

**MEMO# 3445**

January 17, 1992

# **INTERNAL REVENUE SERVICE PROPOSES REGULATIONS ON TAXATION OF PAYMENTS IN CROSS-BORDER SECURITIES LENDING TRANSACTIONS**

11 The exception to this rule would be if the securities lending were effectively connected with a trade or business of the foreign person in the U.S. January 17, 1992 TO: TAX MEMBERS NO. 7-92 ACCOUNTING/TREASURERS MEMBERS NO. 4-92 CLOSED-END FUND MEMBERS NO. 4-92 RE: INTERNAL REVENUE SERVICE PROPOSES REGULATIONS ON TAXATION OF PAYMENTS IN CROSS-BORDER SECURITIES LENDING TRANSACTIONS

The Internal Revenue Service has issued the attached proposed regulations concerning substitute interest or dividend payments made with respect to a securities lending transaction, as defined in Internal Revenue Code section 1058, between a United States person and a foreign person. These proposed regulations clarify the source, character, and tax treaty treatment of the substitute payments under Code sections 861, 871, 881, 894 and 1441, dealing generally with international tax. A substitute interest or dividend payment is a payment made to a security lender of an amount equivalent to an interest or dividend payment that the owner of the security would be entitled to receive during the term of the loan. The proposed regulations provide that, in determining the source and character of these cross-border substitute payments under the above Code sections, the substitute payments will be treated as payments of dividends or interest, as appropriate, with respect to the securities which are the subject of the loan. Thus, for example, if a U.S. securities borrower makes a payment to a foreign securities lender with respect to stock in a U.S. corporation, the foreign person will be treated as receiving U.S. source dividend income, and the U.S. borrower would be required to withhold upon the substitute dividend payment under the withholding tax provisions applicable to nonresidents. However, if the foreign person had loaned stock of a foreign corporation to a U.S. person, the substitute dividend payment generally would be foreign source income to the foreign lender, not U.S. source income, and no withholding would be required on the substitute payment.<sup>11</sup> Similarly, if a U.S. person loans shares of a U.S. corporation to a foreign borrower, the substitute dividend payments received by the U.S. person from the foreign person would be U.S. source income, not foreign source income. Finally, if a U.S. person loans shares of a foreign corporation to a foreign borrower, the substitute dividend payments are foreign source income to the U.S. person. The proposed regulations would not, however, affect the character of substitute payments under provisions of the Code other than those mentioned above dealing with international tax. Thus, for example, substitute interest payments on

loaned municipal securities would not be treated as tax-exempt income, nor would substitute dividend payments be eligible for the dividends received exclusion under Code section 243. In the preamble to the proposed regulations, the Internal Revenue Service states that it is concerned generally about the use of substitute payments to avoid U.S. withholding tax or to increase foreign source income of U.S. persons in order to increase the foreign tax credit limitation. One concern could be that taxpayers would structure cross-border securities lending transactions so as to deliberately fail to qualify as a securities lending transaction under Code section 1058, and to then claim foreign sourcing of the substitute dividend payment from the foreign lender. The proposed regulations, therefore, would apply not only to Code section 1058 securities lending transactions, but to transactions substantially similar to Code section 1058 securities lending transactions. The Service also requested comments on the application of the proposed regulations to repurchase agreements and to certain notional principal contracts, such as equity index swaps structured to replicate the cash flow that would occur when securities are purchased through an installment sale. The proposed regulations would be effective for transfers of securities made more than 30 days after the date the final regulations are published in the Federal Register. A public hearing on the proposed regulations is scheduled for April 15, 1992. Written comments on the proposed regulations, requests to appear at the public hearing and outlines of any oral testimony to be delivered at the public hearing are due April 1, 1992. If you are interested in having the Institute submit comments on the proposed regulations, please contact me at (202) 955-3521 no later than March 16, 1992. We will keep you informed of developments. David J. Mangefrida Jr. Assistant Counsel - Tax Attachment

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