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Internal Revenue Service
memorandum

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date: July 18, 2025

to:

from:

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subject: Taxation of a Foreign Partnership Engaged in Repo Transactions

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

QUESTIONS PRESENTED

Is a foreign taxpayer engaged in a trade or business within the United States for purposes of section 882(a) ("**USTB**") because of its repo transactions (defined below) from which the taxpayer reported "interest" income for book purposes?

If the foreign taxpayer did not engage in a USTB, did the taxpayer receive fixed or determinable annual or periodic income from U.S. sources that is subject to tax under sections 871(a) or 881(a) and withholding thereof?

SHORT ANSWER

Under the facts presented, the taxpayer's repo transactions are generally within a trading safe harbor that prevents them from giving rise to a USTB and the reverse repo transactions which may be outside of the trading safe harbor are merely investment activity ancillary to the safe harbor transactions and insufficiently profit-oriented to give rise to a USTB.

The taxpayer's securities lending fees (defined below), at least to the extent paid by U.S. counterparties (including U.S. branches) and separately stated or not contractually offset by payment of stated return, are U.S.-source income that is subject to tax under section 871(a) or 881(a). The taxpayer is liable as a withholding agent for U.S. tax not withheld from U.S.-source securities lending fees allocable to the taxpayer's foreign partners. If any foreign partners may qualify for benefits of an income tax treaty with the United States, additional advice will be provided.[1]

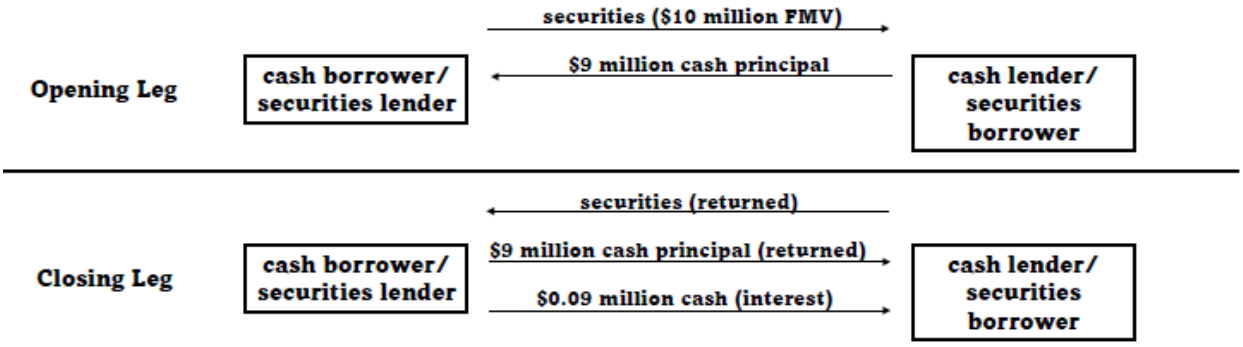
BACKGROUND

I. Commercial and Economic Background

In a sale and repurchase transaction ("**repo transaction**"), one counterparty (the "**cash lender**" and "**securities borrower**") purchases securities from another counterparty (the "**cash borrower**" and "**securities lender**") subject to an agreement for the cash borrower (securities lender) to repurchase the securities in the future. Generally (and for purposes of this memorandum), a "**repo**" is a repo transaction described from the perspective of the cash borrower (securities lender), and a "**reverse repo**" is a repo transaction described from the perspective of the cash lender (securities borrower).

[1] In this regard, it will be relevant whether the entity that is a payor is considered a partnership or instead a company from the standpoint of the tax laws of the resident country of any U.S. treaty-eligible investor.

A repo transaction may function as a secured loan, a securities lending transaction, or both. If the transaction is initiated because the initiating party wants to borrow money or put money on hand to work, then the transaction resembles a loan. Repo transactions are often collateralized by securities with a "value" equal to the loan "principal;" for this purpose, however, the securities' "value" is subject to a "haircut" (below fair market value), which gives the cash lender some margin for price volatility. For example,[2] a $9 million repo "loan" subject to a 1% effective interest rate and a 10% haircut would have the following characteristics:



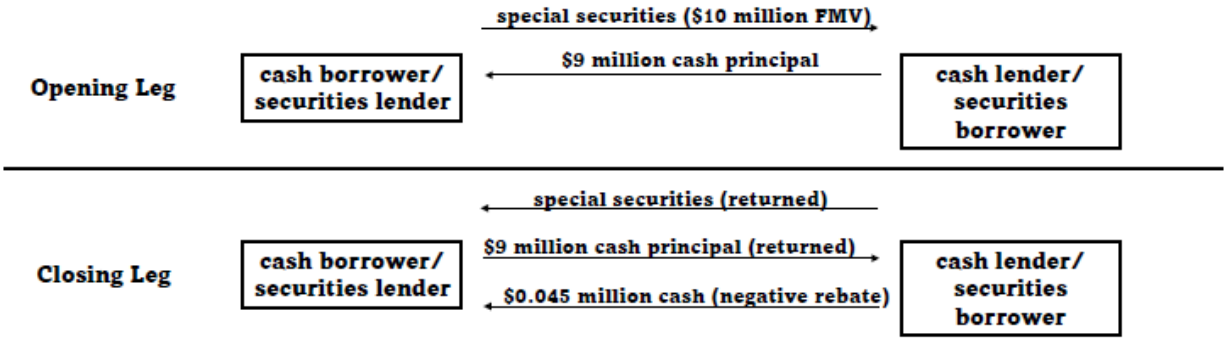
Where a repo transaction is intended primarily as a secured loan, the parties will often agree to a "**general collateral repo**" (or "**GC repo**"). Under a GC repo, the cash borrower (securities lender) elects how to secure the transaction from a basket of specified securities that generally includes U.S. Treasuries. "Interest rates on overnight general collateral R[epo]s on Treasury securities are usually quite close to rates on overnight loans in the federal funds market. This reflects the essential character of a general collateral R[epo] as a device for borrowing and lending money."[3]

A repo transaction may also function as a securities lending transaction. If the securities borrower (cash lender) insists on borrowing (purchasing and reselling) a specific security, then the repo is described as "on special" or as a "**special repo**." Generally, the effective interest rate on a special repo is reduced below the interest rate on a GC repo (of equal tenure) in an amount equal to the price of borrowing the specific security (such amount, the "**securities lending fee**"). Thus, in the example above (interest rate of 1%), a securities lending fee of 0.7% would cause the interest rate to be 0.3%. The greater the "specialness" of (demand for) a security, the greater the securities lending fee.

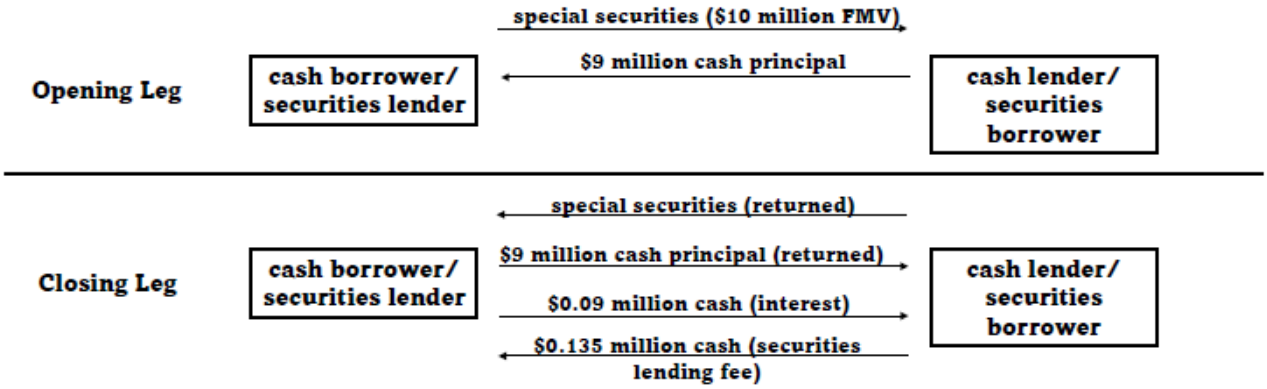
[2] This example is modeled after Figure 2 of Viktoria Baklanova, Adam Copeland & Rebecca McCaughrin, Reference Guide to U.S. Repo and Securities Lending Markets 3 n.4, Fed. Res. Bank of N.Y ("**FRBNY**") Staff Report No. 740 (2015) ("**FRBNY Reference Guide**").

[3] Michael J. Fleming and Kenneth D. Garbade, Repurchase Agreements with Negative Interest Rates,10(5) CURRENT ISSUES IN ECONOMICS AND FINANCE 2 (2004).

If the GC repo rate is already near 0% (as occurred between March 2020 and March 2022),[4] then the securities lending fee can cause the special repo rate to drop below zero. For example, suppose the price of a security is temporarily inflated or the security otherwise is hard to borrow so that a securities borrower is willing to pay a securities lending fee of 1.5% (to avoid a "fail to deliver" or to close out a short sale). If this securities lending transaction is accomplished with a special repo that is executed under terms that are otherwise identical to the repo illustrated above, then the effective interest rate on this special repo would be -0.5%. In other words, the cash *borrower* will receive and report income on the special repo, which some characterize as "negative rebate." This transaction would appear as follows:



In this example, the cost of money is not negative. The cash lender/securities borrower is willing to pay a market-rate securities lending fee greater than what it would have demanded as market-rate compensation for the use or forbearance of money:



II. Facts

("**Macro Fund**") is a that is a partnership for U.S. federal income tax purposes. Macro Fund is owned in part by ("**Master Fund**"), which itself is a partnership for U.S. federal income tax purposes. Macro Fund and Master Fund (collectively, "**Taxpayer**") are under examination for tax year ending (the "**Audit Year**"). Unless otherwise stated, all facts relate to the Audit Year and only the activities of Macro Fund discussed herein were considered in making the USTB determination.

[4] FRBNY, Broad General Collateral Rate Data.

Master Fund is the master fund in one of several master-feeder investment vehicles created by (“**Agent**”).[5] Agent, the investment manager of Master Fund and Macro Fund, had complete discretion to trade on Taxpayer’s behalf.[6] Agent exercised that discretion through domestic and foreign personnel.[7]

A. Trading and Financing Strategy

Agent markets Master Fund as a hedge fund engaged in typical hedge fund strategies. For example, Agent engaged in what it described without elaboration as a “credit and macro” trading strategy. Taxpayer did not provide further information about this strategy.

An organization chart provided by Taxpayer indicates that Macro Fund is the fund through which Master Fund undertook what it termed its “macro strategies.” Master Fund owned interests in several other funds that were domestic (U.S.) and foreign partnerships and through which Master Fund undertook “ .”

Taxpayer depended on large banks to finance its trading strategies. A private placement memorandum for one of the feeder funds that invested in Master Fund (the “**PPM**”)[8] notes that Master Fund was authorized to

The PPM states that Taxpayer had no special access to financing and instead relied on “ .”[9] In this regard, hedge funds typically rely on the handful of prime brokers that are also FRBNY primary dealers, and Taxpayer apparently did the same.[10] The PPM implies that Taxpayer has limited bargaining power over its financing counterparties: while Taxpayer would “ .”[11]

Taxpayer did not market any strategy of loaning money or matched-book dealing. Agent, however, established relationships with its trading counterparties (generally, large banks) and often phoned the counterparties.

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[5] Agent is a . United States citizen(s) indirectly control(s) 100% of the general partner of Agent.

[6]

[7] On Agent’s website, it boasts “ .”

[8]

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[9] PPM, at .

[10] See infra note 14 (noting that % of Taxpayer’s repo transactions were executed with FRBNY primary dealers).

[11] PPM, at .

Taxpayer asserts that it deposited inactive (excess) funds in highly liquid financial assets, including reverse repos:

According to Taxpayer, the returns earned from depositing its inactive funds do not include any embedded markup for services, unusual risk, etc. Taxpayer asserts that it was a price taker on this activity and that it did not advertise itself as a cash lender.

B. The Repo Transactions

During the Audit Year, Agent, on behalf of Taxpayer, executed thousands of repo and reverse repo transactions.[12] These transactions were with respect to government securities and corporate debt.[13] According to Taxpayer's marketing materials, at least some of the repo transactions were undertaken to " " other repo transactions; in other words, Taxpayer would execute a repo to exit a position taken in an identical reverse repo, and vice versa.

Taxpayer undertook most of the repo transactions with large, generally domestic banks[14] and pursuant to master repurchase agreements, which permitted netting of offsetting payments.

Taxpayer executed the repo transactions after accepting an indicative (nonbinding) quote posted to the trading platforms. In the case of a special repo transaction (described above), Taxpayer first made a request for a quote ("**RFQ**") to the several large banks with which Taxpayer maintained working relationships. Taxpayer made RFQs by phone and electronically through a chat function on the trading platforms. Taxpayer represents that it did not make quotes or respond to RFQs.

Taxpayer represents that nearly all the repo transactions permitted rehypothecation, and this is consistent with how repo transactions are typically structured. It is not clear how often the collateral was transferred to the cash lender (as opposed to held in the custody of the cash borrower) or how often rehypothecation was exercised.

Most, if not all, of Taxpayer's repo transactions were performed under standard "master agreements" such as (i) the Global Master Repurchase Agreement ("**GMRA**") published by International Capital Markets Association in collaboration with SIFMA, and (ii) the Global Master Repurchase Agreement ("**TBMA/ISMA**") published by the Bond Market Association and the International Securities Market Association.

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[12] Taxpayer's books described a repo transaction as a "repo" where Taxpayer was the cash lender (securities borrower), and as a "reverse repo" where Taxpayer was the cash borrower (securities lender). This memorandum subscribes to the ordinary description of "repo" as a repo transaction from the perspective of the cash borrower (securities lender).

[13] Financial Statements for

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[14] Approximately % of Taxpayer's repo transactions were undertaken with large banks. Each of the large banks (or an affiliate thereof) is also listed on the current list of FRBNY primary dealers.

A sampling of Taxpayer's repo transactions indicates that most had an overnight term or an open term that is akin to an overnight term. A handful of the transactions had unusually long terms: the sampling identified five reverse repos with an average term of 150 days. The sample indicates that most of the securities subject to the repo transactions were foreign sovereign debt, and the remainder were U.S. Treasuries.

C. Book and Tax Reporting

Taxpayer's books and records reflect considerable (and likely continuous) trading activity. Taxpayer reported approximately: $ of purchased securities; $ of sold securities; $ in proceeds from short sales; and $ in payments on short sales. Taxpayer booked $ of interest income, including $ attributable to reverse repos, and $ attributable to "negative interest expense" on repos.

Each of Master Fund and Macro Fund filed a Form 1065 and concluded that it did not engage in a USTB. Accordingly, each of Master Fund's foreign partners filed a blank (protective) Form 1120-F. Neither Master Fund nor Macro Fund reported any withholding or gross basis tax on securities lending fees, and neither filed a withholding tax return on either Forms 1042/1042-S or Forms 8804/8805. Taxpayer has not claimed treaty benefits.

TAXPAYER IS NOT ENGAGED IN A USTB

I. Law

Section 882(a)(1) provides that a foreign corporation that is engaged in a USTB is taxable on a net basis on its income that is effectively connected with the conduct of a USTB. Section 875(1) provides that "a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged." The question at hand is whether Taxpayer is engaged in a USTB.

A. The Trading Safe Harbors

Congress enacted two statutory safe harbors (the "**Trading Safe Harbors**") pursuant to which certain trading activities conducted by or for a foreign person that might otherwise constitute a USTB are treated as not being a USTB. The first Trading Safe Harbor (the "**(A)(i) Safe Harbor"**) is not available to Taxpayer because it requires that the foreign person not conduct those activities through an agent in the United States who has been granted discretionary authority or through a U.S. office of the foreign person. § 864(b)(2)(A)(i) and (C).

The second Trading Safe Harbor (the "**(A)(ii) Safe Harbor**") provides that the term "trade or business within the United States" does not include "[t]rading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions." § 864(b)(2)(A)(ii). A dealer in stocks or securities may not use the (A)(ii) Safe Harbor. Id. The (A)(ii) Safe Harbor may apply to a foreign person who has an office or other fixed place of business in the United States.

B. The Meaning of "Trading in Stocks or Securities" for Purposes of the Trading Safe Harbors

Both Trading Safe Harbors apply to "trading in stocks or securities." The regulations under section 864 interpret that term to mean "the effecting of transactions in stocks or securities," which includes "buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise … and any other activity closely related thereto (*such as obtaining credit for the purpose of effectuating such buying, selling, or trading*)." See Treas. Reg. § 1.864-2(c)(2)(i) and (ii) (emphasis added). The volume of stock or security transactions effected during a taxable year is irrelevant. See Treas. Reg. § 1.864-2(c)(1) and (2). For these purposes, the term "securities" means any note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing. Treas. Reg. § 1.864-2(c)(2).

C. The Meaning of "Dealer in Stocks or Securities" For Purposes of the (A)(ii) Safe Harbor

The regulations under section 864 define a "dealer in stocks or securities" as "a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom." Treas. Reg. § 1.864-2(c)(2)(iv)(*a*). A person that buys and sells, or holds, stocks or securities solely for investment or speculation is not a dealer. Id. A person's transactions in stocks or securities effected both in and outside the United States are taken into account to determine whether the person is a dealer in stocks or securities. Id. The regulations provide two exceptions to the definition of the term "dealer in stocks or securities," but they are not relevant to a person that is neither an underwriter nor acting as an agent with respect to a customer that is not itself a dealer.

II. Analysis

Based on the facts described herein, we do not view Taxpayer as engaged in a USTB for the period in question. Taxpayer is a non-dealer that generally engaged in exempt trading under the (A)(ii) Safe Harbor. To the extent (if any) that Taxpayer's reverse repo activity as described herein is outside the safe harbor, the activity is an investment activity ancillary to the safe harbor activity and does not give rise to a USTB.

A. Taxpayer is an Eligible Non-Dealer

Taxpayer was not a dealer in stocks or securities for purposes of the (A)(ii) Safe Harbor, even though Taxpayer was "regularly engaged … in purchasing stocks or securities and selling them to" others. See Treas. Reg. § 1.864-2(c)(2)(iv)(*a*). A dealer in the sense used in the (A)(ii) Safe Harbor must be regularly engaged as a merchant with a view towards profiting from "customers," which is to say dealers seek to profit (even without a rise in value during the interval of time between purchase and resale) "because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost." See Kemon v. Comm'r, 16 T.C. 1026, 1032 (1951) (defining property held primarily for the sale to "customers" under a predecessor to section 1221(a)(1)). See also section 475(c)(1) (defining a dealer for purposes of section 475 as a taxpayer who "regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business" or "regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business"). Taxpayer's counterparties (generally large banks)

were "dealers" when they sought to profit from their superior access to the repo market, e.g., through matched-book dealing. Taxpayer, by contrast, had less favorable access to the repo market than its counterparties and could not expect to profit as a dealer. Instead, Taxpayer merely used repo transactions to finance its trading and thereby profit from changes in the intrinsic value of the underlying securities, e.g., "a rise in value during the interval of time between purchase and resale …." See Kemon, 16 T.C. at 1032.

The special repos require a separate analysis, because those transactions were not engaged in by Taxpayer to borrow cash for trading purposes or to put excess cash on hand to work. Special repos *as conducted by the Taxpayer* do not constitute a dealer activity. In Kemon v. Commissioner, the court explained:

> Contrasted to "dealers" are those sellers of securities who perform no such merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells.[15]

Taxpayer offers to lend securities on special repo to the major banks that it deals with. Presumably such major banks have other, and possibly better, ways to find securities they are looking to borrow. Presumably, the banks would not be willing to pay Taxpayer a higher than "normal" securities lending fee because it is easier to borrow these securities from Taxpayer than to find those securities from another source. Thus, even though Taxpayer makes available certain of its securities for loan to certain major banks with whom it normally transacts in its trading strategy, that activity alone does not make Taxpayer a dealer in special repos as described in Kemon.[16] The facts available do not suggest that Taxpayer purchased securities that did not otherwise fit its trading strategy merely so that they could be lent out at a profit on special repo.

B. Taxpayer Generally Engaged in Exempt Trading under the (A)(ii) Safe Harbor

Taxpayer's extensive repo transactions do not give rise to a USTB because Taxpayer is eligible for the (A)(ii) Safe Harbor and the repo transactions generally comprise the "buying, selling (whether or not by entering into short sales), or trading in stocks, securities, or contracts or options to buy or sell stocks or securities, on margin or otherwise for the account and risk of the taxpayer, and any other activity closely related thereto (such as obtaining credit for the purpose of effectuating such buying, selling, or trading)." Treas. Reg. § 1.864-2(c)(2)(i) and (ii).

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[15] Kemon, 16 T.C. at 1033.

[16] We note that a dealer's customers may be other dealers. In Estate of Hall v. Commissioner, a partnership was a dealer in the securities of a particular corporation and "no one else was known in the trade as a dealer in those securities." 29 B.T.A. 1255, 1257 (1934), aff'd sub nom. Comm'r v. Stevens, 78 F.2d 713 (2d Cir. 1935). The partnership had "regular and repeated dealings with persons to whom it sold" the stock; most of those purchasers were members of the New York Stock Exchange. Id. In concluding that the partnership was a dealer, the court explained that the brokers who purchased the stock were customers of the partnership under these particular facts. Id. at 1259. The facts here are distinguishable, including that the major banks who transacted with Taxpayer had other sources of these securities.

1. Taxpayer's repos and "special" repos

Taxpayer's repo transactions in which Taxpayer "sold" securities and agreed to "repurchase" them constitute the borrowing of money for tax purposes, which in substance is a pledge of the securities transferred by Taxpayer.[17] Obtaining credit for the purposes of trading in securities is a permitted activity under the (A)(ii) Safe Harbor. Treas. Reg. § 1.864-2(c)(2)(i).

Because of the right to rehypothecate, a court may characterize the repo transactions for tax purposes as securities lending transactions.[18] The exchange of securities pursuant to a securities lending transaction should qualify as the effecting of transactions in stocks or securities.[19]

2. Taxpayer's reverse repos

Taxpayer engaged in reverse repos to borrow collateral for a short trade. Such transactions are also considered effecting transactions in securities for purposes of the (A)(ii) Safe Harbor.

Taxpayer concedes that it undertook some reverse repos not solely as a way of borrowing collateral for a short trade, but as a way of lending Taxpayer's unused cash at the most competitive rate. It is common knowledge that hedge funds that conduct trading and investment activities are not always 100% invested in securities. Putting excess cash temporarily to work—including by putting it out on repo if that is the best alternative on offer—can be an investment activity ancillary to and consistent with the (A)(ii) Safe Harbor.

Furthermore, Taxpayer should not be viewed as engaged in the financing business of borrowing money and lending it to its repo counterparties. Taxpayer was lending money (through standardized reverse repos) to the same low-risk, large banks that were lending money to Taxpayer (through repos and margin financing), and these banks (unlike Taxpayer) had access to cheap financing through customer deposits and financing from the FRBNY. Courts have not

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[17] Rev. Rul. 74-27, 1974-1 C.B. 24.

[18] The Service and courts have found that a repo transaction was akin to a secured loan in circumstances where the repo transaction did not permit rehypothecation of the collateral. E.g., Nebraska Dept. of Revenue v. Loewenstein, 513 U.S. 123, 134 (1994) ("[I]n economic reality the [cash lender] receive[s] interest on cash [it has] lent …."); Rev. Rul. 74-27, 1974-1 C.B. 24 (1974). "One would be comfortable, indeed extraordinarily comfortable, concluding that where the Purchaser/Lender cannot dispose of or otherwise transfer repoed securities, the transaction is treated merely as a secured loan based on the early cases." Robert A. Rudnick & Kristen Garry, The Ultimate, Definitive Federal Income Tax Treatment of Real Repo Transactions, 5 J. TAX'N FIN. PRODS. 49, 53 (2005). Repo transactions like Taxpayer's, which permit the securities borrower to dispose of the securities, may also involve a securities lending transaction for tax purposes. Id. at 55 ("The grant of the power of disposition should be analyzed as a transaction separate and apart from the lending of money and the provision of collateral, which constitute the collateralized loan.").

[19] We note that the IRS has concluded that securities lending transactions involving publicly traded securities and that meet the requirements of section 1058 constitute "effecting transactions in stocks or securities" for purposes of Treas. Reg. § 1.864-2(c)(2). PLR 9041011 (Oct. 12, 1990); see also Gen. Couns. Mem. 37313 (Nov. 7, 1977) (securities lending is not a trade or business for unrelated business income tax purposes where the securities are not inventory in the lender's hands); cf. Temp. Treas. Reg. § 1.892-4T(c)(1) (lending securities is a permissible activity, rather than the type of commercial activity that must not be engaged in, for a foreign sovereign relying upon the Section 892 exclusion from income).

clearly defined the kind of "profit" that a taxpayer must intend to earn from a USTB, e.g., gross profit, net profit, or something in between. Plainly, however, the taxpayer must intend to earn income or gain in excess of the expenditures from the activity:[20] to conclude otherwise would contradict a long history of case law under sections 183, 162, and 165(a) that does not assume a taxpayer has a "profit motive" from every gross-income-producing activity.[21]

It is highly unlikely that Taxpayer lending excess cash back to its banking creditors under these circumstances could be expected to produce net profit as opposed to being the investment of the excess cash. As in the case of the (A)(ii) Safe Harbor activity, this activity of Taxpayer also was in the standardized repo market, and in this context, Taxpayer was a price taker and targeted a passive return on its funds.

Accordingly, for the reasons stated above, we conclude that Taxpayer's activities described herein do not cause it to be engaged in a USTB.

TAXPAYER IS LIABLE AS A WITHHOLDING AGENT FOR GROSS BASIS TAX ON CERTAIN U.S.-SOURCE LENDING FEES ALLOCABLE TO ITS NON-U.S. PARTNERS

I. Law

Generally, sections 871(a) and 881(a) impose a 30% tax on U.S.-source "fixed or determinable annual or periodic gains, profits, and income" ("**FDAP**") received by a nonresident alien individual or a foreign corporation to the extent that the income is not effectively connected with a USTB. Sections 1441 and 1442 require persons making payments of U.S.-source FDAP income to foreign individuals and corporations to deduct and withhold this tax at source. FDAP includes all gross income under section 61 other than gains from the sale of property and other types of income as determined in published guidance. Treas. Reg. § 1.1441-2(b)(1) and (2). The authority to exclude specified types of income from FDAP in published guidance, Treas. Reg. § 1.1441-2(b)(2)(ii), has not been exercised.

In addition to any income tax treaties as may be applicable, statutory provisions may reduce or eliminate the 30% tax on FDAP. For example, section 871 generally eliminates tax on interest from obligations that are payable within 183 days of the original issue date. Treas. Reg. § 871(a)(1)(A) and (g)(1)(B)(i); see Treas. Reg. § 1.1273-1(c)(5) (obligations with an original term to maturity of one year or less have no "qualified stated interest," so all of the return is necessarily original issue discount, and section 871(g)(1)(B)(i), which provides that original issue discount on an obligation with an original term to maturity of 183 days or less is exempt from withholding). Likewise, most U.S.-source interest payments to unrelated parties will qualify as portfolio interest under sections 871(h) and 881(c) and thus not be subject to withholding ("**the portfolio interest exemption**"). Moreover, regulations extend the portfolio interest exemption to substitute interest payments made to the securities lender as a substitute for portfolio interest paid on the loaned security. Treas. Reg. §§ 1.871-7(b)(2), 1.881-2(b)(2), and

[20] See Profit, BLACK'S LAW DICTIONARY (12th ed. 2024) (defining profit as "[t]he excess of revenues over expenditures in a business transaction").

[21] See, e.g., Engdahl v. Comm'r, 72 T.C. 659, 664 (1979) (examining whether a horse breeding activity was "not engaged in for profit" within the meaning of section 183(a) where the activity had consistently earned "gross income" that fell short of applicable expenses).

1.1441-1(b)(4)(i); see Treas. Reg. § 1.861-2(a)(7) (defining a substitute interest payment as, among other things, a payment "made to the transferor of a security").

Generally, the portfolio interest exemption applies only to payments of interest on an obligation that is in "registered form" within the meaning of Temp. Treas. Reg. § 5f.103-1(c)) (which is cross-referenced by Treas. Reg. § 1.871-14). Generally, an obligation will be treated as in registered form if: (1) the obligation is registered as to both principal and any stated interest with the issuer (or its agent) and any transfer of the obligation may be effected only by surrender of the old obligation and reissuance to the new holder; (2) the right to principal and stated interest with respect to the obligation may be transferred only through a book-entry system maintained by the issuer or its agent; or (3) the obligation is registered as to both principal and stated interest with the issuer or its agent and may be transferred both by surrender and reissuance and through a book-entry system. Treas. Reg. § 5f.103-1(c). Dematerialized obligations and other obligations that are nominally in bearer form are generally treated as being in registered form if they are immobilized and traded through a central clearing system. See Notice 2012-20; Notice 2006-99.

Sections 871(a) and 881(a) impose tax on U.S.-source income only. The general rules for determining the source of income are found in sections 861 through 865. The Code provides specific sourcing rules for, among other items, interest, dividends, compensation for personal services, rents and royalties, and income from sales of personal property. Generally, interest is classified as U.S.-source when it is paid by the United States, a State or any political subdivision of a State, or the District of Columbia. § 861(a)(1); Treas. Reg. § 1.861-2(a)(1). In addition, interest on bonds, notes, or other interest-bearing obligations of noncorporate residents or domestic corporations generally is classified as U.S.-source. § 861(a)(1); Treas. Reg. § 1.861-2(a)(1). Other interest payments are generally classified as foreign-source. § 862(a)(1). Rental and royalty income is generally considered U.S.-source when those payments were made in relation to property located in the United States or for the use of property within the United States. §§ 861(a)(4) and 862(a)(4). Income from services performed in the U.S. is U.S.-source. §§ 861(a)(3) and 862(a)(3).

Income from the sale of personal property other than inventory generally is U.S.-source when sold by a U.S. resident and foreign-source when sold by a nonresident. § 865(a).[22] One exception to this rule is that if a nonresident maintains an office or fixed place of business (an "**Office**") in the United States, income from any sale of property attributable to that Office is U.S.-source. § 865(e)(2). The principles of section 864(c)(5) apply to determine whether a taxpayer has an Office and whether a sale is attributable to that Office. § 864(e)(3).

Section 865(j)(2) directs Treasury and IRS to promulgate regulations as may be necessary or appropriate to carry out the purpose of section 865, including regulations applying the rules of section 865 to income derived from trading in futures contracts, forward contracts, options contracts, and other instruments.[23] Treasury and IRS have not promulgated any rules under section 865(j)(2).

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[22] In the case of sales made by a partnership, source is determined at the partner-level. § 865(i)(5).

[23] Congress did not provide additional guidance regarding regulations to be promulgated under this provision. See S. Rep. 99-313, at 333, 1986-3 C.B. (Vol. 3) 333.

Section 863(a) directs Treasury and IRS to promulgate sourcing rules for all items not subject to any other statutory sourcing rule. However, Treasury and IRS have not promulgated rules for the sourcing of securities lending fees. See T.D. 8735, 1997-2 C.B. 72 (noting that the final regulations addressing substitute interest payments and substitute dividend payments do not address the treatment of fees in securities lending transactions).

"When an item of income is not classified within the confines of the statutory scheme nor by regulation, courts have sourced the item by comparison and *analogy with classes of income specified within the statutes*." Bank of Am. v. United States, 680 F.2d 142, 147 (Ct. Cl. 1982) (emphasis added); see also Container Corp. v. Comm'r, 134 T.C. 122, 131–32 (2010), aff'd per curium without published opinion, 107 A.F.T.R. 2d 2011-1831 (5th Cir. 2011) (stating that "[i]f a category of FDAP is not listed, caselaw tells us to proceed by analogy" and determining the source of guaranty payments by analogy to the statutory sourcing rule for services and rejecting the analogy to the statutory sourcing rule for interest); Howkins v. Comm'r, 49 T.C. 689, 693–94 (1968) (stating that the Code did not provide a specific source rule for alimony and explaining that "the rules which are set forth [in sections 861–64] show, for the most part, that Congress thought of the 'source' of an item of income in terms of the place where the income was 'produced.'"); Rev. Rul. 2009-14, 2009-21 I.R.B. 1031 (explaining the source of income from the payment of a death benefit is not specified in the Code and stating that sourcing of income in such cases is determined by comparison with and analogy to classes of income that are specified within the statute). "When we source FDAP income by analogy, our goal is to find the 'source of income in terms of the business activities generating the income or ... the place where the income was produced. Thus, the sourcing concept is concerned with the earning point of income or, more specifically, identifying when and where profits are earned.'" Container Corp., 134 T.C. at 136 (quoting Hunt v. Comm'r, 90 T.C. 1289, 1301 (1988)).

II. Analysis

In general, as discussed below, the securities lending fees payable in transactions involving U.S. borrowing entities (including U.S. branches of foreign entities) should be considered to give rise to U.S.-source FDAP. If the fees were paid by a United States person or a U.S. branch, Taxpayer is liable for withholding tax under sections 1441 or 1442 on such U.S.-source fees (which are payable with respect to the special repos[24]) to the extent that the fees are allocable to non-U.S. partners.

A. Character and Amount

The securities lending fees give rise to FDAP unless an exception applies. "Specific items of [FDAP] ... are enumerated in section 881(a)(1) ..., but other items of [FDAP] ... are also subject to the tax as, for instance, royalties, including royalties for the use of patents, copyrights, secret processes and formulas, and other like property. Treas. Reg. § 1.881-2(b). See also Treas. Reg. § 1.1441-2(b)(1)(i) (providing that FDAP includes "all income included in gross income under section 61 (including original issue discount) except as provided in [Treas. Reg. § 1.1441-2(b)(2)]" for purposes of withholding under chapter 3 of the Code). Moreover, since the

[24] Exam should confirm that GC repos do not provide for separately stated securities lending fees. In a GC repo the money lender is agreeing to take a security interest in any property in the categories specified in the repo agreement, and the money borrower can change the security within the categories from time to time. Since the money lender has no assurance of getting any particular security, we would have expected that typically the money lender would not be paying a fee to obtain securities.

Supreme Court has concluded that securities lending fees are not interest for U.S. tax purposes, Deputy v. DuPont, 308 U.S. 488, 498 (1940), the portfolio interest exception cannot apply.

At a minimum, separately stated securities lending fees, and securities lending fees to the extent the amount paid exceeds any contractual offset for stated return on cash collateral, is FDAP income.

Additional FDAP may arise from securities lending fees that are not separately stated, but which are implicitly offset by the stated return on the cash collateral. For purposes of chapter 3, a payment is considered made when the amount of income would be includible in income of the beneficial owner under U.S. tax principles, even if there has not been an actual transfer of cash or property. Treas. Reg. § 1.1441-2(e)(1). [redacted][25]

B. Source

Because there are no specific sourcing rules for securities lending fees (i.e., borrow fees), the fees must be sourced by analogy. See Bank of America, 680 F.2d at 147. The fees are compensation for the temporary use of certain financial property rights, and the fees should be sourced like compensation for the use of similar rights. Specifically, as discussed below, the fees resemble interest paid to use money.

1. Analogy to section 861 rule for interest

Although the return for borrowing securities is not interest for tax purposes,[26] interest is the best analogy to securities lending fees. Like interest, securities lending fees are payments for use of an intangible financial asset.[27] Securities lending fees vary depending upon demand for the securities, but then again, interest rates vary depending upon how urgently the borrower needs the money. Like the right to use money in an account, a right to rehypothecate a security is generally exercised through book-entry transfers of dematerialized items that are both fungible

[25] [redacted]

[26] Deputy v. du Pont, 308 U.S. 488 (1940).

[27] Cf., Treas. Reg. § 1.163(j)-1(b)(22)(v)(B), Ex. 2 (return of loan of gold considered interest for section 163(j)).

and limited in number. The securities "borrower," like the "borrower" of money, may either return the original property or any identical property.

Furthermore, the interest sourcing rule—residence of the borrower[28]—is administrable. It avoids the issue of where a dematerialized, fungible security that can be rehypothecated is "used," as fungible and dematerialized securities with rehypothecation rights have no obvious "location." (By way of contrast, as noted below, "rents and royalties" are payable on property with an identifiable "location" of use.)

Accordingly, securities lending fees should be sourced by analogy to interest and should be U.S.-source if paid by a United States person or the U.S. branch of other taxpayers. Other securities lending fees should be foreign-source. In the case of the U.S. branch of a taxpayer that is not a United States person, it is irrelevant whether the taxpayer is deemed not be engaged in a U.S. trade or business under Section 864(b)(2).

2. Analogy to section 864(a)(4) rule for rents and royalties

A second analogy that has been considered is to rent (or royalties). Generally, rent is compensation for the right to use property. Rent, BLACK'S LAW DICTIONARY (12th ed. 2024); Logan Coal & Timber Ass'n v. Helvering, 122 F.2d 848, 850 (3d Cir. 1941). The repo grants the cash lender a right to use Taxpayer's securities on the condition that those securities (or identical securities) are returned when the repo is terminated. Cyril Monnet and Borghan N. Narajabad, Why Rent When You Can Buy?, Working Papers—U.S. Federal Reserve Board's International Finance Discussion Papers 2 (Sept. 6, 2017) ("Even financial traders 'rent' financial assets through repurchase agreements (repo), although they could buy the assets they need."). Under this analysis, because the securities lending fee is akin to compensation for the use of Taxpayer's property, that fee would be sourced like other compensation for the use of property.

If the securities lending fee were to be sourced like rent, the source would be determined based on how and where the securities are used. § 864(a)(4). "Use" is defined as "to employ for the accomplishment of a purpose." Use, BLACK'S LAW DICTIONARY (12th ed. 2024). Selling a security short or delivering it to "cover" a fail to deliver in a securities transaction would appear to be "using" the security under this definition. It typically would be difficult to determine where that use occurs: securities are generally immobilized or dematerialized and "traded" through book entries made by an intermediating custodian. The source of the fee arguably might be located, for example, at the business that holds the rehypothecation rights, on an exchange through which the securities are traded, or where the issuer is located.

Taxpayer would bear the burden of establishing the extent if any that use occurred outside the United States. See Goosen, 136 T.C. at 564 ("Courts have generally allocated all the royalty income to the United States if the contracting parties failed to make a reasonable allocation, unless the taxpayer can show there is a sufficient basis for allocating the income between U.S. and foreign sources."); Rsrv. Mech. Corp. v. Comm'r, 115 T.C.M. (CCH) 1475 (2018) (taxpayer bore the "burden of showing that the income it received is not FDAP income as respondent determined in the notice"), aff'd, 34 F.4th 881 (10th Cir. 2022).

[28] § 861(a)(1); see also § 884(f)(1) (treating interest paid by a U.S. trade or business of a non-U.S. borrower as U.S.-source).

In light of the nature of a financial asset and the attendant difficulties of determining where a security is "used," we believe the analogy to interest is the more apt.

3. Taxpayer's likely arguments to source to the residence of the recipient

Taxpayer may dispute the sourcing of the securities lending fees by contending they should be sourced like notional principal contracts or qualified fail charges under Treas. Reg. §§ 1.863-7 or 1.863-10.[29]

Any such analogy to the regulations should fail for several reasons:

- Courts generally endorse analogies to *statutory* sourcing rules, see Bank of Am., 680 F.2d at 147, and no court has sourced income by analogy to any *regulatory* rule.
- *If* the Taxpayer were to argue that a particular transaction was of (or analogous to) an atypical type of "synthetic" repo that included a total return swap as one of its components,[30] the transaction still would have to include an initial spot sale; and there is no reason why sourcing of a swap under Treas. Reg. § 1.863-7 should take precedence over the sourcing of the spot sale under section 865. See id. (noting that courts analogize to the statutory rules).
- Fails charges are payable as a penalty for failure to settle a transaction within the normal settlement cycle. One might think of a fails charge as compensation for an involuntary securities lending transaction. The failing party is continuing to use a security that ought to have been delivered to someone else. Thus, a securities borrower could be said to be paying the securities lending fee for continuing to use the security. But courts determine the source of income from the perspective of the income recipient, e.g., the securities *lender*. See, e.g., Comm'r v. Piedras Negras Broadcasting Co., 127 F.2d 260 (5th Cir. 1942) (holding that Congress intended that the source of income "is the situs of the income-producing service" and determining that the taxpayer's facilities that generated the income were located outside the U.S.).[31]

C. Other Considerations

Taxpayer may be liable for gross-basis tax on some of the interest paid on the repos, but we expect that most of the interest is exempt from tax. Interest on the repos is not FDAP to the extent it is payable on an obligation with a term of 183 days or less. § 871(a)(1)(A) and (g)(1)(i); see Treas. Reg. § 1.1273-1(c)(5). We understand Taxpayer's repos generally have stated terms of 183 days or less.

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[29] These regulations have no analog to section 865(e)(2), so applying their rules in this case would result in no U.S.-source securities lending fees.

[30] See Edward R. Morrison, Mark J. Roe & Christopher S. Sontchi, Rolling back the Repo Safe Harbors, 69 BUS. LAW. 1015, 1037 n.64 (Aug. 2014); Euroclear Banks Triparty Collateral Management Team, Understanding Repos and the Repo Markets 42 (2009).

[31] Even if securities lending fees might be analogized to fail charges, the fees in this case would not be analogous to *qualified* fail charges. Taxpayer primarily repo'd foreign sovereign debt, whereas *qualified* fail charges generally arise from certain U.S. debt. See Treas. Reg. § 1.863-10(d)(2); see also Treasury Market Practices Group ("**TMPG**"), U.S. Treasury Securities Fails Charge Trading Practice (Rev. July 27, 2018); TMPG, Agency Debt and Agency Mortgage-Backed Securities Fails Charge Trading Practice (Rev. July 27, 2018).

We understand some of the repos may be rolled over and not payable within 183 days of the original issue of the obligation, but those repos are probably eligible for the portfolio interest exception if the repos are in registered form. See § 871(h). Repos executed under GMRA or TBMA/ISMA should be viewed to be as in registered form because those agreements may not be assigned or transferred without consent of the counterparty.[32] If Taxpayer held any repos that do not directly meet the registration requirements, many of those repos may be centrally cleared and treated as if they meet the registration requirements. See Notice 2012-20; Notice 2006-99.

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Please call (202) 317-6938 if you have any further questions.

[32] GMRA § 16(a); TBMA/ISMA § 13(a). As to the concept of registered form for obligations not in the form of "traditional" debt instruments, see DAVID GARLOCK ET AL., FEDERAL TAXATION OF DEBT INSTRUMENTS, ¶ 1905.04[A] (2024 ed.).