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In this report, Shulman examines the tax treatment of loans of fungible property, with a focus on the tax consequences of lending cryptocurrency and other digital assets.

I. Introduction

Securities loans are financial transactions critical to the operation of efficient trading markets. Although these transactions predate the existence of the federal income tax,[1] there are still many important unanswered questions regarding their tax treatment. Further, loans of fungible property other than securities (for example, digital assets or master limited partnership (MLP) units)[2] are occurring with greater frequency — without even the most basic of guidance on their tax treatment. This makes it worthwhile to reexamine the state of the law concerning the appropriate tax treatment of securities loans as well as the extent to which that treatment should extend to loans of non-securities property (which this report refers to as NSP).

One of the conceptual challenges regarding the tax treatment of securities loans stems from the fact that the securities borrower ordinarily transfers the securities to another person, either in a market sale or to repay a prior securities loan. That transferee becomes the tax owner of the borrowed securities. Indeed, the transferee generally is unaware that the securities it acquired were from a securities borrower (as opposed to the original owner of the securities). Because the securities have a new tax owner, the lender can no longer be their tax owner, even though it typically maintains an economic position in the securities that is substantially identical to the position it had before initiating the loan. The fact that tax ownership has been severed while economic exposure continues gives rise to numerous tax issues.

Some of those issues are addressed under current law. Most notably, section 1058 generally provides for nonrecognition treatment when securities are lent to a securities borrower (and when they are returned to the securities lender) if the agreement satisfies specified requirements. As described below, however, the application of section 1058 may be unclear in the context of some types of securities loans (for example, loans with a

[1] Technical Committee of the International Organization of Securities Commissions and Committee on Payment and Settlement Systems, "Securities Lending Transactions: Market Development and Implications" (July 1999) ("Securities lending has existed since at least the 19th century.").

[2] This report focuses principally on the tax treatment of loans of securities and digital assets. The tax treatment of loans of MLP units (including the treatment of substitute payments made with respect to those units) generally is not addressed in this report except when that treatment is co-extensive with digital asset loans (*e.g.*, whether a loan of MLP units triggers gain or loss to the lender).

fixed term). The fact that regulations were proposed under section 1058 over 37 years ago and have yet to be finalized has not helped bring clarity to the treatment of securities loans. Moreover, section 1058 by its terms applies only to the lender of securities, and generally only in determining whether the lender recognizes gain or loss.

As a result, there are several aspects of the tax treatment of securities loans (such as the source of securities lending fees) that have remained stubbornly unclear over the years.[3] Further, the existing authorities on the tax treatment of securities loans, including section 1058, do not directly address the treatment of NSP loans. Most importantly, section 1058 applies only to "securities" (which are defined to include only debt instruments and corporate stock) and thus does not speak to whether the lender of NSP recognizes gain or loss upon making an NSP loan. As will be discussed, the law as it existed before the enactment of section 1058 generally supports treatment of NSP loans (or at least those that conform to the requirements of section 1058) as not giving rise to realization events, because the lender is treated as receiving property in exchange for NSP that is not materially different (within the meaning of section 1001) from the NSP lent under that agreement.

II. The Pre-Section 1058 Landscape

The government's analysis of the tax treatment of securities lending transactions before the enactment of section 1058 in 1978 reached a consistent result (albeit through inconsistent rationales): Securities lending transactions did not trigger the recognition of gain or loss by the securities lender. Put differently, even without the presence of section 1058, the government maintained in guidance over several decades that the lending of securities was not an event that triggered embedded gain or loss in the securities; it just did not settle on a unified rationale for why nonrecognition treatment applied. Because the tax authorities addressing the treatment of securities loans before the enactment of section 1058 potentially have continuing relevance for property loans not addressed by section 1058 (for example, loans of digital assets, commodities,[4] and MLP units), an overview of those authorities is set forth below.

The first authority directly addressing the tax treatment of securities lending transactions was a 1925 solicitor's memorandum that considered the appropriate tax treatment of substitute dividends received under a securities loan.[5] Under the facts considered in the memorandum, C borrowed 100 shares of stock held by A. C then sold those borrowed shares to D. In each case, A, C, and D acted through their own respective brokers. A dividend was declared on the underlying shares before C had repaid his securities loan from A and while D was still the owner of the shares he purchased from C. The memorandum first noted that while A and D are both credited by their brokers with the amount of the dividend, there is only one actual dividend that can be reported. Citing the lower court decision in *Provost*[6] (which was later upheld by the Supreme Court, as discussed below), the IRS stated that ownership of the lent securities transferred to D, and therefore D was the only dividend recipient entitled to a dividends received deduction. The dividend equivalent credited to A's account was income to A but was not treated as a dividend.[7]

In 1926 the Supreme Court in *Provost* addressed whether the lending of stock and its subsequent return were transfers to which a transfer tax applied.[8] At that time, a 2-cent-per-share transfer tax was imposed on "all sales or

[3] Although some issues concerning the borrower in a property-lending transaction are discussed herein, this report is principally focused on the tax consequences to the lender side of a property-lending transaction.

[4] The most common manner for commodities to be lent is for a taxpayer that owns a security that is an interest in a grantor trust that owns commodities to lend that security. For example, SPDR Gold Shares (GLD) represent beneficial ownership of gold bullion held by the SPDR Gold Trust. Because the lending of GLD should be treated for tax purposes as a loan of gold bullion, it is ineligible for the benefits of section 1058 because GLD is not treated as a security under section 1236(c).

[5] S.M. 4281, IV-2 C.B. 187 (1925).

[6] *Provost v. United States*, 60 Ct. Cl. 49 (1924), *aff'd*, 269 U.S. 443 (1926).

[7] Because securities are fungible with one another, the memorandum observed that it is likely impossible for A to know whether it was his stock specifically, rather than the stock of another client of the same broker, that was lent to C and sold to D. In light of the difficulties of tracing the use of specific shares, the IRS stated that it "would seem expedient" to permit A to treat the amount credited to him as an actual dividend when it is not known that the broker had lent his stock.

[8] *Provost*, 269 U.S. 443.

agreements to sell . . . or transfers of legal title to shares or certificates of stock." The Court concluded that the securities lender in that case had transferred ownership of the securities, even though it was contractually entitled to receive all the economic benefits and burdens of the securities as if they had not been transferred.[9] Describing the position of the lender, the Court determined that the lender substituted its ownership of the stock for a personal obligation of the borrower to restore the lender to its prior economic position. However, because the Court was concerned only with determining whether there was a transfer for purposes of the stamp tax, it did not discuss whether the transfers resulted in the recognition of taxable gain or loss to the lender.[10]

In a 1948 letter to the New York Stock Exchange,[11] the IRS for the first time explicitly concluded that no gain or loss is recognized by a taxpayer upon the lending of its stock. The ruling addressed whether a client's loan of stock to a broker and the broker's return of that stock to the lender constitutes a closed transaction to the lender, such that the lender recognizes gain or loss on the lent stock. The ruling made clear the importance of providing clarity to taxpayers on this issue, noting that "the reluctance of security owners to lend their stock is in some measure traceable to a belief that the loaning of the stock would result in a realization of gain or loss on the Shares loaned." The letter concluded: "It is held that the loan of stock and the return thereof to the lender . . . is not a disposition of property which results in recognized gain or loss for Federal income tax purposes; and that such a transaction does not affect the lender's basis for the purposes of determining gain or loss upon the sale or the disposition of the stock, nor the holding period of the stock in the hands of the lender." However, the letter provides no analysis of why this conclusion is warranted. Further, as discussed below, its conclusion that a securities loan does not effect a disposition of the loaned securities is clearly wrong, in the sense that the securities lender cannot be treated as owning the lent shares once ownership of those shares has been vested in another party.

In Rev. Rul. 57-451, 1957-2 C.B. 295, the IRS considered the tax treatment of a taxpayer who deposits shares with a broker and authorizes the broker to lend those shares to its customers in the ordinary course of its business. However, the ruling was confined to the situation of a brokerage customer who acquired his shares pursuant to the exercise of a qualified stock option under section 421 (the predecessor of section 424). Under that provision, a taxpayer's acquisition of shares pursuant to the exercise of a qualified stock option is not taxable if he does not engage in a "disposition" (within the meaning of prior section 421(d)(4)) of the acquired shares within a prescribed period. Thus, the question faced in the ruling was not whether the lending of securities by their owner generally constitutes a realization event to the lender under section 1001. Rather, the ruling addressed only whether such a loan constitutes a disposition as defined in section 421(d)(4). Because that provision defined disposition in a manner independent of normal realization principles, it is worth examining the language of section 421(d)(4) in some detail before returning to the ruling.

Under section 421(d)(4), the question whether a disposition had occurred melded concepts traditionally associated with realization under section 1001 with other concepts that are not. Specifically, section 421(d)(4) began by stating that generally "the term 'disposition' includes a sale, exchange, gift, or transfer of legal title." However, it excepted from the definition of disposition (1) transfers from a decedent to an estate or by bequest or inheritance; (2) exchanges to which section 354, 255, 256, or 1036 (or so much of section 1031 as relates to section 1036) applies; (3) pledges and hypothecations; and (4) acquisitions of stock by joint tenancy or transfers into the joint ownership (but not terminations of that ownership).

[9] *Id.* at 455.

[10] Interestingly, the subsequent authorities that cite and discuss *Provost*, including court decisions and the IRS's published guidance, appear to rely on the case more for its description of a standard share loan than for its legal analysis. This is not altogether surprising in that the federal stamp tax was not *in pari materia* with the federal income tax. *Cf. Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812, 814-815 (2d Cir. 1947) ("The income tax provisions are not to be construed as though they were *in pari materia* with either the estate tax law or the gift tax statutes.").

[11] Reprinted in 5 CCH 1948 *Stand. Fed. Tax Rep.* P6136.

The ruling first concluded that legal title had transferred, thus bringing the transaction within the general definition of disposition, noting:

> All of the incidents of ownership in the stock and not mere legal title, pass to the "borrowing" customer from the "lending" broker. For such incidents of ownership, the "lending" broker has substituted the personal obligation, wholly contractual, of the "borrowing" customer 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. See *Provost v. United States*, 269, U.S. 443, T.D. 3811, C.B. V-1, 417 (1926). Since the "lending" broker is not acting as the agent of the optionee in such a transaction, he must have necessarily obtained from the optionee all of the incidents of ownership in the stock which he passes to his 'borrowing' customer.

In other words, unless an exception applied, the securities loan would have constituted a disposition.

Rev. Rul. 57-451 nevertheless found that no gain was triggered under section 421 because the transfer of the shares and the ultimate return of those shares constituted a tax-free transaction under section 1036, which provides that no gain or loss is recognized upon the exchange of common stock in a corporation solely for common stock in the same corporation. Thus, the ruling concluded that the transfer of title was not considered a disposition for purposes of section 421. Notably, the ruling makes clear that the lending of shares and the subsequent return of those shares can constitute an exchange eligible for tax-free treatment under section 1036, despite the lapse of time between the two transfers.[12]

While it is true that Rev. Rul. 57-451 concludes that a lending and subsequent redelivery of shares qualifies for tax-free treatment under section 1036, it does not address whether such a loan would otherwise give rise to a realization event under section 1001. The failure to mention section 1001 is not surprising because the peculiar structure of section 421 did not require the IRS to follow the traditional sequence of first asking whether a realization had occurred under section 1001 and, only if realization had occurred, inquiring whether a nonrecognition provision applied. Because section 1036 was incorporated into the question whether a disposition occurred under section 421, there was no need to address whether a disposition had occurred for purposes of section 1001. Moreover, if no specific nonrecognition rule or other exception applied, the standard for triggering gain (that is, for determining whether a disposition as defined under section 421 occurred) was whether there was a transfer of legal title — a lower standard than that under section 1001. Unfortunately, the fact that the ruling focused on section 1036 without discussing the particular structure of section 421 may have led some practitioners to believe that section 1036 was the sole and exclusive means for a securities lender to avoid the recognition of gain or loss on the initiation of a securities loan.

The final authority on the treatment of securities loans before the enactment of section 1058 was GCM 36948, issued in December 1976, which analyzed a proposed revenue ruling addressing some aspects of securities loans made by tax-exempt organizations. First, the IRS reaffirmed the government's prior guidance concluding that a securities lending transaction generally results in a disposition of the securities. Next, the general counsel memorandum noted that some public "misunderstanding" of the government's position may have resulted from the 1948 NYSE letter, and it states that that letter's conclusion that a securities loan does not constitute a disposition is "legally unsupportable."

Having determined that securities loans constitute dispositions of the transferred securities, GCM 36948 next analyzed whether those dispositions are taxable to the lender. The IRS observed that the tax treatment of the disposition depends, at least in part, on what the securities lender was treated as receiving in exchange for lent securities. Consistent with the analysis in Rev. Rul. 57-451, the general counsel

[12] In this regard, the ruling states: "A simultaneous delivery of property is not essential to an exchange. If the parties so intend, title to property delivered on one side may pass even though the contract remains executory on the other side."

memorandum concluded that the lent securities were exchanged for the securities ultimately returned to the lender:

> Although exchanges often take the form of simultaneous transfers, recognition of a transaction as an exchange depends on its substance. . . . Since the "loan" and the replacement are reciprocal and mutually dependent transactions, they are a single event, namely, an exchange. The essence of the event is that a party transfers stock to another and receives stock in return. Accordingly, the status of this transaction as an exchange, rather than a sale and a subsequent purchase, is not diminished by the fact that there is an interim period of some duration after the trustee makes the transfer in which the trust holds only the borrower's promise to transfer like securities in satisfaction of its obligation.

Like Rev. Rul. 57-451, GCM 36948 confirmed that section 1036 may apply to the exchange reflected in a loan of stock and a return of that stock. Nevertheless, it clarified that qualification under section 1036 would in most securities loans be unnecessary:

> In the typical case where the broker-dealer satisfies his contractual obligation by delivering securities not differing materially in either kind or extent, there will be no realization of gain or loss under Code section 1001 because of Treas. Reg. section 1.1001-1(a). As such, the question of recognition of gain or loss is not reached under Code section 1002. Accordingly, the exchange will be nontaxable since there is no gain which could be taxed in any event, thus obviating the need to apply a specific statutory provision such as Code section 1036 so as to afford nonrecognition treatment for gain or loss realized.

In other words, the memorandum concluded that as long as the securities returned to the lender were not materially different from the securities it transferred, there would be no realization event for the lender under reg. section 1.1001-1(a).

What conclusions can we draw from the securities lending authorities that predate section 1058? Most importantly, those authorities consistently provided that the lender was not taxable on its transfer of the lent securities or its receipt of replacement securities.[13] Equally interesting, however, is the conceptual path taken by the most recent pre-enactment authorities addressing securities loans (Rev. Rul. 57-451 and GCM 36948), which viewed a securities lending transaction as an exchange of the lent securities for the returned securities (the deferred exchange approach). Implicit in the deferred exchange approach, and as discussed in detail in Section V.A.2 below, is the notion that an exchange of property need not be simultaneous. This view is supported by existing law — particularly authorities under section 1031. One critical aspect of using the deferred exchange approach is that the property treated as received in the exchange is the same property that was lent, which definitionally should not differ materially except in unusual cases:

1. If simultaneity were a necessary component of an exchange, a securities loan would be more likely to be treated as an exchange of the loaned securities for both (1) the right to a return of the securities and (2) the right to substitute payments until the securities are returned (the simultaneous exchange approach). If the simultaneous exchange approach were applied, one would need to determine whether the right to a return of the securities (and the substitute payments due from the borrower) were materially different from the lent securities. As described below, the legislative history of the enactment of section 1058 appears to be more consistent with the simultaneous exchange approach than the deferred exchange approach.
2. Before turning to the enactment of section 1058, it is worth addressing the extent to which the tax policy of encouraging (or at least not discouraging) securities loans played a role in these authorities (as well as the enactment of section 1058). The role

[13] For a contrary view, see Lee A. Sheppard, "The Fashion in Cryptocurrency Taxation," *Tax Notes Federal*, Mar. 29, 2021, p. 1969 (stating that "a securities loan would be a recognition event but for a statute saying it isn't, which provides a generous safe harbor, requiring only qualified loan documentation (section 1058)").

that tax policy, rather than substantive tax law, played in these developments could inform whether those authorities may apply with equal force to NSP loans (especially if one concluded that the tax policy for enabling NSP loans were less compelling than existed for encouraging securities loans). The critical point is that although some of those authorities alluded to the need to provide certainty to the market, the authorities (and in particular Rev. Rul. 57-451 and GCM 36948) ultimately based their analysis on strong technical footing that did not need to rely on tax policy objectives. Similarly, as described below, section 1058 alluded to the importance of securities loans to market liquidity, but it did so in describing why it was important to *clarify* the matter.

III. Section 1058

A. Enactment and Legislative History

Section 1058 was added to the code in 1978 by P.L. 95-345 (the 1978 act). The 1978 act addressed several aspects of securities lending (including some consequences to tax-exempt organizations from engaging in securities lending transactions). Section 1058 provides for nonrecognition treatment for a transfer of securities if made under an agreement satisfying the requirements specified in that section. It is effective for securities transfers occurring after December 31, 1976.

Although brief, the legislative history of the enactment of section 1058 provides useful insight into congressional intent behind the provision. First, the legislative history makes clear that Congress's purpose was to eliminate uncertainty about the tax treatment of securities lending transactions. The Senate report notes that "uncertainty has developed as to the correct income tax treatment of certain securities lending transactions. As a result, some owners of securities are reluctant to enter into such transactions."[14] It is clear that Congress viewed liquidity in the securities lending markets as an important objective and that it enacted section 1058, at least in part, to further that objective by removing existing uncertainty.[15]

The Senate report goes on to state that the IRS "has not disputed the position that a securities lending transaction does not constitute a taxable disposition of the loaned securities."[16] After citing the IRS's conclusions in the 1948 NYSE letter and Rev. Rul. 57-451, the report notes: "Recently, however, the Internal Revenue Service has declined to issue rulings as to whether a securities lending transaction constitutes a sale or exchange."[17] Although that language does not explicitly provide that those securities loans were tax free under pre-enactment law, it appears that the reason for enactment was uncertainty caused by the IRS's unwillingness to provide rulings on that treatment.

Second, the legislative history makes clear that the "materially different" standard in reg. section 1.1001-1(a) should be the appropriate benchmark for finding a securities loan to be taxable: "In order to assure that the contractual obligation does not differ materially either in kind or in extent from the securities exchanged, the committee amendment makes the provision applicable only if the contractual obligation satisfies certain specified conditions." This approach appears to be far more consistent with the analysis in GCM 36948, which relied on reg. section 1.1001-1(a) for nonrealization treatment rather than depending on section 1036 principles for nonrecognition treatment, as in Rev. Rul. 57-451.

It is worth noting that because the legislative history looks to whether the "contractual obligation" differs materially from the securities exchanged, Congress appears to have approached applying section 1001 principles to securities loans by using the simultaneous exchange approach rather than the deferred exchange

[14] S. Rep. No. 95-762, at 7 (1978).

[15] *See Samueli v. Commissioner*, 661 F.3d 399, 402 (9th Cir. 2011), *aff'g* 132 T.C. 37 (2009) ("In 1978, Congress sought to clear up this confusion by enacting section 1058, which provides that securities lending transactions will not be treated as taxable dispositions."); and New York State Bar Association Tax Section, "Report on the Taxation of Securities Loans and the Operation of Section 1058" (June 9, 2011) ("In other words, Congress' clear intention was to remove all perceived tax obstacles to the normal functioning of the securities lending market.").

[16] S. Rep. No. 95-762, at 359.

[17] *Id.*

approach.[18] Nevertheless, its language suggests that Congress believed that when a securities loan complies with the requirements of section 1058, the lender's contractual right to a return of the lent securities should not be viewed as materially different from the securities themselves.

B. Proposed Regulations

On July 26, 1983, Treasury and the IRS issued proposed regulations under section 1058.[19] Although they were proposed to be effective on January 1, 1977, and to apply to transfers of securities under agreements described in section 1058 occurring after December 31, 1976, they have not yet been finalized. As discussed below, although the proposed regulations have no legal force until they are finalized,[20] taxpayers are at risk that they will be finalized in their current form (effectively making them apply retroactively). Nevertheless, given that more than 37 years have elapsed since their issuance, it would be surprising if the regulations were finalized in their current form with the original effective date.

C. Nonrecognition Rule

Section 1058(a) provides that when securities (as defined in section 1236(c)) are transferred under an agreement satisfying the requirements of section 1058(b), no gain or loss is recognized on either (1) the exchange of the securities by the taxpayer for an obligation under the agreement, or (2) the exchange of rights under that agreement by the taxpayer for securities identical to the securities transferred by the taxpayer. An agreement meets the requirements of section 1058(b) (that is, there is a qualifying securities loan) only if the agreement:

1. provides for the return to the transferor of securities identical to the securities transferred;
2. requires that payments shall be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period beginning with the transfer of the securities by the transferor and ending with the transfer of identical securities back to the transferor;
3. does not reduce the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred; and
4. meets such other requirements as the Secretary may by regulation prescribe.

Although the proposed regulations do not prescribe any additional requirements, they do add to the understanding of the first and third of the requirements (as described below). Further, unlike the statutory provision, the proposed regulations require that an agreement be in writing in order to satisfy the requirements of section 1058(b).[21]

1. Requirement to return identical securities.

Section 1058(b)(1) requires a qualifying securities loan to provide that the borrower will return securities identical to the securities transferred. For this purpose, the term "security" has the meaning set forth in section 1236(c), which includes only "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." This is critical to the operation of section 1058 because it means that loans of NSP, such as MLP units, commodities, and digital assets, cannot qualify for nonrecognition treatment under section 1058 even if undertaken in accordance with agreements otherwise satisfying the statute's requirements.

[18] *See also* Edward D. Kleinbard, "Risky and Riskless Positions in Securities," 71 *Taxes* 783, 792 (1993) ("For tax purposes, however, Section 1058 squarely provides that a securities loan (at least for purposes of gain recognition) is a contract separate and apart from the underlying securities, and that a securities lender is treated as exchanging its security for that contract, and then, when the loan is concluded, re-exchanging the contract for an identical security, in each case in a tax-free exchange.").

[19] FI-182-78, 48 F.R. 33912 (July 26, 1983).

[20] *General Dynamics Corp. v. Commissioner*, 108 T.C. 107, 120 ("proposed regulations and revenue rulings are generally not afforded any more weight than that of a position advanced by the Commissioner on brief"); *LeCroy Research Systems Corp. v. Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984) ("proposed regulations are suggestions made for comment; they modify nothing").

[21] Prop. reg. section 1.1058-1(b).

Securities are identical for purposes of the return requirement only if they are of the same class and issue as the lent securities.[22] However, the requirement to return identical securities will be treated as satisfied if the securities lending agreement allows the borrower to return equivalent securities in the event of reorganization, recapitalization, or merger of the underlying issuer of the securities.[23]

2. Requirement that agreement not reduce risk of loss or opportunity for gain.

Section 1058(b)(3) requires that the agreement not reduce the lender's risk of loss or opportunity for gain on the lent securities. As described below, this requirement typically presents the greatest obstacle to tax-free treatment under section 1058.

a. Requirement that lender may terminate the loan on short notice.

i. The proposed regulations.

The proposed regulations first restate the requirement in section 1058(b)(3) that the agreement not reduce the securities lender's risk of loss or opportunity for gain. But they then provide: "Accordingly, the agreement must provide that the lender may terminate the loan upon notice of not more than 5 business days."[24] In other words, although section 1058 provides specific authority for regulations to add requirements that a qualifying securities lending must satisfy, the proposed regulations appear to instead interpret the requirement that the agreement not reduce the lender's risk of loss or opportunity for gain as including the lender's right to terminate the loan on five business days' notice (the five-day rule). The inclusion of the five-day rule in the proposed regulations has been criticized as unnecessary to ensure that the lender not reduce its risk of loss or opportunity for gain.[25] Although the proposed regulations were never finalized, which likely led many taxpayers to believe that the five-day rule was not operative and would not be viewed as part of the statutory requirements, the Tax Court's 2009 decision in *Samueli*[26] breathed new life into the rule (or at least a requirement that the lender have the ability to demand a return of lent securities on short notice), for the reasons discussed immediately below.

ii. **Samueli.**

The taxpayers in *Samueli* entered into a structured transaction in an apparent attempt to convert ordinary income into long-term capital gain. At inception, the transaction consisted of the following steps:

- the taxpayers borrowed cash from Refco Securities LLC under a margin loan;
- the taxpayers used the borrowed cash to buy from Refco Principal STRIPS[27] issued by Freddie Mac;
- the taxpayers lent Refco the STRIPS that they had just purchased from Refco under a securities loan that, unlike a typical securities loan, allowed the taxpayers to demand a recall of the STRIPS on only two days during the 15-month term of the loan;
- Refco transferred to the taxpayers cash collateral equal to the fair market value of the STRIPS it had been lent by the taxpayers; and
- the taxpayers used the cash collateral to repay the initial loan from Refco.

Once these steps were completed, the taxpayers were left with (1) the right to a return of the STRIPS they had lent to Refco and (2) the obligation to return the cash collateral to Refco and to pay a variable rate of interest to Refco for the use of that cash collateral. If the transaction

[22] Prop. reg. section 1.1058-1(b)(1).

[23] *Id.* Although not stated, securities should be "equivalent" to the lent securities for this purpose if they are the amount and type of securities that the lender would have received in connection with the relevant corporate action had it not lent the securities to the borrower.

[24] Prop. reg. section 1.1058-1(b)(3).

[25] *See, e.g.*, American Bar Association Section of Taxation, "Comments on Proposed Regulations Under Sections 1058 and 1223" (Jan. 20, 1984) (recommending that "the regulations be revised to eliminate the requirement that to qualify under section 1058 an agreement must contain the requirement that securities be returned to the lender on 5 business days' notice"); and Securities Industry Association comment letter (Oct. 10, 1983) ("We believe the five-day call provision of the proposed regulations is irrelevant to a determination of whether or not a loan reduces the lender's risk of loss or opportunity for gain.").

[26] *Samueli*, 132 T.C. 37.

[27] Principal STRIPS are securities that entitle the holder to the principal-only cash flows from a pool of mortgages.

was respected, the taxpayers would be entitled to deduct the interest they paid to Refco for their use of the cash collateral. However, because the taxpayers did not own the STRIPS and instead merely had the right to a return of the STRIPS, they took the position that they were not required to include the original issue discount that an owner of the STRIPS would have been required to include. Instead, the taxpayers would take a basis in the STRIPS (or the right to return of the STRIPS) equal to their original purchase price and thus would recognize long-term capital gain upon their ultimate disposition. Upon completion of the securities loan, instead of returning the STRIPS, Refco simply paid the taxpayers the difference between the value of the lent STRIPS at that time and the amount of the cash collateral and the unpaid interest thereon then owed by taxpayers to Refco.

The Tax Court surprisingly framed the case as resting on whether the purported securities loan qualified for the treatment set forth in section 1058. Section 1058 was not directly relevant because it does not identify when a transaction is in substance a securities loan. Rather, it simply provides that no gain or loss is recognized when securities are transferred under an agreement meeting specified requirements. A transaction that has the substance of a securities loan but fails to meet all the requirements of section 1058 should not fail to have the substance of a securities loan merely because of that failure. Of course, recognition of gain or loss in connection with the lending of the STRIPS was not of concern to the taxpayers because their basis in the STRIPS should have equaled the STRIPS's fair market value at the time of the loan. None of this is to say that the purported loan of the STRIPS should have been respected as a loan of those STRIPS; instead, the court could have disallowed the tax benefits sought by the taxpayers on alternative grounds that would have been more appropriately focused on the substance of the transaction (for example, the taxpayers either never were the owners of the STRIPS or sold the STRIPS to Refco immediately after acquiring them). For instance, the court could have concluded that the transaction was not a securities loan at all under step transaction principles, without regard to section 1058.

Because the parties agreed that the other requirements set forth in section 1058 were satisfied, the Tax Court focused solely on whether the securities lending agreement in that case reduced the taxpayers' risk of loss or opportunity for gain within the meaning of section 1058(b)(3). The five-day rule in the proposed regulations was not considered (or even referenced) by the court.

The court determined that a taxpayer's opportunity for gain on a security is reduced for this purpose if the taxpayer's ability to realize a gain on the security is less after it entered into the agreement than it would have been had the taxpayer not entered into the agreement. The court then stated:

> Absent the Agreement, the Samuelis could have sold the Securities and realized any inherent gain whenever they wanted to simply by instructing their broker to execute such a sale. With the Agreement, however, the Samuelis' ability to realize such an inherent gain was severely reduced in that the Samuelis could realize such a gain only if the gain continued to be present on one or more of the three stated days. Stated differently, the Samuelis' opportunity for gain was reduced by the Agreement because the Agreement limited their ability to sell the Securities at any time that the possibility for a profitable sale arose.[28]

The Tax Court specifically rejected the taxpayers' assertion that they had not reduced their opportunity for gain in the STRIPS because all the gain would still exist when those securities were returned. The court stated that the requisite opportunity for gain exists "only if the taxpayer is able to effect a sale of the security in the ordinary course of the relevant market (*e.g.*, by calling a broker to place a sale) whenever the security is in-the-money." Further, the court

[28] *Samueli*, 132 T.C. at 49-50.

found unpersuasive the taxpayers' argument that their opportunity to capture any gain was not reduced because at any time they could have captured that gain by entering into a derivative transaction that would offset their right to a return of the security under the securities loan.[29]

The Ninth Circuit affirmed the decision, stating that "the plain language of section 1058(b)(3), with the gloss provided by elementary economic analysis, supports the Tax Court's conclusion."[30] The Ninth Circuit's reasoning, however, falls short of a full endorsement of viewing the ability to terminate a securities loan on short notice as being an inviolable requirement of section 1058:

> Congress' explicit goal in enacting section 1058 was to encourage loans for the benefit of brokers who needed large supplies of securities on hand to deliver to purchasers, because such loans "can have a favorable impact on the liquidity of securities markets." Senate Report at 6, 1978 U.S.C.C.A.N. at 1292. It may be possible that nonrecognition treatment should be given to a transaction that fails to meet all of the specific requirements of section 1058(b), but that nonetheless is motivated by the goals that Congress had in mind when it enacted section 1058. But this loan, a tax shelter marketed as such for which the borrowing broker (Refco) did not pay the lender any consideration, clearly was not "the thing which the statute intended." *Gregory*, 293 U.S. at 469, 55 S. Ct. 266.

The Tax Court and Ninth Circuit in *Samueli* missed the mark in their analysis of section 1058(b)(3). When it enacted section 1058, Congress was well aware that typical securities loans gave the lender a termination right, and it specifically did not include the presence of that right among the list of requirements for qualifying securities loans. The rationale for providing tax-free treatment for securities loans, both under section 1058 and before its enactment, is that the lender is in essentially the same economic position after the loan is made as it had been in before its execution. This is true even when a loan has a fixed term. If the lender no longer wishes to have exposure to the lent security, it can simply enter into a short sale or another type of short derivative to eliminate its economic exposure to the security and lock in any existing gain in that position.

The IRS's pursuit in *Samueli* of disqualification from section 1058 treatment for term securities loans has led to unintended consequences. First, taxpayers unaware of the need for the securities lender to have the right to terminate a securities loan on short notice[31] may unexpectedly enter into arrangements that may be viewed as violating section 1058(b)(3). On the other hand, a taxpayer wishing to trigger gain in securities it holds may try to trigger that gain intentionally by entering into a fixed-term securities loan. Assuming that such a securities loan has a term that is significant (for example, 60 days), the taxpayer would be in a strong position to claim that the inherent gain is triggered upon the commencement of the securities loan, based on the *Samueli* decision.

iii. How quickly must the lender be able to terminate a securities loan in order to have a qualifying securities loan?

The Tax Court and the Ninth Circuit in *Samueli* specifically avoided setting a standard for how quickly a securities lender would need to be able to recall its securities in order not to violate section 1058(b)(3). For example, in citing a 2011

[29] The taxpayer also argued that because section 512(a)(5)(B) (which provides an exemption from unrelated business taxable income for payments with respect to a securities loan and was enacted alongside section 1058 as part of the 1978 act) specifically requires that a qualifying agreement provide that the loan may be terminated by the transferor upon five business days' notice, Congress must not have intended for such a requirement to apply to qualifying securities loans under section 1058. The court was unpersuaded, stating that the "firmly established law" at the time of the enactment of sections 512(a)(5)(B) and 1058 "provided that a lender in a securities loan arrangement must be able to terminate the loan agreement upon demand and require a prompt return of the securities to the lender. We read nothing in the statute or in its history that reveals that Congress intended to overrule that firmly established law by enacting sections 512(a)(5)(B) and 1058(b)(3)." *Id.* at 47-48.

[30] *Samueli*, 661 F.3d at 407.

[31] This report refers to the ability of a lender to terminate a securities loan in a manner that would not violate section 1058(b)(3) under the standard set forth in *Samueli* as the ability to terminate on "short notice."

report by the New York State Bar Association Tax Section,[32] the Ninth Circuit in *Samueli* stated:

> We are cognizant that a holding that no securities loan for a fixed term can qualify for section 1058 nonrecognition "could affect commonplace market transactions in a manner that arguably violates the overarching policy of section 1058." . . . But we do not so hold today because the resolution of this case does not require us to do so. First, as will be discussed more thoroughly in the next section of this opinion, we believe this transaction falls outside "the overarching policy of section 1058." Second, the transaction at issue here would fail the "facts and circumstances" test that the [1984 ABA report, *supra* note 25 in this report] proposed as an alternative to a rule that would exclude all fixed-term loans from the scope of 1058. Taxpayers' inability to terminate the loan except on one of three dates is clearly not "consistent with the continued evolution of commercial practices," ABA Report, Section IV.2, because the current standard practice for loans of bonds like the Securities is to allow termination by the lender on three days' notice (as is evidenced by the terms of the standard form Loan Agreement in this transaction, which were overriden [sic] by the Addendum).[33]

Given that the five-day rule set forth in the proposed regulations is not now in effect, it is unclear how quickly a securities lender must be able to terminate a securities loan without violating section 1058(b)(3) (as interpreted in *Samueli*). Because the five-day rule was based on the standard settlement period for securities transfers when the proposed regulations were issued, the safest course of action would be to allow for the lender to terminate based on the period that corresponds to the standard settlement cycle for the relevant securities (generally two days for corporate stock).

However, the *Samueli* decisions concluded that the section 1058(b)(3) requirement was violated based on a relatively extreme fact pattern (in which the taxpayers could terminate the securities loan only on two days during a 15-month period). Neither decision should be read to suggest that a taxpayer has per se reduced its opportunity for gain simply because the lender's termination right does not correspond to the standard settlement cycle for the underlying securities.

iv. Effect of penalty imposed for early termination.

One question that arises in practice is whether a securities lending agreement may impose a penalty on the securities lender for terminating the securities loan before the end of its stated term without violating the requirement that the agreement allow the lender to terminate the loan on short notice. As an economic matter, the parties may wish to include such a penalty clause because the borrower may incur costs in reacquiring the borrowed securities and therefore may wish to be compensated for the additional costs associated with the termination.

A penalty imposed on a lender for terminating a securities loan that is intended to economically compel the lender to allow the securities loan to run to its stated maturity (or at least strongly discourage the lender from causing an early termination) may be viewed as tantamount to the lender not having the right to terminate the securities loan early. For example, if the lender lends $100 of securities and is entitled to terminate the loan at any time on five days' notice with a $20 penalty, the termination right might be viewed as illusory.

What if the early termination penalty is set at a relatively insignificant amount? Absent guidance to the contrary, a strong argument can be made that an early termination penalty that is of a magnitude that is unlikely to dissuade the lender from terminating the loan should not negate the lender's early termination right. As discussed above in relation to the *Samueli* case, the importance of the early termination right is that it allows the lender to avoid a reduction in its opportunity for gain by enabling it to recall the loaned securities and sell them quickly to avoid a decline in their value. If the early termination penalty is not large enough to deter the lender

[32] *See* NYSBA, *supra* note 15.

[33] *Samueli*, 661 F.3d at 410.

from terminating the securities loan, it appears that it would not affect the lender's opportunity for gain and risk of loss. But even if this conclusion is correct, it is worth considering why the securities borrower would require the payment of a penalty upon early termination if that penalty is immaterial enough not to affect the lender's decision to terminate.

b. Effect of other related transactions.

Anschutz[34] provides useful (although somewhat confusing) insight into how the qualification of a securities loan for nonrecognition treatment under section 1058 can be affected when the securities lender enters into a closely related transaction regarding the lent securities. In *Anschutz*:

- an S corporation (TAC) wholly owned by the taxpayer (Anschutz Co.) entered into variable prepaid forward contracts (VPFCs) with Donaldson, Lufkin & Jenrette Securities Corp. (DLJ);
- in accordance with the VPFCs, DLJ made an upfront payment to TAC equal to 75 percent of the fair market value of the referenced stock in exchange for a promise to deliver a variable number of shares of the referenced stock to DLJ in 10 years;
- as a result of the variability in the number of shares to be delivered by TAC, Anschutz was entitled to retain economically the first 50 percent of appreciation in the referenced shares, while all appreciation, as well as all depreciation, in the value of the shares accrued thereafter for the benefit of DLJ;
- the VPFCs further required that TAC post referenced shares as collateral and execute share lending agreements (SLAs) for that collateral to be lent by TAC to DLJ;
- although DLJ did not initially borrow the pledged shares under SLAs, it borrowed those shares weeks after the VPFCs were executed and immediately used those borrowed shares to repay other securities loans it executed to hedge its initial position under the VPFCs; and
- in connection with borrowing the pledged shares, DLJ paid a prepaid lending fee equal to 5 percent of the value of the lent shares (which amount was refundable on a pro rata basis if the loans were terminated early).

Viewed in isolation, the securities loans made under the SLAs complied with all the requirements to be treated as qualifying securities loans under section 1058 and the proposed regulations, including the right to terminate the loans on five business days' notice. Because the government asserted that the VPFCs could not have existed without the securities loans, TAC in fact terminated some of the securities loans to demonstrate that the VPFCs were not dependent on the continuation of those loans.

The government asserted that TAC should be treated as having sold its shares for both the amount of cash received and a derivative (representing its retained upside in the shares). The government further maintained that the stock loans by TAC to DLJ should not be respected as true securities loans but instead should be characterized as the delivery of the shares under taxable sales because, in the government's view, the securities loans lacked the following indicia of stock loans: (1) a pledge of liquid collateral; (2) the payment of a securities lending fee payable by the borrower; (3) a right exercisable by the lender to receive distributions payable on the securities; and (4) a right exercisable by the lender to demand return of the lent shares without substantial conditions or restrictions.[35]

In contrast, the taxpayer argued that the VPFCs, like all open transactions, did not cause a currently taxable sale to the forward seller because the number of shares to be sold, and its basis and holding period in those shares, could not be known until the future delivery date. The taxpayer further contended that the securities loans to DLJ satisfied all the requirements of section 1058 (including the proposed regulations).

[34] *Anschutz Co. v. Commissioner*, 135 T.C. 78 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011).

[35] Interestingly, the indicia described in (1) and (2) are not technical requirements of section 1058 or the proposed regulations, and the indicia described in (3) and (4) were present in the SLAs based on the facts presented.

The Tax Court first concluded that the VPFCs and SLAs should not be analyzed as separate transactions: "TAC entered into an integrated transaction comprising two legs, one of which called for share lending. The transaction comprised [VPFCs] and SLAs. The two legs were clearly related and interdependent."[36]

In this regard, the court focused on the fact that the VPFCs and SLAs were entered into at the same time by the same parties, and it described the securities loans as a "vital part" of the transaction.[37]

The court next established that the benefits and burdens of the lent shares had been transferred by TAC to DLJ. This is not surprising because securities loans typically transfer the benefits and burdens of ownership of the lent securities to the borrower, which permits the borrower to vest those benefits and burdens in a third-party purchaser or another party. The real question should be whether the transfer of those benefits and burdens occurred in accordance with a qualifying securities loan.

The court then concluded that the taxpayer could not avail itself of nonrecognition treatment under section 1058 because the arrangement violated the requirement of section 1058(b)(3) that the agreement not limit the taxpayer's risk of loss or opportunity for gain. In doing so, the court rejected the taxpayer's argument that the SLAs were separate and distinct from the VPFCs, stating: "The two are linked, and we cannot turn a blind eye to one aspect of the transaction in evaluating another."[38] Of course, once the court viewed the VPFCs and SLAs together, it necessarily found that the arrangement violated section 1058(b)(3). In finally concluding that there was a taxable sale of the underlying shares to which section 1058 did not apply to prevent gain recognition, the court stated:

> The parties entered into an agreement to sell and lend shares by integrated transactions. The PVFCs and SLAs were clearly related. One could not occur without the other. To the extent that petitioners argue TAC and DLJ could have entered into the PVFCs without corresponding share-lending agreements, that hypothetical transaction is not before the Court. The transaction before the Court transferred the benefits and burdens of ownership of the lent shares, and petitioners do not satisfy the section 1058 safe harbor.[39]

Finally, the court rejected the government's assertion that the taxpayer was required to recognize gain based on an amount realized equal to 100 percent of the value of the transferred shares. Instead, it required the taxpayer to recognize gain based only on the prepaid purchase price and securities lending fees (that is, only 80 percent of the value of the shares). This result is surprising. First, the court could have accepted the government's contention that the value of the taxpayer's retained upside in the shares should be included in its amount realized.[40] Instead, the court appears to have applied something akin to the open transaction doctrine, under which the taxpayer could wait until it received additional consideration for the deemed sale before taking that amount into account. Second, the court might have found that the taxpayer had transferred all the shares under a securities loan that failed to meet the requirements of section 1058, thus resulting in the recognition of all the gain realized on the transfer. Similar to the approach the court took in *Samueli*, however, once the court determined that the section 1058 requirements were not satisfied, it appears to have simply ignored the securities loans in their entirety (as if failing to satisfy the requirements of section 1058 makes a purported securities loan not in substance a securities loan at all).

[36] *Anschutz*, 135 T.C. at 104.

[37] *Id.* at 105.

[38] *Id.* at 107.

[39] *Id.* at 108.

[40] Such an approach would have been consistent with section 453(k)(2)(A), which denies installment sale treatment for a sale of stock or securities that are traded on an established securities market.

Using substantially similar reasoning, the Tenth Circuit affirmed the Tax Court's conclusions.[41]

Although *Anschutz* applied section 1058 to the SLAs and determined that the provision did not apply, the case was not fundamentally about section 1058. Rather, in essence, the case was about whether a VPFC compliant (at least in isolation) with Rev. Rul. 2003-7, 2003-1 C.B. 363,[42] could be combined with a share loan compliant (again in isolation) with section 1058 to find a taxable sale of shares purportedly lent by the taxpayer to its counterparty. Both the Tax Court and the Tenth Circuit declined to adopt the open transaction reasoning of Rev. Rul. 2003-7. Critically, the courts rejected the taxpayer's argument that the VPFCs and the share loans should be analyzed separately because they could be separated. Although the taxpayer argued that long-standing short-against-the-box authorities should be read to allow a share loan to be analyzed separately from a long position in the same securities,[43] the courts declined to address that argument. Instead, they viewed the VPFCs and share loans as integrated and interdependent. Once the VPFCs and share loans were combined, the share transfers of course failed to meet the requirements of section 1058.

The most obvious takeaway from *Anschutz* is that the agreement that must satisfy the requirements of section 1058(b) includes any other transaction that is found to be integrated or interdependent with the shares loan. Therefore, it would be inadvisable for a taxpayer to enter into a VPFC (or some other form of short derivative) for shares it owns and, as part of an integrated plan, lend those shares to the counterparty. Because the Tax Court's conclusions were based largely on its determination that the taxpayer could not have entered into the VPFCs without also making the share loans, a taxpayer might try to distinguish a potential VPFC and contemporaneous share lending from those in *Anschutz* on the basis that it could establish that the VPFC could be done without the share loan. That course of action could be risky, particularly because the Tax Court appears to have based its finding that the *Anschutz* VPFCs could not have been undertaken without the share loans principally on the fact that they were executed at the same time and the parties contemplated that both sets of transactions would occur.

What if instead a taxpayer enters into a VPFC or similar derivative on shares it owns without contemplating that those shares would ever be lent to the counterparty, but the counterparty asks to borrow the shares a significant period of time after the derivative is executed? In that case, the taxpayer would be on stronger footing, assuming it could convince a court that the share loan was not originally contemplated. From the perspective of section 1058, it would seem difficult for the government to prevail on an argument that the derivative should cause the subsequent share loan to violate the requirement of section 1058(b)(3) if in fact the share loan was not contemplated when the derivative was executed.[44] Nevertheless, such an approach may still involve risk, particularly given the evidentiary burden in establishing the separateness of the derivative and the share loan.

A taxpayer would likely have greater confidence in executing a hedge with one counterparty and lending the underlying shares

[41] *Anschutz*, 664 F.3d 313.

[42] In Rev. Rul. 2003-7, the IRS considered the treatment of a VPFC and concluded that the owner of the shares was not treated as selling the stock for federal income tax purposes upon execution of the forward contract. Even though the owner of the stock received cash upon execution of the forward contract and pledged shares of stock sufficient to satisfy the contract, the IRS relied on the following factors to reach its conclusion: (1) the owner could deliver shares under the contract other than the pledged shares or could deliver cash (in an amount equal to the fair market value of the shares required to be delivered) instead of shares of stock; (2) the owner retained the right to receive dividends on, and voting rights regarding, the stock; and (3) the legal title to, and actual possession of, the stock was transferred to an unrelated trustee and not the counterparty to the contract.

[43] *See, e.g.*, Rev. Rul. 72-478, 1972-2 C.B. 487 (ruling that a short sale was not deemed consummated until delivery of property to close the short sale, even when the taxpayer entered into a special loan agreement in connection with executing the short sale that allowed the taxpayer's broker to borrow shares from its account, as long as the broker did not borrow those shares to effect the short sale).

[44] *See* NYSBA, *supra* note 15, at 13 ("The fact that the court chose to pursue a more technical line of reasoning under section 1058(b)(3) does not, in our view, require taxpayers to forgo all hedging activity in respect of a loaned security in order to achieve nonrecognition treatment under section 1058 for the securities loan. If *Anschutz* were viewed as standing for such a rule, then the case likely would have the effect of denying nonrecognition treatment in situations that do not present the concerns that were present before the *Anschutz* court.").

to a different party. In that case, assuming no coordination between the hedging counterparty and the securities borrower, it should be difficult for the government to successfully assert that the hedge and the securities loan constitute a single integrated transaction.[45]

What about a situation in which, in the context of a hedge fund, one portfolio manager makes a loan of shares held in one portfolio and a different portfolio manager sells a call or enters into another short derivative with respect to the same shares on behalf of a separate portfolio? Assuming there is no coordination between the two transactions, the share loan should presumably benefit from section 1058, despite the existence of the short derivative.

D. Basis and Holding Period

Section 1058(c) provides that property acquired by a taxpayer in a transaction eligible for tax-free treatment under section 1058 has the same basis as the property transferred by that taxpayer. The proposed regulations then subdivide this general basis rule into separate basis rules corresponding to the two steps in a qualifying securities loan:

- the lender's basis in the identical securities returned by the borrower is the same as its basis in the securities it lent in a section 1058(a) transaction; and
- the lender's basis in the contractual obligation received from the borrower in exchange for the lender's securities is equal to its basis in the securities exchanged.[46]

One potential oddity of the approach taken in the proposed regulations is that it provides that the lender takes a basis in the replacement securities equal to its basis in the securities it lent, rather than its basis in the contractual obligation from the borrower. As a result, if after the securities loan was initiated an event occurred that adjusted the lender's basis in the borrower's obligation to return the loaned securities, a literal reading might suggest that the adjustment would not be considered in determining the lender's basis in the replacement securities.

Although not explicitly stated, it would appear that the lender does not adjust its basis in its contractual right to a return of the securities, or the replacement securities, for OID or premium that would otherwise have accrued to the lender during the term of the loan had the loan not been made. This is consistent with the view that the lender of a debt instrument does not take into account premium or discount that it would have accrued on that instrument during the term of the loan.[47]

While section 1058 does not itself address the taxpayer's holding period in securities returned in a securities lending transaction, proposed regulations under section 1233 provide that the lender's holding period in those replacement securities includes both the period in which the lent securities had been held before the loan and the period between the transfer of the securities and their return to the lender.[48]

E. Corporate Actions

The proposed regulations provide that when there is "a merger, recapitalization or reorganization (including, but not limited to, a reorganization described in section 368(a)(1))" concerning a lent security, in determining the tax consequences to the securities lender, "the section 1058 loan transaction is deemed terminated immediately prior to the merger, recapitalization or reorganization and a second section 1058 transaction is deemed entered into immediately following the merger, recapitalization or reorganization" (the corporate action rule).[49] The effect of the corporate action rule is twofold. First, it allows the securities loan to satisfy the requirement that the borrower deliver securities identical to those lent by treating the original loan as having been repaid with identical securities

[45] *See id.* ("If the taxpayer in *Anschutz* had loaned securities to someone other than the bank, we do not believe that the loan properly could have been integrated with the forward contract.").

[46] Prop. reg. section 1.1058-1(c).

[47] Whether the lender of debt securities with OID or premium must take into account those amounts during the term of the securities loan is beyond the scope of this report. For a detailed discussion of this issue, see Jeff Maddrey, "Accounting for Income From Securities Lending Transactions," 12 *J. Tax'n Fin. Prod.* 5 (Oct. 14, 2014).

[48] Prop. reg. section 1.1233-2(a).

[49] Prop. reg. section 1.1058-1(f).

and then deeming there to be a new securities loan that will be satisfied by the delivery of identical securities in the future.[50] Second, the rule causes the lender to experience whatever tax consequences would have applied to it in connection with the corporate action had it not lent the securities.

There are several technical points to consider in applying the corporate action rule. First, does the rule apply to mergers and similar transactions that do not qualify as reorganizations under section 368(a)(1)? The answer appears to be yes, because the rule applies to all mergers, recapitalizations, or reorganizations, "including, but not limited to," those described in section 368(a)(1). That reading would be consistent with the apparent intention of the corporate action rule.

Second, how does the corporate action rule apply to corporate actions that are not among the listed types of events (that is, transactions other than mergers, recapitalizations, and reorganizations)? For example, assume that Lender lends stock of Corporation A to Borrower and, before the loan is repaid, A engages in a tax-free or taxable spinoff of its subsidiary, B. If a tax-free spinoff also qualifies as a D reorganization, it is presumably covered by the corporate action rule by virtue of being a reorganization. But if the spinoff is taxable, or if it is tax free under section 355 but is not also a D reorganization, it would appear that the corporate action rule would not technically apply (unless the term "reorganization" were read broadly to cover such a spinoff). What then? On one hand, without the application of the corporate action rule, the lender would appear to have a strong argument that it would not suffer any of the adverse tax consequences that it would otherwise experience because the change to its contractual rights occurred under the terms of the securities loan, thus avoiding both a realization event under section 1001 and the inclusion of dividend income as a result of the receipt of the distribution. On the other hand, it may be the case that the original loan (or at least the part of the loan that thereafter relates to the distributed securities) no longer qualifies under section 1058 because it does not provide for the return of identical securities.

Finally, because the corporate action rule by its terms applies only to determine the tax consequences to the securities lender, it does not address how the securities borrower is treated upon the occurrence of a corporate action. One commentator has expressed concern that the borrower could be taxable in connection with a corporate action, stating:

> The deemed termination and new contract raises the conceptual question of whether there should be recognition of gain or loss on the deemed exchange of securities loans. Could there be a deemed cancellation of the investor's preexisting obligation to deliver stock to the broker to close the short sale that could result in recognition of capital gain or loss under Code Sec. 1234A?[51]

Even without the benefit of the corporate action rule, however, it would appear that the borrower should not have a taxable event in connection with the corporate action if the change in the security to be returned under the securities loan occurs under the terms of the securities lending agreement (which would typically be the case).[52]

F. Form (or Lack Thereof) of Agreement

One question to consider (briefly) is whether an arrangement must be in the form of a securities lending agreement in order to qualify for nonrecognition treatment under section 1058. Section 1058(a) provides for nonrecognition treatment when securities are transferred under

[50] This technical issue also is addressed by prop. reg. section 1.1058-1(b)(1), which states that the requirement to return identical securities will be deemed to be satisfied if the agreement permits the borrower to return equivalent securities in the event of a reorganization, recapitalization, or merger of the issuer.

[51] Stevie D. Conlon, "The Uncertain Tax Consequences of Corporate Actions on Short Positions and Derivatives: Musings on Negative Basis, the Scope of *Cottage Savings* and Uncertain Securities Lending Guidance," 11 *J. Tax'n Fin. Prod.* 23, 28 (Apr. 1, 2014).

[52] *See* Michael Shulman and Nathan Tasso, "Changes to Derivatives 'Pursuant to Their Terms' (Part 2)," *Tax Notes*, May 8, 2017, p. 805, at 819 (arguing that although the government may assert that such a change is still a realization event under the so-called fundamental change doctrine of Rev. Rul. 90-109, 1990-2 C.B. 191, that doctrine is of uncertain validity and, even if valid, would not necessarily apply when the original issuer has been subsumed within the acquiring corporation); and Shulman and Tasso, "Changes to Derivatives 'Pursuant to Their Terms' (Part 1)," *Tax Notes*, May 1, 2017, p. 653, at 664-665.

an agreement satisfying the requirement of section 1058(b), and the proposed regulations further require that the agreement be in writing. Section 1058(b) then sets forth the substantive provisions that the agreement must contain. But neither section 1058 nor any provision in the proposed regulations requires the agreement to be labeled a securities lending agreement, to be in the form of a "securities lending agreement," or to take any particular form. From both a technical perspective and a tax policy standpoint, one can reasonably conclude that nonrecognition treatment is available for transfers of securities under agreements or arrangements not in the form of a securities lending agreement. Nevertheless, regardless of the form it takes, a transaction may benefit from the nonrecognition rule of section 1058 only if it satisfies all the statute's requirements (including the ability to recall the underlying securities on short notice).

Many types of arrangements under which the tax ownership of securities is transferred do not take the form of a securities lending agreement. A common example of such an arrangement is when the obligor under indebtedness or another obligation has pledged securities as collateral under an agreement in which the pledgee is permitted to rehypothecate those securities. In that case, if the terms of the arrangement comply with all the requirements of section 1058, any change of tax ownership resulting from the right to rehypothecate (or any actual rehypothecation) should be entitled to nonrecognition treatment under section 1058. For these purposes, however, it should be sufficient in terms of satisfying the short-notice termination requirement for the pledgor to be permitted to substitute other collateral for the pledged securities at any time, thus allowing it to regain possession of the pledged securities and permitting it to capture any appreciation in those securities quickly by exercising that substitution right.

Similarly, prime brokerage agreements typically allow the broker to rehypothecate or otherwise transfer securities held in a client's brokerage account. Those agreements then require the broker to replace any securities it rehypothecates and credit the client's account with any amount it would otherwise have received for any rehypothecated securities. As discussed above, while those agreements often do not give the client the right to demand a return of any rehypothecated securities, the right to demand a return of those securities should be treated as satisfied because the client can sell them by submitting a sell order (thus addressing the concern in *Samueli* that a securities lender must be able to sell the lent securities quickly to lock in its built-in gain).

Repos also may be treated as including a securities loan when the lender/repo buyer rehypothecates (or at least has the right to rehypothecate) the repo securities. To the extent that the repo terms are consistent with the requirements of section 1058, however, including the right to a return of the repo securities (either by terminating the repo or by replacing the repo securities with other securities), the borrower/repo seller should not recognize gain or loss on the transfer.

G. Noncompliance With Section 1058

1. Failure to satisfy the requirements of section 1058.

Prop. reg. section 1.1058-1(e)(1) provides that "if a transfer of securities is intended to comply with section 1058 and fails to do so because the contractual obligation does not the meet the requirements of section 1058(b) and [reg.] section 1.1058-1(b), gain or loss is recognized in accordance with section 1001 and [reg.] section 1.1001-1(a) upon the initial transfer of the securities." This rule appears to provide that compliance with section 1058 is the sole avenue for nonrecognition treatment in the context of securities.[53]

This approach is supported by neither the technical language of the statute nor the legislative history of its enactment. By its terms, section 1058(a) simply provides that no gain or loss is recognized on a transfer of securities meeting the requirements of section 1058(b). It does not set forth any circumstance in which gain

[53]The rules state, however, that the wash sale rule of section 1091 may apply to a loss that would be recognized as a result of that noncompliance. One interesting question that exists beyond the context of section 1058 is whether property received in an exchange that is materially different for purposes of section 1001 can still be treated as substantially identical for purposes of section 1091.

or loss is to be recognized; it only prevents the recognition of gain or loss. By its drafting, section 1058 appears to be a legislative safe harbor from the recognition of gain or loss,[54] not a provision intended to provide for recognition treatment when that treatment would not have applied in the absence of its enactment. Implicit in any nonrecognition provision is that it applies to gain or loss that would otherwise be realized under the code or common law principles. In other words, section 1058 is needed to prevent the recognition of gain only when that gain is otherwise realized. For an exchange of property, realization is the province of section 1001. As described in Section II above, before the enactment of section 1058, it was likely that a securities loan did not result in a realization event under section 1001 because the lender did not exchange the lent securities for property differing materially in kind or extent.

Interestingly, prop. reg. section 1.1058-1(e)(1) states that the penalty for noncompliance is that "gain or loss is recognized in accordance with section 1001 and [reg.] section 1.1001-1(a)." One might argue that this language does not mean that gain or loss must be recognized per se in the case of noncompliance, and that instead the language is intended to simply redirect taxpayers to the section 1001 standard that applied before the enactment of section 1058 in determining whether gain or loss is realized. In other words, under this approach, the noncompliance rule's phrase "in accordance with" should be interpreted as synonymous with the phrase "to the extent provided in." While it is not clear that this interpretation is what was intended by the drafters of the regulations, that reading would be consistent with the plain language of the statute.[55]

Finally, it is worth observing that the noncompliance rule of prop. reg. section 1.1058-1(e)(1) applies only to transfers of securities intended to comply with section 1058. Thus, an NSP loan (which definitionally cannot satisfy the requirements of section 1058) should not be subject to recognition treatment merely because it does not (and, of course, cannot) meet the requirements of section 1058.

2. Default/failure to return identical securities.

Prop. reg. section 1.1058-1(e)(2) states:

> If securities are transferred pursuant to an agreement which meets the requirements of section 1058(b) and [reg.] section 1.1058-1(b) and the borrower fails to return to the lender securities identical to the securities transferred as required by the agreement, or otherwise defaults under the agreement, gain or loss is recognized on the day the borrower fails to return identical securities as required by the agreement, or otherwise defaults under the agreement.[56]

Unlike prop. reg. section 1.1058-1(e)(1), this rule would not require recognition at the inception of the securities loan, and instead would

[54] *See, e.g.*, ABA tax section, "Securities Loans Task Force Report on Securities Lending Transactions Governed by Section 1058" (Apr. 22, 1991) ("The final regulations should make clear that Section 1058 is a safe harbor from tax recognition and that whether a disposition of loaned securities occurs, resulting in the realization of income or loss, should be determined by reference to Section 1001 realization principles rather than by regulations promulgated under Section 1058."); and NYSBA, *supra* note 15, at 19 ("In our view, section 1058 should operate as a safe harbor.").

[55] It is important to keep in mind that the proposed regulations have not been finalized. Given the text and legislative history of section 1058, it would be difficult for the government to assert successfully that the provision is the sole avenue by which a taxpayer may avoid recognizing gain or loss on a securities loan without operative regulations providing as such. Even if the proposed regulations were finalized in their current form, taxpayers might have one or more viable paths to challenge their validity.

[56] The proposed regulations also provide that in such a case, the lender's holding period in "the securities transferred to the borrower" terminates on the day the borrower fails to return identical securities, and the borrower's holding period in those securities begins on the day it fails to return identical securities as required by the agreement or otherwise defaults under the agreement. Prop. reg. section 1.1233-2(b)(1). The approach taken in this provision appears ill considered. First, the lender's holding period in the securities transferred ceases to be relevant when the loan is initiated because its ownership of the shares has been replaced by the borrower's obligation to return the securities. So it is illogical to speak of the lender's holding period in property that it no longer owns as terminating. Instead, although the rules do not explicitly provide, one would have expected that the lender's holding period in the lent securities is tacked on to its holding period in the right to a return of those securities and that the holding period ceases upon the borrower's failure to return them. From the borrower's perspective, it is rare for it to actually own the borrowed securities (which are almost always delivered to another party). Moreover, if the borrower has failed to redeliver the lent securities as required under the agreement, it would be very unusual for it to do so while actually holding those securities. Hence, it is peculiar for the rule to provide for the borrower's holding period in securities that it almost certainly does not own to begin on the date the borrower failed to return those securities.

trigger the recognition of gain or loss at the time of the default or failure to return identical securities.[57]

Read literally, this provision would require the immediate recognition of gain or loss upon a default, even if the default were remedied quickly. However, Example 5 in prop. reg. section 1.1058-2 suggests that such a hair-triggering of gain or loss recognition may be avoided if prompt action is taken. In that example, the securities lender provided a termination notice and, on the date that the securities were required to be returned, the borrower informed the lender that the return of the securities would occur three days later than required under the securities lending agreement. The example provides that if the parties agree to extend the delivery period under the agreement by three days (to conform with the expected delivery date), the section 1058 agreement will not be treated as breached and no gain or loss will be recognized by virtue of the extension or upon the redelivery of the securities. If, however, the parties do not agree to an extension of the delivery date, the lender "will be treated as selling" the securities on the day after the end of the five-day delivery period and must recognize gain on "the sale of the securities." It seems anomalous that the gain would be recognized on the sale of the underlying securities because the lender at that point does not own them and merely has a contractual right to their return. One uncertainty is whether the relief from immediate gain or loss recognition suggested by the example depends on the agreed extension being for a relatively immaterial period of time (three days in the example), or whether a longer extension (for example, 30 days or longer) to allow the borrower sufficient time to acquire the securities might also be acceptable.

The requirement that gain or loss generally be recognized immediately upon a default by the borrower raises the more fundamental question of why immediate gain recognition is appropriate as a policy matter. If the lender remains entitled to the return of its securities and eventually does receive them, why should gain or loss be triggered by the default? The hair-trigger approach of the proposed regulations stands in contrast with the treatment of defaults by a borrower under the terms of a debt instrument, in which a borrower default generally is not itself treated as a modification to the terms of the instrument.[58] Moreover, a debt holder's agreement to stay collection or waive an acceleration clause in a debt instrument is not a modification until the forbearance period exceeds two years following the borrower's failure to perform, plus any additional period during which the parties conduct good-faith negotiations or during which the borrower is in a title 11 or similar case.[59]

Despite the general approach of prop. reg. section 1.1058-1(e)(2), during the financial crisis of 2008, the government tried to alleviate the requirement of immediate gain recognition when collateral is seized by the lender and used by it to acquire identical securities. Specifically, Rev. Proc. 2008-63, 2008-2 C.B. 946, treats the purchase by a securities lender of identical securities with collateral provided by the borrower (or cash generated by the sale of that collateral) as a tax-free exchange of rights under the agreement for identical securities to which section 1058(a) applies, but only if (1) the borrower's defaults are a direct or indirect result of its bankruptcy (or the bankruptcy of an affiliate) and (2) the purchase of identical securities occurs as soon as is commercially practicable (but in no event more than 30 days) after the default.[60]

H. No Requirement for Collateral

A final interesting aspect of section 1058 is that one of the common terms of a typical securities loan — the posting of collateral by the borrower to the lender — is not specifically required for tax-free treatment under the statutory language or the proposed regulations. Standard-form securities lending transactions generally require the posting

[57] As in prop. reg. section 1.1058-1(e)(1), this rule notes that section 1091 may apply to disallow any loss that would otherwise be recognized under this provision.

[58] Reg. section 1.1001-3(c)(4)(i) (providing that "the failure of an issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification").

[59] Reg. section 1.1001-3(c)(4)(ii).

[60] Of course, Rev. Proc. 2008-63 applies only when its requirements are satisfied. Thus, a taxpayer that held its securities lending position with a built-in loss may wish to avoid the application of the revenue procedure (for example, by not replacing the original securities for at least 31 days after its seizure of the collateral).

of collateral by the borrower to the lender. The lack of a requirement for collateralization is notable because, if the theory for providing tax-free treatment is that the securities lender has not materially altered its economic position with respect to the underlying securities by virtue of having made the loan, an uncollateralized securities loan could in at least some cases materially change the lender's economic position by introducing the credit risk of the borrower into the economic profile of the lender. But if the question is whether collateralization of a securities loan is required for tax treatment under section 1058, the answer should be no.

First, section 1058 specifies the requirements that a securities lending agreement must meet to qualify for nonrecognition under that section, and those requirements do not include the provision of collateral. Section 1058 also gives the commissioner the power to impose additional requirements by regulation, but the proposed regulations do not include any requirements regarding collateral.

Second, when Congress enacted section 1058 as part of the 1978 act, it also enacted (as part of the same bill) other rules governing the tax consequences of receiving payments made under securities loans, such as lending fees and substitute payments, in which the securities lender is a tax-exempt organization or a regulated investment company.[61] To qualify for special treatment under those rules, not only does the corresponding securities lending agreement need to satisfy the requirements of section 1058, but it also must meet other requirements, including that the agreement provide for "reasonable procedures to implement the obligation of the transferee to furnish to the transferor, for each business day during such period, collateral with a fair market value not less than the fair market value of the security at the close of business on the preceding business day."[62]

Also enacted as part of the 1978 act, section 851(b)(2)(A) requires a securities loan to contain collateralization provisions (by cross-reference to section 512(a)(5)) in order for payments "with respect to" the securities loan to constitute qualifying income for purposes of the 90 percent gross income requirement applicable to RICs.

Third, the legislative history to the portion of the 1978 act addressing section 1058 states that "in most cases, the loan of securities is fully collateralized (with adjustments made on a daily basis) by cash or marketable securities. . . . However, no collateral is provided if securities are borrowed from margin accounts." Hence, while Congress understood that most securities loans were fully collateralized, it did not precondition tax-free treatment on the presence of collateral.

In summary, when Congress enacted the 1978 act, it was aware that many securities loans were collateralized, and it enacted two sets of rules: one dealing with the gain or loss from transfers of securities under securities loans (section 1058), and one dealing with the character of payments received under securities loans (section 512(a)(5)). Thus, it seems clear that Congress chose not to require collateralization as a prerequisite to nonrecognition of gain or loss under section 1058. One could argue that Congress simply determined that it was preferrable not to require collateralization as a policy matter, and that such determination should not inform our thinking regarding whether lack of collateralization would otherwise cause a securities loan to fail the materially different standard in the absence of section 1058. In response to that argument, it is worth noting that the legislative history of the enactment of section 1058 states that "in order to assure that the contractual obligation does not differ materially either in kind or in extent from the securities exchanged, the committee amendment makes the provision applicable only if the contractual obligation satisfies certain specified conditions."[63] That language strongly suggests that Congress viewed the specific statutory requirements of section 1058 as being what is needed to satisfy the materially different standard even in its absence. Under this view, by excluding collateralization as a requirement for tax-free treatment under section 1058, Congress was indicating that collateralization does not play

[61] *See, e.g.*, P.L. 95-345, section 2(a), "Treatment of Income From Payments With Respect to Securities Loans" (amending sections 509, 512, 851, and 4940).

[62] Section 512(a)(5)(B)(i).

[63] S. Rep. No. 95-762, at 7.

an important role in applying the materially different standard.

IV. Treatment of NSP Loans

A. Recognition of Gain or Loss

Section 1058 applies only to loans of securities (generally defined to include only stock and debt instruments). Loans of other types of fungible NSP are not addressed by section 1058. Although the legislative history does not address the decision to limit the application of section 1058 to securities, it would appear that the limitation simply reflects the fact that loans of NSP property did not exist (or at least were uncommon) in 1978.

Because section 1058 is properly understood as a statutory safe harbor provision (consistent with its text and legislative history), the question whether a lender of NSP recognizes gain or loss in connection with the transfer of the NSP to the borrower should be analyzed in essentially the same way that securities loans were analyzed in the pre-section 1058 universe. As described in Section III above, guidance issued by the IRS before the enactment of section 1058 consistently concluded that securities lenders did not recognize gain or loss in connection with the transfer of securities under a securities loan. Although the rationale for this conclusion may not have been entirely clear (and, in the case of the 1948 NYSE ruling, no rationale was provided), there appears to have been no authority that questioned the tax-free nature of securities loans even without the benefit of section 1058. The relevant question, then, is whether the legal basis for the tax-free treatment of securities loans before the enactment of section 1058 applies with equal force to NSP loans.

1. Was section 1036 the exclusive basis for tax-free treatment for pre-section 1058 securities loans?

A threshold question in addressing the treatment of NSP loans in light of the pre-section 1058 authorities is whether the tax-free treatment of stock loans was solely a function of their qualification for nonrecognition treatment under section 1036. If tax-free treatment at that time were exclusively based on the application of section 1036, NSP loans would appear to trigger the recognition of gain or loss because NSP is not stock[64] eligible for the benefits of section 1036.[65]

As described in Section III above, the only pre-section 1058 authority that linked reliance on section 1036 to the tax-free treatment of a securities loan was Rev. Rul. 57-451. It appears, however, that the ruling relied on section 1036 for tax-free treatment, rather than citing reg. section 1.1001-1(a) for its conclusion, because a disposition would have been found to have occurred in that specific context as a result of the relatively low transfer of title standard under former section 421(d), absent the application of a specific nonrecognition provision (such as section 1036). In other words, even if the securities loan was not treated as an exchange of the securities for other property differing materially in kind or extent within the meaning of reg. section 1.1001-1(a), a disposition (defined to include any transfer of legal title) would have been found in Rev. Rul. 57-451 unless section 1036 was applicable. Put yet another way, the reliance on section 1036 for nonrecognition treatment in Rev. Rul. 57-451 was attributable to the unorthodox definition of disposition under former section 421(d).

This reading is confirmed by GCM 36948, in which the IRS applied traditional realization principles under section 1001 in determining whether a securities loan triggered gain or loss to the securities lender. The general counsel memorandum concluded that a standard securities loan does not trigger a realization event to the securities lender because the lender does not exchange the securities for materially different property under reg. section 1.1001-1(a). In this regard, the memorandum made clear that the materially different standard in reg. section

[64] Some types of digital assets may give their holders rights that are substantially the same as those of a holder of equity securities in a corporation. In that case, the digital assets might be characterized as stock for federal income tax purposes. Any digital asset that is recharacterized as stock would benefit from the provisions of section 1058 and therefore would not be considered NSP for purposes of this report.

[65] Of course, loans of debt securities (which would not have benefited from tax-free treatment under section 1036) existed before the enactment of section 1058, and there has been no suggestion that those loans were taxable at that time.

1.1001-1(a), and not section 1036, would be the key to avoiding gain recognition in connection with a standard securities loan:

> In the typical case where the broker-dealer satisfies his contractual obligation by delivering securities not differing materially in either kind or extent, there will be no realization of gain or loss under Code section 1001 because of Treas. Reg. section 1.1001-1(a). As such, the question of recognition of gain or loss is not reached under Code section 1002. Accordingly, the exchange will be nontaxable since there is no gain which could be taxed in any event, thus obviating the need to apply a specific statutory provision such as Code section 1036 so as to afford nonrecognition treatment for gain or loss realized.

The approach taken in GCM 36948 of applying the materially different standard to securities loans is correct. The application of section 1036 was not necessary for tax-free treatment of securities loans before section 1058. This conclusion is warranted because reg. section 1.1001-1(a) provides a specific threshold that must be met for a realization event to occur in connection with any exchange of property for other property: Is the property received in the exchange materially different in kind or extent from the property transferred? It would be difficult for the government to dispute that a securities loan or NSP loan involves an exchange of property, and thus that the materially different standard must be met before a realization event can be found. While it is, of course, helpful that GCM 36948 articulated the government's view at that time that the materially different standard was generally applicable to securities loans, that standard would be the correct standard regardless of whether the memorandum had been issued.

However, concluding that the materially different standard is the relevant standard in analyzing NSP loans does not fully resolve whether an NSP loan results in a realization event to the NSP lender. It must first be determined for what property the NSP lender exchanges its NSP. In other words, it must be determined whether the NSP is exchanged for either (1) identical NSP to be returned in the future (applying the deferred exchange approach) or (2) the contractual right to a return of the NSP plus any other rights provided for in the NSP loan, including the right to substitute payments (applying the simultaneous exchange approach). Next, it must be determined whether the property received in exchange for the lent NSP is materially different from the NSP. These issues are addressed below.

2. What does the lender of NSP receive in the exchange?

Several authorities have determined in the context of section 1031 like-kind exchanges that a transfer of property in exchange for a future delivery of other property may constitute an exchange of those properties, despite the lack of simultaneity. In Rev. Rul. 61-119, 1961-1 C.B. 395, the IRS concluded that the taxpayer's sale of old equipment to a dealer and its related purchase of new equipment should be properly characterized as an exchange of property for purposes of section 1031. Regarding the timing of the transfers, the ruling stated:

> The fact that the purchase and sale are consummated concurrently . . . may serve as indication that the purchase and sale were not intended as separate or unrelated transactions. However, the absence of [such a] factor, standing alone, will not be taken to indicate that separate or unrelated transactions were consummated.

Thus, the ruling concluded that the related transfers should be treated as an exchange for tax purposes, even if they were not simultaneous.

Further, in *Starker*,[66] a taxpayer transferred title to a parcel of real property to a corporation in exchange for a promise by the corporation to acquire suitable exchange property and deliver the exchange property to the taxpayer within five years or to pay the balance of the property's value in cash. The corporation also committed to pay a "growth factor" of 6 percent per year (commencing the year after the year of the initial transfer by the taxpayer) until the property or cash was delivered. The taxpayer received

[66] *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979).

exchange property during the following tax year and treated that receipt as a like-kind exchange with its original transfer. The court framed the relevant issue as whether the lack of simultaneity prevented the treatment of a deferred exchange of otherwise like-kind property from benefiting from the nonrecognition rule of section 1031. The court held that the transfer of the real property and the receipt of the replacement property qualified as a like-kind exchange under section 1031, despite the delay between the original transfer and the receipt of replacement property.

Of course, a taxpayer transferring property in a deferred exchange could not have qualified for like-kind exchange treatment under section 1031 if a simultaneous exchange approach had been applied, because the contractual right to the future delivery of replacement property would not have been like kind with the transferred property.

Section 1031(a)(3), which was added to the code as part of the Tax Reform Act of 1984, put limits on the use of deferred exchanges under section 1031. The statutory language in that provision is consistent with the deferred exchange approach representing the natural method of characterizing a current transfer of property in exchange for a future delivery of property. Section 1031(a)(3) provides simply that for purposes of section 1031, any property received by the taxpayer is treated as property that is "not like-kind property" if the taxpayer fails to identify replacement property within 45 days of the transfer or fails to receive the replacement property within 180 days of the transfer (or, if earlier, the due date for the taxpayer's tax return for the relevant year). The statutory language of section 1031(a)(3) is strongly supportive of the deferred exchange approach being the correct characterization of deferred exchanges even without regard to the provision in that it does not specifically state that the transferor in a deferred exchange is treated as receiving the replacement property it receives in the future in exchange for the property it transfers currently; that treatment is simply assumed. Section 1031(a)(3) instead provides for disqualification from like-kind exchange treatment if its requirements are not satisfied.

Consistent with the section 1031 authorities endorsing the use of a deferred exchange approach, both Rev. Rul. 57-451 and GCM 36948 are clear that they were applying the deferred exchange approach in determining the tax consequences of a securities lending transaction. Indeed, without using the deferred exchange approach, Rev. Rul. 57-451 could not have logically arrived at its conclusion that section 1036 applied to the stock loan and subsequent redelivery of identical stock. In this regard, the ruling stated:

> That the delivery of shares of stock by the optionee to his broker and the satisfaction by the latter of the resulting obligation to replace them may constitute an exchange is supported by authority. A simultaneous delivery of property is not essential to an exchange. If the parties so intend, title to property delivered on one side may pass even though the contract remains executory on the other side.

Similarly, GCM 36948 confirmed this analysis by providing:

> Although exchanges often take the form of simultaneous transfers, recognition of a transaction as an exchange depends on its substance. . . . Rev. Rul. 61-119 . . . rules out an argument that two separate events, a sale and a subsequent purchase, occur when a trust "lends" stock and the borrower replaces it in kind. Since the "loan" and the replacement are reciprocal and mutually dependent transactions, they are a single event, namely, an exchange. The essence of the event is that a party transfers stock to another and receives stock in return. Accordingly, the status of this transaction as an exchange, rather than a sale and a subsequent purchase, is not diminished by the fact that there is an interim period of some duration after the trustee makes the transfer in which the trust holds only the borrower's promise to transfer like securities in satisfaction of its obligation.

In both Rev. Rul. 57-451 and GCM 36948, the IRS conceptualized a securities loan and subsequent return of the securities as an exchange

of securities for the securities ultimately returned (the deferred exchange approach), rather than an exchange of securities for the contractual right to a return of the securities and substitute payments. On the other hand, although the legislative history of the enactment of section 1058 makes clear that Congress viewed the tax treatment of securities loans as being subject to the materially different standard, it indicates that whether materially different property was received should be analyzed by looking to whether the contractual rights of the securities lender (rather than the actual replacement securities received) differed materially in kind or extent. As noted earlier, the legislative history states: "In order to assure that the *contractual obligation* does not differ materially either in kind or in extent from the securities exchanged, the committee amendment makes the provision applicable only if the contractual obligation satisfies certain specified conditions."[67] (Emphasis added.)

Although not entirely clear, in applying the materially different standard to NSP loans, the deferred exchange approach is more consistent with pre-section 1058 law on securities loans, as well as the authorities on like-kind exchanges under section 1031, than the simultaneous exchange approach. Moreover, the deferred exchange approach comports with a commonsense understanding of what occurs in a property loan, which is that the lender allows the borrower to use the property during the term of the loan in exchange for the return of the property. The fact that the property is fungible makes the specific identity of the property (for example, as reflected by the Committee on Uniform Securities Identification Procedures number of the particular security) immaterial. As a result, it appears likely (if not certain) that an NSP loan is treated as an exchange of the lent NSP for the NSP received upon repayment of the loan.

3. Is the property received by the NSP lender materially different from the lent NSP?

Now we turn to whether the property that a NSP lender is treated as receiving in exchange for lent NSP satisfies the materially different standard, such that the lender realizes no gain or loss as a result of the NSP loan. If the deferred exchange approach is correct, the NSP lender should easily avoid a realization event under the materially different standard because the property received in the exchange is identical to (and thus not materially different from) the property transferred by the lender.

If, instead, the simultaneous exchange approach were applied, the NSP lender would need to determine whether its rights under the NSP loan are materially different from its ownership rights in the NSP transferred under the loan. To be in a strong position that no realization event has occurred under the materially different standard (and in particular given the uncertainty regarding whether the deferred exchange approach is correct), the NSP loan should have terms that would satisfy the requirements of section 1058 if those requirements applied to NSP:

- the NSP lender should have the right to a return of identical NSP;
- the NSP lender should have the right to the receipt of any cash or other property it would have received for the NSP; and
- the NSP loan should not reduce the lender's opportunity for gain and risk of loss on the NSP.

1. When these provisions are present, the lender's economic profile with respect to the NSP will likely be treated as the same after the NSP loan as it was before the loan was extended.
2. Even when section 1058-compliant provisions are present in the NSP lending agreement, it is worth considering whether two additional terms should be included. First, the proposed regulations provide that a securities lender must have the ability to terminate a securities loan upon five business days' notice to qualify for nonrecognition treatment under section 1058. Further, the Tax Court and Ninth Circuit in *Samueli* determined that a securities lender's opportunity for gain or risk of loss has been reduced when the lender does not have the ability to terminate the securities loan on short notice. Although strong arguments can be made that the *Samueli* courts' holdings regarding the need for a securities lender to

[67] *See* S. Rep. No. 95-762, at 7.

have early termination rights were incorrect or should be limited to their facts, a best practices approach would be to include a right of the NSP lender to terminate the NSP loan on short notice. As with securities loans, it is unclear how quickly the NSP lender should be entitled to a return of NSP. However, it appears reasonable to conclude that any NSP loan entitling the lender to a return of the NSP on five business days' notice (that is, a return right that would satisfy the standard for securities loans in the proposed regulations) should not be treated as running afoul of the materially different standard solely on the basis of the five-business-day notice period.

3. Second, must the NSP borrower transfer collateral to the lender to secure its obligation to return the lent NSP in order to avoid a realization event under the materially different standard? In this regard, it is instructive that section 1058 contains no collateral posting requirement, even though section 512(a)(5) (which was enacted as part of the same legislation) contained such a requirement. The fact that the legislative history of the enactment of section 1058 suggests that the requirements set forth in that provision (which does not require the posting of collateral) are meant to cause the rights under the securities loan not to be materially different from the rights under the lent securities indicates that Congress did not believe that a lack of collateral should cause the securities lender's rights to be viewed as materially different from its rights in the lent securities. Therefore, while it may be preferable for the borrower of NSP to post collateral for its obligations under an NSP loan, it ought not be viewed as a requirement for the NSP lender to avoid realization under the materially different standard.[68]

[68] In this regard, it seems reasonable to conclude that if a court were to find that the simultaneous exchange approach should be adopted on the basis of the legislative history of section 1058, it should similarly find that the materially different standard is not violated because of a lack of collateralization, in light of the absence of such a requirement in section 1058.

B. Special Issues Regarding Digital Asset Loans

As described in Section IV.A above, it is likely that a lender of NSP would not recognize gain or loss on the making of an NSP loan if the loan complies with the requirements of section 1058, including the requirements that (1) the borrower return identical NSP (preferably on short notice) and (2) the borrower make substitute payments to the lender equal to the cash and other property the lender would have received had the loan not been made. A loan of digital assets can present issues that do not typically arise in a loan of other types of NSP. Some of those issues are discussed below.

1. Cryptocurrency should not be treated as currency.

A taxpayer that lends foreign currency to another party generally is treated as engaging in a section 988 transaction that results in the immediate recognition of foreign exchange gain or loss on the lent foreign currency.[69] The question then arises of whether a lender of cryptocurrency[70] should be treated as recognizing gain or loss in the same manner as a lender of foreign currency. The answer is almost certainly no.

Loans of cryptocurrency should not be subject to the tax rules applicable to loans of foreign currency because, as the tax law has long recognized, money (that is, fiat currency) is simply different from other types of property. Even before the enactment of section 988, courts often (but not universally) analyzed foreign currency transactions in a fundamentally different manner than similar property-related transactions. Section 988 codified this separateness by creating a set of rules for foreign currency that differ in myriad ways from those

[69] Section 988(c)(1)(B) and (C).

[70] This section addresses only the treatment of cryptocurrency loans because cryptocurrency (*e.g.*, bitcoin and ethereum) has at least some characteristics in common with foreign currency. Digital assets other than cryptocurrency (*e.g.*, utility tokens) generally do not possess those characteristics. Therefore, loans of those assets do not raise the same concerns as cryptocurrency loans.

applicable to other types of property.[71] In other words, the tax law has long had two separate regimes for transactions involving property: one for foreign currency, and another for all other types of property.

So where does that leave cryptocurrency loans? In Notice 2014-21, 2014-16 IRB 938, the IRS announced that virtual currency is treated as property rather than as "real" currency for federal income tax purposes, and it stated that "general tax principles applicable to property transactions apply to transactions using virtual currency."[72] Consistent with the treatment of virtual currency as property, the notice stated that virtual currency "is not treated as currency that could generate foreign currency gain or loss" for federal income tax purposes.[73] This pronouncement was not some administrative override of the natural treatment of virtual currency; it represented the government's correct interpretation of existing law that even though virtual currency shares some common features with government-issued currency, the tax meaning of the term "currency" is limited to legal tender and therefore cannot include virtual currency.[74]

Further, it is noteworthy that the making of some foreign currency loans does not trigger exchange gain or loss in the lent foreign currency. No exchange gain or loss is recognized on any of the following transactions: (1) the deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) denominated in that currency, (2) the withdrawal of nonfunctional currency from a demand or time deposit or similar instrument denominated in that currency, and (3) the receipt of nonfunctional currency at maturity of a certificate of deposit.[75]

This exemption from the recognition of exchange gain or loss is consistent with the treatment of nonfunctional-currency-denominated demand or time deposits and similar instruments as constituting nonfunctional currency.[76] Even though those bank deposits are treated as loans for federal income tax purposes, the making of such deposits was presumably carved out from recognition treatment because the deposited currency and the deposit itself were viewed as so similar that the making of the deposit (and the withdrawal from that deposit) was not regarded as an appropriate time to treat the depositor as having disposed of the currency. Although this is not precisely the same standard as the materially different standard, which appears to apply for loans of cryptocurrency and other NSP, the carveout from recognition treatment for deposit arrangements even in the context of foreign currency suggests that the existence of material differences between the transferred asset and the right to a return of the asset is an appropriate measure for determining whether a realization event has occurred. The section 988 rules simply specify a potentially different standard for realization treatment than exists for other types of property.

Notwithstanding the question above, El Salvador's recent designation of bitcoin as legal tender (which went into effect on September 7, 2021) raises the issue of whether bitcoin will be treated as foreign currency for U.S. federal income tax purposes simply by virtue of its legal tender status.[77] In this regard, it is worth noting that the background section of Notice 2014-21 states:

> In some environments, [cryptocurrency] operates like "real" currency — i.e., the coin and paper money of the United States

[71] LaBrenda Garrett Stodghill, "Taxing the Yen for Foreign Currency: The Statutory Regime," 7 *Va. Tax Rev.* 57 (1987) ("The enactment of new sections 985 through 989 ('Subpart J') of the Internal Revenue Code heralds the recognition of exchange gain or loss as a separate class of income or deduction, the tax treatment of which is not susceptible to analysis under principles that were developed for treating non-monetary assets.").

[72] Notice 2014-21, Q&A 1. The notice addressed virtual currency, which it defined as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." The IRS later clarified, however, that a digital representation of a foreign currency is not treated as virtual currency for purposes of its guidance (presumably on the basis that the digital representation may itself constitute foreign currency). *See* IRS, "Frequently Asked Questions on Virtual Currency Transactions," Q&A 1 (Oct. 9, 2019). We expect that most cryptocurrency would be treated as virtual currency for purposes of Notice 2014-21.

[73] Notice 2014-21, Q&A 2.

[74] Jim Calvin, *Taxation of Cryptocurrencies*, Tax Management Portfolio No. 190 (2019) ("In order to constitute a real currency, not only must an item have legal tender status, it must have the other attributes of real currency — meaning it circulates, and is customarily used and accepted as a medium of exchange.").

[75] Reg. section 1.988-2(a)(iii).

[76] Section 988(c)(1)(C)(ii).

[77] Enacted on June 8, 2021, article 7 of the Salvadoran bitcoin law provides that "every economic agent must accept bitcoin as payment when offered by whoever acquires a good or service."

> or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance — but it does not have legal tender status in any jurisdiction.

This raises the question whether cryptocurrency that obtains legal tender status in a jurisdiction where it is used and accepted as a medium of exchange becomes foreign currency for federal income tax purposes. It would appear, however, that the quoted language above merely highlights that cryptocurrency cannot be considered foreign currency for tax purposes when it does have legal tender status; it does not suggest that merely having legal tender status is sufficient for it to be treated as foreign currency. Instead, an item of property would appear not to be treated as foreign currency for tax purposes unless it is issued by the country or countries where it is legal tender (or by a body, like the European Central Bank, organized by countries to issue the property).

Further, the quoted language from Notice 2014-21 might be read to suggest that a factor in determining whether property is foreign currency is whether it is "customarily used and accepted as a medium of exchange" in a jurisdiction where it is legal tender. Under this approach, the fact that bitcoin is considered legal tender in El Salvador may be less meaningful if it is not customary for businesses in the country to receive bitcoin as payment for goods or services. Moreover, Rev. Rul. 2019-24, 2019-44 IRB 1004, states: "Foreign currency is the coin and paper money of a country other than the United States that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange *in the country of issuance*."[78] (Emphasis added.)

Further, in *Wisconsin Central*,[79] the Supreme Court analyzed whether stock options transferred to employees constituted "money remuneration" within the meaning of the Railroad Retirement Tax Act of 1937. The Court noted: "When Congress adopted the Act in 1937, 'money' was understood as currency 'issued by [a] recognized authority as a medium of exchange.'" Although the Court was interpreting the term "money" rather than "currency," it is difficult to see why its view that money must be issued by a recognized authority should not apply with equal force to foreign currency.

Treatment of property not issued by a country (or group of countries) as currency could lead to some peculiar results. For example, assume that the country of San Marino changed its laws to allow for gold bullion to be used for all payments to be made in San Marino. Would that change in law suddenly cause all gold bullion to be treated as foreign currency for federal income tax purposes? It would be difficult to imagine that a foreign government could change the U.S. federal income tax treatment of an item of property it does not issue simply by requiring businesses in that country to accept that property as a method of payment.

Although it appears unlikely for bitcoin to be treated for tax purposes as foreign currency simply because it now has legal tender status in El Salvador, it would be helpful for the IRS to update the guidance it provided in Notice 2014-21 to clarify that its conclusion regarding the treatment of digital assets as property and not currency continues to apply to bitcoin even after the change in Salvadoran law.

2. Does it matter whether the digital assets returned are identical to those lent?

One question that might be considered in connection with a loan of digital assets is whether the digital assets to be repaid by the borrower are "identical" to those lent and, if not, whether that could affect whether the loan will trigger the recognition of gain or loss by the lender. One way in which a digital asset may be viewed as not identical to another digital asset of the same type is that each digital asset has a unique transaction history. Using bitcoin as an example, it is possible to trace an amount of bitcoin from its current owner through each of its previous owners to the creation of bitcoin in 2009 (or, if later, when the bitcoin was mined). In this sense, each bitcoin is unique. But this uniqueness should be irrelevant to someone who acquires bitcoin from its prior owner. Subject to the discussion below, any bitcoin so acquired generally should have the

[78] For this proposition, the ruling cited to regulations of the Financial Crimes Enforcement Network defining the term "foreign currency." *See* 31 C.F.R. section 1010.100(m).

[79] *Wisconsin Central Ltd. v. United States*, 138 S. Ct. 2067 (2018).

same value and give the holder the same rights (including the right to additional digital assets in the case of forks or airdrops) as any identical amount of bitcoin. Each bitcoin generally should trade fungibly, causing each unit to have the same value as any other unit. Proof of this fungibility is that under the terms of a bitcoin loan, the borrower is simply obligated to return the same amount of bitcoin, which strongly suggests that there is nothing unique about any particular bitcoin.

If a taxpayer lent certificated stock to its broker and later received replacement stock in uncertificated form (or in the form of a different stock certificate), it would be difficult to conceive that section 1058 (or pre-section 1058 nonrealization principles) would not apply to the loan, because the returned stock is identical in every way that matters. Indeed, the facts in Rev. Rul. 57-541 contemplated that certificated shares would be either deposited along with a stock assignment form signed in blank or endorsed and accompanied by an authorization to lend the shares; in either case, the shares received in return would be different from the original certificated stock. Similarly, the proposed regulations make clear that securities are identical if they are of the same class and issued by the same issuer.[80]

Does the fact that a digital asset may have been acquired as part of illegal conduct, such that the party engaging in that conduct (or potentially a subsequent acquirer) might be required to forfeit the digital asset, prevent digital assets generally from being treated as identical to digital assets of the same type? First, it is not clear that digital assets acquired by an innocent purchaser in the market with no knowledge (and no reason to know) of the association of those assets with prior misconduct would be subject to forfeiture. But even if they were, the possibility of forfeiture could similarly exist for non-digital assets.

In any event, what really matters in terms of the arguments set forth in Section IV.A above is whether the property received in exchange for the digital asset loan (whether the same digital asset or the contractual right to its return) is considered materially different from the digital asset itself. Thus, even if the returned digital asset is not considered identical, that fact alone should not cause the right to a return of the asset to be treated as differing materially in kind or extent from the lent digital asset. Moreover, if the rights conferred by ownership of the asset are the same among assets of the same class and type, it should not be considered materially different from an asset of the same class and type received in return.

3. Substitute payments on digital asset loans.

For a securities loan to qualify for nonrecognition treatment under section 1058, it must require the borrower to make payments to the lender equivalent to all interest, dividends, and other distributions to which the lender would have been entitled had it not lent the securities.[81] The existence of a requirement to make those substitute payments is consistent with how all or nearly all securities lending transactions have been structured, even before the enactment of section 1058.

However, there is a question whether substitute payments are required for digital asset loans (for which section 1058 is inapplicable) in order for the lender to avoid a realization event for the lent digital assets under section 1001. The intuitive answer is that substitute payments should be made to keep the lender's economic position as constant as possible. But whether substitute payments must be contractually required to avoid realization under the materially different standard depends on whether the digital assets transferred by the lender are viewed as exchanged for (1) the digital assets that will ultimately be returned (under the deferred exchange approach) or (2) the contractual right to a return of digital assets plus substitute payments (under the simultaneous exchange approach). If the deferred exchange approach is applied, which, as described above, appears to be the more technically supportable position, a requirement to make substitute payments should be irrelevant as a technical matter because the property received (that is, the digital assets returned by the borrower) should be viewed as identical to (or at least not materially different from) the property initially transferred.

[80] Prop. reg. section 1.1058-1(b)(1).

[81] Section 1058(b)(2).

To be clear, it is strongly advisable for digital asset loans to require the making of substitute payments if doing so is practical, both to minimize tax risk and simply from an economic perspective. As described next, however, it may be difficult (if not impossible) for a digital asset lending agreement to provide the lender in all circumstances with the same rights it would have in property it otherwise would have received had the digital asset loan not been made.

In most loans of securities and MLP units, the borrower's payment of substitute payments to the lender is a reasonably straightforward exercise: The receipt of cash and other property by the holder of the lent property usually occurs on a periodic basis (or upon the occurrence of an infrequent corporate action). Moreover, the amounts received by the holder of the lent property are typically in the form of cash or property that is easy for the borrower to acquire and transfer to the lender.

Challenges may arise regarding substitute payments made on digital asset loans — challenges that would not normally exist with loans of securities and other types of NSP. Hard forks and airdrops[82] may occur far more frequently than payments of dividends and interest.[83] Further, the digital assets received in those forks and airdrops are often of little or no value and take the form of digital assets that may not be supported by exchanges and custodians. This may make it difficult to put the digital asset lender in the same position as if the loan had not been made. Must the digital asset borrower transfer to the lender every additional digital asset that the lender would have received in a hard fork or airdrop had the digital asset not been lent?

While it would be better (if unrealistic) for those forked or airdropped digital assets (the incremental assets) to be paid through to the lender as substitute payments in all events, it is unclear that doing so is critical to the argument that the digital asset loan does not trigger gain or loss. In many cases, the incremental assets have no value when received and will never have any value. Even had the lender not lent the digital assets, and thus technically been able to receive those incremental assets, in many cases the custodian through which the lender holds its digital assets would not support the incremental assets, thus depriving it of value in any event.

Even if the materially different standard is applied using the simultaneous exchange approach, such that substitute payments generally should be required, the relevant question regarding the failure to include all incremental assets in the substitute payment requirement ought to be one of materiality. When the incremental assets that are not included in substitute payments (and are thus forgone by the lender, relative to its position had it not made the loan) are immaterial, the analysis of the loan under section 1001 should not be affected regardless of which approach to applying the materially different standard is used.

4. Issues concerning loans of stablecoins.

Stablecoins are digital assets whose value is tied to the value of another asset. The assets referenced by stablecoins are most often fiat currency (for example, U.S. dollars or euros), but they can also consist of commodities or other digital assets. The issuer of a stablecoin will typically put assets in reserve (often in the form of a bank deposit or other high-quality debt instrument) to ensure repayment of the stablecoin. The holder of the stablecoin generally will be entitled to redeem the stablecoin at any time in exchange for the corresponding amount of referenced asset.

Although there is no guidance directly addressing the appropriate tax treatment of stablecoins, when the stablecoin references government-issued currency, it is reasonable to conclude that the stablecoin should be treated as a debt instrument (denominated in that fiat currency) issued by the party whose credit backs the repayment obligation. Because that stablecoin

[82] A hard fork occurs when the rules that apply to a digital asset are updated or otherwise change and the digital asset effectively splits (or "forks"), such that after the fork there are two separate blockchains (one for the original digital asset and one for a new digital asset complying with the new rules). Each holder at the time of the hard fork receives a corresponding amount of the new digital asset while continuing to own its original digital asset. An airdrop is when a new type of digital asset is created and is distributed (free of charge) to all the holders of an existing digital asset to encourage awareness and use of the new asset.

[83] According to one source, there have been 105 hard forks of bitcoin to date, of which only 74 are considered active projects. Even among the 74 active projects, only 45 of those are digital assets capable of being transacted in. *See* forkdrop.io, "How Many Bitcoin Forks Are There?"

should be treated as debt (and thus a security within the meaning of section 1236(c)), the lending of the stablecoin and its subsequent return should be tax free under section 1058 without the need to rely on the materially different standard.[84]

5. The case of loans of digital assets to be used by the borrower (and not delivered to others).

As discussed above, securities are typically borrowed to allow the borrower to initiate a short sale, to continue a short sale by delivering the borrowed securities to another lender, or to avoid a failure to deliver. In each case, legal ownership of the borrowed securities becomes vested in a third party, and that third party clearly becomes the tax owner of the securities it acquires (that is, neither the borrower nor the lender is the tax owner of the lent securities during the term of the loan). This is why it is necessary to determine whether the lender's loss of tax ownership may still be a tax-free transaction under section 1058. The same holds true for NSP loans in which the lent NSP is sold short by the borrower or otherwise transferred to a third party, in which case the lender's transfer of NSP must be analyzed under section 1001 and common law principles to determine whether the loan results in a taxable exchange.

But not all loans of digital assets necessarily result in a loss of tax ownership of the assets. Some digital assets give their owner the benefit of goods or services or the ability to derive income. For example, blockchain networks that use proof-of-stake (PoS) algorithms[85] allow owners to "stake" their digital assets and thereby participate in the verification and creation of blocks on the blockchain. That PoS staking generally enables the owner staking the digital assets to earn block rewards (in the form of additional digital assets). Another example of digital assets that provide direct value to their holders are filecoin tokens, which allow holders to earn rewards by renting out their personal computer storage space using a decentralized protocol. In each case, the holder of the digital asset can engage in profitable activity (which the lender in turn forgoes) by using the asset without transferring its ownership to a third party (as in a short sale).

A loan of digital assets should not result in a change of tax ownership if the borrower is not permitted to transfer the borrowed assets to a third party. In that case, under a common law analysis of the benefits and burdens of ownership of the digital assets, the lender (and not the borrower) should be treated as the tax owner. Not only does the lender in that case maintain all the economic upside and downside in the lent digital assets (which is true in any digital asset loan), but the borrower is also deprived of the ability to transfer the borrowed assets to another party (typically viewed as a key attribute of ownership). Further, the third-party owner principle (which holds that a property lender cannot be the owner of an asset when the borrower has vested legal and tax ownership in a third party) is simply inapplicable when the borrower cannot transfer ownership of the asset.

In effect, the borrowing of digital assets for their productive use by the borrower (and not for the transfer to a third party) should be viewed as effectively the same as the leasing of a nonfungible, tangible asset. In each case, the borrower/lessee is willing to pay the lender/lessor for use of the property and will ultimately redeliver the property, thus leaving the lender/lessor with all the economic appreciation and depreciation in the asset at the end of the loan/lease term. Further, the residual value of that tail interest is likely to be valuable because, unlike leased tangible property, a borrowed digital asset does not have a limited useful life and is not expected to depreciate over time as a result of wear and tear. Finally, because there should be no need to satisfy the requirements of section 1058 or the materially different standard under section 1001, the parties should be able to enter into a loan of digital assets for a reasonable fixed term (rather

[84]The lending of a stablecoin that references something other than fiat currency (*e.g.*, another digital asset) raises more complex issues because nonrecognition treatment under section 1058 would be unavailable (because the stablecoin would not be a security within the meaning of section 1236). In that case, the taxpayer would be treated as transferring a derivative (*i.e.*, the stablecoin referencing the underlying asset) in exchange for the right to a return of the same derivative, which would raise issues similar to those discussed above regarding the lending of the underlying asset.

[85]Digital assets that use PoS algorithms include tezos, cosmos, cardano and EOS. Also, ethereum, the second most valuable digital asset, has begun using PoS algorithms in its Ethereum 2.0 network. *See* Cryptopedia, "What Are Proof of Stake (PoS) and Delegated Proof of Stake (DPoS)?" (updated Apr. 30, 2021); and Everett Muzzy, "What Is Proof of Stake?" Consensys, May 15, 2020.

than needing the ability of the lender to demand a return of the lent assets on short notice) without jeopardizing the tax-free nature of the loan.

In some circumstances, a borrower might intermediate the transfer of digital assets between the owner of the assets and another party that can make productive use of those assets. In that case, the borrower may borrow the assets under an agreement that does not permit a sale of those assets but would permit an on-lending of them to a party that agrees not to sell, rehypothecate, or otherwise transfer them to another party. That arrangement should not be treated as a transfer of the digital assets by the lender for the same reasons discussed above if at all times during the term of the loan (1) there is no party that has the right to transfer the digital assets to a third party (other than under another loan with the same restriction) and (2) no party other than the lender would treat itself as the tax owner of the lent digital assets.

C. What Happens if the Lending Was Taxable?

If, despite the analysis set forth in this Section IV, the lender is taxable on its loan of NSP, will it similarly be taxable when the NSP is returned by the borrower? At first, it may appear that the return of the NSP would be a recognition event for the same reason that the lending itself was taxable. In other words, if the property right received by the NSP lender is treated as materially different from the NSP itself (such that the lending is treated as a section 1001 event), wouldn't the receipt of NSP in satisfaction of the right to return be treated as an exchange of the right to repayment of the lent NSP for materially different property (that is, the NSP)?

The lender may suffer significant adverse tax consequences if the NSP return were treated as a recognition event. For example, assume that a lender lends NSP in which it has a tax basis of $100, at a time when (1) the lender has a long-term holding period in the NSP and (2) the NSP has a fair market value of $150. If the loan is treated as a taxable event, the lender would recognize $50 of long-term capital gain upon lending the NSP. If the lender were to terminate the NSP loan when the NSP is worth $200 and the lender does not yet have a long-term holding period in the right to a return of the NSP, treatment of the NSP return as a taxable event presumably would result in the recognition of an additional $50 of short-term capital gain. Thus, by virtue of the failure of the NSP to garner tax-free treatment, the taxpayer experiences not only an acceleration of taxable gain (relative to its treatment if the NSP loan were nontaxable) but also a rate detriment by converting $50 of gain that would otherwise have been long-term capital gain into short-term capital gain.

Although unclear, it appears that the NSP return should not be treated as a taxable event, even if the initial lending of the NSP was taxable. It is well established that the receipt of property under an executory contract, such as a forward contract or similar agreement for future delivery, is not a taxable exchange of the right to receive the property for the property itself. Instead, the acquirer takes a basis in the property equal to the amount it paid (either upfront or at settlement) for the property under the contract. While the right to the return of property under a NSP loan is not in the form of a forward contract, it has the same substance as a typical executory contract because it is a contract right providing for the future delivery of property. The fact that the party receiving the NSP under the contract did not transfer cash in exchange for the NSP, and instead made an upfront transfer of NSP, should be of little consequence. Put differently, when the initial NSP loan is treated as a taxable disposition of the NSP, the transaction should be treated no differently than had the lender sold the NSP for cash and used that cash to make an upfront payment on a prepaid forward contract to acquire the NSP. Consequently, the return of the NSP under an NSP loan should not be a taxable event to the lender, regardless of whether the lending of the NSP was taxable. ■