



# **RECENT U.S. TAX DEVELOPMENTS IN SECURITIES LENDING**

2nd Annual CASLA Conference

On Securities Lending

May 9, 2012

Rom Watson, Ropes & Gray LLP

William Young, State Street Bank and Trust Company

# Overview of Presentation

- **IRS Notice 2010-46**
  - “Qualified Securities Lender”/Credit Forward System
  - Application of transition rules
- **“Negative rebates”**
  - Determination of source for U.S. tax purposes
  - IRS Request for Comments
- **FATCA**
  - Withholdable Payments
  - Collateral and grandfathered obligations

# IRS Notice 2010-46 (May 20, 2010)

- IRS Notice addresses over-withholding
  - New exemption for “Qualified Securities Lenders”
  - “Credit Forward” system for proof of withholding in a series of loans involving identical securities
- Formal withdrawal of Notice 97-66

# Notice 2010-46

## Timeline for Effective Dates

- “Old” Notice 97-66
  - November 14, 1997 through May 19, 2010
- “Modified” Notice 97-66
  - May 20 through September 13, 2010
- Notice 2010-46 “Transition Period”
  - September 14, 2010 through ?? (effective date of new regulations)
- New Regulations
  - Anticipated effective date: ?? (proposed regs yet to be issued)

# Notice 2010-46 – Expected Regulations

(Substitute Dividend Payments to a “Qualified Securities Lender”)

- Regulations expected to provide exemption from withholding tax for any substitute dividend paid to a “Qualified Securities Lender” (QSL)
- A QSL is a foreign financial institution meeting all of the following conditions:
  - Regulated bank custodian, broker-dealer, or clearing organization regularly engaged in trade or business that includes the borrowing and lending of US corporate securities from and to its unrelated customers;
  - Subject to IRS tax return audit, or if already a “qualified intermediary” (QI), by an external auditor [Note: QI would have to appropriately amend QI agreement with IRS]; and
  - Files an annual prescribed form with IRS certifying it satisfies QSL conditions.

# Notice 2010-46 – Expected Regulations

(Tax Treatment of a Qualified Securities Lender)

- Substitute dividend payment can be received by QSL free of US withholding tax:
  - where QSL has obligation to make an offsetting substitute dividend payment to another, QSL must withhold on substitute dividend payments it makes, pay and deposit tax, and report on such payments.
  - where QSL has no obligation to make an offsetting substitute payment to another person, QSL remains liable for the tax under §871(a) or §881(a) by virtue of the receipt of the substitute dividend payment.
- Presumably, QSL would pay and deposit the tax and report the substitute payment on Form 1042-S.

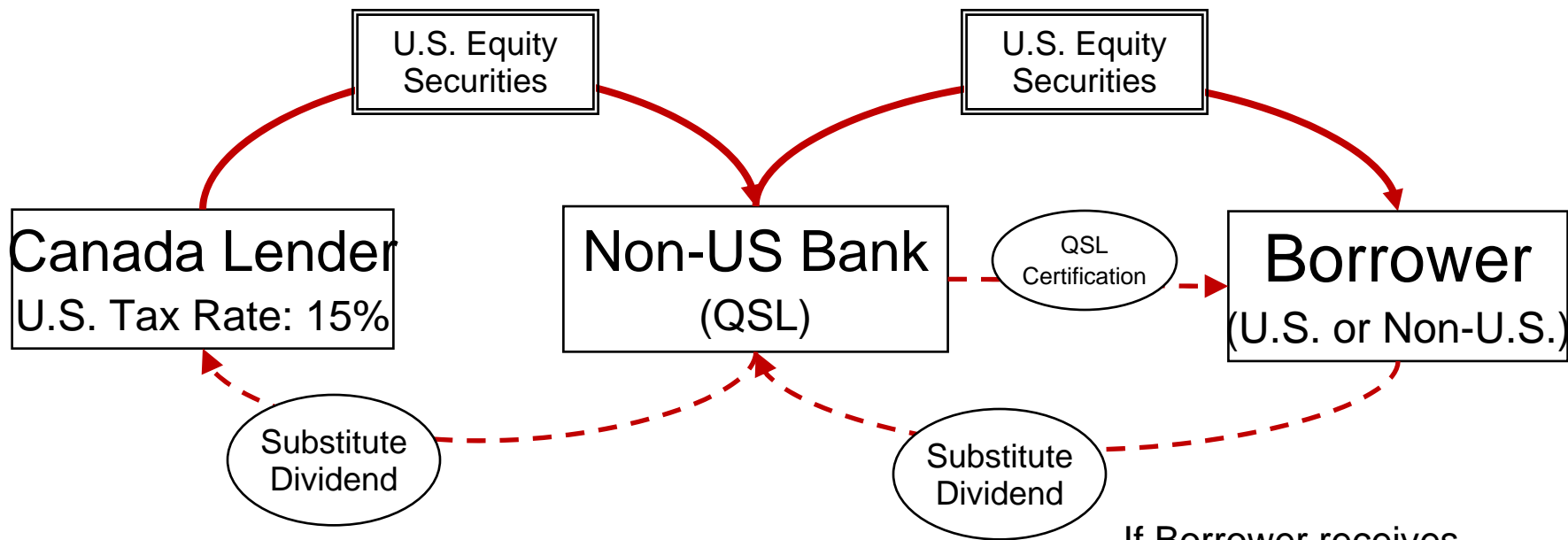
# Notice 2010-46 – Expected Regulations

(QSL Certifications to Withholding Agents)

- Withholding agent relieved from liability to withhold US tax for any substitute dividend paid to QSL, ONLY IF:
  - Withholding agent receives a written certification from QSL
  - On an IRS form, or otherwise as provided in regulations
- Certification must include statements that:
  - Recipient is a QSL
  - Recipient will withhold/remit/ or pay proper amount of US tax on any substitute dividend it receives or makes

# Notice 2010-46 – Expected Regulations

(Example of QSL Payment Flows)



Non-US Bank (QSL) Pays U.S. Tax on Substitute Dividend @ 15% Treaty Rate in one of two ways:

- as withholding tax when substitute dividend is paid to Canadian Lender, OR
- on its own US tax return, if no substitute dividends are paid

If Borrower receives QSL Certification, no US withholding tax is imposed on substitute dividend



# Notice 2010-46 – Expected Regulations

(Credit Forward System for Prior Withholding)

- Withholding agent may limit aggregate US gross-basis tax within a “series of securities lending transactions” to the amount of US gross-basis tax applicable to the foreign taxpayer bearing the highest rate of US gross-basis tax.
  - Thus, aggregate taxes paid in such transactions should not exceed the 30% statutory rate.
- Excessive tax may be relieved by amounts previously withheld to the extent that there is sufficient evidence of prior tax withheld.
- No recipient of a substitute dividend in a series of securities lending transactions may claim a refund (or claim a credit against any other tax liability) solely because a prior recipient in the same series was subjected to a higher rate of gross-basis US tax.

# Notice 2010-46 – Expected Regulations

(Substantiation of Prior Withholding Tax)

- Sufficient evidence deemed to exist if written documentation identifies amounts previously withheld by another withholding agent with respect to an actual dividend or a substitute payment in the same series.
- Withholding agent may presume tax has been withheld by a prior withholding agent, if that agent:
  - Receives substitute dividend net of US withholding tax;
  - Receives a written statement from the “immediately” prior withholding agent setting out amount of such taxes;
  - Identifies person who withheld such tax and the recipient of the payment against which such tax was withheld; and
  - Does not know or have reason to know that the written statement is unreliable.

# Notice 2010-46 – Expected Regulations

(Anti-Abuse Rule)

- Withholding agent or QSL may not rely on above rules (including certification of QSL) if it knows or has reason to know that the transaction (or series of transactions) has a principal purpose of reducing or eliminating US gross-basis tax that would have been due in absence of transaction (or transactions).
- In such case, withholding agent or QSL must withhold at the rate of 30% (or lower treaty rate) on each substitute dividend payment.

# Notice 2010-46 – Expected Regulations

(Effective Date Issues)

- Treasury/IRS anticipated that the regulatory framework outlined in Notice 2010-46 would be effective for transactions entered into on or after January 1, 2012, but proposed regulations have yet to be issued.
- Until regulations are issued, withholding agents may rely on “transition rules” (described below).

# Notice 2010-46 – “Transition Period”

(Presumption for Receipt of Net Payments)

- Withholding Agent that is obligated to make a substitute dividend payment may presume that US tax equal to the amount implied by a net payment was withheld if all of the following are satisfied:
  - Receipt of substitute dividend or dividend payment that reflects a reduction for withholding of US gross-basis tax [Example: WA received substitute payment of 85% of the actual gross dividend payment; WHT of 15% is implied];
  - Withholding agent does not know or have “reason to know” that tax was not withheld and deposited or paid; and
  - WA is subject to IRS tax return audit or, in case of a QI, external audit.
- No refunds or credits solely because a prior recipient in same series of substitute payments was subjected to a higher rate of US tax.

# Notice 2010-46 – “Transition Period”

## Modified Rules for “Qualified Securities Lender” Status

- Exemption for payments to a QSL applies during transition period if withholding agent receives, “at least annually,” a statement from its counterparty that “substantially complies” with a QSL certification (but not including the requirement that a QSL file an annual statement with the IRS).
  - Certification can only be made if QSL reasonably determines that it meets requirements to qualify as QSL under Notice 2010-46.
  - Anticipated future guidance – QSLs may be required to identify themselves to the IRS prior to end of 2010.
- QI that makes a QSL certification will be deemed to have agreed to amend its QI agreement as necessary to report, withhold deposit and pay US tax as described in Notice 2010-46.



# **Negative Rebates (and Borrow Fees)**

Source and Character of Securities  
Lending Fees Paid By U.S. Borrowers to  
Nonresident Lenders

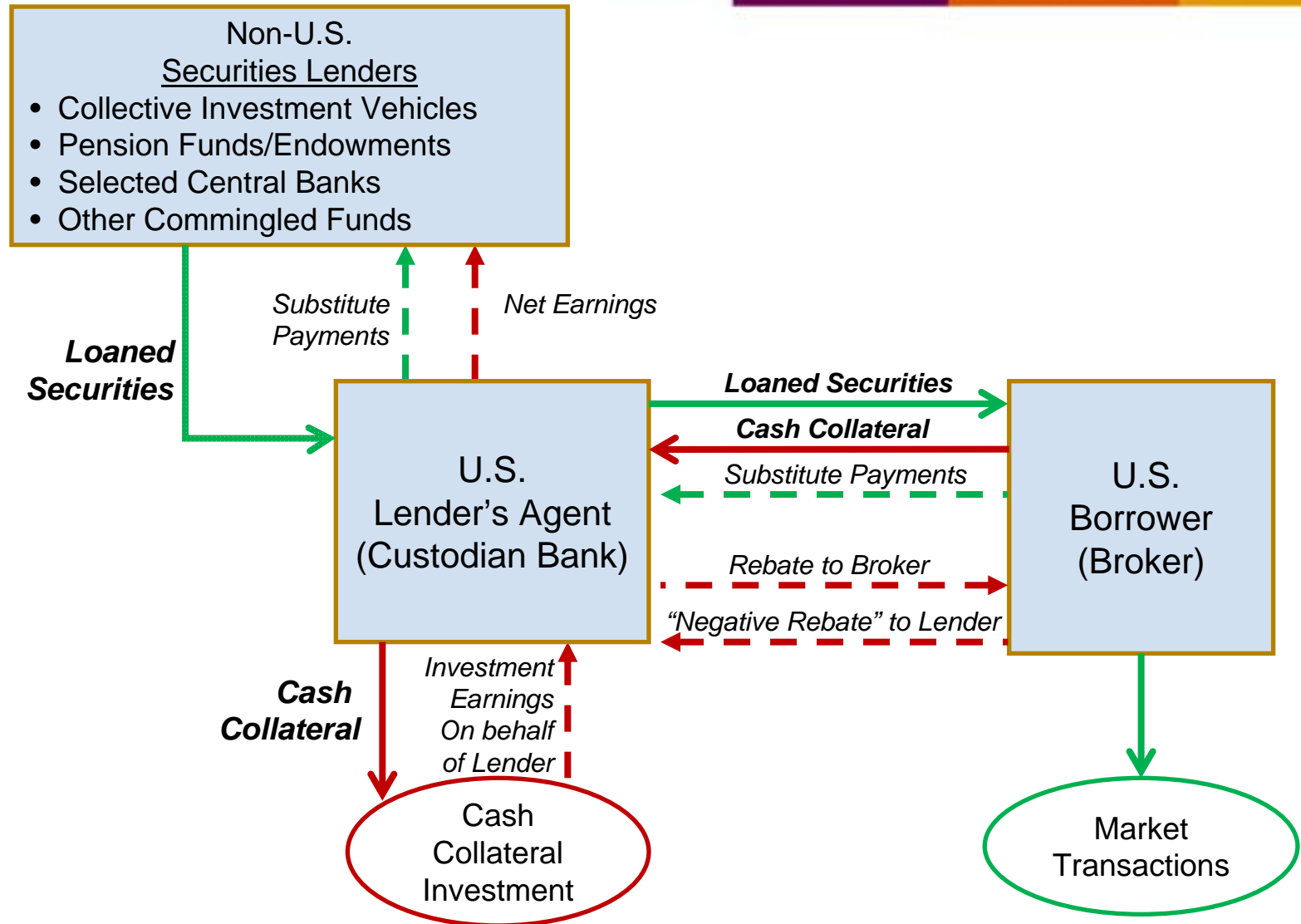
(U.S. Withholding Tax Implications)

# Negative Rebates Paid to Non-US Lenders

- Cash collateral loans
- US Borrowers
- Record low interest rate environment
- US withholding tax obligation?
- Determination of source of negative rebates



# Securities Lending Transaction Cash Collateral



# Cash Collateral Loans

(normal interest rate environment)

- Securities lender delivers securities to borrower versus cash collateral.
- Lender invests collateral for its own account and earns investment income.
- Lender pays a portion of investment earnings as a “rebate” to borrower (“positive” rebate).
- Lender keeps excess of earnings over rebate, in effect compensation for the loan of securities.

# Cash Collateral Loans

(current record-low interest rate environment)

- Securities lender delivers securities to borrower versus cash collateral.
- Lender invests collateral for its own account and earns investment income.
- Borrower pays “negative” rebate to lender; in effect, a borrow fee.
- Lender keeps any investment earnings plus negative rebate as compensation for the loan of securities.

# Negative Rebates – US Taxation

- Is a negative rebate paid by a US borrower to a non-US person subject to US withholding tax?
- The answer depends on whether the negative rebate income has a source in the US, which in turn depends on the character of the income.
- If the income is from US sources, withholding tax of 30% would apply unless a domestic or tax treaty exemption or reduced tax rate applies.
- If the income is not from US sources, there would not be a US withholding tax obligation.
- Unfortunately, no official U.S. guidance has been issued.

# Determination of Character of Securities Lending Payments

- First of all, except for substitute dividends, no regulations or other binding official guidance have been issued by the IRS regarding the taxation of securities lending payments.
- Section 1058 Proposed Regulations (1983) – substitute payment characterized as a “fee” paid by the borrower “for the temporary use of [the borrowed securities].” Although fees were not mentioned, the proposed regs provide some indirect support for classification as “rental income”.

# Source of Other Financial Transaction Payments under US Tax Rules

- Notional principal contract (NPC) payments
  - derivatives linked to foreign currency (1986) – resident of recipient
  - NPC payments (1988) – residence of recipient
- “fails charges” – In Final Regulations (T.D. 9579) issued February 17, 2012, source of income from a “qualified” fails charge” is generally determined by reference to the residence of the income recipient, effective February 21, 2012. In preamble, Treasury/IRS said it is considering whether separate guidance is needed on the source of income attributable to payments that arise in securities lending transactions or repurchase transactions and requested comments.

# Character under US Tax Treaties

- Under recent US income tax treaties (e.g., Japan, France), securities lending fees are treated as exempt “other income” for treaty purposes.
  - Note: US/Canada treaty does NOT have a favorable “other Income” provision.
- In a 1988 private ruling (8822061), which did not address character or source, securities lending fees received by an insurance company were classified as “industrial or Commercial Profits” for purposes of the applicable US tax treaty.

# Negative Rebates: US Tax Treatment for Canadian Lenders

- Exemption under Canada/US tax treaty
  - Canadian charitable organizations – Article XXI, paragraph 1 (broad exemption for “income”)
- Exemption under US domestic law
  - Governmental pension funds – Code section 892
- Note: Under Article XXI, paragraphs 2 and 3, pension funds and collective investment funds for exempt organizations are exempt only on interest and dividend income.
- Above tax treatment also applies to “borrow fees’ received from US borrowers.



# Securities Lending Industry Initiatives

- Members of the Risk Management Association (RMA) and Securities Industry and Financial Markets Association (SIFMA) have assembled task forces to review and possibly submit comments to Treasury/IRS seeking a residence-based source rule for negative rebates and borrow fees.



# **FATCA Proposed Regulations**

## **Potential Impact on Cross-Border Securities Lending**

**(some observations)**

# FATCA Proposed Regulations – Background

- March 18, 2010 – chapter 4 (sections 1471-1474) added to Internal Revenue Code by the HIRE Act.
- Chapter 4 originally introduced as part of Foreign Account Tax Compliance Act of 2009, commonly referred to as FATCA.
- FATCA imposed new reporting obligations on foreign financial institutions (FFIs), including withholding tax on certain payments to FFIs that fail to comply.
- Proposed regulations issued February 8, 2012.
- Comments to IRS were due April 30, 2012; public hearing May 15, 2012.

# FATCA Proposed Regulations – Overview

- Withholding agents must withhold 30% tax from “withholdable payments” made to FFIs that do not enter into an agreement with IRS to comply with FATCA.
- A withholdable payment is, in general, (1) any payment of U.S.-source income and (2) gross proceeds from the post-2014 “sale or *other disposition*” of most U.S. securities.
- As a general rule, if the source of a payment cannot be determined at the time of payment, a withholding agent must treat the payment as being from U.S. sources.
- Securities lending and repo payments with respect to US securities can be withholdable payments covered by FATCA.

# FATCA – Withholdable Payments Securities Lending/Repo

- Substitute payments in lieu of U.S.-source dividends or interest. U.S.-source income regardless of payor residence.
- Rebate fee (cash collateral loans) paid by U.S. lender to Canadian borrower. Interest from U.S. sources. What if loan could not exceed 183 days?
- Borrow fee (and negative rebates) paid by U.S. borrower to Canadian lender. Issue: U.S.-source payment?
- Borrow fee on loan of U.S. securities paid by Canadian borrower to Canadian lender. Issue: U.S.- source payment?

# FATCA – Withholdable Payments Securities Lending/Repo

- Investment of cash collateral generating U.S.-source income on behalf of Canadian lender.
- Income on U.S. collateral securities (as well as substitute payments thereon, if applicable) paid to Canadian resident.
- Repo spreads paid by U.S. counterparty to Canadian resident. But what if MRA limited repo to not more than 183 days?

# FATCA – Withholdable Payments Securities Lending Transfers of U.S. Securities

- Withholdable payment: “Gross proceeds” from “sale or other disposition” of U.S. securities.
- Loan of U.S. securities by a Canadian lender – under U.S. principles – is a “disposition”.
- Under proposed regulations – not a disposition for FATCA purposes unless gain or loss required to be recognized under Code section 1001.
- Code section 1058 – no recognition of gain or loss if securities lending transaction meets conditions of section 1058.
- Caveat: borrower default – e.g., borrower fails to return loaned securities; lender uses collateral to buy in securities identical to loaned securities. Is FATCA withholding required?

# FATCA – Collateral Accounts

- Collateral pledged under SL agreements –
- Should it be excluded from definition of “financial account”?
- Should all accounts that hold collateral be excluded?
- Should collateral accounts be viewed as investment vehicles? Low tax-avoidance risk.
- Other collateral example: ISDA Credit Support Annex (CSA).



# FATCA – Grandfathered Obligations

- Extended to obligations existing on January 1, 2013.
- Repo/Securities Lending Agreements
  - Are loans outstanding as of 1/1/2013 grandfathered?
  - FATCA amendments needed by 1/1/2013?
  - Note: proposed effective date of FFI agreement is July 1, 2013.
  - If MSLA not made FATCA-compliant prior to 12/31/2013, restrictions on new loans? Recall of existing loans?
- Passthru Payments – should SL/Repo payments be entirely excluded from definition of “passthru payments,” where no U.S. referenced assets?

# IRS Circular 230 Notice

\*\*\*\*\*

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained herein is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding U.S. tax penalties.

\*\*\*\*\*