Repo Buyers and Sellers Need to be Aware of Tax Issues

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Near the beginning of the 1980s cult classic film “Repo Man,” Harry Dean Stanton informs Emilio Estevez that the car which he just drove back to a used-car lot was a repossessed vehicle. Upon hearing the news, Estevez empties his can of beer on the pavement and shouts, “I ain’t no repo man!” Stanton then tells him, “You are now, kid.”

Like the Estevez character in the film, many banks find it quite easy to enter the sale-repurchase (repo) business. Although standard “vanilla” repos on liquid assets are a mature, widely-used technology, the United States federal income tax treatment of this type of transaction is somewhat uncertain. This means that care must be taken when entering into repo transactions on certain types of assets, and with certain types of counterparties.

In a typical repo transaction, one party (the repo seller) sells assets to another party (the repo buyer) subject to a commitment to sell the assets back to the repo seller. While the repo is outstanding, the repo buyer makes payments (substitute dividend payments, or substitute interest payments) to the repo seller equal to actual dividends or interest paid on the asset, less a rebate. If, as may be the case in low interest rate environments, payments of current income on the asset are less than the rebate, the repo seller pays a net fee to the repo buyer.

In economic terms, a repo is a secured lending arrangement. The repo buyer buys the assets at a discount (a haircut) to fair market value to ensure over-collateralization. In the event of counterparty default, the repo buyer’s obligation to sell the assets back to the repo seller disappears, and the repo buyer can seize the assets to satisfy the repo seller’s obligation to buy them back.

For tax purposes, the treatment of a repo depends on the terms of the agreement. Most existing tax repo authorities treat repos as secured loans. Under these authorities, the repo seller is treated as the tax owner of the assets during the term of the repo, and the repo buyer is treated as holding the assets as collateral. However, there is a risk that these authorities do not apply to modern repos on liquid, fungible assets. This is because the repo buyer in the existing authorities generally did not have the right to sell or rehypothecate the assets, while the repo buyer in a modern repo often has the right to sell or rehypothecate.

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