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Effectively Connected Income (ECI) and Private Equity Funds

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Introduction

There are a handful of organizational structures that a U.S.-based private equity fund (sometimes referred to in this article as a Fund) may utilize. Nonetheless, non-U.S. investors (sometimes referred to in this article as a foreign person or foreign investor) generally have common goals in making U.S. investments, namely:

1. Avoid having to file U.S. income tax returns and otherwise having their identity be disclosed to U.S. tax authorities
2. Avoid U.S. taxation on an exit event
3. Avoid or minimize U.S. withholding taxes that may be imposed on cash-flow from the United States

In this regard, a foreign person may invest in a Fund indirectly through a fiscally transparent entity (i.e., generally, an entity treated as a partnership or disregarded entity for U.S. federal income tax purposes) or a non-U.S. entity organized in a jurisdiction in which such entity will not be subject to local income taxes, but that will be treated as a corporation for U.S. federal income tax purposes (an offshore corporation).

A foreign person that invests indirectly in the United States through an offshore corporation will not be subject to U.S. income taxes directly nor will it have any U.S. tax return filing obligations. Instead, such offshore corporation may be subject to U.S. income taxation with respect to its investment operations and may be required to file U.S. tax returns (but if it is so required it will generally not be required to disclose the identity of its foreign owners).

On the other hand, for U.S. federal income tax purposes, a fiscally transparent entity is not subject to U.S. federal income tax. In general, a U.S. entity organized as a partnership or a limited liability company with more than one member will be treated as a partnership for U.S. federal income tax purposes and a U.S. limited liability company with a single member will be treated as a disregarded entity for U.S. federal income tax purposes unless an election is made to treat such entity as an association taxable as a corporation (a check-the-box election). With the exception of certain entities that are treated as *per se* corporations under the U.S. Treasury Regulations, a non-U.S. entity may be treated as a partnership or a disregarded entity either under the default rules related to entity classification or by making a check-the-box election. While a fiscally transparent entity is not itself subject to U.S. federal income taxation, each beneficial owner of a fiscally transparent entity must include its allocable share of a fiscally transparent entity's items of income, gain, loss and deduction in its taxable income for each taxable year in which a beneficial owner holds a participation in such entity, and the character of such items as reported by such beneficial owner will be the same as when realized by the fiscally transparent entity. Therefore, if a foreign person is a beneficial owner of a fiscally transparent entity (whether U.S. or non-U.S.) that is engaged in a U.S. trade or business (ETB) such foreign person is deemed to be ETB with respect to the ETB activities conducted by such fiscally transparent entity and is subject to U.S. federal (and possibly state and local) income taxes with respect to its distributive or allocable share of effectively connected income (ECI) realized by such fiscally transparent entity.

Unless a foreign person engages in a trade or business (directly or indirectly through a fiscally transparent entity) within the United States, none of the income it earns or gains it realizes will be subject to U.S. federal income tax on a net basis. If a foreign person were ETB (directly or indirectly), the foreign person would be required to file a U.S. federal income tax return and pay tax at the same graduated rates applicable to U.S. taxpayers on its income that was treated as ECI. In the case of a foreign corporation, an additional 30% branch profits tax (BPT) might be imposed. In addition, if a foreign person derives ECI, it may also be subject to state and local income taxes in applicable jurisdictions.

In addition to taxes on net income that are imposed on ECI, the United States imposes a withholding tax on payments to foreign persons of various types of U.S. source income that are not ECI such as dividends, interest, royalties and other kinds of income that are considered "fixed or determinable annual or periodic" income. (Such types of income, including dividends, interest, and royalties, are commonly referred to as FDAP.) In the absence of an applicable tax treaty that reduces the rate of withholding on FDAP or provides an exemption therefrom (or an internal exemption under the United States' internal tax laws such as the exemption from withholding for so-called portfolio interest), the United States imposes a withholding tax of 30% on payments of U.S. source FDAP. The withholding tax that may be imposed on FDAP income with respect to private equity fund investments is beyond the scope of this memorandum.

Against this backdrop, this article presents an overview of ECI considerations relevant to private equity funds and their foreign investors and illustrates the tension between ECI and the first two of a foreign investor's goals noted above that are generally considered when making U.S. based investments.

Effectively Connected Income (ECI)—Generally

Neither the U.S. Internal Revenue Code of 1986, as amended (the Code) nor the U.S. Treasury Regulations (the Regulations) promulgated thereunder provide a comprehensive definition of the term "trade or business" within the United States. (Except as otherwise indicated herein, all section references are to the Code and Regulations.) Section 864(b) generally provides that the performance of personal services by a foreign person within the United States, with certain limited exceptions, is considered to constitute a trade or business within the United States. In addition, sections 864(b)(2)(A)(1) and (2) provide that the term "trade or business within the United States" does not include the following:

1. "Trading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent"

2. "Trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not such employee or agent has discretionary authority to make decisions in effecting the transactions," provided that, this exception discussed in (2) shall not apply in the case of a dealer in stocks or securities (each of (1) and (2) commonly referred to as a securities trading safe-harbor)

The courts and the U.S. Internal Revenue Service (IRS) have adopted facts and circumstances test for determining whether an activity constitutes the conduct of a trade or business within the United States. (See, for example, Regulation section 1.864-2(e) which provides that "whether or not [a foreign person] is engaged in trade or business within the United States shall be determined on the basis of the facts and circumstances in each case.") Under a facts and circumstances analysis, both the type and the frequency of the activity conducted by a foreign person in the United States are taken into account in determining whether such foreign person is engaged in a trade or business within the United States. Accordingly, much of the learning in this area must be gleaned from judicial decisions which are not only fact-specific but were decided prior to the enactment of the Foreign Investors Tax Act of 1966 (FITA). FITA introduced into the Code a more comprehensive statutory scheme with respect to the U.S. income taxation of foreign persons by, among other things, distinguishing between ECI subject to taxation on a net income basis versus investment income from U.S. sources (e.g., dividends and interest) subject to U.S. withholding tax at source and, therefore, subject to tax on a gross income basis. Notwithstanding the enactment of FITA more than fifty years ago and the fact that Regulations under section 864 were adopted shortly after that, the IRS has never attempted to provide definitive or detailed guidance, whether by Regulation or other administrative pronouncements, as to the circumstances under which a non-U.S. person will be regarded as ETB. However, it is widely regarded that a fairly low level of activity within the United States may be sufficient to cause a foreign person to be ETB. In this regard, courts have found that the activities of an agent may cause a foreign person to be ETB where such agent's activities are considerable, continuous and regular and such agent is conducting a trade or business within the United States. (De Amodio v. Commissioner, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3d Cir. 1962) (holding that a foreign taxpayer had ETB because the activities of the taxpayer's agent were considerable, continuous, and regular and that the agent's activities were attributable to the taxpayer); Handfield v. Commissioner, 23 T.C. 633 (1955) (concluding that a foreign taxpayer was ETB because an agent made substantial sales in the United States on behalf of the taxpayer pursuant to a distribution agreement).

Once a foreign person is found to be ETB, the foreign person's income must be effectively connected with the U.S. trade or business to be subject to U.S. federal income tax. In general, if the income, gain, or loss of a foreign person for the taxable year from sources within the United States consists of (1) gain or loss from the sale or exchange of capital assets or (2) fixed or determinable annual or periodical gains, profits and income (such as dividends, interest, and income from personal services), certain factors must be taken into account in order to determine whether the income, gain, or loss is effectively connected for the taxable year with the conduct of a trade or business in the United States by that foreign person. (Regulation section 1.864-4(a). The principal tests to be applied are (1) the asset-use test, that is, whether the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business in the United States and (2) the business-activities test, that is, whether the activities of the trade or business conducted in the United States were a material factor in the realization of the income, gain, or loss. Regulation section 1.864-4(c)(1)(1).) All other income, gain, or loss of such foreign person for the taxable year from sources within the United States shall be treated as effectively connected for the taxable year with the conduct of a trade or business in the United States by that foreign person. (Section 864(c)(3); Regulation section 1.864-4(a)).

Certain types of foreign source income, gain, or loss of a foreign person for a taxable year may be treated as ECI only if the foreign person also has in the United States at some time during the taxable year an office or fixed place of business to which such income, gain or loss is attributable, and certain other conditions are met. (Section 864(c)(4)(B); Regulation section 1.864-5(a) and (b). In general, this applies to foreign source income that:

1. Consists of rents or royalties for the use of or the privilege of using certain types of intangible property derived in the active conduct of a trade or business

2. Consists of dividends, interest, or amounts received for the provision of guarantees of indebtedness, and either is derived in the active conduct of a banking, financing or similar business within the United States or is received by a corporation the principal business of which is trading in stocks and securities for its own account

3. Is attributable to the sale of inventory items or of property held primarily for sale to customers in the ordinary course of business

This rule may also apply to foreign source income of a foreign person for a taxable year that is attributable to a U.S. life insurance business. Regulation section 1.864-5(c)). Last, it is the position of the U.S. Internal Revenue Service that a foreign person's gain or loss from the disposition of an interest in a partnership that is ETB will be ECI gain or loss to the extent such gain or loss is attributable to ECI property of the partnership. (Rev. Rul. 91-32, 1991-1 CB 107.)

Impact of U.S. Income Tax Treaties

As noted above, while the determination of whether a foreign person is ETB is generally based on the facts and circumstances of a particular investment, it is widely regarded that a fairly low level of activity within the United States may be sufficient to cause a foreign person to be ETB. If a foreign person were a resident of a jurisdiction with which the United States has an income tax treaty, the foreign person generally will not be subject to U.S. federal income taxes on a net basis unless the foreign person has a "permanent establishment" in the United States and recognizes "business profits" that are attributable to such permanent establishment (i.e., when an income tax treaty applies, ETB is replaced with the permanent establishment concept). The terms "permanent establishment" and "business profits" are specific to each particular U.S. income tax treaty, but the concept of permanent establishment" generally refers to a fixed place or business in the United States through which a foreign person conducts business.

As a threshold matter, treaty benefits are only available to "tax" residents of a "Contracting State" (generally the countries that are parties to an income tax treaty). In general, any person who, under the laws of a Contracting State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature would be considered a resident of such Contracting State, with certain exceptions. In addition, while each income tax treaty entered into with the United States is different, all modern income tax treaties with the United States contain specific provisions to prevent "treaty shopping". In a typical case of treaty shopping, a resident of a third state (e.g., the Cayman Islands) wants to derive treaty-favored income from the United States but its country of residence has no treaty or an unfavorable treaty with the United States. The third-country resident would establish an entity resident in another Contracting State (e.g., Luxembourg) for the purpose of deriving income from the United States and claiming treaty benefits with respect to that income under the income tax treaty between the United States and the other Contracting State. To prevent this practice, each modern U.S. income tax treaty contains a "Limitation on Benefits" (LOB) article which seeks to deny benefits to such persons by limiting the benefits of a particular treaty to those persons whose residence in a Contracting State is unlikely to have been motivated by the existence of an income tax treaty (such resident being a qualified resident). While the LOB provision under each U.S. income tax treaty is specific to that particular treaty, each U.S. income tax treaty generally contains a few methods pursuant to which a foreign person may satisfy the LOB provision. In the case of a non-U.S. corporation, one of the most common manners of satisfying the LOB provision of a treaty is the so-called "ownership and base erosion" test. There are slight variations of the application of the ownership and base erosion test across the various U.S. income tax treaties, but the test generally provides:

1. That a minimum percentage (e.g., 50%) of each class of shares of the non-U.S. corporation be owned by qualifying residents of one or both of the relevant Contracting States

2. Less than a fixed percentage (e.g., 50%) of the non-U.S. corporation's gross income is paid or accrued to persons that are not qualified residents of either Contracting State and that are deductible for income tax purposes in the non-U.S. company's state of residence (but excluding certain arm's length payments made in the ordinary course of business)

Often, a foreign person may indirectly make a U.S. investment through a fiscally transparent entity (either in accordance with U.S. or non-U.S. tax laws). In general, in such a case, a foreign person's allocable share of U.S.-source income derived by such a fiscally transparent entity under the laws of the United States and/or any other jurisdiction may be eligible for treaty protection (either for withholding taxes or for purposes of determining whether the foreign person has a permanent establishment in the United States) if the item of income is considered to be derived by such foreign person as a resident of the applicable treaty jurisdiction in accordance with the terms of such income tax treaty. The determination of whether a foreign person's allocable share of income realized by a fiscally transparent entity (in accordance with U.S. or non-U.S. tax laws) will be eligible for treaty benefits will depend on the foreign person's tax jurisdiction, whether such jurisdiction has an income tax treaty with the United States, whether such investor qualifies for the benefits of any such income tax treaty, and whether such investor is considered to be the beneficial owner of income realized by a fiscally transparent entity under the terms of such treaty.

ECI and the Branch Profits Tax

In addition to the tax imposed on ECI, section 884 imposes the BPT on foreign corporations at a rate of a 30% on, among other things, remittances or deemed remittances of dividend equivalent amounts from a foreign corporation's U.S. operations. The dividend equivalent amount consists of a foreign corporation's after tax effectively connected earnings and profits that are not reinvested in United States assets. In the context of a foreign corporation with a United States branch, the BPT is, in effect, the corollary to withholding taxes imposed under sections 1441 and/or 1442 on dividends paid by U.S. corporations to foreign shareholders. A foreign corporation is subject to the BPT if it owns an interest in a partnership, trust or estate that is ETB or otherwise generates ECI. The BPT tax is payable with the corporation's income tax return for the year. The 30% rate may be reduced under the terms of a U.S. income tax treaty.

Return Filing and Withholding Requirements

<u>Tax Returns</u>

Foreign persons deemed ETB or who are members of a fiscally transparent entity that is deemed to be ETB are subject to U.S. federal, state and local tax filing obligations. Because of the compliance burdens associated with such filings, foreign investors frequently prefer to hold investments that generate ECI in blocker entities, discussed below. However, blocker corporations are still fully subject to United States taxation and distributions from such entities may be subject to withholding taxes.

<u>Section 1446</u>

In order to ensure the collection of income tax, section 1446 imposes a withholding tax obligation on a U.S. or non-U.S. entity treated as a partnership for U.S. federal income tax purposes if the entity is ETB and it earns ECI which is allocable to a foreign partner. A foreign partner may be a foreign corporation, a foreign trust or estate, a foreign partnership or a nonresident alien individual. Generally, the withholding tax is equal to the net ECI allocable to such foreign partner multiplied by the highest applicable tax rate and is due regardless of any distributions made to such partner. The foreign partner to which ECI is allocable must still file U.S. returns with respect to the ECI.

Gain from Disposition of U.S. Real Estate

Any gain recognized by a foreign person on the sale of a U.S. real property interest (USRPI) is treated as ECI and subject to U.S. income taxation. (Section 897(a); Section 897(c)). A USPRI is any interest (other than solely as a creditor) in U.S. real property and includes stock in a United States real property holding corporation (USRPHC). (Section 897(c)(2)). Generally, a U.S. corporation is a USRPHC (and thus a share of its stock is a USRPI) if at least 50% of the fair market value of its real property and business assets consists of USRPIs. (Section 897(c); Regulation Section 1.897-2(b)). Certain debt instruments with respect to U.S. real property or a USRPHC, such as a contingent debt obligation in which the holder has a direct or indirect right to share in the appreciation of the corporation, are considered interests other than solely as a creditor. (Regulation Section 1.897-2(d)(2)). Upon the disposition of a USRPI by a foreign person, a transferee is generally required to withhold and remit to the U.S. Treasury an amount equal to 15% of the gross amount realized by the transferor. (Section 1445(a)). However, if a USRPHC were to dispose of all of its assets in a taxable transaction and thereafter liquidated and distributed its sole assets (i.e., cash) to its shareholders, the entity would generally not be treated as a USRPHC at the time of liquidation and any gain recognized by a foreign person in connection with such liquidating distribution would generally not be subject to U.S. federal income tax under the securities trading safe harbor. (Section 897(c)(1)(B)).

Putting It All Together—Application to Private Equity Funds and Foreign Investors

U.S. taxable investors generally prefer to invest in a private equity fund that is organized as a fiscally transparent entity for U.S. federal income tax purposes. On the other hand, foreign investors and U.S. tax-exempt investors may prefer to invest in a U.S. based private equity fund that is organized as an offshore corporation. In such a case, the foreign investor is able to ensure that it will not itself be subject to U.S. tax return filing obligations. Regardless of whether a Fund is structured as a fiscally transparent entity or an offshore corporation, many managers reserve the right to cause a Fund to make an investment that will generate ECI if the manager determines that the anticipated after-tax return justifies the investment. In such a case, (1) if the Fund is structured as a fiscally transparent entity, the investment will often be structured so that the foreign investors are not required to file U.S. federal income tax returns and (2) whether the Fund is structured as a fiscally transparent entity or offshore corporation, a Fund's manager will often seek to structure an underlying portfolio investment to minimize the potential U.S. taxation associated with ECI.

Common Investments That May Generate ECI

Equity Investments in Operating Businesses Structured as Fiscally Transparent Entities

As noted above, each beneficial owner of a fiscally transparent entity must include in its taxable income its allocable share of a fiscally transparent entity's items of income, gain, loss and deduction for each taxable year in which a beneficial owner holds a participation in such entity, and the character of such items as reported by such beneficial owner will be the same as when realized by the fiscally transparent entity. Therefore, if a Fund makes an equity investment in a fiscally transparent entity that is ETB, the Fund will be considered to be ETB and if the Fund is structured as a fiscally transparent entity its foreign investors will be considered ETB as a result of their participation in the Fund. For this purpose, in-the-money warrants that are issued by a fiscally transparent entity may be considered to be an equity interest in such entity for U.S. federal income tax purposes.

Loan Origination

The securities trading safe-harbor is not available to a foreign person that originates loans (either directly or through an agent), and any U.S.-source income or gain associated with loan origination activities will generally constitute ECI. (See, for example, GLAM 2009-010 (holding that income realized from loan origination activities conducted through an agent on behalf of a non-U.S. corporation was not eligible for the securities trading safe-harbor). To fall within the securities trading safe-harbor, a foreign person must assure that its loan trading activities amount to trading securities and not loan origination. The term "securities" generally means any "note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." Absent any facts indicating that a foreign person was involved in arranging or making a loan, the purchase of fully funded loans (secondary market acquisitions) should be considered the purchase of securities and should fall within the securities trading safe-harbor. However, if a foreign person is treated as originating a loan (either directly or indirectly) then such loan origination may expose that person to U.S. federal income taxes. Unfortunately, there is no official guidance to clarify when loan trading activities are considered to be secondary market acquisitions or loan origination, but tax advisors generally provide taxpayers with guidelines under which, if followed, the taxpayer should not be considered to have engaged in loan origination activities.

Investments in USRPIs

As noted above, gains recognized by a foreign person in connection with the disposition of a USRPI constitute ECI.

Potential Solutions to Address ECI Concerns

There are variety of alternative structures that may be utilized by a U.S. based private equity fund to ameliorate or eliminate ECI concerns. Set forth below is a non-exclusive list of examples of strategies that may be utilized.

Investments through Blocker Corporations

A Fund may choose to make an equity investment in a fiscally transparent entity that is or will be ETB (either in its entirety or solely with respect to the foreign investor's allocable share of such investment) through an entity that is treated as a corporation for U.S. federal income tax purposes (a "Blocker"). In part depending on the nature of the income being blocked, a decision can be made as to whether the Blocker should be U.S. or foreign. If a U.S. corporation (or a U.S. entity treated as a corporation for U.S. federal income tax purposes) is used as the Blocker, all of the income that is earned by that entity will generally be subject to U.S. federal plus possibly state and local income taxes. In addition, distributions from such U.S. Blockers to foreign investors (i.e., an offshore corporation or foreign investor's allocable share of income earned through a fiscally transparent entity) will be subject to a U.S. withholding tax of 30% (subject to reduction under an applicable income tax treaty). It should be noted, however, that if a U.S. Blocker disposes of a portfolio investment and thereafter liquidates (with the liquidating distribution being cash), such liquidating distribution generally would not be subject to U.S. federal income tax when received by a foreign investor (or a foreign investor's allocable share of such income would generally not be subject to U.S. federal income tax). For this reason, it is common for a Blocker to hold only one ECI portfolio company investment. On the other hand, if a Blocker is foreign, such Blocker generally would be subject to U.S. income tax on a net basis with respect to ECI and the BPT may also apply.

Investments in Instruments That Are Not Classified as Equity for U.S. Federal Income Tax Purposes

A Fund may also choose to invest in a fiscally transparent entity that is ETB in a manner that does not constitute equity. For example, a Fund may be able to replicate the anticipated equity return by making a debt investment (assuming such investment does not cause the Fund to be engaged in a loan origination business). In such a case, care must be given to ensure that the investment will be classified as debt rather than equity for U.S. federal income tax purposes, an analysis that is fact sensitive. In addition, unless interest payments will be exempt from withholding under the terms of an income tax treaty, a Fund may be able to structure a debt investment so that interest on such debt qualifies for the "portfolio interest" exemption. In general, interest (other than contingent interest) on a debt obligation in registered form issued by a U.S. person will be considered portfolio interest provided that:

1. In the case of debt issued by a corporation, the person receiving the interest does not actually or constructively own 10% or more of the total combined voting power of all classes of the issuer's stock that are entitled to vote

2. In the case of debt issued by a partnership, that person does not actually or constructively own a 10% or more capital or profits interest in the issuer

3. The payor of the interest is provided certain documentation regarding the recipient's non-U.S. status, including IRS Form W-8BEN or W-8BEN-E or a suitable substitute therefor

4. The holder of the debt instrument is not a foreign bank. (Sections 871(h) and 881(c)). Portfolio interest is not subject to U.S. withholding taxes. Depending on the facts, other alternatives may be available.

Investments in Privately Held Domestically Controlled REITs to Make Real Estate Investments

Interests held by a foreign person in a domestically controlled real estate investment trust (REIT) are not considered USRPIs. (Section 897(h)(4).) In general, a REIT is a U.S. corporation that elects to be classified as a REIT and meets certain other organizational requirements (e.g., it must have 100 or more beneficial owners). (Section 856.) Provided that a REIT distributes all of its income annually to its shareholders, a REIT is generally not subject to any U.S. federal income tax at the entity level. (Section 857.) A REIT is a domestically controlled REIT if less than 50% of the value of its stock is held directly or indirectly by foreign persons. (Section 897(h)(4)(B).) Therefore, gains realized by a foreign person from the disposition of stock of a domestically controlled REIT are not subject to U.S. federal income tax under the rules applicable to USRPIs and USRPHCs. Distributions of operating income from a domestically controlled REIT to a foreign person are generally treated as dividends and subject to U.S. federal income tax under the rules applicable to FDAP income described above; however, dividends paid by a domestically controlled REIT to a foreign person are generally not entitled to reduced rates of withholding under many U.S. income tax treaties. Further, dividends from a domestically controlled REIT that are attributable to gain from the sale or exchange of USRPIs are treated as gain from the sale or exchange of USRPIs and such gains are thus treated as ECI. (Section 897(h)(1)).

Related Content

For additional information on tax considerations for private equity funds and managers, see the following practice notes:

- Taxation of Carried Interest
- Unrelated Business Taxable Income (UBTI)
- FATCA and Private Equity
- PFICs and Private Equity