

July 1, 2009

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Dear Messrs. Shapiro, Novey and Harrington:

On behalf of the Securities Industry and Financial Markets Association (SIFMA),¹ I am writing to draw your attention to regulatory and market developments that have created an urgent need for focused guidance concerning the treatment of fails charges paid in connection with certain delivery failures in the market for U.S. Treasury securities.

Effective May 1, 2009, in response to the widespread, chronic and persistent delivery failures in the market for U.S. Treasuries, a new Fails Charge Trading Practice has been voluntarily adopted by most market participants, including the Federal Reserve Bank of New York and most dealers, custodians and assets managers of U.S. Treasuries.² It is anticipated that the new Fails Charge Trading Practice will become market custom for many commonplace

¹ The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

² The final U.S. Treasuries Fails Charge Trading Practice, dated March 31, 2009, an updated Treasury Best Market Practices Revised, dated March 31, 2009, and a related FAQ, dated March 31, 2009, are available at: <http://www.newyorkfed.org/tmpg/> or <http://www.ny.frb.org/tmpg/newsandevents.html> The Asset Managers Group within SIFMA has drafted and has recommended for adoption Treasury Market Practices Group Fails Charge Market Practice, Asset Management and Custodian Industry Procedures, dated April 23, 2009. The procedures are available at: http://www.theassetmanager.com/docs/AM_Custodian_IndustryProcedures_TMPG_FailsCharge.pdf

transactions. The new Fails Charge Trading Practice is being adopted to preserve and enhance the efficiency and operational integrity of the marketplace for U.S. Treasuries by reducing the incidence of delivery failures.

Under the new Fails Charge Trading Practice, when one party (the “Failing Party”) fails to deliver U.S. Treasuries to another party (the “Non-Failing Party”) by a date previously agreed by the parties, the Failing Party will pay a “fails charge” to the Non-Failing Party. The fails charge accrues daily and is actually paid in the month following settlement of the delivery dispute. The daily amount of the fails charge is equal to the product of the trade proceeds and a formula rate.³ The fails charge is intended to provide a mechanism for compensating the Non-Failing Party for a delivery failure and acts as a proxy for actual damages, which are often difficult to ascertain. However, a claim of a fails charge by the Non-Failing Party as a remedy is without prejudice to any other rights or remedies of the parties under the applicable agreement governing the transaction or under applicable law, and does not constitute a waiver of the Non-Failing Party’s right to exercise any other remedy. The first payments of fails charges should be made on or about June 30, 2009.

The U.S. federal tax treatment of fails charges is unclear and guidance is urgently needed so that U.S. withholding agents can determine the proper information reporting and withholding tax treatment of fails charges under Sections 871, 881, 1441 and 1442 of the Internal Revenue Code of 1986, as amended (the “Code”). Absent clarifying guidance, our concern is that U.S. withholding agents will adopt the most conservative withholding tax treatment for outbound fails charges out of an abundance of caution and treat fails charges that appear to be paid by a U.S. payer as U.S. source income that, absent treaty relief, is subject to U.S. withholding tax. This tax treatment will result in disparate withholding tax treatment of fails charges between U.S. payers and non-U.S. payers and, in effect, economically penalize fails charges paid by U.S. payers and exempt similar amounts paid by non-U.S. payers from U.S. withholding tax. It is unclear if this inconsistent treatment is proper because, as a general matter of tax policy, similar amounts should be treated similarly for U.S. federal tax purposes. Given the very high degree of comfort that withholding agents customarily demand on legal interpretative matters, it is doubtful that the industry or tax practitioners can reach a consensus interpretation of the applicable law without further guidance from the Treasury Department or the Internal Revenue Service.

Payer based sourcing of fails charges also results in administrative hardships for market participants and persons that process fails charges, especially considering the fact that fails charges paid and received will generally be aggregated and netted on a monthly basis for each market participant for operational purposes. Also, of acute concern is the fact that withholding agents may not have access to all of the information needed to determine if a fails charge is properly sourced under U.S. tax principles to a U.S. payer at the time that an actual payment is made. Information may be lacking because liability for investor-related claims will be determined in a secondary process that is separate and apart from the Fails Charge Trading Practice among industry participants and it may not be clear to a withholding agent if the payer

³ The formula rate is equal to 3 percent minus the target federal funds rate specified by the Federal Open Market Committee (FOMC) (if the FOMC specifies a target rate) or the lower limit of the target band specified by the FOMC (if the FOMC specifies a target band in lieu of a target rate) at the close of business on the preceding business day, or zero, whichever is greater.

will be ultimately a U.S. person or a foreign person at the time payments are made among industry participants. As a result, certain participants may be unfairly penalized and inconvenienced by overly conservative policies that result from the abundance of caution of a particular withholding agent rather than from a proper application (or interpretation) of law.

The enclosed memorandum provides more background on the new Fails Charge Trading Practice and a more thorough discussion of administrative and operational hardships from a U.S. tax perspective. Additionally, the enclosed memorandum summarizes the possible U.S. tax treatment of fails charges as: (i) interest, (ii) a borrow fee, (iii) a return of basis or other capital transaction, (iv) a termination payment subject to Section 1234A of the Code, (v) a payment of liquidated damages, and (vi) a payment of “other fixed or determinable annual or periodical gains, profit, and income” (“FDAP”) under Section 871(a)(1)(A) of the Code. Although the proper U.S. tax treatment of a fails charge is not clear, SIFMA does not believe that the closest analogy mandates that a fails charge must be of a type that is U.S. sourced in all events. Importantly, although the matter is not free from doubt, persuasive arguments can be made that fails charges are properly treated as capital transactions under the common law or Section 1234A of the Code for holders of capital assets, and, consequently, are sourced by residence of the recipient under general U.S. federal tax principles.

SIFMA believes that all fails charges should be treated similarly for U.S. tax purposes, and that (i) similar tax treatment is supportable under current law, and (ii) consistent tax treatment of all fails charges is in keeping with the stated purposes of the new Fails Charge Trading Practice. SIFMA kindly urges that guidance be promptly published that clarifies the U.S. federal tax treatment of fails charges, notwithstanding that Revenue Procedure 2009-7, 2009-1 I.R.B. 226, provides that the IRS will not normally issue determination letters or rulings on the character and sourcing of borrow fees (which, in the view of some practitioners, fails charges may be analogous to). Our hope is that this guidance would clarify the proper withholding tax treatment for outbound fails charges and provide guidance on the proper information reporting for all fails charges.

Absent clarifying guidance on the proper tax treatment of fails charges, there is a significant risk that withholding tax disputes could undermine the new Fails Charge Trading Practice, and there will be wastage of time and resources among market participants in reaching consistency on the tax treatment. Considering that persuasive arguments can be made that fails charges are properly treated as capital for holders of capital assets and that, in any event, the Secretary has legislative regulatory authority under Section 863(a) of the Code to prescribe the sourcing of fails charges by the residence of the recipient, the industry would greatly appreciate clear guidance confirming that fails charges are not FDAP income and that recipient based sourcing applies to fails charges. While we view guidance that provides clarity on the withholding tax treatment of fails charges as most urgent, we are also concerned about the lack of guidance and the lack of systems to effect proper information reporting. Under the new Fails Charge Trading Practice, all fails charges are purposefully treated the same for processing purposes and for operational netting purposes. If all fails charges are not treated the same for tax purposes, and, consequently, fails charges with respect to different transaction types (i.e., repos, securities loans, forwards, cash sales) are treated differently for tax purposes, new sorting and tax reporting systems will be needed. Considering that most market participants are now focused on

implementing new systems in support of basis reporting for information reporting purposes (and that these limited resources will be further stretched when anticipated legislative changes in the information reporting and withholding tax area are enacted into law), we hope that any information reporting guidance would provide market participants with sufficient time to build out systems. Nonetheless, we believe that all fails charges should be treated the same for tax purposes because there are persuasive arguments under the common law and Code which support this view and because dissimilar treatment solely for tax purposes is clearly inconsistent with preserving and enhancing the efficiency and operational integrity of the marketplace for U.S. Treasuries. In other words, taking into account the size and significance of the marketplace for U.S. Treasuries, and the unique facts underlying this new market practice (which is a direct result of a cooperative effect among the industry and the Federal Reserve Bank of New York and the U.S. Department of Treasury), we cannot understate the importance of clear, simple and straightforward guidance on the tax treatment of fails charges.

If you have any questions, or if you would like to meet to discuss these issues, please feel free to contact me at 202-962-7333 or sknight@sifma.org. Thank you for your consideration.

Sincerely,



Shahira Knight
Managing Director
Securities Industry and Financial Markets Association

cc: Michael Mundaca, Acting Assistant Secretary for Tax Policy, U.S. Treasury Department
John Harrell, Senior Counsel, U.S. Treasury Department
Jeffrey Van Hove, Deputy Tax Legislative Counsel, U.S. Treasury Department
Steven A. Musher, Associate Chief Tax Counsel (International), Internal Revenue Service
Steve Larson, Associate Chief Counsel (Financial Institutions & Products), Internal Revenue Service

Attachment: A Discussion of U.S. Federal Tax Matters Related to the New Fails Charge Trading Practice for U.S. Treasury Securities

A Discussion of U.S. Federal Tax Matters Related to the New Fails Charge Trading Practice for U.S. Treasury Securities

Background

During the fall and winter of 2008 and 2009, in response to an increase of delivery and settlement failures in the U.S. Treasury market, the Treasury Market Practice Group (“TMPG”)¹ developed and recommended a new market practice for claiming a fails charge for a settlement fail in U.S. Treasury securities (the “Fails Charge Trading Practice”).² On January 6, 2009, the U.S. Treasury issued a press release endorsing the Fails Charge Trading Practice.³ The Federal Reserve Bank of New York (the “FRBONY”) issued press releases on January 15, 2009 and May 1, 2009 stating that it will adopt this new trading practice in its own operations, and, in a release dated April 20, 2009, the Securities and Exchange Commission (the “SEC”) approved this new trading practice for settlements of U.S. Treasury securities effected through the Government Securities Division (“GSD”) of the Fixed Income Clearing Corporation.⁴ While the Fails Charge Trading Practice is elective by market participants, it is anticipated that it will become market custom. For electing market participants, the new policy applies to settlement fails occurring on or after May 1, 2009.

Under the Fails Charge Trading Practice, the fails charge applies to any delivery-versus-payment settlement in U.S. Treasury securities and any delivery-versus-transfer (of other securities) for U.S. Treasury securities settlement that fails to settle as scheduled regardless of the transaction that led to the settlement obligation.⁵ As such, it does not matter if the fails charge arises from operational negligence⁶ or an intentional act by the failing party. The fails charge does not apply to “free deliveries,” where a recipient is not obligated to make a payment upon

¹ The TMPG is a group of market professionals committed to supporting the integrity and efficiency of the U.S. Treasury market. The TMPG is composed of senior business managers and legal and compliance professionals from securities dealers, banks and buy-side firms and is sponsored by the Federal Reserve Bank of New York. The TMPG meets periodically to discuss Treasury trading issues and promote best practices in Treasury cash, repurchase and related markets.

² The final U.S. Treasuries Fails Charge Trading Practice, dated March 31, 2009, an updated Treasury Best Market Practices Revised, dated March 31, 2009, and a related FAQ, dated March 31, 2009, are available at: <http://www.newyorkfed.org/tmpg/> or <http://www.ny.frb.org/tmpg/newsandevents.html>. The Asset Managers Group of SIFMA has drafted and has recommended for adoption Treasury Market Practices Group Fails Charge Market Practice, Asset Management and Custodian Industry Procedures, dated April 23, 2009. The procedures are available at: http://www.theassetmanager.com/docs/AM_Custodian_IndustryProcedures_TMPG_FailsCharge.pdf

³ The press release is available at: <http://www.ustreas.gov/press/releases/hp1344.htm>

⁴ The FRBONY press releases are available at: <http://www.newyorkfed.org/newsevents/index.html>. The SEC approval is available at 74 Fed. Reg. 19248 (April 28, 2009).

⁵ The Fails Charge Trading Practice does not apply to transactions settling through a clearing agency (as such term is defined in Section 3(a)(23)(A) of the Securities and Exchange Act of 1934) where the rules of the clearing agency subject the failing party to a fails charge.

⁶ For example, operational negligence may result from incomplete or incorrect wire details, from an untimely tender for delivery, or from an erroneous “don’t know” tender rejection (a “DK trade”).

receipt of U.S. Treasury securities (e.g., a margin delivery). It is anticipated that this new market practice will apply to a wide variety of common transactions that involve U.S. Treasury securities, including: security lending transactions; repurchase agreements; securities pledged as collateral for swaps, futures or other deposit or escrow requirements; cash market, option and forward delivery settlements; and various types of dealer-to-dealer settlements effected through the GSD.

The fails charge accrues daily over the duration of the delivery failure and the daily claim amount is equal to the product of the total proceeds due from the buyer and a formula rate, which rate is equal to (i) 3 percent minus the target federal funds rate specified by the Federal Open Market Committee (FOMC) (if the FOMC specifies a target rate) or the lower limit of the target band specified by the FOMC (if the FOMC specifies a target band in lieu of a target rate) at the close of business on the preceding business day, or (ii) zero, whichever is greater. To claim a fails charge, the non-failing party must submit a claim by the tenth business day of the following month.⁷ Dealers and custodians will submit and resolve claims on behalf of investor clients, in addition to their own claims when acting as principals.⁸ Fails charges will be actually paid on a settlement basis and will be billed during the monthly period following the month in which the trade settles or the delivery failure is otherwise resolved. Fails charges for the life of the failure that are less than or equal to \$500, as determined on a per trade basis, are not eligible for submission.

While in most instances it is anticipated that a large majority of settlement failures will be cured within several days of the original delivery failure, and that most failures will be cured by actual delivery of the underlying U.S. Treasury securities by the failing party to the non-failing party, a significant percentage of failures will be cured by other means, including situations where the non-failing party mitigates his damages by acquiring covering securities from other sources. When covering securities are acquired, the failing party will still be liable for the payment of a fails charge to the non-failing party (in addition to any other damages allowed by the agreements or applicable law). There will be, however, no completed delivery or sale or exchange of U.S. Treasury securities between the failing party and the non-failing party.

It is anticipated that liability for a fails charge claim in many instances will be resolved by mutual agreement of the dealers, investment managers and custodians involved, especially when such parties are acting as principals. However, because investor clients will not directly participate in the claim processing among industry participants, investor claims require a resolution process that is separate and apart from the Fails Charge Trading Practice among industry participants. In some cases, this secondary process may not be fully completed by the end of the month in which a fails charge is actually paid under the Fails Charge Trading Practice, in large part, because the industry participant will not receive notice that a fails charge has been

⁷ Procedures are under development. As a matter of claim processing, it is anticipated that most claims will be submitted to the asset manager (i.e., investment manager) and that the asset manager will accept or reject the claim, and determine which person (i.e., asset manager, custodian or dealer) is responsible for payment of the fails charge by the end of each month.

⁸ Because industry participants will submit and resolve claims on behalf of client investors, which will include both U.S. persons and non-U.S. persons, the operational burdens involved with resolving investor related claims will affect both U.S. and non-U.S. market participants.

accepted or rejected until the end of that month. Moreover, a process to resolve disputes regarding ultimate liability has yet to be developed.

While fails charges will not be netted or aggregated for claim purposes, it is anticipated that market participants will aggregate and net fails charges to facilitate wire transfers at the end of each monthly period. Similarly, for GSD transactions, each member's GSD monthly bill will be debited and credited, as appropriate, for the prior month's fails charges.

For accounting purposes, the industry recommended Asset Management and Custodian Industry Procedures provide that the fails charges should be accounted for at the fund level and that fails charges should be recorded in a gain or loss account as opposed to operating expense or investment income account. This industry recommendation also urges market participants to seek their own tax advice, thereby acknowledging the lack of consensus among practitioners regarding the proper tax treatment of fails charges.

Tax and Operational Issues

The treatment of the fails charge for U.S. federal tax purposes, including for withholding tax purposes, is unclear. Before matters related to the proper sourcing of outbound fails charge can be resolved, the tax characterization of a fails charge, including its character as ordinary income or capital, must first be determined. Absent guidance from the Treasury Department or the Internal Revenue Service, it is anticipated that many U.S. withholding agents may take the most conservative view for U.S. federal tax purposes and treat fails charges as "other income" that is sourced by the residence of the apparent payer of the fails charge. This tax treatment will result in disparate withholding tax treatment of fails charges between U.S. payers and non-U.S. payers and, in effect, economically penalize fails charges paid by U.S. payers and exempt similar amounts paid by non-U.S. payers from U.S. withholding tax.⁹ It is unclear if this inconsistent treatment is proper because, as a general matter of tax policy, similar amounts should be treated similarly for U.S. federal tax purposes.

If payer based sourcing applies, fails charges should be sourced to the person that bears ultimate liability for delivery failure, and not to that person's agent (unless that agent assumes liability for the fails charges). And, because the ultimate liability for the client investor claims is to be resolved separately outside of the new market practice among industry participants, it may be impossible for the industry participant (and downstream paying agents) to determine which party bears ultimate liability for an investor claim at the time payment is actually made at month's end because the industry participant does not receive notice until month's end if a submitted claim has been accepted or rejected. Accordingly, it is administratively difficult to effect payer based sourcing at the time that fails charges are actually paid.

Because fails charge payments will be aggregated and netted at the end of each month for each industry participant, it is administratively and operationally burdensome to sort fails charges

⁹ For example, in a chain of fails, where a non-U.S. person (the failing party) fails to deliver U.S. Treasuries to a counterparty because another U.S. party failed to deliver the securities to it, it is seemingly unfair for the failing party to receive a fails charge net of U.S. withholding tax but be obligated to pay the gross amount to its counterparty under the uniform rules of a industry-wide market practice.

paid by U.S. persons from fails charges paid by non-U.S. persons solely for U.S. information reporting and withholding tax purposes. Current financial reporting systems do not support this sorting process on an automated basis and it would be a time consuming and costly task to update systems to implement this new sorting process.¹⁰ Given that a certain percentage of fails charges may require re-sourcing at a later date once ultimate liability for the delivery failure is resolved, it is apparent that payer based sourcing is operationally unworkable considering the size and significance of the U.S. Treasury security market.

Technical Tax Discussion

There is no guidance directly on point that confirms the proper treatment of fails charges for U.S. federal tax purposes. Accordingly, it is reasonable to determine its proper tax treatment by its closest analogy.¹¹ The discussion below summarizes several possible tax treatments and establishes that there is a basis under current law to treat outbound fails charges as not subject to U.S. withholding tax under Sections 871, 881, 1441 and 1442 of the Internal Revenue Code of 1986, as amended (the “Code”).¹² The following discussion assumes a person holds the underlying U.S. Treasuries as capital assets for U.S. tax purposes (i.e., not inventory), and is not a mark-to-market taxpayer, such as a dealer¹³ or a trader under Section 475. For mark-to-market taxpayers, fails charges should be treated as ordinary income in accordance with the taxpayer’s normal method of accounting.¹⁴

- Treatment as interest: A fails charge can be treated as a payment of interest for U.S. federal tax purposes by the failing party to the non-failing party.¹⁵ Provided

¹⁰ Also, it is important to understand that if the tax treatment of a fails charge depends on the tax characterization of the underlying transaction, and, as a result, there is more than one tax treatment (or information reporting treatment) of fails charges, this results in the operational sorting of all fails charges solely for tax purposes.

¹¹ Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982).

¹² Fails charges will arise from many types of transactions. This discussion is intended to demonstrate that there are several persuasive technical arguments for not treating fails charges as FDAP income and to apply recipient based sourcing rules for many common transactions. We would be happy to discuss any fact pattern of particular concern to you in greater detail.

¹³ Most broker-dealers and banks should be treated as dealers (within the meaning of § 475 of the Code) for this purpose. Nonetheless, since many broker-dealers and banks act as withholding agents in customer transactions, the tax treatment of fails charges for accrual and cash method taxpayers is of interest to SIFMA and its members.

¹⁴ While the character of fails charges to dealers, electing traders and banks is likely an ordinary item (§§ 162, 163 or 475 and, for dealers, § 1236, and, for banks, § 582), the sourcing of such amounts depends on the tax treatment of fails charges as a purchase price (or other similar) adjustment, as interest, or as a fee. As such, the discussion herein on the tax treatment of fails charges is likewise applicable to dealers and banks (except that § 1234A applies to holders of capital assets only). Also, in many cases involving a non-U.S. bank or dealer, outbound fails charges, if U.S. source income, should not be subject to U.S. withholding tax if a relevant tax treaty includes a “business profits” or “other income” clause (and the non-U.S. bank or dealer otherwise qualifies for treaty relief). Treaty protection, however, may not be available in all cases.

¹⁵ And, with respect to a repurchase agreement, a fails charge can be treated as an adjustment to interest paid or received in connection with the financing transaction.

that the requirements of the portfolio interest exemption are met, U.S. source interest is not subject to U.S. withholding tax for interest paid to non-resident, foreign persons that are not engaged in the conduct of a U.S. trade or business (“Foreign Persons”).¹⁶ This characterization requires that the non-failing party be deemed to make a loan of money to the failing party for U.S. federal tax purposes when the failing party defaults on its original delivery obligation; no actual lending takes place. The difficulty with treating the fails charge as interest is that the non-failing party has not advanced any cash. An additional difficulty under this approach is that the tax treatment of lifetime fails charges that are equal to or less than \$500 is unclear (i.e., are such non-charges better treated as contingent interest, forgiven interest, or a non-tax event and not interest?).

- Treatment as a borrow fee: A fails charge can be treated as a payment of a borrow fee under a securities loan for U.S. federal tax purposes by the failing party to the non-failing party.¹⁷ While borrow fees paid by U.S. persons to Foreign Persons are subject to U.S. withholding tax (absent treaty relief) if such amounts constitute FDAP income under Section 871(a)(1)(A) of the Code, Revenue Procedure 2009-7, 2009-1 I.R.B. 226, provides that the IRS will not normally issue determination letters or rulings on the source or character of borrow fees.¹⁸ This characterization requires that the non-failing party be deemed to make a securities loan to the failing party for U.S. federal tax purposes when the failing party defaults on its original delivery obligation. To provide certainty with respect to tax consequences, this approach would require that the deemed securities loan be deemed compliant with securities lending safe harbor of Section 1058 of the Code, notwithstanding the fact that there is no formal agreement between the failing party and the non-failing party to lend securities and that the deemed lending is a consequence of a unilateral act (or failure to act) by the failing party and an involuntary act by the non-failing party. Absent the protection of Section 1058, it is unclear if a deemed securities loan as of the original delivery date would result in an accelerated tax event as of the original delivery date, as opposed to the actual settlement date. Consistent with current law, industry practice for sales and exchanges is to effect tax information reporting as of the actual settlement date.
- Treatment as a return of basis or capital adjustment: A fails charge can be treated as a return of basis by the non-failing party, akin to a purchase price adjustment¹⁹

¹⁶ §§ 871(h) and 881(c).

¹⁷ Alternatively, a fails charge could also be treated as an adjustment to a substitute payment.

¹⁸ PLR 8822061 suggests that borrow fees may be properly treated as FDAP income for U.S. federal tax purposes.

¹⁹ Freedom Newspapers v. Comm’r, 36 T.C.M. (CCH) 1755 (1971) [holding that an inducement payment paid by a broker to a newspaper publisher in connection with its purchase of several newspaper operations is a basis reduction and not income]. Sun Microsystems v. Comm’r, 66 T.C.M. (CCH) 997 (1993) accord Convergent Tech v. Comm’r, 70 T.C.M. (CCH) 87 (1995) [holding that warrants were a sales incentive and should be treated as a sales discount or allowance by seller to buyer and that a specified dollar discount at the inception of the agreement is not necessary; the warrants could only be exercised if buyer performed per the terms of their agreement]. Rev. Rul. 76-96, 1976-1 C.B. 32, holds that rebates paid in connection with an automobile purchase are treated as a reduction in the vehicle’s

or other capital adjustment for U.S. federal tax purposes.²⁰ The delivery promise of the failing party can be likened to an asset (or a potential asset) of the non-failing party that ripens into a present right to adjust the purchase price in the event of a breach by the failing party.²¹ Revenue Ruling 79-278, 1979-2 C.B. 302, is also instructive here and supports treating the fails charge as capital; the revenue ruling holds that a court approved settlement arising from a stock issuer's securities law violation that is paid to an investor in a tax year after the investor has disposed of its stock is treated as capital gain in the year that the settlement is reached.²² Capital adjustments paid to Foreign Persons are not FDAP income and are not subject to U.S. withholding tax because such amounts are normally sourced by residence of the recipient and, hence, are foreign sourced.²³

- Treatment under Section 1234A: A fails charge can be treated as a payment attributable to the cancellation, lapse, expiration or other termination of a right or obligation to timely delivery of property with respect to a capital asset. Under Section 1234A of the Code, such a termination payment is treated as gain or loss from a capital asset and, consequently, recipient based sourcing applies. As such, outbound Section 1234A payments made to Foreign Persons are not subject to U.S. withholding. Application of Section 1234A to the fails charges is very helpful because it applies equally to fact patterns involving sales and exchanges of U.S. Treasury securities and extinguishments and other terminations of contracts under which there is no actual delivery of U.S. Treasuries between the failing party and the non-failing party.²⁴
- Treatment as liquidated damages: A fails charge can be treated as a payment of liquidated damages from the failing party to the non-failing party. The U.S. federal tax treatment of liquidated damage payments depends on whether the underlying transaction is an open or a closed transaction. In an open transaction,

purchase price and not income to the customer. However, Rev. Rul. 2005-28, 2005-1 C.B. 997, suspends Rev. Rul. 76-96, in part, with regard to the treatment of the rebate as a business expense under § 162, or as a reduction of gross receipts of the manufacturer.

²⁰ Burnet v. Logan, 283 U.S. 404 (1931) [to the effect that a potential fails charge cannot be valued at the time that a buyer and seller enter into an agreement for delivery of U.S. Treasuries].

²¹ Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 12.66[5][b] (7th ed. 2006).

²² PLR 200702032 [applying Rev. Rul. 79-278 to a dispute between a realtor and seller of a home] and PLR 200724012 [applying Rev. Rul. 79-278 to a dispute between taxpayers and their stockbroker].

²³ § 865(a). Also, § 865(j) authorizes the Secretary to prescribe regulations regarding the sourcing of income for trading in future contracts, forward contracts, option contracts and other instruments; no regulations have been published to date.

²⁴ S. Rep. No. 33, 105th Cong., 1st Sess. (1997), and H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. (1997).

liquidated damages are treated as ordinary income.²⁵ If so, such amounts paid by U.S. persons to Foreign Persons are subject to U.S. withholding tax (absent treaty relief) if the amounts are FDAP income under Section 871(a)(1)(A) of the Code and if payer based sourcing applies. For closed transactions, liquidated damages are treated as a capital adjustment and should be treated similar to the return of basis and Section 1234A discussion above for U.S. federal tax purposes.²⁶ While the treatment of fails charges as a type of liquidated damages is very plausible,²⁷ the facts (i) that the non-failing party may seek damages as permitted by the parties' agreement or applicable law in addition to any fail charges (e.g., for lost profits), and (ii) that the fails charge may be better viewed as a penalty or performance incentive fee borne by the failing party (that can be avoided by a timely delivery) raise difficult to answer questions when deciding if fails charges are best treated as liquidated damages for U.S. tax purposes. Also, as discussed more thoroughly below, it is administratively and operationally complicated to determine the sourcing of a fails charge based on whether the underlying transaction was open or closed and by application of payer based sourcing rules.

- Treatment as FDAP income under Section 871(a)(1)(A): A fails charge can be treated as a payment of “other fixed or determinable annual or periodical gains, profit, and income” (“FDAP”) under Section 871(a)(1)(A) of the Code, which, if attributable to U.S. sources, would be subject to U.S. withholding tax if paid to Foreign Persons. The treatment of fails charges as FDAP income is in conflict with the common law pertaining to capital adjustments, such as purchase price adjustments, and Section 1234A. Moreover, payer sourcing of fails charges as FDAP income is complicated by administrative and operational hardships in determining which person is ultimately liable for the delivery failure at the time payment is made and by the operational netting of payments each month. A determination that a fails charge is treated as analogous to FDAP income does not necessitate that payer based sourcing must apply. Section 863(a) of the Code provides that the Secretary may promulgate regulations to allocate items of income, expenses, losses, and deductions, other than those specified in Sections 861(a) and 862(a), to sources within or without the United States. Income attributable to a fails charge is not income specified in section 861(a) or 862(a).

²⁵ Smith v. Comm’r, 50 T.C. 273 (1968), aff’d 418 F.2d 573 (9th Cir. 1969) and Boatman v. Comm’r, 32 T.C. 1188 (1959) [the “relation back” or “integrally related” rationale of Arrowsmith v. Comm’r, 344 U.S. 6 (1952) applies to closed transactions and not open transactions].

²⁶ Lowe v. Comm’r, 44 T.C. 363 (1965), acq. in result 1966-2 C.B. 5, action on decision, August 26, 1965 [the IRS disagreed that the underlying transaction was a closed transaction – for further discussion, G.C.M. 37943 (April 27, 1979)], and Kimbell v. United States, 490 F. 2d 203, (5th Cir. 1974), cert. denied 419 U.S. 833 (1974).

²⁷ For example, Binns v. United States, 254 F. Supp 889 (M.D. Tenn 1966), aff’d 385 F.2d 159 (6th Cir. 1967), [open transaction/ordinary income], Handelmann v. Comm’r, 509 F.2d 1067 (2d Cir. 1975) [open transaction/ordinary income], Mittleman v. Comm’r, 56 T.C. 171 (1971), aff’d 464 F.2d 1393 (3d Cir. 1972) [open transaction/ordinary income], and Becher v. Comm’r, 22 T.C.M. (CCH) 1251 (1963) [closed transaction/capital].

As a result, the Treasury Department has regulatory authority to source fails charges under recipient based sourcing rules.²⁸ Considering that similar payments should be treated similarly for U.S. tax purposes, and that treatment of fails charges under payer sourcing would result in disparate tax treatment between U.S. payers and non-U.S. payers for withholding tax purposes, tax policy considerations suggest that fails charges should be sourced under recipient based sourcing rules.

Summary

The foregoing discussion demonstrates an urgent need for focused guidance concerning the treatment of fails charges paid in connection certain delivery failures in the market for U.S. Treasuries. Any tax guidance issued should take into account the tax policy and practical considerations described above and should strive to preserve and enhance the efficiency and operational integrity of the marketplace for U.S. Treasuries in keeping with the stated goals of the new market practice, and not undermine these goals with unnecessary tax complexity and administrative burdens. Considering the weight of authorities under the common law and Section 1234A, and the Secretary's regulatory authority under Section 863(a), the better view is that outbound fails charges are not FDAP income and should be sourced under recipient based sourcing rules. When operational and policy considerations are taken into account, a persuasive argument is made that all fails charges should be treated the same for tax purposes, and that all outbound fails charges should not be FDAP income and should be sourced under recipient based sourcing rules.

²⁸ Notice 87-4, 1987-1 C.B. 416, the preamble to the temporary regulations under Section 863(a) in T.D. 8258 regarding the sourcing of payments under notional principal contracts, and Treas. Reg. § 1.1441-2(b)(2)(ii).