US
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Securities loan gone bust

Under a securities loan agreement, a borrower typically borrows securities from a lender and posts collateral to secure its obligation to return identical securities. Even though the securities are loaned, for US federal income tax purposes there is a transfer of ownership from the lender to the borrower resulting in an exchange upon entering into the agreement and upon termination. However, no gain or loss is recognised to the lender for US federal income tax purposes upon the initial transfer of securities to the borrower and the return of identical securities to the lender upon termination of the securities lending agreement, provided the securities loan agreement meets certain requirements specified by Section 1058 of the Internal Revenue Code.

On March 16 2009, the US Tax Court ruled in *Samueli v Commissioner* that a transaction documented as a securities loan did not meet those specified requirements with the result that the taxpayer failed to achieve his sought-after tax benefits. The taxpayer had purchased stripped Freddie Mac bonds (zero-coupon bonds) from his broker on margin. The taxpayer subsequently loaned the stripped bonds back to the broker and the broker posted cash collateral with the taxpayer. The taxpayer used the cash collateral to repay the margin loan. The taxpayer took the position that he was not required to accrue income on the stripped bonds because he was not the owner for tax purposes. Under US federal income tax law, there is no accrual of interest or original issue discount on a securities loan. The taxpayer took the position that his holding period in the stripped bonds, once returned to him, included his holding period in the securities loan agreement. As such, the taxpayer argued he had converted the original issue discount, generally taxed at ordinary tax rates, into long-term capital gain generally taxed at lower preferential rates.

One of the requirements a securities loan agreement must meet in order to qualify for favourable treatment is that it must not reduce the lender's risk of loss or opportunity for gain in the securities loaned. Treasury regulations that have been proposed more than two decades ago, but which have never been finalised, clarify that the securities loan agreement must provide that the lender may terminate the loan upon notice of not more than five business days in order to meet the aforementioned requirement. The notion is that if the securities rise in value, the lender can terminate the loan and sell the securities in the market. The securities loan agreement entered into between the taxpayer and his broker had a term of approximately 15 months and prevented the taxpayer on all but three days during that period from causing the broker to transfer the stripped bonds, or identical securities, back to the taxpayer.

The Tax Court held that the transaction between the taxpayer and his broker was not a securities loan agreement that qualified for favourable treatment under the Internal Revenue Code because the taxpayer's ability to cause his broker to transfer the stripped bonds, or identical securities, back on only three days of the entire 15-month term of the agreement reduced the taxpayer's opportunity for gain in the stripped bonds. This was the case, according to the court, because the taxpayer could only realise any inherent gain in the securities if the gain continued to be present on one of the days the taxpayer was able to cause his broker to transfer the stripped bonds, or identical securities, back.

Although the Tax Court did not refer to the proposed Treasury regulations, after the Samueli case it seems wise to structure securities loan agreements to give the lender the right to cause a return of the loaned or other identical securities on short-term notice – generally not more than three days (because today's regular way stock settlement is three days) – in order to qualify for Section 1058 treatment.

The bottom line? Once the court had determined that the securities loan agreement did not qualify for Section 1058 treatment, it recharacterised the transaction as two separate sales and a forward contract between the taxpayer and his broker. The court treated the taxpayer as purchasing and selling the stripped bonds for the same price upon entering into the transaction. Upon settlement of the transaction, the court treated the taxpayer as purchasing the stripped bonds pursuant to the forward contract and as immediately selling them to his broker for a gain, which was treated as a short-term capital gain taxable at ordinary tax rates.

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