THE AFTERMATH OF *YA GLOBAL*: WHO IS A PARTNER?

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INTRODUCTION

The *YA Global* case has drawn widespread attention due to the U.S. tax implications for foreign investment entities investing in U.S. securities or making use of a U.S. investment manager. The I.R.S. prevailed in the U.S. Tax Court, and the foreign investment entity was found to have been engaged in the conduct of a U.S. trade or business in the facts presented. The Tax Court has now released a memorandum opinion[1] (the "Follow-up Opinion") that addresses the following question: what standard should be applied when determining whether a purported partner should be recognized as a partner for income tax purposes? In the context of the *YA Global*, the answer controls whether a distribution to a non-U.S. person is subject to withholding tax under Code §1446.

BACKGROUND

YA Global, the taxpayer in the case, was a Cayman Islands investment entity that was classified as a partnership for U.S. income tax purposes. It provided funding to portfolio companies in exchange for stock, convertible debentures, promissory notes, and warrants.

Because YA Global had no employees, it retained Yorkville Advisors ("Yorkville"), a U.S. corporation, to manage its assets. Yorkville also served as YA Global's general partner. YA Global could impose restrictions from time to time on the management of its assets with appropriate notice to Yorkville.[2] As part of the transactions in which YA Global acquired securities from portfolio companies, those companies paid fees to both YA Global and Yorkville.

For each of the years in issue, YA Global filed Form 1065 (U.S. Return of Partnership Income) but did not file Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)), a form used to report withholding tax on a foreign partner's share of effectively connected income of a partnership. Ultimately, the I.R.S. issued notices of final partnership administrative adjustment ("F.P.A.A.'s"), the equivalent of deficiency notices in the context of a partnership. The F.P.A.A.'s asserted the YA Global was engaged in the conduct of a trade or business in the U.S., that all of its taxable income was effectively connected with that trade or business, and that YA Global was liable for withholding tax under Code §1446 on the portion of the partnership's effectively connected income ("E.C.I.") allocable to its foreign partners.

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1 T.C. Memo. 2024-78.

2 As Yorkville was both the general partner of YA Global and the asset manager engaged by YA Global, the importance of the notice for income tax purposes seems to be limited to form rather than substance.

The F.P.A.A.'s also determined that YA Global was a dealer in securities, meaning it was subject to the mark-to-market accounting rules of Code §475.

In a previous opinion,[3] the Tax Court held that the activities of Yorkville were attributable to YA Global in the sense that Yorkville was acting as YA Global's agent. YA Global's ability to give interim instructions to Yorkville regarding the management of YA Global's account demonstrated a relationship between an agent and principal. The activities that Yorkville conducted on behalf of YA Global were continuous, regular, and engaged in for the primary purpose of income or profit.

The Tax Court also held that YA Global regularly purchased securities from customers in the ordinary course of a trade or business. Consequently, it accepted the I.R.S. assertion that YA Global was a dealer in securities and was subject to the mark-to-market rule. Moreover, all of YA Global's income was properly treated as E.C.I.

WHO IS A PARTNER?

In the Follow-up Opinion, the Tax Court addressed several residual issues.[4] Among the most notable was the question of determining when a partner of YA Global converts to being a nonpartner. The question became particularly relevant following the Tax Court's initial decision because of the relevance of the partnership withholding rules in Code §1446.

Code §1446 requires a partnership that reports E.C.I. to pay a withholding tax on "effectively connected taxable income" ("E.C.T.I.") allocable to foreign partners. Withholding tax generally is collected at the highest possible tax rate specified in Code §1 for individual partners or the tax rate in Code §11 for corporate partners. In the event withholding tax exceeds the actual tax, a refund is available, provided a tax return is filed. A partnership that fails to withhold as required is liable for the tax owed unless the relevant foreign partner pays the tax. In either case, interest and penalties will still apply to the partnership.[5] Alternatively, the partnership's liability for the withholding tax is waived if it can demonstrate that the tax liability was zero.[6]

Investors in YA Global directly held interests in one of two feeder funds, depending on the status of the investor. U.S. investors held interests in YA Onshore, and foreign investors held their interests in YA Offshore. Yorkville, the general partner and investment manager of YA Global, established several special purpose vehicles ("S.P.V.'s") to allow investors to redeem their investments. An investor seeking redemption was given the option of receiving an in-kind distribution of securities or an ownership interest in an S.P.V., which conferred "*pro rata* participation interests" in YA Global's portfolio of securities.[7] The S.P.V.'s received cash distributions when YA Global liquidated its securities. YA Global issued Schedule K-1's to YA Offshore and the S.P.V.'s, suggesting that YA Global viewed the S.P.V.'s as partners in YA Global.

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3 *YA Global Investments, LP v. Commr.,* Nos. 14546-15 and 28751-15, 161 T.C. (2023).

4 T.C. Memo. 2024-78.

5 Code §1463.

6 Treas. Reg. §1.1446-3(e)(2).

7 YA Global did not provide detail on what these participation interests entailed.

The I.R.S. conceded that YA Offshore's tax liability, and therefore YA Global's withholding liability, had been zero. However, the I.R.S. argued that YA Global failed to withhold tax due for the S.P.V.'s, identified as the other purported foreign partners.

Before addressing substantive arguments, the court dealt with a procedural matter. The I.R.S. took issue with the fact that YA Global asserted that the S.P.V.'s were not partners. While the court agreed that this was a violation of procedural rules, it felt justified in dealing with the substantive arguments because any inadequacy of evidence (owing to the issue having not been brought up at an earlier point in the controversy) would only harm YA Global, the party making the argument.

The court first considered the participation rights that the S.P.V.'s carried. It surmised that if the participation rights merely gave ownership interests in the securities held by YA Global, the S.P.V.'s were not partners. But the Schedule K-1's showed the S.P.V.'s were allocated income and losses from YA Global, indicating that the S.P.V.'s rights might include contractual rights to share in YA Global's revenue. The court found no evidence indicating otherwise.

"Before addressing substantive arguments, the court dealt with a procedural matter . . ."

FORMER CODE §704(e)(1) VS. *CULBERTSON*

The court turned to the question of the appropriate test for identifying a partner. During 2009, the tax year in question, Code §704(e)(1) provided the following definition of partner:

> A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.[8]

The regulations define a "capital interest" as follows:

> For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership.[9]

Based on the plain reading of the statute in combination with the Schedule K-1's that were issued, it would appear that the S.P.V.'s were partners. However, YA Global asserted that Code §704(e)(1) contained an additional requirement under which the provision would impute partner status only if the holder of the capital interest intended to join in the conduct of the partnership's business.

This requirement is not found in the text of the provision. Instead, YA Global's argument was based on two older Supreme Court cases involving family partnerships. Family partnerships were viewed with suspicion by the I.R.S. because they could be used to "escape surtaxes by dividing one earned income into two or more."[10]

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8 This provision was repealed in 2015.

9 Treas. Reg. §1.704-1(e)(1)(v).

10 *Commr. v. Tower*, 327 U.S. 280 (1946).

Commr. v. Tower

In the first case, *Commr. v. Tower*, a husband transferred several shares of a corporation to his wife, after which both contributed their shares to a partnership. The Supreme Court upheld the Tax Court's conclusion that the wife was never a partner because the husband and wife never intended to carry on business as a partnership. The court found that the wife neither invested her own capital nor provided vital services such as control and management of the business to the purported partnership.

Culbertson v. Commr.

On similar grounds, the Tax Court found in *Culbertson v. Commr.*[11] that a father and his four sons did not enter into a partnership. However, the Supreme Court remanded the case, advising that the contribution of vital services or original capital was not a necessity to the formation of a partnership:[12]

> The question…is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts – the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent – the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

In other words, the most important inquiry was the intent of the possible partners rather than the nature of what they contributed.

The *YA Global* court suggested that former Code §704(e)(1) was enacted as a response to these cases: Congress wished to steer the definition of a partner in a partnership to a more objective standard. This responded to YA Global's argument that former §704(e)(1) was never intended to provide an alternative test to *Culbertson*. In fact, legislative history indicates that one reason Congress ultimately repealed the provision was the worry that it did create such an alternative.[13]

One court case that hinted at this concern was *TIFD III-E Inc. v. U.S.*[14] There, the 2nd Circuit found that no partnership existed under *Culbertson* but instructed the district court to apply former §704(e)(1). The case left open the possibility that a nonpartner under *Culbertson* might be a partner under Code §704(e)(1).[15]

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[11] 6 T.C.M. (CCH) 692 (1947).

[12] 337 U.S. 733 (1949).

[13] Pub. L. No. 114-74.

[14] 459 F.3d 220 (2006).

[15] In that case, the district court found a partnership existed under §704(e)(1) but was reversed again by the 2nd Circuit, which found that the purported partners' interests were debt interests rather than capital interests.

The Tax Court in *YA Global* ultimately found that §704(e)(1) required the recognition of the S.P.V.'s as partners based on their rights to proceeds from the sale of securities owned by YA Global.

Application of *Culbertson*

The court nonetheless entertained YA Global's request to use *Culbertson* as the proper test, but reached the same conclusion. Based on the reasoning of *Culbertson*, YA Global argued that because the S.P.V.'s were a means for investors to redeem their investments, the S.P.V.'s had no intent to carry on with YA Global's business.

In response, the court first noted that the participation rights suggested an intent to continue with the business while also distinguishing between the investors' intent and the S.P.V.'s' intent. Moreover, the court characterized YA Global's position as the proposition that a partner ceases to be a partner "simply by announcing an intention to withdraw from the partnership," which the court described as a false premise. Instead, under the principles of Code §736, the court observed that a withdrawing partner remains a partner until the partner receives his or her final payment.

Finally, YA Global argued that to the extent that the S.P.V.'s were allocated income, they were acting in a nonpartner capacity under Code §707. Code §707 characterizes certain payments from a partnership to a partner as compensation income rather than a distributive share of partnership income. The court found this argument to be merely rehashing YA Global's earlier arguments that the S.P.V.'s were not partners.

TAKEAWAY

The court's analysis is of somewhat limited relevance since this version of §704(e)(1) no longer is in effect. Nonetheless, it illustrates the difference in the type of inquiry when determining partner status under past law and current law. The reversion to only a subjective test makes planning more uncertain.

Under either test, the court was ultimately persuaded that the S.P.V.'s were partners of YA Globa based on YA Global's tax reporting and the absence of any contradictory evidence. Even under a subjective test, it can be difficult to defeat the objective facts.