ARE REPOS REALLY LOANS?

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A repo is the sale of a security accompanied by the seller's agreement to repurchase it. Repos are traditionally treated as secured loans. A modern repo permits the buyer to resell the security and substitute an identical security in the repurchase transaction. In this respect, the author explains, a modern repo is similar to a stock loan, which has traditionally been treated as an exchange of securities. This raises a question whether modern repos should continue to be treated as loans.

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A "repo" is the sale of a security accompanied by the seller's agreement to repurchase the security at a later time for the original purchase price plus a differential that equates to interest between the dates of the sale and repurchase. If the security itself pays interest or dividends between the dates of the sale and repurchase, the purchaser pays them over to the seller.

For federal income tax purposes, the Internal Revenue Service has long held that the sales proceeds from a repo are really a loan from the purchaser to the seller (so that the repurchase price differential is interest income to the purchaser and interest expense to the seller) and the transferred security is really collateral (so that the seller remains the owner of the security and of any interest or dividends paid on the security). Few tax advisers would dispute these longstanding holdings. Indeed, the ability to explain how a repo works, and the knowledge that it is taxed as a loan rather than a sale, demonstrates the adviser's tax sophistication.

Yet, are repos really loans? The consensus that repos are collateralized loans is based on court decisions and revenue rulings that dealt with transactions essentially different from those that constitute the vast repo business that is nowadays conducted in New York, London, and other financial centers. In the traditional repo transaction, the purchaser was a bank that purchased a security from a customer and held onto that security until the customer repurchased it. Only two parties were involved, and the courts readily concluded that the bank was really a lender in the transaction and that the customer retained ownership of the security for tax purposes. In contrast, the purchaser in a modern repo transaction may have the power to dispose of the security that was purchased, so that the repurchased security is not the same security that was purchased from the customer, although it may be identical in every respect. The longstanding notion that a repo seller remains the owner of the security may be untenable once tax ownership of that security has passed to a third party.

In this respect the modern repo is like a securities loan. A securities "lender" transfers a security in exchange for cash or other collateral. The securities "borrower" commits to return an equivalent security plus a "rebate" that equates to interest on the collateral. Like a repo purchaser, a securities borrower pays over any interest or dividends that are paid on the security between the two legs of the transaction. A securities borrower typically delivers the borrowed security to a third party that has purchased the security from the borrower or from one of the borrower's customers. For even longer than the Service and courts have held that a repo seller remains the tax owner of the security that it sold, the Service and courts have held that a securities lender has given up tax ownership of the security that it lent, primarily on the grounds that a third party had become the owner.

If a securities lender cannot remain the owner of a loaned security once tax ownership has passed to a third party, how can a repo seller remain the owner of a sold security that has likewise been transferred to a third party? As the economics of repos and securities loans converge, the disparity in tax treatment becomes more difficult to sustain. Should a taxpayer or the Service mount a court challenge to the current consensus on the tax treatment of repos, the challenge might be upheld. That would have important consequences for multinational financial institutions.

International Tax Consequences

Even a purely domestic repo business has important international tax consequences for a multinational bank or securities firm. If a repo is a loan for tax purposes, then the price differential paid by the repo seller when it repurchases the security is interest expense. Under the section 861 regulations, a U.S. financial institution with foreign operations must apportion the interest expense between foreign and worldwide income in proportion to the ratio of foreign to worldwide assets, even if all of the income generated from the transaction is from U.S. sources. This may impair the institution's ability to use foreign tax credits under section 904. Under the section 882 regulations, a foreign financial institution with a U.S. branch suffers an equity "haircut" on the interest expense, even if all of the income generated from the transaction is taxable as effectively connected income.

Even a purely domestic repo business has important international tax consequences for a multinational bank or securities firm.

The starkest example of the negative arbitrage that results from treating repo price differentials as interest occurs in a "matched book" repo business. A dealer running a matched book purchases securities from a customer or dealer that owns securities but needs money (the reverse repo) and sells them to a customer or dealer that has money but needs securities (the repo). The dealer agrees to repurchase the security from the repo purchaser, and the reverse repo seller agrees to repurchase the security from the dealer. The dealer profits from any "spread" in the price differentials.

Very recently, in Technical Advice Memorandum 200207003, *Doc 2002-3903 (4 original pages), 2002 TNT 33-26*, the Service ruled that the repo transactions in a dealer's "matched book" generated interest expense that had to be allocated between income from U.S. and foreign sources, notwithstanding that the repos were "matched" with reverse repos that generated income only from U.S. sources. The taxpayer had instead been netting the income and expense and reporting the net amount as a service fee, which had the effect of directly allocating 100 percent of the repo interest expense to the reverse repo interest income. To refute the taxpayer's netting approach, the Service cited court decisions and revenue rulings that held repos are collateralized loans. According to the memorandum, the "Service is not aware of any legal authority . . . that does not treat repos as collateralized loans for federal tax purposes."

The assertion that a dealer running a matched book is really an intermediary providing a service is a reasonable characterization of the economics of the business.[1] Nevertheless, because is it always difficult for a taxpayer to argue against the form in which it chose to frame a transaction, the Service would have the upper hand were it to contend that matched book repos involved sales and repurchases, not the performance of services. However, in TAM 200207003, the Service did not argue in favor of the form of the transactions. Had the transactions been characterized in accordance with their form, as sales and repurchases, losses on the repos would have been netted against gains on the reverse repos, producing the same result as was reported by the taxpayer, albeit on different grounds. To avoid netting, the Service had to agree with the taxpayer that the substance of the matched book repo business differed from its form but then disagree as to the substance. In so doing, the Service is on less solid ground because participants in the financial services industry probably have a better notion of the substance of modern financial transactions than does the government.

As noted above and explained below, all of the legal authorities that characterize repos or reverse repos for tax purposes dealt with sales and repurchases of the same security. TAM 200207003 is the first official consideration of a repo in which the purchaser was permitted to dispose of the purchased security and routinely did so. By relying on authorities that dealt with essentially different transactions, rather than analyze the matched book transaction as a matter of first impression, the Service arguably erred in its analysis, although not necessarily in its conclusion.

Tax Authorities on Repos

Repos have been around for a long time, and the case law on repos begins with early decisions of the Board of Tax Appeals. In both the earlier and later cases, the issue has always been whether the repo purchaser is entitled to treat a portion of its profit as tax-exempt interest on the security. In *First Nat'l Bank of Wichita v. Commissioner,*[2] the taxpayer was a bank that purchased municipal bonds from a bond dealer under an agreement that entitled, but did not require, the dealer to repurchase them. The court found that the transaction was structured as a sale only to circumvent a restriction on how much the bank could lend to a single customer. Although the dealer was not legally bound to repurchase the bonds, the board found: "At no time were any bonds placed by this company with the bank under repurchase agreements ever sold to anyone other than the company; and in no case did the company ever fail to repurchase such bonds for the amount advanced with interest."[3] Based on those facts, the board held that the "true relationship" between the dealer and the bank was that of borrower and lender,

[1]Saul Rosen, "Securities Industry Seeks Regulatory Exclusion From PFIC and Excess Passive Assets Rules," *Tax Notes*, Dec. 5, 1994, p. 1192.

[2]19 B.T.A. 744 (1930), *aff'd* 57 F.2d 7 (10th Cir. 1932).

[3]19 B.T.A. at 747.

that the bank held the bonds only for security, and that the bank was therefore not entitled to exclude any amount as tax-exempt bond interest.

In General Counsel Memorandum 12355,[4] the General Counsel of the Internal Revenue Service cited *Wichita* in opining that an agreement to sell and repurchase securities was really a loan collateralized by the securities. In arriving at his opinion, the General Counsel stated that it appeared from the agreement that "the identical securities which are 'sold' to the bank are required to be held by it for repurchase by the customer, and that the customer is entitled to demand and receive such identical securities when he performs his agreement to repurchase."

The board's decision in *Wichita* was discussed and analyzed in *American Nat'l Bank of Austin v. U.S.*,[5] which held that a bank that "took up" state bond issues on behalf of dealers and held them until the dealers sold them to their customers was a lender of money rather than a purchaser of securities for tax purposes. The rationale of *American Nat'l Bank of Austin* was followed in *First American Nat'l Bank of Nashville v. U.S.*,[6] which involved similar facts, and also in *Union Planters Nat'l Bank v. U.S.*,[7] which involved facts similar to those in *Wichita.*

In Revenue Ruling 74-27,[8] the Internal Revenue Service cited *American Nat'l Bank of Austin* and *First American Bank of Nashville* as authorities for updating and restating its 1933 holding in General Counsel Memorandum 12355. The reverse repo agreements at issue provided that "the identical securities which are 'sold' to the bank are required to be held by it for repurchase by the customer."

Revenue Ruling 74-27 was cited in Revenue Ruling 77-59 and Revenue Ruling 79-108[9] in arriving at the same conclusion with respect to reverse repos entered into by, respectively, a real estate investment trust and a municipality. In Revenue Ruling 77-59, no specific security was credited to the real estate investment trust's account and possession of the securities was normally not transferred to the trust. In Revenue Ruling 79-108, there was an understanding that the securities transferred to the municipality would be "retransferred" to the dealer from which they were purchased.

In *Nebraska Dep't of Revenue v. Loewenstein*,[10] the Supreme Court upheld a State of Nebraska ruling that income from reverse repos of federal securities was not eligible for the state tax exemption of income from these securities. The *Loewenstein* decision is important, not only because it came down from the Supreme Court, but also because of the Court's unique analysis. All of the prior cases took for granted that the taxpayer's entitlement to the tax benefit associated with interest on the securities depended on whether the taxpayer had purchased the securities or merely taken a security interest. The *Loewenstein* decision stated in contrast that it did not matter whether the taxpayer "owned" the securities and it therefore did not matter whether the securities had been "sold."[11] What mattered was that the taxpayer's profit from the transaction was "in economic reality" tied to the cash that had been transferred to the seller rather than to the coupons on the securities.[12] While the *Loewenstein* analysis was unique, the conclusion was not — the purchaser's return on the transaction could not be characterized as income from the security.

The Modern Repo

In all of the court decisions and revenue rulings holding that repos were collateralized loans, it was expressly stated or apparent from the statement of facts that the purchaser of the securities was going to hold onto the securities until they were repurchased by the original seller.[13] Yet, in a modern repo the security that is "repurchased" by the repo seller is frequently not the same security that was sold in the first leg of the transaction.

The master repo agreement endorsed by the Public Securities Association and the International Securities Market Association does not require the repo purchaser to return to the repo seller the same securities that were purchased. The repo purchaser is obliged only to return securities "equivalent" to the securities that were purchased. "Equivalent" securities are defined as securities that are part of the same issue and are identical as to amount, type, description, and nominal value.

The repo purchaser's ability to sell the purchased securities and satisfy its repurchase obligation with equivalent securities does not change the proper accounting of the transaction, which must be reported as a secured loan under Generally Accepted Accounting Principles (GAAP). According to Paragraph 9 of Financial Accounting Standard 140, the critical question in determining whether securities have been sold rather than posted as collateral is whether the transferor has surrendered control of the securities, and a transferor is considered to have retained effective control if there is an "agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity." Paragraph 100 provides that "contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same . . . securities

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[4]XII-2 C.B. 100 (1933).

[5]421 F.2d 442 (5th Cir. 1970).

[6]467 F.2d 1098 (6th Cir. 1972).

[7]426 F. 2d 115 (6th Cir. 1970), *cert. denied* 400 U.S. 827 (1970).

[8]1974-1 C.B. 24.

[9]1977-1 C.B. 196 and 1979-1 C.B. 75, respectively.

[10]513 U.S. 123 (1994).

[11]513 U.S. at 133-34.

[12]513 U.S. at 134.

[13]Although the matter was not discussed in *Loewenstein,* the parties had stipulated to a form of agreement that prohibited reselling the securities to third parties. Brief of *Amicus Curiae* Investment Company Institute, 1993 U.S. Briefs 823, *Nebraska Dept. of Revenue v. Loewenstein,* 513 U.S. 123 (1944).

as those concurrently transferred is assured." In other words, financial institutions must account for repos as secured lending transactions whether or not the securities purchaser must return the same security, as long as the security is "substantially the same."

Notwithstanding that modern GAAP accounting of repo transactions follows the traditional tax treatment, the traditional tax treatment is premised on assumptions that often no longer apply. In the repo rulings and cases, the parties had entered into a complex financial transaction that took the form of a sale but had the economics and other indicia of a loan. Under those circumstances, the courts and the Service could examine both the formal agreement of the parties and their course of behavior to discover the real agreement between the parties and the "real owner" of the security. Many facts could have a bearing on that determination, and the courts found that a sale rather than a loan had occurred in cases with facts only slightly different from those in cases in which a loan was found.[14] However, when the security in question has been transferred by the repo purchaser to a third party, there is no need to scrutinize the arrangement between the repo seller and repo purchaser to discern the "real owner" of the security. Unequivocally, neither the repo seller nor the repo purchaser is the owner.

Notwithstanding that modern GAAP accounting of repo transactions follows the traditional tax treatment, the traditional tax treatment is premised on assumptions that often no longer apply.

Because all of the repo authorities were premised on the repo seller's continuing ownership of the security, it may be that none of them controls the tax treatment of modern repos in which the repo purchaser may and does transfer ownership of the security to a third party. If the repo seller no longer owns the security, the transfer to the repo purchaser is difficult to characterize as a mere transfer of collateral, and the tax consequences may have to be determined under section 1001, which provides for the recognition of gain or loss from the "sale or other disposition of property." Treasury reg. section 1.1001-1(a) provides that "the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."

A repo seller receives cash from the repo purchaser plus the repo purchaser's commitment to return an equivalent security. The tax result will depend on how the transaction is analyzed. If the transaction is bifurcated into a sale and repurchase, in accordance with its form, then the repo is a taxable sale followed by a purchase of equivalent property in which the repo seller acquires a basis equal to the repurchase price. There would be no interest income or expense for purposes of the interest allocation rules of section 861 or 882. If the transaction is bifurcated into a cash transaction and a securities transaction, then the cash transaction is likely treated as a loan, the securities transaction is likely treated as an exchange, and sections 861 and 882 would apply to the interest expense arising from the loan.

If the security that is sold is treated as exchanged, a question arises whether it is exchanged for the security that is repurchased or exchanged for the repo purchaser's obligation to deliver that security. If there is an exchange of securities, the exchange is likely to be a nonevent for tax purposes because a security that is "equivalent" under current repo arrangements is not likely to differ "materially either in kind or scope" from the originally purchased security. However, if the security that is sold is treated as exchanged for the purchaser's obligation to deliver equivalent securities, then there may have been a taxable disposition. In *Cottage Savings Ass'n v. Commissioner,*[15] the Supreme Court held that an exchange of interests in economically equivalent mortgage pools was a taxable disposition because the obligors on the mortgages were different. In a repo transaction, the repo purchaser's obligation to deliver equivalent securities (and to pay over interest or dividends on the securities in the meantime) is economically equivalent to holding the security, but the repo purchaser and the issuing entity are clearly not the same obligor.

Were one to rely only on the traditional repo authorities, one might conclude that the default classification for a repo that is not a collateralized loan is a sale rather than an exchange. All of the cases that did not characterize repos as secured loans characterized them instead in accordance with their form, that is, as sales. However, part of the rationale of those cases was that the repo seller was not really obligated to repurchase the security.[16] Consequently, they may not govern the tax character of a modern repo, in which the purchaser may dispose of the purchased stock but in which the seller is genuinely obligated to "repurchase" an equivalent security.

As a general rule, when a taxpayer sells property to another person and purchases property from the same person in "reciprocal and mutually dependent transactions," the taxpayer is treated as exchanging the property sold for the property purchased.[17] This rule was applied by the Tax Court to the simultaneous sale and purchase of mortgage pool interests in the *Cottage*

[14]*See, e.g., Bank of California v. Commissioner,* 30 B.T.A. 556 (1934), *aff'd* 80 F.2d 389 (9th Cir. 1935); *Citizens Nat'l Bank of Waco v. U.S.,* 551 F.2d 832 (Ct. Cl. 1977); *American Nat'l Bank of Austin v. U.S.,* 573 F.2d 1201 (Ct. Cl. 1978).

[15]499 U.S. 554 (1991).

[16]*See, e.g., Bank of California v. Commissioner,* 30 B.T.A. at 561; *Citizens Nat'l Bank of Waco v. United States,* 551 F.2d at 842; *American Nat'l Bank of Austin v. United States,* 573 F.2d at 1207.

[17]Revenue Ruling 61-119, 1961-1 C.B. 395.

Savings case.[18] The Supreme Court's upholding of the Tax Court's decision did not amount to an endorsement of this rule because the parties agreed in that venue that there had been an exchange rather than a sale.[19]

Although all of these issues remain to be addressed for the modern repo, they have already been raised and addressed with respect to securities lending. Because a modern repo is in some respects more akin to a securities loan than to a traditional repo, the securities lending authorities may have more bearing on the tax character of modern repos than the cases and rulings cited in TAM 200207003.

Tax Authorities on Securities Lending

According to American Institute of Certified Public Accountants, *Brokers and Dealers in Securities*, paras. 1.100, 1.102 (2001):

> A stock loan is an arrangement in which securities are loaned from one broker-dealer to another in exchange for collateral. Broker-dealers may lend securities to enable a borrowing broker-dealer to make delivery of securities sold that the borrowing broker-dealer does not have available to deliver on the settlement date. . . . Securities lending is generally collateralized by cash, although securities or letters of credit may also be used as collateral. . . . When a stock loan is terminated, the securities are returned to the lender and the collateral or cash to the borrower. Fees (often referred to as rebates) are paid to the cash lender based on the principal amounts outstanding.

In *Provost Bros. & Co. v. U.S.*,[20] the Supreme Court found that the lender of securities in a securities lending transaction had passed title to the borrower for purposes of a federal stamp tax on sales and transfers of title to securities. Because the purpose of the transaction was to provide stock for delivery to a third party, the Court held specifically that the loaned stock could not be treated as collateral:

> When the transaction is thus completed, neither the lender nor the borrower retains any interest in the stock which is the subject matter of the transaction and which has passed to and become the property of the purchaser. . . . Unlike the pledgee of stock, who must have specific stock available for the pledgor on payment of his loan, the borrower of stock has no interest in the stock nor the right to demand it from any other. For that reason he can be neither a pledgee, trustee, nor bailee for the lender, and he is not one "with whom stock has been deposited as collateral security for money loaned." For the incidents of ownership the lender has substituted the personal obligation, wholly contractual, of the borrower to restore him, on demand, to the economic position in which he would have been, as owner of the stock, had the loan transaction not been entered into.[21]

In describing the procedure and consequences of a stock loan, the Supreme Court might as well have been describing a modern repo, in which the purchaser has given its "personal obligation" to restore the seller to the economic position of owning the security rather than having "specific stock available" to meet that obligation.

In Solicitor Memorandum 4281[22] the Service followed *Provost Bros.* in holding that when a borrower of stock sells the stock to a customer, the dividend belongs to the customer, not the borrower or the lender. In Revenue Ruling 60-177,[23] the Service addressed the tax consequences of loaning stock to a broker that delivered the stock to a customer to close a short sale. As is customary in stock lending transactions, the stock borrower had paid over to the stock lender an amount equal to the dividends on the borrowed stock. The Service ruled that the lender was not eligible to claim a dividends-received deduction because the customer who had purchased the stock from the broker, not the lender, was the "real owner" of the stock. In Revenue Ruling 80-135,[24] the Service concluded that the lender of a municipal bond to a broker to cover a short sale was not entitled to exclude as municipal bond interest amounts received from the broker in substitution for interest. The Service reasoned: "Because title passed to the purchaser as a result of the short sale, the lender is no longer the owner of the bond."

Provost was concerned only with a transfer tax and the subsequent revenue rulings only with determining which taxpayer should be treated as receiving dividends on the loaned securities. The income tax consequences of the transfer itself were addressed only in Revenue Ruling 57-451,[25] which ruled that a lender of stock is regarded as having exchanged its stock for the stock returned by the borrower and that the exchange is tax-free if section 1036 applies. The Service concluded explicitly that an exchange could occur even though the stock borrower did not yet possess the security to be returned in exchange:

> That the delivery of shares of stock by the optionee to his broker and the satisfaction by the latter of the resulting obligation to replace them may constitute an exchange is supported by authority. A simultaneous delivery of property is not essential to an exchange. If the parties so intend, title to property delivered on one side may pass even though the contract remains executory on the other side.[26]

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[18] *Cottage Savings Ass'n v. Commissioner,* 90 T.C. 372, 386-87 (1988), *rev'd* 890 F.2d 848 (6th Cir. 1989), *rev'd and remanded* 499 U.S. 554 (1991).

[19] *Cottage Savings v. Commissioner,* 499 U.S. at 599.

[20] IV-1 C.B. 352 (1924).

[21] VI-1 C.B. at 420.

[22] IV-2 C.B. 187 (1925).

[23] 1961-1 C.B. 9.

[24] 1980-1 C.B. 18.

[25] 1957-2 C.B. 295.

[26] 1957-2 C.B. at 298.

In General Counsel Memorandum 36948 (Dec. 10, 1976), the General Counsel of the Internal Revenue Service considered the stock lending transaction in Revenue Ruling 57-451 and affirmed that the passage of time between the loan of the stock and the return of equivalent securities did not preclude treating the stock that was loaned as having been exchanged for the stock that was returned. Citing Revenue Ruling 61-119, *supra*, the General Counsel reasoned that the loan and return of stock, as "reciprocal and mutually dependent transactions," should be treated as an exchange rather than "a sale and a subsequent purchase." The General Counsel also noted that if the securities lent and returned were not materially different, then no gain or loss would be realized under reg. section 1.1001-1(a), making resort to section 1036 unnecessary.

In 1978, Congress enacted section 1058 of the Internal Revenue Code, which provides that when a taxpayer transfers securities pursuant to an agreement providing for the return of "identical securities" meets certain conditions, "no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer." Proposed Treasury reg. section 1.1058-1(b) defines "identical securities" as securities "of the same class and issue" as the securities lent to the borrower.

According to the legislative history of section 1058, Congress intended to endorse the holding in Revenue Ruling 57-451 and was acting in response to a recent suspension in the issuance of letter rulings on securities loans.[27] However, the main benefit to taxpayers of Revenue Ruling 57-451 was that it treated the securities loan as an exchange of one security for another, even though the borrower did not own the security at the time it committed to return an identical security. That made it possible to qualify the exchange as tax-exempt under either section 1036 or Treasury reg. section 1.1001-1(a). Section 1058 presupposes instead that the security is being exchanged for an obligation of the borrower, in which case sections 1.1001-1(a) and 1036 do not necessarily apply, and the taxpayer's only secure defense against a taxable transaction may be section 1058 itself. That troubling consequence of Congress's action seems to be confirmed by proposed Treasury reg. section 1.1058-1(e), which provides that a stock lender that does not satisfy all the requirements of section 1058 is engaged in a taxable sale or exchange of the loaned securities.

Sale vs. Exchange?

The principal question presented by this article is how to analyze a repo if it is not a secured loan. While the case law and revenue rulings on securities lending clearly support the conclusion that a modern repo is not a secured loan, they do not clearly point to an alternative characterization, in part because of the lesser significance assigned to collateral in securities lending transactions. While securities lending often entails the transfer of cash collateral in exchange for the transferred securities, the posting of collateral is not an inevitable incident of securities lending, and the collateral may be, and often is, securities rather than cash. The case law and revenue rulings either omit reference to the posting of collateral or say nothing about its tax treatment.

Section 1058 may provide more guidance on the tax characterization of repos that are not secured loans. If we are to infer from enactment of section 1058 that a modern repo cannot be viewed as a security-for-security exchange, we are left with treating it as a sale for cash or as an exchange for the buyer's obligation to sell back an equivalent security. If the repo is characterized as a sale and repurchase, then any gain or loss will be recognized to the original seller in the first leg of the transaction and to the original purchaser in the second leg, and there will be no interest expense for purposes of sections 861 and 882. If the repo sale is characterized as an exchange of the security for the buyer's obligation to sell back an equivalent security, then the repo might be covered by section 1058, which never uses the words securities loan and would apply to any transaction that met its requirements.

> ***Section 1058 would be a futility if the tax risk in securities lending was that cash collateral would be treated as sales proceeds.***

Can we also infer from section 1058, which never refers to a sale, that exchange classification trumps sales classification for any transaction that meets its requirements? Possibly, because Congress clearly understood that securities loans usually involved collateral, and section 1058 itself does not exempt a securities sale from taxation. Section 1058 would be a futility if the tax risk in securities lending was that cash collateral would be treated as sales proceeds.

Because section 1058 and the prior authorities on securities lending implicitly segregate the transaction in collateral from the transaction in securities, it is inevitable that the return to the securities borrower attributable to cash collateral is treated as interest. This implicit segregation of the securities transaction from the cash transaction in the securities lending authorities calls to mind the Supreme Court's analysis in *Loewenstein*, wherein the Court fixed on the fact that the stock purchaser's return was ultimately determined by reference to the cash transaction, not the stock transaction. However, the *Loewenstein* Court emphasized that its decision on the ownership of income from the securities was not a decision on how to characterize the securities transaction itself. Because the Court refrained from characterizing the repo before it in *Loewenstein*, it would be pointless to speculate how it might have characterized a different version of the same transaction. The Loewenstein analysis and

[27] *See* S. Rep. No. 762, 95th Cong., 2d Sess. 1, 4 (1978).

decision is arguably confined to its facts and not binding on a lower court faced with a repo of securities that will be sold to third parties.

Absent definitive guidance from either the repo or securities lending authorities on how to characterize a modern repo transaction, at least four alternatives present themselves as reasonable:

(1) Secured Loan. Treat the sale and repurchase as a single, integrated transaction in which the securities are collateral for a cash loan. This characterization has the merit of being endorsed by the Service in TAM 200207003, but it flies in the face of the Supreme Court's decision in *Provost* and every subsequent authority on securities lending.

(2) Loan Plus Exchange. Segregate the cash transaction from the securities transaction, treating the former as a loan and the latter as an exchange subject to section 1058. This yields the same result as the analysis in TAM 200207003, except for the risk of a taxable exchange if one of the section 1058 requirements is not satisfied.

(3) Sale Plus Repurchase. Segregate the sale transaction from the repurchase transaction and treat each as a taxable sale. This characterization has the merit of following the form of the transaction, a conservative approach whenever the law is unclear on what alternative characterization might apply. This yields the same netting as advocated by the taxpayer in TAM 200207003, albeit on different grounds.

(4) Service Plus Service. If the repo is executed pursuant to a matched book strategy, treat the repo and the matching reverse repo as a single integrated transaction in which the dealer performs a matching service for both the repo buyer and the reverse repo seller. This is the characterization advanced by the taxpayer in TAM 200207003.

Under both (1) and (2), the repo seller treats the price differential on the repurchase as interest expense for purposes of sections 861 and 882. Under both (3) and (4), the repo seller nets the results of its transactions, eliminating interest expense for purposes of sections 861 and 882.

Tax Consequences of Netting

The taxpayer in TAM 200207003 assumed that netting would leave no repo interest expense to allocate against foreign-source income under section 861. That would be the case, provided that the price differentials on the repos were not characterized as "interest equivalents" under reg. section 1.861-9T(b)(1)(i), which provides as follows:

> Any expense or loss (to the extent deductible) incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time shall be subject to allocation and apportionment under the rules of this section if such expense or loss is substantially incurred in consideration of the time value of money.

At first glance this rule might seem to reach characterization (3), a sale plus a repurchase, because the repurchase price differential is unequivocally measured by the time value of money. However, if the analysis in (3) applies, and the repo is characterized in accordance with its terms, there is arguably no "interest equivalent." The repo seller would have gain or loss on the sale, but the amount of the gain or loss would not represent the time value of money. There is no deductible "expense or loss" incurred on the repurchase: The repurchase price simply becomes the basis in the repurchased security. While the taxpayer may realize a loss on a subsequent disposition of the repurchased security, a gain might be realized instead, and a loss would be driven by changes in market value and not the time value of money.

> ***TAM 200207003 puts financial institutions on notice that at least one of their competitors does not subscribe to the supposed consensus on the tax character of repos and reverse repos.***

Assuming that characterizations (3) and (4) eliminate repo interest expense from the section 904 calculation, that does not necessarily mean an increase in the section 904 limitation. If the reverse repos do not create loans, then the would-be loans are disregarded in the denominator of the fraction used to allocate other interest. Because repo financing is usually low-cost financing, the benefit of allocating repo interest to interest income from U.S. sources could theoretically be outweighed by the detriment of eliminating a domestic asset to which higher-rate interest expense would have been apportioned.

While the service-fee analogy is limited to repos that are part of a matched book, the reasons for treating a repo as a sale followed by a repurchase would apply equally to any repo in which the repo buyer is free to dispose of the security. If characterization (3) is applied to repos and reverse repos that are not part of a matched book, gain or loss will be recognized by the repo seller on the original sale and by the repo buyer on the subsequent repurchase. This may not matter for securities dealers, who must mark their securities holdings to market under section 475 in any event, but it might matter for their customers.

There would also be state and local tax consequences if repos and reverse repos were no longer characterized as loans, although some states, including New York, have their own criteria for characterizing repos, leaving open the theoretical possibility of treating them as sales for purposes of section 904 and loans for purposes of state franchise tax.

Conclusion

TAM 200207003 puts financial institutions on notice that at least one of their competitors does not subscribe to the supposed consensus on the tax character of repos and reverse repos. TAM 200207003 is not binding on other taxpayers and, for all most of us know, is not even the final word on that case. Until the proper tax character of the modern repo is sorted out, taxpayers may be motivated to adopt the characterization that results in the most section 904 limitation or the lowest section 882 haircut. What will drive taxpayers to disparate positions is the negative arbitrage inherent in the consensus classification of repos as secured loans. The Service has it in its power to eliminate the negative arbitrage by permitting the direct allocation of repo interest expense against reverse repo interest income for purposes of sections 861 and 882. It could mitigate the incentive to disparate reporting by exercising that power as promptly as possible.

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