THE NINTH CIRCUIT COURT OF APPEALS HOLDS THAT THE TAXPAYERS WERE NOT ENTITLED TO NONRECOGNITION TREATMENT PURSUANT TO CODE SECTION 1058

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ABSTRACT

In Samueli v. Commissioner of Internal Revenue, CA-9, 2011-2 USTC ¶50,628, the Ninth Circuit Court of Appeals recently upheld a decision of the Tax Court that denied taxpayers' nonrecognition treatment pursuant to Code § 1058. Code § 1058 prescribes rules for tax-free treatment of securities whereby no gain or loss is recognized on the exchange of the securities. This section was drafted primarily to provide tax relief for exempt organizations and regulated investment companies that lend their investment portfolios to brokers who use the securities for delivery in separate transactions. However, the terms of the statute do not limit the application to loans extended to brokers so long as the requirements of the statute are met.

The Tax Court recently addressed securities lending arrangements in Samueli. On appeal from the United States Tax Court, the Ninth Circuit held that the Tax Court properly recharacterized an alleged securities loan transaction as two separate sales. The Court reasoned that the purported securities lending arrangement violated one of the requirements of Code § 1058. Specifically, it violated §1058(b)(3) because the transaction reduced the opportunity for gain of the transferor. The transaction's structure only allowed the lender access to reclaim and sell its securities on three separate days during the entire term of the deal. On a separate issue, the Ninth Circuit ruled that the Tax Court erred in disallowing the taxpayers' interest deduction. However, the error did not affect the amount of deficiency.

INTRODUCTION

The importance of liquidity in securities lending markets cannot be understated. It is especially noteworthy during a time of economic uncertainty. The recent volatility in the securities markets casts an even brighter spotlight on the need for liquidity. Under a typical securities loan agreement, someone borrows securities and posts collateral to secure its obligation to return identical securities. Congress and the Internal Revenue Service have always recognized the need for liquidity in the securities lending markets and acknowledged that if a lender of securities was subject to a federal tax liability when making a loan, the lending markets would be impaired. However, the tax treatment of these loan transactions has been inconsistent.

In 1978, Congress enacted Section 1058 of the Internal Revenue Code of 1986, as Amended (Code) which makes it relatively easy for a securities lender to make or settle a securities loan so long as certain criteria are met. These transactions were developed in response to the needs of securities brokers, who faced delays in obtaining securities to deliver to purchaser and therefore were forced to borrow the required securities from organizations and individuals who held the securities for investment purposes.

Recently, in *Samueli v. Commissioner*, the Ninth Circuit Court of Appeals largely affirmed the decision of the United States Tax Court holding that the taxpayers were not entitled to non-recognition treatment for a purported securities lending transaction. Specifically, the Ninth Circuit held that the transactions reduced the taxpayer's risk of loss or opportunity for gain which is a requirement under Code Section 1058(b)(3). An additional issue was raised regarding the deductibility of interest. The Tax Court held that the taxpayers were not entitled to interest deductions for interest paid on the transactions because the debt was not recognized for tax purposes. The Ninth Circuit disagreed with the Tax Court and ruled that the deduction for the interest should be allowed but the amount of the deficiency was unchanged. However, on rehearing, the case was remanded to the Tax Court for a redetermination of the amount of the deficiency. Before looking at the specific facts of the case, the relevant sections of the Code should be reviewed.

RELEVANT SECTIONS OF THE INTERNAL REVENUE CODE

Code § 1001(c) provides the general rule for the recognition of gains and losses. It provides in pertinent part, "Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized."

As a general rule, any sale or other disposition of property is a taxable event unless a transaction qualifies for nonrecognition or exclusion treatment. One Code provision that affords taxpayer preferential tax treatment is Code § 1058.

Code §1058 provides the general rule under subsection (a) which provides that "In the case of a taxpayer who transfers securities (as defined in section 1236 (c) pursuant to an agreement which meets the requirements of subsection (b), no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer".

In order to qualify for non-recognition treatment, the Agreement must meet the requirements in §1058(b) which provides that an agreement shall;

provide for the return to the transferor of securities identical to the securities transferred as per Code §1058(b)(1);

require that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor as per Code §1058(b)(2);

not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred as per Code §1058(b)(3); and meet such other requirements as the Secretary may by regulation prescribe as per Code§1058(b)(4).

Accordingly, pursuant to Code §1058(a), all four requirements of Code§1058(b) must be met before a securities loan agreement qualifies for nonrecognition treatment. The main issue in this case focuses on the requirement of Code §1058 (b)(3).

Code §163(a) provides that "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Interest has been defined as a compensation for the use or forbearance of money. Additionally, interest is deductible if the related debt represents an obligation for which the taxpayer is liable.

Code §1236 (c) provides a definition of Security , the term "security" means any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

Code §512(a)(5)(A) defines payments with respect to securities loans. Specifically, the term "payments with respect to securities loans" includes all amounts received in respect of a security transferred by the owner to another person in a transaction to which section 1058 applies.

Code §512 (a)(5)(B) provides that subparagraph (A) shall apply only with respect to securities transferred pursuant to an agreement between the transferor and the transferee which provides for termination of the loan by the transferor upon notice of not more than 5 business days as provided in Code §512(a)(5)(B)(ii) .

Code §1234A provides for the gain or loss attributable to the cancellation, lapse, expiration, or other termination of (1) a right or obligation (other than a securities futures contract, as defined in section 1234 B with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

On appeal, one of Samuelis' arguments focused on their Transaction qualifying for long term capital gain treatment pursuant to Code §1234A.

SAMUELI V COMMISSIONER

In a case of first impression, the Ninth Circuit largely affirmed the Tax Court and held that a leveraged securities transaction was not a securities transaction under Code §1058. The transaction did not qualify for non recognition treatment because the purported securities loan reduced the opportunity for gain, a specific requirement of § 1058(b)(3). The Ninth Circuit also held that he Tax Court erred by disallowing the interest deduction under Code §163. At first, the Ninth Circuit held that the error was harmless as the amount of the deficiency was unaffected. However, on rehearing, the case was remanded to the Tax Court for a redetermination of the deficiency for one year.

FACTS

On October 17, 2001, the taxpayers, Mr. and Mrs. Samueli and Mr. and Mrs. Ricks ("Samuelis") purchased a $1.7 principal strip ("Securities") issued by the Federal Home Loan Mortgage Corporation ("Freddie Mac") from their securities broker, Refco Securities, LLC (Refco) by obtaining a margin loan at a price of $1.64 billion as outlined per the agreement underlying the transaction ("Agreement"). By purchasing a strip, they were purchasing the right to receive the principal on a Freddie Mac bond at the

date of maturity but not to right to receive interest prior to maturity. Simultaneously, they transferred the securities back to Refco pursuant to Refco's promise to transfer identical securities to the Samuelis on January 15, 2003. There was an addendum to the agreement between the Samuelis and Refco that allowed the taxpayers to require an earlier transfer of the identical securities only by terminating the transaction on July 1, 2002 or December 2, 2002. Once the transaction settled, the Samuelis transferred the Securities to their broker in exchange for cash collateral of $1.64 billion and when they received the cash, they repaid their margin loan. The Samuelis were required to pay a variable rate fee for the use of the cash collateral. The taxpayers treated the transaction as a securities lending agreement eligible for non-recognition treatment under §1058. Accordingly, the Samuelis reported an approximate $50.6 million long term capital gain on the sale also deducted millions of dollars of interest related to the transaction.
The IRS determined that the transaction was not a security lending arrangement subject to § 1058. Instead, the IRS determined that the Samuelis purchased and immediately sold the securities in 2001 to Refco at no gain or loss and the repurchased the securities pursuant to a forward contract and immediately resold the securities in 2003 realizing an approximate $13.5 million short term capital gain. Additionally, the IRS determined that the Samuelis could not deduct the cash collateral fees claimed as interest in connection with the reported securities lending arrangement because no debt existed.

HOLDING AND ANALYSIS

The primary issue before the court is whether a purported securities loan with a fixed term of at least 250 days and possibly as long as 450 days entered into not for the purpose of providing the borrower with access to the lent securities, but instead for the purpose of avoiding taxable income for the lender, qualifies for nonrecognition treatment as a securities loan pursuant to Code §1058.

The consolidated cases were brought before the court on Petitioners' (Samuelis) motion for summary judgment and respondent's cross-motion for partial summary judgment. The parties agree on all material facts relating to the issue. The Samuelis' position was that they satisfied all of the requirements of §1058 (b). The Respondent agreed with the Petitioners on all of the requirements except the requirement contained in §1058(b)(3). The consolidated cases present an issue of first impression on the interpretation of Code § 1058 (b)(3).

Specifically, the focus of the court's attention was on the meaning of the phrase, "not reduce the**** opportunity for gain of the transferor of the securities in the securities transferred." The court looked to the dictionary for a definition of the verb "reduce" to mean "to diminish in size, amount, extent, or number" and noun "opportunity" to mean " a combination of circumstances, time and place suitable or favorable for a particular activity or action." The Court opined "We therefore read the relevant phrase in the context of the statutory scheme to mean that the Agreement will not meet the requirement set forth in section 1058(b)(3) if the Agreement diminished the Samuelis' chance to realize a gain that was present in the Securities during the transaction period. Stated differently, the Samuelis' opportunity for gain as to the Securities was reduced on account of the Agreement if during the transaction period their ability to realize a gain in the Securities was less with the Agreement than it would have been without the Agreement."

The Court concluded that the Agreement reduced the Samuelis' opportunity for gain in the Securities for purposes of §1058(b)(3) because the Agreement prevented the Samuelis on all but three days of the approximate 450-day transaction period from causing Refco to transfer the Securities to the Samuelis. If not for the Agreement, the Samuelis could have sold the Securities and realized an inherent gain whenever they wanted.

The Court rejected the Samuelis' argument that they always retained an opportunity for gain by continuing to own the securities until the day they are sold. The Samuelis' theory focused on the retention of the opportunity for a gain while the statute speaks to the reduction of the opportunity for a gain. The Court opined that a taxpayer has such an opportunity for gain as to the security only if the taxpayer is able to effect a sale of the security in the ordinary course of the market.

Additionally, Samuelis argued that their opportunity for a gain turned on the consequences of their variable rate financing arrangement. It was their position that their opportunity for gain as to the Securities depended entirely on whether their fixed return on the Securities was greater than their financing exposure which was the fee paid to Refco and concluded that the Agreement did not reduce this opportunity throughout the transaction period.

The Samuelis also asserted that they could have locked in their gain in the Securities on any day of the transaction period by entering into a financial transaction in the marketplace that allowed them to fix their gain. However, the Court dismissed that argument since Code §1058 concerns itself only with the agreement connected with the transfer of securities.

Additionally, the Samuelis argued that Code §1058(b)(3) cannot contain a requirement that loaned securities be returned to the lender upon demand because Code§512(a)(5)(B) specifically contains such a requirement. Their argument focuses around the fact that the Code sections were enacted in the same legislation and that Congress is presumed not to have included unnecessary words in a statute. See *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998); *Johnson v. Commissioner,* 441 F.3d 845, 850 (9th Cir. 2006). Samuelis concluded that part of Code § 512(a)(5)(B) would be surplusage. The Tax Court disagreed and reasoned that the firmly established law at the time of the enactment of those sections provided that a lender in a securities loan arrangement be able to terminate the loan agreement upon demand and require a prompt return of the securities to the lender. The Court added that it was not going to read such intent into the statute.

The Tax Court recognized that evidence of a clear legislative intent may sometimes override a plain meaning interpretation and lead to a different result. See *Consumer Prod. Safety Commn. V. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980). However, the legislative history of the applicable statute supports the plain meaning of the relevant text and does not override it. Congress enacted Code § 1058 mainly to clarify the then-existing law that applied to the loan of securities by regulated investment companies and tax-exempt entities, on the one hand, and by security lenders, on the other hand. See S. Rept 95-762, at 4 (1978).

The Court noted "The legislative history is consistent with our analysis. The legislative history explains that Code §1058 codified the firmly established law requiring that a securities loan agreement keep the lender in the same economic position that the lender would have been in had the lender not entered into the agreement."

The Court opined, "For Federal Tax purposes, the characterization of a transaction depends on economic reality and not just form employed by the parties to the transaction." *See Frank Lyon Co. v. United States,* 435 U.S. 561. The Tax Court concluded that " the economic reality of the Transaction establishes that the Transaction was not a securities lending arrangement as structured but was in substance two separate sales of the Securities without any debt obligations running between petitioners and Refco from October 2001 through January 15, 2003."

A secondary issue involved the Samuelis' claim to interest deductions. The Tax Court disallowed the deduction for the interest paid to Refco in 2001 and 2003. The Court stated that "there was no collateral outstanding and the payment did not represent a payment of interest 'on indebtedness'." The Samuelis argued that their payment in 2001 was made with respect to debt in the form of cash collateral. The Court disagreed and reasoned that the cash transferred in 2001 represented the proceeds of the first sale and not collateral.

THE NINTH CIRCUIT'S DECISION

On appeal, the Ninth Circuit Court of Appeals largely affirmed the decision of the Tax Court and denied nonrecognition treatment pursuant to Code §1058. However, the Samuelis not only challenged the conclusion of the Tax Court, but also argued that Code §1058 is not determinative or relevant to the Transaction.

The Ninth Circuit expanded the reasoning of the Tax Court and held that the terms of the Addendum reduced Samuelis' upside exposure to the market value of the Securities in another way as well, not highlighted by the Tax Court in its decision. Per the Addendum, if Samuelis had elected to terminate the loan on either of the two optional early termination dates, Refco would have had the right to purchase the Securities at a LIBOR-based price. On both such dates, the LIBOR based formula ended up yielding a price that was *higher* than the trading price for the Securities. It is likely that Refco would not have exercised its right to purchase the Securities if Samuelis had terminated the transaction on either date. If this happened, Samuelis could only have terminated the transaction on one of those dates at the risk of being forced to sell the Securities to Refco for less than their market price. In effect, this reduced Samuelis' ability to exit the transaction at will.

Samuelis argued that their inability to secure the return of the Securities on demand did not affect their ability to recognize gain because the Securities were "zero-coupon bonds whose value did not widely fluctuate with windfall profits at some momentary period." The Court opined that "Although the argument seems convincing, it was not a sufficient basis for finding that this transaction *did* comply with § 1058(b)(3). First, the value of the Securities would not need to fluctuate "widely" during the term of the loan to provide opportunities to sell at a profit; when one owns $1.6 billion of a particular security, even a small fluctuation in value can produce a significant opportunity for profit. Second, as noted above, even if one could assume that there was zero risk of any fluctuation in the market value of the Securities, Refco's option to purchase the Securities at the LIBOR-based prices still affected Taxpayers' ability to realize the market price of the Securities on the dates when they had the option of getting them back from Refco. Finally, the assumption that the market price of the Securities — Freddie Mac bonds — will never fluctuate widely or unexpectedly seems less valid today than it may have when Taxpayers invested in the Securities"

Congress' explicit goal in enacting § 1058 was to encourage loans for the benefit of brokers who needed large supplies of securities on hand to deliver to purchasers, because such loans "can have a favorable impact on the liquidity of securities markets." Senate Report at 6, 1978 U.S.C.C.A.N. at 1292. It may be possible that nonrecognition treatment should be given to a transaction that fails to meet all of the specific requirements of § 1058(b), but that nonetheless is motivated by the goals that Congress had in mind when it enacted § 1058. But this loan, a tax shelter marketed as such for which the borrowing broker (Refco) did not pay the lender any consideration, clearly was not "the thing which the statute intended." *Gregory v Helvering*, 293 U.S. at 469.

Samuelis' second argument is that § 1058 is not relevant and that their transaction should not be treated as a securities loan at all. Instead of treating it as the purchase and immediate resale of the Securities, creating short-term capital gain, Samuelis argue that what really happened in 2003 was that they liquidated a contractual right to receive the Securities from Refco (the "Contractual Right"). The Contractual Right was a capital asset that they acquired in consideration of their 2001 sale of the Securities to Refco; their basis in it was the price that first Samuelis and then Refco paid for the Securities in 2001 ($1.643 billion). Over a year later, in 2003, that asset was liquidated when Refco paid Samauelis the market value of the Securities in lieu of delivering the actual Securities. The liquidation of the capital asset yielded exactly the long-term capital gain that Samuelis reported.

The Court opined, "The Taxpayers are correct that a contractual right of this nature could be a capital asset under § 1221 and that gain attributable to the cancellation or termination of such an asset is capital gain under § 1234A, which provides that "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset." § 1234A. *See also Wolff v.Comm'r*, 148 F.3d 186, 188 (2d Cir. 1998) ("[A] gain or loss from the cancellation of a futures or forward contract would result in capital gain or loss pursuant to [§ 1234A].")."

The Commissioner in turn argues that Samuelis' theory is valid only if the Contractual Right was "cancelled" or" terminated," rather than merely fulfilled, in 2003. Specifically, if Refco actually sold the Securities to Samuelis as provided in the Contractual Right , there was no cancellation or termination of the capital asset, and the Tax Court's interpretation is correct. The Court agreed with the Commissioner with regard to this argument. However, the Court reasoned that there was nothing in the record to support the assertion that Refco "cancelled" or "terminated" its contract with Samuelis. The terms of the Loan Agreement required Refco to return the Securities to Samuelis. In Tax Court, the parties also stipulated that "Shiloh sold the Securities to Refco" at that time, which Shiloh could not have done if Refco had not first delivered the Securities to Shiloh as Refco was required to do under the Contractual Right. Additionally, the Court noted that Taxpayers do not have the right to call the transaction whatever they want after the fact.

The Tax Court disallowed Samuelis' interest deductions in this case because it determined that no loan of the Securities occurred in 2001 and that the purported cash collateral on which the Cash Collateral Fee was paid "represented the proceeds of the first sale and not collateral for a securities loan." *Samueli*, 132 T.C. at 53. The Tax Court treated the question of whether Taxpayers' interest deductions should be allowed as largely dependent on the analysis of whether the transaction qualified for Code § 1058 treatment.

The Court held that the Tax Court's approach was in error. The Code permits taxpayers to deduct "all interest paid or accrued within the taxable year on indebtedness."§ 163(a). Indebtedness is "an unconditional and legally enforceable obligation for the payment of money," *Linder v.Comm'r*, 68 T.C. 792, 796 (1977), and is generally found to exist if, at the time funds were advanced, the parties actually intended that they would be repaid, *Welch v. Comm'r*, 204 F.3d 1228, 1230 (9th Cir. 2000). Interest, meanwhile, is defined in its typical business sense as "compensation for the use or forbearance of money." *Deputy v. DuPont*, 308 U.S. 488, 498 (1940). The Court explained that even though the 2001 Fee Payment may have been a sham, the indebtedness existed on which interest might have accrued. The Court pointed out that the Tax Court's determination ignored the fact that the Margin Loan made the entire transaction possible.

The Court reasoned that the cash collateral and the Cash Collateral Fee were economically equivalent to the Margin Loan and the interest thereon. Regardless of whether the purported loan of the Securities was entitled to nonrecognition treatment under § 1058, and regardless of whether it was a true loan, a sale, or something else, Refco did forbear from the use of money when it purchased the Securities for Taxpayers' benefit. *See DuPont*, 308 U.S. at 498. It makes no economic sense to assume that they did so for free. Unlike the 2001 Fee Payment, the 2003 Fee Payment did come out of Taxpayers' pocket.

The Court held that the Tax Court erred in disallowing the deduction of the 2003 Fee Payment. The Tax Court's treatment of the interest expense as dependent on whether the transaction qualified for §1058 treatment was erroneous. The borrower did forebear from the use of money when it purchased securities and therefore there was an indebtedness upon which interest accrued.

CONCLUSION

In *Samueli,* the Ninth Circuit largely affirmed the Tax Court and held that a purported securities loan transaction did not qualify for non-recognition treatment. The main issue before the courts was whether the securities loan requirement met the specific requirement of §1058(b)(3), which states that the securities loan agreement must not reduce the lender's risk of loss or opportunity for gain in the securities loaned. A secondary issue involved the availability of an interest deduction.

There is a question about whether this holding should be read to create a necessity for a lender to obtain an immediate right to recover lent securities. However, that would preclude many, if not all, securities loans from qualifying for §1058 treatment. As a practical matter, a borrower cannot be sure of its ability to deliver securities to a lender in a time period that is shorter than the settlement period for security purchases in the market.

Treasury regulations proposed two decades ago, but never finalized, indicate 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 requirement. 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 identical securities back to the taxpayer.

The Tax Court never mentioned the proposed regulations in its decision but it would seem beneficial to structure a transaction in a manner that gives the lender the right to ask for the loaned or other identical securities on short term notice, perhaps not more than 3 – 5 days since today's regular stock settlement is three days in order to qualify for §1058 treatment.

REFERENCES

Code § 163

Code § 512

Code § 1001

Code § 1058

Code § 1234A

Code § 1236

Consumer Prod. Safety Commn v. GTE Sylvania Corp, 447 U.S. 102 (1980)

Deputy v. Dupont, 308 U.S. 488 (1940)

Frank Lyon Co. v. United States, 435 U.S. 561 (1978)

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