NEW YORK STATE BAR ASSOCIATION
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Report No. 1525
March 31, 2026

The Honorable Scott Bessent
Secretary of the Department of the Treasury, and Acting Commissioner of the Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Kenneth J. Kies
Assistant Secretary (Tax Policy) of the Department of the Treasury, and Acting Chief Counsel of the Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: NYSBA Tax Section Report No. 1525 - Report on Notice 2025-63

Dear Secretary Bessent and Assistant Secretary Kies:

Please see attached Report No. 1525 of the Tax Section of the New York State Bar Association (the "**Report**") commenting on Notice 2025-63 (the "**Notice**"), issued by the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") on October 23, 2025. The Notice announces the intention of Treasury and the IRS to propose regulations concerning the sourcing of certain securities borrow fees by reference to the residence of the recipient.

We commend Treasury and the IRS for undertaking to address this longstanding area of uncertainty and we support the core principle of sourcing borrow fees to the residence of the recipient. This approach is consistent with the economic substance of borrow fees, preserves the orderly operation of the capital markets, and is aligned with the approach embedded in U.S. tax treaties.

Our two principal recommendations are that the forthcoming regulations (i) remove the provision in the Notice that limits the scope of the transactions to which the residence-based sourcing rule applies to those "documented on an industry-standard master agreement and confirmation … with standard market terms" and instead apply the sourcing rule to any fee that *in substance* is paid for making the securities available to the borrower; and (ii) define "residence" for purposes of sourcing borrow fees without reference to IRC Section 988(a)(3)(B) and provide that, in the case of a partnership, the determination of residence generally is made at the partner level.

We appreciate the opportunity to comment on Notice 2025-63 and thank Treasury and the IRS for considering the views of the Tax Section. If you have any questions or would like to discuss any aspect of the Report, please do not hesitate to contact us. We would be pleased to assist in any way.

Respectfully submitted,

Lawrence M. Garrett
Chair

Enclosure

cc:

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Report No. 1525

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON NOTICE 2025-63 ANNOUNCING THE INTENTION TO PROPOSE REGULATIONS CONCERNING SOURCING OF BORROW FEES BY RESIDENCE OF THE RECIPIENT

March 31, 2026

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I. INTRODUCTION

This report (the "Report") comments on selected aspects of Notice 2025-63, published by the Internal Revenue Service (the "IRS") on October 23, 2025 (the "Notice"), announcing that the Department of the Treasury ("Treasury") and the IRS intend to propose regulations (the "Forthcoming Regulations") that would provide that certain borrow fees (as described in section 3 of the Notice) are sourced based on the residence of the recipient.[1]

We commend Treasury and the IRS for undertaking to address this longstanding area of uncertainty in the law and we support the core principle in the Notice of sourcing borrow fees to the residence of the recipient.[2] This approach is consistent with the economic substance of borrow fees, preserves the orderly operation of the capital markets, and is aligned with the approach embedded in U.S. tax treaties.[3] The Notice, in our view, correctly defines a borrow fee (including negative rebate),[4] in part, as a payment pursuant to a securities lending transaction or sale-repurchase ("repo") transaction (a "Securities Lending Transaction")[5] "paid *in substance* to compensate the lender of the securities . . . for making its securities available to the borrower of the securities." We believe all fees that qualify as borrow fees under this definition should be sourced by reference to the residence of the recipient.

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[1] The principal drafters of this Report were Vadim Novik and Elena Romanova. Substantial contributions were made by Raphael Rabinowitz. Helpful comments were provided by Kimberly Blanchard, Robert Cassanos, Olivier De Moor, Lucy Farr, Lawrence Garrett, Kevin Glenn, Edward E. Gonzalez, Lorenz Haselberger, Robert Kantowitz, John Lutz, Jeffrey Maddrey, Richard Reinhold, Stuart Rosow, David M. Schizer, Michael Schler, Peter F.G. Schuur, Eric B. Sloan, Wade Sutton, and Libin Zhang. This Report reflects solely the views of the Tax Section and not those of its individual members or any other party.

[2] We understand that the Notice was issued in response to Chief Counsel Advice 202548005 (July 18, 2025, released Nov. 23, 2025), and supersedes the sourcing analysis therein. *See* CCA 202548004 (Nov. 28, 2025). In CCA 202548005, the IRS confronted the question of whether the source of a type of fixed, determinable, annual or periodical income that lacks a specific sourcing rule in the statute must be determined by analogy to another statutory provision or whether the analogy may also extend to detailed regulatory sourcing rules. The Notice does not raise this question and, accordingly, we do not address this particular issue at this time.

[3] Under the 2006 U.S. Model Income Tax Convention and numerous U.S. treaties (e.g., Japan, France, the U.K.), borrow fees generally fall under the "Other Income" article (typically, Article 21). That article generally provides that items of income not dealt with elsewhere are taxable only in the recipient's country of residence, with no "source" country taxing rights (absent a permanent establishment).

[4] In the background section, the Notice describes the market practice of netting a rebate (which is functionally interest paid with respect to cash collateral) and the amount economically constituting a borrow fee. In circumstances in which the amount constituting a borrow fee exceeds the interest on cash collateral, the net amount paid is often referred to as "negative rebate." See Notice, Section 2.02(2). The Notice applies the new sourcing rule directly to the net borrow fee amount without the need to gross up, separate, or otherwise disaggregate the offsetting flows. This streamlined approach matches commercial netting conventions. This Report does not address this netting principle adopted by the Notice.

[5] The Notice defines the term "securities lending transaction" by reference to Treas. Regs. §§ 1.861-2(a)(7) and 1.861-3(a)(6), which in turn define such term as a transfer of securities described in Section 1058(a) or a substantially similar transaction. This Report does not address any issues that may be raised by this definition.

The Notice, however, limits the scope of the transactions to which this sourcing rule applies to those "documented on an industry-standard master agreement and confirmation … with standard market terms" (the "Industry Standard Documentation Requirement").[6] We believe that the Industry Standard Documentation Requirement is unnecessary. Securities Lending Transactions documentation and commercial terms vary among industry participants for reasons unrelated to the U.S. federal income tax treatment of borrow fees. The differences in the manner in which a transaction is documented do not typically support an inference about the transaction's substance. To assist Treasury and the IRS in evaluating the relevance of the Industry Standard Documentation Requirement and considering whether it should be removed or modified, this Report includes a brief summary of the information that we solicited and received from several leading market participants regarding contemporary Securities Lending Transactions documentation practices.

Accordingly, this Report recommends that the Forthcoming Regulations remove the Industry Standard Documentation Requirement altogether. As an alternative, Treasury and the IRS could modify the Industry Standard Documentation Requirement (1) to treat the use of industry standard documentation as probative—but not dispositive—evidence that the borrow fees are paid in substance to compensate the securities lender or repo seller for making the securities available, instead of a prerequisite, and (2) to broaden it to include agreements that are "substantially similar" to industry-standard agreements with "arm's-length" terms instead of "standard market" terms. We further recommend that Treasury and the IRS consider providing examples of the application of the facts and circumstances test. These examples may take into account one or more other facts that may be viewed as indicative of whether the fees are, in substance, paid to compensate the lender of the securities for making the securities available.

Finally, this Report recommends that the Forthcoming Regulations provide that residence be determined without reference to the Section 988 rules and, in the case of any partnership, that the determination of residence be made at the partner level.[7]

This Report focuses solely on the selected aspects of the Notice, which we read to have articulated principles applicable solely to borrow fees that do not constitute income effectively connected with the conduct of a trade or business within the United States (such income, "ECI"). Accordingly, this Report solely discusses considerations relevant to borrow fees that do not constitute ECI. To ensure that the Forthcoming Regulations comprehensively address the sourcing of borrow fees, the IRS and Treasury may need to consider the appropriate rules for determining

[6] As examples of such standard master documentation, the Notice lists Securities Industry and Financial Markets Association (SIFMA), Master Securities Loan Agreement (2017) ("MSLA"); International Securities Lending Association, Global Master Securities Lending Agreement (2010); SIFMA, Master Repurchase Agreement (1996); SIFMA and International Capital Market Association, Global Master Repurchase Agreement (2011); and The Bond Market Association and International Securities Market Association, Global Master Repurchase Agreement (2000) ("GMRA").

[7] Unless otherwise specified, all "Section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations promulgated thereunder (the "Treasury Regulations").

under what circumstances borrow fees constitute ECI, which may involve the resolution of potentially challenging policy and technical issues.[8]

A. Background

1. Description of the Notice

Section 3 of the Notice defines a borrow fee (including negative rebate) as:

> [A] fee that is (1) paid pursuant to a securities lending transaction or sale-repurchase transaction that is (i) documented on an industry-standard master agreement and confirmation (or electronic equivalent thereof) with standard market terms and (ii) entered into in the ordinary course of the taxpayer's and counterparty's trades or businesses or pursuant to their normal investment activities or objectives, and (2) paid in substance to compensate the lender of the securities (including a cash borrower in a sale-repurchase transaction) for making its securities available to the borrower of the securities (including a cash lender in a sale-repurchase transaction).

In addition to the substantive requirement in the second prong that a borrow fee, by its nature, must compensate the lender for making securities available to the borrower, the first prong contains the two-part requirement of "industry standard documentation" and "standard market terms."

The Notice also specifies that the residence of the recipient is determined under Section 988(a)(3)(B).

2. Overview of Securities Lending Transactions

The global securities lending market is vast. Approximately $30-40 trillion of securities are available to be loaned globally, and approximately $2.6 trillion of securities were on loan globally as of April 2023.[9] Securities lending plays a crucial role in maintaining efficient and liquid financial markets by enabling short selling and price discovery, contributing to liquidity in over-

[8] For example, it may be appropriate for the Forthcoming Regulations to apply the principles of Treas. Reg. § 1.863-7(b)(3) and Treas. Reg. § 1.988-4 for determining when borrow fees constitute ECI and prescribing appropriate sourcing rules for such borrow fees. Since this Report addresses solely the sourcing of borrow fees that do not constitute ECI, we reserve comment on these issues.

[9] S&P Glob. Mkt. Intel., *Lendable Inventory Skyrockets to over $40T for the First Time Ever* (Aug. 28, 2024), https://www.spglobal.com/market-intelligence/en/news-insights/research/lendable-inventory-skyrockets-to-over-40t-for-the-first-time-e; Int'l Sec. Lending Ass'n, *The Securities Lending & Borrowing Hub*, https://www.islaemea.org/sl-hub/ (last visited Mar. 8, 2026); DataLend, *Securities Lending 101: Understanding Market Metrics*, DataLend (May 2023), https://datalend.com/securities-lending-101-understanding-market-metrics/.

the-counter markets, preventing settlement failures by covering operational shortfalls, and supporting hedging and risk management.[10]

The Notice clearly lays out the mechanics of a typical Securities Lending Transaction, including the payment mechanics of borrow fees. Generally, in a securities lending transaction, one party (the "Securities Lender") lends securities to another party (the "Securities Borrower") in exchange for the Securities Borrower's obligation to return equivalent securities and to pay dividend equivalent amounts or interest equivalent amounts with respect to the borrowed securities. The Securities Borrower generally transfers collateral, such as cash, other securities, or other financial instruments to the Securities Lender to secure its obligation to return equivalent securities. In a repo, one party that owns securities (the "Repo Seller") sells them to a counterparty (the "Repo Buyer") for cash in exchange for the Repo Buyer's agreement 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 (generally referred to as the "price differential" or "repo rate").

Borrow fees generally are paid by a Securities Borrower or Repo Buyer (the "Borrow Fee Payer") to the Securities Lender or Repo Seller (the "Borrow Fee Recipient") in exchange for making the securities available. Borrow fees represent compensation to the Borrow Fee Recipient solely for the transfer of possession in a manner that allows the Borrow Fee Payer to transact in securities, while the Borrow Fee Recipient incurs the opportunity cost of foregoing its own ability to transact, including to sell the borrowed securities or to engage in corporate actions as the holder of record. Borrow fees thus are distinct from interest on collateral, substitute dividends, and substitute interest.

Pricing of borrow fees is determined based on the demand and the relative availability or scarcity of a security in the borrow market. Borrow fees are generally quoted as an annualized percentage of the market value of the borrowed securities, accrued and charged daily. For "special" securities that are difficult to source (*e.g.*, when few lenders are willing to lend), the borrow fee rate could be as high as 100% of trading value (*i.e.*, approximating the actual purchase cost of the security). Real-time borrow fee quotes for both equities and debt securities available to be borrowed are supplied by several specialized financial data providers, analytics platforms, market data aggregators, and brokers participating in Securities Lending Transactions markets.[11] Institutional participants typically access debt securities borrow rates through custodian banks, prime brokers,[12] or specialized lending agents. However, market participants often rely on private

[10] *See generally* Viktoria Baklanova, Adam Copeland & Rebecca McCaughrin, *Reference Guide to U.S. Repo and Securities Lending Markets*, 2015 Staff Rep. No. 740 (Fed. Reserve Bank of N.Y.) ("By effectively increasing the supply of securities, securities lending improves global market liquidity and enhances price discovery.").

[11] Leading providers include EquiLend/DataLend, Markit (S&P Global Market Intelligence) and Bloomberg Terminal (FIRS/Orbisa).

[12] Prime brokerage is a bundle of financial services provided by major investment banks to large institutional investors, such as hedge funds, asset managers, and proprietary trading firms. These services usually include securities lending for short selling, margin financing to leverage positions, trade execution and settlement, asset custody, cash

quotes from potential counterparties and negotiate borrow fees to set the rates for Securities Lending Transactions.

Based on our informal survey of market participants, prime brokerage platforms serve as the principal channel for accessing securities borrowing and lending. Institutional borrowers also source securities from agent lenders (such as custodians). We further understand that direct bilateral lending between parties, third-party agent specialists, and non-prime brokerage associated platforms constitutes a relatively smaller segment of the market transactions.

The vast majority of Securities Lending Transactions in which a borrow fee is paid are ordinary course transactions involving liquid securities that are borrowed for a specific use related to trading, short sales, coverage of existing positions, preventing settlement failures, or participating in corporate actions. The terms of such Securities Lending Transactions generally are shaped by the market and pricing is derived either from the available market rates or via an arm's-length negotiation between the parties. However, payments that are denominated as borrow fees may also be made in more complicated, structured transactions involving unique securities for which there may be no market pricing data and no apparent need for borrowing. Facts and circumstances surrounding such transactions may indicate that the payments to the purported lender of the securities are not being made in substance to compensate the Borrow Fee Recipient for making such securities available to the Borrow Fee Payer. As discussed further below, whether the agreement is documented on an industry standard form, however, does not, by itself, support inferences about the nature of the fees paid.

3. Market documentation practices

Based on our general experience and our informal survey of several market participants, the form of documentation used by various parties to Securities Lending Transactions varies significantly. As discussed below, some market participants use the industry standard agreements with only minor modifications; others leverage the standard agreements, but modify them substantially; and a third category prefer to use their own bespoke agreements.

a. Certain market participants use industry standard forms

Certain market participants use industry standard forms (*e.g.*, the MSLA or MRA) for their Securities Lending Transactions. The forms generally adequately address many pertinent issues, permit a certain range of flexibility (including through the use of elections and annexes), and are generally thought to streamline negotiations among transaction parties by setting a neutral starting point with respect to the commercial and legal protections to be enjoyed by the parties. Accordingly, many market participants find it acceptable and efficient to use the standard forms and simply include the economic terms of their specific transactions on the relevant documentation.

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management, and consolidated risk reporting. Institutional investors often outsource operational and financing needs as well as back-office functions to one or more prime brokers.

b. Extensive differences from industry-standard forms

Sophisticated participants on both sides of a Securities Lending Transaction often modify industry standard documentation to tailor it to their own businesses or procure more favorable legal terms. Industry standard forms reflect a middle ground compromise between borrowers and lenders, but do not necessarily reflect the views of each particular institution or market participant on its preferred risk allocations, its ability to negotiate better terms with counterparties due to its position in the market, or its own operational constraints or efficiencies. Accordingly, most, if not all, prominent market participants have modified the industry standard forms and adopted those modified versions as their preferred starting point template. For example, a leading U.S. bank may use its own version of a MSLA to document industry standard securities lending transactions to remedy what it believes to be deficiencies in the MSLA (*e.g.*, ambiguous drafting, lack of certain indemnities, or gaps in addressing comprehensively withholding tax risk, including under the Foreign Account Tax Compliance Act (generally referred to as "FATCA") and/or Section 871(m)). Furthermore, special provisions may be added to address securities with unique cash flows or that are categorized differently for tax purposes than they are for non-tax purposes (*e.g.*, preferred equity that trades as a fixed income security). Similarly, market participants based in non-U.S. jurisdictions may modify industry standard documents to reflect considerations specific to those jurisdictions that better represent local regulatory or market practices. Finally, documentation for Securities Lending Transactions is often negotiated—these negotiations may start with an industry standard form, which is modified by the parties and, in its execution version, reflects the compromise reached. Tax considerations (such as the potential application of Section 1058) are sometimes taken into account but usually do not determine whether industry standard forms are revised or supplemented.

c. Bespoke documentation

Certain market participants use templates that are completely distinct from industry standard documentation to document their Securities Lending Transactions. We refer to these types of documents as "bespoke." Most of the time, market participants use bespoke documentation for historical reasons, because some firms have developed "house" documentation which remains in use notwithstanding the expansion of industry-standard documentation.

However, one distinct and critical category of bespoke documentation is prime brokerage agreements. Such agreements are generally entered into between an institutional investor (such as a hedge fund) and a broker, whereby the broker agrees to provide the investor with prime brokerage services, such as clearing or settling trades as well as holding the investor's securities. It is common for brokers to borrow their customers' securities and also to source and lend securities to their customers. We understand that, generally, when a Securities Lending Transaction occurs in connection with margin securities in a prime brokerage arrangement, the prime brokerage agreement itself (and not an industry standard agreement that governs Securities Lending Transactions generally, such as a MSLA) governs the terms of the Securities Lending Transaction. To our knowledge, there is no industry standard prime brokerage agreement, even though prime brokerage agreements of leading financial institutions would be largely similar to each other.

Regardless of whether the agreements under which Securities Lending Transactions are documented vary significantly from the industry standard agreements, or may be of a kind where no industry standard form has emerged, the choice of agreement or the decision to modify it offers little information about whether borrow fees are paid in substance to compensate the Borrow Fee Recipient for making the securities available because, as described above, such choice or decision typically is driven by non-tax considerations unrelated to the substantive nature of the fees charged under the agreement.

II. SUMMARY OF RECOMMENDATIONS

1. We recommend that the Forthcoming Regulations remove the Industry Standard Documentation Requirement altogether.

2. As an alternative to that recommendation, we recommend that Treasury and the IRS modify the Industry Standard Documentation Requirement to treat it as probative—but not dispositive—evidence of substance instead of a prerequisite, and broaden it to include "substantially similar" agreements with "arm's-length" terms instead of only "industry standard" agreements with "standard market" terms. In addition, if Treasury and the IRS adopt this alternative, we recommend that the Forthcoming Regulations also explicitly provide that a "prime brokerage agreement used in the ordinary course" would be an agreement substantially similar to "an industry-standard master agreement and confirmation."

3. We recommend that Treasury and the IRS consider providing specific examples that would demonstrate the application of the facts and circumstances test to Securities Lending Transactions and may identify certain facts which could be relevant for evaluating whether fees are being paid in substance to compensate the Borrow Fee Recipient for making its securities available to the Borrow Fee Payer.

4. We recommend that the Forthcoming Regulations define "residence" for purposes of sourcing borrow fees without reference to Section 988(a)(3)(B) and provide that, in the case of any partnership, the determination of residence generally is made at the partner level.

III. DEFINE BORROW FEES SOLELY BASED ON SUBSTANCE

A. The Industry Standard Documentation Requirement Should Be Removed

The Notice acknowledges that "the label given to a payment does not govern the determination of source; whether a fee labeled as a borrow fee is treated as such for Federal income tax purposes is determined based on the substance of the fee." We believe that any fee that in substance is paid for making the securities available to the borrower is appropriately sourced by the residence of the recipient. We believe that this standard is sufficient and the Industry Standard Documentation Requirement as a prerequisite to such treatment is unnecessary.

Although we understand that the Industry Standard Documentation Requirement may have been intended to ensure that the rule applies only to bona fide Securities Lending Transactions, we believe the presence of industry standard documentation is merely probative, but not dispositive, evidence of the substance of the payment. The requirement, if applied as a prerequisite, may exclude legitimate commercial Securities Lending Transactions that satisfy the "substance" requirement, which, for the various reasons discussed above, are not documented on standard forms. Furthermore, taxpayers potentially could use the choice of documentation as a means to elect out of the residence-based sourcing rule for borrow fees mandated by the Forthcoming Regulations if an alternative sourcing rule is more advantageous.

In addition, the component of the Industry Standard Documentation Requirement that mandates "standard market terms" is not entirely clear, particularly because standard agreements are routinely modified by market participants. On the one hand, it is possible to interpret this condition as reinforcing the requirement for standard legal terms, which would prevent any significant modifications to the industry standard agreement. On the other hand, it is possible to interpret this requirement as addressing pricing or other commercial terms (*e.g.*, duration of the loan, recall rights, collateralization, or indemnities). The "standard market terms" requirement makes the range of legal and commercial terms that are intended to be within the scope of the Forthcoming Regulations uncertain.

Even though the Notice clearly aims to decrease uncertainties and assist in the efficient functioning of the securities lending and repo market, the Industry Standard Documentation Requirement in its current form could prevent the Notice from achieving this objective. In particular, it is questionable whether the Notice would apply to the Securities Lending Transactions in which margin securities are borrowed in a prime brokerage arrangement, because there is simply no industry standard agreement on which such transactions are documented. Because withholding agents tend to avoid the risk of under-withholding, this uncertainty could lead to excessive withholding and, potentially, claims for refunds filed by the Borrow Fee Recipients. In addition, the Industry Standard Documentation Requirement could incentivize participants to change their documentation practices without clear tax policy justification for encouraging or compelling the modification of normal market behavior, thereby creating inefficiencies.

We, therefore, recommend that the Forthcoming Regulations remove the Industry Standard Documentation Requirement altogether and rely solely on the definition of a borrow fee as paid in substance to compensate the Borrow Fee Recipient for making its securities available to the Borrow Fee Payer.

B. Modifying the Industry Standard Documentation Requirement

As an alternative to removing the Industry Standard Documentation Requirement completely, Treasury and the IRS could modify the Industry Standard Documentation Requirement to treat it as probative, but not dispositive, evidence of substance—instead of a requirement—and broaden the permitted documentation to better align with the actual market practice. We envision that the Industry Standard Documentation Requirement would not be a part

of the definition of "borrow fee," but instead that the Forthcoming Regulations would specify that whether the Industry Standard Documentation Requirement is met is probative, but not dispositive, evidence of substance of the payment being a borrow fee. In addition, we envision that the revised definition of the Industry Standard Documentation Requirement would read as follows: "an industry-standard master agreement and confirmation**, or a substantially similar agreement (including a prime brokerage agreement entered into in the ordinary course)** … with **arm's length** ~~standard~~ ~~market~~ terms." We believe that these revisions could mitigate taxpayers' ability to elect out of the Notice by selectively choosing documentation and could provide sufficient flexibility to market participants to continue using the agreements and documentation that they have become comfortable with for their own reasons, while emphasizing the economic terms of the transaction being arm's length. This change may alleviate concerns in the market that a significant portion of borrow fees paid with respect to routine Securities Lending Transactions may fail to qualify for the residence-based sourcing rule because they are entered into pursuant to an agreement that does not closely adhere to an industry standard agreement, or because there is uncertainty as to whether the legal terms in that agreement are "market standard terms." Although, in some cases, this approach would still raise interpretive questions about what constitutes a "substantially similar agreement" and when a transaction has "arm's length" terms, such questions already arise with respect to other provisions of the Code and Treasury Regulations.

C. The Forthcoming Regulations Could Include Examples Identifying Certain Facts Relevant for the Application of the Facts and Circumstances Test

Under either of the two approaches described above, we believe that the core definition of a borrow fee as paid in substance to compensate the Borrow Fee Recipient for making its securities available to the Borrow Fee Payer should control whether the fee would qualify for residence-based sourcing. We believe that the IRS can rely on the strength of existing jurisprudence to challenge any transaction that does not comport with this definition based on substance over form and similar doctrines.[13]

As noted above, an overwhelming majority of Securities Lending Transactions are ordinary course transactions between unrelated parties engaged in commercial activity. However, certain transactions could present a more difficult case and certain facts may be viewed as potentially indicating that fees are not being paid in substance for making the securities available, but instead are paid in consideration for services, capital, or some other provision of value. Such transactions could warrant more scrutiny. To establish parameters for a facts-and-circumstances inquiry, we recommend that Treasury and the IRS consider providing examples that would describe certain relevant facts, such as whether the transaction is entered into in the ordinary course of the parties' trades or businesses or their normal investment activities and whether the timing, amount, or other terms of the borrow fee are linked to other payments or transfers of value between the same or related parties.

[13] *Gregory v. Helvering*, 293 U.S. 465 (1935); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

Consider the following two potential examples.

Example 1: US Dealer is organized in the United States and F Fund is organized in Country A, a jurisdiction that does not have a tax treaty with the United States. F Fund owns Shares, a block of stock of an unrelated corporation that is hard to borrow due to increased short activity in the market. US Dealer needs to borrow the Shares in order to cover its own hedging transactions. US Dealer enters into a loan agreement (based on its own bespoke form) with F Fund with respect to the Shares at an annualized fee of 90% of the trading price of the Shares, established based on an arm's length negotiation between the US Dealer and F Fund. US Dealer posts collateral with F Fund and agrees to mark the collateral and the Shares to market daily for purposes of adjusting the amount of posted collateral. US Dealer uses the Shares in its hedging activities. Under these facts, the fee paid by US Dealer is being paid to F Fund in substance for making the Shares available, which is indicated by the use of the borrowed Shares and the terms negotiated by the parties at arm's length.

Example 2: F Bank is a bank organized and chartered in F Country, a jurisdiction that does not have a tax treaty with the United States. US Corporation enters into a loan agreement (documented on a MSLA) to borrow from F Bank the publicly traded and readily-available stock of F Corporation, an unrelated foreign corporation organized in F Country. The parties negotiate a substantial fee characterized in the documentation as a borrow fee. US Corporation maintains the stock purportedly borrowed in a custodial account with F Bank and does not engage in any transactions in which the stock may be needed. F Bank has unrestricted use of the F Corporation stock as needed. Under these facts, the borrower does not use the borrowed stock, and the lender retains the use of the stock. These facts may suggest that the payment that is purported to be a borrow fee is in substance not being paid to compensate the lender for making the stock available and should not be characterized as a borrow fee for sourcing purposes. The IRS may determine that the timing, amount, and other terms of the borrow fee may indicate that the payment is made as compensation for another transfer of value between US Corporation and F Bank or related parties. Depending on the nature of other transactions between US Corporation and F Bank, a payment with respect to such other transactions could be characterized as U.S. source fixed, determinable, annual or periodical income.

IV. DETERMINATION OF RESIDENCE

A. The Section 988 Residence Rules

The Notice provides that "[t]he residence of the recipient is determined in the same manner as under section 988(a)(3)(B)." The fundamental principle of Section 988 is that foreign currency should generally be treated as property and that gains and losses should be sourced accordingly. In addition, the concept of "qualified business unit" (a "QBU") is central to the Section 988 rules. A QBU is generally any separate and clearly identified unit of a trade or business of a taxpayer if

that separate unit maintains separate books and records.[14] The QBU concept is central to the Section 988 rules, because Section 988 characterizes foreign currency gain and loss by reference to a functional currency, and it is more logical and consistent with real-world business practices to assign a functional currency at the level of a separate business unit (*i.e.*, a QBU), not the taxpayer as a single entity. The residence-based sourcing rules under Section 988 incorporate the QBU concept. Specifically, the language of Section 988(a)(3)(B)(ii) provides:

> In the case of a qualified business unit of any taxpayer (including an individual), the residence of such unit shall be the country in which the principal place of business of such qualified business unit is located.

We do not believe that it is necessary to reference the Section 988 source rules for purposes of sourcing borrow fees. The QBU concept, although necessary for purposes of the Section 988 rules, is not relevant to the sourcing of borrow fees. The existence of a QBU (*i.e.*, a separate business unit with its own books and records) is crucial to the appropriate sourcing of foreign currency gains and losses, because functional currency is assigned at the level of the QBU. However, the QBU concept is not relevant in the case of borrow fees that are paid in the functional currency of both the Borrow Fee Payer and the Borrow Fee Recipient.[15] Accordingly, there is no need to reference the Section 988 rules for purposes of determining residence in the context of sourcing borrow fees.

B. Determination of Residence for Partnerships

1. Background

A substantial segment of market participants conducts Securities Lending Transactions through investment funds that are organized as partnerships for U.S. tax purposes. Frequently, investment funds end up being passive securities lenders because they hold their securities in a prime brokerage account that permits the broker to borrow their securities.

The Notice specifies that the residence of the recipient will be determined under Section 988(a)(3)(B). In the case of a Borrow Fee Recipient that is classified as a partnership for U.S. federal income tax purposes, this implicates the ambiguities that surround the proper application of Treas. Reg. § 1.988-4(d)(3). Based on a literal reading of the applicable Treasury Regulations, if the recipient is a partnership that is not engaged in a U.S. trade or business by reason of the "trading" safe harbor set forth in Section 864(b)(2), the source of the borrow fee will

[14] *See generally* Section 989(a).

[15] As noted above, this Report focuses solely on borrow fees that do not constitute ECI.

be determined at the partner level,[16] and, if the recipient is any other partnership, based on whether such partnership is a United States person, as defined in Section 7701(a)(30).[17]

The application of Treas. Reg. § 1.988-4(d)(3) is not entirely clear. For example, it is not entirely clear whether a partnership that takes the position that it is not engaged in the conduct of a U.S. trade or business because it is merely an investor in stocks, securities, or commodities literally is entitled to rely on the rule, because such a partnership does not need the protection of the "trading" safe harbor to conclude that it is not engaged in a U.S. trade or business. As a practical matter, we understand that this rule usually is read broadly to cover partnerships that are not engaged in a trade or business within the United States.[18] Treas. Reg. § 1.988-4(d)(3) further illustrates why relying on the Section 988 rules for purposes of determining "residence" in sourcing borrow fees may create unneeded complexity, since paragraph (d)(3) presumes that the partnership is engaged in a trade or business, which is one of the prerequisites for a QBU.

2. Recommendation for Determining Residence

The determination of whether to treat a partnership as an entity or aggregate traditionally turns on the contextual determination of which treatment is "more appropriate," based on the policy of a particular Code provision or the Treasury Regulations.[19] For example, in *PBD Sports*, the Tax Court said:

> For purposes of interpreting Code provisions outside of subchapter K, a partnership may be treated as either an entity, separate from its partners, or an aggregate of its partners depending on which characterization is more appropriate to carry out the intent and/or purpose of the particular Internal Revenue Code section under consideration.[20]

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[16] *See* Treas. Reg. § 1.988-4(d)(3).

[17] Specifically, Treas. Reg. § 1.988-4(d)(1) provides in the case of a partnership that is a United States person (as defined in Section 7701(a)(30)), residence shall be deemed to be in the United States, and in the case of a partnership that is not such a person, residence shall be deemed to be in a country other than the United States.

[18] *See* New York State Bar Association, *Report on Securitization Reform Measures*, Report No. 1024 (Dec. 20, 2002) (noting that, under Treas. Reg. § 1.988-4(d)(3), it would be illogical for a wholly passive investment vehicle to be less transparent than a slightly more active vehicle that trades).

[19] *See* H.R. Rep. No. 83-2543, at 59 (1954) (the "1954 House Report") ("Both the House provisions and the Senate amendment provide for the use of the 'entity' approach in the treatment of the transactions between a partner and a partnership. . . . No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions."). Courts have cited the 1954 House Report and applied the "more appropriate" standard to conclude whether the entity or aggregate approach should be taken to advance a certain Code section. *See, e.g.*, *Burde v. Commissioner*, 352 F.2d 995, 999-1001 (2d Cir. 1965), *aff'g* 43 T.C. 252 (1964). This concept is reflected in Treas. Reg. § 1.701-2(e), which presumes that application of the "aggregate theory" is normally the correct approach.

[20] *PBD Sports Ltd. v. Commissioner*, 109 T.C. 423, 433–34 (1997).

We believe that, with respect to a partnership receiving borrow fees that are not ECI, it would be more appropriate to source such borrow fees at the partner level (*i.e.*, apply the "aggregate theory" of partnerships), regardless of whether the partnership is foreign or domestic.[21] As discussed further below, we believe that treating partnerships as "entities" in such circumstances generally would not achieve any discernable improvement in the administrability of sourcing borrow fees.

The partner-level approach would cause a foreign partner in a domestic partnership to treat its allocable share of borrow fees paid to the partnership as foreign source income. In practice, a domestic partnership would be the withholding agent and generally should have information readily available to determine each partner's residence. To be consistent, the aggregate theory should be applied to foreign partnerships as well. In practice, non-withholding foreign partnerships generally have the ability, when required, to provide withholding agents with a copy of IRS Form W-8IMY with attached IRS Forms W-8 or W-9 for the partners (accompanied by a withholding statement and an allocation schedule), and withholding foreign partnerships generally would be in a position similar to those of domestic partnerships in this regard. As a result, the application of a partner-level residence determination should not create significant administrative burdens either for foreign partnerships or withholding agents.

As discussed above in Section IV.B.1, there is no need to reference Section 988(a)(3)(B) and the Treasury Regulations thereunder for purposes of determining residence in the context of borrow fees. Rather, it is appropriate to determine residence based on the U.S. tax status of the beneficial owner of the borrow fees. Accordingly, we recommend that the Forthcoming Regulations provide the following rules for determining residence:

- The residence of an individual that is a United States person (as defined in Section 7701(a)(30)) should be the United States.
- The residence of an individual that is not a United States person (as defined in Section 7701(a)(30)) should be a country other than the United States.
- The residence of a corporation, trust, or estate that is a United States person (as defined in Section 7701(a)(30)) should be the United States.
- The residence of a corporation, trust or estate that is not a United States person (as defined in Section 7701(a)(30)) should be a country other than the United States.

As discussed above, it generally is appropriate to determine residence at the partner level for purposes of sourcing borrow fees. The IRS and Treasury can accomplish this with a clear

[21] As noted above, this Report focuses solely on the sourcing of borrow fees that do not constitute ECI and the residence rules that apply for purposes of that determination. In the case of a partnership engaged in a U.S. trade or business, it may be appropriate to depart from the "aggregate" treatment of partnerships that we recommend here. We reserve comment on these issues.

statement in the Forthcoming Regulations providing that the determination of residence for purposes of sourcing borrow fees shall be made at the partner level.

In many cases, the approach outlined above would achieve largely the same result as Section 988(a)(3)(B) and the regulations thereunder,[22] but we believe the approach above would achieve more justifiable results in other cases because it would (1) not incorporate the QBU rules, which are not relevant to the sourcing of borrow fees, (2) ensure that borrow fees paid to individuals are sourced based on the individual's status as a United States person (as defined in Section 7701(a)(30)), rather than the individual's "tax home,"[23] and (3) provide that residence is determined at the partner level in the case of all partnerships receiving non-ECI borrow fees.

V. CONCLUSION

We again commend the IRS and Treasury for addressing this longstanding area of uncertainty and expressing their intention to promulgate clear and administrable rules. We believe that the Notice correctly identifies that the key criterion for residence-based sourcing is whether the fee is paid in substance to compensate the Borrow Fee Recipient for making the security available, which we believe should be the only relevant substantive factor for determining whether such fee is a borrow fee. We believe that the recommendations in this Report offer Treasury and the IRS modest, workable revisions that would significantly improve the clarity and certainty provided by the Forthcoming Regulations while appropriately addressing transactions that present a heightened risk of tax avoidance.

[22] *See* Treas. Reg. § 1.988-4(d).

[23] This approach to sourcing borrow fees paid to individuals would be more administrable, because withholding agents would be able to easily determine an individual's status as a United States person (as defined in Section 7701(a)(30)) based on whether the individual provides the withholding agent with IRS Form W-9 or IRS Form W-8. It is significantly more challenging for withholding agents to discern an individual's "tax home" (as defined under Section 911(d)(3)).