

## IRS Launches New Audit Campaign Targeting Credit Funds

On June 10, 2021, the IRS's Large Business and International Division ("LB&I") announced a broad compliance campaign targeting "financial service entities engaged in a U.S. trade or business." Through issue-based audits, the LB&I campaign will examine "whether foreign investors were subject to U.S. tax on effectively connected income from lending transactions engaged in through a U.S. trade or business." The campaign's description explains that there is a safe harbor rule under Section 864(b)(2) of the Internal Revenue Code (the "Code") for foreign investors who only trade stocks and securities for their own accounts and are not engaged in a U.S. trade or business. That safe harbor is unavailable for dealers in stocks or securities, including entities engaged in a lending business, or to foreign investors in partnerships engaged in these activities.

LB&I appears to be targeting credit funds and other financial service entities through which foreigners invest into the U.S. to determine whether they are engaged in a U.S. trade or business. In connection with these audits, the IRS may scrutinize:

- Whether offshore financial service entities are originating loans in the U.S.;
- Whether foreign investors are accurately reporting effectively connected income from lending through partnerships;
- "Season and sell" structures, such as a structure with two parallel funds where one fund originates loans and the other fund purchases loans from the originating fund after a specified time period; and
- Treaty fund structures that rely on provisions in the U.S.'s network of treaties with other jurisdictions that provide that eligible non-U.S. investors will not be subject to tax in the U.S. when treated as engaged in a U.S. trade or business carried out on its behalf by an independent agent.

The campaign's announcement comes on the heels of the Biden administration's proposals to increase audits of businesses and high-net-worth individuals through \$80 billion of additional funding to the IRS over the next decade. Further, the IRS has previously announced that audits of large partnerships, including funds, will begin in the summer of 2021.

Please contact the [Ropes & Gray tax controversy team](#) with any questions you may have or for further information.