OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: PAUL EPSTEIN
SENIOR TECHNICAL REVIEWER CC: INTL: BR 5

SUBJECT:

This Field Service Advice responds to your memorandum dated July 31, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

FC =
Country Z =
x =
USP =
Year Y=

ISSUE(S):

(1) Does USP's activity of purchasing and holding stocks and securities for a two to six year period constitute the conduct of a trade or business that may be attributed to FC, and if so, was such business conducted or deemed conducted in the United States?

(2) Are gains from the disposition of USP's investment taxable to FC in the United States?

CONCLUSION:

Based on the USP's offering documents, it appears that USP's stock activity does not constitute a trade or business and consequently, FC's distributive share of USP's gains are not taxable in the United States. However, if USP in fact traded stock in a frequent, regular and continuous manner in an effort to profit from the short term market swings, its stock trading activity may constitute a trade or business, and consequently, FC's distributive share of USP's gains would be taxable in the United States.

FACTS:

FC is a foreign corporation established under the laws of country Z. None of FC's shareholders are citizens of the United States. FC owns a x% limited partnership interest in USP, a U.S. limited partnership which primarily invests in stocks. FC does not directly engage in trade or business within the United States.

USP maintains all its offices in the United States (including its principal office), and conducts all its management activities in the United States. Materials submitted from USP's offering documents indicate that USP's objective is to invest its committed capital in a diversified portfolio of leveraged equity investments that are expected to generate superior long term capital gains. USP expects to hold its investments for a period of two to six years. The facts indicate in Year Y FC recognized interest, and dividend income and capital gains. The vast majority of income was capital gains. We have no information as to the holding period of the stock which generated the capital gains (or losses).

FC's distributive share of USP's dividends and interest was subject to withholding at the applicable rate. FC claims that its distributive share of the long term capital gains are not taxable in the United States since it was not engaged in a trade or business within the United States. The Service seeks to tax FC's gains under the theory that the section 864(b)(2)(A)(ii) safe harbor for trading stocks and securities for taxpayer's own account does not apply. FC argues, however, based on the Tax Considerations section of USP's offering documents, that it should not be considered to be engaged in a trade or business as a result of its investment in the fund which itself engages in only an investing activity.

LAW AND ANALYSIS:

A. Introduction

You have requested assistance regarding whether FC will be exempt from taxation on its distributive share of USP's capital gains under section

864(b)(2)(A)(ii) (the safe harbor for trading in stocks and securities for one's own account). As discussed below, we first analyze whether or not FC is eligible for the section 864(b)(2)(A)(ii) trading safe harbor. In addition, we also analyze whether FC may not be subject to tax on its distributive share of USP's capital gains, notwithstanding its ineligibility for the trading safe harbor, since USP's activity of purchasing, holding and selling stocks may not rise to the level of engaging in a trade or business.

The main issue in this case is whether FC engaged in a trade or business as a result of the investment activities conducted by USP. If FC engaged in a trade or business within the United States, and the gain is effectively connected with that trade or business, FC will be subject to tax on that gain under section 882(a)(1). If however, FC is not engaged in a trade or business within the United States, it will not be subject to tax on that capital gain, because the gain is not FDAP income, notwithstanding that the gain is U.S. source. See section 881(a) (imposing 30% tax on U.S. source fixed, or determinable, annual or periodical income of a foreign corporation). FC's distributive share of USP's capital gain is sourced to the United States since under section 865(e) if a foreign corporation maintains an office in the United States, income from any sale of personal property attributable to such office is U.S. source income. Although FC itself did not maintain an office in the United States, USP's office is attributed to FC. Donroy, Ltd. v. United States, 301 F. 2d 200 (9th Cir. 1962); Unger v. Commissioner, T.C. Memo. 1990-15 (1990), aff'd, 936 F. 2d 1316 (D.C. Cir. 1991). Therefore, FC's distributive share of USP's capital gains will be U.S. source income.

If FC does not itself engage in trade or business within the United States, it may still be so treated through the activities of USP. See section 875(1) (if a partnership is engaged in a trade or business within the United States, a foreign corporation which is a partner in the partnership is also considered to be so engaged).

B. Trading Safe Harbors

Section 864(b)(2)(A) establishes two safe harbors for foreign persons trading stocks and securities. If either safe harbor is applicable, USP's trading stocks and securities on FC's behalf will not constitute a trade or business to FC. We conclude that neither safe harbor applies to FC. First, section 864(b)(2)(A)(i) states that a taxpayer will not be engaged in trade or business if the taxpayer trades stock or securities through a resident broker or other independent agent. This safe harbor does not apply if the taxpayer has an office in the United States through which the transactions in stocks and securities are effected. Section 864(b)(2)(C). Since USP's office is attributable to FC, this safe harbor does not apply.

The second safe harbor provides that a taxpayer will not be engaged in trade or business through trading stocks and securities for its own account. Section 864(b)(2)(A)(ii). For tax years beginning before January 1, 1998, this safe harbor generally does not apply to a partner in a partnership the principal business of which is trading in stocks and securities for its own account, if it has its principal office in the United States. Section 1.864-2(c)(2)(ii).[1] Section 1.864-2(c)(2)(iii) provides rules for determining whether the taxpayer's principal office is in the United States. In this case there is no issue as to the fact that USP's principal office is in the United States, since USP does not have any operations from an office outside the United States. Therefore, for Year Y, the taxable year at issue, this safe harbor also does not apply to FC. However, we note that the Taxpayer Relief Act of 1997, P.L. 105-34, § 1162(a), removed the requirement that the partnership have its principal office outside the United States. Therefore, for taxable years beginning after December 31, 1997, even if it was determined that USP was a trader rather than investor in stocks and securities, FC nevertheless would not be subject to tax on its distributive share of USP's capital gains due to the section 864(b)(2)(A)(ii) safe harbor. After December 31, 1997, FC would fail the trading safe harbor in section 864(b)(2)(A)(ii) only if either FC or USP was also a dealer in stocks or securities. Id.

C. Investing vs. Trading In Stocks and Securities

The fact that the trading safe harbors of section 864(b)(2)(A) do not apply to FC, is not to be considered as a determination that FC was in fact engaged in a trade or business within the United States. This determination must still be made separately based on the facts and circumstances of the case. Section 1.864-2(e).

Assuming the safe harbors do not apply, the issue is whether USP's purchasing, holding and selling stocks and securities rises to the level of a trade or business. Section 864 does not define what constitutes a trade or business. For section 864 purposes, the standard for what constitutes a trade or business is the judicial rule of regular and continuous activity of the taxpayer. See Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff'd per curiam, 221 F.2d 227 (9th Cir. 1955). For nonresident taxpayers the tax law applies the same standard with respect to the trade or business as applies to domestic taxpayers. See Liang v. Commissioner, 23 T.C. 1040 (1955).

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[1] There is an exception to this rule for partnerships in which five or fewer individuals own more than fifty per cent of either the capital interest or profits interest of the partnership. Section 1.864-2(c)(2)(ii). Based on the information provided, it appears that in fact USP is widely held so that this exception does not apply.

Cases that hold that mere investing in stocks and securities does not rise to the level of a trade or business, e.g., Higgins v. Commissioner, 312 U.S. 212 (1941); Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983); Mayer v. Commissioner, T.C. Mem. 1994-209 (1994), are relevant to determining whether a nonresident is engaged in a U.S. trade or business. See Liang, 23 T.C. 1040 (1955). The cases have held consistently that "managing one's own investments in securities is not the carrying on of a trade or business, irrespective of the extent of the investments or the amount of time required to perform the managerial functions." Wilson v. United States, 376 F.2d 280, 293 (Ct. Cl. 1967). See also Estate of Yaeger v. Commissioner, 889 F.2d 29 (2d Cir. 1989); Mayer, T.C. Mem. 1994-209. Determining whether a taxpayer's trading activities constitute investing in stocks and securities or rise to the level of a trade or business turns on the facts and circumstances of each case. Higgins, 312 U.S. 212 (1941).

In determining whether a taxpayer is an investor or a trader, the courts have stated that "relevant considerations are the taxpayer's investment intent, the nature of the income to be derived from the activity, and the frequency, extent, and regularity of the taxpayer's securities transactions." Yaeger, 889 F.2d at 33, quoting Moller, 721 F.2d at 813; Mayer T.C. Mem. 1994-209. Generally an investor purchases stocks and securities with the intent of earning income from the interest, dividends, and capital appreciation of the securities. An investor is "primarily interested in the long term growth potential of [his] stocks." Yaeger, 889 F.2d at 33. In contrast, one who is engaged in a trade or business of trading securities purchases and sells securities "with reasonable frequency in an endeavor to catch the swings in the daily market movements and [profits] thereby on a short term basis." Liang, 23 T.C. 1040, 1043 (1955).

The controlling case in the Second Circuit states that "the two fundamental criteria that distinguish traders from investors are the length of the holding period and the source of the profits." Yaeger, 889 F.2d at 33; see also Mayer, T.C. Mem. 1994-209. Relatively large amounts of dividend income and long term capital gains or losses, and long holding periods of the stocks owned and of the stocks sold during the relevant period indicate that the taxpayer is an investor. Yaeger, 889 F.2d 29; Moller, 721 F.2d 810; Purvis v. Commissioner, 530 F.2d 1332 (9th Cir. 1976); Mayer T.C. Mem. 1994-209.[2] Lastly, the fact that the taxpayer made a

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[2] The cases do not state a bright line as to how short an average holding period one must have to be characterized as a trader. However, an average holding period of one year or longer indicates that the taxpayer is an investor. See, e.g., Mayer, T.C. Mem. 1994-209, at 2949-5, in which the taxpayer was held to be an investor when the weighted average holding periods of stock sold were 317 days, 439 days, and 415 days in 1986, 1987, and 1988 respectively, and approximately two thirds or more of the stocks sold during the years in issue were held more than six months.

relatively small number of purchase or sales transactions during the relevant period is also indicative of investor status. Moller, 721 F.2d 810; Purvis, 530 F.2d 1332.

The information presented to us strongly supports the conclusion that USP's activities were in the nature of mere investing, and therefore, do not rise to the level of a trade or business. First, USP's offering document states that the fund's objective is to invest its committed capital in a diversified portfolio of equity investments that are expected to generate superior long-term capital gains. It expects that the general partner will exert oversight and control of the acquired companies on an ongoing basis, and will continuously review the performance of each investment to determine the appropriate timing for disposing of the investment. On average, it expects that the investments will be held for a period of two to six years. This mind set is characteristic of an investor who plans to hold its investments for the long haul, and to realize profit through long term capital appreciation. It is not the mind set of a trader who expects to purchase and sell securities frequently with an intent to profit from the short term market swings. Compare Yaeger, 889 F.2d 29 (although taxpayer initiated 2,000 securities transactions over a two year period, and pursued his activities vigorously and extensively, he was an investor since most of his sales were of securities held for over a year, none of his sales were of securities held for less than three months, and most of his profit came from holding undervalued stock until its market improved) and Paoli v. Commissioner, T.C. Memo. 1991-351 (many of taxpayer's securities transactions involved stock held for less than a day, and approximately 63% of the sale transactions and approximately 78% of the sales proceeds involved stocks held for less than 31 days; nevertheless taxpayer was not a trader since its extensive trading activity only spanned one month).

The information submitted does not indicate the holding period of the stocks which USP sold during Year Y or during the rest of its life. Therefore, we are not certain whether in fact USP carried out its intended "investment strategy" or conducted a trading operation. If in fact USP traded stock in a frequent, regular and continuous manner in an effort to profit from the short term market swings, its stock trading activity may well constitute a trade or business, and consequently, FC's distributive share of USP's gains may be taxable in the United States. However, qualification for long-term capital gain characterization is not a necessary condition to be qualified as an investor. Mayer, T.C. Mem. 1994-209, at 2949-5.

The offering documents indicate that USP was going to hold its stocks on average for a period of two to six years. If you find that in fact USP engaged in a large volume of day trades, or of selling securities with a regular short holding period, this may support trader characterization. Otherwise, our conclusion is that FC is not engaged in a U.S. trade or business and its distributive share of gains are not taxable in the United States solely by virtue of USP's activities.

No information has been provided concerning the residency of FC's shareholders or FC's income other than to the extent it relates to its investment in USP. Accordingly, we express no opinion as to whether FC is a controlled foreign corporation, see sec. 957, a foreign personal holding company, see section 552, or a PFIC, see sec. 1297, or whether FC's shareholders may be directly subject to tax in the United States.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

If you have any further questions, please call the branch telephone number.

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