

**INTERNAL REVENUE SERVICE**  
**NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**

October 23, 2001

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Release Date: 2/15/2002  
Index (UIL) No.: 861.09-06  
CASE MIS No.: TAM-125481-00/CC:INTL:B5

District Director,

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No.:  
Years Involved:  
Date of Conference:

LEGEND:

Taxpayer =

ISSUE:

Whether, for purposes of the interest allocation rules under I.R.C. section 864(e), a U.S. taxpayer may treat its matched book repurchase agreement ("matched book repo") operation as producing net fee income rather than interest income and interest expense, or alternatively, net the interest income and expense.

CONCLUSION:

Repos and reverse repos entered into as part of a matched book repo operation are properly characterized as collateralized lending transactions and thus generate interest income and expense. Pursuant to Temp. Treas. Reg. §1.861-10T(c), such interest income and expense cannot be netted.

FACTS:

A repurchase agreement or "repo" is a sale of a security with a simultaneous agreement by the seller to repurchase the same security at a future date at a specified price that reflects a time value of money component. Thus, the economic substance of a repo is a collateralized loan from the buyer to the seller. A "reverse repo" is the same

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transaction viewed from the perspective of the buyer that has agreed to purchase (“reverse in”) and sell back the security at a later date.

The taxpayer, a U.S. corporation, is a primary dealer in U.S. government securities and actively participates in the distribution of U.S. Treasury securities. In its matched book repo operation, the taxpayer routinely “reverses in” securities, earning income attributable to the time value of money on the reverse repos, and rehypothecates or “repos out” these securities, generating expense attributable to the time value of money on the repos. The taxpayer earns an economic net profit (or loss) from the matched book that is equivalent to the difference between such income and expense.

At issue is whether, for purposes of the interest allocation rules under I.R.C. section 864(e), the taxpayer may treat its matched book repo operation as producing net fee income rather than interest income and interest expense, or alternatively net the interest income and expense which, in effect, treats the expense as directly allocable to the reverse repo interest income rather than apportioning such expense between all domestic and foreign source income on the basis of the taxpayer’s asset values. On its consolidated tax returns for the years under examination, the taxpayer treated its matched book repo operation as giving rise to net fee income. It did not treat the repos entered into by its matched book repo operation as giving rise to interest expense subject to allocation under §1.861-9T. The Field proposes to treat the taxpayer’s matched book repo operation as generating interest income and expense, increasing the interest expense subject to allocation under §1.861-9T. The effect of this proposed adjustment is to allocate interest expense to foreign source income, reducing the taxpayer’s foreign tax credit limitation under section 904 in the years under examination.

#### LAW AND ANALYSIS:

Interest has been defined as the amount which one has contracted to pay for the use of borrowed money. Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932). The Service has consistently held that repos and reverse repos are treated as secured loans giving rise to interest expense (in a repo) and interest income (in a reverse repo) for federal income tax purposes. See Rev. Rul. 74-27, 1974-1 C.B. 24; Rev. Rul. 77-59, 1977-1 C.B. 196; Rev. Rul. 79-108, 1979-1 C.B. 75; Rev. Rul. 79-195, 1979-1 C.B. 177. The U.S. Supreme Court cited the Service’s position in Nebraska Dept. of Revenue v. Loewenstein, 513 U.S. 123, 128 n. 3 (1994), in holding that repos are collateralized lending agreements for purposes of characterizing payments with respect to such transactions for state tax purposes. See also First American Nat’l Bank of Nashville v. United States, 467 F.2d 1098 (6<sup>th</sup> Cir. 1972); Union Planters Nat’l Bank of Memphis v. United States, 426 F.2d 115 (6<sup>th</sup> Cir.), cert. denied, 400 U.S. 827 (1970); American Nat’l Bank of Austin v. United States, 421 F.2d 442 (5<sup>th</sup> Cir.), cert. denied, 400 U.S. 819 (1970). The Service is not aware of any legal authority that is inconsistent with these revenue rulings and Loewenstein and that does not treat repos as

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collateralized loans for federal tax purposes. That the taxpayer simply earns a spread on matched financing transactions between unrelated borrowers and lenders does not change the character of the income and expense associated with the repos and reverse repos since the taxpayer is engaged in lending and borrowing funds.

Section 864(e) generally requires taxpayers to allocate and apportion interest expense on the basis of assets rather than gross income (the "asset method"). Specifically, interest expense must be allocated to U.S. and foreign source income by reference to assets that generate such U.S. and foreign source income. Section 864(e)(2). This allocation is made as if all members of an affiliated group are a single corporation. Section 864(e)(1). Financial institutions, however, are treated as separate from non-financial companies for this purpose. Section 864(e)(5)(B), (C), and (D). These principles are set forth in §1.861-9T.

The Conference Report to the 1986 Act states:

In the case of an integrated financial transaction such as a debt financed acquisition of foreign currency debt obligations or similar arbitrage transactions, the agreement authorizes the Secretary to provide for the direct allocation of interest expense incurred on funds borrowed to acquire these assets against income from the assets involved in the integrated transaction, if appropriate.

H.R. Rep., No. 841, 99<sup>th</sup> Cong., 2d Sess., Vol. II 606 (1986). Section 864(e)(7)(B) grants the Service authority to provide regulations for the direct allocation of interest expense incurred to carry out an integrated financial transaction to any interest income derived from such transaction. Promulgated under section 864(e), §1.861-10T(c)(1) permits integration for certain integrated financial transactions, but this provision expressly does not apply to financial services entities and thus is unavailable to the taxpayer. See §1.861-10T(c)(2)(vi).<sup>1</sup>

Accordingly, the amounts earned and paid by the taxpayer with respect to repos and reverse repos entered into as part of its matched book repo operation constitute interest

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<sup>1</sup> Prop. Treas. Reg. §1.1296-6(i) defines securities income to include the net (rather than the gross) income from a matched book of repos and reverse repos. However, this section only applies for purposes of determining whether a foreign corporation is a passive foreign investment company ("PFIC"). See Prop. Treas. Reg. §1.1296-6(a). The preamble to these proposed regulations states that dealers act as intermediaries in setting up matched books of repos and reverse repos, but it does not address the issue of whether repos and reverse repos are lending transactions, and application of the regulations is expressly limited to determining the PFIC status of a foreign corporation.

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income and expense, not net fee income. These amounts cannot be netted, and interest expense from the taxpayer's matched book repo operation is subject to allocation under section 864(e) and §1.861-9T.

CAVEAT

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.