REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON CERTAIN ASPECTS OF THE TAXATION OF SECURITIES LOANS AND THE OPERATION OF SECTION 1058

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Report No. 1239

REPORT OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON CERTAIN ASPECTS OF THE TAXATION OF SECURITIES LOANS AND THE OPERATION OF SECTION 1058

I. INTRODUCTION

This report of the Tax Section of the New York State Bar Association[1] comments on various issues arising under section 1058 of the Internal Revenue Code of 1986, as amended (the "Code"),[2] which provides nonrecognition treatment for securities loans that meet certain requirements. The impetus for this report is a series of relatively recent Tax Court decisions ─ *Samueli,*[3] *Anschutz*[4] and *Calloway*[5] ─ that interpret section 1058 in the context of three fact patterns, each involving a securities loan as a component of a larger, more complicated transaction, and each raising its own specific set of tax policy concerns. Although it is not the purpose of this report to comment on the overall results reached in those decisions, the decisions nonetheless have raised questions among tax practitioners as to how the cases should be interpreted and applied in the broader context of more commonplace, ordinary-course market activity. The cases raise issues regarding the degree to which securities loans should be integrated for purposes of section 1058 with other transactions that a securities lender might enter into. In addition, the cases hold that securities loans with fixed terms are *per se* taxable transactions, a holding that allowed the Tax Court to reach a specific result when faced with certain specific sets of facts, but that we believe as a general matter interprets section 1058 more narrowly than is necessary or desirable to advance the statute's policies.

In addition to the issues raised by the Tax Court cases, there is also a more general need for guidance under section 1058. Specifically, since section 1058 was enacted in 1973, the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") have issued only two items of meaningful guidance interpreting section 1058. First, in 1983, Treasury and the IRS issued proposed regulations under section 1058 that remain in proposed form and have never been updated to reflect the numerous changes in market practice and tax law since that time. Second, Treasury and the IRS issued Revenue Procedure 2008-63[6] in 2008 in response to a specific urgent problem that arose in connection with the recent financial crisis. The revenue procedure provides conditions under which the default of a securities borrower on a

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[1] The principal author of this report is William L. McRae. Helpful comments were provided by Diana Wollman, David Miller, Willard Taylor, Michael Farber, Michael Schler, Yaron Reich, David Hariton, Kim Blanchard, Erika Nijenhuis, Larry Salva, Gordon Warnke, David Mattingly, Mary Harmon, David Schnabel, David Sicular, Douglas Borisky, Eric Sloan, L. Howard Adams, and Shlomo Boehm. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] Unless indicated otherwise, all section references in this report are either to the Code or to Treasury regulations promulgated thereunder.

[3] 132 T.C. No.4 (March 16, 2009).

[4] 135 T.C. No. 5 (July 22, 2010).

[5] 135 T.C. No. 3 (July 18, 2010).

[6] 2008-42 I.R.B. 942.

securities loan will not give rise to a deemed taxable disposition for the lender. Prior to the decisions in *Samueli*, *Anschutz* and *Calloway*, this paucity of guidance under section 1058 was a matter of relatively minor concern, because ─ putting aside certain questions at the margin, discussed in more detail below ─ most practitioners believed they understood the basic workings of section 1058 and the general principle that ordinary-course securities loans were not intended to be taxable events. However, in light of the recent Tax Court cases and the questions they raise, the Tax Section believes that now it would be appropriate for Treasury and the IRS to provide guidance under section 1058 ─ both for the purpose of allowing tax practitioners and taxpayers to understand better how Treasury and the IRS view the potential scope of the Tax Court cases, and to address other more general points of uncertainty.

Part II of this report provides an executive summary of our recommendations regarding section 1058 and the tax treatment of securities loans. Part III then provides a general overview of the policies underlying section 1058, as well as some background to the statute's enactment. Part IV then describes the facts and holdings of *Samueli, Anschutz* and *Calloway*, as well as the issues raised by those cases and our recommendations for addressing those issues. Part V then discusses several other aspects of section 1058 where either clarification might be useful or where the rules adopted in the proposed regulations might usefully be updated to reflect changes in market practice since their original issuance in 1983.

II. EXECUTIVE SUMMARY

- We recommend that Treasury and the IRS issue guidance clarifying that they do not interpret *Samueli, Anschutz* and *Calloway* as having broad application for market-standard, ordinary-course transactions.

  - We recommend that Treasury and the IRS issue guidance (primarily in response to *Anschutz*) to the effect that a securities loan meets the requirement of section 1058(b)(3) (the requirement that the loan not reduce the lender's opportunity for gain or risk of loss with respect to the loaned security) if the lender in fact retakes full possession of the securities at the end of the loan and enjoys a full right of disposition with respect to the loaned securities at the end of the loan. This recommendation is intended to address what may have been the primary concern underlying the court's decision in *Anschutz* while still allowing taxpayers to enter into ordinary-course hedges and offsetting positions in respect of loaned securities without losing the protection of section1058.

  - We also believe that it would be appropriate to provide a safe harbor under section 1058 for securities loans with a fixed term of no more than some maximum period (*e.g.,* three months).

- We recommend that Treasury and the IRS issue guidance to the effect that section 1058 is intended as a safe harbor for purposes of achieving nonrecognition treatment for securities loans, and does not negate the positions taken by the IRS prior to the enactment of section 1058 (*i.e.,* that stock loans could qualify for nonrecognition treatment under section 1036 in appropriate cases, and that certain securities loans do not give rise to a recognition event under the general principles of section 1001).

- We recommend that Treasury and the IRS adopt a rule requiring securities lenders to include amount in income with respect to loaned securities that accrues over the term of the loan but that does not give rise to a cash payment before the loan's maturity (*e.g.,* accruals of original issue discount).

- To the degree that Treasury and the IRS decide to retain some form of the "five-day rule" for securities loans contained in proposed Treasury regulation section 1.1058-1(b)(3), we believe the rule should be modernized to take account of current settlement conventions.

- We recommend that Treasury and the IRS expand the definition of "securities" under section 1058 to include certain instruments that are publicly traded and capable of being lent and borrowed by broker/dealers, but that are "securities" within the meaning of section1236(c) (*i.e.,* are not "stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture or evidence of indebtedness, or any interest in or right to subscribe to or purchase any of the foregoing"). Although section 1058 references section 1236 specifically, we note that section1058 was enacted at a time when there were fewer publicly traded instruments than there are currently, and we believe that an expansion of nonrecognition treatment to loans of a broader category of instruments would both support the policy underlying section 1058, and could be achieved through the use of various avenues that the IRS used to reach a nonrecognition outcome for securities loans prior to the enactment of section1058.

- The proper tax characterization of "borrow fees" should be clarified, and the proposed regulations under section 1058 (which provide that substitute payments in respect of securities loans generally are treated as rental payments) should be updated to reflect the current treatment of substitute payments under the tax laws.

- Guidance should be provided to the effect that if a broker/dealer assigns its obligation to return securities under a securities loan to another broker/dealer, that assignment will not as a general matter give rise to a taxable event to the securities lender.

III. GENERAL BACKGROUND

This Part III provides a general overview of the background to section 1058 and of the taxation of securities loans prior to the statute's enactment. As an initial matter, the law has been clear since the Supreme Court's 1926 decision in *Provost v. United States*[7] that a securities loan constitutes a disposition of the loaned security for U.S. tax purposes — that is, constitutes an exchange of physical securities for the promise to receive back identical securities at a later date.[8] Realizing the importance of securities lending activity to the proper functioning

[7] 269 U.S. 443 (1926).

[8] The treatment of securities loans under *Provost* can be distinguished from the treatment of sale/repurchase transactions ("repo" transactions), in which a taxpayer sells securities to a counterparty subject to an agreement to repurchase those same securities at a later date for a predetermined price that is set by reference to the initial sale price increased by a time-value-of-money component. The law is well settled that, for U.S. federal income tax

(footnote continued)

of securities markets, however, the IRS early on adopted a policy of treating securities loans as nonrecognition transactions. In a private letter ruling dated April 19, 1948, and addressed to the New York Stock Exchange, the IRS considered a securities lending transaction and ruled:

> "that [the transaction] is not a disposition of property which results in recognized gain or loss for Federal income tax purposes; and that such a transaction does not affect the lender's basis for purposes of determining gain or loss upon the sale or the disposition of the stock, nor the holding period of the stock in the hands of the lender."[9]

Similarly, in Revenue Ruling 57-451,[10] the IRS ruled that a stock loan constitutes in substance an exchange of the loaned shares for the identical shares ultimately returned to lender to close out the loan, and as such qualifies as a nonrecognition transaction under section 1036. In addition, the IRS issued General Counsel Memorandum 36948 (December 10, 1976), which reconfirms the conclusion of the revenue ruling and offers an additional ground for according nonrecognition status to securities loans ─ *i.e.,* that the disposition of securities in a lending transaction does not constitute an exchange of property for other property "differing materially in either kind or extent" within the meaning of Treasury regulation section 1.1001-1(a).[11]

When the IRS began to waver in its application of this nonrecognition policy in the 1970s, Congress affirmed its commitment to the policy in 1978 through the enactment of section 1058. The legislative history of section 1058 described the situation as follows:

> "Under present law, uncertainty has developed as to the correct income tax treatment of certain securities lending transactions. As

(footnote continued)

purposes, repo transactions constitute money borrowings in which the purchase price paid initially for the security is an amount borrowed and the "sold" securities are viewed as collateral securing the loan. *See e.g., Nebraska v. Lowenstein*, 513 U.S. 123 (1994); *American National Bank of Austin v. United States*, 421 F. 2nd 442 (5th Cir. 1970); *First American National Bank of Nashville v. United States*, 467 F.2nd 1098 (6th Cir. 1972); Rev. Rul. 77-59, 1977-1 C.B. 196.

Traditionally repo transactions have been viewed as a means to finance securities positions (particularly positions in Treasury securities), while securities loans have been viewed as a means to gain access to securities (*e.g.,* to effect a short sale or otherwise deliver securities to a purchaser). Because of the strong economic similarity between repo transactions and securities loans, however, these functions in fact often overlap. A securities loan that is collateralized by cash, for example, can serve the function of a money borrowing for the securities lender. Similarly, if a party purchasing a security under a repo agreement has the ability to use the security over the term of the repo (a feature distinguishing some modern repos from the more classic repos addressed in the above-cited authorities), the repo can serve as a means of gaining temporary access to securities. In spite of this overlap, repos and securities loans generally are documented under different forms with different terminologies, and generally are subject to different regulatory and legal regimes.

[9] This quoted language is reprinted in the legislative history to section 1058. *See* Senate Finance Comm. Report, Internal Revenue Code of 1954—Nonmember Telephone Companies—Income, S. Rep. No. 762, 95th Cong. 2nd Sess. 3, at page 4, *reprinted in* 1978 U.S. Code Cong. & Admin. News 1286, 1289 (the "Senate Report").

[10] 1957-2 C.B. 295.

[11] Revenue Procedure 2008-63 also refers approvingly to the standard of exchanging securities for rights not differing materially either in kind or extent.

> a result, some owners of securities are reluctant to enter into such transactions. . .[12]
>
> "The [IRS] has not disputed the position that a securities lending transaction does not constitute a taxable disposition of the loaned securities, or that the transaction does not interrupt the lender's holding period. . . Recently, however, the [IRS] has declined to issue rulings as to whether a securities lending transaction constitutes a sale or exchange or whether the transaction interrupts the lender's holding period."[13]

The legislative history then goes on to assert the importance of securities lending to the proper functioning of the securities markets, and discusses the need to preserve the general nonrecognition policy as the reason behind the enactment of section 1058:

> "Because of time delays which a broker may face in obtaining securities (from a seller or transfer agent) to deliver to a purchaser, brokers are frequently required to borrow securities from organizations and individuals with investment portfolios for use in completing these market transactions. 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 loan the less frequently will brokers fail to deliver a security to a purchaser within the time required by the relevant market rules."[14]

In order to address the perceived "uncertainty" in the law, section 1058(a) now provides that: "In the case of taxpayer who transfers securities (as defined in section 1236(c)), pursuant to an agreement meeting the requirements of [section 1058(b)], no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such

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12 The Senate Report at 3.

13 *Id.* at 5.

14 *Id.* at 5. The securities lending legislation included many provisions other than section1058 and addressed many other areas of taxpayer "uncertainty" regarding securities loans. The larger legislative package was intended to address numerous potential obstacles that might have prevented pension funds and other tax-exempt institutions, as well as mutual funds, from lending securities freely. Because these lenders were such an important source of securities, that aspect of the legislation was viewed as crucial to the securities loan markets. In order to address concerns that income from securities lending activity might constitute "unrelated business taxable income" ("UBTI"), section 512(b)(1) was modified to provide that securities loans (as defined in the simultaneously enacted section 512(a)(5)) would be excluded from the calculation of UBTI. Similarly, section 514(c)(8) was added to the Code to clarify that securities loans (again as defined in section 512(a)(5)) would not give rise to unrelated debt-financed income. Section 851(b) was amended to clarify that payments received in respect of securities loans would be treated as "good" investment income for purposes of the requirement contained in that section that at least 90 percent of a regulated investment company's gross income be investment income of a certain type. Section 4940 was also amended to clarify that payments received from securities loans are investment income for purposes of the private foundation rules, and Congress expressed its view that the mere lending of securities would not constitute business activity for purposes of section 4943. *In other words, Congress' clear intention was to remove all perceived tax obstacles to the normal functioning of the securities lending market.*

agreement, or on the exchange of the rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer."

Section 1058(b) then provides that, in order for a securities loan agreement to qualify for nonrecognition status under section 1058(a), the agreement must meet the following requirements:

(i) Section 1058(b)(1) states that the agreement must "provide for the return to the transferor of securities identical to the securities transferred";

(ii) Section 1058(b)(2) states that the agreement must "require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of the identical securities back to the transferor";

(iii) Section 1058(b)(3) states that the agreement must "not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred"; and

(iv) Section 1058(b)(4) states the agreement must "meet such other requirements as [Treasury and the IRS] may by regulation prescribe."

As discussed above, other than Revenue Procedure 2008-63 and proposed regulations that were issued in 1983 and never finalized or updated, there has been no significant guidance from Treasury and the IRS interpreting these requirements. We believe, however, that the legislative history makes certain points clear. First, the requirements are intended to ensure that nonrecognition status is available only to transactions that in substance are mere temporary transfers of property without any greater economic significance. In this regard, the legislative history again invokes the standards of Treasury regulation section 1.1001-1(a) and states that the requirements are "[i]n order to assure that the contractual obligation [of a securities borrower to return the borrowed securities] does not differ materially either in kind or extent from the securities exchanged [by the lender for that contractual obligation]."

Second, it is clear that Congress expected market-standard securities lending activity to qualify for nonrecognition treatment, and did *not* intend for the requirements of section 1058(b) to impose substantive restrictions not already satisfied in ordinary-course lending activity. In this regard, the legislative history states that, in exercising its regulatory authority under section 1058(b)(4), the IRS is "not to include requirements which are inconsistent with normal commercial practice, as permitted by the Securities and Exchange Commission, as of the date of enactment of this provision."[15]

IV. THE TAX COURT CASES

This Part IV describes the facts and decisions reached in the recent Tax Court cases of *Samueli*, *Anschutz* and *Calloway.* As discussed above, the purpose of this report is not

[15] The Senate Report at 7.

to present a view as to the outcomes reached in those cases, because we do not believe that it would be appropriate for us to do so. We do believe, however, that, by interpreting section 1058 in three relatively unusual contexts (and in *no other* contexts to date), the Tax Court has raised a question as to the appropriate scope of those decisions and specifically how those decisions should be applied to more ordinary-course securities loans. We also believe that the three decisions can be fairly criticized for using section 1058 as a tool to achieve results that might more appropriately have been achieved through other means.

A. The *Samueli* Decision

1. *The Facts and Holding*. The facts of Samueli, greatly simplified, were as follows: A taxpayer in late 2001 took the view that interest rates were likely to decrease over the following year, and therefore sought to finance the purchase of fixed-yield debt obligations (Treasury STRIPS)[16] with a floating-rate borrowing. If the cost of the borrowing were to decrease while the yield on purchased debt obligation remained constant, the taxpayer would profit from the spread between the two interest rates. In addition, as discussed in more detail below, the taxpayer also attempted to avoid the current inclusion of interest income in respect of the Treasury STRIPS by lending the STRIPS to its broker in what was intended to be a nonrecognition transaction under section 1058, so that the taxpayer did not have direct ownership of the STRIPS while the income was accruing.

The taxpayer purchased Treasury STRIPS in a transaction financed entirely by margin debt. The taxpayer then immediately delivered the STRIPS to the broker under a securities loan that had a term of greater than one year and a maturity date one month prior to the maturity of the STRIPS. The broker provided cash collateral to the taxpayer to secure its obligation under the loan of the STRIPS, and the taxpayer returned the cash collateral immediately to the broker in order to pay down the margin loan in its entirety. The taxpayer was required to pay a variable rate "borrow fee" to the broker for the use of the cash collateral, and thus attained the floating-rate cost of carry needed to execute the intended market strategy. Upon maturity of the securities loan, the broker paid the taxpayer cash equal to the then-current fair market value of the STRIPS (a cash settlement in lieu of an actual delivery of the physical securities), and the taxpayer returned the cash collateral to the broker, plus an amount representing borrow fees accrued over the term of the transaction. The taxpayer realized an overall gain on the transaction.

In considering the facts of *Samueli*, it is worth noting that the taxpayer's economic goal of purchasing a fixed-yield instrument with a floating-rate cost of carry was achieved prior to the lending of the securities back to the broker (assuming that the margin loan was a standard floating-rate loan).[17] As a purely economic matter, the primary effect of the securities loan appears to have been to replace one type of financing (the margin loan) with a

[16] STRIPS is an acronym for "Separate Trading of registered Interest and Principal Securities," which in turn refers to zero-coupon Treasury obligations (the result of "stripping" the interest coupons from a typical fixed-rate instrument and selling the individual coupons and the right to principal as separate, standalone debt instruments).

[17] Although that assumption certainly seems reasonable, the decision does not state whether the interest rate on the original margin loan was fixed or floating, presumably because the loan's short life made its terms irrelevant.

different type (the use of cash collateral in exchange for the payment of a floating-rate borrow fee).

From a tax perspective, the taxpayer attempted to achieve a timing and character benefit from the securities loan. Specifically, if the taxpayer had maintained a direct ownership stake in the Treasury STRIPS over the term of the transaction, the taxpayer would have been required to include the accreting yield on the STRIPS on a constant-yield basis as ordinary income. By taking the view that the STRIPS had been disposed of in a section 1058 transaction, however, the taxpayer sought to avoid this current inclusion. In this regard, the taxpayer sought to benefit from the fact that section 1058(b)(2) requires a securities borrower to make substitute payments to a securities lender in respect of "dividends, interest and other distributions" received in respect of the borrowed securities (which payments would constitute taxable income), but makes no mention of amounts that are *accrued but not paid* in respect of the loaned security.[18] Accordingly, because the taxpayer's basis in the STRIPS was equal to the amount the taxpayer initially paid for them (*i.e.,* the face amount of the STRIPS reduced to take account of the accrual of discount over time), the taxpayer was able to take the position that the difference between that basis and the higher amount received by the taxpayer in respect of the STRIPS upon the termination of the transaction constituted a capital gain ─ even though at least some portion of that difference economically would have been attributable to accrued discount. In addition, because section 1058 allows a taxpayer to "tack" the term of the securities loan onto the holding period of the security received to terminate the loan, the taxpayer took the view that it was entitled to a long-term holding period in the STRIPS upon the receipt (or deemed receipt) of the STRIPS at the end of the transaction. The result of these two positions was that the taxpayer sought to convert current ordinary income into deferred, long-term capital gain.

The court denied the taxpayer its long-term capital gain treatment by focusing on the narrow question of whether the securities loan qualified for nonrecognition treatment under section 1058. The court held that the securities did *not* so qualify, because the court held that a securities loan with a fixed term violates the requirement under section 1058(b)(3) that the loan not "reduce [the taxpayer's] risk of loss or opportunity for gain" in the loaned security. The court justified this holding on the grounds that the term loan deprived the taxpayer of the ability to sell the STRIPS at will and thus take advantage of any short-term price swings over the duration of the loan, and that this reduction in control over the disposition of the STRIPS amounted to a reduction in the taxpayer's opportunity for gain.[19]

Having thus concluded that the loan of the STRIPS was ineligible for nonrecognition treatment under section 1058, the court then recharacterized the transaction as follows: the taxpayer purchased the STRIPS in 2001 and immediately disposed of them in a taxable disposition, but recognized no gain or loss due to the fact that the sale price was the same

[18] One of our recommendations, described in more detail in Section V.B, below, is to change this situation by requiring securities lenders to include in income amounts that accrue in respect of the underlying securities.

[19] The taxpayer attempted to argue that it had in fact retained the ability to take advantage of short-term price swings, on the grounds that it had the ability to lock in profits from such swings through the use of derivatives. The court, however, dismissed this argument, noting that section 1058 "concerns itself only the agreement connected with the transfer of securities" and that "[w]hether the Samuelis could have entered into another agreement to lock in their gain is of no moment."

as the initial purchase price. The securities loan agreement was recharacterized as a forward contract under which the taxpayer agreed to repurchase the STRIPS at the end of the transaction for a price equal to their value as of the beginning of the transaction plus an amount representing the floating-rate "borrow fee" accrued over the transaction's term. Then, after repurchasing the STRIPS at the forward price upon the maturity of the forward contract, the taxpayer immediately resold the STRIPS and realized *short-term* capital gain. The court denied the taxpayer interest deductions in respect of the "borrow fees" on the grounds that the obligation to return the cash collateral was properly viewed merely as an obligation to pay a purchase price under a forward contract and not as a *bona fide* debt obligation.[20]

2. *Issues Raised by Samueli ─ Treatment of Term Loans.* In the *Samueli* decision, the Tax Court held that term securities loans are taxable dispositions,[21] and in doing so, the court prevented a taxpayer from achieving long-term capital gain treatment for income that economically represented accrued bond discount. Although it is not our intention here to comment on the outcome of the *Samueli* case, we do note that the court might have achieved its desired result through other means. The court, for example, could have ignored the STRIPS loan altogether and treated the taxpayer as owning a leveraged investment in STRIPS over the life of the transaction. Alternatively, the court might have ignored the taxpayer's initial purchase of STRIPS and treated the taxpayer simply as having entered into a forward contract without the deemed "cross in." Perhaps the court also could have found that the transaction was a conversion transaction, within the meaning of section 1258, and thus denied the taxpayer long-term capital gains treatment.[22] For these reasons, we believe that the *Samueli* decision can be criticized fairly on the grounds that the court chose an indirect means to address concerns that it could have addressed directly and without creating the same amount of collateral uncertainty.

[20] We also believe that it would be appropriate for Treasury and the IRS to confirm that it does not interpret *Samueli* as rejecting the general treatment of cash collateral as borrowed money for U.S. federal income tax purposes in the case of securities loans that meet the requirements of section 1058, or in the case of securities loans that are recognized as such but that fail for some reason to meet all of the technical requirements of section 1058. Under *Provost* and other authorities, the receipt of cash collateral in respect of a securities loan generally is treated as a cash borrowing, and thus the posting of cash collateral to a securities lender in a market-standard securities loan routinely serves as a form of financing. In fact, as discussed in note 8, above, securities loans against cash collateral can be economically interchangeable with repo transactions, which are treated as secured cash borrowings for U.S. federal income tax purposes. However, as also indicated above, upon concluding that the securities-loan leg of the transaction was a taxable transaction, the court in *Samueli* recharacterized the cash leg as well and held that the overall transaction was an up-front sale of the Treasury STRIPS and a subsequent purchase and immediate resale of the Treasury STRIPS pursuant to a forward contract, without any borrowing of cash. Whatever the merits of that conclusion in the context of the transaction before the *Samueli* court, we do not believe that the decision should be read as a wholesale rejection of the view that the posting of cash collateral gives rise to a money borrowing for U.S. federal income tax purposes.

[21] Once concluding that the STRIPS loan failed to meet the requirement of section 1058(b)(3), the court appears to have assumed that the loan therefore constituted a taxable disposition, but did not consider whether the loan might have qualified for nonrecognition treatment under any other theory, such as the theory under section 1001 used by the IRS prior to the enactment of section 1058.

[22] Section 1258(c) defines a "conversion transaction" as, among other things, a transaction in which substantially all of the taxpayer's expected return is attributable to the time value of money of the taxpayer's net investment, and is "marketed or sold as producing capital gains." Although there is a potential question as to whether the taxpayer's bet on interest rate fluctuations amounted to an attempt to realize a time-value-of-money return (and thus whether "substantially all" of the taxpayer's profits constitute a time-value-of-money return), the conversion of accrued OID into capital gains is precisely the type of issue that section 1258 is intended to address.

The court's decision to take the view (at least under the most literal reading of the case) that *all* term securities loans are taxable dispositions, however, has the potential to call into question several types of market-standard loans that we believe do not raise the types of issues that the *Samueli* court sought to address. For example, it is not uncommon for a securities borrower to wish to have the use of a borrowed security for some minimum period of time in order to effect a trading strategy before having to close out the borrowing. That situation could arise particularly in cases where a specific security is difficult to locate and borrow, either because it is relatively illiquid or because there are numerous would-be borrowers and only a limited amount outstanding of the security in question. In those cases, a borrower may be willing to compensate a lender for allowing the securities to be borrowed for some minimum term, or for agreeing to pay significant "breakage costs" if the loan is recalled before a certain date. In sum, we believe that there are term loans that do not raise the tax concerns that were in front of the *Samueli* court.

Before the *Samueli* decision, many practitioners had taken the view that term securities loans (at least of relatively short durations, such as a few months) should be entitled to nonrecognition treatment under section 1058. Even though the proposed regulations under section 1058 required that a lender be entitled to the receipt of the loaned securities upon five days' notice, the failure of the IRS to finalize the proposed regulations brought into question whether the IRS ultimately considered the "five day rule" to be an appropriate interpretation of section 1058(b)(3).[23] In addition, because a term loan has the effect, if anything, of *increasing* a taxpayer's economic exposure to the loaned security by locking in the taxpayer's exposure for a minimum period, there had been an argument (rejected by the court in *Samueli*) that a term loan should not be viewed as reducing a taxpayer's risk of loss or opportunity for gain within the meaning of section 1058(b)(3). Finally, certain practitioners took comfort from the fact that there are other commonplace transactions in which a securityholder may reduce its ability to dispose of the security at will ─ such as a pledge of the security to secure a borrowing[24] ─ that clearly do not in and of themselves give rise to a disposition of the security. Again, however, the *Samueli* court appears to have rejected that argument.

We believe that there is a legitimate question as to whether it is appropriate to apply the court's apparently straightforward holding to all term securities loans. Read most broadly, the *Samueli* decision could affect commonplace market transactions in a manner that arguably violates the overarching policy of section 1058 (to facilitate the normal operation of market-standard securities lending activity). For this reason, we believe that it would be useful for Treasury and the IRS to issue guidance clarifying their view as to the appropriate scope of the *Samueli* decision, and of the proper tax treatment of term securities loans.

As a substantive matter, if the IRS and Treasury are concerned about term securities loans, we would recommend that guidance adopt a safe harbor under which term loans

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[23] The fact that section 512(a)(5) specifically includes the five day rule for purposes of determining whether a tax-exempt entity has unrelated business taxable income could have been viewed as evidence that Congress, by omitting the rule from the statutory language of section 1058, did not intend to the rule to apply to all securities loans generally. The *Samueli* court rejected that view.

[24] In the case of a pledge, however, the pledged property typically cannot be sold freely to third party, which is a factor distinguishing a typical securities loan from a pledge.

of up to a certain duration would be accorded nonrecognition status (*e.g.,* loans with terms of up to three months). Such a safe harbor would go a long way to protecting commonplace lending activity. In addition, a term of only three months generally would not create the opportunities for deferral and for holding-period tacking that were present in *Samueli*, or in the *Anschutz* case where, as discussed below, the taxpayer entered into a ten-year transaction.

B. The *Anschutz* Decision

1. *The Facts and Holding.* The second case recently interpreting section 1058 is *Anschutz*, in which the taxpayer entered into a variable prepaid forward contract with a bank for the sale of a large block of stock, and in connection with that contract, loaned the same shares of stock to the bank. Under the terms of the prepaid forward contract, the bank was required to make an upfront payment to the taxpayer in exchange for the right to receive a variable amount of shares in ten years' time. The number of shares delivered upon the maturity of the contract was to be determined under a formula as a function of the market value of the stock at the time of the contract's maturity. The economic effect of the formula was to transfer all downside exposure with respect to the stock to the bank, and to divide the upside exposure between the bank and the taxpayer by allowing the taxpayer to retain ownership of some of the shares in the event of an appreciation in the stock price above a certain level.[25] The taxpayer entered into a pledge agreement whereby the maximum amount of shares deliverable under the variable prepaid forward contract was placed into a collateral account in order to secure the taxpayer's obligation to deliver those shares at the contract's maturity.

In order to hedge its exposure under the prepaid forward contract, the bank borrowed an amount of identical shares from third-party stock lenders equal to the number of shares held in the collateral account and sold those shares short into the market. The amount of proceeds received by the bank from the short sales determined the amount of money paid by the bank under the prepaid forward contract ─ that is, the bank effectively was in the same position as if it had used the proceeds from a current sale of shares to make the payment to the taxpayer for the forward sale of shares. Finally, under the terms of the pledge agreement, the bank had the ability to borrow the shares held in the collateral account, and the bank in fact did borrow those shares and deliver them to the third-party stock lenders to close out the third-party stock loans. The interaction of the terms of the pledge agreement and the prepaid forward, at least as described by the court, were such that, as a practical matter, the bank's obligation to return the shares borrowed from the collateral account effectively would be expected to negate the taxpayer's obligation to deliver those same shares in satisfaction of the prepaid forward contract.

In other words, the *Anschutz* opinion describes the transaction as one in which the taxpayer received an up-front cash payment for stock from a counterparty and effectively

[25] As discussed below, the taxpayer in fact delivered the maximum amount of shares to the bank in what the court determined to be a permanent disposition of all of those shares. Therefore, the taxpayer's continuing position in the shares amounted effectively to a claim against the bank, which the court characterized as a call option. As a legal matter, this exposure was expressed through a formula that reduced to the amount of shares the taxpayer was ultimately required to deliver to the bank in final settlement of forward contract.

delivered that stock to the counterparty with no expectation of seeing the stock again.[26] As stated by the court: *"For all intents and purposes, those lent shares were gone and could not be recovered."*[27] (Emphasis added.)

The IRS took the position that the transaction described above amounted to a current sale of the underlying stock. The taxpayer, while acknowledging that it in fact had disposed of the stock, argued that the disposition was nontaxable by virtue of section 1058. In rejecting the taxpayer's attempt to use section 1058 to achieve nonrecognition treatment for what appeared to it to be a simple current cash sale of securities, the court took the view that the stock loan had to be integrated with the variable prepaid forward contract for purposes of evaluating it under the technical requirements of section 1058. The court stated that the securities loan and the prepaid forward were "linked," and that it could not "turn a blind eye to one aspect of the transaction in evaluating another." Viewing the loan and the forward contract as a single, integrated transaction, the court then found that the taxpayer had "loaned" its stock in a manner that allowed it to eliminate its downside exposure to the stock, as well as a substantial portion of its upside exposure, in violation of the "risk of loss/opportunity for gain" requirements of section 1058(b)(3).

2. *Issues Raised by Anschutz.* The court in *Anschutz* reached its decision by focusing on the supposedly integrated nature of the stock loan and the prepaid forward contract, and for that reason the decision raises the more general question of when it is appropriate to take a taxpayer's hedging activity into account when evaluating the tax consequences of a securities loan. The issue is of considerable importance, because section 1058(b)(3) by its terms prohibits any "reduction" in the taxpayer's risk of loss or opportunity for gain, and thus suggests that *any* hedging activity that could be integrated with a securities loan would prohibit nonrecognition treatment under section 1058.

In order to understand the concern raised by *Anschutz*, consider the case of a taxpayer that hedges its position with respect to appreciated stock by entering into a "costless collar," and that simultaneously loans the underlying shares to the counterparty that provided the collar. Assume that, in contrast to the facts described by the court in *Anschutz,* the taxpayer expects to receive back the shares lent to the counterparty and continue to hold them for the foreseeable future, and that the collar will be cash-settled by its terms. This example does not constitute the type of permanent disposition that the *Anschutz* court perceived, and the collar and the stock loan in this example are not capable of being integrated to the same extent as the court found the transactions in *Anschutz* to be. Also, the costless collar and the stock loan in this

[26] As discussed above, in order to explain the fact that the taxpayer had retained some residual upside exposure to the stock, the court characterized the taxpayer as having received a call option on the stock in addition to the cash payment. Because that point is not directly relevant to the section 1058 analysis, however, it will not be discussed further in this report.

[27] Although the taxpayer in Anschutz had the formal ability to recall the loaned shares, which it exercised, the court, viewed the recalls essentially as window dressing effected solely in order to bolster the taxpayer's position vis-à-vis the IRS, and thus appears to have accorded them no significance:

> "Although we agree with petitioners that [the taxpayer] could recall the loaned shares, the recalls were accomplished only to influence the tax analysis. The recalls were not a foreseeable economically motivated event when the transaction was structured. They were rather an after-the-fact effort to change the earlier tax effect which was fixed in [previous years]." (Anschutz at 47).

example are not linked together legally and economically, as were the transactions in *Anschutz.* However, a literal reading of *Anschutz* nonetheless raises the question as to whether the taxpayer in this example should be concerned about having violated the requirements of section 1058(b)(3) on the grounds that the collar and the securities loan could be integrated. Although we believe that integration would be inappropriate in this example, it would be useful to receive guidance as to the IRS and Treasury's view as to the scope of *Anschutz* on this point.

In raising this concern, however, we wish to be clear that we do not read *Anschutz* as treating any hedge of a loaned security as a violation of section 1058(b)(3). We believe that the court in *Anschutz* was responding to a set of arrangements that it believed, when viewed in their totality, amounted to a current and *permanent* disposition of stock for an up-front cash payment. The court was clear on this point, and as such could have concluded that the taxpayer's disposition of stock did not amount to a loan of securities ─ since a loan is generally understood to be a temporary transfer of property or money ─ and thus could have concluded that section 1058 was irrelevant to the transaction at hand, or could have disqualified the loan for nonrecognition treatment solely on the grounds that the loan failed to meet the requirement of section 1058(b)(1) (*i.e.,* the requirement that a securities loan agreement provide for the return of the loaned securities). The fact that the court chose to pursue a more technical line of reasoning under section 1058(b)(3) does *not*, in our view, require taxpayers to forego all hedging activity in respect of a loaned security in order to achieve nonrecognition treatment under section 1058 for the securities loan. If *Anschutz* were viewed as standing for such a rule, then the case likely would have the effect of denying nonrecognition treatment in situations that do not present the concerns that were present before the *Anschutz* court. Furthermore, given the widespread nature of hedging activity in modern securities markets, such a rule likely would undercut the overarching policy of section 1058 of promoting ordinary-course securities lending activity.

One obvious means of limiting the *Anschutz* holding is to draw a distinction between, on the one hand, hedging transactions entered into between a securities lender and a securities borrower and, on the other hand, hedging transactions entered into between the securities lender and a third party that is independent of the securities borrower. Integration in the third-party case is conceptually very different from the situation before the *Anschutz* court, because contracts with different and independent counterparties cannot be netted and collapsed into a single agreement in the same way that offsetting contracts with a single counterparty can be. If the taxpayer in *Anschutz* had loaned securities to someone other than the bank, we do not believe that the loan properly could have been integrated with the forward contract.[28] For that

[28] If the taxpayer had allowed the bank to borrow securities for the account of another of the bank's customers, rather than for the bank's own account, then it is also possible to treat such a transaction as a loan to a third party, since the bank in that situation presumably would have been required to find another third-party securities lender to cover its own hedge of the prepaid forward contract. Such an approach would be consistent with Revenue Ruling 72-478, 1972-2 C.B. 487, which considers a "short against the box" trade, in which a taxpayer owned securities and then had its broker borrow identical securities from a third-party securities lender to effect a short sale. The ruling holds that the taxpayer did not dispose of the securities, even where the taxpayer also loaned its securities to the broker to sell in an unrelated transaction. Although the revenue ruling notes merely that the shares borrowed from the taxpayer were not delivered into the short sale, it seems implicit in the terms of the ruling that the third-party borrowing would have remained open for the duration of the short-against-the-box trade. By contrast, the court in *Anschutz* seems to have given little credibility to the third-party borrowing which the bank initiated at the inception of the prepaid forward, since the bank's presentation materials discussing the transaction stated that the third-party

(footnote continued)

reason, we believe that it would be appropriate for Treasury and the IRS to confirm that the independent-third-party situation simply is not addressed by *Anschutz*, and instead focus on cases where a securities lender and a securities borrower enter into ancillary arrangements between themselves in respect of the loaned securities.

In considering the potential effect of ancillary arrangements between a securities borrower and lender, we do *not* recommend an approach that applies section 1058(b)(3) effectively by forbidding all ancillary economic hedges of a loaned security. For taxpayers with large securities portfolios that engage in various hedging strategies and lending activities, for example, it may not always be straightforward to determine over the course of a given securities loan what the taxpayer's economic exposure to the loaned securities really is. In addition, if the primary concern with a transaction is that a taxpayer has used a hedging strategy to offset more than a certain level of economic exposure to a position, we believe that such a transaction more properly is addressed through the constructive sale regime of section 1259, rather than through section 1058(b)(3). A rule applying some stricter standard than that of section 1259 in the context of a securities loan would discourage lending activity but would not be an effective means to advance section 1259's purpose of policing hedging activity.

Instead, we recommend that Treasury and the IRS consider a standard that applies section 1058(b)(3) by looking to whether ancillary agreements between a securities lender and securities borrower have the effect of turning what formally is a securities loan into a permanent disposition of the underlying securities. We believe that such a standard would be consistent with the policies underlying the *Anschutz* decision, and would require that a securities lender *retake the securities at the end of the loan* and once again enjoy a *full right of disposition over them*.[29]

(footnote continued)

borrowing would be closed out quickly. According to the court, the presentation "stated that [the bank] would borrow shares from [the taxpayer] pursuant to the [securities lending agreement] to cover the initial short sale obligation."

Similarly, in Technical Advice Memorandum 200604033 (Jan. 27, 2006), which addresses facts that appear to be those of the *Anschutz* case, the IRS distinguishes Revenue Ruling 72-478 from the facts there under consideration, on the grounds that the presence of a third-party securities lender in the revenue ruling made it more difficult to conflate the short sale with the securities loan by the taxpayer. The TAM states that the revenue ruling was distinguishable, because taxpayer in the ruling "borrowed shares from, and sold to, different parties. Thus, there were no offsetting obligations."

[29] In considering what it means for a taxpayer to retake securities and enjoy a full right of disposition over them, we believe that Revenue Ruling 2003-7, 2003-1 C.B. 363, might provide a useful analogy. Revenue Ruling 2003-7 considers the treatment of a variable prepaid forward contract on appreciated stock and concludes that the prepaid forward did not give rise to an actual or deemed disposition of the stock for U.S. federal income tax purposes. In reaching that conclusion, the revenue ruling emphasizes the fact that, even though the taxpayer pledged stock to secure its delivery obligations under the variable prepaid forward, the taxpayer also had "the unrestricted legal right to deliver the pledged shares, cash, or shares other than the pledged shares to satisfy its obligation under the [variable prepaid forward contract]." Although the taxpayer fully intended to deliver the pledged shares to satisfy that obligation, the revenue ruling makes clear that the taxpayer was not "economically compelled" to do so. The implication of Revenue Ruling 2003-7 is that a securities loan should be considered to provide for the return of securities to the lender (and thus meet the requirements of section1058(b)(3)) if the loan puts the lender in a similar

(footnote continued)

We acknowledge that our recommendation may have the effect of minimizing the importance of section 1058(b)(3) in addressing concerns related to hedges of loaned securities, since the standard purposely ignores hedges that do not prevent the taxpayer from retaking possession of the loaned securities. This approach reflects our view that the types of concerns that were present before the *Anschutz* court (and the *Samueli* court, for that matter), are better addressed through general tax principles than through the application of the technical requirements of a Code section intended ultimately to facilitate securities lending. Our purpose is *not* to prevent courts from applying substance-over-form principles to recharacterize transactions differently from their legal form as may be appropriate, but rather to discourage the use of section 1058 as an alternative to that exercise, since the use of section 1058 for that purpose is almost certain to lead to unintended collateral effects on ordinary-course securities lending transactions.

We further acknowledge that our recommended standard overlaps with section 1058(b)(1), which requires that a securities loan "provide for the return to the [lender] of securities identical to the [loaned] securities." As discussed above, however, the concerns expressed by the *Anschutz* court arguably could have been addressed more appropriately through section 1058(b)(1) than section 1058(b)(3) ─ because of the court's clear view that the taxpayer had effected a permanent disposition of the underlying stock, rather than a mere temporary transfer. By using section 1058(b)(1), rather than 1058(b)(3), as support for its ultimate holding, the *Anschutz* court effectively would have taken the view that the transaction was not in fact a genuine securities loan, and therefore would have reached a decision more directly based on its view of the economic substance of the transaction. Because the *Anschutz* court reached its conclusions instead through section 1058(b)(3), however, we believe that it would be appropriate for Treasury and the IRS to acknowledge that a taxpayer that lends securities and then, at the end of the loan, retakes full possession of the securities ─ and enjoys *full rights of disposition over the securities* ─ has not "reduced the risk of loss or opportunity for gain" with respect to the securities within the meaning of section 1058(b)(3).

C. The *Calloway* Decision

1. *The Facts and Holding.* In many ways, the situation presented in *Calloway* is the most straightforward of the three Tax Court cases addressing section 1058. Similar to *Anschutz, Calloway* involved a taxpayer with an appreciated position in stock. The taxpayer delivered its securities to a counterparty (an organization known as "Derivium") as security for a three-year, nonrecourse loan in an amount equal to 90 percent of the stock's then-current value. Under the terms of the loan, interest was payable by the taxpayer only at the loan's maturity. In connection with the transfer, Derivium had the ability to borrow the collateral shares, and the taxpayer had no right to recall the shares during the three-year term of the money loan.

(footnote continued)

position with respect to the underlying securities once the lender has retaken possession of them. (Of course, as discussed above in note 27, the taxpayer in *Anschutz* had the formal ability to recall the loaned shares, which it then exercised, and the court accorded no significance to those facts, on the grounds that the taxpayer had no motive to recall the shares other than to influence the outcome of its dispute with the IRS.)

Although Derivium stated that it would hedge the downside exposure to the shares in such a manner that the taxpayer would never be required to post additional collateral for the loan, the decision states that Derivium simply sold the shares, delivered 90 percent of the sales proceeds to the taxpayer as loan proceeds, and kept the remaining ten percent as a profit. Under the term of the money loan, the taxpayer had the ability to allow Derivium to keep the collateral at the loan's maturity in full satisfaction of the taxpayer's obligations to pay principal and interest on the money loan, or to pay off the money loan in cash and receive the shares back. (Derivium subsequently entered into bankruptcy, apparently after several of its customers chose the second option at a time when Derivium lacked the funds to acquire and deliver the requisite securities.) Over the term of the transaction, the taxpayer never reported any dividends paid on the stock as income, and at the maturity of the loan, the taxpayer allowed Derivium to take the shares in satisfaction of the money loan, but did not report any income or loss from this supposed disposition of the shares.

As in *Anschutz*, the court was faced with a transaction that resembled a simple current sale of stock for cash, and as in *Anschutz*, the court chose to apply (unnecessarily in our view) the technical requirements of section 1058 to what had been labeled as a stock loan. Specifically, the court relied on the holding in *Samueli* that term securities loans fail to meet the requirements of section 1058(b)(3), with the result that the taxpayer's supposed three-year term securities loan resulted in an impermissible reduction in the taxpayer's opportunity for gain: "[The taxpayer] was bereft of any opportunity for gain during the 3-year period because he could reacquire the . . . stock only at maturity." In this regard, it is worth noting that two Tax Court memorandum opinions apply the holding of *Calloway* to other clients of Derivium and make no mention of section 1058. Instead, the courts did not respect the initial transfers as securities loans in the first instance, and apparently for that reason, found no reason to consider whether section 1058 might apply.[30]

2. *Issues Raised by Calloway.* Under the standard recommended above in the discussion of *Anschutz*, it would be difficult to conclude that the purported stock loan to Derivium was a mere temporary transfer of securities or that the arrangement provided for the return of the securities to the taxpayer within the meaning of section 1058(b)(1). The taxpayer appeared to have viewed itself as selling the shares at the inception of the transaction, and there is nothing in the facts reported by the court to contradict that view. Of course, the arrangement

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[30] *See Edward M. Kurata*, TC Memo. 2011-64 (March 16, 2011), in which the court considered the case of a taxpayer who had entered into a "loan" of securities with Derivium similar to the transaction described in *Calloway*, except that ─ unlike taxpayer in *Calloway* ─ the taxpayer in *Kurata* had been careful to report taxable income and expense on his returns in a manner consistent with the form of the transaction. In describing the *Calloway* decision as the basis for granting a summary judgment motion against the taxpayer, the court said: "we held that the transaction [in *Calloway*] was not a loan and that the taxpayers sold their stock in the year the stock was transferred to Derivium." The court then went on to list common-law standards for determining when ownership of property has transferred, and did not even consider the argument that the taxpayer's loan could be respected as such. When describing the transaction, the court placed the word "loan" in quotation marks, and at one point stated: "The fact that petitioners treated the transactions as loans in 2000 . . . does not make them so." *See also Kurt Sollberger*, TC Memo 2011-78 (April 4, 2011), in which the court based its grant of summary judgment against the taxpayer on the finding that the transaction in question did not constitute a securities loan.

with Derivium resulted in the taxpayer never in fact taking back possession of the loaned securities.

With respect to the court's use of the *Samueli* holding regarding term securities loans, we merely note that, although three years is much longer than the typical duration of a term securities loan, the court likely did not need to resort to that technical rule to find that the substance of the transaction was an up-front taxable sale of securities. Again, while we believe that a blanket prohibition on all term securities loans is unnecessary to serve the policies of section 1058 (and may in fact undercut those policies by preventing otherwise commonplace securities lending activity), we also believe that a workable rule could be achieved through the adoption of a safe harbor that allows term securities loans of a up to a certain duration (*e.g.,* three months) to benefit from section 1058 nonrecognition treatment.

A slightly more difficult question presented by *Calloway*, however, arises when one considers the case with somewhat different facts. Consider the situation, for example, where a taxpayer entering into the Derivium transaction in fact does report dividends (or substitute amounts) as income over the term of the transaction, and does receive the stock back at the end of the three-year term after paying off the loan in cash. In such as case, would it be appropriate to treat the taxpayer as having loaned the security on a nonrecognition basis under section 1058 on the grounds that the transfer did, in fact, turn out to be temporary? Would one need to look to the prohibition of term loans under *Samueli* to prevent section 1058 nonrecognition treatment?

We believe the answer to these questions is "no." Under the facts of the *Calloway* case, the taxpayer received a full upfront payment in respect of its stock and was never under any obligation ─ under the formal terms of its agreement with Derivium or otherwise ─ to return the cash or retake possession of the stock. In fact, as Derivium's subsequent financial difficulties demonstrate, Dervium perhaps anticipated that it never would be required to have to repurchase the stock to deliver to the taxpayer.[31] As noted above, section 1058(b)(1) requires that a securities loan "provide for the return to the transferor of securities identical to the securities transferred" in order to qualify for nonrecognition treatment. Under our reading of the statute, this requirement is not met in cases where the lender of securities merely has the *option* to retake the securities, but is not obligated to retake them.

V. OTHER ISSUES

As discussed above, *Samueli*, *Anschutz*, and *Calloway* have raised questions about the proper scope of section 1058, and thereby present an occasion for Treasury and the IRS to issue long overdue guidance under section 1058. This Part V therefore discusses several

[31] One particular feature of the *Calloway* case that distinguishes its facts from those of a typical securities loan is that, in a securities loan, the cash advanced to the lender serves the function of collateral for the borrower's obligation to return the securities. Accordingly, in a market-standard securities loan the collateral would have been marked to market on a daily basis, so that the taxpayer would have been required to return cash to Derivium to the extent that the value of the stock fell over the term of the loan, and would have been entitled to additional cash in the event of an increase in the stock's value. Section 512(a)(5)(B)(i) in fact includes such a marking-to-market of collateral in its definition of the term "securities loan."

technical questions raised by section 1058 that could be addressed usefully in whatever guidance Treasury and the IRS decide to issue.

A. Is Section 1058 a Safe Harbor, or the Only Route to Nonrecognition Treatment?

As discussed above in Part III, prior to the enactment of section 1058, the IRS had adopted the position that securities loans (or at least some securities loans) are nonrecognition transactions, and had supported that position by reference to section 1036, as well as by reference to Treasury regulation section 1.1001-1(a), which refers to taxable exchanges only where property is disposed of for cash or for other property "differing materially, either in kind or extent." As also discussed above in Part III, the legislative history of section 1058 makes it clear that the statute was intended to support and clarify that position. Given that background, there is a question among tax practitioners as to whether section 1058 provides merely a "safe harbor" within which all securities loans are afforded nonrecognition treatment, or instead should be read to deny nonrecognition treatment to all securities loans that do not meet the requirements of section 1058 and any regulations that might be issued thereunder.

There is nothing in the language of the statute itself or the history of the statute to suggest that it was intended to be more than a safe harbor. To the contrary, the legislation introducing section 1058 into the Code also contained numerous other provisions[32] that provided, among other matters, that payments in respect of certain types of securities loans (those meeting the requirements of section 512(a)(5)) would not give rise to UBTI and would be treated as "good" investment income under the RIC rules. With respect to those provisions at least, the legislative history states that the requirements for a securities loan contained in section 512(a)(5) were *not* intended to preclude other securities loans from qualifying for whatever benefits may have been available under the common law or otherwise:

> "In making these provisions for payments on securities loans which meet the prescribed standards, the committee intends that no inference is to be drawn with respect to the active or passive classification of income from securities loans that lack the safeguards required in the bill, either for purposes of the unrelated business income tax, treatment as gross investment income, or for other income tax purposes, such as determining whether such income is personal holding company income."[33]

Although the above-quoted language does not refer explicitly to section 1058, it is difficult to imagine why Congress would have viewed section 1058 differently for these purposes.

On the other hand, proposed Treasury regulation section 1.1058-1(c) contains a statement to the effect that compliance with the technical requirements of section 1058 and the regulations thereunder is a precondition for nonrecognition treatment, but it is unclear whether this position proposed in 1983 would reflect the government's current thinking on the issue.

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[32] *See* note 14, above.

[33] The Senate Report at 9.

The courts in *Samueli, Anschutz* and *Calloway* all seem to assume that section 1058 is the sole means to nonrecognition treatment for securities loans, but they do not appear to have considered the issue.

In our view, section 1058 should operate as a safe harbor. If final regulations under section 1058 were to contain technical requirements that a securities loan might fail to meet in cases where the loan otherwise could still qualify for nonrecognition treatment under section 1036 or section 1001, then we do not believe that the section 1058 regulations should have the effect of "turning off" the operation of those other Code sections. For example, consider the case where a taxpayer loans shares a certain class of common stock in a corporation in order to receive at the end of a five-day period shares of a different class of common stock of the same corporation (*e.g.,* an exchange of Berkshire Hathaway "A" shares for the corresponding amount of Berkshire Hathaway "B" shares, or high-vote common stock for low-vote common stock). Arguably the initial loan of securities would fail to meet the requirements of section 1058(b)(1), because the borrower is not required to return securities that are "identical to the securities" originally loaned. However, we do not believe this fact should have any bearing on whether or not the transaction might qualify as a nonrecognition stock-for-stock exchange under section 1036.

B. Inclusion of Accrued Amounts By Securities Lender

As discussed above, section 1058(b)(2) requires a securities borrower to make payments to the lender of amounts received in respect of "dividends, interest and other distributions" made in respect of loaned securities. The rule does *not* address amounts that are accrued, but not paid, in respect of the loaned securities, and this point was implicated by the *Samueli* decision, where the taxpayer loaned zero coupon Treasury STRIPS and did not include accrued discount in respect of the STRIPS in income on a current basis.

We believe that Treasury and the IRS have the authority under section 1058(b)(4) to require securities lenders to include in income amounts accrued under loaned securities, and recommend that they do so. One stated justification for allowing nonrecognition status to securities loans is that the loans do not amount to more than a temporary transfer of securities, and that the right to the return of loaned securities does not "differ materially, either in kind or extent" from the securities themselves.[34] Therefore, a securities lender's right to the return of, say, Treasury STRIPS at the close-out of a loan arguably should not be viewed as economically distinguishable (or materially distinguishable) from a continuing and uninterrupted direct position in the STRIPS. Of course, that argument has its limits, as evidenced the fact that substitute payments of dividends or interest, are *not* viewed under current law as actual payments of dividends or interest. On balance, however, as an economic matter, the value of the return right would benefit in the same amount and at the same rate as discount accruing in respect of the

[34] Even if one takes the view that a securities loan might qualify as an event giving rise the realization of income under section 1001 under current law (*e.g.,* due to standards for realization adopted by the Supreme Court in *Cottage Savings v. Commissioner*, 111 S.Ct. 1503 (1991)), it remains the case that section 1058 accords nonrecognition treatment based at least partially on the premise that a securities lender has not changed his position vis-à-vis the loaned security sufficiently to warrant taxation.

underlying security. It seems appropriate to require a lender that seeks section 1058 treatment to take such accreting value into income on a current basis.[35]

C. The Five-Day Rule

Proposed Treasury regulation section 1.1058-1(b)(3) contains a requirement that the lender of securities must be entitled to the return of the securities on five days' notice. This requirement mirrors a similar rule contained in section 512(a)(5), and presumably reflects the fact that securities were delivered under a "T + 5" settlement convention at the time sections 1058 and 512(a)(5) were enacted in 1978. In other words, in 1978, a securities loan callable "on demand" was still subject to a five-day period before called securities actually would be delivered to the lender's account. Although we do not support this requirement under section 1058 for reasons discussed above, we would note that, if the IRS and Treasury decide to adopt a rule requiring that securities loans be callable "on demand," current market practice allows typically for settlement on a "T+3" basis, and in the case of certain debt markets on a "T+0" basis. For that reason, we recommend that any requirement that loans be callable on demand be phrased in terms of the lender being entitled to the return of the underlying securities no later than the normal settlement period in the relevant market following delivery of notice to the borrower.

D. Definition of "Securities"

By its terms, section 1058 applies only to loans of "securities" within the meaning of section 1236(c). Section 1236(c) in turn defines "securities" to include only "stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture or evidence of indebtedness, or any interest in or right to subscribe to or purchase any of the foregoing." This definition does not include, however, certain types of financial instruments that may also be widely traded on established securities markets. For example, the definition does not include interests in publicly traded partnerships, or publicly traded trust certificates. The exclusion of interests in publicly-traded partnerships is particularly a problem,[36] because the absence of lenders limits the ability of publicly-traded partnerships to issue convertible debt.[37]

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[35] Similarly, from the point of view of a borrower, the accrued amount represents an increase in the borrower's liability, and accordingly a deduction to the borrower would appear to be appropriate.

[36] Treasury and the IRS should give some attention to the proper treatment of partnership interests that might be treated as "securities" for purposes of section 1058. Specifically, the lender of a partnership interest ceases to be a partner in the underlying partnership during the term of the loan (as least as far as the loaned interest is concerned), and accordingly would not be allocated a portion of any income earned by the partnership during the term of the loan. For example, at least as a theoretical matter, there might be potential for the owner of a partnership interest to lend the interest prior to the time when the partnership expects to realize a significant amount of income, and then close out the loan prior to an actual cash distribution in respect of that income, so that the cash distribution might then be used to offset pre-existing basis in the partnership but would not give rise to a current income inclusion in the hands of the former lender.

We also note that, while this issue deserves some attention, there is significant doubt among our members as to whether trades of the type described above would be practical. First, a securities lender seeking to effect such a trade likely would need to locate a tax-indifferent counterparty. Many U.S. tax-exempt entities, however, would not want to hold interests in a partnership that would use leverage to finance investments and thus give rise to "unrelated debt financed income" within the meaning of section 514. Similarly, many foreign investors might want to avoid

(footnote continued)

We would recommend that the definition of "securities" be broadened to include all instruments that are publicly traded and that are susceptible to being loaned on conditions otherwise meeting the requirements of section 1058. We see no policy reason for drawing a distinction between instruments that qualify as securities under section 1236(c) and those that do not. Although the reference to section 1236(c) is contained in the statutory language of section 1058, we note that the statute was enacted in a time when there were many fewer types of publicly traded property than there are in the current markets, and believe that the reference to 1236(c) is more likely an historical accident than the reflection of a conscious policy choice.[38] In any event, even if Treasury and the IRS were to take the view that there is no authority under section 1058 to expand the definition of "securities," we believe that it would be appropriate to apply nonrecognition status to loans of publicly-traded property under the interpretation of Treasury regulation section 1.1001-1(a), discussed above in Part III.

Should Treasury and the IRS decide to broaden the definition of "securities" for these purposes, we would recommend that they adopt a definition that looks to a position's *liquidity* (*e.g.,* the straddle rules under section 1092 or the rules on publicly traded partnerships), as opposed merely to whether or not the instrument is capable of being valued accurately (*e.g.,* the recently issued proposed regulations under section 1273). Again, the important definitional goal, in our view, is to capture positions that are capable of being borrowed in the ordinary course of modern financial transactions.

E. Treatment of Substitute Payments to Securities Lenders and Borrow Fees

Proposed Treasury regulation section 1.1058-1(d) provides that substitute payments to securities lenders in respect of interest, dividends, etc., are treated as rent for the use of personal property. The one consequence of this rule specifically identified in the regulations is that substitute payments constitute ordinary income and are not entitled to particular tax benefits that might be accorded the underlying payment (*e.g.,* no dividends received deduction or reduced rate for qualified dividend income). The proposed regulations are silent as to whether the treatment of such payments as rent is to apply for other purposes. Subsequent to the release of the proposed regulations, regulations were issued that adopt a "transparency approach" under which substitute payments have the same source, character and treatment under treaties as the underlying amounts that they represent.[39] For that reason, it may be appropriate at this point to

(footnote continued)

investing in partnerships that could give rise to U.S.-taxable "effectively connected income" (*e.g.,* master-limited partnerships invested in U.S. real property). In addition, we understand that it is generally impermissible under U.S. securities laws for a borrower to "borrow to hold," which means that securities can only be borrowed for the purpose of satisfying the borrower's obligation to deliver the security in question to a third party (*e.g.,* to effect a short sale). Therefore, any "accommodation borrower" in such a transaction likely would not actually be able to hold the partnership interest during the term of the loan.

[37] Purchasers of convertible debt often sell short the underlying equity.

[38] The much broader definition of "securities" contained in section 475, for example, was not yet part of the Code in 1978.

[39] *See* Treasury regulation sections 1.861-2(a)(7), 1.861-3(a)(6), 1.864-5(b)(2)(ii), 1.871-7(b)(2), 1.881-2(b)(2) and 1.894-1(c).

abandon the characterization of substitute payments as rent. To the degree Treasury and the IRS believe that the characterization is viable, however, updated regulations at a minimum should define more clearly the contexts in which that characterization is intended to apply.

In addition, we recommend that Treasury and the IRS consider addressing the proper taxation of payments made to a securities lender other than substitute payments (so-called "borrow fees"). Other than Private Letter Ruling 8822061 (March 3, 1988), which holds that "borrow fees" paid to securities lenders are "industrial or commercial profits" for purposes of a treaty (the identity of the specific treaty was redacted in the ruling), we are aware of no guidance addressing how such payments should be characterized generally.

F. Assignments of Loan Obligations

Revenue Procedure 2008-63 states that a securities lender whose borrower defaults may use loan collateral to purchase securities identical to those loaned and treat those newly purchased securities effectively as if they had been returned in compliance with the requirements of section 1058(b). The revenue procedure thus reflects an policy that, so long as the taxpayer ultimately retakes possession of loaned securities and thus is in substantially the same economic position as if the loan had terminated in accordance with its terms, then nonrecognition treatment under section 1058 should be preserved. Similarly, we believe that it would be appropriate for future guidance under section 1058 to provide that, if a securities broker/dealer borrows securities and then assigns that liability to return those securities to a new broker/dealer, then the assignment should not be viewed as a taxable event to the lender. Treasury regulation section 1.1001-4 provides a similar rule for the assignment of notional principal contracts, although we would not recommend that guidance under section 1058 replicate the requirement under that regulation that assignability be contained specifically in the terms of the contract assigned. That requirement has rendered Treasured regulation section1.1001-4 largely inoperable, and we do not see a policy justification for it.