

## **IRS Issues Sourcing Rules for “Fails Charges” That Impact the Application of U.S. Withholding Tax Rules**

**December 8, 2010**

On December 7, the Internal Revenue Service (IRS) issued new temporary regulations providing sourcing rules for “fails charges” that may arise in the delivery-versus-payment market for Treasury securities. The new sourcing provisions impact whether U.S. withholding taxes are applicable to such payments since U.S. withholding tax is typically limited to U.S.-sourced payments. The new regulations at Temp. Treas. Reg. § 1.863-10T generally source fails charge payments by reference to the residence of the recipient of any such payment. The new regulations are effective with respect to “qualified fails charges” that are paid or accrued on or after December 8, 2010.

The new regulations are a follow-up to IRS Notice 2009-61, which announced that the IRS would not challenge taxpayer positions that a fails charge paid on or before December 31, 2010 is not subject to U.S. withholding tax. Notice 2009-61 further stated that the U.S. Treasury Department and the IRS were considering prospective guidance addressing when a fails charge would constitute a U.S.-sourced payment, and thus trigger a U.S. withholding tax.

The new temporary regulations generally provide that the source of income from a qualified fails charge is generally determined by the residence of the recipient of such payment. Thus, if the recipient is a non-U.S. taxpayer, then the payment should be characterized as foreign source income that is not subject to U.S. withholding tax. The regulations introduce two exceptions to this general residency-based sourcing provision: (1) a qualified fails charge earned by a qualified business unit (QBU) of a taxpayer is sourced by reference to the country in which the QBU is engaged in a trade or business and (2) a qualified fails charge that arises from a transaction that is effectively connected to a U.S. trade or business will be sourced to the United States and characterized as income that is effectively connected to the conduct of a U.S. trade or business.

The new temporary regulations are expressly limited in their application to “qualified fails charges.” In order for a payment to constitute a “qualified fails charge,” two requirements must be satisfied pursuant to Temp. Treas. Reg. § 1.863-10T(d)(1): (1) the payment must be made pursuant to a trading practice or similar guidance approved by a U.S. Government agency or the Treasury Market Practices Group (sponsored by the Federal Reserve Bank of New York), or published in separate guidance from the IRS; and (2) the transaction that generates the fails charge must be with respect to a bill, note, or other evidence of indebtedness issued by the U.S. Treasury Department.

According to the preamble to the new temporary regulations, the provisions of Temp. Treas. Reg. § 1.863-10T are limited in application solely to qualified fails charges. The regulations do not address

the source of any other type of damages payment, including a fails charge that is not a qualified fails charge.

Although the provisions of Temp. Treas. Reg. § 1.863-10T are limited in their application to fails charges, the residency-based sourcing rules provide a solid basis for analogizing the sourcing for similar payments. For instance, a stronger case can now be made that borrowing fees that arise in securities loans should also be sourced by reference to the residency of the recipient.

The new temporary regulations are a welcome clarification concerning the application of the U.S. sourcing and withholding tax provisions with respect to fails charges. Prior to the release of these regulations, there was concern that the government would apply a rent-based analogy, which would have required a determination of where the securities were located or used.

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