 42 *Tax L. Rev.* 689, 734-735 (1987) (discussing relationship of certain U.S. office requirements to concept of permanent establishment in treaties). It is possible that the CCM may have wished to avoid addressing the unfavorable precedents or the uncertainty itself.

¹⁵Reg. section 1.864-4(c)(5)(ii). See reg. section 1.864-4(c)(5)(iii) (describing attribution requirements).

¹⁶CCM, *supra* note 1.

lending business is defined in reg. section 1.864-4(c)(5)(i) and does not have its origin in or even relate to section 864(c)(2).¹⁷

The CCM's statement also misses the issue. Reg. section 1.864-4(c)(5)(ii) does not elaborate on section 864(c)(2) but rather provides an express carveout to it. Section 864(c)(2) provides the general ECI rules for certain income, including interest income and related capital gains from U.S. sources. These rules apply the "asset-use" test and the "business-activities" test. Under the asset-use test, such income is ECI if it is derived from assets used or held for use in the FC's U.S. trade or business. Under the business-activities test, such income is ECI if the activities of the FC's U.S. trade or business are a material factor in the realization of such income. Reg. section 1.864-4(c)(2) and (c)(3) elaborate, respectively, on each of the two tests. However, the lending-related ECI rules apply "notwithstanding the rules in" reg. section 1.864-4(c)(2) and (c)(3).¹⁸

Reg. section 1.864-4(c)(5)(ii) provides the lending-related ECI rules for U.S.-source interest income. If an FC's U.S. trade or business is the lending business, its U.S.-source interest income is ECI "only if the . . . securities giving rise to such income, gain, or loss are attributable to the U.S. office through which such business is carried on."¹⁹ Because both the definition of a lending business and the requirement of a U.S. office are creatures of the regulations, we must turn to the regulations to construe properly the special ECI rules.

2. The regulations. The CCM places more reliance than is warranted on the unfortunate fact that the regulations are worded in the passive.²⁰ In requiring that there be a "U.S. office through which such business is carried on," reg. section 1.864-4(c)(5)(ii) does not specify whose office it must be, either directly or through a reference to reg. section 1.864-7. The passive voice, the CCM states, leaves it unclear whether the U.S. office must be the FC's own for the FC's U.S.-source interest income to be ECI.

Despite this uncertainty, we believe the office attribution rules of reg. section 1.864-7 should apply to U.S.-source interest income for the following three reasons. *First*, the overall structure of the regulations dealing with the lending business indicates that, in general, a uniform set of ECI rules should apply to both U.S.-source interest income and non-U.S.-source interest income. Whereas section 864(c)(2) does not include any reference to the lending business, section 864(c)(4)(B)(ii) does. However,

¹⁷Reg. section 1.864-4(c)(5)(i).

¹⁸Reg. section 1.864-4(c)(5)(ii).

¹⁹*Id.* "Security" is any "bill, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items." Reg. section 1.864-4(c)(5)(v).

²⁰The CCM does not base any of its arguments on the use of the term "U.S. office" in reg. section 1.864-4(c)(5)(ii), as compared to the use of the term "office or other fixed place of business" in the United States in reg. section 1.864-5(a) or reg. section 1.864-7(a). We likewise attribute no significance to this difference. We believe that our discussions below make it clear that the same substantive rules should govern the interpretation of each term.

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the definition of the lending business is not provided in reg. section 1.864-5 dealing with section 864(c)(4), but is instead provided in reg. section 1.864-4 otherwise dealing with section 864(c)(2). When provided, the definition is made to apply for purposes of reg. section 1.864-4 and reg. section 1.864-5(b)(2).²¹ Because reg. section 1.864-4(c)(5)(ii) carves out U.S.-source interest income from the asset-use test and the business-activities test of section 864(c)(2) and subjects such income to special ECI rules applicable to the lending business, the regulations should be construed to apply generally uniform ECI rules to both U.S.-source interest income and non-U.S.-source interest income.

Second, the evolution of the ECI rules for the FC's capital gains income makes it clear that the U.S. office requirement for U.S.-source interest income is subject to reg. section 1.864-7. Reg. section 1.864-4(c)(5)(ii) applies not only to U.S.-source interest income, but also to U.S.-source gains from the sale or exchange of securities that are capital assets.²² The FC's gain from the sale of personal property is generally sourced from outside the United States.²³ However, if the FC "maintains an office or other fixed place of business in the United States, income from any sale of personal property . . . attributable to such office or other fixed place of business shall be sourced in the United States."²⁴ For this purpose, "the principles of section 864(c)(5) shall apply in determining whether a taxpayer has an office or other fixed place of business and whether a sale is attributable to such an office or other fixed place of business."²⁵ Reg. section 1.864-7 spells out the principles. As a result of the source rules, the FC's capital gains could only be U.S.-source income, and therefore subject to reg. section 1.864-4(c)(5)(ii), if the FC itself already has a U.S. office; under these source rules, the U.S. office requirement, whatever the agency attribution rules, of reg. section 1.864-4(c)(5)(ii) appears redundant regarding gains.

The redundancy is historical. Reg. section 1.864-4(c)(5)(ii) was promulgated under the prior source rules for sales of personal property. The prior rules sourced the income according to the *situs* of sale, which provided that the gain from the sale of personal property would be U.S.-source if sold in the United States.²⁶ Under the prior

source rules, there was no redundancy of the U.S. office requirement regarding gain. Reg. section 1.864-4(c)(5)(ii) was meant to, and did, impose the same ECI rules for both interest income from the loans and gain from the sale of the loans.

Section 865 changed the source rules for the FC's gain from the sale of the loans in 1986, but the ECI rules of reg. section 1.864-4(c)(5)(ii) have remained the same. Not applying reg. section 1.864-7 to reg. section 1.864-4(c)(5)(ii) would render reg. section 1.864-4(c)(5)(ii) incoherent and impracticable. The CCM does not consider any ECI issues for the FC's gains from sales of the loans. But, under the CCM's facts, the U.S. agent's U.S. office would not be attributed to the FC for income source rule purposes, and the FC's gain would not be U.S.-source gain.²⁷ As a result, the FC's gain would not be ECI under reg. section 1.864-5(b)(2), to which reg. section 1.864-7 applies. So the FC's interest income would be treated as ECI but its gain from the sale of the loans would not be. In this case, it would be difficult for the FC to allocate deductions including expenses and interest.²⁸

Third, whereas the U.S. office requirement is worded in the passive voice in its initial appearance in reg. section 1.864-4(c)(5)(ii), further explanations later in the provision leave little doubt that the U.S. office should be the FC's own. Under reg. section 1.864-4(c)(5)(ii), U.S.-source interest income derived from certain securities is subject to a special ECI rule.²⁹ Under this rule, the amount of such interest which is treated as ECI is an amount determined by multiplying the entire U.S.-source interest from those securities by a fraction, the numerator of which is 10 percent and the denominator of which is the

manufactured goods not applicable to loans; as in effect before 1986). These source rules were changed in 1986 when section 865 was enacted. See Tax Reform Act of 1986, section 1211, and sections 861(a)(6), 862(a)(6), 863, and 865. For a general discussion of the history of the *situs*-of-sale rule, see Linda Galler, "An Historical and Policy Analysis of the Title Passage Rule in International Sales of Personal Property," 52 *U. Pitt. L. Rev.* 521 (1991).

²⁷Section 865(a)(2) and (e). This is the case even if the FC's loans are treated as ordinary assets under section 1221(a)(4) according to *Federal Nat'l Mortgage Ass'n v. Commissioner*, 100 T.C. 541 (1993); *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *Doc 93-6895*, 93 TNT 129-11, *aff'd in part and rev'd in part on other grounds*, 335 F.2d 125 (9th Cir. 1964); Announcement 2008-41, 2008-19 IRB 943, *Doc 2008-10273*, 2008 TNT 92-39. *But see Capital One Fin. Corp. v. Commissioner*, 133 T.C. No. 8, 2009 WL 2998142, at 41 (Sept. 21, 2009) (refusing to hold that in general "the lending of money is the sale of a service" based on preceding authorities). Section 1221(a)(1) properties are excluded from section 865, but section 1221(a)(4) properties are not excluded. Section 865(b) (excluding "inventory property" from section 865); section 865(i)(1) (defining "inventory property" to be section 1221(a)(1) property).

²⁸See reg. section 1.882-5 and -5T (providing rules for interest deductions against FC's ECI).

²⁹See reg. section 1.864-4(c)(5)(ii)(b)(3) (special ECI limitation rule for interest income from certain securities not including securities acquired as result of making loans to public).

This special limitation applies to both interest and gains, *id.*, underlying the intent that the same rules should apply to interest and gains. See *supra* text accompanying notes 26 and 27.

²¹Reg. section 1.864-4(c)(5)(i).

²²For a brief discussion of why those securities are generally treated as capital assets for this purpose unless the FC is a dealer, see James M. Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions* 785 n.66 (Frank J. Fabozzi Associates 3d ed. 2001 and Supp. 2008). See also *infra* text accompanying notes 26 and 27.

²³Section 865(a)(2) and (g)(1)(B).

²⁴Section 865(e)(2)(A). However, the U.S.-source rule does not apply to any "sale of inventory property which is sold for use, disposition, or consumption outside the United States if an office or other fixed place of business of the taxpayer in a foreign country materially participated in the sale." Section 865(e)(2)(B).

²⁵Section 865(e)(3).

²⁶For source rules before 1986, see section 861(a)(6) (U.S.-source if sold in the United States; as in effect before 1986), section 862(a)(6) (non-U.S.-source if sold outside the United States; as in effect before 1986) and section 863 (special rules for

(Footnote continued in next column.)

same percentage “as the book value of the total of such securities held by the U.S. office through which such business is carried on bears to the book value of the total assets of such office.”³⁰ It is impossible to determine the percentage for the denominator in this special rule unless the U.S. office at issue is the FC’s own.³¹

3. *InverWorld*. *InverWorld* is the only published case addressing the ECI rules involving a lending business.³² In *InverWorld*, the Tax Court considered whether the securities trading safe harbor of section 864(b)(2)(A)(i) applies to an FC. Under section 864(b)(2)(C), the safe harbor does not apply if the FC “has an office or other fixed place of business in the United States through which or by the direction of which the [securities trading] transactions are effected.”³³ For this purpose, neither the code nor the regulations provide further elaboration on how to determine whether the FC has a U.S. office or fixed place of business. However, the Tax Court stated:

[Reg.] section 1.864-7(d)(1)(i) expressly provides that it is to apply for purposes of section 864(c)(4)(B) and section 864(c)(4)(B)(iii), and the regulations thereunder, but it does not expressly provide that it is to apply for purposes of section 864(b)(2)(C). Nonetheless, because both parties argue their respective positions based on [reg.] section 1.864-7(d)(1)(i), and because those regulations construe the phrase “office or other fixed place of business in the United States,” which is also found in section 864(b)(2)(C), we use those regulations in the instant case as a framework to decide whether [an FC] has “an office or other fixed place of business in the United States” for purposes of section 864(b)(2)(C).³⁴

Section 864(b)(2)(C) provides the exception to the safe harbor when “the taxpayer has an office or other fixed place of business in the United States.” Reg. section 1.864-4(c)(5)(ii) requires, on the other hand, the U.S.-source interest income be “attributable to the U.S. office.” The CCM does not challenge *InverWorld*’s reliance on reg. section 1.864-7 to interpret section 864(b)(2)(C), but seeks to distinguish *InverWorld* solely on the basis of the use of the passive voice in reg. section 1.864-4(c)(5)(ii).

³⁰Reg. section 1.864-4(c)(5)(ii). The amount is capped by the total amount of U.S.-source interest from such securities. *Id.*

³¹It is not entirely clear whether this special rule is still operative. Before 1984, reg. section 1.864-4 provided that for a loan to be attributable to a U.S. office, it had to be recorded on the books and records of the office. Reg. section 1.864-4(c)(5)(iii)(a) (before amendment by T.D. 7958, 1984-1 C.B. 174). This book requirement was removed from reg. section 1.864-4(c)(5)(iii)(a) in 1984, but the special booking-related ECI rule remains in reg. section 1.864-4(c)(5)(ii).

Nevertheless, both the special booking-related ECI rule of reg. section 1.864-4(c)(5)(ii) and the booking requirement of the prior reg. section 1.864-4(c)(5)(iii)(a) make it clear that, in initially promulgating reg. section 1.864-4(c)(5), the IRS itself contemplated the U.S. office to be that of the FC’s own.

³²See *InverWorld*, note 12, *supra*.

³³Section 864(b)(2)(C).

³⁴71 T.C.M. (CCH) at 3237-21 (internal citations omitted).

The distinction is too tenuous. The Tax Court in *InverWorld* did not have the occasion to consider in detail the overall regulatory regime.³⁵ Nevertheless, with reg. section 1.864-7(d) “expressly provid[ing] that it applies for purposes of Section 864(c)(4)(B),” to apply it to section 864(b)(2)(C) requires overcoming the same hurdle of the express limitation of the applicability of reg. section 1.864-7(d). Moreover, reg. section 1.864-7(d) is based on section 864(c)(5)(A), which is made expressly to apply to section 864(c)(4)(B). There is nothing in section 864(b)(2)(C) that indicates that reg. section 1.864-7(d), including its elaborate rules for agency attribution, would apply to section 864(b)(2)(C). It appears, therefore, that it is significantly less of a jump to apply reg. section 1.864-7(d) to U.S.-source interest income than it is to apply reg. section 1.864-7(d) to section 864(b)(2)(C).

We believe that the Tax Court’s opinion in *InverWorld* has a broader sweep than is admitted by the CCM. Because the lending-related ECI rules for U.S.-source interest income and those for non-U.S.-source interest income were cut from the same cloth and introduced as a package, we believe that the Tax Court would more readily apply reg. section 1.864-7(d) to reg. section 1.864-4(c)(5)(ii) than to section 864(b)(2)(C).

4. Administrative consistency. Although the CCM does not mention it, the IRS appears to have consistently taken

³⁵While an important authority in this area of law, the decision in *InverWorld* has a significant flaw. In *InverWorld*, the Tax Court treated, without explanation or authorities, the loans not as securities when applying the ECI rules for a lending business. *Id.* at 3237-33 and 3237-43. This appears to have been an error. See reg. section 1.864-4(c)(5)(v) (defining “security” to include “any bill, note, bond, debenture, or other evidence of indebtedness” for purposes of applying special ECI rules for lending business). See also reg. section 1.864-4(c)(5)(vii), Example 1 (treating loans as securities) and Example 5 (referring to “securities involved in loans” made by branch).

But for this flaw, the Tax Court may have had to consider whether the ECI rules for U.S.-source interest income would also have the U.S. office requirement of reg. section 1.864-7(d). The reason is as follows. Reg. section 1.864-5(a) provides that any non-U.S.-source interest income is not ECI under reg. section 1.864-5 if, were it U.S.-source interest income, it would not be ECI under reg. section 1.864-4. As a result, even though the Tax Court concluded that the interest income at issue was non-U.S.-source interest income, it proceeded to consider whether such income would have been ECI under reg. section 1.864-4 if it were U.S.-source interest income. 71 T.C.M. (CCH) at 3237-44. In this consideration, however, the Tax Court did not apply the lending-related ECI rules for U.S.-source interest because it treated the interest income as “other than interest from stocks or securities.” *Id.* at 3237-43. Instead, it applied the business-activities test of reg. section 1.864-4(c)(3) under the residual rule of reg. section 1.864-4(c)(5)(vi). *Id.* at 3237-44.

If the Tax Court had addressed the question of whether the ECI rules for U.S.-source interest income would also have the U.S. office requirement of reg. section 1.864-7(d), its holding would have been dicta because its decision in *InverWorld* did not depend on its answer to the question. The Tax Court earlier concluded the U.S. office requirement was met under reg. section 1.864-7(d) when it considered whether the FC had a U.S. office under section 864(b)(2)(C). 71 T.C.M. (CCH) at 3237-18 to 3237-30.

COMMENTARY / VIEWPOINTS

the view that the various U.S. office requirements of section 864 including reg. section 1.864-4(c)(5)(ii) should be construed in accordance with reg. section 1.864-7(d). As noted above, the IRS in *InverWorld* “argued [its] position based on [reg.] section 1.864-7(d)(1)(i),” and the Tax Court took note of that.³⁶ More directly, a field service advice states that, for an FC engaged in the lending business, “as a practical matter, [the requirement of a U.S. office or fixed place of business] applies regardless of whether the interest income is U.S. source or foreign source.”³⁷ In support of this position, the field service advice states that “although the rules of [reg. section 1.864-7] apply only to determine if foreign source income is effectively connected income, the Tax Court in *InverWorld, Inc. v. Commissioner* . . . also held that those rules furnish a proper framework to determine if U.S.-source income from a debt obligation is effectively connected.”³⁸

In fact, the IRS has further extended reg. section 1.864-7 even to section 863(e). Another field service advice states that “the rules under [reg.] section 1.864-7, although issued for purposes of section 864(c)(4), should be consulted for” purposes of applying the special source rule for international communications income,³⁹ which also refers to a U.S. office or fixed place of business without further elaboration on agency attribution.⁴⁰

Although these administrative positions are not binding precedents, they represent a consistent approach to the numerous U.S. office requirements in these closely related contexts. It would appear that a drastic departure from this approach with potentially uncertain reach would be better undertaken through the issuance of regulations with a more deliberative process.

C. Conclusion

As a matter of future tax planning, prudent taxpayers are likely to follow the CCM until further judicial or administrative guidance becomes available. But the CCM stands alone in asserting that an agent’s U.S. office⁴¹ would in all cases be attributed to an FC for purposes of determining whether the FC’s U.S.-source interest in-

come with respect to the FC’s lending business constitutes ECI. We believe that the CCM’s conclusion in this regard is incorrect under current law, and expect taxpayers affected by the CCM to contest and litigate the issue of office attribution. It should be noted that the release of the CCM does not permit the IRS to issue regulations to give the CCM’s position the force of law with a retroactive effective date.⁴²

⁴²Section 7805(b)(1)(C).

³⁶*Id.* at 3237-21.

³⁷1998 W.L. 1984756 (Sept. 18, 1998) (unpublished field service advice).

³⁸This appears to be a misread of *InverWorld*. The ECI portions of the opinion were based on the Tax Court’s determination that the interest income at issue was non-U.S.-source interest income. *InverWorld*, 71 T.C.M. (CCH) at 3237-42 to 3237-46.

³⁹1995 W.L. 1918514 (Nov. 21, 1995) (unpublished field service advice) (citing *InverWorld* as authority for this approach).

⁴⁰Section 863(e)(1)(B)(ii).

⁴¹It is not clear whether the term “agent” as used in the CCM is intended to correspond to the same term under general common law principles. See Jasper L. Cummings, Jr., “IRS Memo on Foreign Lenders and Engagement in U.S. Trade or Business Stands on Shaky Authority, Demonstrates Need for Formal Published Guidance,” DTR, *Viewpoint* (Oct 19, 2009); Steven R. Lainoff, Stephen Bates, and Chris Bowers. “Attributing the Activities of Corporate Agents Under U.S. Tax Law: A Fresh Look From an Old Perspective,” 38 *Ga. L. Rev.* 143 (2004). For a brief discussion, see *supra* notes 3 and 14.