YA Global v. Commissioner Tax Court Decision Released

The Tax Court released a precedential opinion in *YA Global v. Commissioner* on November 15, 2023, upholding the IRS's determination that a fund was engaged in a U.S. trade or business and sustaining additions to tax. While the facts of the case are unusual, this is the first case to consider the application of the U.S. trade or business standard to a partnership fund arrangement in the modern era of asset management, and as such this case has been followed closely by the asset management industry.

YA Global ("the Fund") was a non-U.S. partnership that included non-U.S. partners. The Fund engaged a U.S. manager to perform investment management services on its behalf. The manager performed services only for the Fund. The Fund invested in a range of investments, but predominantly entered a type of convertible debt termed a "standby equity distribution agreement" with companies that required the fund to acquire a certain amount of the company's stock over a fixed term. The manager received payments from the companies for entering into this arrangement. These payments were often termed as "fees," which the manager passed along to the Fund net of expenses.

The court held that the Fund did not meet its burden of proof to establish that it was not engaged in a U.S. trade or business. To the contrary, the record showed that the Fund's receipt of fees was income for the performance of services within the United States and, as such, the Fund was deemed to be engaged in a U.S. trade or business. The court further concluded that the activities were dealer activities within the purview of section 475, and as no identification was made, the activities were all deemed to be part of the Fund's dealer book. All the Fund's income was treated as income effectively connected with the fund's U.S. trade or business and subject to tax.

Where a partnership is engaged in a U.S. trade or business, it is generally required to withhold taxes on the income effectively connected with the U.S. trade or business on payments to a non-U.S. person under section 1446. The court held that because the income of the Fund was all effectively connected income, it should have been subject to withholding. The Fund had filed Forms 1065, *U.S. Partnership Income Tax Return*, but it had not filed Forms 8804, *U.S. Annual Return for*

Partnership Withholding Tax. The court did not allow the Fund any deductions against its effectively connected income because it had not filed Forms 8804. Furthermore, the court sustained the government's additions to tax for failure to file the Forms 8804 and rejected the Fund's defenses based on the statute of limitations.

Initial impressions

The case is both interesting and potentially narrow in its precedential value, given its unusual facts. The opinion carefully considers important issues including agency law and the proper characterization of fees.

The opinion includes a lengthy analysis of when fees earned by a manager on behalf of a fund could constitute the performance of services. In particular, the court took issue with the Fund's assertion that a portion of the fees were analogous to a premium earned under a put option arrangement. Funds or their managers that earn fees from portfolio companies or borrowers, including those for which they waive to the manager or for which they analogize to derivative treatment, will likely want to revisit those arrangements in light of this opinion.

Some of the meatier issues on which the facts of this case implicate, and for which there is no other guidance—such as the outer limits of the trading safe harbor under section 864(b)—are not directly addressed by the opinion. Funds that are involved in loan origination, distressed debt, workout, or similar activities will not likely draw much certainty from this decision for many of the common fact patterns that they face.

The Tax Court sustained the additions to tax IRS proposed for failure to file Forms 8804 and rejected the Fund's statute of limitations defense. The court held that the Forms 1065 filed by the Fund were not adequate to protect the Fund from the additions to tax or to start the statute of limitations for withholding tax that should have been reported on Form 8804. Further, the court rejected the Fund's argument that its tax return preparers provided sufficient advice to establish a reasonable cause and good faith defense to the additions to tax.

The Tax Court noted that other issues remain to be determined in a subsequent opinion, and any decision of the Tax Court is subject to appeal.

Conclusion

As noted above, practitioners have been awaiting the Tax Court's opinion in the *YA Global* case for some time. It may not be a coincidence that the IRS announced an enforcement campaign titled *Financial Service Entities engaged in a U.S. Trade or Business* just months after briefing was completed in the *YA Global* case in 2021. The IRS is currently auditing many non-U.S. financial services partnerships, asking whether those partnerships are engaged in a U.S. trade or business. The Tax Court opinion may fuel even more of these inquiries.

Contact us

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