July 9, 2020

Mr. Chip Harter
Deputy Assistant Secretary, International Tax Affairs
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Ms. Erika Nijenhuis
Senior Counsel, Office of Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
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Mr. Brett York
Deputy Tax Legislative Counsel, Office of Tax Legislative Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
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Re: Treatment of Negative Rate Payments for U.S. Tax Information Reporting and Withholding Purposes

Dear Mr. Harter and Ms. Nijenhuis and Mr. York:

The Securities Industry and Financial Markets Association ("SIFMA")[1] would like the opportunity to raise the issue of negative rate payments—colloquially known as "negative interest"—and present our recommendations for guidance on the tax treatment of such payments.[2]

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[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] Despite the colloquial use of the term "negative interest," it may not be appropriate to characterize a negative rate payment as payment for the use or forbearance of money. Accordingly, use of the term is not indicative of character or source for U.S. Federal tax purposes.

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As you are aware, in mid-2014, central banks in Europe and Japan began making negative rate payments, a trend that has sustained for several years and does not appear to be reversing. The practice has raised questions on its tax treatment since the inception of the idea. We discussed the reasoning and trend toward negative interest in the December 2014 SIFMA letter[3], and in the current market environment some analysts have considered whether the U.S. Federal Reserve would drop rates below zero as well.

This letter focuses on cross-border transactions.

SIFMA members increasingly engage in cross-border transactions that involve negative rate payments or charges, but the U.S. tax rules do not currently provide specific guidance on either the characterization or sourcing of these payments. Final Regulations issued in January 2014 amended Treasury Regulation section 1.171-2 to provide rules applicable to premiums paid on bonds, and these regulations appear to encompass bonds with negative yield that may be attributable to negative interest rates, but there are no other direct tax precedents.[4] Withholding agents need guidance from the government to ensure correct and consistent treatment across the industry.

Below are a few scenarios highlighting situations in which negative rate payments might arise:

- Cash Deposits: In this scenario, a U.S. financial institution has a deposit account with a non-U.S. bank. Typically, the non-U.S. bank would pay interest on the amount deposited. In a negative rate environment, the U.S. financial institution would make a negative rate payment to the non-U.S. bank with respect to the funds held in the deposit account.

- Margin Loan: A non-U.S. client borrows cash from a U.S. broker to purchase U.S. securities. Typically, the non-U.S. client would pay interest to the U.S. broker on the borrowed funds and the securities are used as collateral. In a negative rate environment, the U.S. broker would pay the non-U.S. client an amount based on the negative rate.

- Derivatives: Cash collateral is pledged by a U.S. financial institution to a non-U.S. counterparty. Usually, the non-U.S. counterparty would pay interest on the cash collateral. In a negative rate environment, the U.S. financial institution would make a negative rate payment to the non-U.S. counterparty with respect to the funds held as collateral.

- Sale-and-repurchase transactions ("repos"): A non-U.S. client that owns U.S. Treasury securities (repo seller) sells them to a U.S. counterparty (repo buyer) for cash. The repo buyer agrees to resell the securities at a later date to the repo seller at the original price plus an amount determined by reference to an interest rate. The incremental amount is termed "Price Differential." When positive, the Price Differential is generally treated as interest when paid by the repo seller. In low interest rate environments, the Price Differential may be negative and there would be a negative rate payment. Additionally, if the repo buyer fails to deliver the repoed securities to the repo seller at repurchase, the U.S.

[3] Please refer to the enclosed SIFMA letter, dated December 19, 2014.
[4] T.D. 9653, 79 Fed. Reg. 2589 (Jan. 15, 2014).

repo buyer might be obligated to pay a "fails charge" to the repo seller. If paid, the fails charge would further lower the yield to the repo buyer. The fails charge is, in effect, a surrogate for a negative repo rate.[5]

In each of these scenarios, the question arises as to how to characterize and source the negative rate payment. In the repo example, it seems clear the negative rate payment is economically comparable to a "fails charge" and should be sourced based on existing guidance to the residence of the recipient.[6] In other examples, discussions among industry members have suggested that the character and source of this type of payment could be treated similar to interest (or "interest-like"), fees, or another type of payment not subject to withholding (e.g., premium or an additional amount lent).

SIFMA recommends these payments, to the extent characterized as a payment of income, be sourced on a prospective basis to the recipient or payee. This directly follows guidance from Treasury and IRS relating to "qualified fails" charges. This also follows rules applicable to fees or services income, where the recipient of a negative rate payment is effectively receiving a payment similar to a custodial fee for holding and safeguarding the payee's cash. When the recipient or payee is outside the United States, the payment should be sourced outside the United States and not subject to U.S. withholding. Moreover, as a policy matter, this would put U.S. and foreign payors on equal footing. Such treatment would also be consistent with and analogous to the U.S. tax treatment of: Notional Principal Contracts, and premiums paid with respect to a negative yield bond, deposit/CD or loan.

Generally, this approach would create a practical and administrable solution for withholding agents by eliminating U.S. withholding tax on payments made to non-U.S. persons, and treating payments of income to U.S. persons as U.S. source income.

The alternative conclusion that the payment be sourced to the residence of the payor would be extremely disruptive. As mentioned in the 2014 SIFMA letter, application of the 30% withholding tax on amounts received from sources within the U.S. by foreign businesses and individuals could cause market participants to withdraw from the markets to avoid significant liability. This gross-basis tax often far exceeds the income earned on particular transactions, and both intermediaries and principals are liable for the tax.

Finally, because banks and financial institutions have been operating in this uncertain environment without guidance regarding the proper tax characterization of negative rate payments, SIFMA requests that firms not be challenged on audit if the prior tax treatment of these payments is inconsistent with the position the government ultimately dictates.

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[5] For more detailed information on the source of income attributable to negative repo rate payments and certain other payments made in connection with repos and securities lending transactions, please refer to the enclosed SIFMA letter, dated August 1, 2012. The 2012 letter was submitted in response to a request for comments in the final regulations on the source of income for qualified fails charges.

[6] T.D. 9579, 77 Fed. Reg. 9846 (Feb. 22, 2012).

We appreciate your consideration of our members' concerns and our recommendations. Please don't hesitate to contact me at JSok@sifma.org or (202) 962-7399, or Jillian Enoch at JEnoch@sifma.org or (202) 962-7339.

Respectfully submitted,

Justin Sok
Managing Director, Tax

Enclosures

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The Hon. Matthew Rutherford
Undersecretary for Domestic Finance (Acting)
& Assistant Secretary for Financial Markets
U.S. Department of Treasury
1500 Pennsylvania Ave. NW
Washington, DC 20220

December 19, 2014

Dear Mr. Rutherford,

Thank you for meeting with us on Wednesday, December 3rd to discuss the concerns our members have raised with us regarding the U.S. income tax characterization of "negative interest." As you know, the European Central Bank (ECB) began charging nominal, negative interest on deposits, beginning this summer, as one of several measures the central bank has adopted to combat price deflation in Europe. Following the action by the ECB, key benchmark rates in Europe, such as the Euro Overnight Index Average (EONIA) rate also have dropped to a nominal rate below zero; and negative interest is now being paid on many common transactions in the billions of dollars of notional, including on euro deposits with banks, on euro collateral under standard derivatives agreements, and on euro-denominated margin loans. Earlier this week, the Swiss National Bank also announced that it will introduce negative interest rates on overnight deposits. Moreover, the sovereign debt of several countries, including Germany and Japan, have negative yields, and there has been increased negative interest paid in the repo markets. Some analysts predict these movements into negative territory will continue during the coming year.

Increasingly, our members are engaging in cross-border transactions that involve nominal, negative interest, but there is little available tax guidance on how these amounts should be treated for federal tax purposes. In particular, there is uncertainty about the amount, source, timing, character, and income tax withholding liability applicable to these amounts.

Of these issues, the most potentially disruptive relates to the applicability of the 30% tax on amounts received from sources within the United States by foreign businesses and individuals. This gross-basis tax often far exceeds the income earned on particular transactions, and liability for the tax attaches to intermediaries, as well as to principals. Our members try diligently to comply with the highly complex rules in this area, but, uncertainty about the proper tax characterization of a transaction can cause market participants to withdraw from the affected markets to avoid ruinous liability. If key benchmark rates continue to trend negative, the risk will increase that such tax uncertainties could cause a sudden loss of liquidity or lack of intermediation in important, cross-border financial markets.

Again, I greatly appreciate your willingness to listen to our members' concerns, as well as your offer to explain the importance of this matter to your colleagues in Treasury's Office of Tax Policy. We will follow up separately with the Office of Tax Policy.

Sincerely,

Payson R Peabody

Payson R. Peabody
Managing Director & Tax Counsel
SIFMA

cc: Andy Blocker, EVP, Public Policy & Advocacy, SIFMA,
Jonah Crane, Senior Advisor to the Undersecretary for Domestic Finance, U.S. Department of Treasury

August 1, 2012

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Re: Guidance on Securities Loan and Repo Payments

Ladies and Gentlemen:

On behalf of the Securities Industry and Financial Markets Association (SIFMA),[1] we are writing to submit comments on the need for guidance on the source of income attributable to certain payments made under cross-border securities loans and repo transactions,

1 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

namely so-called “positive rebate,” “borrow fees” and “negative repo rate” or “negative rebate” payments. These issues are raised in the preamble to the recent final regulations on the source of income for qualified fails charges.[2] We hope these comments will assist you in considering both the legal issues at stake and the practical impact of any guidance that you provide. Please feel free to call our tax counsel, Payson Peabody, at (202) 962-7333, or our outside counsel, Erika W. Nijenhuis, at (212) 225-2980, if we can answer any questions or assist you further in any way.

Securities loans are an integral part of the securities markets, allowing brokers to ensure that ordinary-course purchases of securities can be completed in accordance with the purchaser’s expectations and facilitating short sales. Repos play a fundamental role in the market for Treasuries, where they function both as a financing vehicle and a tool for taking risk positions, and a similar role in other markets for fixed income securities. Uncertainty about the tax treatment of borrow fees for securities loans is long-standing. Similar uncertainty now exists about the tax treatment of negative rebate. Accordingly, we would welcome guidance addressing those issues.

For the reasons described in more detail below, we request guidance with respect to borrow fees and negative rebate payments providing, on a prospective basis, that the source of these payments will be determined under the same rules applicable to qualified fails charges and notional principal contracts, namely generally by reference to the residence of the recipient. We believe that residence-based sourcing is appropriate both as a matter of law and because of the significance of these transactions to the financial markets. In view of the long-standing uncertainty as to the proper U.S. tax characterization of borrow fees and negative rebate and the Service’s designation of that issue for more than 20 years as one that it will not ordinarily grant rulings on, we further request that guidance provide that taxpayers that have taken a reasonable position regarding the source of such payments prior to the issuance of the guidance will not be challenged on audit.

Longstanding market custom treats positive rebate as a payment of portfolio interest at the rate agreed to by the parties, based on the judicial authorities characterizing such amount as interest that are discussed later in this submission. We are aware that it may be possible to treat positive rebate as an economic matter as the sum of two offsetting amounts, consisting of a higher interest payment and a borrow fee. We do not believe recharacterization along these lines is necessary to prevent tax abuse or warranted as a policy matter. If any guidance is issued on positive rebate we request confirmation of the historic treatment of positive rebate as a (single) payment of interest.

If instead rules are adopted that would have the effect of treating any of these payments as U.S. source FDAP other than portfolio interest, and therefore as subject to withholding tax under domestic law when paid by a U.S. person to a foreign person, we request that those rules apply only on a prospective basis, with sufficient lead time to allow withholding agents to modify their systems and for market participants to modify contracts to take those rules

[2] T.D. 9579, 77 Fed. Reg. 9846 (Feb. 22, 2012).

into account. Adequate lead time would need to be much longer if the rules require withholding agents to decompose actual payments into hypothetical gross payment streams one of which is subject to withholding tax. We recently described in detail in two recent letters on other topics the complex operational steps that are required in order for a withholding agent to implement any new withholding tax system, and the additional types of regulatory guidance and internal procedures required if withholding is required on hypothetical payments.[3] Those considerations are also relevant here, with the additional consideration that new withholding rules for securities loans and repos would be at least the fourth set of new rules that our members must implement in a relatively short time frame (in addition to cost basis reporting, FATCA, and section 871(m) rules).[4] Accordingly, we request that any new withholding tax rules applicable to actual cash flows have an effective date that is at least one year from the end of the year in which final guidance is issued, but no less than 18 months after the date on which the final guidance is issued; and that any new withholding tax rules applicable to hypothetical cash flows have at least an additional year before they become effective.

The remainder of this letter first provides an overview of the U.S. securities lending and repo markets for U.S. securities, and then discusses the basis for our request for guidance in more detail.

I. DESCRIPTION OF THE SECURITIES LOAN AND REPO MARKETS.[5]

Securities loans

In a typical securities loan in the U.S. markets, a broker borrows shares of a U.S. issuer in order to cover a "fail to deliver" – that is, a failure by another broker-dealer to deliver shares to the broker that the broker is obligated to deliver to a customer that has purchased those

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3 *See* Letter from Payson Peabody, Managing Director and Tax Counsel, SIFMA, to Pamela Lew, Office of Associate Chief Counsel (Financial Institutions and Products), dated February 14, 2012, regarding the implementation of basis reporting rules on debt instruments and options, at 3-4, available on the SIFMA website at http://www.sifma.org/issues/item.aspx?id=8589938594; Letter from SIFMA to the Honorable Emily McMahon, Acting Assistant Secretary (Tax Policy), Department of the Treasury, et al., dated April 4, 2012, regarding proposed regulations under Section 871(m), at 48-52, available on the SIFMA website at http://www.sifma.org/issues/item.aspx?id=8589938205.

4 Some SIFMA members are also implementing the credit card payment reporting rules.

5 This letter provides only a brief overview of the U.S. securities lending and repo markets for U.S. securities. More information can be found at M. Stigum & A. Crescenzi, STIGUM'S MONEY MARKET (4th ed. 2007 Mc-Graw Hill); T. Adrian et al., *Repo and Securities Lending* (Federal Reserve Bank of New York Staff Report No. 529, Dec. 2011 (revised Jan. 2012)), *available at* http://www.newyorkfed.org/research/staff_reports/sr529.pdf; Federal Reserve Bank of New York, *Repurchase and Reverse Repurchase Transactions*, available at http://www.newyorkfed.org/aboutthefed/fedpoint/fed04.html; G. D'Avolio, *The market for borrowing stock*, 66 J. FIN'L ECONOMICS 271 (2002); P. Lipson et al., *Securities Lending* (Federal Reserve Bank of New York Staff Report No. 555, March 2012, reprinting paper originally released in August 1989); *see also* CACEIS Investor Services, *Securities Lending and Repo Markets: A practical guide* (2010), available at http://www.caceis.com/fileadmin/pdf/reference_papers_en/securities_lending.pdf; *see also* Payments Risk Committee, *Task Force on Tri-Party Repo Infrastructure* (May 17, 2010), available at http://www.newyorkfed.org/prc/report_100517.pdf, for a description of one type of repo.

shares -- or to settle a short sale executed on its own behalf or for the account of a customer. Under the terms of the market-standard securities lending agreement,[6] the broker also contracts to return identical shares to the stock lender and to pay substitute dividends (or substitute interest if the borrowed securities are debt obligations) to the stock lender. The broker also posts collateral at least equal to the value of the shares to the stock lender, to secure its obligation to return the shares, which is supplemented or returned as the mark-to-market value of the shares fluctuates. A securities loan transaction may also involve the loan of debt securities of U.S. issuers, including U.S. Treasury obligations ("Treasuries"), debt issued or guaranteed by government-sponsored enterprises ("agencies"), or corporate bonds, or of shares or debt instruments issued by a non-U.S. issuer.

The U.S. securities lending market measures in the billions of dollars of outstanding securities loans at any one time. A survey of leading custodial banks active in the area indicates that on average about $255 billion of securities loans of U.S. equities were outstanding through those banks in the first quarter of 2012.[7] Securities lenders are primarily institutional investors that own large portfolios of securities on a long-term basis, such as asset managers, mutual funds, pension funds, insurance companies and endowments.[8] The most active borrowers of equity securities are typically either major financial institutions, such as securities dealers, broker-dealers, prime brokers and investment banks, or asset managers and traders such as hedge funds.[9] Publicly available information from several years ago indicates that over a quarter of outstanding securities loans in the U.S. markets were with U.S. dealers, nearly 12 percent were with pension funds, just over 11 percent were with U.S. investment managers, including hedge funds, and U.S. mutual funds and insurance companies each represented more

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6 In the U.S. market, the standard form of securities loan agreement (the "Master Securities Lending Agreement," or "MSLA") is a SIFMA document that can be found at http://www.sifma.org/services/standard-forms-and-documentation/mra,-gmra,-msla-and-msftas/ . The international standard form of securities loan agreement (the "Global Master Securities Lending Agreement, or "GMSLA") is also available on that webpage.

7 The Risk Management Association, Securities Lending Quarterly Aggregate Composite, 1st quarter 2012 (hereinafter "RMA Q1 201s survey"), Lending Composite –USD. This number includes securities loans of American depositary receipts for stock of non-U.S. issuers.

These numbers reflect primarily the lending of securities held with custodian banks, as described in note 12, *infra*. The borrower of those securities is often a securities broker. Securities brokers also borrow securities from other sources, however, such as their customers (such transactions are usually referred to as "rehypothecations" as a regulatory matter), so that the numbers quoted in the text are not comprehensive. We are not aware of a more complete source of information.

8 Based on discussions with participants in the industry, we understand that the lender base for custodial banks constitutes approximately 30 percent U.S. tax-exempt investors, about two-thirds of which are pension plans; approximately 20 percent U.S. taxable investors, principally mutual funds; and at least 15 percent governmental entities, principally central banks. Of the remaining 35 percent, about 25 percent are unknown but were thought to be divided along the same lines as the known lender base. If that is right, taxable foreign lenders, including lenders resident in treaty countries, represent less than 20 percent of that entire lender base. As noted in note 7, *supra*, these numbers do not reflect the entire universe of taxpayers whose securities are borrowed or rehypothecated.

9 T. Adrian et al., *supra* note 5, page 7; CACEIS report, *supra* note 5, section 2.1.

than 5 percent of the total.[10] The overwhelming majority of these transactions were with "true" (from a U.S. tax perspective) U.S. counterparties.

If the securities borrower provides non-cash collateral to the securities lender, the securities borrower pays a "borrow fee" or "loan premium" to the securities lender. This is relatively infrequent in the U.S. markets, and most often takes place when foreign shares are borrowed, because that is the market convention for the principal securities loan market for those shares.

Usually, a U.S. securities borrower will provide cash collateral to the securities lender. Historically, the securities lender would pay "rebate" amounts on that cash collateral, determined by reference to the Fed Funds rate, the number of days that the cash collateral is posted and the amount of that cash on each of those days. The rebate rate paid by securities brokers for borrowing of "general collateral" (shares for which there is an adequate supply available to borrow, which is the case for most shares) has typically been in the neighborhood of Fed Funds minus 25-40 basis points. For example, if a transaction is entered into under a MSLA, the Fed Funds rate is 3 percent (300 basis points) and the rebate rate for that transaction is Fed Funds minus 25 basis points, then the securities lender will pay a return on the cash collateral equal to the amount of that cash collateral multiplied by the number of days the transaction is outstanding, divided by 360, and multiplied by 275 basis points. This is a typical transaction in which positive rebate is paid, and has been the norm for several decades.[11]

If a stock is "hard to borrow," the negotiated rebate rate payable by the lender will be lower, reflecting the premium value of obtaining that stock. Stock may become hard to borrow because of non-tax-motivated market conditions, such as a restriction in the supply of stock available for lending – for example, because securities lenders call back their stock so that they can vote it in connection with a proposed acquisition of the issuer or in order to tender it in a tender offer – or because of a high level of demand to borrow the stock – for example, if there is a lot of interest in shorting the stock because the issuer is the acquiror in a proposed merger transaction.

If the Fed Funds rate is low, as in the current environment – for some time it has been in the neighborhood of 10-15 basis points – then a 25 basis point negative spread for general collateral securities loans may mean that the rebate amount will be a "negative" number, and will result in payment by the securities borrower to the securities lender. Regardless of whether the rebate amount is positive or negative, and regardless of whether the securities lender

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[10] The Bond Market Association [now SIFMA], *Repo and Securities Lending Survey of U.S. Markets Volume and Loss Experience* 3 (Jan. 2005).

[11] The D'Avolio and Lipson articles cited in note 5, *supra*, describe transactions of this kind.

Brokers may also use securities they hold in inventory or securities owned by customers as a source of supply to cover fails and short sales. In the latter case, the use of the customer's securities is governed by the brokerage agreement between the parties, subject to the limitations imposed by the U.S. securities laws, and generally does not result in any rebate, fee or other payment or credit to the customer. Large customers may negotiate different arrangements with their brokers on a one-off basis.

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is a U.S. or foreign person, the rebate amount is negotiated between the parties in the same way – as a spread off the Fed Funds rate, regardless of either party's actual cost of funding – and is reflected on the confirmation evidencing the transaction in that manner.

The cash collateral received by the securities lender is typically invested, either by the securities lender or by a custodian that acts as an agent for the stock owner in lending out the securities and reinvesting the collateral.[12] Typically the collateral is invested in a liquid highly-rated fixed income or fixed income-like asset. A survey of leading banks for the first quarter of 2012 indicated that roughly one-third of cash collateral received by such custodians was reinvested in the repo market (described below), with the remainder invested primarily in commercial paper, Treasuries, asset-backed securities, corporate bonds and bank deposits.[13] The securities lender attempts to maximize its yield in a prudent manner to earn more return on the invested cash collateral than it pays in rebate. As described above, however, the rebate rate is determined by reference to an objective market rate, and not by reference to the return on the cash collateral earned by the securities lender.

Repos

In a typical sale-and-repurchase transaction ("repo") in the U.S. markets, a party that owns Treasuries or agencies sells them to a counterparty that wishes to provide funding against highly rated and liquid collateral. Under the terms of the market-standard repo agreement,[14] the repo buyer agrees to resell the securities to the repo seller for an amount equal to the purchase price plus an amount determined by reference to an interest rate – for example, Fed Funds plus 5 basis points – multiplied by the cash amount multiplied by the number of days the transaction is outstanding divided by 360. The incremental amount is termed "Price Differential." The repoed securities may also be corporate debt or shares. For U.S. federal income tax purposes, a repo historically has been treated as a secured loan, and the Price Differential has been treated as interest on that loan.

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[12] Many securities available for loan are held by U.S. and non-U.S. institutional investors such as pension plans, insurance companies, mutual funds and similar collective investment vehicles with a custodian bank that offers as part of its services to act as the investor's agent for lending out the securities and reinvesting the cash collateral provided by the securities borrower. Often, therefore, the parties negotiating a securities loan are a broker that borrows securities for the reasons described in the text, and a custodian bank that lends out customer securities in order to earn incremental income for the customer and fees for itself from the customer for providing that service. The individuals at the broker who borrow the securities do not know the identity of the bank's customers at the time they negotiate the terms of the securities loan. Indeed, it is sometimes impossible to know the identity of the securities lenders at the moment the loan is entered into, because the bank allocates the securities loan among multiple customers that own the loaned security later in the day after the transaction has been negotiated and entered into.

[13] RMA Q1 2012 survey, *supra* note 7, Cash Reinvestment Portfolio Composite – USD. Of this total, about half was invested in repos with Treasuries and agencies as collateral, and the rest in repos with alternative collateral. At time, cash collateral is also invested in money market funds.

[14] The U.S. standard form of repo agreements (the Master Repo Agreement, or "MRA,") is a SIFMA document that can be found at http://www.sifma.org/services/standard-forms-and-documentation/. The international standard form of repo agreement (the Global Master Repo Agreement, or "GMRA") is also available on that webpage.

Repos are an essential component of the capital markets. They are one of the critical tools used by the Federal Reserve Bank of New York to increase and decrease bank reserves, and thus to affect the supply of money (U.S. dollars) in circulation. They are also widely used by banks, dealers, money market funds, state and local governments, custodial banks seeking to invest cash collateral arising from securities lending transactions for their customers, and other institutional investors including hedge funds, REITs and banks, as a way of borrowing or lending money on a short-term secured basis. The U.S. repo market is one of the largest and most liquid financial markets in the world.

According to publicly available information, as of the end of the fourth quarter of 2011, the average daily amount of total outstanding repo and reverse repo agreement contracts in the U.S. markets was $4.9 trillion;[15] and as of the fall of 2011, for triparty repo transactions U.S. government securities represented about 31 percent of the most common collateral types, agencies about 52 percent, non-agency mortgage-backed securities 4.5 percent, corporate bonds just under 6 percent, and equities about 4 percent.[16] Repo markets outside the United States also have billions of dollars of transactions outstanding.[17]

As with the securities loan market, the parties to a repo negotiate a return (technically, the "pricing rate," but more often referred to as the "repo rate") on the cash advanced by the repo buyer to the repo seller. In a "general collateral" repo, the parties agree on the types of securities that may be sold in the repo, and the repo buyer is indifferent to which of those securities it receives and may permit the repo seller to substitute one security for another provided that the repo buyer remains adequately collateralized. In a "specified collateral" or "special" repo, the repo buyer identifies a specific security as the only acceptable one. The general collateral repo rate is generally very close to the Fed Funds rate.[18] The specials rate is lower. Unlike the securities loan market for U.S. equities, where most stocks are considered general collateral, many Treasuries are at least a little "special." That is particularly true for "on-the-run" Treasuries.[19]

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15 SIFMA, *Research Quarterly 4Q 2011*, page 8, available at www.sifma.org/research/reports.aspx. This report reflects primary dealer repos on Treasuries, agencies and corporate bonds but not other securities. SIFMA, *Financing by U.S. Government Securities Primary Dealers*, available at http://www.sifma.org/research/statistics.aspx. These numbers do not include triparty repo transactions and thus understate the size of the repo market by billions of dollars.

16 SIFMA, *U.S. Repo Fact Sheet* 2011 (Nov. 17, 2011), available at http://www.sifma.org/research/item.aspx?id=8589936501. These numbers do not include primary dealer transactions, which as indicated above primarily involve Treasuries and agencies.

SIFMA, V *Research Quarterly 2Q 2010*, No. 12, page 8, available at www.sifma.org/research/reports.aspx.

17 *See* ICMA, *European Repo Market Survey Number 22* (Jan. 2012), available at http://www.icmagroup.org/ICMAGroup/files/e5/e5106351-2467-47c6-97dc-6f05cc5666aa.pdf.

18 *See* M. Fleming & K. Garbade, *When the Back Office Moved to the Front Burner: Settlement Fails in the Treasury Market after 9/11*, FRBNY ECON. POL'Y REV. 35 (Nov. 2002) (henceforth M. Fleming & K. Garbade, *Settlement Fails*); K. Garbade et al., *The Introduction of the TMPG Fails Charge for U.S. Treasury Securities*, FRBNY ECON. POL'Y REV 45 (Oct. 2010) (hereinafter K. Garbade, *TMPG Fails Charge*).

19 For a discussion of these issues, see D. Duffie, *Special Repo Rates*, 51 J. FIN. 493 (June 1996); M. Fleming & K. Garbade, *Settlement Fails, supra* note 18.

Historically, the repo rate has been positive, with a floor of zero. That is, historically rebate amounts were virtually always paid by the party who received cash in the repo (the repo seller). As described below, as a result of two recent and related developments – the introduction of a "fails charge" for Treasuries and the very low interest rates prevailing in the market for Fed Funds – the repo rate on special collateral securities is now often negative, with the result that it is the party that advances cash in the repo that pays (negative) Price Differential. The payment of negative repo rates is analogous to the payment of negative rebate in the securities lending market. At times, even the repo rate for Treasury general collateral repos has turned negative,[20] meaning that virtually every Treasury repo entered into during that period trades with a negative repo rate.

Fails charges and negative repo rates

In a very small number of instances in the last few decades, participants in the Treasury markets failed to timely deliver Treasuries notwithstanding a contractual obligation to do so.[21] Most notably, there were widespread fails in the Treasuries markets in the days and weeks immediately following the terrorist attacks of 9/11, because market participants ceased to engage in repo and similar transactions as a result of concerns about disruptions to the operational infrastructure for those transactions caused by the attacks. While the U.S. Treasury Department ultimately resolved the short-term shortage of supply by reopening a critical security, a senior Treasury official described the situation as one that could threaten the smooth operation of the Treasury market.[22] Extended fail periods have occurred under less dramatic circumstances as well.

Economists who have studied the reasons for these fail situations have identified the zero floor for repo rates as a contributing factor. The reason for that is that market practice prior to introduction of the fails charge was effectively to impose a penalty equal to current market interest on the outstanding balance of the repo if a party failed to deliver a security. If market interest rates were low, the penalty was correspondingly low. For example, if the purchaser in a repo failed to redeliver the repoed Treasuries at maturity of the repo, market practice was that the seller would not declare an event of default, would continue to hold the cash paid by the purchaser at the beginning of the transaction, but would not pay interest on that cash. The cost to the purchaser of failing to redeliver the Treasuries was thus equal to the foregone interest on that cash. The purchaser could have avoided that cost by buying or borrowing the Treasuries from another party. But if that party would have charged the purchaser more than the

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20 *See* J.P. Morgan, *Securities Lending Update* 7 (July 2011) ("Fed Funds opened at a record low 0.02% and Treasury general collateral traded as low as a negative rebate rate as Treasury supply dwindled.")

21 For discussions of the history of fails in the Treasuries markets, see M. Fleming & K. Garbade, *Settlement Fails*, *supra* note 18; K. Garbade, *TMPG Fails Charge*, *supra* note 18; *see also* U.S. Treasury Securities Fails Charge Trading Practice, http://www.newyorkfed.org/tmpg/pr033109.pdf; *see generally* materials on the Treasury Markets Practice Group page on the website of the Federal Reserve Bank of New York, at http://www.newyorkfed.org/tmpg/faq.html. The articles describe a certain residual level of fails caused by operational hitches, but those do not seem to create systemic concerns and are not discussed herein.

22 Statement by Peter Fisher, the Under Secretary of the Treasury Department for Domestic Finance, quoted in *U.S. Acts on Shortage of Treasuries*, New York Times (Oct. 5, 2001), p. C1.

foregone interest in order to make the Treasuries available, it was cheaper for the purchaser to fail to deliver and to forgo interest on the repo than to obtain the Treasuries to satisfy its obligations under the repo. At moments of stress in the market -- when holders of Treasuries became more reluctant to make them available and the cost to obtain them therefore rose -- if interest rates were low, the rate at which market participants failed to deliver Treasuries rose significantly.

Two influential economists employed by the Federal Reserve Bank of New York proposed a solution to this fail-to-deliver problem: an adjustment to the purchase price in a repo or certain other transactions that would have the effect of penalizing a party that failed to deliver securities.[23] This was ultimately adopted in the form of a "fails charge" that accrues for each day during which a fail-to-deliver Treasuries continues. Because the zero floor was considered a problem only in a low interest rate environment, the amount of the Treasury fails charge is equal to 3 percent less the target Fed Funds rate. We understand that as a direct consequence of the adoption of the fails charge for Treasuries, the Treasury repos market now trades with negative repo rates, because it is generally cheaper for a repo buyer who is obligated to redeliver Treasuries to (a) pay a negative repo rate – for example, at a one percent rate -- to obtain those Treasuries from another party and make delivery of them to the repo seller than it is to (b) fail to deliver and consequently both forego the receipt of interest and pay the fails charge, for a total cost of three percent.[24] In short, a negative repo rate and the fails charge each arise when a party entitled to receive delivery of a Treasury (the seller in the example above) is in effect forced to lend it to a counterparty (the purchaser in the example above). Payments at a negative repo rate on Treasury repos and the fails charge for Treasuries thus are surrogates for each other.[25]

A fails charge for "agency" securities, i.e., debt issued by Fannie Mae, Freddie Mac or the Federal Home Loan Banks or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae has also been introduced recently, for similar reasons.[26]

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[23] *See* Fleming & Garbade, *Settlement Fails*, *supra* note 18.

[24] *See Low rates crimp securities lending*, 55 FTSE GLOBAL MARKETS (Oct. 2011) (describing the payment of negative repo rates as a result of the introduction of the fails charge, and quoting a senior bank officer as saying that "[t]he [fails charge] penalty has definitely helped to increase the spreads on Treasuries in this low rate interest environment. We have seen and should continue to see Treasuries trade below zero rebate."); J.P. Morgan, *From the Lending Desks: Fixed Income* ("The Treasury Market Practices Group (TMPG) recommended fails charge created select specials and negative rebate rates for many current issues.") (2012), http://www.jpmorgan.com/tss/General/From_the_Lending_Desks_Fixed_Income/1159392983048.

We also understand, based on discussions with market participants, that there is now a new floor on repo interest rates, namely negative 3 percent, because if the negative repo rate were higher it would be cheaper to pay the fails charge than to pay at the negative repo rate.

[25] SIFMA is currently endeavoring to revise the Master Repo Agreement to update it in response to changes in the market and the law over time. We understand that it is expected that the trading practice that sets forth the fails charge will be incorporated in the Agreement, with the effect that the obligation to pay relevant fails charges will become one of the terms of any transactions entered into under the Agreement.

[26] *See* Agency Debt and Agency Mortgage-Backed Securities Fails Charge Trading Practice, available at http://www.newyorkfed.org/tmpg/pr092311.pdf. The agency fails charge is two percent less the target Fed Funds rate.

II. REQUEST FOR GUIDANCE

As described above, we request that guidance provide:

1) *Residence-based sourcing rule (prospective)*. Borrow fees and negative rebate/negative repo rate payments should be sourced on a prospective basis by reference to the residence of the recipient, under rules comparable to those applicable to fails charges and notional principal contracts.

2) *Adequate transition period*. To the extent that guidance instead treats those payments as U.S. source FDAP or otherwise as subject to U.S. withholding tax when paid by a U.S. person to a foreign person, the effective date of such guidance should be such that withholding agents can make appropriate modifications to their systems to provide for such withholding, and the guidance should apply only to transactions entered into after that date. The size of the securities lending and repo markets, and the critical function that the repo market plays in the liquidity of the market for Treasuries, also counsel that any new rules resulting in the imposition of withholding tax should be imposed in a manner that gives the markets ample time to digest the change and to adjust market practices and contractual arrangements to reflect it.

3) *Respect for reasonable historic positions on audit*. Taxpayers that have taken any reasonable position in the past with respect to the sourcing of borrow fees and negative rebate should not be challenged on audit. The remainder of this letter sets forth a number of different theories for sourcing borrow fees that have been suggested by commentators over the years as well as other arguments based on changes to the law, illustrating that there are multiple plausible approaches that can be taken to that issue.[27] The fact that the Service requested comments on the sourcing issue many years ago, and has had a no-rule policy on it since that time, also demonstrates that there is a lack of clarity on the right sourcing rule. Consequently, we believe that taxpayers should not be penalized for adopting any one of the approaches described below, provided that the taxpayer has consistently applied it or, if the taxpayer's position has changed over time, that any change to the taxpayer's position has been one that led to increased withholding of tax.

4) *Positive rebate treated as interest.* If guidance is issued with respect to positive rebate, we request that (a) positive rebate be treated as portfolio interest, and (b) positive rebate be treated as a single payment and not as the sum of a higher interest amount payable by the securities lender on the cash received from the securities borrower and a borrow fee paid by the securities borrower to the securities lender. Similarly, negative rebate should be treated as a single payment and not as the combination of two offsetting payments.

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[27] A bar association report from 1992 summarizes the then-state of the law as follows: "Numerous analyses of securities lending fees have failed to produce a consistent, non-manipulable, and theoretically sound basis for determining the tax treatment of such fees." New York State Bar Association Tax Section, *Proposed Regulations on Certain Payments Made Pursuant to Securities Lending Transactions* 14 (July 7, 1992) (hereinafter "NYSBA 1992 Report").

5) *Alternative sourcing approach*. If the government does not adopt the prospective residence-based sourcing rule that we recommend, we request the opportunity to discuss with you what the best alternative rule would be. We describe below numerous considerations that we think any alternative rule would need to take into account. For example, any guidance provided should take into account that U.S. persons borrow non-U.S. securities as well as U.S. securities, and that foreign persons borrow U.S. securities, both from U.S. counterparties and in foreign-to-foreign transactions.

The remainder of this letter explains why we believe that guidance providing for residence-based sourcing of borrow fees and negative rebate is supported by existing law. Because the request in 4(b) above is relevant only if actual borrow fees are treated as subject to U.S. withholding tax, we first discuss the treatment of borrow fees and negative rebate.

A. Borrow Fees and Negative Rebate

Uncertainty about the source of borrow fees is long-standing. The government requested comments on the "source, character, and income tax treaty treatment of fees paid to a lender of securities" 20 years ago, in the preamble to proposed regulations on substitute dividends and interest paid under securities loans.[28] We submitted comments in response to that request, recommending the same sourcing rule for borrow fees that we request today.[29] Every other comment on the proposed regulations that addressed the issue, and every subsequent article and report on the topic, that we are aware of has made the same recommendation.[30]

The only forms of guidance that have been issued on this topic that we are aware of are a private letter ruling from 1988 on the application of a treaty to borrow fees earned by a foreign life insurance company, concluding that the fees are eligible for treatment as industrial or commercial profits, and the inclusion of a reference to securities lending fees in the Technical Explanation to the 2006 U.S. Model Treaty and a number of treaties entered into since that time.[31] It has been IRS policy for more than 20 years that it will not ordinarily issue rulings on the character or source of borrow fees,[32] so taxpayers have not been able to use the normal ruling

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[28] Notice of Proposed Rulemaking, *Certain Payments Made Pursuant to a Securities Lending Transaction* (INTL-106-89), 1992-1 C.B. 1196, 1197.

[29] Letter from Securities Industry Association to Internal Revenue Service, *Re: Proposed Regulations Regarding Certain Payments Made in Securities Lending Transactions* (March 31, 1992). The Securities Industry Association is one of the predecessors of SIFMA.

[30] *See*, *e.g.,* Section of Taxation, American Bar Association, *Report of the Committee on Financial Transactions on the Proposed Cross-Border Securities Lending Regulations* (April 1, 1992); NYSBA 1992 Report, *supra* note 27; M. Barnes & P. Spector, *Cross-Border Securities Lending Payments: Income in Search of a Character*, 21 Tax Mgmt. Int"l . J. 295, 305-306 (No. 6, 1992); L. Swartz, *ABCs of Cross-Border Derivatives,* 27 THE CORPORATE TAX PRACTICE SERIES ch. 408 (PLI 2010, ed. L. Freeman); M. Gaffney, *Cross-Border Securities Lending & Qualified Securities Lender Regime*, Tax Notes 603, 621-22 (Aug. 8, 2011).

[31] Private Letter Ruling 8822061; United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, at page 62 (discussing the scope of the Other Income article of the model treaty).

[32] *See* Rev. Proc. 91-6, 1991-1 C.B. 413, section 4.01(20) (listing as an area in which ruling letters ordinarily will not be issued: "Section 1058. — Transfers of Securities under Certain Agreements. — Whether the amount of

process to obtain clarification on the sourcing question. Because the existing authorities implicitly presume that borrow fees paid by a U.S. person to a foreign person are U.S. source FDAP, we understand that some U.S. payors of borrow fees to a foreign person that lends U.S. equities and is not eligible for appropriate treaty benefits withhold tax on those fees, as a matter of prudence in light of the liability borne by withholding agents. As described in Part I, above, however, such fees are rarely paid. Accordingly, we discuss principally the source of income for negative repo rate payments and negative rebate (generically, negative rebate).

As described in Part I, it is only very recently that Treasury and agency repo buyers have started to pay negative rebate. (Repo participants do not pay borrow fees.) Negative rebate has a longer history in the securities loan market. We do not know of any authority or commentary addressing negative rebate payments.

1. General Observations on Sourcing Negative Rebate.

When the source of an item of income is not specified by statute or regulations, the courts have determined the source of the item by comparison and analogy to classes of income for which the source of income is specified by the Internal Revenue Code.[33] The Service has applied the same approach in ruling on the source of items of income not addressed in the Code or regulations.[34] Under this doctrine, the goal is to find the "source of income in terms of the business activities generating the income or … the place where the income was produced."[35] To state this differently, there is no "default" rule under which payments from a U.S. person to a foreign person are presumed to be U.S. source unless a different treatment is established.[36] Rather, the issue is how best to describe the place and type of activities that give rise to the payment.

We believe that this approach is grounded in sound tax policy, because like things should be subject to similar tax rules. Any guidance on borrow fees and negative rebate therefore should be guided by the question of what the right analogy is for negative rebate. Possible analogies, most of which have been discussed by commentators include (i) rules that would source the income generally by reference to the residence of the recipient, such as qualified fails charges, notional principal contracts, purchase price adjustments, and services, (ii) rules that would source the income by reference to the residence of the payor, such as interest, and (iii) rules that would source the income by reference to the issuer of the underlying

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any payment described in section 1058(b)(2) or the amount of any other payment made in connection with a transfer of securities described in section 1058 is from sources within or without the United States; the character of such amounts; and whether the amounts constitute a particular kind of income for purposes of any United States income tax treaty.") Identical language appears in the most recent version of this Revenue Procedure.

33 *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982) , is the leading case. The Tax Court recently has reaffirmed and applied this doctrine in *Container Corp.*, 134 T.C. 122 (2010).

34 *See* Rev. Rul. 2009-14, 2009-21 I.R.B. 1031, 1034 (citing *Bank of America* and other cases); Rev. Rul. 2004-75, 2004-2 C.B. 109 (same); *see also* Notice 2004-52, 2004-2 C.B. 168 (acknowledging role of analogies in determining sourcing of income from credit default swaps).

35 *Lamar Hunt*, 90 T.C. 1289, 1301 (1988).

36 *Container Corp.*, *supra* note 33, 134 T.C. at 140.

security, such as the "transparency" rules that apply to substitute dividends and interest. Another frequently mentioned analogy is the rules for the use of property, i.e., rent. We briefly discuss each of these possible analogies below.

In evaluating the possible alternatives, we urge that Treasury and the Service keep in mind that Congress has already expressed its views about both the utility of promoting securities lending and the types of payments that should be subject to withholding tax when paid to a non-U.S. person not eligible for a favorable treaty. Section 1058 and its companion provision section 512(a)(5) were enacted because Congress recognized the value of encouraging holders of securities to lend them out, thereby expanding the supply of such securities available to prevent fails-to-deliver or to facilitate short sales, and consequently wished to remove tax impediments to such transactions.[37] As both the courts and the government have recognized, nothing has changed this long-standing statutory policy.[38] Section 871(m) addresses a specific type of payment – dividend equivalents – that gave rise to concerns about abuse. We think it is significant that the very close scrutiny that Congress gave to cross-border securities loans in that context did not give rise to any articulated concerns about other types of payments made pursuant to securities loans or repos. Thus, we do not see a reason to depart from the general agreement expressed by commentators for decades that residence-based sourcing is the most appropriate rule for borrow fees, and therefore for negative rebate.

2. Residence-of-Recipient Sourcing Rules.

Fails charges

Treasury regulation section 1.863-10 provides that the source of income for a "qualified fails charge" is the residence of the recipient as determined under section 988(a)(3)(B)(i). A qualified fails charge is generally defined as a payment that compensates a party to a transaction calling for the delivery of Treasury or agency securities in exchange for cash if the security is not delivered, and that is provided for under a trading practice approved by the government or the Treasury Market Practices Group. Fails charges of this kind may be paid in connection with repos, securities loans or simple purchases of Treasury and agency securities.

In the case of negative repo rate payments on Treasury and agency repos (or securities loans of those securities), the argument that the best analogy for sourcing those payments is the treatment of fails charges is overwhelming. As described in Part I above, a negative repo rate on those transactions is integrally related to, and effectively acts as a substitute

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37 S. Rep. No. 762, 95th Cong. 2d Sess. 1291 ("It is generally thought to be desirable to encourage organizations and individuals with securities holdings to make the securities available for such loans since the greater the volume of securities available for such loans the less frequently will brokers fail to deliver a security to a purchaser within the time required by the relevant market rules.") (April 25, 1978).

38 *See* Rev. Proc. 2008-63, 2008-42 I.R.B. 946 (recognizing Congressional intent in adding section 1058 to encourage securities holders to lend their securities); *Samueli v. Commissioner*, 661 F.3d 399, 412 (9th Cir. 2011) ("Congress' explicit goal in enacting §1058 was to encourage loans for the benefit of brokers who needed large supplies of securities on hand to deliver to purchasers, because such loans 'can have a favorable impact on the liquidity of the securities markets,'" quoting the 1978 Senate Report.).

for, a fails charge payment. We believe that any court applying the *Bank of America* principles would conclude that the same sourcing rule would apply.

Moreover, there are compelling practical reasons for applying the same sourcing rules to qualified fails charges and to negative rebate on Treasury and agency repos and securities loans. It would be both irrational and undesirable for economically comparable payments to be subject to different withholding tax regimes. In this case, imposing withholding tax on negative rebate but not on qualified fails charges could reduce the supply of non-U.S. parties willing to participate in the Treasuries market or provide a tax reason for market participants to fail to deliver Treasuries and agencies, either of which would undermine the beneficial effect that the fails charge was intended to have on the smooth operation of the Treasuries market.[39] We urge that guidance confirming that negative rebate on Treasury and agency repos and securities loans is subject to the same source rules as qualified fails charges be issued promptly.

Negative repo rates on other repos, and negative rebate on securities loans on other securities, perform the same function as negative repo rates on Treasury and agency repos. Treating payments that have the same economic function as having the same source is sound tax policy. Moreover, existing tax rules sourcing payments under securities loans and repos generally apply in the same way for all such transactions, and without regard to whether the underlying securities are debt or equity.[40] Similarly, the sourcing theories described below generally do not distinguish between transactions involving debt securities and equity securities. Accordingly, we believe that it is appropriate to apply residence-based sourcing rules for these payments as well.

Notional principal contracts

In 1986 section 988 was adopted, providing among other matters that exchange gain or loss on payments on derivative financial instruments linked to foreign currency or foreign currency-denominated debt instruments generally should be sourced by reference to the residence of the recipient. In 1989, the predecessor of current Treasury regulation section 1.863-

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[39] To take a simple hypothetical, assume the purchaser of Treasuries in a repo can either (i) pay negative rebate of 2.5% to a non-U.S. hedge fund or other person generally subject to 30% U.S. withholding tax in order to borrow the Treasuries to make delivery of them to the seller in the repo, or (ii) choose not to borrow those securities, fail to make redelivery to the repo seller and pay a 3% fails charge to the seller. If the negative rebate is subject to 30% withholding, and the hedge fund will lend its Treasuries only if it receives 2.5% in cash, then a rational hedge fund would either refuse to lend its Treasuries or would increase the rebate rate that it quotes to U.S. counterparties to about 3.6%, which effectively means that the purchaser must gross up for the withholding tax. Under those facts, the purchaser will either have to find another, presumably more expensive, source for the Treasuries or choose to fail to deliver the Treasuries and suffer the 3% fails charge, since the fails charge is not subject to U.S. withholding tax.

More realistically, the problem is one of cascading. There is often a long chain of parties selling or lending Treasuries to each other. If a withholding tax is imposed on one or more legs of that chain, the economics of the transaction will be disrupted, with potential consequences for everyone else in the chain.

[40] Treasury regulation section 1.861-2(a)(7) (substitute interest sourced like interest); Treasury regulation section 1.861-3(a)(6) (substitute dividend sourced like dividend). Section 871(m) is consistent with this paradigm.

7 was adopted, providing the same sourcing rules for payments on notional principal contracts ("NPCs"). These rules are the most recently adopted comprehensive set of sourcing rules for financial instruments. They generally have stood the test of time well, serving the dual function of eliminating withholding tax on NPC payments (other than those recharacterized as interest) made to non-U.S. persons and treating those payments when received by U.S. persons as U.S. source income.

We believe the same considerations should apply today to payments on securities loans and repos, other than substitute dividend and interest payments. We note that the government has recently proposed to expand the NPC rules to credit default swaps, including ones that provide for the delivery of securities, to contracts on a broader range of indices and to single-payment contracts historically treated by taxpayers as forward contracts.[41] This proposal demonstrates a recognition of the NPC rules as both functional and good tax policy.

The enactment of section 871(m) supports the analogy between securities loans and NPCs insofar as the sourcing of payments is concerned, particularly with respect to transactions involving U.S. equities. Section 871(m) applies the same sourcing rules to "dividend equivalents" paid under a securities loan or repo and under a specified notional principal contract. A Senate committee carried out extensive scrutiny of cross-border securities loans in order to identify the types of transactions that were of concern to Congress as a policy matter, and its findings were the basis for the enactment of section 871(m).[42] Congress identified a single type of payment – dividend equivalents – that gives rise to withholding tax concerns under both securities loans and notional principal contracts, implying that other types of payments under those transactions do not give rise to withholding tax concerns and are appropriately subject to similar residence-based sourcing rules.

Purchase price adjustments

Section 1058 treats a securities loan as an exchange of securities for the borrower's obligation under the agreement, followed by an exchange of the obligation for identical securities. The Supreme Court similarly has held, in the seminal U.S. federal tax case on securities loans, that a securities loan involves the "sale or a complete transfer of all the legal elements of ownership" from the lender to the borrower, in exchange for the borrower's contractual obligations under the loan agreement.[43] A negative rebate payment is one of the borrower's contractual obligations under a securities loan agreement. Indeed, in a repo – which as a legal matter is a sale and a repurchase of securities – a negative repo rate payment is

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[41] Proposed Treasury regulation sections 1.446-3(c)(1)(ii) (single-payment contracts treated as NPCs), 1.446-3(c)(1)(iii) (credit default swap that permits or requires delivery of debt instruments can qualify as an NPC), and 1.446-3(c)(2)(ii) (provisions relating to non-financial indices for NPCs).

[42] *See Dividend Tax Abuse,* Hearing before the Permanent Subcommittee on Investigations, 110th Cong. 2d. Sess. (Sept. 11, 2008, S. Hrg. 778), available at http://www.hsgac.senate.gov/subcommittees/investigations/reports.

[43] *See Provost v. United States*, 269 U.S. 443, 453 (1926); *see also* Private Letter Ruling 9041011 (securities loan treated as sale of securities for purposes of section 864 "trading in securities" rules).

documented as a price adjustment. Consequently, another possible basis for sourcing rebate payments that do not constitute interest for tax purposes is as a purchase price adjustment.

Income from the sale of securities generally is sourced under section 865 according to the residence of the seller.[44] For this purpose, the sourcing rules of section 865 broadly define "sale" to include "an exchange or any other disposition."[45]

Services

Section 1058 and its companion provision section 512(a)(5) were enacted in part because Congress recognized the value of encouraging holders of securities to lend them out, thereby increasing the liquidity of the securities markets.[46] Courts and the Service have recognized in a number of different settings that making liquidity available to the market is a service, including originating loans,[47] providing a deep secondary market for mortgage loans,[48] and making advances on credit cards.[49]

Since every securities loan requires the participation of both a securities lender and a securities borrower, and the essential nature of the transaction is that the lender makes its property (securities) available for borrowing in a manner comparable to how the taxpayers referred to above made their property (cash) available for borrowing, a possible basis for sourcing negative rebate is by treating it as a fee for services provided by the securities lender. Compensation for services is sourced by reference to the location where the services are provided.[50] Consequently, under this analogy, negative rebate generally would be sourced by reference to the location of the lender.

We note that complications could arise if a rule based on a services analogy took into account the location of the personnel acting on behalf of the lender who actually negotiate a securities loan. While a rule of that kind might be a more principled rule, it would make the source of a negative rebate payment highly fact-dependent and therefore difficult for withholding agents and other market participants, and for the Service, to determine. For example, uncertainty could arise if personnel from multiple jurisdictions were involved in the transaction, or if a principal in one jurisdiction authorized an agent in another jurisdiction to lend out securities on

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44 *See* Section 865(a).

45 *See* Section 865(i)(2).

46 *See* note 37, *supra.*

47 *See Burbank Liquidating Corp.*, 39 T.C. 999 (1963), *acq. sub nom. United Assocs., Inc.*, 1965-1 C.B. 3, *aff'd in part and rev'd in part on other grounds*, 335 F.2d 125 (9th Cir. 1964) (savings and loan association originating mortgages); Rev. Rul. 72-238, 1972-1 C.B. 65 (bank originating loans partially secured by mortgage); Rev. Rul. 80-56, 1980-1 C.B. 154 (REIT originating loans); Rev. Rul. 80-57, 1980-1 C.B. 157 (REIT originating loan).

48 *Federal National Mortgage Association*, 100 T.C. 541 (1993) (government-sponsored enterprise providing secondary market for mortgages)

49 *Capital One Financial Corp.*, 133 T.C. 136 , 200 (2009) ("In lending its cardholders funds, Capital One provided a service …").

50 Section 861(a)(3); section 862(a)(3).

the principal's behalf. Accordingly, if a services-based approach were adopted, it would be important for there to be a presumption that the place where the lender is organized is the place where its services are provided. The presumption could provide special rules for branches and other qualified business units.

3. Residence-of-Payor Sourcing Rules.

Negative rebate paid by a U.S. person to a foreign person would be treated as U.S. source income if the source was determined by reference to the rules for interest. Negative rebate could also be treated as U.S. source under the rules relating to the source of payments for the use of property. The latter raises a number of issues that would require additional guidance and that are not present in the other possible analogies described herein, and therefore is discussed further in Section II.B.5, below.[51]

We think an analogy to interest is inappropriate. Interest is compensation for the use of money. The Supreme Court has held that the borrowing of a security involves the use of property, not money, and does not give rise to indebtedness.[52] That doctrine has been broadly and consistently applied by case law and rulings over a long period of time.[53] It would stand matters on their head for the party that *advances* cash (the securities borrower in the securities loan, or the repo buyer) to be treated as paying an interest-like amount for that privilege. Moreover, negative rebate is not determined primarily by reference to the time value of money.

We are also concerned that a payor-based sourcing rule for rebate payments would encourage market participants to structure their activities to conduct securities lending and repo activities outside the United States, where commercially feasible. A shift in the market of this kind would give rise to a competitive disadvantage for U.S. financial institutions as compared to non-U.S. financial institutions, as a result of the relative participation of each type of institution in the U.S. and non-U.S. markets. A payor-based sourcing rule also would not provide the much-needed certainty that withholding agents require, to the extent that the conduit rules or conduit principles might override treaty relief that is otherwise available. It would also increase compliance and oversight burdens on the Service. For these reasons, if a payor-based sourcing rule for rebate payments is envisaged, we request the opportunity to discuss these issues further.

4. Transparency Sourcing Rule.

The source of substitute dividends and interest paid in cross-border securities loans and repos is determined by reference to the source of the actual dividend or interest to which they relate, under regulations and under section 871(m) where applicable. We understand that some practitioners have suggested that because substitute dividends and borrow fees, where

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51 As described above, there is no default rule that would treat a payment as U.S. source simply because it is paid by a U.S. person.

52 *Deputy vs. Dupont*. 308 U.S. 488 (1940).

53 Rev. Rul. 95-8, 1995-1 C.B. 107; Rev. Rul. 95-26, 1995-1 C.B. 131; Rev. Rul. 95-45, 1995-1 C.B. 53.

applicable, are both required by securities lenders as a condition of the securities loan the latter should be subject to the same sourcing rule.

However, substitute payments have a different function and are economically distinct from borrow fees or negative rebate. Substitute payments keep a lender whole for dividends and coupons paid during the period when it is not holding the loaned security. There are many ordinary course transactions that are treated for tax purposes as borrowings of securities where the securities borrower does not pay a borrow fee or negative rebate, notably when a broker rehypothecates securities held in a customer's margin account. By contrast, the borrower will always make substitute payments. Accordingly, we do not think the arguments in favor of this approach are entirely sound.

Moreover, a transparency sourcing rule would result in the imposition of U.S. withholding tax on rebate payments made between non-U.S. borrowers and lenders of U.S. securities, for example a loan by a non-U.S. pension plan of U.S. securities to a non-U.S. derivatives dealer to provide a hedge for an ordinary course transaction by that dealer with non-U.S. customers. The assertion of extraterritorial U.S. taxing jurisdiction over such payments would raise significant practical and legal issues, as evidenced by the deep and broad objections by foreign governments and other parties to the potential imposition of U.S. withholding tax on foreign passthru payments in the FATCA context. Unlike FATCA and section 871(m), however, in this case the imposition of U.S. withholding tax on foreign-to-foreign transactions would not be grounded in a recent express determination by Congress that such withholding tax is appropriate.

5. Use of Property (Rent) Sourcing Rule.

Long-standing proposed regulations under section 1058 provide that substitute dividends and interest "shall be treated by the lender as a fee for the temporary use of property."[54] Whether that characterization is appropriate for either substitute payments or borrow fees and negative rebate is open to some question. On the one hand, the securities lender retains economic exposure to the loaned security and will get equivalent securities back, which comports with the temporary use of the security by the borrower. On the other hand, the securities lender surrenders legal and tax ownership of the security while it is the subject of a securities loan, which is not the case for typical rentals of property. Rental income from "property located in the United States," or, under regulations, from the "use of property" within the United States, is treated as U.S. source income.[55]

The 1988 private letter ruling referred to above, which is the only source of guidance that specifically addresses borrow fees in the cross-border context, does not characterize borrow fees earned by a foreign life insurance company from lending portfolio securities to a U.S. broker as compensation for the use of property. Rather, the ruling characterizes the borrow fees as investment income earned in the active conduct of a life

54 Proposed Treasury regulation section 1.1058-1(d).
55 Section 861(a)(4); Treasury regulation section 1.861-5.

insurance business. Consistent with that approach, the technical explanation to the 2006 Model Tax Convention, and treaties entered into after the release of the 2006 model, treat securities lending fees derived by an institutional investor as income from financial transactions, in the same category as income earned by non-dealers from transactions in notional principal contracts and other derivatives.[56] Thus, in the cross-border context borrow fees have not historically been treated by the government as compensation for the use of property.

The tax rules relating to payments for the use of property typically have been fleshed out as applied to real property, tangible personal property, or intangible personal property that constitutes intellectual property or similar property. It would be necessary to have very clear guidance if the same approach is extended to other intangible assets that do not have a physical location in the conventional sense, or to put it differently could be viewed as having a connection with more than one person or place at the same time.

Consequently, if guidance were to take the position that borrow fees and negative rebate constitute income from "property located in the United States," it would be necessary to specify how one determines where fungible securities are "located" or "used" for this purpose, and how to resolve any circumstances where they might be viewed as located in one country but used in another. By way of some examples, securities conceivably could be treated as located or used where the clearing organization that holds the actual physical security issued by the issuer, if any, is based;[57] or where custodians are located that hold the securities (generally in the same location as the principal trading market for the securities);[58] or where brokers or banks that borrow the security are located;[59] or where the customer for whom a broker borrows the security is located, as the true "user" of the property.[60]

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56 2006 Technical Explanation, Article 21, and the corresponding discussion in the technical explanations of the U.S. income tax treaties with Malta, Hungary, the United Kingdom, France, and Iceland. Similarly, Rev. Rul. 78-88, 1978-1 C.B. 163, describes borrow fees earned by a tax-exempt entity as investment income, not rental income.

57 Typically, securities of a U.S. corporate issuer will ultimately be held by the Depositary Trust Company ("DTC"), and securities of a non-U.S. issuer will be held by Euroclear or Clearstream. (Treasuries and some agencies are ultimately held by the Federal Reserve Bank of New York in its Fedwire system.) This statement is a considerable simplification, however, as securities that are issued both inside and outside the United States frequently are held through multiple tiers of clearing organizations, and debt securities of a U.S. issuer that are issued solely outside the United States may be held solely through a non-U.S. clearing organization. For example, yen-denominated securities issued by a U.S. corporate issuer solely in Japan will be held through the Japanese clearing organization, the JASDAQ Securities Exchange, not through DTC. *See* Notice 2006-99, 2006-2 C.B. 907.

58 When securities owned by taxpayer A are borrowed by taxpayer B and then delivered to taxpayer C, they may be simply transferred from A's custodian to B's custodian to C's custodian, all of whom operate in the same country.

Under a rule of this kind, it would be necessary to specify how to deal with American Depositary Receipts, which are receipts issued by a U.S. depositary holding stock of a non-U.S. issuer so that the stock can trade more easily in the United States, and Global Depositary Receipts, which are similar arrangements outside the United States under which non-U.S. depositaries may hold stock of U.S. issuers.

59 It would be necessary under such a rule to address transactions in which broker A borrows a security from a customer and lends the security to broker B, who may sell it, on-lend it, or deliver it to prevent or close out a fail, if brokers A and B are in different countries. It would also be necessary to make clear how the rule would apply if

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While all of these theories would give rise to the same answer in the case of the borrowing of U.S. equities by a U.S. borrower from a foreign lender for the benefit of a U.S. customer, they could give rise to different answers if one or more of the facts changed, for example if the securities borrowed were ADRs. Depending on the details of such a rule, it could encourage market participants to restructure transactions so that a security is treated as located or used outside the United States; could give rise to cascading withholding tax; and, where treaties are involved, could give rise to possible questions about conduit transactions. We do not suggest that these issues cannot be resolved, but we believe that a rule of this kind would require more detailed fleshing out than may be apparent at first instance. If the government were to adopt this approach we request the opportunity to discuss those details with you.

In any event, we hope that this discussion makes clear that it would be very difficult under current law to be sure how a rule of this kind should apply to securities that typically exist only or primarily in book-entry form, with interests therein held by multiple intermediaries. These complexities of modern securities transactions argue strongly against applying any such rule retroactively.

In summary, we believe that the theoretical and practical arguments for treating negative rebate on repos and securities loans of Treasury and agency securities as subject to the same sourcing rules as qualified fails charges are compelling. The litany of arguments set forth above also demonstrates the current uncertain state of the law and makes a persuasive argument that any rule that imposes withholding tax on borrow fees or negative rebate paid by a U.S. person to a foreign person should be prospective only. Finally, we believe that the facts set forth in Part I demonstrate that the current operation of the securities lending and repo markets is driven by business considerations rather than tax considerations, and that both the Congressional policy of promoting securities loans and the desirability of tax rules that are consistent with those that apply to other financial products and transactions favor a residence-of-the-recipient sourcing rule on a going-forward basis for all borrow fees and negative rebate on cross-border securities loans and repos.

B. Positive Rebate

If, notwithstanding our recommendations above, guidance were to be issued that imposed U.S. withholding tax on payments of borrow fees by U.S. persons to foreign persons, we believe that any such rule should apply only to separately stated borrow fees and to the actual amount of negative rebate paid. In particular, if a securities lender pays positive rebate to a

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personnel from multiple jurisdictions are involved, for example if personnel of a foreign bank sitting in London arrange for the bank's U.S. branch to borrow securities held by a U.K. customer of the bank.

[60] In practice, it will frequently be impossible to match a particular borrowing of securities by a broker to a particular transaction in which the securities are used, because a stock loan desk generally operates as a "black box" that borrows and lends securities based on the net demand or supply for any particular security. Moreover, if broker C borrows in order to execute a short sale on behalf of customer D, the security will then be located in the hands of, or used by, some third party who purchases the security.

The articles and reports cited in note 30, *supra*, also comment on the uncertainties and complexities of a sourcing rule based on the location or use of securities.

securities borrower, that payment should be treated as a payment of portfolio interest at the stated rate, and not as a payment by the securities lender of a grossed-up payment of interest and a payment by the securities borrower of a notional borrow fee. (Similarly, if a securities borrower pays negative rebate to a securities lender, that payment should be treated as a single payment and not as the composite of an interest payment by the securities lender and a borrow fee paid by the securities borrower.) As described below, we believe that treating positive rebate as a (single) payment of interest is the law today.

The courts have repeatedly characterized positive rebate paid on cash collateral provided pursuant to a securities loan as a payment of interest, starting with the Supreme Court in *Provost*. These authorities also have recognized that the rate of interest may vary as a matter of negotiation, and may be zero.[61] Most recently, the Ninth Circuit in *Samueli*, while concluding that it did not need to reach the characterization of positive rebate, described it as economically comparable to interest on a margin loan and payable as a result of the fact that a broker/securities borrower did "forbear from the use of money" in connection with the *Samueli* transaction.[62]

More generally, the courts have regularly held that amounts that are treated by taxpayers as a single (net) amount as an economic and business matter should be treated as such for U.S. federal income tax purposes.[63] As described in Part I, rebate payable in connection with a loan of U.S. securities is typically negotiated as a positive or negative spread off the Fed Funds rate, and is reflected as such in the legal documentation exchanged by the parties. That is true regardless of whether a securities lender (or borrower) is a U.S. or foreign person, and regardless

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61 *Provost v. United States,* 269 U.S. 443, 452 (1926) ("the rate of interest [on securities lending cash collateral] is a matter of negotiation or agreement, and the deposit may, on occasion, carry no interest, or the borrower of the stock may pay a premium [that is, negative rebate] when the stock is greatly in demand."); *Commissioner v. Wilson*, 163 F.2d 680 (9th Cir. 1947), *cert. denied* 332 U.S. 842 (1947) (a short seller who borrows shares "maintains a deposit equal to the value of such shares with the [securities] lender, usually receiving interest on the deposit."); *Commissioner v. Wiesler*, 161 F.2d 997, 998 (6th Cir.), *cert. denied* 332 U.S. 842 (1947) (a short seller who borrows shares "may or may not receive interest on the deposit [of cash collateral], depending on the agreement.")

62 *Samueli v. Commissioner*, 661 F.3d 399, 416 (9th Cir. 2011). While the court found that the *Samueli* transaction was atypical, the payment of amounts characterized as "rebate" or "fees" on cash collateral in connection with a securities loan is not.

63 *See, e.g., Gulf Oil Corporation*, 87 T.C. 548 (1986) (taxpayer that netted intercompany payables and receivables required to treat those amounts as net rather than gross amounts for section 956 purposes); *William J. Cutts,* T.C. Summary Opinion 2004-8 (taxpayer that had open accounts payable and receivable with his controlled corporation permitted to net them, in case of first impression under section 7872). By way of comparison, the rate of interest paid on amounts in a bank checking account ordinarily is substantially below the rate that the depositor would receive if the funds were held in a money market account. The lower rate for the checking account reflects at least in part the fact that the bank provides services in connection with the checking account, like processing checks, that were not historically associated with money market accounts. The depositor is not, however, treated for tax purposes as receiving interest at the money market rate and then paying fees to the bank for services received.

The general question of when U.S. federal income tax law separates, or "bifurcates," property interests into multiple components is complex. For an extensive discussion of the law, *see* J. Peaslee & D. Nirenberg, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS AND RELATED TOPICS, ch. 16 (2011); *see also* Technical Advice Memorandum 9836003 (discussing case law under which the courts rejected IRS attempts to decompose a lending transaction into multiple components).

of whether the party is subject to or exempt from U.S. tax under domestic law or under a treaty. The fact that borrow fees may be separately stated in connection with loans of non-U.S. securities does not change the facts regarding U.S. market practice for U.S. securities transactions. In the repo market, moreover, borrow fees are not paid for repos "on special" and to the best of our knowledge never have been paid. We believe these facts demonstrate that the treatment of positive rebate as a single payment of interest – and zero rebate as a zero payment when brokers rehypothecate customer securities from a margin account – is not motivated by tax avoidance. We also note that market practice has long been to treat positive rebate as interest, and that commentators view that characterization as noncontroversial.[64] Under the common law, therefore, we do not think there is a basis to recharacterize the substance of positive rebate paid in connection with a securities loan or a repo "on special."

We recognize that there is regulatory authority under section 7872(c)(1)(E), relating to "other" below-market loans, to treat the party that receives cash collateral and pays positive rebate (that is, the securities lender or repo seller) as paying to the other party an amount equal to "foregone interest," determined by reference to the applicable federal rate, and to treat the second party as paying an offsetting hypothetical amount to the first party.[65] If this regulatory authority were exercised in connection with securities loans, the offsetting hypothetical amount presumably would be treated as a borrow fee. We think that there is not only no need to exercise this authority, for the reasons described above, but that doing so would create enormous confusion and disruption in the market. If applied consistently, it would also potentially give rise to transactions in which a U.S. person making an actual positive rebate or positive interest payment to a foreign person would be treated for tax purposes as receiving a foreign source borrow fee.

Confusion would result both from the fact that the AFR is a different base from the actual rate that the market prices off of (Fed Funds) and that section 7872 would apply only to some transactions and not to others, depending on the rebate rate payable. More broadly, confusion would arise from the fact that the distinction between a securities loan and other transactions, and between variations on those other transactions, is not clear. The distinction between securities loans and repos is often not clear, because they both involve transfers of cash against securities. The distinction between repos and secured loans also is not clear, as no

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64 *See, e.g.,* NYSBA 1992 Report, *supra* note 27, at 15 ("Rebate fees are generally viewed as interest for tax purposes, since they compensate the Borrower for the Lender's use of the Borrower's cash collateral during the securities loan period and, therefore, fall within the traditional definition of interest."); M. Barnes & P. Spector, *supra* note 30, at 303 ("… the [positive rebate] is properly characterized as a payment for the use or forbearance of money, and, accordingly, as interest for U.S. federal income tax purposes"); L. Swartz, *supra* note 30, at 408-28 ("The IRS has historically viewed rebate fees paid by U.S. lenders to foreign borrowers from earnings on collateral as U.S. source interest income.")

65 The "foregone interest" calculation would apply under section 7872(a), if the loan were considered a demand loan. A somewhat different calculation would apply under section 7872(b), if the loan were other than a demand loan.

authority specifically addresses repo transactions in which the repo buyer can and does retransfer the securities.[66] Would section 7872 regulations apply to all secured loans? to unsecured loans?

The fact is that many lending transactions have some element associated with them that is not purely a time value of money return and that is taken into account in setting the rate of interest on the transaction rather than being paid for through a separately stated fee. Bank deposits, mortgages and student loans are common examples of such transactions. As those transactions demonstrate, the tax law historically respects the commercial decision whether or not to "unbundle" fees from the rate of interest. We believe that the same rule is appropriate for securities loans and repos.

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66 Private Letter Ruling 200207003 is the only guidance we are aware of addressing such transactions. It treats them as secured loans of cash, like other repos.

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SIFMA appreciates the opportunity to comment on the sourcing of borrow fees and negative rebate payments. We have endeavored to provide information about the securities lending and repo markets as well as to lay out potentially relevant legal analyses and their strengths and weaknesses to inform your decision-making process. As critical participants in the securities lending and repo markets, as well as withholding agents who have been faced with these issues for many years, we think we can offer both unique insights and practical advice in connection with these transactions. Please let us know if we can further assist your consideration of these issues in any way.

Sincerely,

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