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Tax Court Issues Decision Recharacterizing Term Securities Loan

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On March 16, 2009, the Tax Court held in Samueli v. Commissioner, 132 T.C. No. 4, that a transaction documented as a securities loan did not qualify for favorable treatment under section 1058 of the Internal Revenue Code because the lender did not have the right to require the borrower to return the securities at any time on short notice. The court also refused to treat the posting of cash collateral in respect of the securities loan as giving rise to *bona fide* indebtedness.

Section 1058 generally provides that, from the perspective of a qualifying lender, the delivery of securities to the borrower at the inception of the transaction is not a taxable sale of the securities; the receipt of the securities from the borrower upon termination also is not a taxable event; and the securities returned to the lender will have a holding period in the lender's hands that includes the period during which the securities loan was outstanding. Section 1058 is also relevant to the sourcing and withholding tax treatment of payments in lieu of dividends and interest on borrowed securities.

The Samueli case arose in a special context, and it is unclear whether the decision will have implications outside that context. A victory would have allowed the taxpayer to convert interest income on a short-term, relatively low-risk investment into long-term capital gain taxable at a lower rate in a later year. By adding a step that did not meaningfully change its economic position, the taxpayer would have saved about ten million dollars in taxes.

Nevertheless, the decision is important because there are virtually no cases or rulings dealing with the criteria for distinguishing securities loans qualifying for favorable treatment under section 1058 from other economically similar arrangements. Although the circumstances of the case may have affected the Internal Revenue Service's decision to challenge the taxpayer's intended treatment of the transaction, the Tax Court's decision is not premised on anti-abuse arguments and instead relies on the technical requirements of section 1058. Accordingly, in the absence of further guidance, taxpayers should take

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account of the possibility that the rationale of the decision could be applied to term securities loans generally.

For this reason, taxpayers that would be unfavorably affected by a failure to qualify for the benefits of section 1058 should consider entering into a securities loan only if the loan includes a customary provision permitting the loan to be unwound on five days' notice. Market participants such as mutual funds or insurance companies (or high net worth individuals, like the taxpayer involved in the Samueli case) could be required to recognize gain if they lend appreciated securities and do not have the right to require that the securities be returned promptly upon demand.

It is conceivable (but we think unlikely) that the Samueli case could lead to a broader reexamination of the principles for distinguishing securities loans from other classes of transactions, such as repo transactions. The securities lending and repo markets involve daily volumes in the hundreds of billions of dollars. The overwhelming majority of the transactions are not motivated or influenced by tax considerations. The deep theory underlying the tax classification of securities loans and similar transactions has long been of interest to commentators. In the absence of a strong policy reason for doing so, however, the present would seem to be a particularly inappropriate time to risk disrupting functioning financial markets by revisiting questions of deep theory. Accordingly, the consequences of the Samueli case are likely to be limited to term securities loans, where the specific rationale for the decision conceivably could affect transactions that are not tax-motivated.

Facts of the Samueli Case:

In October of 2001, the taxpayer (an individual named Samueli)[1] purchased $1.7 billion of agency STRIPS from his securities broker, Refco Securities Inc. The purchase price was funded entirely by margin debt from Refco. The STRIPS represented the right to receive a single payment in February of 2003.

Samueli then immediately loaned the STRIPS back to Refco in a fixed-term securities loan maturing in January of 2003, one month prior to the maturity of the STRIPS. Refco provided cash collateral to Samueli in the same amount as the margin loan used to purchase the STRIPS, and Samueli used the cash to repay the margin loan. Samueli was required to pay a variable rate "borrow fee" (for all practical purposes, interest) on the collateral,[2] but apparently there were no formal arrangements concerning the timing of

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1 Technically the taxpayer in the case is an LLC owned 99.5% by Samueli and his wife through their trust and .5% by two of Samueli's advisors.

2 As discussed below, the court recharacterized the transaction and treated the cash collateral as purchase price for Refco's immediate repurchase of the Securities from Samueli in 2001. Moreover,

payment of that fee. Samueli paid an $8 million borrow fee on December 28, 2001, and received a corresponding amount back from Refco about two weeks later. Samueli deducted the payment on his 2001 tax return. It does not appear that the collateral was subject to standard mark-to-market requirements.

The taxpayer thus entered into two transactions pursuant to a single agreement with the same counterparty on the same day. In considering what was at stake, it is worth considering the two transactions separately. The rights and obligations of the parties, and the economic consequences of the arrangements between them, would have changed hardly at all if the taxpayer had simply made a leveraged investment in the STRIPS, and had not entered into the second step (lending the STRIPS back to Refco, and using cash collateral received from Refco to repay its margin loan). In either case, Samueli would have incurred a floating-rate cost (interest on the margin loan, or a "borrow fee" on the cash collateral), to earn a fixed-rate return on the STRIPS; that is, Samueli was "long" the fixed-rate yield of the STRIPS, and was "short" a floating-rate funding cost. Short-term rates fell over the life of the trade, and Samueli made a profit of about $13 million on the transaction.

Although the court offers no discussion of Samueli's motives for entering into the transaction, it seems clear that the securities loan was intended to allow Samueli to claim character and timing benefits. Specifically, if Samueli had simply purchased the STRIPS with margin debt without entering into the second step, he would have been required to include original issue discount accruing on the STRIPS in income over the term of the transaction. He would also have been entitled to deduct interest expense on the margin loan on a current basis; the net result would have been taxation, at ordinary income rates, of his net economic income over the term of the transaction. By lending the STRIPS to Refco, however, Samueli was able to take the position that: (i) he was not required to accrue discount on the STRIPS (because during the term of the securities loan he did not own the STRIPS, and instead owned a contract right to receive them from Refco); (ii) he was not required to include a corresponding amount in income on the securities loan (because section 1058 requires that securities loans provide for payments corresponding to "interest, dividends and other distributions" on the borrowed security but does not by its terms import original issue discount and similar timing rules); and (iii) he was entitled under section 1058 to "tack" the holding period of the securities loan to his holding period in the STRIPS, thereby entitling him to a long-term holding period in the STRIPS immediately upon the end of the term securities loan. In this manner, it appears that Samueli's strategy was to use the transaction as a means of converting interest income on a short-term, low-risk

because Samueli used the cash collateral to repay the margin loan the court found that there was no debt outstanding.

investment into long-term capital gain. Instead of recognizing $50 million of ordinary income ratably over the life of the transaction, the taxpayer would have recognized $50 million of long-term capital gain upon the ultimate disposition of the STRIPS after the conclusion of the securities loan.

In addressing the transaction, the court focused on the narrow question of whether the transfer of the STRIPS to Refco qualified as a tax-free disposition under section 1058. In order to qualify for the benefits of section 1058, a securities loan must not "reduce [the taxpayer's] risk of loss or opportunity for gain." The government argued that the securities loan reduced Samueli's opportunity for gain, because Samueli could not sell the STRIPS during the term of the securities loan, and thus could not take advantage of short-term swings in their value. The court agreed with the government's position.

One point to note about the court's holding on the section 1058 issue is that Samueli conceded that the securities loan increased his risk of loss on the STRIPS, presumably also because he could not sell the STRIPS and thus avoid a drop in their value. This concession presumably made it easier for the court to find a concurrent reduction in Samueli's opportunity for gain. In reaching its conclusion, the court rejected two arguments that are worth noting:

First, the court was not persuaded by Samueli's argument that it was possible for him to have taken advantage of short-term swings in the price of the underlying STRIPS by "locking in" short-term gains through the use of derivatives. Although the court acknowledged that such possibilities might have existed, the court chose to consider only the specific "agreement connected with the transfer of the securities," stating that "whether the Samuelis could have entered into another agreement to lock in their gain is of no moment."

Second, Samueli argued that it was inappropriate for the court to hold that term loans are outside the scope of section 1058, on the grounds that section 512(a)(5)(B), which was enacted at the same time as section 1058, specifically requires that a tax-exempt lender of securities be able to terminate the loan on five days' notice as a condition for the loan not to give rise to "unrelated business taxable income." Samueli argued that Congress' silence in section 1058 should be understood as an implicit endorsement of term loans for purposes of that section. The court, however, took the view, based on the history of section 1058, which was enacted in 1978, that Congress intended for section 1058 to codify the IRS's pre-existing administrative position to treat securities loans as non-taxable transactions. Because the administrative authorities predating section 1058 generally dealt with securities loans that were callable by the lender on demand, the court concluded that

section 1058 was intended to have a similarly limited application.[3] The court therefore concluded that a term loan could have the effect of reducing the taxpayer's opportunity for gain and thus failed to meet the requirements of section 1058.

Having concluded that the securities loan constituted a taxable disposition of the STRIPS, the court then recharacterized the transaction as follows: Samueli purchased the STRIPS in 2001 and immediately resold the STRIPS to Refco, recognizing no gain or loss. Samueli and Refco then entered into a forward contract pursuant to which Samueli would repurchase the STRIPS from Refco in 2003. Refco chose to cash-settle the transaction, which the court treated as if Samueli had purchased the STRIPS and then immediately sold the STRIPS, recognizing a short-term capital gain. Finally, because the court held that there was no actual securities loan to Refco in respect of the STRIPS, it characterized Samueli's obligation to return the cash collateral to Refco as an obligation to deliver a purchase price under the forward contract. Consequently, Samueli was denied interest deductions on the cash collateral, on the theory that there was no indebtedness on which interest could have been paid, and the economic cost of the borrow fees was taken into account as a reduction in the amount of its gain.

At this point, the ultimate significance of the Samueli case is difficult to assess. On the one hand, the case could be read as an example of a court using the technical rules of section 1058 to prevent a taxpayer from using that section to avoid the current recognition of income in respect of what amounted to a leveraged purchase of STRIPS. Under such a view, it is possible to conclude that the case should be confined to its facts, or at least to cases involving the use of a securities loan to place the taxpayer in a better tax position than had the taxpayer merely continued to own the underlying security.

On the other hand, if one takes at face value the court's holding that term loans fail to meet the requirements of section 1058, then the Samueli decision could have more far-reaching consequences.

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[3] Strangely, the court did not discuss proposed Treasury regulation section 1.1058-1(b), which states that for a securities loan to meet the requirements of section 1058, a lender must be permitted to terminate the loan on 5 days' notice. That regulation was issued in 1983 and was never finalized.

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