

## Source of Certain Borrow Fees

Notice 2025-63

### SECTION 1. PURPOSE

Neither the Internal Revenue Code (the “Code”) nor Treasury regulations directly specify how to determine the source of payments referred to as borrow fees or negative rebate (collectively, “borrow fees”) with respect to securities lending transactions or sale-repurchase transactions. As a result, the appropriate source rule for those payments is uncertain. See, e.g., TD 9579, 77 FR 9846, 9846 (Feb. 21, 2012) (“The Treasury Department and the IRS are considering whether separate guidance is needed on the source of income attributable to certain payments . . . that arise in securities lending transactions or repurchase transactions”). This notice announces that the Treasury Department (“Treasury”) and the Internal Revenue Service (“IRS”) intend to issue proposed regulations (the “forthcoming proposed regulations”) providing that certain borrow fees (as circumscribed in section 3) are sourced based on the residence of the recipient.

## SECTION 2. BACKGROUND

### .01 Sourcing Items of Income

The general rules for determining whether items of income are from sources within or without the United States are found in sections 861 through 865 of the Code. The Code provides specific sourcing rules for, among other items, interest, dividends, compensation for personal services, rents and royalties, and income from sales of personal property. Section 863(a) grants authority to the Secretary to prescribe regulations allocating or apportioning items of gross income not otherwise specified in sections 861(a) and 862(a) to sources within or without the United States.

### .02 Securities Lending and Sale-Repurchase Transactions<sup>1</sup>

#### (1) Transactional Documentation

Securities lending transactions and sale-repurchase transactions are typically entered into under a standardized form of agreement<sup>2</sup> that includes industry-standard legal and commercial terms and definitions, and attached annexes or schedules, which provide other standardized terms applicable to specific types of transactions and may include procedures for making elections permitted by the standardized agreement

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<sup>1</sup> The description of securities lending transactions and sale-repurchase transactions in this Section 2.02 is intended as a description of market practice and does not represent a conclusion by Treasury or the IRS as to the tax characterization of the transactions.

<sup>2</sup> For examples of standardized master agreements for securities lending transactions, *see, e.g.*, Securities Industry and Financial Markets Association (SIFMA), Master Securities Loan Agreement (2017) (referring to a borrow fee as a “Loan Fee”); International Securities Lending Association, Global Master Securities Lending Agreement (2010). For examples of standardized agreements for sale-repurchase agreements, *see, e.g.*, SIFMA, Master Repurchase Agreement (1996); SIFMA and International Capital Market Association, Global Master Repurchase Agreement (2011); The Bond Market Association and International Securities Market Association, Global Master Repurchase Agreement (2000).

(together, a “master agreement”). A related short-form confirmation memorializes the specific business terms of a particular securities lending transaction or sale-repurchase transaction.

## (2) Securities Lending Transactions

In a securities lending transaction, one party (the “securities lender”) lends securities (the “loaned securities”) to another party (the “securities borrower”), subject to an obligation by the securities borrower to return equivalent securities to the securities lender, and the securities borrower typically transfers collateral in the form of cash, securities, or other financial instruments to the securities lender as security for the securities borrower’s obligation under the agreement.

Under the standard master agreement used in the U.S. financial markets, the fee arrangement in a securities lending transaction depends on the type of collateral posted. When the securities borrower posts non-cash collateral with the securities lender, the securities borrower pays the securities lender an explicit fee, often referred to as a borrow fee.

By contrast, when cash collateral is posted, the master agreement provides for the securities lender to pay the securities borrower an amount frequently described as a fee or “rebate” with respect to the cash collateral, which is computed daily based on the amount of cash held by the securities lender as collateral at a rate agreed to by the parties. The securities lender retains the excess of the return it generates on the cash collateral over the amount paid to the securities borrower. This differential retained by

the securities lender provides it with the economic equivalent of a borrow fee. In most such cases, no explicit fee is paid by the securities borrower to the securities lender.

However, in certain circumstances where the securities borrower has posted cash collateral, the securities borrower may pay an explicit fee (sometimes referred to as a “negative rebate”) to the securities lender. This may happen, for example, when the prevailing interest rates are low or the demand for the loaned securities is high. More specifically, if the borrow fee, on a standalone basis, exceeds the return the securities lender could earn on the cash collateral, the securities borrower would pay the securities lender a negative rebate equal to the excess of the borrow fee over the return on the cash collateral.

The terms of master agreements used in international financial markets or with respect to non-U.S. securities differ in some respects. Some master agreements require the securities borrower to pay an explicit fee to the securities lender without regard to the type of collateral posted by the borrower. In such cases, the securities borrower is always required to pay a borrow fee, although the payment may be set off against the return on the cash collateral.

### (3) Sale-Repurchase Transactions

In a sale-repurchase transaction (sometimes referred to as a “repo”), one party (the “cash lender”) purchases securities from another (the “cash borrower”) subject to an agreement for the cash borrower to repurchase equivalent securities in the future at a prearranged price. A sale-repurchase transaction may function economically as a

secured loan of money, a securities lending transaction, or both.

If the transaction is initiated because the initiating party wants to borrow money or earn a rate of return on excess funds, then the transaction economically resembles a loan of money. The securities sold function as collateral for the loan, with the amount of that collateral determined based on the loan “principal.” Where a sale-repurchase transaction is intended primarily as a secured loan of money, the parties will often agree to a general collateral sale-repurchase agreement. Under a general collateral sale-repurchase agreement, the parties agree in advance on the types of securities and related haircuts that the cash lender is willing to accept, which generally includes U.S. Treasuries, and the cash borrower can choose which of those securities to provide. The cash borrower will pay a “general collateral” rate of return on the loan “principal.”

A sale-repurchase agreement may also function as a securities lending transaction. If the cash lender requires the cash borrower to sell and repurchase a specific security, then the sale-repurchase agreement is described as a “special sale-repurchase agreement.” Generally, the effective interest rate on a special sale-repurchase agreement is less than the interest rate on a general collateral sale-repurchase agreement (of equal tenure). The difference between those rates economically functions as a borrow fee to the cash borrower. The greater the demand for a security, the greater the implicit borrow fee. In a manner similar to a securities lending transaction, a special sale-repurchase agreement may result in the cash lender paying a negative rebate when the interest rate for a general collateral sale-repurchase

agreement is low or the demand for the specific security is high.

### SECTION 3. PROPOSED REGULATIONS TO BE ISSUED

Pursuant to the Secretary's rulemaking authority under section 863(a), the forthcoming proposed regulations would provide that the source of borrow fees (as defined in this section) paid with respect to a securities lending transaction or a sale-repurchase transaction (also as defined in this section) is determined based on the residence of the recipient, subject to the following definitions and rules applicable solely for this purpose.

A securities lending transaction and a sale-repurchase transaction have the meanings provided under §§1.861-2(a)(7) (transactions with respect to debt securities) and 1.861-3(a)(6) (transactions with respect to equity securities).

A borrow fee (including negative rebate) is a fee that is (1) paid pursuant to a securities lending transaction or sale-repurchase transaction that is (i) documented on an industry-standard master agreement and confirmation (or electronic equivalent thereof) with standard market terms and (ii) entered into in the ordinary course of the taxpayer's and counterparty's trades or businesses or pursuant to their normal investment activities or objectives, and (2) paid in substance to compensate the lender of the securities (including a cash borrower in a sale-repurchase transaction) for making its securities available to the borrower of the securities (including a cash lender in a sale-repurchase transaction).

The residence of the recipient is determined in the same manner as under

section 988(a)(3)(B).

#### SECTION 4. APPLICABILITY DATE AND RELIANCE

The forthcoming proposed regulations would provide that the regulations will apply prospectively to taxable years ending after the forthcoming proposed regulations are published in the Federal Register. The forthcoming proposed regulations would also provide that taxpayers may choose to apply the regulations, once finalized, before the applicability date. In addition, taxpayers may rely on the rules described in section 3 of this notice with respect to securities lending transactions and sale-repurchase transactions entered into before the forthcoming proposed regulations are published in the Federal Register.

This notice does not address the source of any other payments with respect to securities lending transactions, sale-repurchase transactions, or substantially similar transactions, including a payment described as a borrow fee that is not within the scope of this notice, such as an amount paid with respect to a one-off or structured transaction or a transaction that does not have standard market business terms. The label given to a payment does not govern the determination of source; whether a fee labeled as a borrow fee is treated as such for Federal income tax purposes is determined based on the substance of the fee.

#### SECTION 5. DRAFTING AND CONTACT INFORMATION

The principal author of this notice is D. Peter Merkel of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department

and the IRS participated in its development. For further information regarding this notice, contact D. Peter Merkel on (202) 317-6938 (not a toll-free call).