Caveat Re-*Emptor*

By John Kaufmann

John Kaufmann examines in detail sale-repurchase transactions ("repos") both "capital markets" and "bespoke" repos, their mechanics in general, and the relevant tax rules.

Twins, doubling, and parallel plots are a staple of comedy narratives. For example, the story of *The Menaechmi*, by Plautus, centers around the confusion that ensues when a long-lost, presumed dead twin of a citizen of Epidamnus arrives in town not knowing that he himself has a twin brother, to the confusion of himself, his twin brother, the twin brother's wife, the twin brother's mistress, and their respective slaves. Similarly, the plot of *Guys and Dolls* centers on the parallel love stories of the sublime Sarah Brown and Sky Masterson, and the ridiculous Nathan Detroit and Adelaide. However, nothing quite compares to the twin plots of the 1980s cult film *Repo Man.* The film opens with a scene in which a 1980s clunker driven by a disheveled older mad scientist-type is pulled over by a highway patrolman. Over the driver's protestations, the policeman opens the trunk of the car and is immediately vaporized, except for his boots. The car drives away, and as the movie progresses, we learn that it is travelling from Area 51, in New Mexico, to a rendezvous with an alien space ship in L.A. This story is interleaved with that of Otto ("Otto Maddox"), a 20-year-old everyman played by Emilio Estevez. Near the beginning of the movie, Otto is fired from his job stocking supermarket shelves, dumped by his girlfriend and abandoned by his parents. He is tricked into helping a repo man (Bud, played by Harry Dean Stanton), who works for a finance company named the Helping Hand Acceptance Corporation (the "HHAC"), take possession of a car, and soon joins Bud at the HHAC. A description of how Otto's story joins up with the story of the UFO would spoil the plot for our readers.

The scene in which Otto becomes a repo man unfolds as follows. Otto is walking through the streets of L.A., at a loose end. Bud pulls up beside him and shouts out the window:

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BUD: Hey kid! Hey! Hey kid! Hey! Hey! Are you hard of hearing?

OTTO: What do you want?

BUD: You want to make ten bucks?

OTTO: No thanks, pervert.

BUD: Now wait a minute, wait a minute kid—you got the wrong idea. Look, my old lady is real sick and I got to get her to the hospital, okay?

OTTO: So what? Take her there.

BUD: I can't. I can't leave her car in this bad area. Look, I need some helpful soul to drive it for me, okay? She's pregnant. She's with twins. She could drop at any time. All right?

OTTO: Well, uh, how much are you going to give me?

BUD: Fifteen bucks.

OTTO: No. Won't do it for less than twenty.

BUD: Twenty-five. Follow me in my old lady's car. It's right here. Okay?

OTTO: All right … Where's, uh, where's your old lady at?

BUD: Never mind about that. Right now we need to get both of my cars out of this bad area, alright? Come on.

Otto gets in the car and drives away. The owner of the car sees this happen, and a chase ensues. After some time, Otto and Bud pull into the lot of the HHAC. The HHAC cashier, Marlene, is speaking on the phone when they arrive. Otto is handed a beer.

OTTO: What happened to your old lady?

BUD: My old lady? Oh, nuts! I forgot all about her. Well, she'll take the bus. She's a rock. Marlene! Marlene!

MARLENE: Can you hold? Got a name, kid?

OTTO: Yeah! It's Otto.

MARLENE: You got a driver's license honey? Let me see it. Are you really twenty-one?

OTTO: That's what it says, doesn't it?

OTTO: Wait—you're all repo men!

BUD: What if we are?
Otto pours the beer on the floor.

BUD: You know kid, usually when someone pulls stuff like that, my first reaction is I want to punch his lights out. But you know something? You're all right!

MARLENE: Maybe he's looking for a job?

BUD: Could be. What do you say, kid? We're always on the lookout for a few good men.

OTTO: Screw that! I ain't going to be no repo man. No way!

Marlene hands Otto $25.

MARLENE: You are now, kid.

So begins all of our professional careers. You research a question about Code Sec. 1259.[1] A client asks about *North Texas Lumber*.[2] You sign up for direct deposit—and before you know it, you are a repo man.

Doubling and parallel contexts also apply to what readers of the current article mean when they use the term "repo," *i.e.*, sale-repurchase transactions. In this type of repo, one party (the "repo seller") sells property to another party (the "repo buyer") and simultaneously enters into an agreement to repurchase the property in the future. The repurchase agreement may be documented through a forward contract, a synthetic forward contract consisting of a put-call combination, or the purchase of a deep-in-the-money option by one of the parties. Regardless of the form the repurchase agreement takes, it is economically certain that the assets will be returned to the repo seller at the end of the transaction. The repo buyer generally has the right to retain the repoed assets and sell them to satisfy the repo seller's obligation to them in case the repo seller does not repurchase the repoed assets at the end of the term. The repo buyer is compensated for its provision of cash to the repo seller, either through retention of current cash flows paid with respect to the pledged property or by a differential in the initial purchase price and the repurchase price.

Every repo shares the foregoing characteristics, but repos may also differ from each other in material ways. Commentators have written regarding the effect of the right of a repo buyer to sell or rehypothecate repoed assets on the tax characterization of a repo.[3] However, less has been written regarding the effect that the character of the underlying property and the parties' purpose for entering into a repo may have on the characterization of the repo and the ability of the parties to disavow the form of the transaction. Modern day repos fall into two distinct categories, *i.e.,* transactions that I will refer to herein as "capital markets repos" and transactions referred to as "bespoke repos." These two types of transaction differ from each other fundamentally. Because of this, practitioners should avoid citing capital markets repo authority when analyzing bespoke repos, and *vice versa*.

The practice of securing a *de facto* loan through the sale and repurchase of assets is a mature technology, with a long history.[4] The repo business grew up in the capital markets and is still widely practiced in the capital markets. Capital markets repos are generally entered into with respect to liquid, or at least fungible, property, and are documented on standard forms issued by securities industry groups, such as the Master Repurchase Agreement (the "MRA"), or the Global Master Repurchase Agreement (the "GMRA"). Parties who enter into these repos do so repeatedly and on an aggregate, or "mass produced," basis. Typically, when a buy-side firm decides that it will need to finance balance sheet assets on repo, it will enter into a master agreement with a bank or other sell-side firm. The master agreement will not, itself, govern any specific repo transaction; however, it will provide the general rules for subsequent repo transactions. When the buy-side firm determines that it wants to enter into a specific repo, it will contact its counterparty, and that specific repo will be documented using a confirmation. Because the general terms of each repo are spelled out in the master agreement, the process for entering into any specific confirm can be quite simple. Many confirms may be executed under a single master. In this sense, entering into a master agreement is similar to entry into a revolving credit agreement with deferred draw-downs. Although the hybrid nature of these transactions gives rise to questions of tax character, current-day capital markets repos are generally not tax motivated.[5] Repo sellers enter into capital markets repos in order to borrow money at cheap rates; repo buyers do the same in order to secure credit support from their counterparties. Use of the repo form neither increases nor decreases the parties' aggregate tax burden. By contrast, bespoke repos are generally entered into between related parties, or between a bank and a customer of the bank. The repoed property is often not property which the repo seller would have on its balance sheet absent entry into the repo; it is usually illiquid property, which is issued to or purchased by the repo seller in order to allow the repo seller to participate in the repo. These repos tend to be one-off, heavily negotiated deals that are not documented using standard forms. They usually involve counterparties who are tax-resident in jurisdictions which treat the repo inconsistently. This provides the counterparties with a "double dip" tax benefit, which is reflected in a reduced cost to the repo seller, or as an extra tax benefit to the repo buyer.

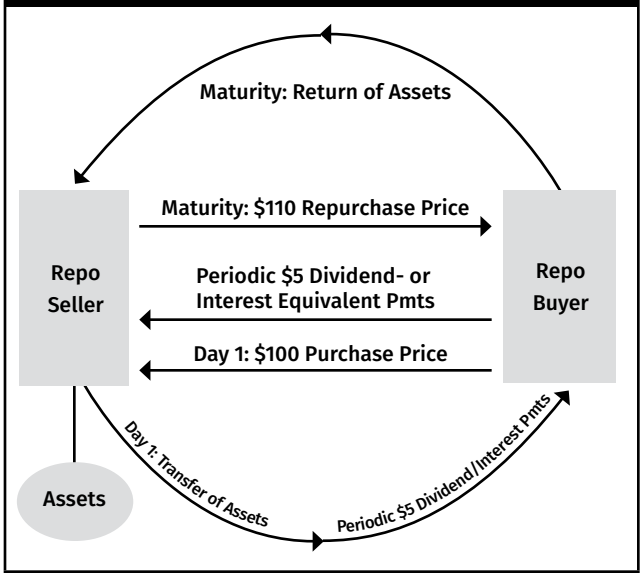
Because the bulk of legal authority regarding the tax character of repos arose in the context of capital markets repos, advisors who opine on the proper tax treatment of bespoke repos generally cite to capital markets repo authorities to support their suggested treatment of bespoke repos. As discussed in more detail below, this may be problematic.

Repos Generally

The Facts

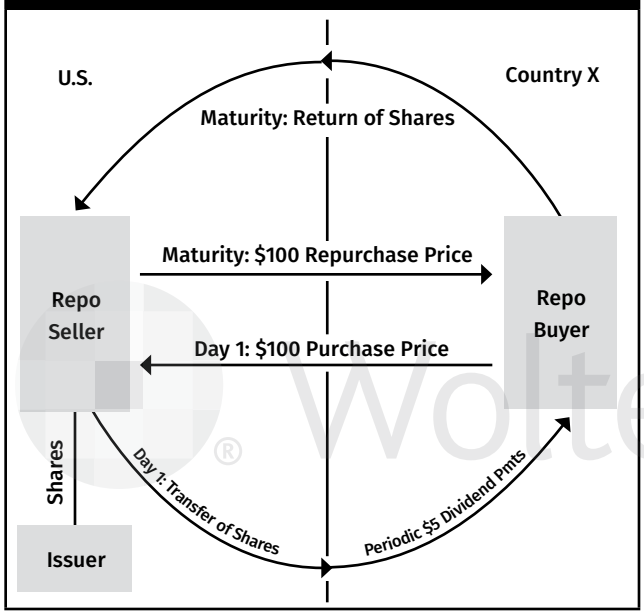
A bare-bones capital markets repo is depicted in Figure 1. In this example, the Repo Seller sells assets (either dividend-paying stock, or coupon-paying debt instruments) to the Repo Buyer on Day 1 in exchange for an initial purchase price of $100. As the owner of record during the pendency of the repo, the Repo Buyer receives periodic payments of dividends or interest, and it makes equal and opposite offsetting dividend-or interest-equivalent payments to the Repo Seller currently. At maturity, the Repo Seller buys back the repoed assets for $110. The $10 difference between the sale price and the repurchase price compensates the repo buyer for the use of its money[6]:

FIGURE 1. A CAPITAL MARKETS REPO



A bespoke repo is depicted in Figure 2. In this example, the Repo Seller is a U.S. taxable entity, and the Repo Buyer is resident in a country with a territorial tax system. The Repo Seller sells assets (in this case, preferred shares of Issuer) to the Repo Buyer on Day 1 in exchange for an initial purchase price of $100. The Issuer makes periodic payments of $5 on the preferred shares. As the owner of record during the pendency of the repo, the Repo Buyer receives these dividend payments, and retains cash therefrom; no dividend-equivalent payments are made from the Repo Buyer to the Repo Seller. At termination, the Repo Seller repurchases the preferred shares for $100:

FIGURE 2. A BESPOKE REPO



As illustrated in the two examples, the form of bespoke repos generally differs from that of capital markets repos in two respects. First, the parties to a bespoke repo are not similarly situated; in most cases, this means that the repo buyer and the repo seller in a bespoke repo are resident in different jurisdictions. Second, the repo buyer in a bespoke repo is often not obligated to make dividend—or interest equivalent payments to the repo seller during the life of the repo. Since the repo buyer in these cases retains periodic cash flows from the repoed assets, there is no need for the repo seller to pay a repurchase premium or a rebate in order to reimburse the repo buyer for the use of its money during the term of the repo.

Issues at Stake

The basic question in any repo is whether the repo seller retains tax ownership to the repoed assets during the term of the transaction, or whether tax ownership is transferred to the repo buyer. To the extent that ownership is not treated as transferred from the repo seller to the repo buyer, the transaction is treated as a loan from the repo buyer to the repo seller, secured by the pledge of the repoed assets. To the extent that ownership is treated as transferred to the repo buyer, a repo is treated as a true sale and repurchase. This is relevant to the taxation of the parties to a capital markets repo, and it is the *sine qua non* for a bespoke repo. For example, to the extent that the Repo Seller in the repo depicted in Figure 1 is treated as retaining ownership of the repoed assets, the transaction is treated as a loan of $100 from the Repo Buyer to the Repo Seller with a redemption amount of $110, secured by a pledge of the repoed assets. Since tax ownership of the repoed assets remains with the Repo Seller, periodic payments, such as dividends or interest, on the repoed assets, are considered received by the repo seller. If these periodic payments qualify for a special tax regime (for example, if they constitute tax-exempt payments on municipal bonds or if they are dividends which may qualify for the dividends received deduction under Code Sec. 243(a), or qualified dividend income treatment under Code Sec. 1(h)(11)), the Repo Seller receives the tax benefit due to the beneficial owner thereof. The $10 difference between the initial purchase price and the repurchase price is treated as OID on a zero-coupon bond, which, absent an applicable exception, is accrued as taxable income by the Repo Buyer under Code Secs. 1272–1275, and deducted by the Repo Seller under Code Sec. 163(e).

If the Repo Seller is treated as retaining tax ownership of the shares in the repo depicted in Figure 2, the treatment of cash flows is somewhat different. Payment of $100 by the Repo Buyer to the Repo Seller is treated as a loan, and the transfer of the shares from the Repo Seller to the Repo Buyer on Day 1 is treated as a pledge of collateral. Dividends on the preferred shares are treated as received by the Repo Seller, and then as paid over to the Repo Buyer in the form of equal and offsetting payments of coupon interest on the loan. The Repo Seller deducts these payments from U.S. taxable income as interest under Code Sec. 163(a). If the Repo Buyer is resident in a jurisdiction that treats the repo as a true sale, the Repo Buyer may be able to exclude dividend payments under a territorial tax regime or credit taxes paid by the Issuer against residence-jurisdiction taxes due with respect to the dividend payments.

The bespoke repo described above differs from the capital markets repo in two crucial respects. First, the bespoke repo creates a "double dip" tax benefit consisting

of the deduction of the deemed coupon payment from the Repo Seller's U.S. taxable income and the exclusion of the same amounts from the Repo Buyer's residence-jurisdiction taxable income.[7] Second, in order to square the characterization of the bespoke repo with real cash flows, it is necessary to posit an imaginary payment of a dividend from the Issuer to the Repo Seller, followed by an offsetting imaginary coupon payment from the Repo Seller to the Repo Buyer. The characterization of the capital markets repo described above as a loan also requires a bit of hocus-pocus because, in that case, the Repo Seller is treated as the recipient of dividend or interest payments on the repoed assets, when in fact dividends or interest payments are made to the Repo Buyer and passed on to the Repo Seller in the form of substitute payments—but it is less of a strain on common sense to treat substitute payments as simply transferring dividends or interest payments by an agent or custodian to the beneficial owner than it is to posit the existence of an imaginary payment where no actual cash changes hands, as one must do to treat a bespoke repo as a secured loan.

Tax Ownership—Generally

As discussed above, the threshold question regarding any repo is whether beneficial ownership of the repoed assets remains with the repo seller or whether it is transferred to the repo buyer for the term of the transactions; therefore, a review of general doctrines of tax ownership is appropriate. Although ownership is a concept that is fundamental to tax law, it is not defined in the Code or regulations. In determining the true tax owner of an asset, courts and the IRS look at all relevant facts and circumstances.[8] Indicia of ownership of an asset include (i) the intent of the parties to a transaction; (ii) legal title to the asset; (iii) possession; (iv) control, or the ability to dispose of the asset; and (v) economic exposure to the asset (the "burdens and benefits" thereof).[9] For purposes of this discussion, "legal title" means "bare" legal title, *i.e.,* formal legal indicia of ownership, such as appearance on a share registry or a share certificate. It does not necessarily include certain legal rights, such as the right of control, which may (or may not) follow legal title. Because legal title is the easiest of these indicia for the parties to manipulate, and because it is least indicative of the economic substance of a transaction, courts and the IRS tend to place the primary focus on the other indicia.[10] Although possession may be evidence of ownership in certain cases, "naked" possession is often indicative of a custodial or bailment relationship, rather than ownership. Therefore, the intent of the parties, and the final two factors, tend to be given the most consideration.

The weight placed on the remaining factors varies depending on whether the asset at issue is a liquid asset or an illiquid asset.[11] In the case of liquid assets, such as publicly traded securities and certain fungible commodities, courts and the IRS generally look to the identity of the party who controls the disposition of the asset to determine the identity of the beneficial owner rather than to the intent of the parties or the identity of the party who bears the "burdens and benefits" of ownership. This rule tends to be counter-intuitive because it is arrived at by process of elimination; nevertheless, it is the only rule that makes sense in this context.[12] Economic exposure to a liquid asset is not sufficient to identify the unique tax owner thereof because there may be infinitely many long positions that grant "delta one" exposure to the asset, but there can only be one tax owner.[13] Although the behavior of the parties to a transaction involving illiquid assets may evince the parties' intent as to the beneficial ownership of the underlying asset, it is rare for the parties to a "plain vanilla" capital markets transaction to leave a paper trail of this type, and a trader's intent is generally to simply make a winning trade. Finally, in order to calculate gain or loss from the disposition of an asset, it is necessary to know both the amount of proceeds from the disposition and the seller's basis in the asset. In the case of derivatives on liquid assets, where referenced assets may be substituted up to the instant of closing, it is impossible to calculate gain or loss from the disposition of a referenced asset until the actual asset to be delivered is identified and delivered.[14] Because capital markets repos tend to reference liquid assets, transfer of the right to sell or rehypothecate the repoed assets to the repo buyer is the most material factor in determining the character of a capital markets repo as a loan or as a true sale.

By contrast, in the case of derivatives on illiquid assets, courts and the IRS generally look to the party that has economic exposure to the underlying asset (the "burdens and benefits" analysis). In the case of repos on illiquid assets that occur in the context of another transaction or series of transactions, courts have looked to the intent of the parties as manifested from the situation of the repo within its business context and the course of dealing of the parties to determine beneficial ownership. As one would expect, the result of this intent-based analysis tends to be consistent with the burdens and benefits analysis.[15]

Liquid Property—Capital Markets Repos

Tax Ownership of Liquid Property

The rules regarding tax ownership of liquid property are illustrated most clearly by the treatment of securities loans, short sales, and variable prepaid forward contracts. These rules are consistent with capital markets repo cases if due attention is paid to the facts of the relevant cases.

Treatment of Securities Lenders

A securities loan is a transaction whereby one party (the securities lender) transfers securities in its possession to another party (the securities borrower) in exchange for a promise to return substantially similar securities at the end of the transaction. Until the substantially similar securities are returned, the securities borrower is required to make payments to the securities lender equal in amount to dividend or interest payments made on the loaned securities. In addition, the securities borrower compensates the securities lender for the use of the loaned securities through the payment of a rebate on collateral interest, or the payment of a "borrow fee."[16] In either event, the securities lender retains its economic exposure to the loaned security and is compensated for the loan.

In most cases, the "end user" of a securities loan is a short seller; a trader wishing to gain negative exposure to an asset may borrow the asset and sell it "short" in the market for its then-fair market value. To the extent that the price of the asset decreases, the trader's position will increase in value because the cash needed to purchase a substantially similar asset will be less than the cash obtained from selling the borrowed assets. By contrast, to the extent that the price of the asset increases, the trader's position will lose value. That said, short sellers are not the only borrowers. For example, certain desks may borrow securities in order to on-lend them to other borrowers. Traders may also borrow securities to cover failed settlements, and they might borrow securities to cover a short position if the original securities lender demands its shares back.

Regardless of the context in which a security has been loaned, there will always be at least two parties who have "delta one" exposure to the security, *i.e.,* the initial security lender and the party to whom the securities are ultimately delivered.[17] For example, in the simplest case, a securities lender will lend securities to a securities borrower, who will sell the securities to a buyer. In this case, both the securities lender and the buyer have a position whose value will increase by $1 whenever the price of the loaned securities increases by $1, and which will decrease in value by $1 each time the price of the loaned securities decreases by $1. Therefore, courts and the IRS cannot look to the party that has economic exposure to loaned securities to determine the beneficial owner thereof because more than one party has economic exposure to the asset. Instead, they look to the party that has control over the disposition of the asset.

The Supreme Court examined this issue in *G.D. Provost*, an early stamp-tax case.[18] In *G.D. Provost*, the taxpayer was a brokerage that operated on the New York Stock Exchange. Pursuant to its business, the taxpayer regularly loaned shares of stock that it held in inventory. The taxpayer took the position that these transactions were not dispositions for purposes of the then-extant share stamp tax because the taxpayer retained economic exposure to the loaned shares during the term of the transactions. The government challenged this position, and the Supreme Court held for the taxpayer:

> When the transaction is thus completed, neither the lender nor the borrower retains any interest in the stock which is the subject-matter of the transaction and which has passed to and become the property of the purchaser. Neither the borrower nor the lender has the status of a stockholder of the corporation whose stock was dealt in, nor any legal relationship to it. Unlike the pledgee of stock who must have specific stock available for the pledgor on payment of his loan, the borrower of stock has no interest in the stock nor the right to demand it from any other. For that reason he can be neither a pledgee, trustee nor bailee for the lender, and he is not one "with whom stock has been deposited as collateral security for money loaned." For the incidents of ownership, the lender has substituted the personal obligation, wholly contractual, of the borrower to restore him, on demand, to the economic position in which he would have been, as owner of the stock, had the loan transaction not been entered into.[19]

Stated otherwise, because the security lender's fee ownership in the loaned shares is replaced by a contractual right against the security borrower, and because the buyer purchases the shares "long," under no obligation to return them, the buyer, rather than the securities lender, is the beneficial owner of the shares. This holding has been followed by the IRS and by Congress.[20] Therefore, in determining the beneficial owner of loaned securities, courts, the IRS and Congress look to the party who has the right to control and dispose of the specific securities that have been lent (*i.e.,* the buyer), rather than the party who has economic exposure thereto.

Treatment of Short Sellers

Courts and the IRS have adopted a similar rule with respect to traders who sell borrowed securities short. As described above, a short seller borrows securities, which she then sells in the market. When she borrows the securities, she undertakes an obligation to return substantially similar securities to the securities lender, and when she sells the borrowed shares, she receives cash proceeds from the sale equal to the fair market value of the securities at the time of the borrowing. In order to "close out" her short position, she needs to deliver substantially similar securities to the securities lender. If the price of the referenced securities decreases after the initial borrowing, the trader will profit because her basis in the securities purchased to cover the position will be less than cash proceeds from the sale of the borrowed securities; by contrast, if the price of the securities increases, she will lose money because her basis in the securities purchased to cover her position will be greater than the proceeds of the initial sale. The method for calculating gain or loss from a short sale is the same as that for calculating gain or loss from a "long" sale; applicable basis is subtracted from applicable proceeds. The only difference is that, in the case of a short sale, basis is established after proceeds from the sale are received, while in the case of a long sale, basis is established prior to receipt of proceeds.

The tax ownership issue that arises most often in the context of short sales is—what if a short seller places an order to purchase securities to cover a short position in Year 1 and delivers them to its securities lender in Year 2? Should the short position be treated as terminated in Year 1, or in Year 2? The question is relevant to the tax ownership analysis because a short position is treated as closed when the securities borrower delivers substantially similar property to the securities lender; therefore, the securities borrower should be treated as disposing of the substantially similar property at the time when the securities loan is closed. Courts, the IRS and Congress have held unanimously that, even though a trader is economically "flat" with respect to a short position the minute he or she places an order to buy securities that can be used to close a short position, the position remains open until the securities are actually delivered to the securities lender. This is because, so long as the taxpayer retains control over the disposition of the purchased securities, he or she has the right and ability to substitute different securities, in which he or she has a different basis, to the securities lender. Substitution of securities with a different basis would lead to recognition of a different amount of taxable gain or loss from the transaction. Because of this, the transaction remains open until the purchased securities are actually delivered, even though the trader relinquishes economic exposure to the borrowed securities when the purchase is made:

> The taxpayer says that even if the short sale transactions were closed by the deliveries in June and July, 1933, some of the shares then delivered were purchased in 1932 and the gain or loss qua these shares was fixed when they were purchased, irrespective of the time of delivery. Yet they remained under control of the taxpayer and up to the time of actual delivery could have been sold and replaced by other purchases in the absence of prior agreement with the lender to use them to make restitution. Such a shifting intent to cover a short sale ought not to be the critical event which would determine gain or loss under a tax statute. It would leave the whole matter of fixing the event to the taxpayer's own will. We hold that the time of delivery was the time at which the covering transactions must be regarded as closed.[21]

This remains the law today.[22] There is some confusion as to whether securities purchased to cover a short position are deemed delivered on the date on which the covering trade is entered into or on the trade on which the covering trade settles,[23] and a special statutory rule requires that gain (although not loss) on short positions be recognized when covering securities are purchased,[24] but a securities borrower remains the beneficial owner of securities purchased to cover a short position until control over the securities is delivered to the securities lender.[25]

VPFCs

A series of pieces of published and unpublished Treasury guidance and court cases dealing with variable prepaid forward contracts ("VPFCs") on liquid property apply the same doctrine.[26] Under the contract in the earliest piece of published guidance, the seller received cash up-front on the date on which the forward was entered into.[27] The contract matured three years after that date. At maturity, the seller was obligated to deliver anywhere from 80% to 100% of a certain number of shares, depending on the value of the underlying stock. In order to secure the seller's obligations under the forward, the seller pledged to the buyer the maximum number of shares deliverable under the contract, although the seller retained the right to receive dividends on and vote the pledged shares. The seller could deliver cash or substitute shares with a fair market value equal to the number of shares deliverable at maturity. Although the seller intended to deliver all or some of the pledged shares at maturity, the ruling assumed

that the seller was under no economic compulsion to do so. The economic result of the foregoing was that the buyer, rather than the seller, bore all risk of loss associated with the shares as of the date on which the forward was entered into, but that the seller retained 20% of the upside associated with share ownership after that date. Citing case law,[28] the IRS held that, because the seller retained both *de facto* and *de jure* control over disposition of the shares until the settlement date, the pledge of the shares at the outset of the term of the forward did not constitute a disposition under Code Sec. 1001 even though the seller had parted with all of the risk associated with ownership of the shares, as well as most of the upside thereof.

The facts in the later two pieces of guidance, as well as the case law, were materially identical to those of Rev. Rul. 2003-7, with one crucial difference.[29] In both the Treasury guidance and the case law, the transferor and the transferee entered into a securities lending agreement at the time of the original pledge of the shares. Under the securities lending agreement, the transferee had the unfettered right to sell, pledge or re-pledge the transferred shares to a third party, and, when sold, the shares would be completely unencumbered to the third party. In this case, the Tenth Circuit and the IRS took the position that, because the transferors had given up control of the transferred shares upon entry into the securities loan, Rev. Rul. 2003-7 could be distinguished.[30]

Treatment of Capital Markets Repos

The transfers of property and cash that occur pursuant to a modern capital markets repo are often indistinguishable from those of securities loans. On Day 1, the repo seller (the "securities lender," where this is a securities loan) transfers the repoed assets (the "loaned securities") to the repo buyer (the "securities borrower"). At the same time, the repo buyer transfers cash or other, more liquid securities (the "collateral") to the repo seller. Under standard MRA and GMRA documentation, the repo seller has the right to sell or rehypothecate the repoed assets, as does the securities borrower in a securities loan. The repo buyer is obligated to make dividend- or coupon-equivalent payments to the repo seller, as is a securities borrower to a securities lender. Upon termination, the repo seller is obligated to return the collateral, and the repo buyer is obligated to return the repoed assets or assets that are substantially identical thereto. Since the transaction is materially similar to a securities loan, and since we know that beneficial ownership of the underlying is transferred pursuant to a securities loan because rights of control are transferred pursuant to a securities loan, why are capital markets repos treated as cash loans secured by pledges of repoed assets, while securities loans are treated as dispositions of loaned securities?

The short answer is—they probably should not be, for two reasons. First, the cases most often cited as support for the position that capital markets repos should be treated as loans are factually distinguishable from many capital markets repos because in those cases, the repoed property was held by the repo buyer in a segregated account for the benefit of the repo seller.[31] Second, the same cases are also distinguishable because they were results-oriented. In all of those cases, the taxpayers sought to have a party not subject to the interest deduction rules of then Code Sec. 265(2) (*i.e.,* a bank) treated as the beneficial owner of repoed municipal bonds. A contrary finding prevented this perceived abuse.[32] There is no such factor at issue in the majority of today's capital markets repos.

Right to Rehypothecate

The cases most often cited as support for the treatment of repos as secured loans involved repos on municipal bonds entered into between bond dealers and banks, mostly during the 1960s and 1970s.[33] In the typical transaction, when the issuer announced that it was going to issue bonds, municipal bond dealers would submit bids for the bonds to the issuer and specify that a bank (usually a bank located in the state capital, well-situated to perform certain administrative tasks in pre Internet days) would take delivery for the account of the dealer.[34] The dealer would post a small deposit with the issuer; in certain cases, this deposit was credited against the purchase, but more often, it was refunded when the full price was paid.[35] If the dealer's bid was matched, the bank would purchase the applicable bonds with its own funds and inform the dealer that the bonds had been purchased for the dealer's account. As soon as the dealer learned that its bid had been matched, it would market the bonds to its customers. In many cases, customers willing to buy the bonds were found before the bonds had been delivered to the bank; in certain other cases, the bank held the bonds for some time while the dealer marketed them. While the bank held the bonds, it collected coupons payable on the bonds.[36] Once a customer purchased the bonds, the dealer delivered cash to the bank equal to the price paid by the bank to purchase the bonds plus accrued interest and a handling fee, and the bank delivered the bonds either to the dealer or to the dealer's customer. The dealer was exposed to fluctuations in the price of the bonds; if the dealer managed to sell the bonds for more than the price paid by the bank, the dealer retained the overage; however, if the dealer was not able to obtain a price equal to or greater than the price

at which the bank purchased the bonds, the dealer was required to make up the difference.[37] In certain cases, the bank had an enforceable legal right to put the bonds to the dealer, and the dealer had a right to call the bonds. In other cases, the dealer had a legal right to call the bonds, and the bank's prominence in the market made it virtually certain that this right would be exercised, even if the call right was out of the money.[38]

In all of these transactions, the bank took the position that it was entitled to treat coupon payments and accrued interest as exempt municipal bond interest rather than as interest on a purchase-money loan from the dealer. By contrast, courts and the IRS took the position that the dealer was the beneficial owner of the bonds, both because the dealer had "delta one" exposure to the bonds and because the dealer, through its marketing efforts, controlled disposition of the bonds. This was a product of the repo seller's function as a dealer; as a distributor of the bonds, it *had* to retain control, if not possession, of the bonds, in order to market and sell them to customers:

> The dealer exercised complete dominion over the bonds after they came into the bank's possession. He sold them at his pleasure, at prices he determined, and without reference to the bank, except that the proceeds were collected from the customer by the bank and applied to the dealer's account … [T]he conclusion is inescapable that taxpayer was not entitled to the [Code Sec.] 103(a)(1) income exclusion.[39]

The importance of the dealers' right to control disposition was highlighted by contrary holdings in cases with non-dealer repo sellers. For example, in *Citizens National Bank of Waco*,[40] the repo buyer was a bank, and the repo seller was an insurance company with a large block of municipal bonds on its balance sheet. In order to raise cash, the insurance company sold the bonds to the bank and granted the bank the right to put the bonds back to the insurance company at par. In case the insurance company did not perform its obligation under the put, the bank had an unsecured right to collect the difference between par value and fair market value of the bonds. Although it was understood that the insurance company would re-acquire the bonds (and, in fact, did repurchase all of the bonds *sua sponte*, much like the dealers in the trial and Fifth Circuit cases of *American National Bank of Austin*), the insurance company did not have an enforceable call right with respect to the bonds. The bank took the position that it was the beneficial owner of the bonds, and the Court of Claims agreed, both because the bank had the right to profit from increases in the value of the bonds and because the bank had the right to sell the bonds to whomever it chose.[41] In so doing, it distinguished the facts from those of earlier cases involving bond dealer repo sellers because a bond dealer repo seller by its nature needs to retain the right to control disposition of repoed property:

> It is significant that the cases relied on by defendant all involve the financing of bond dealers by banks in connection with the sale of tax-exempt bonds to the general public. This contrasts with the instant case where we have a single isolated transaction where no one is involved except Amicable and the Bank. The deal between them appears to have been a straightforward aboveboard arm's-length sale and resale between two reputable business institutions, with no thought or purpose of tax evasion. The defendant has never claimed that the transaction was a sham nor a scheme that was carried out for the purpose of tax evasion. It is likely that had Amicable not repurchased the bonds from the Bank, no tax deficiency would have ever been assessed against the Bank. Nevertheless, the Bank finds itself caught in the backwash of the bond dealer decisions, which the government apparently seeks to extend to the instant case. We think the cases are entirely different, and if there is any similarity, it is very remote and speculative.[42]

This is consistent with cases and guidance dealing with tax ownership in the non-repo context, discussed above. To the extent that a repo seller of liquid assets retains the right to sell or rehypothecate same, the repo seller should be considered the tax owner thereof; to the extent the repo seller relinquishes this right, the analysis is much less clear. In *American National Bank of Austin* and its progeny, the repo seller retained this right because of the nature of its business. This was recognized both by the Fifth Circuit in *American National Bank of Austin* and by the Court of Claims when it distinguished the transaction in *Citizens National Bank of Waco* therefrom.[43] Nevertheless, it is not uncommon these days for this rule to be more honored in the breach than in the observance. For example, the Master Repurchase Agreement, published by the Securities Industry and Financial Markets Association, allows the repo buyer to rehypothecate repoed assets absent contrary specification in the schedule or confirm.[44] Private guidance issued by the IRS in 2002 assumed, without analysis, that repos entered into by a taxpayer that ran a "matched book" operation were collateralized loans for purposes of the apportionment of interest expense under Code Sec. 864(e) even though the repos in question granted the applicable repo buyers the right to rehypothecate the

repoed assets—and even though this right was exercised.[45] The Supreme Court explicitly refused to consider the beneficial ownership issue in the only case in which it examined this issue—although its holding would imply that, in that case, tax ownership remained with the repo seller.[46] Regardless, well-advised repo sellers wishing to retain beneficial ownership of repoed assets should ensure that their counterparties do not have the right to sell or rehypothecate those assets.

Anti-Abuse

As mentioned above, *American National Bank of Austin* and its progeny differ from many current capital markets in one other respect; they represented an attempt by the courts to curb perceived abuse. Under prior Code Sec. 265(2) (current Code Sec. 265(a)(2)), interest on indebtedness incurred or continued to purchase or carry tax exempt obligations could not be deducted from taxable income.[47] Guidance issued by the IRS in 1970 indicated that the government took the position that interest incurred by banks in the ordinary course of its business should not be treated as interest incurred to purchase or carry tax-exempt obligations unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment.[48] Guidance published shortly thereafter indicated that, by contrast, in the case of non-bank taxpayers, including municipal bond dealers, whether indebtedness is incurred to purchase or carry municipal bonds may be established by direct evidence or by circumstantial evidence.[49] *Inter alia*, intent to incur debt to carry municipal bonds may be inferred if municipal bonds are pledged to secure the debt.[50] Therefore, interest incurred by a bank in the ordinary course of its business (say, short-term interest paid to depositors) could be deducted even if funds from the deposits were used to purchase municipal bonds, while interest on funds borrowed by a municipal bond dealer to acquire or carry municipal bonds could not be deducted from taxable income. To the extent that a repo was characterized as a loan secured by a pledge of such municipal bonds, interest paid or deemed paid on the loan would fall within the exclusion of former Code Sec. 265(2). This was explicitly recognized by the Sixth Circuit in *Union Planters National Bank of Memphis*,[51] a case decided shortly after the Fifth Circuit decision in *American National Bank of Austin*, with materially similar facts:

> [T]he Government argues, the transactions constitute an attempt to avoid the effect of § 265(2) of the Internal Revenue Code. This provision disallows deductions of interest paid on loans the proceeds of which are used to buy municipal bonds. Its obvious purpose is to deny the recipient of tax exempt income the further tax benefit of deducting the cost of money employed to purchase the securities which produce it. Accordingly, if the dealer had borrowed the money to purchase the bonds, the coupon interest would be tax-free to him, but he would not be able to deduct the interest paid to the Bank for the loan; and the Bank, of course, would be taxed fully on the income represented by that interest. But if the transactions are characterized as sales-repurchases, the Government contends, the Bank will avoid paying tax on the coupon interest, which in economic effect is equivalent to interest paid for the use of its money, and the dealer will have obtained the funds to purchase the bonds without paying interest. Thus, if the parties' characterization of these transactions is accepted as decisive for federal income tax purposes, they would be able to enjoy the benefit of the double tax advantage which Congress intended to prevent.[52]

The Court of Claims discussed the same issue in *National Bank of Waco*, discussed above.[53] In that case, the court declined to hold that a repo was a secured loan because, *inter alia*, the case did not present potential for the type of abuse at issue in *National Bank of Austin* and its progeny.[54] Therefore, when citing *American National Bank of Austin* and its progeny as support for the treatment of a repo, it is helpful to recall that law and policy were aligned therein in a way absent from many current repo transactions.

Illiquid Property—Bespoke Repos

Tax Ownership of Illiquid Property

The test to determine tax ownership of illiquid property is different from that used to determine the tax ownership of liquid property. In the case of illiquid property, the intent of the parties and the allocation of economic exposure to an asset are the most important factors in determining the owner thereof.[55] This is because derivatives on illiquid assets have certain features that are absent from derivatives on liquid assets; it is also because certain issues attendant upon derivatives on liquid assets are absent from derivatives on illiquid property. For example—as discussed above, one of the reasons why properly structured monetization strategies such as VPFCs and collars are not deemed to give rise to Day 1 gain or loss is because the short party retains control over the referenced assets and may deliver assets other than the assets pledged on Day 1 to close out the transaction.[56]

Until actual assets are delivered, it is impossible to determine gain or loss from the disposition thereof.[57] This is not the case with derivatives on illiquid assets. Because illiquid assets are difficult to source, the short party to a physically settled derivative with respect to an illiquid asset is usually economically compelled to segregate that asset and to deliver it to the long party upon maturity. Therefore, there is no uncertainty regarding the specific asset to be delivered or sold to settle the transaction.[58] Furthermore, transactions in illiquid assets tend to be highly negotiated transactions, in which the paper trail and dealings of the parties give clues as to the intent of the parties in ways that are absent from capital markets transactions. Because of this, courts have generally looked to the intent of the parties and economic exposure to the underlying asset in determining the tax ownership of illiquid assets.

The foregoing is illustrated through courts' and the IRS's treatment of forwards and repos on illiquid assets. These cases tend to fall into three categories. First, some cases involve forwards or repos entered into with respect to controlling blocks of stock purchased pursuant to a corporate acquisition for the purpose of securing short-term funding for the acquisition (referred to hereinafter as "bridge loan forwards or repos"). Second, some involve forward transactions entered into with respect to interests in a joint venture by the parties to the joint venture for the purpose of setting a hard exit date for the joint venture ("joint venture forwards or repos"). Finally, some involve forwards and repos entered into with respect to property used in the repo seller's trade or business for the purpose of financing that property ("business property forwards or repos"). In all of these cases, courts and the IRS looked to the business context within which a repo occurs to determine the party intended to be the beneficial owner of the applicable property by the parties to the transaction. After viewing all relevant facts, courts and the IRS did not treat these transactions as forwards or repos; instead, they treated them as bridge loans, joint ventures, or loans secured by a pledge of business property, consistent with their place within the context of a broader transaction, series of transactions, or business relationship.

Bridge Loan Repos

One of the most-cited bridge loan cases is *Comtel Corp.*[59] The taxpayer in this case was a corporation set up to assist its counterparty, Zeckendorf, in the acquisition of shares of a corporation that owned a hotel pursuant to a tender offer. After a quorum of the target's shareholders had tendered their shares, Zeckendorf found that it was unable to obtain financing for the purchase thereof. Two of the parties whom Zeckendorf had approached for financing suggested an alternative. Pursuant to the alternative, a Zeckendorf nominee and the two lenders formed a corporation, Comtel. Comtel was capitalized with equity and with debt and bought the tendered shares. Zeckendorf received a call option with a maturity of slightly longer than six months, and a strike price that reflected a financing rate. In order to ensure that the call was exercised, the interest of the Zeckendorf nominee was subordinated to that of the other two Comtel shareholders, and Zeckendorf and a Zeckendorf affiliate guaranteed the return of those two shareholders to match their initial capital contribution plus the finance rate reflected in the strike price. In the event, Zeckendorf exercised the call option on the maturity date and refinanced the property with long-term debt.

Comtel, the repo buyer, took the position that it was the beneficial owner of the shares during the "window" between the tender offer and the option exercise. The Tax Court and the Second Circuit disagreed, holding that, in economic substance, Comtel had the exposure of a secured lender, rather than that of a beneficial owner, and that this reflected the intent of the parties. In reviewing the Tax Court decision, the Second Circuit noted that relevant facts "although not the significant one of intent" were stipulated. It then went on to review the Tax Court's reasoning:

> In overturning the consistent formal pattern of purchase and resale, the Tax Court relied on various circumstances: First, it found that Zeckendorf never wavered in its desire to acquire the Commodore stock and ultimately did achieve its objective, and never intended to and did not surrender complete ownership of the Commodore shares to Comtel. Second, Tri-Fi and Eastman Dillon were primarily interested in making a high yield, risk proof investment, not in embarking on hotel operation. Third, Comtel's rights in the Commodore stock during the period Zeckendorf's option was outstanding were similar to those of a mortgagee; e.g., Comtel was not permitted to sell or dispose or pledge the shares (except to Irving Trust Company). Fourth, the profit from the option was not intended to result from appreciation in value of the Commodore shares or from operation of the hotel, but from the prearranged fixed option price. Fifth, the option was of short duration, and Zeckendorf could exercise it merely by paying a sum which looks just like interest and compensation for financing services on a purchase-money mortgage. Finally, though concededly there was no legal obligation binding Zeckendorf to exercise its option, the Tax Court found that realistically Zeckendorf was compelled to do so. Otherwise,

> through the subordination agreement, Zeckendorf might lose the $633,000 capital investment it made in Comtel, through the indemnity agreement Webb & Knapp might lose an even greater amount, and in addition Zeckendorf would lose the benefits of all its efforts and expenses in arranging the Commodore stock acquisition, negotiating the Comtel deal, and planning for the subsequent statutory merger of Commodore Hotel, Inc. into itself.[60]

The repo seller was a corporate raider, whose intent was to buy the repoed shares. The repo buyer expressed an intent to lend money and assumed economic exposure to match. The repo happened within the context of a tender offer. Because of all of these factors, the court held that the repo seller was the tax owner of the repoed assets *repone pendente*. Other bridge loan repo cases held similarly.[61]

Joint Venture Repos

Although apparently inconsistent with the bridge loan repo cases at first blush, "joint venture" repo cases also allocate tax ownership consistently with the parties' intent. These cases involve transactions between parties with complementary business assets, which enter into a joint venture with a "baked in" exit date. The purchaser generally tries to claim that the sale of interests in the joint venture occurred at the time when the joint venture was entered into in order to have a portion of the purchase price allocated to deferred-payment interest. In so doing, the purchaser generally claims that economic exposure shifted to the purchaser as of Day 1. This is not sufficient to overcome the conclusion that the parties entered into a joint venture for the purpose of engaging in the business jointly until the exit date. For example, in *Griffin Paper Corp.*, the parties to the transaction at issue were Griffin, a U.S. subsidiary of a Finnish corporation that owned a sawmill and some land in Mississippi, and GNN, a U.S. corporation whose management desired to enter the wood pulp business.[62] GNN saw a need to purchase a sawmill because sawmill byproducts are an important input for pulp mills. Griffin initially wanted to sell the sawmill to GNN outright, but GNN requested that they form a joint venture because Griffin's parent had deep expertise in the pulp business. Therefore, in 1981, the two parties formed a new entity, which was capitalized with assets contributed by Griffin, and with cash from GNN. In exchange, Griffin received 5% of the new entity's common stock, and 32.8% of its preferred shares, as well as a long-term contract to purchase pulp from the new entity. GNN received the balance of the equity. As of January 1, 1989, Griffin had the right to sell, and GNN had the right to buy, all of Griffin's common and preferred shares in the new entity for a fixed price per share plus 5% of the entity's undistributed earnings. Until that time, Griffin had the right to receive dividends paid on the common stock, the right to appoint two out of 10 directors, and other rights generally held by minority shareholders. GNN took the position that, since it was economically certain that either the put or the call right would be exercised, GNN was the beneficial owner of the new entity as of 1981 because economic exposure thereto had shifted to GNN as of that date. The court did not buy it. Even though Griffin's sale price for the shares was fixed as of Day 1, and even though it was economically certain as of Day 1 that the shares would be sold on the options' maturity date, the court noted that Griffin retained significant rights of ownership until that date because neither of the options could be executed until 1989, and until that time, Griffin could nominate directors, receive dividends, and block certain corporate actions.[63] In addition, the court found none of the traditional indicia of debt in the documentation or in the parties' course of dealing with each other. Instead, it was clear that the parties had entered into the joint venture in order to benefit from synergies between their respective competences while the joint venture lasted, even though the exit price had been set on Day 1. Because of that, beneficial ownership of the interests in the new entity was held to be transferred in 1989, rather than in 1981.[64]

Business Property Repos

Courts have similarly looked to the intent of the parties in examining repos on illiquid assets used in one of the parties' business. Like the bridge loan repo cases, these tend to be cases in which one party seeks to extend financing to another party; however, the borrower in these cases tends to be a going concern seeking to finance business property rather than a corporate acquirer. In determining the beneficial owner of the subject property, courts look to which party bears the benefits and burdens of ownership, but they also look to which party uses the property in its trade or business; active management of the subject property by one of the parties is evidence of beneficial ownership by that party. For example, in *Kwiat*, the asset in question was industrial shelving.[65] The taxpayer, Kwiat Capital ("Kwiat"), was a small business investment company whose shareholders had hitherto been primarily engaged in the diamond trade. The counterparty was an entity engaged in the business of manufacturing paperboard packaging. The counterparty needed to finance the purchase of industrial-strength pallet racking shelves to use in their business. Kwiat purchased the shelving and leased it to the counterparty for a term of four years and 11

months. At the same time, the parties to the lease entered into a put and a call, pursuant to which the shelving could be sold to the lessee. However, the put and the call were asymmetrical, in two respects. First, the put strike price was significantly higher than the call strike price; second, the put expired almost a year before the call went into effect. Neither of the original options was exercised, and the options were amended when the lease was subsequently extended. The amended put had a strike price that was less than that of the amended call, and the amended put expired three months before the amended call became effective. Neither of the amended options was exercised. Lease payments paid by the counterparty to Kwiat were adjusted both up and down to reflect fluctuations in Kwiat's cost of funds. The counterparty was required to insure the shelving, and to indemnify Kwiat for any physical damage thereto. The counterparty was also required to indemnify Kwiat for any loss to the shelving due to claims from Kwiat's creditors. The counterparty could sell or rehypothecate the shelving with not-to-be-unreasonably-withheld permission from Kwiat. The shelving was fixed to the counterparty's business premises, and nobody in the Kwiat Group had any familiarity with pallet racking.

Seeking to claim depreciation deductions, Kwiat took the position that it was the beneficial owner of the shelving during the term of the lease. In so doing, it cited *Penn-Dixie* as support for the position that non-contemporaneous puts and calls are not sufficient to transfer the "burdens and benefits" of ownership.[66] The Tax Court disagreed, on several grounds. First, it said that since the taxpayer in *Penn-Dixie* sought to disavow its form, the taxpayer in that case was required to produce "strong proof" that beneficial ownership was shifted by the relevant option positions; the government did not need to clear that higher bar in *Kwiat*. Second, the Tax Court noted that the subject property was significantly different in the two cases. In *Penn Dixie*, the property was an interest in a joint venture between a supplier and a manufacturer; in *Kwiat*, the property was assets used exclusively in the business of the ostensible lessee. Finally, the Tax Court said that the mere fact that the options were not exercised is not sufficient to indicate that economic exposure to the referenced property was not transferred on Day 1; instead, the relevant question is whether it appeared certain as of Day 1 that one or the other of the options would be exercised.[67]

Although the result in *Kwiat* appears to be correct, the analysis is lacking in three respects. First, the court distinguished joint venture interests from pallet shelving by saying that the value of a joint venture interest is more volatile than that of pallet shelving. Because of this, the Tax Court said, it is more likely that the price of the referenced asset will fluctuate to such a degree that neither option will be exercised.[68] While possibly true, this is not the feature that most distinguishes a tangible business asset from an interest in a joint venture. Per *Griffin*, burdens and benefits of ownership include features other than exit price; *inter alia*, they include the right to distributions, the right to vote on and influence corporate actions, and, in the case of a joint venture interest, the right to participate actively in the joint venture's business and to benefit from its synergies. By contrast, a tangible business asset does not confer governance or distribution rights, and only one party can use it in its business. The pallet shelving in *Kwiat* was fixed to the lessee's premises, and only the lessee knew how to use it. The lessee, and only the lessee, benefitted from revenue produced by the pallet shelving. By contrast, both parties participated in the joint venture businesses in *Griffin* and *Penn-Dixie*. Second, the Tax Court did not discuss the differences between the options in *Kwiat* and those in *Penn Dixie.* The options in *Penn Dixie* were consecutive (*i.e.,* the term of the call began the day after the day on which the term of the put expired), and they had the same strike price. By contrast, the original put in *Kwiat* had a strike price that was higher than the original call, and there was a significant amount of time that elapsed between the maturity date of the put and the initial effective date of the call. Everything else being equal, the higher put strike price would increase the probability of exercise of either the put or the call; however, the 11-month "window" between the put expiration and the call effective date would *decrease* the likelihood of one or the other option's being exercised. The amended put had a strike price that was lower than the amended put, decreasing the likelihood of exercise further. Finally, although the Tax Court noted that lease payments would fluctuate with Kwiat's cost of funds, and the counterparty was liable for losses in value of the property (even to the point of protecting Kwiat from loss of same to Kwiat's own creditors), these points were not mentioned in the court's analysis.[69]

To summarize—in determining tax ownership of illiquid property, courts and the IRS look to the intent of the parties. Economic exposure is one very strong indicium of same (it is hardly plausible that parties would allocate the burdens and benefits of ownership of an asset to a party *not* intended to be the beneficial owner thereof), but the nature of the asset and the business context within which the repo occurs appear to have comparable weight. Furthermore, the concept of "economic exposure" is, itself, context-dependent. In the case of a purely economic asset, such as shares of stock, "burdens and benefits" seem to boil down to exit price. However, in the case of non-fungible assets, such as a block of stock granting participation rights

in a joint venture or hard assets used in an active business, the burdens and benefits of ownership include possession, control, the right to vote, and the right to receive dividends. These rights are discerned from the intent of the parties, as manifested by the economic context in which the repo occurs.

Duty of Consistency—*Danielson* and the Strong Proof Doctrine

Another issue that is relevant to repo participants and their advisors is whether parties to a repo can characterize the repo on their tax return in a manner that is inconsistent with the form of the transaction. Repos are documented as "sales" and "repurchases" of the repoed assets, and they are treated as distinct from other types of secured loans for bankruptcy law purposes.[70] Despite this, taxpayers usually take the position that both capital markets repos and bespoke repos are secured loans for federal income tax purposes. This is particularly relevant in the case of a bespoke repo, in which the parties take inconsistent positions regarding the proper treatment of the transaction for U.S. and foreign income tax purposes.

Taxpayers who take a position that the proper tax treatment of a transaction is not consistent with the agreed-upon form of the transaction must address the so-called *Danielson,* or "strong proof" rules, which limit taxpayers' ability to disavow the form which they choose for a transaction.[71] It is a fundamental principle of U.S. federal income tax law that taxation should be based upon the substance, not the form, of a transaction.[72] However, because a taxpayer, unlike the government, is free to choose the form of a transaction, a taxpayer's ability to disavow the form of a transaction is more circumscribed than the IRS's ability to do so.[73] Taxpayers sometimes challenge (or take positions that contravene) the express, unambiguous terms of their contractual agreements based on the substance of the transaction involved. The Tax Court and certain Federal Courts of Appeal have determined that taxpayers may prevail in such cases only if they demonstrate with "strong proof" that construing the transaction based on its overall substantive economic effect better reflects economic reality and the actual intent of the parties.[74] By contrast, some other Courts of Appeal apply a stricter test to determine whether a taxpayer's characterization of its transaction may contravene such express contractual provisions. This test permits the taxpayer to challenge the tax consequences of contractual agreements as construed by the IRS only "by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."[75] The Tax Court applies this rule (the "Danielson rule") only in cases appealable to a Court of Appeal that has adopted the rule.[76]

Although the application of these rules may be draconian, they are subject to certain exceptions. *Inter alia*, the Tax Court has held that, where the terms of an agreement are ambiguous, the parties thereto need not be held to their form.[77] The term "ambiguous," as used here, has more than one meaning. In certain instances, courts have held that the terms of a contract are ambiguous if the contract itself is ambiguous, or if its terms are inconsistent with each other.[78] However, in certain other cases, courts and the IRS have held that the terms of an agreement are "ambiguous" if the terms contained in the four corners of the document are inconsistent with the economic substance of the transaction and the course of dealing of the parties. It is worth noting that this definition of "ambiguous" is not consistent with the everyday definition of the word. In everyday parlance, an utterance is "ambiguous" if a reasonable person could understand it to have more than one meaning. For purposes of the *Danielson* and strong proof doctrines, a transaction is "ambiguous" if the economic substance of the transaction is at odds with its form, and all parties to the transaction treat it consistently with its economic substance, rather than with its form.[79] One articulation of this principal is in a General Counsel Memorandum issued in 1972, in which the IRS stated the following regarding the treatment of capital markets repos that were clearly intended to function as secured financings:

> The totality of the facts as they appear in this situation are almost totally inconsistent with a sale transaction. However, the agreement is phrased in terms of a "purchase" by the Bank from the Trust Company. This fact alone is not sufficient to make the transaction a sale. Nor is it controlling that the taxpayer claims that the form should not prevail. … It should also be recognized that we are not dealing with a situation in which the contract is absolute on its face and therefore the taxpayer should not be able to attack the form of the agreement. See e.g., *Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967). In the present situation, the provisions of the agreement are such that a loan transaction is more apparent than a sale, notwithstanding the usage of the term "purchase."[80]

In taking the foregoing position, the IRS cited *American National Bank of Austin* and the other seminal capital markets repo cases.[81] As discussed above, although the

transactions in those cases were documented as sales and repurchases for bankruptcy law purposes, the parties thereto consistently took the position that the repo seller, rather than the repo buyer, was the tax owner of the repoed assets for tax purposes. Consistent treatment is relevant because one of the primary policy goals of the *Danielson* and strong proof doctrines is to prevent taxpayers from taking *in*consistent tax positions with respect to the same transaction. For example, courts have articulated three primary reasons for applying the *Danielson* and strong proof doctrines in contexts in which the parties take inconsistent positions. First, taxpayers who negotiate an agreement at arm's length will generally rely on the agreement when filing their tax return. To the extent that a taxpayer's counterparty departs from the agreed=upon form in reporting its side of a transaction, the taxpayer may be deprived of a bargained-for benefit in reporting the transaction on its own return. Second, inconsistent positions may expose the IRS to the danger of a "whipsaw," in which inconsistent treatment of the same item of income, gain, deduction, or loss distorts the parties' aggregate recognition of taxable income. Finally, inconsistent reporting by taxpayers would significantly increase the government's administrative burden in enforcing the law because it would require the government to audit and compare each side of every transaction.[82] By contrast, where these issues are not implicated (as, for example, in cases in which a consistent and unanimous intent of the parties is evidenced by the parties' behavior, irrespective of the language of the relevant agreements), courts have declined to apply the *Danielson* and strong proof rules.[83]

Treatment of Bespoke Repos

Given the foregoing—should bespoke repos be treated as the same animal as capital market repos? As discussed above, bespoke repos differ from capital market repos in two ways, *i.e.,* in the type of property that they reference and in their net after-tax effects (and, likely, in their purpose). Are these differences material? This raises three questions, which need to be addressed when examining any bespoke repo:

- Can existing cases and guidance be cited as authority for treating a bespoke repo as a secured loan? This question is relevant because, as discussed above, it is not uncommon for taxpayers entering into these transactions to cite *National Bank of Austin* and its progeny as authority for these cases—but the property underlying the two types of transactions are as different from each other as apples and elephants, and the purpose for the transactions tends to differ.
- Can existing authorities for the treatment of repos on illiquid assets be cited as authority for the treatment of all repos on illiquid assets? This question is relevant because cases that discuss the treatment of repos on illiquid property tend to look to the intent of the parties to determine the beneficial owner—and not all repo participants share the same intent.
- Could the government successfully argue that the strong proof and *Danielson* doctrines prevent a taxpayer entering into a bespoke repo from disavowing its form? To the extent that cases allowing taxpayers to disavow the form of a repo are limited to capital markets repos—and to the extent that these are qualitatively different from bespoke repos—the strong proof and Danielson doctrines cannot be assumed away.

Apples and Oranges

Capital markets repos and bespoke repos reference different types of assets. This distinction makes a difference both because the test for tax ownership of these two types of assets differs, and because, in determining ownership of illiquid assets, courts and the IRS look to the intent of the parties.

As discussed above, the test for determination of tax ownership of liquid assets is different from that regarding illiquid assets. Because there can be infinitely many long positions with respect to a liquid asset, and because liquid assets are fungible and may be substituted for each other—and because gain or loss from the disposition of any asset can only be determined once the specific asset has been identified—the party who has control over the segregation and disposition of a liquid asset is generally treated as the owner thereof. This is most clearly demonstrated in cases and guidance dealing with securities loans, short sales, and monetization strategies.[84] In the case of repos, the analysis is muddied because the IRS and courts in recent years have not emphasized the importance of the repo buyer's right to sell or rehypothecate repoed assets to the tax ownership analysis.[85] However, an examination of earlier capital markets repo cases indicates that the repo seller's ability to control the disposition of the repoed assets was dispositive in those cases.[86] This is in contrast to authorities governing tax ownership of illiquid assets, in which economic exposure to the underlying asset and the intent of the parties are the dispositive factors. Since the test for tax ownership of liquid assets is different from that of tax ownership of illiquid assets, only cases and guidance dealing with tax ownership of illiquid property should be cited as authority for the proper treatment of bespoke repos.

As a secondary matter, it should also be noted that the seminal cases involving capital markets repos were also

intended to prevent perceived abuse; the courts in those cases sought to prevent banks from obtaining a deduction for interest incurred to purchase or carry tax-exempt bonds.[87] Because these cases were intended to prevent abuse, it would be optimal for these cases not to be cited as precedent for transactions that may be perceived as abusive.

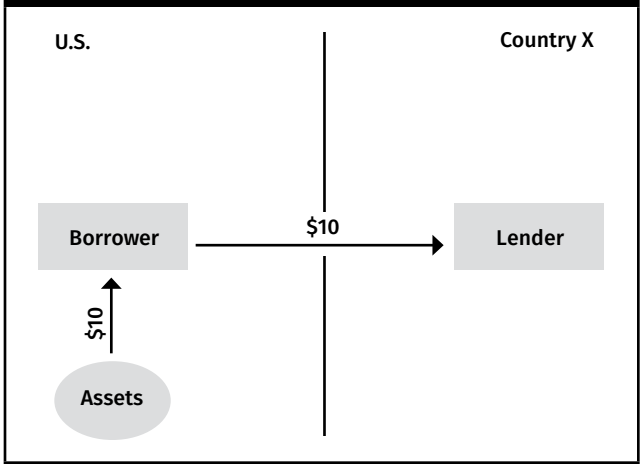
Intent Matters

Inter alia, tax ownership of illiquid assets is determined by reference to intent of the parties, as manifested by business context. This explains the apparent inconsistency of the illiquid repo cases. In bridge loan repo cases, the repo seller was treated as the beneficial owner of the repoed shares because the course of dealing between the parties made it clear that the intent of the repo seller was to obtain financing for the acquisition of control over the issuer of the repoed shares.[88] In joint venture repo cases, courts treat the repo buyer as the tax owner of the repoed shares because the course of dealing of the parties indicates that they intend to act as joint owners of the issuer of the repoed shares *repone pendente*, and in business property repos, courts treat the party which uses the repoed assets in its business as the tax owner thereof.[89] In each of these cases, the court was able to discern a robust intent to treat the transaction in a certain manner that was clearly manifested by the occurrence of the repo within the broader context of business dealings between the parties thereto. Therefore, in citing these cases as precedent for the treatment of a bespoke repo as a secured loan, one should be comfortable that the intent of the parties to treat the repo as a secured loan is reflected by the business dealings of the parties.

Unlike the repos on illiquid property discussed above, bespoke repos usually do not occur within the context of another transaction or series of transactions with a well-defined business purpose. However, it may be possible to discern the state of mind of a participant in many transactions by using a principle of epistemology (and common sense) attributed to the 14th century logician William of Okham, often referred to as Okham's Razor: "*Pluritas non est ponenda sine necessitate*," or "*Frustra fit per plura quod potest fieri per paucoria*" ("Don't posit multiple steps when one step, or fewer steps, will suffice"). In the context of tax law, it can be re-phrased to state that, when a taxpayer enters into a complex transaction that is economically equivalent to another, simpler transaction, but which has more steps and transaction costs, and which yields a tax benefit absent from the simpler transaction, it is reasonable to conclude that the complex transaction is tax motivated. The mere existence of an intent to maximize tax efficiency may not require a transaction to be recharacterized in all cases.[90] However, it might be sufficient to distinguish a tax-motivated bespoke repo from the illiquid property repo cases decided above. This is because in those cases, the courts determined tax ownership by reference to intent, determined by the applicable repo's occurrence in the context of a well-defined, business-motivated transaction or series of transactions. There is a risk that a court could distinguish a transaction that does not occur in such a context. The presence of a tax-avoidance motive, and the absence of a compelling narrative, such as a tender offer, the financing of steel shelving, or a joint venture to produce wood pulp, might be sufficient to do this.

It is easy enough to infer a non-business tax motive for certain types of bespoke repos by comparing the before- and after-tax benefits thereof with similar items from a simpler, base-case transaction. As discussed above, regardless of the legal question of tax ownership, the economic effect of a repo is generally similar to that of a loan; the repo buyer gives money to the repo seller on Day 1; the repo seller has the use of that money for the life of the repo, and the repo buyer is compensated for the use of that money. Therefore, the benchmark in this case should be a "plain vanilla" financing transaction. For example, assume a "plain vanilla" unsecured loan with a U.S. borrower and a foreign lender, in which the borrower uses the proceeds of the loan to purchase coupon-paying bonds. The bonds pay a coupon of $10 per period. Coupon payments qualify for either the portfolio interest exemption under Code Sec. 871(h)/881(c) or under a treaty. Payments of interest on the bonds and the loan would look like this (see Figure 3):

FIGURE 3. A PLAIN VANILLA LOAN



If tax were imposed on net income by both the United States and Country X at a rate of 35%, aggregate benefits to all parties to the transaction, including the borrower, the lender, the U.S. government, and the Country X taxing authority would be summarized in Table 1.[91]

TABLE 1. BENEFITS OF A VANILLA UNSECURED LOAN

	Borrower-Cash	Borrower-Tax	U.S. Gov't	Lender-Cash	Lender-Tax	Foreign Gov't
Receipt of Coupons	$10.00	$(3.50)	$3.50			
Payment of Interest	$(10.00)	$3.50	$(3.50)	$10.00	$(3.50)	$3.50

Borrower Benefits	–
Lender Benefits	$6.50
US Gov't Benefits	–
Foreign Gov't Benefits	$3.50

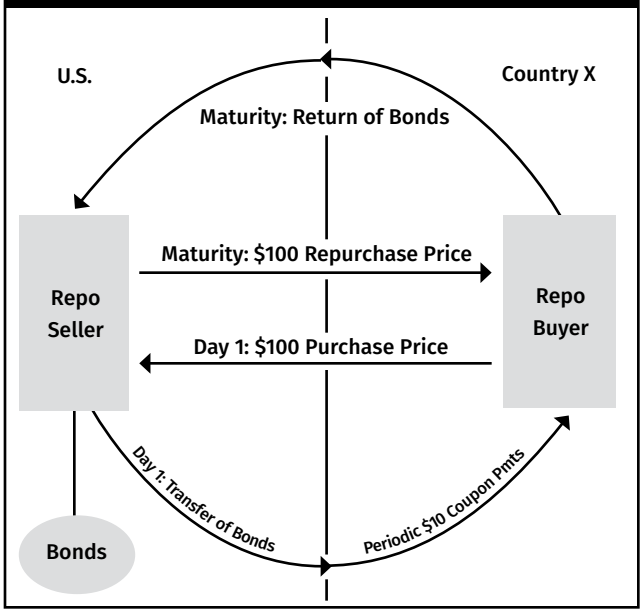
Aggregate Private Party Benefits	$6.50
Aggregate Government Benefits	$3.50

Total Benefits	$10.00

As Table 1 shows, total benefits to all parties in the present case are $10 (not surprising, since there was a cash coupon of $10 paid on the bonds and the loan). Of this, $6.50 is retained by the lender, and $3.50 was received by the Country X taxing authority.

If, instead of lending $100 to the borrower, the Lender were to buy $100 of bonds on repo, tax benefits to the respective parties would be the same, as summarized in Figure 4 and Table 2.

FIGURE 4



Again, $10 total benefits, of which the lender (*i.e.,* the repo buyer) receives $6.50, and the Country X taxing authority receives $3.50.

Things change if, instead of bonds, the repoed assets are preferred shares in a taxable U.S. corporation that holds nothing but bonds.[92] Assume that dividends on the shares are matched to coupon payments on the bonds. Under the terms of the repo, no separate interest or rebate is paid to the Repo Buyer; instead, the Repo Buyer is permitted to retain cash dividends on the repoed shares as compensation for its provision of cash to the Repo Seller. Although legal ownership of the preferred shares does not grant the Repo Buyer creditor's rights, assume that the Repo Seller guarantees these payments. Assume, further, that Country X has an "exemption" regime that allows recipients of dividends paid by corporations resident in non-tax haven jurisdictions to receive these dividends tax free, and that Country X treats the Repo Buyer as the beneficial owner of the repoed shares. The "surface structure" of the transaction would look like the transaction in Figure 5.

FIGURE 5. A PREFERRED SHARE REPO

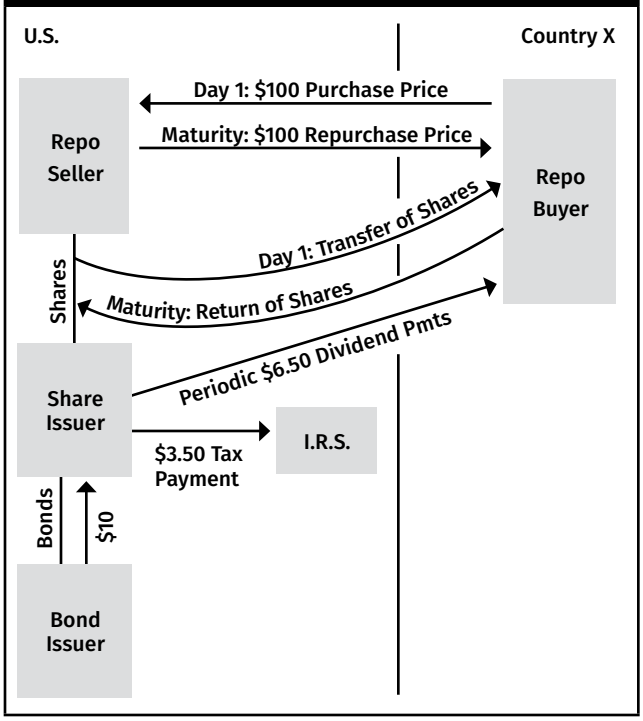


TABLE 2. BENEFITS OF A NON-HYBRID BOND REPO

	Repo Seller-Cash	Repo Seller-Tax	U.S. Gov't	Repo Buyer-Cash	Repo Buyer-Tax	Foreign Gov't
Receipt of Coupons	$10.00	$(3.50)	$3.50			
Deemed Interest Payment	$(10.00)	$3.50	$(3.50)	$10.00	$(3.50)	$3.50

Repo Seller Benefits	$—
Repo Buyer Benefits	$6.50
US Gov't Benefits	$—
Foreign Gov't Benefits	$3.50

Aggregate Private Party Benefits	$6.50
Aggregate Government Benefits	$3.50

Total Benefits	$10.00

Assume that both parties take the position that, for U.S. federal income tax purposes, the transaction is a pledge of the repoed shares to secure a loan of $100 from the Repo Buyer to the Repo Seller. Therefore, cash payments of $10 made on the shares to the Repo Buyer would be deemed to be received by the Repo Seller as dividends from the Share Issuer and then paid as interest by the Repo Seller to the Repo Buyer. However, to the extent that the Repo buyer is treated as the beneficial owner of the repoed shares under Country X law, dividends received by the Repo buyer on the repoed shares should qualify for the country X participation exemption.

As is evident from Table 3, total benefits in this case are also $10. However, these benefits are allocated differently from the way in which they are allocated in the base case, as described in the previous two examples.

The shifting of benefits to private parties is due to two factors, *i.e.,* the U.S. dividends received deduction and the Country X participation exemption. The U.S. dividends received deduction allows the Repo Seller to exclude the $6.50 deemed received by it as a dividend from the Share Issuer. Nevertheless, the deemed interest payment of $6.50 may be deducted from the Repo Seller's taxable income. Assuming that the Repo Seller has taxable income subject to the 35% rate, this deduction has a value of $2.28 to the Repo Seller. The Country X participation exemption allows the Repo Buyer to exclude the $6.50 net interest received from taxable income. Effectively, this means that the net $6.50 deemed received by the Repo Seller and paid over to the Repo Buyer can be both excluded and deducted from taxable income by the Repo Seller and excluded from taxable income by the Repo Buyer.[93]

A greater portion of aggregate benefits is retained by the private parties than in the base case. Benefits shifted to private parties; more legal entities, more steps, and more transaction costs—the transaction would appear to be tax motivated. This may not be fatal to recharacterization as a secured loan *per se*, but it may be sufficient for the government to distinguish cases in which secured loan characterization rested on repos' occurring in a well-defined non-tax-motivated business context.

Danielson and Strong Proof Concerns

Because repos are "papered" as sale-repurchases, a threshold issue in treating any repo as a secured loan is whether the taxpayer may disavow the form of the transaction. Courts and the IRS have taken the position that, in certain cases, taxpayers who enter into a repo may do so.[94] However, taxpayers who enter into bespoke repos should bear in mind that these cases are based on the doctrine of ambiguity. As discussed above, for these purposes, a transaction is "ambiguous" if, in spite of the form of the transaction, the economic reality of the transaction and the consistent course of dealing of the parties present overwhelming evidence to the contrary.[95] For example, in *Coulter Electronics*, the taxpayer transferred certain equipment leases to a bank in exchange for cash, subject to an obligation to repurchase the leases in certain cases. Although the transfers were documented as "sales," the transferor retained all material risk associated with the leases, and the return to the bank was comparable to a return on secured loans issued by the bank. The taxpayer took the position that the transfers were secured loans. The IRS took the position that the taxpayer was not permitted to disavow its form under the *Danielson* rule. The Tax Court held for the taxpayer because the course of dealing indicated unambiguously that both parties to the transaction intended to treat it as a secured loan. This unambiguous course of dealing inconsistent with the form of the transaction made the transaction ambiguous:

TABLE 3. BENEFITS OF A PREFERRED SHARE REPO

	Share Issuer-Cash	Share Issuer-Tax	U.S. Gov't	Repo Seller- Cash	Repo Seller-Tax	Repo Buyer-Cash	Repo Buyer-Tax	Foreign Gov't
Receipt of Coupons	$10.00	$(3.50)	$3.50					
Dividend Payment	$(6.50)			$6.50				
Deemed Interest Pmt			$(2.28)	$(6.50)	$2.28	$6.50		

Share Issuer Benefits	$—
Repo Seller Benefits	$2.28
Repo Buyer Benefits	$6.50
US Gov't Benefits	$1.22
Foreign Gov't Benefits	$—

Aggregate Private Party Benefits	$8.78
Aggregate Government Benefits	$1.22

Total Benefits	$10.00

> In the instant case the original agreement of November 6, 1972, as well as the assignment forms used to transfer the leases to Continental contain terms which denote a sale. Yet the original agreement and its subsequent amendments contain numerous provisions which are inconsistent with a sale and more like the terminology usually found in financing arrangements. For instance, the original agreement required petitioners to annually furnish Continental with audited financial statements prepared by an independent firm of certified public accountants satisfactory to Continental, and with unaudited quarterly statements. Petitioner was also required to permit Continental reasonable access to its accounting books and records, to maintain or cause to be maintained such insurance as is usually required in like businesses, and to timely pay all taxes and other liabilities. These provisions in particular, plus the tenor of all relevant documents and the overall conduct of the parties as set forth in our findings, are indicative of a loan relationship rather than a sale. Thus, the original agreement between petitioner and Continental as well as its supplements are clearly ambiguous on their face; and their exact nature for tax purposes must be determined from the documents as a whole in light of all the surrounding facts and circumstances. Therefore, neither Danielson nor the strong proof doctrine is applicable to this case.[96]

This was good news for the taxpayer in *Coulter Electronics*; however, it should not be construed as license to ignore the *Danielson* and strong proof doctrines in all repo cases. The court in *Coulter Electronics*, and the IRS in GCM 35036, allowed repo participants to disavow the form of their transaction because their course of dealings clearly manifested a consistent and unambiguous intent for the transaction to be a secured loan in substance. Many factors indicated this; the retention of risk by the repo seller; the retention of the right to control disposition of the repoed assets by the repo seller; the fact that the repo buyer was a bank, which earned a debt-like return and assumed debt-like risk by entering into the transaction; and the existence of reporting requirements and financial covenants usually found in loan documentation. Many bespoke repos do not provide this type of "grand slam" array of positive factors. For example, parties to many bespoke repos will treat an applicable transaction as a secured loan for U.S. federal income tax purposes but as a true sale and repurchase for foreign income tax purposes. The repo buyer's residence jurisdiction may have its own substance-over-form doctrine, which could cause the parties to tweak the transaction in such a way as to make it less unambiguously a secured loan in economic substance.[97] These may not weaken the economic substance of the transaction; however, they will make the course of dealing between the parties less consistent and less unambiguous, and this will create a risk that the parties may not be able to benefit from the exemption from the *Danielson* and strong proof doctrines for ambiguous transactions.

But we digress. As discussed above, *Repo Man* has two intertwined plots. These include the story of how Otto becomes a repo man and the story about the alien space ship. Over the course of the movie, Otto finds two mentors to navigate these two worlds, *i.e.,* Bud and Miller, played by Tracey Walter, a drug-addled *idiot savant* who alone among the staff at HHAC is able to handle the rendezvous with the UFO.[98] Bud is a loose cannon, hot-tempered, selfish, and ontologically incapable of telling the truth. He is eventually fired from his job and loses his significance in the narrative. Miller is everything that Bud is not—wise, kind, gentle, and musically inclined. You barely notice him at first, but he turns out to be the hero. Despite their differences, both men say the same thing to Otto at crucial points in his development: "The life of a repo man is always intense." Those of us who deal in repos of a different kind can learn from that piece of wisdom. Repos (if not the lives of all tax professionals who analyze repos) are intense. We should be careful not to lump all transactions named "repo" together any more than we lump together all transactions labelled "sale," "debt," or "equity". We should not assume away important issues. Failure to act accordingly could make our lives—and the lives of our clients—more intense than we would like.

ENDNOTES

1 Unless otherwise noted, Code Sec. references herein are to the Internal Revenue Code of 1986, as amended to date. References to regulations are to Treasury regulations promulgated thereunder.

2 *Lucas v. North Texas Lumber Co.*, 281 U.A. 11 (1930).

3 For a discussion of this point, *see* William W. Chip, *Are Repos Really Loans?* Tax Notes 1057 (May 13, 2002) [hereinafter "Chip"]. For a discussion of the effect of the right to dispose of property on beneficial ownership generally, *see* Edward Kleinbard, *Risky and Riskless Positions in Securities*, Taxes, December 1993, at 783 [hereinafter "Kleinbard"], and Alex Raskolnikov, *Contextual Analysis of Tax Ownership*, 85 B.U.L. Rev. 431 (2005) [hereinafter "Raskolnikov"].

4 A colleague says that his grandfather, who ran a scrap yard in the Midwest, would sell scrap metal to lenders, subject to an obligation to repurchase it, in order to raise working capital. This was not referred to as a "repo" in the scrap business, but was a common practice.

5 However, *see infra* re the importance of Code Sec. 265 to early capital markets repo cases.

6 In most contemporary capital market repos, the repo buyer is compensated through a "rebate." Dividends or interest on repoed assets are paid to the repo buyer, and the repo buyer makes equal and opposite dividend—or interest equivalent payments to the repo seller, less a rebate that represents a financing fee. If interest or dividend payments are less than the rebate, the repo seller pays the repo buyer the net rebate.

7 For a detailed discussion of "double dip" transactions in general and their effect on U.S. tax policy, *see* Edward Kleinbard, *Stateless Income*, 11 FLLR 699 (2011). For a discussion of hybrid transactions resulting in double dip benefits, including, *inter alia*, cross-border repos, *see* OECD (2015), *Neutralizing the Effects of Hybrid Mismatch Arrangements Action 2—2015 Final Report*, available online at *www.keepeek.com/Digital-Asset-Management/oecd/taxation/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report_9789264241138-en#.WIpne00o408#page3* [hereinafter "OECD Report"], discussed in more detail *infra*.

8 *E. Torres*, 88 TC 702, Dec. 43,809 (1987).

9 The following discussion is heavily indebted to Kleinbard and Raskolnikov, *supra* note 3.

10 *See*, *e.g.*, *Frank Lyon Co.*, SCt, 78-1 ustc ¶9370, 435 US 561, 573, 98 SCt 1291, quoting *Corliss v. Bowers*, SCt, 2 ustc ¶525, 281 US 376, 50 SCt 336 ("taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid").

11 Raskolnikov says that the distinguishing factor is whether the asset is "fungible" or not. This does not appear to be entirely correct. A fungible asset is an asset, any part of which can be replaced by another equal part of a similar asset. It is possible for fungible assets to be illiquid—for example, interests in certain investment partnerships may be fungible with each other even if they are owned only by a few individuals who hold large blocks thereof. Similarly, contracts in certain commodities may be fungible but illiquid. All liquid assets are fungible, but not all fungible assets are liquid. As discussed in more detail below, the ability to control disposition of a liquid asset is the hallmark of tax ownership thereof because the taxpayer who has that power has the ability to choose the specific asset used to settle a derivative with respect thereto up to the instant of settlement. This ability does not exist in the case of illiquid fungible assets.

12 *See* John Kaufmann, *The Trade Date Rule*, Tax Notes Today (June 2, 2015) ("T]he rules regarding the ownership of liquid, fungible property are counterintuitive because they are an example of the rule of logical proof called *reductio ad absurdum* (RAA). RAA works by assuming a fact and deriving from that assumption an absurdity—that is, a statement that both a proposition and its opposite are true. Because assumption of the fact leads to an absurdity, the negative of the fact is proved (the rule takes as given that an absurdity cannot be the case). For example, if the assumption of P leads to the conclusion Q and -Q, we know that -P is true. In the instant case, we take as given that there can be only one tax owner and that gain = (proceeds—basis). As detailed below in the discussion of short sales and variable prepaid forward contracts (VPFCs), if we were to assume that the tax owner of a liquid, fungible asset were someone other than the party with the power to dispose of a specific share of stock or barrel of oil (for example, a party with long exposure through a swap, or a stock lender), we would have to conclude that more than one party owns the referenced asset. However, because we know that the asset can have only one owner, we know that this rule for determining ownership is insufficient. Although it is tempting to think that any party with economic exposure to a liquid, fungible asset is the owner thereof, we know that is false because using that rule would lead to an absurd result.").

13 Kleinbard, *supra* note 3 ("[I]t is perfectly possible that for one share of stock there will be 21 'longs' and 20 'shorts'").

14 *See*, *e.g.*, *B. Ruml*, 31 BTA 534, Dec. 8771 (1934), *rev'd*, CA-2, 36-1 ustc ¶9221, 83 F2d 257 (taxpayer sold shares short and pledged segregated shares to cover; courts held that covering transaction occurred in year in which taxpayer finally identified and gave up control over pledged shares); *see also*, *Huntington National Bank*, CA-6, 37-2 ustc ¶9323, 90 F2d 876; *D.F. Mott*, 35 BTA 195, Dec. 9537 (1936), *aff'd*, CA-6, 39-1 ustc ¶9477, 103 F2d 1009; *C.R. Dashiell*, CA-7, 39-1 ustc ¶9217, 100 F2d 625.

15 *See* discussion of illiquid repos, *infra*.

16 When securities are transferred to a securities borrower under a securities loan, the securities borrower is required to post collateral. Amounts received as interest on this collateral by the securities lender are paid over to the securities borrower. To the extent that these interest amounts are sufficient to compensate the securities lender for use of the securities, these amounts will be reduced by a rebate, which is retained by the securities lender. If these amounts are not sufficient, the securities borrower will pay a cash "borrow fee" to the securities lender.

17 "Delta" is a concept borrowed from options pricing. The delta of an option is the rate at

which the option's value is expected to change per unit of change in the option's underlier. The value of an instrument with a delta of one will correlate perfectly with the price of the asset which it references.

[18] *G.D. Provost,* SCt, 1 USTC ¶153, 269 US 443, 46 SCt 152.

[19] *Id.*, 269 US, at 455.

[20] *See*, *e.g.,* Rev. Rul. 80-135, 1980-1 CB 18 (lender of municipal bonds not permitted to treat coupon-equivalent payments received from borrower as tax-exempt interest under Code Sec. 103 because beneficial ownership of the bonds transferred pursuant to securities loan); Rev. Rul. 60-177, 1960-1 CB 9 (lender of shares not permitted to treat dividend-equivalent payments received from securities borrower as dividends for purposes of then-current dividends received credit and/or exclusion because beneficial ownership of the shares was transferred pursuant to securities loan); Code Sec. 1058 (certain securities loans granted non-recognition treatment, implying that a securities loan is a transfer that would give rise to taxable gain or loss absent a special non-recognition provision).

[21] *H.S. Richardson*, CA-2, 41-2 USTC ¶9592, 121 F2d 1. Reg. §1.1233-1(a) (similar).

[22] Reg. §1.1233-1(a) (similar).

[23] Kaufmann, *supra* note 12.

[24] Code Sec. 1259 (introduced in the Taxpayer Relief Act of 1997, P.L. 105-34).

[25] *See*, *e.g.,* Rev. Rul. 2002-44, 2002-2 CB 84 (gain on a short sale recognized when covering shares purchased under Code Sec. 1259, but loss not recognized until covering shares delivered). *Note also* that the gain recognition rule in Code Sec. 1259 itself is a tacit admission by Congress that the mere purchase of covering shares does not close out a short position.

[26] Rev. Rul. 2003-7, 2003-1 CB 363; TAM 200604033 (Jan. 27, 2006) (the "2006 TAM"); EMISC 2007-004 (Feb. 2, 2007) (the "2007 Guidance").

[27] Rev. Rul. 2003-7, 2003-1 CB 363.

[28] *See W.W. Cruttenden*, CA-9, 81-1 USTC ¶9440, 644 F2d 1368; *J. Lorch*, 70 TC 674, Dec. 35,336 (1978); *Miami Nat'l Bank*, 67 TC 793, Dec. 34,251 (1977); *H.S. Richardson*, CA-2, 41-2 USTC ¶9592, 121 F2d 1; *K. Hope*, 55 TC 1020, Dec. 30,685 (1973).

[29] 2006 TAM and 2007 Guidance. *See also Anschutz Co.*, CA-10, 2012-1 USTC ¶50,117, 664 F3d 313.

[30] *See*, *e.g.,* 2007 Guidance: "Because the pledge agreement entitles Purchaser to borrow all of the pledged shares, Purchaser has control over the shares, including the unconstrained right to do as it wishes with the shares. Moreover, Purchaser exercises this right by transferring full control over the shares, including the voting and dividend rights, to a third party. Purchaser could not have done this had it not acquired ownership of the shares on the Execution Date. Consequently, the Transaction is not analogous to Rev. Rul. 2003-7."

[31] *See American National Bank of Austin*, DC-TX, 68-2 USTC ¶9662, 296 FSupp 512 , *rev'd* by CA-5, 70-1 USTC ¶9184, 421 F2d 442 and related cases, discussed *infra*. *See also*, Chip, *supra* note 3, for the most complete discussion of this issue.

[32] *See* discussion of *Union Planters Bank of Memphis*, CA-6, 70-1 USTC ¶9372, 426 F2d 115, *infra*.

[33] *See*, *e.g., American National Bank of Austin*, *supra*; *First National Bank in Wichita*, 19 BTA 744, Dec. 6008 (1930) (repo of municipal bonds held to be a collateralized loan. Repoed bonds were never sold to any party other than the repo seller; repo seller had the right to substitute collateral; and repo seller was exposed to the economics of the repoed bonds); GCM 12355, XII-2 CB 100 (1933); *Union Planters National Bank of Memphis*, CA-6, 70-1 USTC ¶9372, 426 F2d 115; *First American National Bank of Nashville*, CA-6, 72-2 USTC ¶9694, 467 F2d 1098; GCM 35036 (Sept. 13, 1972); Rev. Rul. 74-27, 1974-1 CB 24.

[34] *See*, *e.g.*, *American National Bank of Austin*.

[35] *Id.*, CA-5, 70-1 USTC ¶9184, 421 F2d 442.

[36] In older cases, the bank clipped paper coupons as they came due and presented them to the applicable issuer. *See*, *e.g., Bank of California, Nat'l Ass'n*, 30 BTA 556, Dec. 8538 (1934), *rev'd*, CA-9, 35-2 USTC ¶9670, 80 F2d 389.

[37] *Id.*

[38] For example, the trial court in *American National Bank of Austin*, *supra*, held that, since the bank did not have a legally enforceable right to put the bonds to the dealer in case they declined in value, the bank was the beneficial owner of the bonds because the bank was exposed to risk of loss thereon. In reversing, the Fifth Circuit held that even though the bank did not have a legally enforceable put right, its share of the municipal bond market in Texas gave it a *de facto* put right because dealers who did not buy back bonds that had declined in value at a loss risked losing the ability to do business with the bank. In a case of an observer-participant influencing the data, after the American National Bank of Austin lost the case on appeal, it announced to its counterparties that it would withdraw from the municipal bond underwriting business, presumably due to its loss of the Code Sec. 103(a) exemption. Once the repeat-player incentive was removed, six of its counterparties refused to exercise their out-of-the-money call options. Because of this, in a subsequent proceeding, the Court of Claims held that, in fact, the bank had never held a *de facto* put. *American National Bank of Austin*, CtCls, 78-1 USTC ¶9317, 573 F2d 1201, 216 CtCls 92. This seems to have been wrongly decided because the Court of Claims case examined tax years 1965 through 1970, and the bank exited the municipal bond business only in 1970. The *de facto* put should have existed during all tax years in which the bank had a majority share of the Texas municipal bond business.

[39] *American National Bank of Austin*, *supra*.

[40] *Citizens National Bank of Waco*, CtCls, 77-1 USTC ¶9298, 551 F2d 832, 213 CtCls 236.

[41] "The Bank places great emphasis on the fact that it was not required to resell the bonds to Amicable, but could sell them to a third party and keep the profit, if any, due to market value if it desired to do so. The defendant says there was an 'implied' agreement that the Bank could be required to resell the bonds to Amicable. This argument is unpersuasive because there is no evidence to support it. We conclude that the Bank was not required to resell the bonds to Amicable. This is a very important fact in this case. It tends to prove and indicates that the Bank was the owner of the bonds and could keep them to maturity or sell them to Amicable or anyone else. Also, this circumstance shows that the Bank did not advance money to Amicable to carry the bonds." *Id*.

[42] *Id*. *See also*, *Bank of California, N.A.*, 30 BTA 556, Dec. 8538 (1934), *aff'd,* CA-9, 35-2 USTC ¶9670, 80 F2d 389.

[43] *Id*.

[44] Master Repurchase Agreement, 1996 Version (the "MRA"), Section 8, available online at *www.sifma.org/services/standard-forms-and-documentation/mra,-gmra,-msla-and-msftas/*. Note that the MRA also allows the repo seller to substitute new assets for repoed assets, absent agreement to the contrary. *Id.*, Section 9. The right to substitution should be treated as evidence that the repo seller retains tax ownership of the repoed assets because it grants the repo seller the right to control same.

[45] TAM 200207003 (Feb. 15, 2002). As support for this position, the IRS cited *First American National Bank of Austin* and its progeny, as well as earlier guidance regarding capital markets repos. *Id*. The transactions discussed in these authorities may be distinguished from a matched-book repo because, as discussed above, the repo sellers in the applicable transactions retained the right to control disposition and rehypothecation of the repoed assets.

[46] *Nebraska Department of Revenue v. Loewenstein*, SCt, 513 US 123, 115 SCt 557 (1994) ("We do not believe it matters for purposes of § 3124(a) whether the repo is characterized as a sale and subsequent repurchase. A sale-repurchase characterization presumably would make the Trusts the 'owners' of the federal securities. … [b]ut the dispositive question is whether the Trusts earned interest on 'obligations of the United States Government,' not whether the Trusts 'owned' such obligations … The substance and economic realities of the Trusts' repo transactions, as manifested in the specific facts discussed above, are that the Trusts do not receive either coupon interest or discount interest from federal securities by participating in repos. Rather, in economic reality, the Trusts receive interest on cash they have lent to the Seller-Borrower.")

[47] Code Sec. 265(2) (1954); current Code Sec. 265(a)(2).

[48] Rev. Proc. 70-20, 1970-2 CB 499, amplified by Rev. Proc. 78-34, 1978-2 CB 535 and Rev. Proc. 80-55, 1980-2 CB 849, and modified by Rev. Proc. 83-91, 1983-2 CB 618. The guidance was

issued in order to avoid the creation of a chilling effect on investment in municipal bonds by banks, which fund their activities almost exclusively through borrowing. *Id*.

[49] Rev. Proc. 72-18, 1972-1 CB 740, clarified by Rev. Proc. 74-8, 1974-1 CB 419, amplified by Rev. Proc. 80-55, 1980-2 CB 849, and modified by Rev. Proc. 87-53, 1987-2 CB 669.

[50] *Id.*; *see also*, *J.S. Wynn, Jr.,* CA-3, 69-1 USTC ¶9400, 411 F2d 614 (debt secured by pledge of municipal bonds held to be incurred to carry same).

[51] *Union Planters National Bank of Memphis,* CA-6, 70-1 USTC ¶9372, 426 F2d 115.

[52] *Id*.

[53] *National Bank of Waco,* CtCls, 77-1 USTC ¶9298, 551 F2d 832, 213 CtCls 236, discussed *supra*.

[54] *Id*.

[55] *See*, *e.g.,* Rev. Rul. 82-150, 1982 CB 110 (owner of deep in-the-money option to acquire illiquid stock treated as beneficial owner of stock because it was exposed to the "benefits and burdens" of ownership); *Tennessee Natural Gas Lines*, 71 TC 74, Dec. 35,486 (1978) (ownership of illiquid asset deemed to shift between consolidated group members in Year 1, rather than Year 2, despite regulatory contingency, both because contract was amended in Year 1 and because certain other factors indicated that burdens and benefits of ownership had shifted in Year 1); *Comtel Corp.*, 45 TC 294, Dec. 27,663 (1965), *aff'd,* CA-2, 67-1 USTC ¶9433, 376 F2d 791, discussed *infra* note 59. It may be more appropriate to describe economic exposure to illiquid property as evidence of the intent of the parties, rather than as a factor in its own right, because parties to a transaction will always allocate the risks and rewards of equity ownership to the party intended to be the owner in substance.

[56] *See*, *e.g.,* Rev. Rul. 2003-7, 2003-1 CB 363 and cases and guidance discussed in the context of VPFCs, *supra*.

[57] *See*, *e.g., Ruml*, *supra* note 14 (short sale not closed until specific shares to be delivered were identified; absent specific identification, basis could not be calculated).

[58] For example, the IRS stated in Rev. Rul. 2003-7 that the fact that the taxpayer was not economically compelled to deliver the pledged shares in order to settle the contract was a necessary condition for determining that tax ownership did not shift on Day 1. *See also*, *Anschutz Co.*, CA-10, 2012-1 USTC ¶50,117, 664 F3d 313 (contrary holding, due to securities loan of pledged shares; Code Sec. 871(m)(3)(iii) (a notional principal contract that references property that is not readily tradable on an established securities market is a "specified notional principal contract"—presumably because the short party to such a contract would be economically compelled to deliver shares pledged or held as a hedge to settle the contract); and Rev. Rul. 82-150, 1982-2 CB 110 (holder of deep in-the-money call option on a large block of shares of closely held stock treated as the beneficial owner of the shares). This is clearest in the case of physically settled transactions, where the referenced asset must be delivered to settle the contract. However, it is also true in the case of cash-settled contracts on illiquid assets because to the extent that the short party is economically compelled to purchase a specific asset in order to hedge its position, it is certain that the short party will need to liquidate its position in that specific asset in order to raise cash to settle the transaction.

[59] *Comtel Corp.,* 45 TC 294, Dec. 27,663 (1965), *aff'd,* CA-2, 67-1 USTC ¶9433, 376 F2d 791.

[60] *Id*.

[61] *See*, *e.g.*, *Patton v. Jonas*, CA-7, 57-2 USTC ¶10,002, 249 F2d 375; *Rupe Investment Corp*., CA-5, 59-1 USTC ¶9403, 266 F2d 624; *J.R. Green*, CA-7, 66-2 USTC ¶9706, 367 F2d 823.

[62] *Griffin Paper Corp*., 74 TCM 559, Dec. 52,242(M), TC Memo. 1997-409.

[63] *Id*. Although not discussed by the court, the inclusion of 5% of the new entity's undistributed income in the options' strike prices effectively kept economic exposure to 5% of the common shares with Griffin until exercise of the options; to the extent surplus cash was distributed as a dividend prior to option expiration, Griffin had a right to dividends paid on its shares, and to the extent that the majority shareholder blocked distributions prior to exercise, undistributed surplus was included in the strike price.

[64] *Id*. *See also*, *Penn-Dixie Steel Corp*., 69 TC 837, Dec. 35,001 (1972) (joint venture between raw material supplier and steel products manufacturer with built-in exit consisting of a put and a call with the same strike price, including an undistributed profits component, holding similarly on similar grounds). The facts of *Penn-Dixie* differ slightly from those of *Griffin Paper* because the put and the call in *Penn-Dixie* were not contemporaneous; the put expired the day before the call became effective. Additionally, the court in *Penn-Dixie* noted that, since the taxpayer sought to impeach the form of the transaction by treating the transaction as a finished transfer as of Day 1, the taxpayer was required to produce "strong proof" of its position. *See infra* for a discussion of the strong proof doctrine.

[65] *S.F. Kwiat*, 64 TCM 327, Dec. 48,388(M), TC Memo. 1992-433.

[66] *See* note 64, *supra*.

[67] *Id*.

[68] The Tax Court's reasoning in *Penn Dixie* was that, even though the put expired the day before the call became effective, it could be the case that the put would expire out of the money and the buyer would find a better way to deploy its capital during the call period than by exercising its call right. In the case of a liquid asset, this would be very unlikely, but it is more plausible in the case of a large investment in an illiquid business asset.

[69] Courts and the IRS have held similarly in the case of sale-leaseback and repo transactions involving real property. *See*, *e.g., M.A. Blake*, 8 TC 546, Dec. 15,668 (1947); *D. Vickers*, 36 TCM 391, Dec. 34,335(M), TC Memo. 1977-90; Rev. Rul. 72-543, 1972-2 CB 87; Rev. Rul. 83-47, 1983-1 CB In all of these cases, the fact that the repo seller managed the real estate was a factor that indicated that burdens and benefits of ownership remained with the repo seller.

[70] For example, a repo buyer is not prevented by the automatic stay in bankruptcy from liquidating the repoed assets. 11 USC §559—Contractual right to liquidate, terminate, or accelerate a repurchase agreement. However, any excess of proceeds from disposition of repoed assets over repurchase price and expenses is the property of the bankruptcy estate. *Id*.

[71] *C.L. Danielson*, CA-3, 67-1 USTC ¶9423, 378 F2d 771, 774–775.

[72] *See Court Holding Co.*, SCt, 45-1 USTC ¶9215, 324 US 331, 334, 65 SCt 707.

[73] *See*, *e.g.*, *Danielson, supra* note 71; *J. Durkin, Sr., Est.*, 99 TC 561, 571, Dec. 48,644 (1992); *R. Coleman*, 87 TC 178, 202, Dec. 43,193 (1986), *aff'd*, without opinion, 833 F2d 303.

[74] *See J.L. Schmitz*, 51 TC 306, Dec. 29,250, *aff'd* sub nom. *A.H. Throndson*, CA-9, 72-1 USTC ¶9333, 457 F2d 1022; *Harvey Radio Laboratories, Inc.*, CA-1, 73-1 USTC ¶9121, 470 F2d 118.

[75] *Danielson*, *supra*.

[76] *See Coulter Electronics, Inc.*, 59 TCM 350, Dec. 46,518(M),TC Memo. 1990-186, *aff'd*, *unpublished opinion*, 943 F2d 1318; *M. Mittleman*, 56 TC 171, 175, Dec. 30,746 (1971); *J.A. Lardas*, 99 TC 490, 498, Dec. 48,592 (1992); *J.E. Golsen*, 54 TC 742, 757, Dec. 30,049, *aff'd,* CA-10, 71-2 USTC ¶9497, 445 F2d 985, SCt, *cert. denied*, 404 US 940, 92 SCt 284 (1971).

[77] *J.M. Smith*, 82 TC 705, Dec. 41,180 (1984).

[78] *See*, *e.g., Smith*, 82 TC 705, Dec. 41,180 (1984). (Holding that the *Danielson* rule did not apply where an agreement regarding the redemption of shares of in a privately held corporation engaged in the real estate brokerage business was ambiguous. The agreement was ambiguous because the original agreement allocated proceeds between sales proceeds and the payout of certain earnings, while an addendum to the contract allocated all of the proceeds to sales proceeds. Inconsistency between the documents themselves was held to constitute ambiguity.)

[79] *See*, *e.g., J.V. Elrod*, 87 TC 1046, Dec. 43,486 (1986) (transaction held to be an installment sale of land plus issuance of a non-recourse purchase-issue note rather than an option, even though documented as an option, because the economic substance of the transaction was inconsistent with option characterization); *Coulter Electronics, Inc.,* 59 TCM 350, Dec. 46,518(M), TC Memo. 1990-186 (neither *Danielson* nor strong proof doctrine prevented taxpayer from characterizing transfer of equipment leases to lender as a secured loan even though the transfer was documented as a "sale" because the transaction was ambiguous, *i.e.,* the economic substance and dealing of the parties was inconsistent with loan treat-

ment); GCM 35036 (Sept. 13, 1972) (similar, re capital markets repo). By contrast, in ordinary parlance, "ambiguous" means "unclear," or "susceptible to more than one meaning." For example, the first definition given by Dictionary.com to the word is "open to or having several possible meanings or interpretations; equivocal." Following this definition, a contract whose terms are clear and internally consistent is not "ambiguous" even if it is inconsistent with the economic reality of the transaction which it memorializes.

[80] GCM 35036, *id.,* at 79.

[81] *Id*. *See also* discussion of capital markets repos, *supra*.

[82] *See*, *e.g.*, *Danielson*, *supra*; *See also*, *B.D. Spector*, CA-5, 81-1 USTC ¶9308, 641 F2d 376; *Harvey Radio Laboratories, Inc.,* CA-1, 73-1 USTC ¶9121, 470 F2d 118.

[83] *See, e.g., Comdisco, Inc.*, CA-7, 85-1 USTC ¶9245, 756 F2d 569. *See also Smith* and *Coulter Electronics*, *supra*. A fourth, not-often articulated reason for the *Danielson* and strong proof doctrines echoes the old definition of chutzpah: a taxpayer who shoots her parents has no standing to throw herself upon the mercy of the court by claiming that she is an orphan. *See also*, OECD Report (requiring scrutiny of repos treated inconsistently under the laws of the jurisdictions in which the repo buyer and the repo seller of a transaction are resident).

[84] *See* discussion of tax ownership, *supra*.

[85] *See*, *e.g., Nebraska Department of Revenue v. Loewenstein*, SCt, 513 US 123, 115 SCt 557 (1994), *supra* ("[T]he dispositive question is whether the Trusts earned interest on 'obligations of the United States Government,' not whether the Trusts 'owned' such obligations."); *see also*, TAM 200207003 (Feb. 15, 2002) (Repo seller in "matched book" repo treated as secured lender for purposes of interest allocation and apportionment under Code Sec. 864(e), even though repo buyer had, and exercised, the right to rehypothecate).

[86] *See National Bank of Waco*, CtCls, 77-1 USTC ¶9298, 551 F2d 832, 213 CtCls 236, discussing *American National Bank of Austin*, 421 F2d—discussed *supra*.

[87] *See* discussion of capital markets repos—anti abuse, *supra*.

[88] *See* discussion of bridge loan repos, *supra*.

[89] *See* discussion of joint venture repos, *supra*.

[90] *See*, *e.g.*, *E.F. Gregory v. Helvering,* CA-2, 1934 CCH ¶9180, 69 F2d 809, 810 ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes").

[91] In the table, benefits to the two private parties are broken down into "cash" benefits and "tax" benefits. For these purposes, a "cash" benefit is a before-tax payment or receipt of money, and a "tax" benefit is the economic value produced by the tax consequences of a cash payment. For example, if a taxpayer receives a $10 tax payment, which is subject to a 35% income tax, cash benefits will be $10, and tax benefits will be $(3.50). By contrast, if a taxpayer makes a $10 tax payment which can be deducted from taxable income, this will produce a cash benefit of $(10), and a tax benefit of $3.50.

[92] For purposes of this example, assume that the Repo Seller held the repoed shares "naked" for 91 days prior to entry into the repo. This would satisfy the holding period requirement of Code Sec. 246(c)(2).

[93] There could be a risk that the U.S. government would attack the availability of the dividends received deduction. Code Sec. 246(c)(2) disallows a dividends received deduction under Code Sec. 243 to a taxpayer, to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make payments with respect to positions in substantially similar or related property. *See also*, Reg. §1.246-3(a)(2). The reference to short sales in both the code and the regulations makes clear that dividend-equivalent payments under a stock loan constitute payments with respect to positions in substantially similar or related property; it is likely that payments made on a short position in, say, a dividend swap or a total return swap that references shares held by a taxpayer would also fall within the rule. However, to the extent that a repo is truly respected as a secured loan, deemed interest payments should be treated as interest payments, rather than as dividend-equivalent payments made with respect to stock owned by the repo seller. Of course, this position assumes the conclusion; in order for these payments to qualify for the dividends received deduction, the repo needs to be characterized as a loan. If the transaction were treated as a disposition, rather than as a loan, the Repo Buyer would be deemed to receive the dividend directly, as though it were a stock borrower. The position that the transaction is a loan would be strengthened if the Repo Seller guaranteed payments of the dividends.

[94] *See*, *e.g.*, *Coulter Electronics, Inc.*, 59 TCM 350, Dec. 46,518(M), TC Memo. 1990-186; GCM 35036 (1972), discussed *supra*.

[95] *Id*.

[96] *Id.* (citations omitted).

[97] For example, the repo buyer might be required to have the right to sell or rehypothecate the repoed assets in order to be treated as the beneficial owner thereof under local law. Payments made to the repo buyer may have to be labeled "dividends" paid out of earned surplus for the repo buyer to get a participation exemption. The repo seller would almost certainly be prohibited from providing disclosure or financial covenants.

[98] The issue of the significance of the names of Otto's two mentors will be the subject of a later article.