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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD [9579]

RIN 1545-BJ78

Source of Income from Qualified Fails Charges.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that prescribe the source of income received on a qualified fails charge under section 863 of the Internal Revenue Code (Code). The regulations finalize proposed regulations and withdraw temporary regulations published on December 8, 2010, and affect persons that pay or are entitled to receive qualified fails charges, including withholding agents.

DATES: Effective Date. These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date. For the date of applicability, see § 1.863-10(g).

FOR FURTHER INFORMATION CONTACT: Karen Walny, Office of Associate Chief Counsel (International) (202) 622-3870 (not a toll free call).

SUPPLEMENTARY INFORMATION:

Background

In response to persistent delivery failures in delivery-versus-payment transactions involving U.S. Treasury securities (Treasuries), the Treasury Market Practices Group (TMPG) and the Securities Industry and Financial Markets Association published a trading practice governing failed deliveries of Treasuries in 2008. In July, 2009, the Treasury Department and the Internal Revenue Service (IRS) issued Notice 2009-61 (2009-2 CB 181), which provided that the IRS will not challenge the position taken by a taxpayer or a withholding agent that a fails charge paid with respect to a Treasury on or before December 31, 2010 is not subject to U.S. gross basis taxation. On December 8, 2010, the Treasury Department and the IRS issued temporary and proposed regulations that establish source rules for a fails charge paid with respect to a Treasury, with a correction to the temporary regulations on December 28, 2010. 75 FR 76262, 75 FR 76321, and 75 FR 81457, respectively.

The temporary and proposed regulations provide that the source of income from a qualified fails charge is generally determined by reference to the residence of the taxpayer that is the recipient of the qualified fails charge income, with two exceptions. Qualified fails charge income earned by a qualified business unit (QBU) of a taxpayer is sourced to the country in which the QBU is engaged in a trade or business, and qualified fails charge income that arises from a transaction the income from which is effectively connected to a United States trade or business is sourced in the United States and treated as effectively connected to the conduct of a United States trade or business.

No comments were received on the proposed regulations, and no hearing was requested or held. This Treasury decision adopts the proposed regulations with the changes discussed in this preamble.

Explanation of Provisions

These final regulations adopt, with one substantive change, the proposed regulations on the source of a qualified fails charge. The final regulations also make a number of clarifying changes to the language of the regulations.

The preamble to the temporary regulations noted that no trading practice existed at that time for fails charges on securities other than Treasuries, but that if a fails charge trading practice pertaining to other securities was endorsed by the TMPG or an agency of the United States government, the Treasury Department and the IRS would consider whether the source rule in the regulations should be extended to those fails charges. The TMPG has subsequently endorsed a trading practice for debentures issued by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks and agency pass-through mortgage-backed securities issued or guaranteed by the Government National Mortgage Association (Ginnie Mae), Fannie Mae, and Freddie Mac (Agency Debt and Agency MBS, respectively) beginning in February, 2012.

The Treasury Department and the IRS have determined that the same source rule should apply to fails charges incurred with respect to Agency Debt and Agency MBS as to fails charges on Treasuries. Accordingly, these final regulations expand the scope of a qualified fails charge to fails charges paid with respect to Agency Debt. The sourcing rule in the final regulations also applies to a fails charge on Agency MBS guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae (for tax purposes, Fannie Mae, Freddie Mac, and Ginnie Mae do not issue Agency MBS). The final regulations do not address the source of any other payment, including a fails charge that is not a qualified fails charge.

The Treasury Department and the IRS are considering whether separate guidance is needed on the source of income attributable to certain payments, other than qualified fails charges, that arise in securities lending transactions or repurchase transactions and request comments regarding this issue.

Effective Date

These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date

These regulations apply to a qualified fails charge paid or accrued on or after December 8, 2010.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Karen Walny, Office of the Associate Chief Counsel (International). However, other persons from the Office of Associate Chief Counsel (International) and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1-- INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 863(a) and 7805 * * *

Par. 2. Section 1.863-10 is added to read as follows:

§1.863-10 Source of income from a qualified fails charge.

(a) In general. Except as provided in paragraphs (b) and (c) of this section, the source of income from a qualified fails charge shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).

(b) Qualified business unit exception. The source of income from a qualified fails charge shall be determined by reference to the residence of a qualified business unit (as defined in section 989) of a taxpayer if—

(1) The taxpayer's residence, determined under section 988(a)(3)(B)(i), is the United States;

(2) The qualified business unit's residence, determined under section 988(a)(3)(B)(ii), is outside the United States;

(3) The qualified business unit is engaged in the conduct of a trade or business in the country where it is a resident; and

(4) The transaction to which the qualified fails charge relates is attributable to the qualified business unit. A transaction will be treated as attributable to a qualified business unit if it satisfies the principles of §1.864-4(c)(5)(iii) (substituting "qualified business unit" for "U.S. office").

(c) Effectively connected income exception. Qualified fails charge income that arises from a transaction any income from which is (or would be if the transaction produced income) effectively connected with a United States trade or business pursuant to §1.864-4(c) is treated as from sources within the United States, and the income from the qualified fails charge is treated as effectively connected to the conduct of a United States trade or business.

(d) Qualified fails charge. For purposes of this section, a qualified fails charge is a payment that—

(1) Compensates a party to a transaction that provides for delivery of a designated security (as defined in paragraph (e) of this section) in exchange for the payment of cash (delivery-versus-payment settlement) for another party's failure to deliver the specified designated security on the settlement date specified in the relevant agreement; and

(2) Is made pursuant to—

(i) A trading practice or similar guidance approved or adopted by either an agency of the United States government or the Treasury Market Practices Group, or

(ii) Any trading practice, program, policy or procedure approved by the Commissioner in guidance published in the Internal Revenue Bulletin.

(e) Designated security. For purposes of this section, a designated security means any—

(i) Debt instrument (as defined in §1.1275-1(d)) issued by the United States Treasury Department, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or any Federal Home Loan Bank; or

(ii) Pass-through mortgage-backed security guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association.

(g) Effective/applicability date. This section is effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. This section applies to a qualified fails charge paid or accrued on or after December 8, 2010.

§1.863-10T [Removed]

Par. 3. Section 1.863-10T is removed.

Steven T. Miller

Deputy Commissioner for Services and Enforcement.

Approved: February 14, 2012

Emily S. McMahon

Acting Assistant Secretary of the Treasury (Tax Policy).

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