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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9508
Source of Income From Qualified Fails Charges

RIN 1545-BJ85

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations which set forth the source of income attributable to qualified fails charges. The temporary regulations provide guidance about the treatment of fails charges for purposes of sections 871 and 881, which generally require gross-basis taxation of foreign persons not otherwise subject to U.S. net-basis taxation and the withholding of such tax under sections 1441 and 1442. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the Federal Register.

DATES:

Effective Date. These regulations are effective on December 8, 2010.

Applicability Date. These regulations apply to qualified fails charges paid or accrued on or after December 8, 2010.

FOR FURTHER INFORMATION CONTACT: Sheila Ramaswamy or Anthony J. Marra, Office of Associate Chief Counsel (International) (202) 622-3870 (not a toll free call).

SUPPLEMENTARY INFORMATION:

Background

In response to persistent delivery failures in delivery-versus-payment transactions involving U.S. Treasury securities (Treasury securities), a trading practice governing failed deliveries of Treasury securities was published in 2008 by the Treasury Market Practices Group (TMPG) and the Securities Industry and Financial Markets Association (SIFMA). This trading practice, which was recommended by the Federal Reserve Bank of New York in addition to TMPG and SIFMA, has subsequently been voluntarily adopted by almost every participant in the Treasury securities market. Transactions that involve delivery-versus-payment include a sale, a purchase, a sale and repurchase transaction (commonly known as a "repo"), a securities lending transaction, and an option.

The trading practice addresses the problem that in certain situations, including a low interest rate environment, a party to a delivery-versus-payment transaction may lack the economic

incentive to deliver Treasury securities in a timely manner. Under the trading practice, the parties to a contract that provides for delivery-versus-payment of Treasury securities agree that if one party fails to deliver Treasury securities at the time specified in the contract, the failing party will pay an amount (a “fails charge”) to the party entitled to receive the Treasury securities. The fails charge is calculated using a formula that takes into account current interest rates and trade proceeds, and accrues each day that the failure to deliver continues. The trading practice is generally expected to impose a fails charge whenever the interest rate on a repo that can be settled with any of a variety of securities (referred to in the market as the “general collateral rate”) falls below a certain level.

As noted in this preamble, the delivery-versus-payment market encompasses a variety of transactions, each of which can generate a fails charge. Some transactions, such as a repo, where delivery is required both at inception and at settlement, can produce more than one fails charge. In back-to-back transactions, it can also be difficult to determine whether a party that incurs a fails charge is acting as an intermediary or a principal. As a result, there is considerable uncertainty about the treatment of fails charges for purposes of sections 871 and 881, which generally impose gross-basis taxation at a rate of 30 percent on certain U.S. source income of foreign persons that is not effectively connected with the conduct of a trade or business in the United States and the withholding of such tax under sections 1441 and 1442.

Notice 2009-61, (2009 IRB 181), issued in July 2009, addressed the issue temporarily by providing that the Internal Revenue Service (IRS) will not challenge the position taken by a taxpayer or a withholding agent that a fails charge that is paid on or before December 31, 2010 is not subject to U.S. gross-basis taxation. Notice 2009-61 further announced that the Treasury Department and the IRS were considering issuing prospective guidance on the circumstances, if any, that would cause a fails charge to be subject to U.S. gross-basis taxation. These temporary regulations provide further guidance on the treatment of fails charges. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register. See Sec. 601.601(d)(2).

Explanation of Provisions

In order to provide certainty and consistency in the treatment of fails charges for purposes of sections 871, 881, 1441 and 1442, these temporary regulations establish source rules for qualified fails charges that arise in the delivery-versus-payment market for Treasury securities. The temporary regulations provide that the source of income from a qualified fails charge is generally determined by reference to the residence of the taxpayer that is the recipient of the qualified fails charge income, with two exceptions. Qualified fails charge income earned by a qualified business unit (QBU) of a taxpayer is sourced to the country in which the QBU is engaged in a trade or business, and qualified fails charge income that arises from a transaction that is effectively connected to a United States trade or business is sourced in the United States and treated as effectively connected to the conduct of a United States trade or business.

The temporary regulations provide a source rule only for income from a qualified fails charge. In order to be a qualified fails charge, the fails charge must satisfy two requirements. First, it must be paid pursuant to a trading practice or similar guidance approved by a U.S. government agency or the Treasury Market Practices Group (which is sponsored by the Federal Reserve Bank of New York), or published in separate guidance by the IRS. Second, the transaction that generates the fails charge must be with respect to a bill, note, or other evidence of indebtedness issued by the United States Treasury Department. These temporary regulations do not address the source of any other type of damages payment, including a fails charge that is not a qualified fails charge.

Although there is not currently a fails charge trading practice relating to securities other than Treasury securities, one may be considered in the future for agency securities (including mortgage-backed securities). If a fails charge trading practice pertaining to agency securities is endorsed by the Treasury Market Practices Group or an agency of the United States government and widely adopted, the Treasury Department and the IRS will consider whether fails charges paid with respect to such a trading practice should be sourced under these regulations.

Effective/Applicability Date

These regulations apply to qualified fails charges paid or accrued on or after December 8, 2010.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Sheila Ramaswamy and Anthony J. Marra, Office of the Associate Chief Counsel (International). However, other persons from the Office of Associate Chief Counsel (International) and the Treasury Department have participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

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Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 863(a) and 7805 * * *

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Par. 2. Section 1.863-10T is added to read as follows:

Sec. 1.863-10T Source of income from a qualified fails charge (temporary).

(a) In general. Unless paragraph (b) or (c) of this section applies, the source of income from a qualified fails charge shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).

(b) Qualified business unit exception. The source of income from a qualified fails charge shall be determined by reference to the residence of a qualified business unit of a taxpayer if--

(1) The taxpayer's residence, determined under section 988(a)(3)(B)(i), is the United States;

(2) The qualified business unit's residence, determined under section 988(a)(3)(B)(ii), is outside the United States;

(3) The qualified business unit is engaged in the conduct of a trade or business in the country where it is a resident; and

(4) The transaction to which the qualified fails charge relates is attributable to the qualified business unit. A transaction will be treated as attributable to a qualified business unit if it satisfies the principles of Sec. 1.864-4(c)(5)(iii) (substituting "qualified business unit" for "U.S. office").

(c) Effectively connected income exception. Income from a qualified fails charge that arises from a transaction that under the principles described in Sec. 1.864-4(c) is effectively connected with a United States trade or business shall be sourced in the United States and the income from the qualified fails charge shall be treated as effectively connected to the conduct of a United States trade or business to the same extent as the transaction from which it arises.

(d) Definitions.--(1) Qualified fails charge. For purposes of this section, a qualified fails charge is a payment that

(i) Compensates a party to a transaction that provides for delivery of a Treasury security in exchange for the payment of cash (delivery-versus-payment settlement) for another party's failure to deliver the specified Treasury security on the settlement date specified in the relevant agreement; and

(ii) Is made pursuant to:

(A) A trading practice or similar guidance approved or adopted by either an agency of the United States government or the Treasury Market Practices Group, or

(B) Any trading practice, program, policy or procedure approved by the Commissioner in guidance published in the Internal Revenue Bulletin.

(2) Treasury security. For purposes of this section, a Treasury security is any bill, note, or other evidence of indebtedness issued by the United States Treasury Department.

(e) Effective/applicability date. This section applies to qualified fails charges paid or accrued on or after December 8, 2010.

(f) Expiration date. This section expires on December 9, 2013.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved: December 2, 2010.

Michael Mundaca,
Assistant Secretary of the Treasury.