

## HEDGE FUND FOUND TO HAVE A UNITED STATES TRADE OR BUSINESS

On November 15, 2023, the Tax Court released its decision in *YA Global Investments, LP v. Commissioner*. The petitioner YA Global Investments, LP ("**YA Global**") is a Cayman hedge fund treated as a partnership for US tax purposes. The case examined YA Global's activities for the period from 2006 to 2008. The Tax Court determined that YA Global's activities, as a result of the activities of its manager Yorkville Advisors ("**YA**") conducted on its behalf within the United States, were continuous, regular and directed at income or profits that went beyond the management of investments and were not within the statutory safe harbor for securities trading. The Tax Court, in light of this determination, found that YA Global had not met its burden of establishing that it was not engaged in a US trade or business. While the IRS argued YA Global's activities were a lending business, the Tax Court noted that its analysis did not turn on whether any trade or business conducted by YA Global could properly be characterized as a lending business.

### FACTS

YA Global provided funding to portfolio companies in the form of convertible debentures, standby equity distribution agreements (SEDAs), promissory notes and warrants. In a SEDA, YA Global committed to purchasing up to a specified dollar value of a portfolio company's stock. YA Global entered into 25 SEDA transactions in 2006, 19 in 2007, and 9 in 2008. It also acquired 202 convertible debentures in 2006, 116 in 2007, and 111 in 2008.

- YA Global had no employees and hired YA to manage its assets, who did so from its office in Jersey City, NJ.
- YA identified, sourced and negotiated transactions, conducted due diligence, and structured and managed transactions on behalf of YA Global.

- As part of the transactions in which YA Global acquired securities from portfolio companies, those companies paid various fees (such as "structuring" fees and "monitoring" fees) to both YA Global and YA.
- YA was compensated for its services by a management fee equal to a specified percentage (generally 2%) of YA Global's assets and a 20% incentive fee based on YA Global's profits. Fees that YA received from portfolio companies were used to offset its expenses and overhead and excess amounts were remitted to YA Global.

## **ANALYSIS**

The Tax Court concluded that YA Global was engaged in a US trade or business based on its findings that (1) YA was YA Global's agent whose activities could be attributed to YA Global for purposes of determining whether YA Global was engaged in a US trade or business and (2) the activities that YA conducted on YA Global's behalf (a) were continuous, regular, and engaged in for the primary purpose of income or profit, (b) went beyond the management of investments, and (c) were not within the safe harbor for securities trading.

- One interesting aspect of the opinion is that the Tax Court found YA Global received fees from portfolio companies as compensation for the services YA provided to such companies on behalf of YA Global and such fees were not paid just to access capital. YA Global argued that the names given to certain fees was irrelevant (e.g., a monitoring fee or a structuring fee) because all of the amounts were solely for the use of capital (i.e., a substitute for interest) and no services were provided. The Tax Court was not persuaded by this argument, noting that the designation of the payments as fees had economic consequences (as they were paid to YA, who had discretion to remit to YA Global only such amounts that exceeded YA's expenses).
- The Tax Court distinguished YA's activities from those of both a typical investor and securities trader for the following reasons:
  - Investors who purchase securities on the open market do not deal directly with the companies in which they invest;
  - Any benefit to the issuer from the investor's purchase on the open market is negligible;
  - Even an investor who buys securities upon initial issuance provides no benefit to the issuer other than the capital provided; and
  - When the purchaser of a security goes beyond simply deciding whether to purchase a security on the terms offered by arranging and structuring the transaction in which the security is issued, the issuer realizes a benefit beyond the receipt of capital.
- The Tax Court also determined that all of YA Global's taxable income was effectively connected with its US trade or business, that YA Global was liable for withholding tax under Section 1446 of the Code on the portion of its effectively connected income allocable to its foreign partners, and that

YA Global was a "dealer in securities" subject to the mark-to-market accounting rules provided in Section 475 of the Code.

Few cases have addressed what activities of a taxpayer can constitute a US trade or business where the taxpayer "only" transacts in securities. The facts in this case are substantially outside of the norm based on the number of loans made each year, the type of fees received and the activities attributed to YA Global. Nonetheless, this case is instructive in identifying conduct to avoid in structuring investment funds and we at Clifford Chance can help address any concerns this case may raise. For further information please contact Paul Seraganian, Kevin Colan, Avrohom Gelber, James Gouwar, Rebecca Pereira, Michael Seaton, Philip Wagman and Hannah Richard.

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