

# Tax Court Rules Offshore Lending Hedge Fund Is Engaged in a U.S. Trade or Business

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In the long-awaited decision of *YA Global Investments, LP v. Commissioner*<sup>1</sup>, the Tax Court held that YA Global Investments, LP, a Cayman Islands limited partnership (“YA Global”), generated income effectively connected with a U.S. trade or business (“ECI”) as a result of the activities of its investment manager. Despite the fact that YA Global was generally engaged in investment activities, the court held that YA Global’s income allocable to its foreign partners was effectively connected with a U.S. trade or business and therefore subject to withholding tax under Section 1446(f) of the Internal Revenue Code of 1986, as amended (the “Code”). While the facts of YA Global are unique, it raises concerns regarding the IRS’s willingness to attribute the activities of an investment manager to a fund and to apply a broad definition of the meaning of a dealer for purposes of Section 475 of the Code.

## *Facts:*

YA Global, an offshore hedge fund, entered into an investment management agreement with its general partner, Yorkville Advisors, LLC (“IM”), which named IM as an agent of YA Global subject to the ongoing direction and control of YA Global. Although IM provided similar services for two other entities, those services were not material in relation to the activities performed by IM for YA Global. YA Global’s investments were primarily in standby equity distribution agreements (which are commitments to purchase public securities within a specified period of time for a discounted price) and convertible debentures (which either had a fixed or a discounted conversion price). Aside from the above-mentioned discounts, the securities issuers often paid IM fees in connection with these investments. IM remitted such fees in excess of its expenses to YA Global.

## *Holding:*

The Tax Court held that YA Global was engaged in a U.S. trade or business as a result of the activities of IM and it was therefore required to withhold taxes on the portion of its effectively connected income allocable to its foreign partners under Section 1446 of the Code. Although YA Global contended that the fees paid to IM by the portfolio companies were paid as a cost of capital, the Tax Court held that these fees were in exchange for certain investment services provided by IM for YA Global. Further, because IM was acting as an agent on behalf of YA Global, all of its activities were attributed to YA Global and the activities of IM were sufficiently regular and continuous for the income from these investments to be treated as ECI.

The court also held that YA Global was a dealer for the purposes of Section 475 of the Code because it “regularly offer[ed] to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business” which would cause it to be a dealer that is required to mark to market its securities on an annual basis. The Tax Court took an expansive view of the meaning of “customers” by treating underlying portfolio company issuers as customers for purposes of Section 475 of the Code.

## *What does this mean going forward?*

While *YA Global* is decided based upon a specific combination of facts, it can be understood to mean that the IRS is more willing now than they have been in the past to attribute the activities of an investment manager to an offshore fund in order to treat the fund's income as ECI. Going forward, offshore funds should ensure that the activities of the investment manager do not rise to the level of engaging in a U.S. trade or business, as such activities may be attributed to the offshore fund. While it is unusual for an investment manager to be named an agent in the formal sense that IM was, the court's reasoning that IM was an agent because it was acting on behalf of the fund and not as a service provider can be asserted with respect to many investment manager arrangements.

*YA Global* also raises concerns for any fund that engages in debt or equity structured finance arrangements that it may be treated as a dealer subject to mandatory mark-to-market tax rules with respect to income treated as ECI based on the negotiations of the investment manager.

In addition, the IRS's assertion and the subsequent court holding that portfolio company issuers are "customers," raises questions about whether other arrangements may be scrutinized and recharacterized under a substance over form analysis. *YA Global* realized ECI because it received income from IM. Offshore funds should take care to avoid receiving cash from the investment manager based on this ruling.

Offshore funds engaged in non-ECI investments should consult with a tax advisor to ensure that their fund structure does not expose them to ECI risk under a similar substance over form analysis.

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<sup>1</sup> 161 T.C. No. 11 (2023).