

1988

## Tax Consequences of Interest Rate Swaps: Characterization by Function, Not Prejudice

Patricia Brown

---

### Recommended Citation

Patricia Brown, *Tax Consequences of Interest Rate Swaps: Characterization by Function, Not Prejudice*, 6 INT'L TAX & BUS. LAW. 122 (1988).

Available at: <http://scholarship.law.berkeley.edu/bjil/vol6/iss1/6>

This Article is brought to you for free and open access by the Law Journals and Related Materials at Berkeley Law Scholarship Repository. It has been accepted for inclusion in Berkeley Journal of International Law by an authorized administrator of Berkeley Law Scholarship Repository. For more information, please contact [jcera@law.berkeley.edu](mailto:jcera@law.berkeley.edu).

# Tax Consequences of Interest Rate Swaps : Characterization by Function, Not Prejudice

by  
Patricia Brown†

## INTRODUCTION

An interest rate swap is a transaction in which two parties, known as counterparties,<sup>1</sup> contract to make periodic payments to each other during the contract period. Most often, these streams of payments are meant to coincide with and cover obligations, usually interest payments, that the parties owe to creditors that are not parties to the swap.<sup>2</sup> A swap is a means by which a borrower can change the terms of existing debt by “swapping” those terms with another borrower<sup>3</sup> that has procured debt on terms more attractive to the first borrower.<sup>4</sup> Although a swap is often described as a financing technique, it is not, in itself, a new source of funds for a corporation seeking to raise more capital. The parties to the swap must look to the regular capital markets to obtain the loans whose terms they swap.<sup>5</sup>

---

† B.S.F.S. Georgetown University, 1984; J.D. Boalt Hall School of Law, 1987, University of California, Berkeley. Associate, Cleary, Gottlieb, Steen & Hamilton, New York.

1. In this article, the term “counterparty” refers to the party to the swap whose activity or treatment is not being discussed at that point. Therefore, the identity of the counterparty will change when the discussion shifts to the effect on the other party to the swap.

2. The “asset-based” swap has also emerged as a means of matching a corporation’s liabilities to the income from its assets. Walmsley, *Understanding Interest Rate Swaps*, *BANKER’S MAG.*, July-Aug. 1984, at 44, 46.

3. It is becoming more common for corporations to enter into swaps with intermediaries. See *infra* note 117.

4. In most cases, a party that has borrowed money at floating rates later decides that it prefers the stability of fixed rates. It finds a counterparty that has borrowed at fixed rates but has floating rate receivables as assets and wants to match more closely its payments on liabilities to its income. In some cases the counterparty simply expects interest rates to fall. The party that has borrowed at floating rates receives payments from its counterparty to equal the interest obligations and makes payments to the counterparty to equal the counterparty’s interest obligations.

An interest rate swap allows a debtor to effectively change the terms on which it has borrowed capital without affecting the underlying obligation. Often, a creditor is not aware that its borrower has entered into an interest rate swap.

5. Although many parties issue paper expecting to enter immediately into a swap in order to take advantage of a relative strength in a particular market, the parties must actually issue some type of security in order to raise the capital they need. The swaps ensure that obligations are incurred on the most favorable interest terms.

INTEREST RATE SWAPS

An increasing number of corporate treasurers are turning to interest rate swaps as a means of regulating and reducing financing costs,<sup>6</sup> but many of these managers have no real understanding of the issues involved in negotiating swaps, much less a clear conceptual framework with which to analyze them. This lack of understanding stems in part from the lack of regulatory guidelines. In fact, despite the fantastic growth in the number and size of swaps negotiated, no Internal Revenue Code [hereinafter I.R.C.] section, regulation, or revenue ruling before the end of 1986 directly addressed the tax treatment of interest rate swaps. In this vacuum, tax professionals have attempted to determine the correct tax treatment of swaps by drawing analogies to those transactions whose treatments are specified in the I.R.C.<sup>7</sup>

Because many swaps occur across borders<sup>8</sup> many practitioners and analysts feel that the most pressing question about them is whether the payments made under a swap agreement are subject to the thirty percent withholding tax. That tax is levied on any fixed or determinable annual or periodic gains which are not effectively connected with a U.S. trade or business engaged in by a nonresident alien or foreign corporation.<sup>9</sup> In June 1985, the New York

---

6. The first "swap" of any kind apparently occurred in 1976. Bos Kalis Westminster Group NV entered the swap agreement with ICI Finance Ltd. Continental Illinois Limited advised Bos Kalis and Goldman Sachs advised ICI. Both banks avoided publicity in order to maintain their monopoly on the technique. One commentator has determined that the first "tombstone" advertisement for a currency swap appeared in 1977. S. HENDERSON & J. PRICE, CURRENCY AND INTEREST RATE SWAPS 3 (1984).

Most sources cite 1982 as the beginning of the interest rate swap market, as currency swaps concluded before that date generally produced exchanges of interest rates only as a side benefit. As late as December 1982, an article in *Business Week* said that the "practice [of negotiating swaps] is shrouded in secrecy for competitive reasons." *A Back Door to Fixed Rate Loans*, BUSINESS WEEK, Dec. 13, 1982, at 85.

By the end of 1984, Tanya S. Arnold, a swap specialist with The First Boston Corporation, was advising the public on *How to do Interest Rate Swaps*, HARV. BUS. REV., Sept.-Oct. 1984, at 96. The technique has become so popular that the International Swap Dealers Association estimates that its thirty-three largest members had modified the terms of \$170 billion of debt by the end of 1985. The Association projected a figure of well over \$200 billion by the end of 1986. Miller, *When Swaps Unwind*, INSTITUTIONAL INVESTOR, Nov. 1986, at 165.

7. See, e.g., Olander & Spell, *Interest Rate Swaps: Status Under Federal Tax and Securities Laws*, 45 MD. L. REV. 21 (1986); Reid, *United States Tax Implications of International Interest Rate Swaps (U.S. Dollar Denominated Agreements)* 37 U. FLA. L. REV. 671 (1986); and Belmore, *United States Withholding Tax on Swap Payments*, in INTEREST RATE AND CURRENCY SWAPS 1986, at 215 (1986).

8. In fact, corporations started entering into interest rate swaps because foreign banks had cheaper access to floating rate funds. Today, many U.S. corporations enter into swaps with multinational corporations or intergovernmental organizations, such as the World Bank, which have access to many different capital markets and which need many different currencies in order to fund their operations. Sometimes a corporation, that has oversubscribed its credit in the domestic capital markets, can improve its advantages in the fixed or floating rate capital markets by seeking capital in overseas markets. Thus, many current swaps are cross-currency, fixed to floating rate swaps, rather than pure interest rate swaps. See Price, Keller & Neilson, *Exchanges of Borrowings*, in SWAP FINANCING TECHNIQUES 17, 18-20 (B. Antl ed. 1983).

9. I.R.C. §§ 871, 881 (1986). The sample "Conversion Agreement" included in the Practising Law Institute's book INTEREST RATE AND CURRENCY SWAPS 1986, *supra* note 7, at 63, includes a clause providing that the swap may be terminated if the payments become subject to withholding tax. *Id.* at 67. One would suspect that this sample documentation will be used quite

State Bar Association [hereinafter NYSBA] Tax Section asked the Internal Revenue Service [hereinafter Service] to rule that payments made pursuant to an interest rate swap are not subject to withholding.<sup>10</sup>

On December 24, 1986, the Service issued Notice 87-4 [hereinafter Notice], which contains source rules for swap income and swap expense.<sup>11</sup> The Notice states that income from swap payments will be sourced by reference to the residence of the recipient of the swap income, except that all income attributable to a U.S. trade or business shall be sourced in the U.S. and effectively connected to the U.S. trade or business. This ruling is of practical importance because it assures that income earned by a non-U.S. company is subject to the thirty percent withholding tax<sup>12</sup> only if it is U.S. source income. Therefore, nonresidents who do not engage in a trade or business in the United States run no risk of incurring the thirty percent withholding tax<sup>13</sup> on the receipt of swap payments. The Notice applies only to U.S. dollar-denominated swaps, where one party is a U.S. resident and the U.S. dollar is its functional currency.

Although of practical importance, the Notice is of little help in defining a swap for other purposes. The Notice specifically states that it does not cover issues regarding income or expenses from the disposition of swap agreements. It also clearly indicates that the Service has not taken any position with respect to whether swap payments are in fact fixed or determinable annual or periodic income subject to withholding. The Service has left open the possibility of making a future assertion on this subject.

The Notice gives little guidance on the issue of swap income sourcing generally, because it reaches its conclusion on sourcing without reference to standard I.R.C. principles. Until recently, all I.R.C. provisions concerning the "source" of income resulting from economic activity made the site of that activity the source of the income.<sup>14</sup> In contrast, in some recently enacted I.R.C. sections, the source of the income derived from certain specific economic activities is the residence of the taxpayer. The most obvious examples

---

a bit in the future if it has not already become standard. Therefore, a decision by the Internal Revenue Service [hereinafter Service] that the payments are subject to withholding could have a serious effect on agreements already in place.

10. See Ad Hoc Committee, Tax Sec., New York State Bar Assoc., *Report on the Withholding Tax Consequences of Interest Rate Swap Agreements Under the Internal Revenue Code* [hereinafter *Report*] (June 6, 1985), in TAX NOTES, June 24, 1985, at 1438 (for the full text of the report in electronic form, see TAX NOTES TODAY, June 13, 1985, at 85 TNT 118-52).

11. I.R.S. Notice 87-4, 1987-3 I.R.B. 7. General source rules are found in I.R.C. sections 861-863 (1986).

12. See *supra* note 9.

13. Although the source rules only apply to swap income included in income after December 24, 1986, a U.S. taxpayer may make an irrevocable election to apply the new source rules to all of the taxpayer's swap income for years beginning before that date.

14. See, e.g., I.R.C. § 861. Section 861(a)(3) provides an excellent example of sourcing according to the site of economic activity. It treats "[c]ompensation for personal services performed in the United States" as "income from sources within the United States."

are the new rules concerning income from sales of personal property<sup>15</sup> and for gain or loss from foreign currency transactions.<sup>16</sup> Nothing in the Notice indicates whether the Service believes that the receipt of swap payments is analogous to one of those types of income or is in fact one of those types of income. Thus, it would be foolhardy to try to determine from the Notice what position the Service will take in future cases involving different swap issues.

More helpful in defining a swap is Revenue Ruling 87-5 [hereinafter Revenue Ruling]<sup>17</sup> which was issued on the same day as the Notice. The Revenue Ruling decided the withholding question with respect to the tax treatment of payments received by a Netherlands bank pursuant to a cross-border U.S. dollar-denominated interest rate swap with a U.S. person. Interpreting the United States-Netherlands Income Tax Convention,<sup>18</sup> the Service determined that amounts received by the Netherlands bank under the swap agreement were exempt from United States tax because they resulted in industrial or commercial profits to the Netherlands bank.

The Service used the process of elimination to reach its decision. These payments constituted commercial or industrial profits "because they [were] derived from the active conduct of a trade or business and [were] not covered by any other article of the Convention."<sup>19</sup> The Service must have considered other possible categorizations for income derived from these payments, such as interest income or income from the sale of a capital asset, because both these types of income are covered by specific provisions of the tax treaty.<sup>20</sup>

Although the Service considered other categorizations, it ended its inquiry when the remaining possibilities each yielded the same tax consequences. Therefore, the Service never reached a final conclusion as to what swaps are. The Service's decision not to place swaps into a category makes its analysis similar to that of commentators<sup>21</sup> who conclude that what a swap really "is" does not matter, because swaps would not be subject to the withholding tax under any of the possible categorizations.

By using this fairly safe approach of not deciding a non-necessary issue, the Service has failed to resolve some basic issues regarding the tax treatment of swaps. It does not indicate what the general tax treatment of swaps should

---

15. Section 865 was added to the I.R.C. by section 1211(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

16. Section 988 was added to the I.R.C. by section 1261(a) of the Tax Reform Act of 1986. *Id.*

17. Rev. Rul. 87-5, 1987-3 I.R.B. 6.

18. 1950-1 C.B. 92 (as amended by the Protocol of Dec. 30, 1965 1967-2 C.B. 472).

19. 1987-3 I.R.B. 6.

20. Article VIII of the Convention, as amended, covers "[i]nterest on bonds, notes, debentures, securities, deposits or any other form of indebtedness." Article XI of the Convention, as amended, makes gains derived "from the alienation of a capital asset" (other than real property) taxable by the country of residence of the taxpayer, unless the capital asset was effectively connected with a permanent establishment of the taxpayer in the other country. 1950-1 C.B. 96 (as amended by the Protocol of Dec. 30, 1965 1967-2 C.B. 476).

21. See, e.g., Reid, *supra* note 7, at 689.

be; moreover, it does not indicate what the treatment of particular aspects of the swap such as "premium" or "discount" should be.<sup>22</sup> The Revenue Ruling has also failed to give insight into new issues that arise from variations in the swap form or the treatment of settlement payments resulting from terminations.<sup>23</sup> Tax attorneys asked to render opinions on those issues must continue to rely on analogy or on functional analysis, similar to that undertaken in this article, without any assurance that the Service will accept their views. The Service can only help the situation by committing itself to a specific position on the nature of swaps. A final determination is critical because, unlike the basic form of the swap, some of the new types of swaps may result in significant deferral of income. It is important that the Service prevent this deferral with means that do not give an unfair tax treatment to the basic swap. The means by which the Service prevents that deferral, and therefore the treatment of swap income as well, could vary widely depending on which characterization the Service chooses.

The Service should not make a hasty decision to meet current needs, if that decision would lead to future inconsistencies. The Service's classification of swaps should be both theoretically and practically sound, reflect the legal relationships and economics of swaps, and also give the Service the flexibility it will need to deal with future swap permutations.

Part I of this Article will explain why there is uncertainty concerning the correct classification of interest rate swaps and will use a case study of one of the newest forms of swap, the "zero coupon" swap, to demonstrate the need for a final resolution of this question. Parts II and III will suggest a possible mode of analysis and treatment of swaps which is grounded in basic property and contract law and which yields conclusions based on the reasons for entering into the transactions. It is hoped that this approach will be comprehensive enough to meet the future needs of the Service as well as practitioners.

---

22. Often a party to a swap will want the swap to have terms slightly different from those used throughout the market. When this is the case, the parties will agree to payment of a lump sum at the beginning of the swap to adjust for the fact that the terms are different. This amount is either swap premium or discount.

23. One of the most important clauses in the typical swap agreement provides for the payment of a "settlement amount" if the swap is terminated before the end of the agreed contract period. These payments compensate a party, whose counterparty has terminated a swap prematurely, for the loss of valuable contract rights, the right to pay the counterparty's interest rate, which, as it turns out, is substantially better than its own. (If the counterparty's interest rate were not better than the party's, the counterparty would have no incentive to terminate the swap because the swap allows it to pay the party's rate. Rather than terminate, it would sell its rights under the contract if it could no longer engage in the swap for other reasons.)

These settlement payments and their purpose are described and analyzed more fully in the text accompanying note 37.

I.

THE MECHANICS OF INTEREST RATE SWAPS

Although practitioners now utilize many different types of swaps, all of them have evolved from the same basic form and so have many common characteristics. This Part will begin by describing the basic concepts necessary to understand swaps. The second section of this Part will describe why the commentators' discussions of interest rate swaps have generally been confused. In the last section of this Part, the "zero coupon" swap, a type of swap that capitalizes on the fact that swaps are executory contracts that could defer income for relatively long periods of time, will be used to demonstrate that the Service cannot afford to allow this confusion to continue.

A. *The Basic Concepts*

The "plain vanilla" interest rate swap is, as its name suggests, the purest, simplest<sup>24</sup> version of the interest rate swap.<sup>25</sup> In this type of swap, there are two entities seeking to borrow funds on the capital markets. In relation to the swap agreement, these borrowed funds are referred to as the underlying debt. One corporation has, in relation to a second corporation, a comparative advantage<sup>26</sup> in fixed rate capital markets. The first corporation decides, for one reason or another, that it prefers to pay floating interest rates on the underlying debt.<sup>27</sup> It can accomplish this if it finds such a second corporation with complementary needs and strengths,<sup>28</sup> one with the ability to borrow at comparatively favorable rates in the floating rate market but which prefers the stability of paying at fixed rates.

---

24. For clarity, this section of the article will deal, whenever possible, only with the plain vanilla swap. Variations and complicating features ("whistles and bells" in Wall Street terms) will be discussed later, as necessary.

25. Currency swaps, essentially concurrent exchanges of two currencies coupled with agreements to re-exchange the currencies after a stated period, often result in swapping interest rates, even though the major impetus for the transaction is to ensure a stream of foreign currency at a fixed rate. Currency swaps developed before interest rate swaps.

26. The term "comparative advantage" refers to the situation where one party is able to do each of two different activities more cheaply than another party is, but the cost differential is greater for one of the two activities than for the other. The party that has the cost advantage in both activities has a comparative advantage in the one for which the differential is greater. The other party has a comparative advantage in the activity for which the difference is less, despite the fact that it has an absolute disadvantage in both. Both parties will be better off if they each specialize in the activity in which they have a comparative advantage and then trade with each other. See generally A. SMITH, *THE WEALTH OF NATIONS BOOK IV: OF SYSTEMS OF POLITICAL ECONOMY* (1937).

27. There are many potential applications of the swap. Henderson and Price give a list of thirteen reasons to use interest rate and currency swaps in the Preface to *CURRENCY AND INTEREST RATE SWAPS*, *supra* note 6. These include arbitraging capital markets in order to reduce the cost of funds on either a fixed or floating rate basis, hedging foreign net worth exposure on a long-term basis at a favorable time in the currency cycle, eliminating the risk associated with financing fixed rate or long term assets with floating rate liabilities, and profiting by exploiting an advantage in one market to make up for a weakness in another.

28. It is possible for the first party to have an absolute advantage in both types of credit markets simply because it is rated higher by bond rating agencies. The comparative advantage

Once the borrower finds a suitable counterparty that it believes will remain solvent and meet its obligations under the agreement, each party borrows an identical sum of money in the capital market in which it has its comparative advantage.<sup>29</sup> The parties then enter into a swap agreement in which they agree to make payments to each other corresponding to the interest payments on the underlying debt that each will make directly to its respective creditor.<sup>30</sup> The swap payments are equal to the parties' respective rates, which are set by the swap agreement (typically one fixed and one floating), multiplied by a "notional amount." The notional amount is generally equal to the principal amount of each party's underlying debt. The rates set by the swap agreement are closely related to the interest rates the parties pay on the underlying debt, so that the payment flows adequately cover the interest payments the parties owe to their creditors.

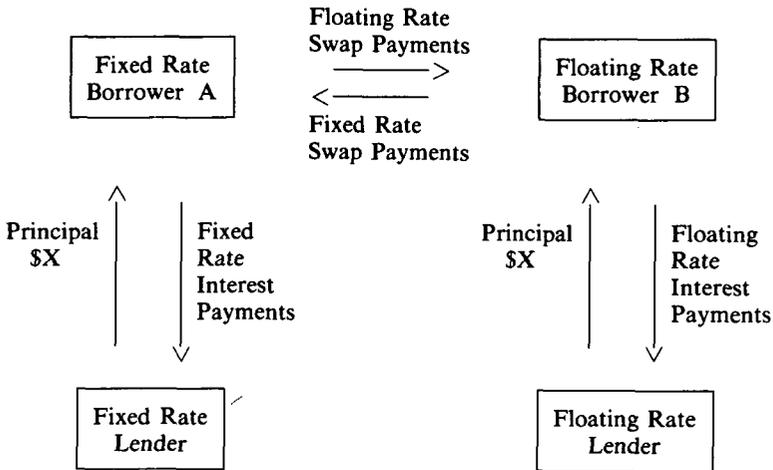
The diagram below illustrates the interest rate swap's basic structure. For clarity, it includes four entities, although only two are actually parties to the swap; the other two are the creditors that lend capital to the parties, creating the underlying debt. A is the fixed rate borrower; it will make floating rate payments to B under the swap. B borrows at floating rates and makes fixed rate payments to A. The notional amount equals the principal amount that each party borrowed from its respective creditor.

---

arises from different pricing practices in the public capital markets and the bank credit market. Banks are willing to lend money to less credit worthy entities on a short-term basis while charging them a lower premium than they would have to pay in the fixed-rate bond market, if they were even able to issue the bonds. Price, *Exchanges of Borrowings*, *supra* note 8, at 17.

29. This sequence of events, in which the parties find each other and arrange for the swap before creating the underlying debt, is given as an example here because it best highlights the motivations of the parties. It is not a necessary sequence, and may not even be the most common one. In practice, many corporations enter into swaps to modify the terms of already existing debt. Corporate treasurers frequently decide that the terms on which the corporation has borrowed could be improved, and the swap gives financial managers a new tool that avoids the need to issue new paper and also procures better terms.

30. The parties assume no obligations to each other's creditors on the underlying debt. There is no reason for the creditor to know that its obligor has entered into a swap, because the creditor's obligor remains liable for the debt. The entity whose credit was analyzed in order to set the terms of the loan is still responsible for making the payments, so the swap cannot harm the creditor. In reality, there is no need for underlying debt or a creditor. If there is no underlying debt, the swap is termed "unmatched." Wishon & Chevalier, *Interest Rate Swaps - Your Rate or Mine?* 160 J. ACCT. 63, 74 (1985). Unmatched swaps are not discussed extensively here because they may be entered into for speculative purposes or to hedge a corporation's overall exposure to interest rate risk. *Id.* Thus, like matched swaps, they may be entered into for investment or for business purposes and their tax treatment will depend on the same considerations that determine the treatment of matched swaps. Of course, the fact that a swap is unmatched may suggest that the business is not hedging and so may be relevant in deciding whether that particular swap is entered into for speculative or for business reasons.



Corporations will often issue bonds or otherwise borrow in the particular financial market in which they have advantages<sup>31</sup> and then swap with another entity whose strength lies in another financial market. Each party, in effect, borrows on attractive terms at a cost lower than if it had entered the desired market on its own. In this way, each party uses the other's credit rating<sup>32</sup>

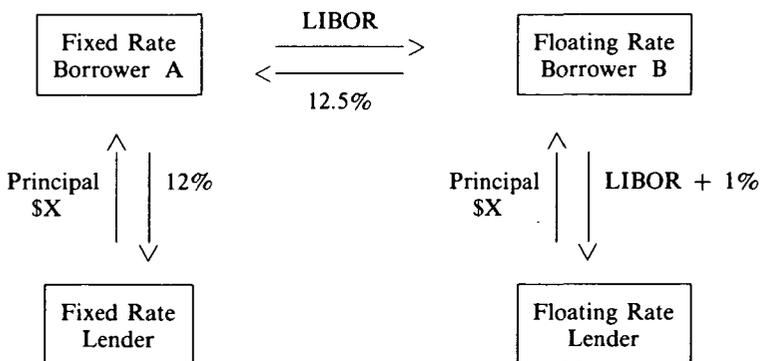
31. Transaction costs provide an economic incentive to engage in interest rate swaps. Differential information and institutional restrictions cause differences in transaction costs. For example, in Europe there are almost no registration or disclosure requirements for new bond issues, so bonds can be issued much more quickly there. However, underwriting costs are higher, as are credit premiums. Relatively small and unknown banks or business firms find it more difficult to issue Eurobonds. U.S. short-term interest rates, however, are usually lower than those in the European money market. These disparities create an economic rationale for a swap between a U.S. corporation desiring medium-term fixed rate funds and Eurobanks desiring short-term floating rate funds. Bicksler & Chen, *An Economic Analysis of Interest Rate Swaps*, 41 J. FIN. 645, 646 (1986).

32. Since discovering this application of interest rate swaps, the World Bank has exploited its impeccable credit rating by issuing a large amount of debt in fixed rate dollars, swapping with corporations that cannot match the international organization's standing in the eyes of U.S. lenders but who can borrow funds as cheaply as the World Bank in currencies with low interest rates. In Switzerland, for example, the World Bank has issued so much fixed rate debt that it now has to pay premium rates to create a demand for its paper. However, Swiss investors are currently enamored of Swiss franc paper issued by U.S. corporations. Swaps with surrogate U.S. corporations who want dollar-denominated debt are an ideal way for the World Bank to continue to raise capital from investors who already hold a lot of its paper. Now it is looking for another market in which it has a comparative advantage, which in essence means a market that is not already saturated with its debt paper. S. HENDERSON & J. PRICE, *supra* note 6, at 7. Apparently, it has decided that the best new place to raise capital is in the floating-rate dollar market where demand for World Bank issues is still high. Price, *The Development of the Swaps Market*, in SWAP FINANCING TECHNIQUES, *supra* note 8, at 32. For a full discussion of the World Bank's Swiss franc and deutsche mark dollar swaps with IBM, which established the cross-currency fixed to floating rate swap as a financial skill in its own right, see Price, *Exchanges of Borrowings*, *supra* note 8, at 20-22.

without affecting the obligation of the counterparty to abide by the terms of its underlying debt instrument.<sup>33</sup>

Some of the advantages of a "plain vanilla" swap are illustrated by a concrete example.<sup>34</sup> In this illustration, A is a prime bank or other entity with a better credit rating than B. A can issue debt at a fixed rate of twelve percent per annum. In the floating rate market, A could borrow at the London Interbank Offered Rate [hereinafter LIBOR]. B could borrow at LIBOR + one percent per annum, but would have to pay fourteen percent in the fixed rate market. A has an advantage over B in both markets but a comparative advantage in the fixed rate market because the interest rate differential between A and B in that market is two percent, as opposed to only one percent in the floating rate market. Because of A's comparative advantage, both parties gain if A borrows in the fixed rate market and B borrows in the floating rate market and then A and B enter into an interest rate swap with one another.

A makes payments to B of LIBOR times the notional amount, and B pays to A 12.5 percent times the notional amount per annum. B's total interest cost is twelve percent plus the 0.5 percent paid as a differential plus one percent above LIBOR (since it is paying LIBOR + one percent to the floating rate lender but only receiving LIBOR from A) or 13.5 percent. Since B would have had to pay fourteen percent for fixed rate funds if it had issued fixed rate debt itself, under this arrangement, it will save 0.5 percent per annum. A's total cost of borrowing is LIBOR - 0.5 percent because it pays LIBOR to B but receives 12.5 percent from B despite the fact that it only pays twelve percent to its fixed rate lender. Therefore, under this arrangement, A will also reduce its cost of borrowing by 0.5 percent per annum.



33. The lender is not harmed by its borrower's financial obligations under the swap because the borrower would be released from swap obligations if its counterparty fails to make payments to the borrower under the swap.

34. This example was developed in Gray, Kurz & Strupp, *Interest Rate Swaps*, in SWAP FINANCING TECHNIQUES, *supra* note 8, at 12-13.

This example does not specify when the parties will make payments under the swap. In a "plain vanilla" swap, the parties make payments to each other at the same time, generally quarterly, because swap payments are intended to cover quarterly interest payments that the parties must make to their creditors. The swap agreement generally provides that if one party fails to make one of its payments under the swap, its counterparty may also terminate its payments. The defaulting party's creditor cannot sue the counterparty, because the counterparty has not assumed the defaulting party's obligations on the underlying debt. Therefore, the counterparty cannot be in default on the party's underlying debt. Many agreements call for the party owing the greater amount in a particular swap period simply to pay the difference between the amounts owed by each party. This amount represents the cost of assuming the counterparty's risk of interest rate fluctuation for that payment period.

Typically, swap payment schedules differ from the quarterly payment model. Fixed payments are usually made annually, and floating payments made semi-annually or quarterly, depending on the terms of the underlying loan. For example, a borrower that makes interest payments annually may tailor its swap terms so that it receives an annual payment that mirrors this obligation. As discussed below,<sup>35</sup> the "zero coupon" swap, mirroring the payment requirements of a zero coupon bond, requires one party to make payments quarterly or annually although it may not receive any payments for several years. That party assumes a much greater credit risk than that usually found in swap agreements. Its counterparty may only be required to make one large payment years later, by which time the company could have financial difficulties.<sup>36</sup>

In addition to the credit risk, a party runs the risk that, if interest rates change dramatically, its counterparty may want to avoid its obligations under the swap. In this situation, even a solvent counterparty may decide that its position under the swap has become so disadvantageous that it would be cheaper to terminate the agreement and pay the settlement amount. The swap agreement sets out the method used to determine the settlement amount, and generally calls for market professionals' estimates of how much the corporation would have to pay a new counterparty to assume the swap obligations.<sup>37</sup> This amount depends on current and projected interest rates.

---

35. See *infra*, Part IC.

36. As discussed below, the primary purpose of a swap is not to make a loan, since the parties have already borrowed the money they need. However, when an entity receives the use of money, there may be an interest element included in any payments made in return. These residual amounts are incidental to the purpose of the swap agreement and should not confuse the discussion.

37. This method is intended to compensate the party, whose counterparty has terminated, for being left without a swap and so should approximate actual damages. Of course, a liquidated damages clause which bears no relation to expected or actual damages can usually be attacked as an unenforceable penalty. See, e.g., U.C.C. § 2-718(1) (1978).

Swaps allow a corporation to change the terms of its debt for as long as that debt exists. Since this is a major attraction of swaps,<sup>38</sup> their value could fall dramatically if parties began to routinely terminate them. This has not yet been a problem,<sup>39</sup> but there have been too few long-term swaps on which to base a prediction of whether this will be a problem in the future.<sup>40</sup>

The swap technique itself provides ways for a party to avoid large losses without prematurely terminating the contract. If, under the swap, party B pays a fixed rate to party A and B decides that it really prefers a floating rate, it can "unwind" the swap by entering into a "mirror" or "reverse" swap with another party (C) that prefers a fixed rate to its own floating rate.<sup>41</sup> The fixed

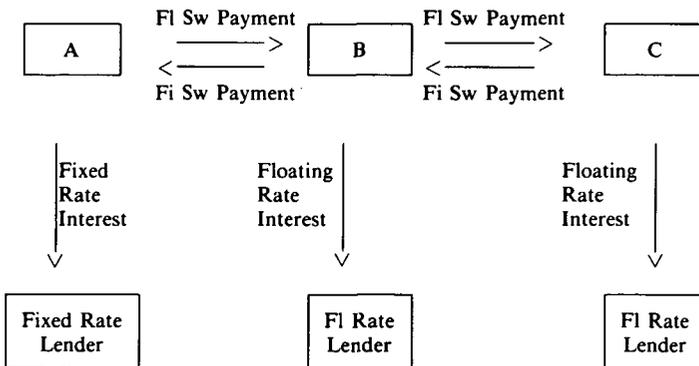
38. Swaps offer a great advantage over interest rate futures contracts, to which they are often analogized, because swaps offer long-term protection. Futures contracts are generally of shorter duration, and they present the further disadvantage of standardized delivery dates and contracts because they are traded on regulated futures markets. Hume, *Remaining Calm in Troubled Markets: The Growth of Risk Hedging Vehicles-Part 1*, J. COMM. BANK LENDING, Dec. 1984, at 36, 39.

39. It is difficult to find estimates of the number of swaps that have been terminated, primarily because there were very few swaps before 1985 and those that occurred involved relatively small amounts of money. Miller, *When Swaps Unwind*, INSTITUTIONAL INVESTOR, Nov. 1986, at 165, 171.

The first U.S. litigation involving interest rate swaps concerned the enforceability of the termination clause when one of the parties, a savings and loan, failed. The savings and loan's counterparty was prohibited from terminating the swap. The court apparently agreed that the assumption of the obligation by the savings and loan's successor, a new federal mutual association, had cured any default. *Beverly Hills Savings v. Renault Acceptance BV*, No. C549684 (Los Angeles Superior Ct. June 18, 1985). Thus, it appears that not even insolvency will cause the termination of a swap if the failing party can find an equally credit worthy entity to assume the obligations. This case is discussed in Peck, *Swap Programmes for Correspondent Banks*, 4 INT'L FIN. L. REV., Dec. 1985, at 27, 29.

40. Miller notes that most swap contracts have been written within the last two years and that interest rates have fallen during this time. It also "takes a couple of years for things to go wrong," according to a credit specialist at Bankers' Trust. Miller, *supra* note 39, at 171.

41. The payment flows in a "plain vanilla" swap which is unwound by a reverse swap are illustrated by the following diagram:



Essentially, B receives payments from A to cover its payments to C and vice versa. When they are netted, B ends up making its original interest payments to its creditor.

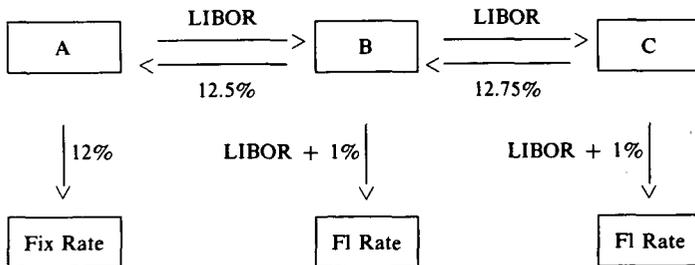
rate might even be attractive enough to other entities<sup>42</sup> that B will be able to decrease its cost of borrowing by receiving a differential from C.<sup>43</sup> Thus, a party to a swap can continue to improve its position without being forced to terminate the original swap and pay the settlement amount. If it no longer wants to be involved in the swap market, it can always sell its contractual rights under the swap agreement.

### B. Sources of Confusion

Difficulties in classification render the analysis of interest rate swaps troublesome. The classification is not aided by the fact that interest rate swaps have evolved from established financial products, such as parallel loans,<sup>44</sup> because those products are not easily classified either. In dealing with these financial instruments, the Service has had to contend with the fact that the evolution of the meaning of the key terms describing certain features of the instruments have been circumscribed by outmoded judicial definitions. Added to this historical complexity is a functional complexity: swaps serve purposes different from those served by the financial products from which they evolved. The tax treatment of those products also has its murky areas.<sup>45</sup>

42. One should remember, of course, that the floating rate was obtained by an entity with particular strengths in the floating rate capital market.

43. This is true even if C is in the same position financially as B was when it entered into the original swap. In the following example, C could borrow in the fixed rate markets at fourteen percent and in the floating rate market at LIBOR.



C's total cost of borrowing is 12.75 percent, paid to B, plus the one percent that is the difference between what it receives from B and what it pays to its creditor. Of the total payment C makes in this model, 0.25 percent (the difference between the 12.5 percent B pays to A and the 12.75 percent B receives from C) is the differential it pays to B to procure a lower rate than either B or C could have procured if they had gone into the fixed rate market on their own.

B's total cost is now LIBOR + 0.75 percent because its payments from A and its payments to C net; B is left paying LIBOR + one percent to its creditor, but receives the 0.25 percent differential from C which reduces the total cost of borrowing.

If fixed rates have increased since B entered into the swap with A, then the differential could be even greater.

44. S. HENDERSON & J. PRICE, *supra* note 6, at 3.

45. For example, much confusion surrounded the question of the nature of the gain or loss recognized upon the repayment of a foreign currency loan and the source country of those gains or losses. Samuels, *Federal Income Tax Consequences of Back-to-Back Loans and Currency Exchanges*, 33 TAX LAW. 847, 863-69 (1980).

The development of a new generation of innovative financing techniques simply layers uncertainty on top of uncertainty.

A thorough analysis of the possible tax treatment of swaps must begin with the background of the problem. The next sub-sections discuss, respectively, the evolution of the interest rate swap and the general approaches the Service has taken in analyzing financial instruments.

### 1. *The Evolution of a Financing Technique*

The interest rate swap technique evolved from earlier methods of regulating interest and exchange risk. The swap developed when corporate finance managers realized that they were shifting around larger amounts of money and incurring greater credit risk than was necessary to achieve their objectives. Managers could regulate borrowing costs by separating interest and exchange risk from the principal debt and passing those risks to another party, without transferring the principal debt. The interest rate swap, a simpler way to achieve those objectives, may be difficult to understand precisely because it has been stripped of nonessentials.<sup>46</sup>

The earliest identifiable forerunners of the interest rate swap were back-to-back and parallel loans.<sup>47</sup> In a back-to-back loan, two companies make loans of equivalent amounts to each other. The loans are made in two different currencies but have the same maturity date. In a parallel loan, a French company, for example, lends francs to the French subsidiary of a U.S. company while the U.S. company lends an equivalent amount in dollars to the U.S. subsidiary of the French company.<sup>48</sup>

These financing techniques originally developed in response to foreign exchange restrictions that prevented residents of the United Kingdom from purchasing foreign currency. Both forms allowed corporations to convert one currency to another in order to fund investments or business activities in a different currency.<sup>49</sup>

A secondary benefit of the back-to-back and parallel loans was the creation of a fixed interest foreign currency loan, which, due to local conditions,<sup>50</sup> might not otherwise have been available.<sup>51</sup> In addition, a long term forward

46. For a full description of the evolution of interest rate swaps, see Price, *The Development of the Swap Market*, *supra* note 32, at 23-34.

47. The use of these terms may be somewhat confusing in that similar terms are used to denote very different transactions in different contexts. Even in the context of exchanges of borrowings, the usage is not standard. The two terms are occasionally used interchangeably so that either encompasses both types of transactions described. The alternative terminology, which keeps the two concepts separate, will be followed here for the sake of clarity.

48. Price, *The Development of the Swap Market*, *supra* note 32, at 23.

49. Samuels, *supra* note 45, at 847.

50. Sometimes, fixed rate loans are simply unavailable except through foreign firms with reserves in the desired currency. Exchange restrictions prevent the use of this currency. Antl, *Mechanics and Key Characteristics*, in SWAP FINANCING TECHNIQUES, *supra* note 8, at 1, 6.

51. Samuels, *supra* note 45, at 849.

exchange contract could be uneconomical, even if available.<sup>52</sup> Given the wide fluctuations in exchange rates and interest rates during the 1970s, the secondary benefit of a fixed rate loan may have proven more important in the long run.

Eventually, with the lifting of exchange restrictions, the currency swap made it possible to achieve the results of a parallel loan without making loans to the counterparty. Instead, each party simply agreed to provide a specified amount of foreign currency to the other party on certain dates, in exchange for an equivalent amount of another currency, and to make the corresponding reverse exchange in the future.<sup>53</sup> There was no underlying debt between the parties to these transactions, but the currency received under the terms of the swap provided a means, at a predetermined exchange rate, for parties to meet their foreign currency requirements.

During the 1970s, as interest rates fluctuated almost as wildly as exchange rates, conditions became ripe for the development of the interest rate swap. Companies without foreign exchange requirements adapted the basic concept of the currency swap into the interest rate swap as a hedge against changes in interest rates. Since then, corporate treasurers have expanded the swap's possible uses so that the technique is as important in reducing the cost of borrowing as it is in regulating those costs.<sup>54</sup>

The large number of transactions has brought about the rapid development of the basic interest rate swap as a financial instrument. In addition, like other financial products, the swap continues to evolve. Financial managers have developed new types of swaps to meet the payment requirements of some of the more arcane debt instruments developed by the financial community and to minimize taxes. It is therefore necessary to adopt a general approach to swaps that can be adapted to new forms as they develop. The general problems the Service has traditionally had in dealing with financial instruments complicate this process, as described in the next section.

## 2. *Reliance on Analogies*

Most of the Service's difficulties in determining the correct federal income tax treatment of transactions involving financial instruments arise because many instruments disguise the receipt of interest payments as capital gains. Although the difference between ordinary income and capital gains is

---

52. *Id.*

53. Taylor, *Currency Swaps and Related Exchange Transactions*, in INTEREST RATE AND CURRENCY SWAPS 1986, *supra* note 7, at 187, 191.

54. It has been said of swaps that, "[n]otwithstanding the growing volume and variety of these transactions, by their nature all swap deals arbitrage market imperfections. They have the following common features: A currency swap is an exchange by one party of a benefit which it enjoys in a particular marketplace for a corresponding benefit available to another party in a different marketplace." A. SNIDER & M. COLLINS, A GUIDE TO CURRENCY AND INTEREST RATE SWAPS 5 (1985).

now almost immaterial,<sup>55</sup> the legacy of those schemes lives on in a series of I.R.C. sections that makes any analysis of financial products quite complicated.<sup>56</sup>

Because of this profusion of I.R.C. sections, the Service may be tempted to analogize swaps to the types of transactions dealt with in particular I.R.C. provisions. It is easy to assume that the interest rate swap, like many other financial instruments, is a method to disguise interest. The Service could, by analogy, apply to interest rate swaps the same tax treatment that the I.R.C. prescribes for one of those financial instruments.<sup>57</sup> In this manner, the problem is solved.

There are also historical reasons for the almost overwhelming urge to apply specific I.R.C. sections by analogy. Until the proliferation of I.R.C. sections described above, the Service had to rely on analogies because it did not have the tools it needed to attack schemes directly. It has not yet adjusted its approach to the fact that it now has the tools it needs - the recently added I.R.C. sections.

In the past, outmoded judicially-created definitions of financial terms prevented the Service from attacking deferral schemes directly. The most important of these definitions is the standard definition of interest. As originally set out in *Old Colony Railroad v. Commissioner of Internal Revenue*<sup>58</sup> and explained in *Deputy v. Dupont*,<sup>59</sup> this definition of interest, limited as it is to situations where there is an underlying indebtedness, defined as "borrowing," is particularly stifling. It prevents the Service from responding to the business community's continual development of the concept of interest, based on increasing sensitivity to the time value of money.<sup>60</sup> The business community has come to regard interest as the payment for the use of money over

---

55. Sections 301 and 302 of the Tax Reform Act of 1986 repealed the net capital gain deduction for individuals. However, section 1211 of the I.R.C. limits the capital loss deduction so that taxpayers with capital losses still must go through the old calculations of a capital gain or capital loss.

Section 311 of the Tax Reform Act reduced the alternate rate for capital gains for corporations to thirty percent, which is the regular corporate tax rate. The capital loss provisions did not change.

56. These include I.R.C. section 72 (annuities), section 483 (interest on deferred payments), section 453 (installment method), section 467 (payments for property or services), and sections 1271-1275 (the original issue discount rules) (1986).

57. The most obvious example is the original issue discount rules [hereinafter OID rules], dealing with the treatment of debt instruments, which are found in I.R.C. sections 1271-1275 (1986).

58. 284 U.S. 552 (1932).

59. 308 U.S. 488 (1940).

60. The "time value of money" refers to the fact that an amount of money received currently is worth more than the same amount of money received at some point in the future, because the money can be used to make more money during the ensuing period. This relationship holds true as long as interest rates are positive. Many business persons create tax deferral schemes to hold onto tax dollars longer.

Because such schemes deprive the U.S. government of the use of the many during the deferral period, Congress is always enacting I.R.C. provisions to prevent such deferral. For example, Congress has recently attacked schemes in which U.S. taxpayers set up foreign corporations to

time. In many cases, it is clear that someone is making such payments, but the Service cannot reach payments that are economically equivalent to interest through I.R.C. provisions taxing interest because of the narrow definition of interest set out in these two cases.

In *Old Colony*, the U.S. Supreme Court held that the definition of interest will depend on the "business understanding" of interest. Nonetheless, it then went on to define interest based on the business understanding at that time. To the Court in 1932, interest was "the amount one has contracted to pay for the use of borrowed money."<sup>61</sup> This definition created the requirement that there be an underlying debt. Even though the Court suggested by its language that the definition could change with time, the fact that it defined interest in its opinion almost ensured that the definition would not change with changes in the understanding of the business community. If the Court had not defined interest so narrowly, or if it had more explicitly stated that it was only defining interest according to the business understanding at that time, the Service would have been able to attack directly those schemes that depend on the time value of money by recognizing and taxing as interest any adjustments in price that are sensitive to delayed payments.

The adverse consequences of the restrictive definition might have been avoided but for the Court's decision a few years later in *Dupont*, which relied on the particular definition of interest in *Old Colony*, thus preventing that definition from changing along with economic theories. The *Dupont* Court held that neither the amounts described in *Old Colony* as "effective interest" under accounting theory nor the compensation in *Dupont* for the detention or use of money was interest. Moreover, the Court held that, even though there was undeniably an obligation in *Dupont*, the payments made were not interest because "although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of [I.R.C. section 163]."<sup>62</sup>

As everyone, including judges, became more sensitive to the time value of money, the Service was able successfully to attack some attempts to disguise interest. For example, in *Dixon v. United States*,<sup>63</sup> the Second Circuit found that original issue discount [hereinafter OID] was taxable at ordinary rates, disagreeing with a Sixth Circuit case that had held OID to be taxable as

---

hold their investments. Income earned by the corporations was not subject to U.S. taxation until the corporations distributed dividends to the U.S. shareholders, usually years after the income was earned. In the Tax Reform Act of 1986, Congress added the Passive Foreign Investment Company [hereinafter PFIC] provisions, I.R.C. §§ 1291-1296 (1986). Under these provisions, when the shareholder sells shares in a PFIC, the gain recognized is allocated over the shareholder's entire holding period. The amount allocated to each year is taxed at the highest rate applicable to the shareholder for that year, and the taxpayer must pay interest on the deferred amount at a rate equal to three percent over the applicable short-term federal funds rate. These onerous provisions are more than adequate to serve Congress' purpose of preventing deferral.

61. 284 U.S. at 560.

62. 308 U.S. at 497.

63. 333 F.2d 1016 (2d Cir. 1964).

long-term capital gain.<sup>64</sup> The *Dixon* court only reached that result, however, by relying on *Dupont* and concluding that OID was equivalent to other "traditional forms" of interest on indebtedness.<sup>65</sup>

More recently, in order to circumvent the *Old Colony* definition of interest, Congress enacted new rules, which, however, still allowed some transactions to fall through gaps in the I.R.C. and judicial interpretation. It created the concept of the "interest equivalent" and passed the original issue discount rules [hereinafter OID rules].<sup>66</sup> These rules have spawned ever-growing and increasingly complex regulations to deal with deferral of income with respect to "debt instruments." The definition of debt instruments continues to grow along with the ingenuity of tax planners.<sup>67</sup>

The Service has consciously expanded the concept behind the OID rules to apply to other types of payments. I.R.C. section 467,<sup>68</sup> requiring the reallocation to earlier tax periods of deferred payments for rental of property and for services, was added to the I.R.C. in 1984.<sup>69</sup> I.R.C. section 483,<sup>70</sup> which was enacted to reverse the result in *Burnet v. Logan*,<sup>71</sup> attacks the deferral of income on sales of property other than debt instruments. These sections make it very difficult for a taxpayer to recover all her capital investment before declaring any income. Previous law allowed such a deferral if, for

64. *Commissioner v. Caulkins*, 144 F.2d 482 (6th Cir. 1944).

65. 333 F.2d at 1017.

66. I.R.C. section 1232 (1986) was added to the I.R.C. in 1954 in order to "clarify" existing law and to ensure that original issue discount [hereinafter OID] was treated as the "form of interest income" it is. SENATE FINANCE COMMITTEE REPORT, INTERNAL REVENUE CODE OF 1954, S. DOC. NO. 1622, 83rd Cong., 2nd Sess. 116, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4745. Of course, these rules were applied to "a bond or other evidence of indebtedness" so that the provisions were not in conflict with the definition of interest in *Old Colony* or *Dupont*.

67. See, e.g., the Tax Reform Act of 1984, Pub.L. No. 98-369, § 41(a), 98 Stat. 494 (1984) (codified as amended in various section of the I.R.C.) which extended the OID rules to debt instruments that are not publicly traded and that are issued for nontraded property, to obligations issued by individuals, and to debt instruments issued for services or for the use of property.

68. For a discussion of I.R.C. section 467 (1986) see *supra* notes 110-13 and accompanying text.

69. The Tax Reform Act of 1984, Pub. L. No. 98-369, § 92(a), 98 Stat. 494 (1984).

70. I.R.C. section 483 (1986) applies to deferred payments for the purchase or exchange of any property which are received more than six months after the sale if any part of the purchase price is paid more than one year after the sale and if there is "total unstated interest." *Id.* § 483(c).

"Total unstated interest" is the excess of the payments due under the contract over the sum of the present values of those payments and any interest payment due under the contract. *Id.* § 483(b). The amount that constitutes unstated interest must be allocated to each payment as it is made, *id.* § 483(a), thereby reducing the amount that can avoid taxation as a return of capital.

71. 283 U.S. 404 (1931). In *Logan*, the taxpayers had the right to receive payments of a certain percentage of the value of ore removed from a mine. The Supreme Court allowed the taxpayers to recover their entire basis in property before recognizing any income. The Court felt this result was required because the total amount to be received was uncertain. It resisted efforts to estimate the value of the interest in future profits. *Id.* at 412-13. The Logans were, therefore, able to defer all recognition of income for at least eight years (since they had not yet recouped their capital investment at the time of the deficiency judgment and the commencement of the case.)

example, the total amount of income to be received was uncertain. Although section 483 was obviously aimed at preventing deferral of income, it rested on the recognition that almost everything has an economic value that can be ascertained by looking to the appropriate market.<sup>72</sup>

Since payments made pursuant to almost any contract can be classified as payments either for purchase or rental of some type of property, as payments for services, or as interest payments, the Service should be able to deal with almost any type of income deferral scheme under these sections.<sup>73</sup> The Service could simplify its approach to these problems by looking only at the legal relationships involved and taxing the participants accordingly. It could then avoid the tortuous analogies in which it now engages when trying to bring new transactions under one of the existing classifications described above.

### C. Possible Tax Treatments of the "Zero Coupon" Swap

This section will demonstrate the different tax treatments that a "zero coupon" swap, one of the newest forms of swap, could receive under the various I.R.C. sections and doctrines. One of the interesting features of a "zero coupon" swap is that it is an executory contract that could defer income for relatively long periods of time. The manner in which the Service characterizes interest rate swaps generally will determine which of several methods it uses to prevent this potential deferral of taxable income.

In a "zero coupon" swap, one party makes payments to its counterparty over the life of the swap but receives no payments until the end of the swap.<sup>74</sup> In general, this occurs because the deferring party has raised capital by issuing zero coupon bonds but has since decided that it prefers making floating

---

72. Obviously, in order for I.R.C. section 483 (1986) to reverse the result in *Logan* and cases like it, it is also necessary to overcome the Court's hesitation towards estimating the total value of a contract. Without such an estimate, it would be impossible to determine the sum of payments to be received and, in turn, the amount of interest to be allocated to the payments as they are received.

73. The rules do vary in the extent to which they require current inclusion of interest income when applied to interest rate swaps and, potentially, to other transactions. Under I.R.C. section 467 (1986), for example, only the interest component of the payment for services is recognized during the deferral period, while the OID rules in I.R.C. section 1272 (1986) require the entire payment received to be allocated over the deferral period.

Although this may seem to be equivalent treatment, it is not. The analogous payment in the context of the debt instrument is the entire amount of interest to be paid when bonds are repaid so the entire amount received must be reallocated. Treatment equivalent to the treatment of services under I.R.C. section 467 (1986) would require only a portion of that payment to be allocated to the deferral period.

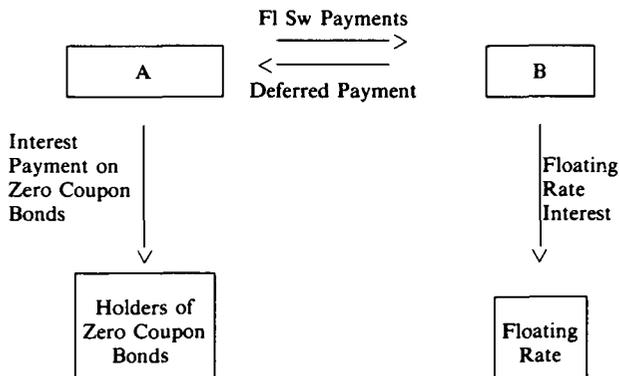
74. For the purposes of this example, the period during which the party is making but not receiving payments will be referred to as the "deferral period." The party making payments will be designated the "deferring party" because it is attempting to defer income. This may appear counterintuitive because the party is making payments, not deferring them, but the important point is that income is deferred. The payment the deferring party receives at the end of the deferral period is the "deferred payment." The party receiving payments during the deferral period will be designated the "counterparty."

rate interest payments over the duration of the loan rather than a fixed payment upon maturity of the bonds.<sup>75</sup> The counterparty is in the opposite position, having determined that it prefers to make a fixed payment at the end of the deferral period rather than the floating rate payments to which it is committed. Thus, as do all swaps, the "zero coupon" swap offers financial officers the opportunity to effect a *de facto* change in the terms of almost any type of debt.<sup>76</sup>

In addition to the business reasons that make any swap attractive, the "zero coupon" swap introduces the possibility of substantial income deferral by at least one of the parties. The Service is well aware that it will have to face the problem of income deferral through the use of swaps now that it has, for all practical purposes, resolved the issue of withholding taxes.<sup>77</sup> The Service can improve its position by reaching a conclusion as to its theoretical approach to the entire puzzle before it makes any pronouncement on one of the pieces.

The potential benefits from deferral depend on the timing of deductions and the fact that interest rate swaps are executory contracts,<sup>78</sup> under which

75. For example, A is the deferring party, B the counterparty. The parties enter into the swap in 1986. The floating rate swap payments from A to B are paid every six months. The deferred payment is made in July 1991.



76. These transactions are currently popular with parties that issued fourteen percent zero coupon debt in the high interest environment of the early 1980s and now want to convert it to floating rate debt.

77. See *supra* notes 11-20 and accompanying text. The Service has, however, explicitly refused to rule out the possibility that it will someday take the position that payments made under a swap are fixed or determinable annual or periodic gains subject to the thirty percent withholding tax.

78. In *Farrington v. Tennessee*, 95 U.S. 679 (1878), the Supreme Court described an executory contract as "one where it is stipulated by the agreement of minds, upon a sufficient consideration, that something is to be done or not to be done by one or both the parties." *Id.* at 683. "A contract is executed where everything that was to be done is done, and nothing remains to be done." *Id.* The term "executed contract" is sometimes used to describe unilateral contracts which have been executed on only one side, but Williston frowns on this. 1 S. WILLISTON, *TREATISE ON THE LAW OF CONTRACTS* 27 (3d ed. 1957).

the recognition of income may be deferred until performance by at least one party is completed. Interest rate swaps require new streams of payments, one flowing into the corporation and one flowing out. The outflowing payment may create a current deduction in addition to the interest deductions the parties already take for the interest paid on the underlying debt. The additional income from the inflowing stream of payments may not have to be accrued until it is actually received, even for accrual basis taxpayers,<sup>79</sup> because the swap is an executory contract.<sup>80</sup> The possibility of deferral arises because the two streams of payments can be separated by the swap agreement so that the income is recognized in a tax period after that in which the deduction is taken.

Those using swaps generally assume that they may take current deductions for swap payments as ordinary and necessary business expenses under I.R.C. section 162 because they enter into swaps for legitimate business reasons.<sup>81</sup> The accounting and tax treatment of the underlying debt should continue unchanged, with interest payments made by the deferring party to its creditor deductible under I.R.C. section 163(a).<sup>82</sup> Thus, the deferring party to a "zero coupon" swap will make two different payments to two different parties and will take both interest deductions and business expense deductions.

There is some difference of opinion as to whether the entire amount paid should be deducted and the amount received included in income, or the payments attributable to a single swap netted and either the income or loss recognized.<sup>83</sup> Although the two approaches yield the same mathematical result, they demonstrate two different views of the swap, sometimes called the "expense" and the "financial instrument" approaches. The name for the second approach stems from its seeming acceptance of the view, adopted by the NYSBA Tax Section in its request for a revenue ruling,<sup>84</sup> that each swap should be treated, for tax purposes, as if it had been broken into a series of

---

79. For an accrual method taxpayer, the right to receive income triggers the responsibility to recognize the gain in income. The right to receive income arises in the tax year when the "all events" test is satisfied. The "all events" test is two-pronged: it is satisfied when (1) all the events have occurred which fix the right to receive the income and (2) the amount thereof is determinable with reasonable accuracy. The first prong is satisfied when (a) the required performance takes place, or (b) payment is due, or (c) payment is made. Rev. Rul. 83-106, 1983-2 C.B. 77.

80. An executory contract is one that has yet to be performed. Such contracts do not meet the first requirement of the all events test. Payment is not due or made to the deferring party until the end of the deferral period.

81. Reid, *supra* note 7, at 673, makes the bald declaration that this is the appropriate treatment, citing only the *Corn Products* case, see *infra* note 121. Olander, *supra* note 7, at 44, supports the observation that this is the general view.

82. Olander, *supra* note 7, at 41.

83. Belmore states that a "U.S. taxpayer should ordinarily net the payments it makes and receives with respect to a given U.S. dollar interest rate swap agreement in each taxable year." Belmore, *United States Taxation of Swap Transactions*, in INTEREST RATE AND CURRENCY SWAPS 1986, *supra* note 7, at 261, 281.

84. See Report, *supra* note 10 and accompanying text.

interest rate futures contracts. If this treatment were adopted, each payment would be a return of capital with a concomitant gain or loss.

This difference of opinion is not of particular importance to parties that make and receive payments under the swap in the same accounting period, but it is important to parties that delay payments or receipts until a later tax period. For taxpayers, even accrual method taxpayers, the tax results are the same under either method if both parties make payments to each other at the same time. For an accrual method taxpayer that makes its swap payment in one tax period but receives the corresponding payment from its counterparty in a later tax period, the tax treatment differs depending on which approach is taken.

Under the financial instrument approach, the Service would almost certainly not allow the deduction of payments made under the swap until the corresponding payments had been received. The two would then be netted and gain or loss recognized.<sup>85</sup> Under the expense approach, payments would continue to be deductible as made but payments received could not be included in income until "all the events have occurred which fix the right to receive" such income.<sup>86</sup> Because the contract is executory,<sup>87</sup> the all events test is satisfied with respect to the party receiving deferred payments only after it has made all corresponding payments.<sup>88</sup> Until it makes all these payments, the party has not fixed the right to receive the deferred payment. It has merely fixed the right to receive damages if its counterparty does not perform. This is the right of any party to an executory contract.<sup>89</sup>

By separating deductions from the recognition of income, the deferring party in a "zero coupon" swap can defer a substantial amount of income by making payments for five years or more while the contract is still executory. During this period it can deduct interest on the underlying loan<sup>90</sup> and, under the expense theory set out above, can probably also deduct payments made under the interest rate swap. It will not have to declare any income under the swap until the end of the swap contract.

---

85. This approach adopts the view that payments under a swap are payments to purchase a financial instrument which is a capital asset. See *infra* notes 135-55 and accompanying text.

86. Under the accrual method, a deduction is allowable for the taxable year if (1) all the events have occurred which establish the fact of liability giving rise to such deduction and (2) the amount can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii) (1986).

87. In this respect, the interest rate swap is different from most financial instruments which are fully executed on one side, establishing rights under the instrument.

88. The party receiving payments during the deferral period includes those payments in income when received because the all events test is satisfied with respect to it when payment is made by the deferring party. Rev. Rul. 83-106, *supra* note 79.

89. Farnsworth states that "the award of damages is the common form of relief for breach of contract. Virtually any breach gives the injured party a claim for damages." E. FARNSWORTH, *CONTRACTS* 838 (1982).

90. If the party actually has zero coupon bonds outstanding, it will be able to deduct the OID under I.R.C. section 163(e) (1986) because its bondholders will be required to include the OID in income under I.R.C. section 1272 (1986).

If past experience is any guide, the Service is likely to attack the practice of income deferral on such a large scale<sup>91</sup> by asserting that this method of accounting for swaps does not clearly reflect income for an accrual method taxpayer.

Although the I.R.C. explicitly allows taxpayers to use the accrual method of accounting to compute taxable income,<sup>92</sup> it also allows the Secretary to prescribe another method, which clearly reflects income, if it is the Secretary's opinion that the method chosen by the taxpayer does not clearly reflect income.<sup>93</sup> The Service can require this change in accounting method for all items or for a single item.<sup>94</sup>

Logically, to decide what method would clearly reflect income, the Service must first decide which of several theories best describes what a swap is. Most theories would classify the payments made under interest rate swaps into one of the broad categories of interest payments, payments for services, or payments made under an installment purchase of property. Tax treatment under each of these theories varies widely as will be discussed below. Since it varies so widely, the Service will not have the flexibility it had when answering the withholding tax question under the United States - Netherlands Treaty.<sup>95</sup> The nature of a swap is an issue that does not have a simple resolution. In order to prevent taxpayers from deferring income received under interest rate swaps, the Service must be able to assert that its proposed tax treatment is sound and that the taxpayer's treatment is unsound.

### 1. *Treatment of the Payments as Interest Income*

If the Service were to determine that payments under an interest rate swap constitute interest, or more likely an "interest equivalent," the deferring party in a "zero coupon" swap would lose the benefit of income deferral. Although the analogy is somewhat strained, the Service would probably find that the transaction was equivalent to a back-to-back loan and that the payments were interest on the notional amount which the Service would treat as principal. This situation would be analogous to that of a zero coupon bond in which there is one lump payment of interest at the end of a contract period. The Service would claim that "zero coupon" swaps, like zero coupon bonds,

---

91. For many years the Service expended a fair amount of energy attacking the comparatively small scale deferral of income from deferred compensation plans for employees on the cash method of accounting. In these plans, employers agree to pay a portion of an employee's compensation at some later date, usually after retirement. The Service attacked these plans using both a constructive receipt and an economic benefit theory. The Service was rebuffed in *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953), and generally gave up the battle on deferred compensation in Revenue Ruling 60-31, 1960-1 C.B. 174.

92. I.R.C. § 446(c)(2) (1986).

93. *Id.* § 446(b).

94. Treas. Reg. § 1.446-1(a)(1) (1986).

95. In that situation, the Service placed the swap in a broad category of types of payments, all of which received the same tax treatment. See *supra* notes 19-21 and accompanying text.

fall under the OID rules in I.R.C. section 1272<sup>96</sup> which allocate the amount deemed to be interest over the course of the deferral period. The income thus allocated would be ordinary income.

It is not clear that the Service could support the claim that the OID rules should apply to interest rate swaps. These rules apply to “debt instruments,” a term defined as “a bond, debenture, note, or certificate or other evidence of indebtedness.”<sup>97</sup> It does not include any annuity contract to which I.R.C. section 72 applies.<sup>98</sup> The regulations specify that “all rights to deferred payments under a contract whether or not evidenced by a formal instrument” are included in the category of debt instruments.<sup>99</sup> Debt instruments may be issued for money or for property, including services and the right to use property.<sup>100</sup>

If a swap is a debt instrument, it must have been issued either for money (in which case the contract called for each party to sell a debt instrument) or for property (either services or another “debt instrument.”) Logically, a swap could be issued in exchange for services and still be a debt instrument only if it falls under the rubric “all rights to deferred payments under a contract.”<sup>101</sup> In this case, both parties would really be paying for services, but the deferring party’s counterparty would also have issued a debt instrument by signing the contract. The deferring party under a “zero coupon” swap and the parties to more typical swaps could only be issuing debt instruments for money or for other debt instruments, because section 1272 would be inapplicable if they were purchasing and providing services. This is so because they would be making periodic payments, not creating rights to deferred instruments.

If it were determined that swaps are debt instruments, by definition they would have an OID, requiring recognition of income.<sup>102</sup> The next step in applying the OID rules would be to determine the amount of OID, which is determined by subtracting the “issue price” from the “stated redemption

96. I.R.C. sections 1273 and 1274 (1986) together determine the amount of OID. I.R.C. section 1273 (a)(1) (1986) states the general rule that OID means the excess of the redemption price at maturity over the issue price. Section 1273(b) (1986) gives rules to determine the issue price for debt instruments not issued for property and for instruments issued for property and publicly traded. For this section, “property” includes services and the right to use property, but not money.

Section 1274 (1986) is used to determine the issue price of debt instruments issued for property if at least some of the payments are due more than six months after the sale or exchange. This section applies when the redemption price at maturity exceeds the stated principal amount if there is adequate stated interest, or, if there is not, if the redemption price exceeds the testing amount, which is the imputed principal amount determined by finding the present value of all payments, using 110 percent of the Federal rate as a discount rate.

97. I.R.C. § 1275(a)(1)(A) (1986).

98. *Id.* § 1275(b)(1)(B).

99. Treas. Reg. § 1.1275-1(b)(1) (1986).

100. I.R.C. § 1273(b)(5) (1986).

101. Treas. Reg. § 1.1275-1(b)(1) (1986).

102. I.R.C. § 1272(a)(1) (1986).

price at maturity.”<sup>103</sup> This discount is supposed to capture the amount of interest that is implicit in any deferred payment. The OID is itself an interest equivalent.

A debt instrument’s “stated redemption price” includes all amounts, including interest, payable at maturity.<sup>104</sup> For most debt instruments, this would include a principal amount, but, for a “zero coupon” swap, this would presumably be the amount of the deferred payment. For all other swaps, this phrase would make sense only if the swap were broken into pieces with each payment date becoming a date of “maturity,”<sup>105</sup> or if the payments were treated as installment payments made pursuant to an installment obligation with the total equalling the “stated redemption price at maturity.”

The next step in determining the amount of OID is to determine the “issue price” to be subtracted from the redemption price as determined under I.R.C. section 1273(a)(2). The issue price would be determined under I.R.C. sections 1273 or 1274, depending on whether the debt instrument is issued for money or property. If it is issued for property, the I.R.C. requires the taxpayer to determine the “imputed principal amount” which is the present value of all payments due under the debt instrument.<sup>106</sup>

If a debt instrument is issued for money, the I.R.C. defines the issue price as the price paid by the first buyer.<sup>107</sup> This definition of price includes the aggregate payments made under the purchase agreement by the purchaser,<sup>108</sup> and presumably includes deferred payments. In the context of the “zero coupon” swap, the issue price would equal all payments made by the deferring party to the counterparty pursuant to the swap agreement. Since the “stated redemption price” of a “zero coupon” swap is the amount of the deferred payment, the OID would equal the difference between the deferred payment and the amount paid out over the course of the swap.

Because the payments the deferring party made would be characterized as interest, it could deduct the payments it made pursuant to the swaps under I.R.C. section 163.<sup>109</sup> Nevertheless, it would lose the chance to defer income because of the OID rules.

## 2. Treatment of Swap Payments as Payment for Services

The Service could decide that the swap agreement consists of back-to-back contracts for financial services and bring the payments under I.R.C.

---

103. *Id.* § 1273(a)(1).

104. *Id.* § 1273(a)(2).

105. Such an approach was suggested by the New York State Bar Association Tax Section in order to analogize the swap to an interest rate futures contract. *See Report, supra* note 10.

106. I.R.C. § 1274(b)(1) (1986).

107. *Id.* § 1273(b)(2).

108. *Id.* § 1273(c)(1).

109. I.R.C. section 163(a) (1986) provides: “There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.”

section 467.<sup>110</sup> This would require that some, but not all, of the deferred payment be accrued over the life of the “zero coupon” swap, thus preventing some deferral of income. I.R.C. section 467 was added to the I.R.C. to make the treatment of deferred payments for rental of property or services consistent with the other sections that are based on present value concepts and that provide for the reallocation to earlier periods of portions of deferred payments, treating them as interest regardless of their purported purpose.<sup>111</sup> This section reflects Congress’ increased sensitivity to the time value of money.<sup>112</sup> The section explicitly covers rental payments but provides that the Secretary may promulgate regulations under which the “interest element” of the deferred payment for services would be allocated to the deferral period.<sup>113</sup>

If the rules that the Secretary promulgates are reasonably close to those set out for rental payments, then swap payments would be deductible as made, but the part of the deferred payment that is deemed to constitute interest would be allocated to the deferral period. The bulk of the deferred payment would be recognized in the year in which it is received by the deferring party. The Service would have to determine how much of the deferred payment is attributable to services rendered in each year of the swap. Although the Service will not require the deferring party to recognize income in those years, interest on the amount attributable to the services performed in each period would be included in income from the time the services were deemed rendered. The Service would use “present value concepts” to determine how much of the deferred payment is actually payment for services and how much is attributable to interest, under regulations that presumably will be similar to those implementing I.R.C. section 1274. Because the largest part of the payment would be considered compensation for services, the amount to be recognized as income during the deferral period would be much less than the amount that would be allocated to the deferral period if the entire payment were considered to be interest on a hypothetical back-to-back loan subject to the OID rules.

---

110. Contracts for services which meet requirements, to be promulgated by the Secretary, comparable to those for section 467 rental agreements, will be subject to section 467 treatment. A section 467 rental agreement includes any agreement for the rental of tangible property under which there is at least one amount allocable to the use of property during the year, which is payable after the close of the calendar year following the calendar year in which the use occurs, section 467(d)(1), or in which there are increases in the amount to be paid as rent. There is an exception if the total consideration does not exceed \$250,000. I.R.C. § 467(d)(2) (1986).

Since the services are rendered over the life of the contract, any “zero coupon” swap which lasts more than two years would be subject to regulations promulgated under this section, as there would be a payment after the close of the calendar year following the year in which the first services, assuming the risk, were rendered.

111. These sections include the OID rules of I.R.C. section 1272 and I.R.C. section 7872 (1986) which, together with I.R.C. section 1272 (1986), redetermine and reallocate the interest payment in loans made at below market interest rates.

112. See *supra* note 60.

113. I.R.C. § 467(g) (1986).

### 3. Treatment of Swap Payments as Made to Purchase Property

Complicating matters further, it has been suggested that payments made under an interest rate swap are made to purchase any one of several possible types of property.<sup>114</sup> However, it is not clear what that type of property could be. One possibility is that the payments are made to buy the swap itself,<sup>115</sup> a theory that will be discussed below. A second possibility is that the payments received under the swap constitute property.

Characterization of payments as made for the purchase of property would lead to more complications because of the I.R.C.'s differentiations among types of taxpayers and the purposes for which property is bought and sold. For example, if the swap payments were considered to be made pursuant to an installment purchase of property, they would be treated as payments made to purchase a capital asset. This is so because neither kind of property suggested falls under one of the exceptions in I.R.C. section 1221, unless it is stock in trade of the taxpayer.<sup>116</sup> As of this writing, it does not appear that either characterization of property would fall under this exception. However, the stock in trade exception could attain importance if the Service were to decide that the payments were made for the purpose of buying the swap. More banks are engaging in swaps as intermediaries<sup>117</sup> and even entering into swaps as primary parties in order to stockpile the swaps until they can "unwind" them at an advantageous rate.<sup>118</sup> This practice is similar to that of a dealer accumulating inventory.

Although some banks may fall under the stock in trade exception, most corporations entering into swaps would probably not be considered dealers.

---

114. Olander, *supra* note 7, at 48. The NYSBA Report states that gains from interest rate swaps are closely analogous to gains from commodity futures transactions which "[have] been exempt from withholding tax as gain from the sale of property." See *Report supra* note 10, at 1438.

Belmore suggests that the final swap exchanges under a currency swap may be treated as a purchase or sale of non-U.S. currency. He does not describe what the parallel treatment would be for a U.S. dollar-denominated interest rate swap. Belmore, *United States Taxation of Swap Transactions, supra* note 83, at 285.

115. Olander, *supra* note 7, at 48.

116. The term "capital asset" does not include "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." I.R.C. § 1221(a)(1) (1986).

117. This structure is known as a double swap and protects the borrower who is unwilling to risk nonpayment by the other party. The intermediary enters into complementary swaps with each borrower. Often each borrower will not even know the identity of the other borrower. In effect, the intermediary guarantees that the payments will be made by the other borrower. The intermediary's liability is limited, however, because it will stop making payments under a swap if that borrower fails to make a payment. Its risk is limited to the difference between the payment to be made and the payment it would have received from the defaulting party. Of course, at that point it will also have an unmatched swap against which it will have to hedge.

Another structure using banks as intermediaries is described in Gray, Kurz & Strupp, *Interest Rate Swaps*, in SWAP FINANCING TECHNIQUES, *supra* note 8, at 11.

118. Miller, *Making a Market in Slightly Used Swaps*, INSTITUTIONAL INVESTOR, Nov. 1984, 77, 78.

Thus, a swap in their hands would be a capital asset,<sup>119</sup> assuming that the swap itself would be considered the "property", unless it is bought and sold for hedging purposes. The distinction between speculative and hedging transactions,<sup>120</sup> sanctioned by the Supreme Court in *Corn Products Refining Co. v. Commissioner*<sup>121</sup> requires that property be treated as a capital asset unless the property is used by the taxpayer as an integral part of the taxpayer's trade or business.<sup>122</sup> If the property is acquired as an integral part of the business, its disposition gives rise to ordinary income because it is a "legitimate form of insurance" used to decrease costs of necessary items.<sup>123</sup>

119. This section assumes that the exception for "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered", I.R.C. § 1221(a)(4) (1986), does not apply; if the Service had decided that the swap is a form of property, it necessarily would have determined that the swap is not a contract for the sale of services.

120. There is a third possible characterization for trading in commodities futures — wagering contracts. Wagering losses are deductible, but only to the extent of wagering gains. I.R.C. § 165(d) (1986).

The Supreme Court divided those who deal in "futures" into three classes. First are those who enter the market to insure themselves against losses in buying or selling things needed or manufactured in their business. These are hedging transactors. Second are those "legitimate capitalists" "who, exercising their judgment as to the conditions, purchase or sell for future delivery with a view to profit based on the law of supply and demand." The third, a disreputable group, are "gamblers or irresponsible speculators who buy and sell as upon the turn of a card." *United States v. New York Coffee and Sugar Exchange, Inc.*, 263 U.S. 611, 619 (1926).

At least one court has presumed that these transactions are not wagering contracts. *Commissioner v. Farmers & Ginners Cotton Oil Co.*, 120 F.2d 772 (5th Cir. 1941). Most of the entities engaging in swaps are corporations. Therefore, the presumption should be that swaps are not wagering contracts because the officers engaging in swaps, and the directors that allow them to do so, would breach their duty of care to the corporation if they were not exercising at least the level of "judgment" used in investment, the second tier that leads to capital gain or loss treatment. In most cases, the alternative is really that these officers are engaging in some form of hedging.

121. 350 U.S. 46 (1955). On September 30, 1987, the Service announced that it was suspending all Revenue Rulings that rely on the "Corn Products Doctrine" until the Supreme Court decides *Arkansas Best and Subsidiaries v. Commissioner*, 800 F.2d 215 (8th Cir. 1986), *cert. granted* 107 S.Ct. 1564 (1987). The Eighth Circuit decided that *Corn Products* merely interpreted the term "inventory" in I.R.C. section 1221 (1986) and that only those items specifically mentioned in section 1221 are not capital assets. The Supreme Court may accept this argument, or it may decide the case on other or much narrower grounds. It is impossible to predict at this point what the decision will be.

122. 350 U.S. at 50.

123. *Id.* Arguments that interest rate swaps are a form of insurance, because one party is paying another to assume risks, are generally discounted because swaps simply do not fulfill the requirements in the definition of insurance risk set out by the Supreme Court. For tax purposes, both the shifting and the spreading of risk are essential elements of an insurance contract. *Helvering v. LeGierse*, 312 U.S. 531, 539 (1941). Courts continue to use this definition, recently holding that "[a]n arrangement without the elements of risk-shifting and risk-distributing lacks the fundamentals inherent in a true contract of insurance." *Beech Aircraft Insurance v. United States*, 797 F.2d 920, 922 (10th Cir. 1986).

Although one of the main elements of an interest rate swap is shifting of risk by one party to its counterparty, that counterparty generally lacks the ability to distribute that risk to others, because many entities participate in swaps only occasionally. A single entity could spread risk if it were a party to many different swaps, so that it would lose on some swaps and gain, according to the same movement in interest rates, on others, much as an insurance company does. However, this scenario is unlikely because most counterparties either do not enter into many swaps or they do enter into many swaps only because they can exploit a particular type of market. They

If the swap agreement were treated as a capital asset and payments under the swap treated as payments to purchase the capital asset, then the parties could not deduct the payments when made, as they are not "ordinary" business expenses.<sup>124</sup> Amounts used to "purchase" the swap would be added to the taxpayer's basis<sup>125</sup> in the swap and so recovered, as a return of capital, when the taxpayer disposes of the swap.<sup>126</sup> This treatment would necessarily prevent the mismatching of deductions and income by postponing the deduction until the income is recognized rather than allowing the deduction as payment is made and allocating income to earlier periods.<sup>127</sup>

On the other hand, a determination that the transaction is an integral part of a taxpayer's ordinary trade or business would allow the taxpayer to deduct its costs as an ordinary and necessary business expense. Loss from the disposition of the swap would be ordinary, under the holding of *Corn Products*, as long as the transactions are used to hedge against the risks of increases in necessary business costs, in this case, to reduce the risk that capital costs will increase.<sup>128</sup> If the Service were to characterize the swaps as a form of property, it is quite likely that most corporations would be able to deduct

---

are, therefore, unlikely to spread risk among their counterparties, because they will take the same type of position on all their swaps and will realize gains or losses on all their contracts at the same time.

As banks increasingly enter into swaps as counterparties, they may serve as risk-spreaders because prudence will require them to keep a balanced portfolio. If they maintain a range of positions, they will lose on some contracts but spread that loss to other contracts on which they will gain with the same change in rates.

If interest rate swaps were treated as insurance, payments made would likely be treated as insurance premiums, which are generally deductible as an ordinary and necessary business expense. Proceeds from an insurance policy, analogous to the payments received, are recognized as gain to the extent that they exceed adjusted basis in the property insured, which would probably be analogized to the total of the payments made under the swap. The tax treatment for insurance was specified in *Central Tablet Manufacturing Co. v. United States*, 417 U.S. 673 (1974).

124. "Ordinary" is used to distinguish current expenses from capital expenditures. *Welch v. Helvering*, 290 U.S. 111, 113-16 (1933).

125. I.R.C. § 1012 (1986).

126. This treatment will result if the disposition of a swap is treated as a "sale or exchange." A corporation may deduct capital losses only to the extent that it has capital gains, I.R.C. § 1211(a) (1986), subject to the "cap" in I.R.C. sections 1222 and 1211(b)(1) (1986). Capital gains and capital losses only arise from the "sale or exchange" of a capital asset. *Id.* § 1222 (1986). If it is not a sale or exchange, the disposition produces ordinary income or loss and cannot be used to offset any capital loss that the corporation may want to deduct.

127. Reallocating the income to earlier periods, according to a formula meant to determine the element equivalent to interest, more clearly reflects the time value of money than capital asset treatment. Capital asset treatment would prevent income deferral but in a way that is not itself "time-conscious."

128. But note the cases like *Hoover v. Commissioner*, 72 T.C. 206 (1974) that do not treat as hedging transactions those currency transactions made to decrease translation risks, specifically the risk of paper losses due to currency fluctuations. These holdings suggest that unmatched swaps, those not linked to a particular underlying debt, may not be legitimate for hedging purposes. This view seems logical, as the advantage of taking deductions for hedging transactions should only be granted to those with something to hedge.

payments made to purchase swaps as ordinary and necessary business expenses, because the swaps are used to regulate and reduce the cost of borrowing funds.

Even though this decision would dictate that payments are deductible when the swap has been entered into as a hedging transaction, the problem of the timing of income remains unresolved. *Corn Products* did not discuss this problem because, as the Court noted, under the rules of all commodity exchanges, futures contracts are required to be "closed out" in periods shorter than two years, and this precludes the possibility of deferral in the vast majority of cases. Income cannot be deferred for long periods because the contracts must be closed out relatively quickly; when they are closed out, gain or loss is recognized. Swap transactions do not have to be closed out, so the deferring party may continue to take current deductions for the swap payments and postpone the recognition of gain or loss indefinitely. Therefore, this treatment does not, in itself, provide a solution for the deferral problem.

Although treatment of swaps as hedging transactions is insufficient to solve the income timing problem for the Service, this problem would be alleviated if the Service could require that swap agreements be marked to market under I.R.C. section 1256.<sup>129</sup> This section treats the contracts to which it applies as if they had been sold on the last day of the tax period, thus requiring gain or loss to be declared at the end of each accounting period.

However, there are two reasons why swaps would not be marked to market. First, swap agreements that do not involve an exchange of currency are not within the scope of the section that mandates this treatment for certain types of contracts.<sup>130</sup> No other section allows the Service to choose this treatment for interest rate swaps. Second, even if the Service stretched the section 1256(b) definitions to include plain interest rate swaps, most swaps would be exempted from the mark to market rules. Swaps are used to reduce the risk of interest rate fluctuations and so fall under the hedging exception<sup>131</sup> exempting such transactions from the mark to market rules.<sup>132</sup>

---

129. I.R.C. section 1256 (1986) provides that certain contracts, generally limited to those traded on commodities exchanges, shall be treated as sold for their fair market value on the last business day of the year, with proper adjustments to be made for any subsequent gain or loss. Forty percent of any gain or loss is treated as short-term capital gain or loss and sixty percent of such gain or loss is treated as long-term capital gain or loss.

This provision was included in the I.R.C. to correspond to the daily cash settlement mark to market system used on U.S. commodity exchanges to determine margin requirements. H.R. CONF. REP. NO. 215, 97th Cong., 1st Sess. 258, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 285, 347.

130. The section is limited to regulated futures contracts, foreign currency contracts, non-equity options and dealer equity options. I.R.C. § 1256(b) (1986).

131. I.R.C. section 1256(e)(2)(A)(ii) (1986) provides that hedging transactions include a transaction entered into in the ordinary course of business "to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made or obligations incurred or to be incurred, by the taxpayer."

132. I.R.C. § 1256(e)(1) (1986).

Since this is the only theory that would require or even allow a taxpayer to mark to market, the characterization of swaps as property would require a legislative change to prevent the deferral of income for corporations that are not dealers and that enter swaps as hedging transactions. Therefore, the Service cannot solve its income timing problems simply by declaring that entering into an interest rate swap is the equivalent of purchasing interest rate futures. The Service, or Congress, would need to do more.

## II.

### A CONTRACTUAL APPROACH TO INTEREST RATE SWAPS

When considering transactions, the Service should seek to answer the question "What does it look like?" only when it has no other way to classify the transaction. In this situation, it is not necessary; Congress has given the Service many weapons to combat the deferral of income. The proper question, therefore, is "What is it?," and the simple answer to "What is a swap?" is that it is a contract.<sup>133</sup> While interest rate swaps may never be easy to understand, their analysis is aided if one disregards the voluminous rulings and interpretations which the service has compiled with regard to financial instruments and returns to basic concepts of contracts and property law. A swap should be analyzed as a contract; in particular, it should be analyzed as an executory contract.

Like many other contracts, the swap contract requires one party to make payments to the other. These payments will be referred to in this Article as payments made under the swap. Unlike most contracts, the swap requires both parties to make such payments. It is that feature which causes some confusion. This confusion is compounded by the fact that related payments are being made on the underlying debts, which are incidental to the swap agreement.

All contracts, including interest rate swaps, create rights that may be or may become valuable. Those rights constitute property<sup>134</sup> and may be

---

133. The essential elements of an informal contract, meaning one that is not under seal but that derives its efficacy from the substance of the transaction rather than from its form, are mutual assent and consideration. S. WILLISTON, *supra* note 78, at 22. Offer and acceptance of the terms of the swap demonstrate mutual assent.

Although parties may make deals on the telephone, the agreement is generally reduced to writing and signed. In fact, the International Swap Dealers Association has developed a "code" of standard wording and assumptions so that deals can be concluded even on the telephone with no confusion as to the meaning of the terms used. The consideration for the contract is the parties' mutual promises to each other to perform.

Farnsworth describes these contracts, whose only consideration is mutual promises, as "purely executory contracts." He points out that these have been enforceable since the common law courts of England succeeded in developing the action for *assumpsit* as the general basis for the enforcement of promises in the fifteenth and sixteenth centuries. E. FARNSWORTH, *supra* note 89, at 19.

134. *Commissioner v. Covington*, 120 F.2d. 768 (5th Cir. 1941) (Holmes, J., concurring), *cert. denied*, 315 U.S. 822 (1942).

bought and sold, either in face-to-face transactions or on organized exchanges. Payments made to buy these rights, which must be distinguished from payments made under the swap, will be referred to in this Article as payments made for a swap. The payment made to terminate rights and obligations under a swap is usually termed the "settlement amount" in the contract. The contract usually sets out the method by which that amount is determined.

The payments related to a swap are made for different reasons and at different times during the life of the swap. A sound analysis must take that fact into account, and the tax treatment of the payments must differ accordingly. For this reason, practitioners can only determine the correct tax treatment of the various types of payments by looking for the reason the payments were made.

Analyzing a swap agreement as a contract avoids preconceptions that arise when characterizing the agreement as a "financial instrument," and clarifies the tax treatment of some of the payments. Payments made for a swap are payments made to acquire property; further analysis will determine whether the property is a capital asset or not, as with any other property. The settlement amount is essentially liquidated damages, that is, damages as determined by a procedure agreed to in the contract.

Analysis of the payments made under the swap is not as easy. In most contracts, one party makes a payment and the other party provides something, be it services, property or the use of money for a period of time. The payment of money by one party in return for the payment of money by another party appears aberrational. It is not obvious what those payments buy or why they are made. Discomfort with the mechanism leads some analysts to explain swaps with unnecessary theoretical complexities.

Those analyzing swaps have not always managed to differentiate between the types of payments that are involved and, thus, have seen in swaps more complexity than actually exists. Perhaps most notable are Olander and Spell<sup>135</sup> who analogize interest rate swaps to interest rate futures. Interest rate futures are commodity futures contracts in which the underlying properties are Treasury Bills, Eurodollar deposits, and Certificates of Deposit.<sup>136</sup> Parties dealing in these contracts agree to buy or sell, at a certain price, notes bearing a specified rate of interest at a specified date in the future.<sup>137</sup> The analogy itself is reasonable. As the NYSBA explained in Appendix II to its report, a choice between an interest rate swap and a series of purchases of interest rate futures is economically neutral.<sup>138</sup> Both types of transactions should, thus, give rise to reasonably similar treatment.

---

135. Olander & Spell, *supra* note 7, at 45.

136. Priv. Ltr. Rul. 84-40-025 (June 29, 1984).

137. *Id.*

138. *Report, supra* note 10.

Olander and Spell build upon this endorsement of the analogy and suggest that the payments made under a swap represent the purchase price of an acquired capital asset.<sup>139</sup> This treatment would prevent a party to a swap from deducting payments as they are made.<sup>140</sup> They argue that the payments made under the swap should be aggregated as the swap's basis, depreciable over the life of the swap or recovered against gain from the swap upon sale or termination.<sup>141</sup> Any payments received pursuant to the swap agreement would be a return of capital plus gain from the sale or disposition of a capital asset. However, the *Corn Products* doctrine could dictate that the gain be ordinary, not capital, in nature.<sup>142</sup> This doctrine applies to losses or gains from "hedging" transactions.

Olander and Spell's analysis is odd because, in analogizing interest rate swaps to futures contracts, it does not compare them to the entire futures contract, but only to its second step. It is the original transaction creating the futures contract that establishes the rights that may become valuable if the market swings in the right direction. That transaction, rather than the subsequent one, is therefore most analogous to the contract that creates an interest rate swap.

A commodities futures contract is an executory contract to buy or sell an underlying commodity for a specified price at a specified date in the future.<sup>143</sup> To terminate the rights and obligations created by the futures contract before delivery, a contracting party can enter into a closing or setoff transaction, which is a corresponding and opposite position to the one it took when entering the contract. Settlement by setoff constitutes a sale or exchange of the original contract for tax purposes<sup>144</sup> and locks in gain or loss.

As in the case of the interest rate swap, there are at least two different payments with which commodities futures traders must deal: payments made under the contract and payments made to acquire the contract rights (analogous to payments made under a swap and to payments made for a swap). If the party does not sell the contract, it will have to take delivery of the commodity and make payments under the contract. These transactions are easy to overlook because most of the activity on commodities futures exchanges involves sales of the contract rights and obligations and, thus, give rise to contract acquisition payments. There is no doubt that these rights constitute property which can be a capital asset under I.R.C. section 1221.<sup>145</sup> If they are capital assets which do not fall under the *Corn Products* doctrine, the

---

139. Olander & Spell, *supra* note 7, at 48.

140. See *supra* notes 124-27 and accompanying text for a discussion of the treatment of a capital asset.

141. *Id.*

142. *Id.*

143. *New Mexico Timber Co. v. Commissioner*, 84 T.C. 1290, 1300 (1985).

144. *Vickers v. Commissioner*, 80 T.C. 394 (1983).

145. *Commissioner v. Covington*, 120 F.2d at 771 (Holmes, J., concurring).

payments made to acquire those rights will not be deductible as they are made.<sup>146</sup>

Olander and Spell apparently have not focused on the fact that two different types of payments are involved in both swaps and futures contracts. Unfortunately for their argument, the futures contract "does not represent the commodity itself, but rather the right to acquire the specific commodity."<sup>147</sup> The payments made under the contract are not to "buy" the contract. Payments are mandated by the contract and are to buy commodities.<sup>148</sup> If the commodities are raw materials used in the company's manufacturing process, the amounts paid will be included in the cost of goods sold as long as the company takes delivery under the contract. If the commodities are not needed for the manufacturing processes, the company will find it difficult to prove that it deserves to deduct payments for the futures contracts as "hedging" expenses.<sup>149</sup> Thus, the payments made under the contract, which are analogous to payments made under an interest rate swap, are to pay for the goods delivered under the contract. A party usually enters into this sort of contract in order to hedge against changes in the market price for the commodity.

Similarly, payments made under an interest rate swap are not payments to buy the contract. They are analogous to payments made at the time of delivery under a futures contract, not the payments made when buying the *rights* in a futures contract. By confusing these two types of payments in the futures contracts context, and analogizing payments made under a swap to the wrong one, Olander and Spell have come to the wrong conclusion as to the proper tax treatment of interest rate swaps.

The fact that contract negotiations create a debt that may later be sold as a security does not affect the conclusion that the payments made under the contract are not to buy the instrument itself. The creation of a security is analyzed separately; if it were not, a party issuing bonds would have to treat the proceeds as gain from the sale of a security rather than as a debt.<sup>150</sup>

Similarly, a contractual obligation requiring a party to pay for the rendering of services creates an account receivable which belongs to the party which rendered services. Under the Uniform Commercial Code, an account

---

146. If they do fall under the *Corn Products* doctrine, then the amount spent to acquire the futures contract is added to the cost of the commodity bought and deducted as an ordinary and necessary business expense. See *supra* note 124.

147. *New Mexico Timber Co.*, 84 T.C. at 1300.

148. The court rejected the argument that futures contracts are only paper transactions, and not contracts to purchase commodities. *Covington*, 120 F.2d. at 770.

149. *Corn Products* is an excellent example of what *will* give rise to ordinary deductions or income. The corporation entered into futures contracts to protect itself against rises in the cost of its raw materials. It took delivery under some of its contracts and sold others as they were no longer needed. The Court found that these trades were an integral part of the taxpayer's business and, thus, that the futures contracts were not capital assets.

150. This article does not consider the issue of whether a swap is a security, and in no way should it be interpreted as concluding that it does create a security.

receivable is property which one may buy or in which one may perfect a security interest.<sup>151</sup> Although this property may be assigned or sold, the party making the payments for services rendered is entitled to a business deduction if the expense meets the requirements of I.R.C. sections 162 or 212.

The theoretical reason that the originally negotiated swap contract cannot be a contract for the sale of property is that no property exists until the contract is concluded and a right created. The contract itself creates the rights which may later be treated and traded as property. The creation of a right is not itself a sale of a right.

The Fourth Circuit's opinion in *Helvering v. Stein*<sup>152</sup> supports the conclusion that the creation of a right does not constitute a sale for tax purposes. The court had to determine whether the negotiation of commercial paper constituted a sale for the purposes of the Internal Revenue Act in order to determine whether the income at issue was sourced<sup>153</sup> in the United States or Germany. The court found that "a promissory undertaking to pay money is not property in the hands of the person who makes the promise or the agreement,"<sup>154</sup> because "the original negotiator . . . did not transfer a claim which he already had; rather did he, by the negotiation, create a claim for the first time."<sup>155</sup> Therefore, the court held that the original negotiation of commercial paper retains its character as a loan, despite the fact that subsequent transfers of the rights embodied in the paper are sales of property.

Since payments made under a swap are not to buy the contract, it is necessary to determine what the payments do "buy." The three obvious possibilities are that they are (1) interest, i.e., payments made to buy the use of money, (2) the purchase price for property, or (3) payment for services. The next section will examine these possible characterizations.

### III. THE ZEN OF SWAPS

In order to decide how the payments made under an interest rate swap should be treated for tax purposes, it is necessary to determine why the payments are made. The form of an interest rate swap is clearly odd, but the substance of the swap, not its form, controls its treatment. This Part seeks to discover what the substance is.

---

151. U.C.C. § 9-106 (1978).

152. 115 F.2d 468 (4th Cir. 1940).

153. The I.R.C. sets out a fairly elaborate scheme for determining the source of income. The source of income is important for several reasons, but in the context of *Stein*, the most important use of the source rules was their relation to the definition of gross income. Section 212(a) of the Internal Revenue Act, the predecessor section to I.R.C. section 872 (1986), provided that gross income of a nonresident alien included only gross income from sources within the United States.

154. 115 F.2d at 471.

155. *Id.*

*A. Proper Tax Treatment of Payments Made Under the Swap*

This section looks more closely at the nature of swaps. It is not enough to ask why a firm enters into a swap. Although the firm most likely wants protection against changes in interest rates, there are many different ways to achieve that objective. Everyone wants to protect himself against changes in the weather, but the tax treatment of those who rent a house to do it is very different from the treatment of those who buy a house. The important factor is the difference in legal relationships.

Thus, proper tax treatment of swaps depends not only on the party's intent but also on how it achieved its goal. A corporation chooses the swap as a method of "hedging" risk in large part because of the legal relationships the swap creates. These relationships should not be ignored for tax purposes but should be considered when deciding which characterization to choose.

*1. Why Swap Income is not Interest Income*

As noted above, the Service apparently decided in its Revenue Ruling that the payments made under an interest rate swap are not interest.<sup>156</sup> This decision is probably correct, because the definition of interest set out in *Old Colony* apparently prevents a characterization of payments as interest, because there is no underlying debt.<sup>157</sup> However, in domestic situations and in international contexts where the Service is not bound by a treaty, it may argue that swap payments are an interest equivalent because they are identical in amount to payments that would have been made had the parties instead entered into back-to-back loans.

Reid, in his article analyzing swaps for sourcing purposes,<sup>158</sup> discusses the impact of the holding in *Bank of America v. United States*<sup>159</sup> on the possibility of treating swap payments as interest. In that case, the court held that commissions received by Bank of America for issuing letters of credit had characteristics of both interest income and payment for personal services. The "predominant feature" of the transactions was the substitution of Bank of America's credit for that of the foreign banks. As a result of this predominance, the commissions had to be treated as interest.<sup>160</sup> The court based its decision on the fact that the interest aspect of direct loans would dominate the personal services aspect under the sourcing rules in I.R.C. sections 861 and 862, since interest is placed in a specific category and not in the more

---

156. See *supra* notes 17-21 and accompanying text.

157. The first time any governmental body mentioned interest rate swaps was when the House Ways and Means Committee explained the treatment of currency transactions in its report on the tax bill that eventually became, with modifications, the Tax Reform Act of 1986. The report briefly described interest rate swaps, then stated that payments made under an interest rate swap are not interest because there is no underlying debt. H.R. REP. NO. 3838, 99th Cong., 1st Sess. 457 (1985).

158. Reid, *supra* note 7, at 21.

159. 680 F.2d 142 (Ct. Cl. 1982).

160. *Id.* at 149.

general "personal services" category.<sup>161</sup> Even so, the court admitted that the acceptance commissions in issue could not be directly equated with interest<sup>162</sup> and that it used the analogy to interest only because it was the closest of the categories specified in the statute's sourcing provisions.<sup>163</sup>

The payment of money involved in the confirmation commission was not the decisive point for the court. It analogized both acceptance and confirmation commissions to interest<sup>164</sup> because both types of commissions were paid to cover credit risk. Given this basis for the decision, the "contrast"<sup>165</sup> between swap transactions and interest that Reid draws in his article is misguided. Reid states that the difference, which he uses to distinguish swaps for sourcing purposes, depends on the fact that a swap "does not involve even the temporary use of another party's funds."<sup>166</sup> However, this fact was not important to the court and did not dictate its decision. The court focused on the fact that, by accepting the time draft, Bank of America guaranteed the payment. The draft became freely tradeable after acceptance where it had not been before because Bank of America's credit was much better in that market than the foreign banks'. The foreign banks paid Bank of America for the use of its credit rating. The foreign banks effectively used Bank of America's credit rating because Bank of America guaranteed payment.

Thus, the payments made in *Bank of America* were made for reasons very similar to the reasons for swap payments. Swaps allow a party to use the credit rating of another to enter a market it could not otherwise enter. Therefore, if the criterion to determine whether something is analogous to interest were really whether one party has substituted its credit rating for another's, as the court in *Bank of America* held, it would be clear that the parties under a swap had met that criterion. Under that analysis, interest would be the most closely analogous type of payment specified in the sourcing rules. If the court were right about the criterion, the analogy to interest might provide the correct characterization for other inquiries about interest rate swaps as well.

Even if the court in *Bank of America* were correct in saying that Congress has indicated through its statutory scheme that the element of interest dominates payment for personal services in the sourcing rules, its decision does not necessarily follow. The decision depends on the determination that

---

161. *Id.*

162. *Id.*

163. I.R.C. sections 861(a) and 862(a) (1986) are complementary sections that provide rules for sourcing income arising in the United States or in foreign countries. The income is separated into eight different categories: interest, dividends, personal services, rentals and royalties, disposition of real property, sale or exchange of personal property, underwriting income, and social security benefits.

164. 680 F.2d at 148. The only difference between the two types of commissions is that in the latter, Bank of America paid the amount of the sight draft and was reimbursed by the foreign bank that had issued the letter of credit; in the former, the bank merely guaranteed that it would pay the amount of the draft when it was presented by "accepting" the time draft.

165. Reid, *supra* note 7, at 677.

166. *Id.*

payments made for the substitution of credit constitute interest, and this idea does not comport with the business community's general understanding of the term "interest." The business community is concerned about the time value of money. The substitution idea certainly does not fit the definitions given in *Old Colony* and *Dupont* which, although constraining, are still the standard definitions of interest. These definitions employ terms such as "money" and "debts," rather than "risk." Moreover, the Service has stated that assumption of credit risk through the guarantee of a loan constitutes personal services,<sup>167</sup> not interest.

Since it does not seem likely that *Old Colony* will soon be overturned, the Service is more likely to argue that swap payments are interest equivalents than it is to characterize them as interest. This could be done either by bringing them under the OID rules or by showing that in some other way the payments are economically equivalent to interest.

Superficially, the payments appear to be similar to interest. The parties make payments in patterns that approximate the timing of interest payments on debt instruments. The payments are calculated as a certain percentage of a fixed amount or are based on one of the indexes, such as LIBOR, on which floating interest rates are based. The only difference is that the fixed amount, the notional amount, is never actually transferred from one party to another as it is in a parallel loan, in which it is called the principal.

That one difference, that the transfer never takes place, is the key to understanding why the payments under an interest rate swap are not interest. While the amounts may be mathematically equivalent, they serve different functions.

Parties undertake a parallel loan because one needs foreign currency but, for one reason or another, was unable to get it at a reasonable price. For example, in the past the United Kingdom charged a premium on purchases of dollars for foreign investment.<sup>168</sup> This charge created an incentive for a corporation to borrow money abroad if it wanted to invest abroad, even if the company did not really need an infusion of capital. All it needed to do was exchange its pounds for dollars without selling the pounds.

The parallel and back-to-back loans were ways for the companies to make the exchanges they needed while avoiding penalties. Before the loans, the parties had the capital they needed but not in a form they could use. The parties did not use each other's money so much as they used each other's currency. Therefore, even the "interest" payments on a back-to-back loan may not have been paid because of the time value of money. The parties were paying to change the form of their assets, which is much closer to a purchase of property as a hedge than to paying interest. Thus, even if the Service shows that the transactions are economically the same, it may not come out

---

167. Priv. Ltr. Rul. 78-22-005 (Feb. 22, 1978).

168. Antl, *Parallel Loans, Swaps and FX Contracts*, in *SWAP FINANCING TECHNIQUES*, *supra* note 8, at 2.

ahead. It could end up trying to show that the payments under the back-to-back loans were really interest on "indebtedness" when in fact they look more like "hedging" income similar to payments under the swap.

Even if the payments on a back-to-back loan are true interest, it is not clear that the two types of payments are identical, because the transactions still have different purposes. There is no reason for the parties to a domestic interest rate swap to make loans to each other; the loans would cancel each other out because dollars are fungible. Dollars and pounds are not fungible, however. The loan, or another transaction that provided a like amount of currency, was a necessary part of the parallel and back-to-back loans because the financial market has multiple currencies. Loan payments are for the use of money within another country, as well as for the assurance of a certain exchange and interest rate.

By the time the technique had evolved into the interest rate swap, the party no longer needed to borrow the money from the counterparty. The party had already borrowed the money, at better terms, from a lender, and paid interest to that lender for the use of its money.

As used in the I.R.C., Committee Reports and regulations, the term interest equivalent usually refers to the amounts which a party pays to compensate another, whose money the party is using, for the time value of that money.<sup>169</sup> This time value compensation element of the payments found in a back-to-back loan has been eliminated from a swap, so that swap payments should not be considered an interest equivalent, except in the case of a "zero coupon" swap where one party defers paying the other, in which case a portion of its eventual payment is in compensation for the use of the money.<sup>170</sup> This residual amount may be captured under any of the sections that provide for reallocation of portions of deferred payments to account for interest.

Even though it does not appear that these payments are equivalent to interest, the practitioner must still be aware of the possibility that they will fall under the OID rules, a specific interest equivalent. Since swaps do not clearly fall under the I.R.C. definition of "debt instruments,"<sup>171</sup> to decide that swaps are not "debt instruments" and, consequently, that the OID rules do not apply to them, would neither do violence to the construction of the I.R.C. nor violate Congress' intent in enacting those rules. Moreover, it

---

169. For example, the Report of the House Ways and Means Committee on H.R. 3838 describes OID as "functionally equivalent" to an increase in the stated rate of interest, "i.e., OID compensates the lender for the use of the borrowed funds." H.R. REP. NO. 3838, 99th Cong., 1st Sess. 453 (1985).

170. Part of any deferred payment may in fact constitute interest to the extent that money has been "borrowed" from the deferring party, which has made payments under a "zero coupon" swap but has not yet received the deferred payment. The same is true, to a lesser extent, of any swap where payments are not made at the same time so that one party has the use of the other's money for a period of time. In that case, some portion of the payment may be attributable to interest on the deferral of payment just as it is in deferred payments for property.

171. See *supra* notes 97-101 and accompanying text.

would do violence to the concept of an interest equivalent if interest rate swaps were found to be "debt instruments."

Applying the OID rules to interest rate swaps would hurt the concept of the interest equivalent by treating as interest amounts that clearly are not paid because of the time value of money. Payment flows under swaps are very different from payment flows under typical "debt instruments." The amounts that would be required to be reallocated to the deferral period under the two methods of application of the OID rules explained above bears no relation to the time value of money. If the issue price is determined under I.R.C. section 1274(b)(1), which applies to debt instruments issued for property, then, by definition, every swap would have OID. Consequently, every party engaging in a swap would have to recognize income<sup>172</sup> whether or not the party realizes gain by receiving more under the swap than it pays its counterparty. Even if the party receives more than it pays out, that outcome will be due in large part to the fluctuations in interest rates against which the parties were hedging, not the time value of money.

Similarly, if the issue price were determined under I.R.C. section 1273(b)(2), which applies to debt instruments issued for money, then the amount received in a swap would depend on fluctuations in interest rates, not on the fact that one party is using the other's money. In this case, the OID would equal the difference between the amount a party pays and the amount it receives under the swap. Only in rare cases would this amount even approximate the standard rate of interest, inasmuch as the fixed rate used to compute the deferral payment would nearly have to be double the floating rate in order for the premium to equal a rate of interest that is reasonable for the deferral.<sup>173</sup>

Given that the amounts determined to be OID under the OID rules would have no relation to the payments actually made, the Service would be ill-advised to characterize the swap as a debt instrument, or back-to-back debt instruments. If it is not a debt instrument, then the OID rules do not apply. The purpose of the designation "interest equivalent" is to capture payments made because of the time value of money. Logically, swap payments should be safe from such a characterization. Fortunately, the Revenue Ruling contains at least the tacit admission that the payments are not interest, and a Congressional report is consistent with the Revenue Ruling. It is necessary to look elsewhere for the correct tax treatment.

---

172. I.R.C. § 1272(a)(1) (1986).

173. It is easiest to illustrate this by using a "plain vanilla" swap with a notional amount of \$1 million. A makes floating payments at LIBOR. B makes fixed payments to A at fourteen percent. If the payment due dates are every quarter when the payments are made, A's "stated redemption price" is fourteen percent of the notional amount; its issue price is LIBOR times the notional amount. If LIBOR is seven percent, then the OID would be equal to seven percent of the notional amount. If LIBOR is greater than seven percent, the party paying fixed rates would get less than a reasonable return (assuming that LIBOR is the reasonable return).

2. *The Payments as Payments for Property*

There are two ways in which the payments made under a swap could be considered payments made for property. First, the payments could have been made to purchase the swap itself. This theory was discussed, and disproved, in Part II above. Although it is possible to purchase a swap, the payments made pursuant to a swap contract differ from the payments made to purchase a swap. Second, the payments received from the counterparty might be characterized as personal property purchased by the taxpayer, a theory that will be discussed below.<sup>174</sup>

Payments made under the original contract should be treated as payments to purchase property only if the payments received from the counterparty are considered personal property and the benefit of the bargain embodied in the contract. To focus on the fact that the contract calls for a stream of payments leads to confusion between the benefit sought and the method by which it is attained. The parties contract in order to insulate each other against risk; by promising to make cash payments if the risk materializes, they only do what insurance companies have done for years.<sup>175</sup> Such payments are not payments for the purchase of property, rather they are payments for the rendering of services because the parties are actually paying for risk reduction and not for the particular payments that each makes to the other.

Although the method by which the benefit of the contractual bargain is attained is by streams of payments, the benefit of the bargain is not the right to purchase property. The idea of treating the payment of cash as the purchase of personal property when the alleged personal property is also cash,<sup>176</sup> is one that could only be understood by Alice or Humpty Dumpty,

---

174. It is possible that the Service pronouncement that payments made under a swap will be sourced by residence was based on a conclusion that the payments are gains from the sale of personal property. This is, of course, by no means certain or perhaps even probable.

175. There are some services that can be provided only through payment of money. It is difficult to conceive of a way in which an entity could be protected against financial losses without paying money. Insurance premiums are not payments for the "purchases" of insurance proceeds; no one would argue that paying premiums is purchasing property. While payments made under a swap are *not* insurance, since there is no risk-spreading, the method used to protect the parties from financial risk is similar to insurance. A party can protect against risk of harm either by preventing the anticipated harm from occurring or by promising to repair the damage after it has occurred. In an interest rate swap, the parties protect each other from financial loss due to fluctuations in interest rates. Because the participants cannot prevent the loss (since they cannot control world financial markets,) they can only repair the damage. The damage consists of loss of money, and it is repaired by replacing that lost money. This is much more straightforward than many types of insurance, which "repair" the damage from losing a limb or a life with money.

176. Cash is not personal property for purposes of tax straddle provisions in I.R.C. section 1092 (1986). See STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981 (Comm. Print 1981). These provisions were enacted in order to clarify the law and prevent deferral of income through the use of offsetting positions in personal property that is actively traded. *Id.* at 283. I.R.C. section 1092 (1986) limits the loss that can be recognized when a taxpayer closes out such a

who could avoid conceptual difficulties by calling something anything they wanted.<sup>177</sup>

Unfortunately, the Service cannot pretend that the terms it employs are quite so malleable. This particular conceptual difficulty is demonstrated in *Old National Bank in Evansville v. Commissioner of Internal Revenue*,<sup>178</sup> which held that cash retained by a bank is not includable in "operating assets" because it cannot be considered "property used in trade or business" nor is it property held for sale to customers.<sup>179</sup> In the court's view, analogies to mercantile establishments holding goods for sale to customers are misleading, as a bank whose purpose is to render financial services to its customers cannot be said to "sell" cash to its customers.<sup>180</sup>

Similarly, the parties to an interest rate swap are not buying cash from each other.<sup>181</sup> Olander and Spell suggest that it makes no difference whether or not the payments are netted because the distinction is irrelevant in determining how the transaction is to be treated.<sup>182</sup> Consistent with this observation, the fact that many parties do net the payments suggests that the payments themselves are not the benefit that the parties to the contract seek. The reason for the phenomenal growth in the number of swaps is that they allow a debtor to procure the best possible rate in the financial market, while protecting itself from changes in the financial market at the same time. Without that benefit, the parties would certainly not contract to "buy" and "sell" to each other nearly identical amounts of cash on a quarterly or annual basis. Certainly, transaction costs would almost certainly offset whatever profit they stood to gain through the swap.

### 3. *The Payments as Payments for Services*

As is shown by the nature of the benefits which an interest rate swap provides,<sup>183</sup> a "swap transaction is essentially a back-to-back service agreement, that is, an agreement in which each party agrees to provide the service

---

position at a loss while postponing gain on the offsetting position. The straddle rules therefore affect all discussions of investment activities involving deferral issues.

177. "When I use a word," Humpty Dumpty said, in a rather scornful tone, 'it means just what I choose it to mean — neither more nor less.'" L. CARROLL, *ALICE'S ADVENTURES IN WONDERLAND AND THROUGH THE LOOKING GLASS* 186 (New Am. Libr. ed. 1960) (1871).

178. 28 T.C. 1075 (1957).

179. *Id.* at 1081.

180. *Id.*

181. In this respect, the parties to an interest rate swap differ from the parties to a currency swap in which the parties really do buy the currency from each other. Foreign currency contracts are specifically included, and given special treatment, in the straddle rules of I.R.C. section 1092(d)(7) (1986).

182. Olander & Spell, *supra* note 7, at 42 n.67.

183. See *supra* notes 27-34 and accompanying text.

of assuming a particular risk in exchange for the other party agreeing to provide the service of assuming the mirror risk.”<sup>184</sup> The payments a party receives pursuant to a swap contract are compensation for assuming risks, and the payments the party makes are for the counterparty’s service of assuming the corresponding risks.

It might be easier to look at this proposition from the party’s point of view with respect to the payments it receives, rather than those it pays. The party is receiving payments because it is assuming risk for its counterparty. This fact alone justifies treatment of the payments as payment for services. Additionally, an increasing number of entities enter into swaps to exploit their superior credit rating,<sup>185</sup> presenting an even stronger case for the characterization of swaps as contracts for services. Looking at the transaction from this perspective, the payments that the party makes under the contract are simply the costs it incurs to provide those services. While those services may bear little resemblance to what one thinks of as a service, generally defined, they are similar to several other types of financial services.

Since the risks involved in interest rate swaps can be characterized as credit risks,<sup>186</sup> analogies to guarantees or indemnities are natural. A party that furnishes a guarantee assumes the risk that the indemnified party will not meet its obligations. A party to a swap retains ultimate responsibility for repayment of its debt, even though another party is getting the advantage of the lower rate. The Service has characterized the fee received by the entity guaranteeing a loan as payment for the rendering of services under I.R.C. section 482.<sup>187</sup> Because both parties to an interest rate swap also assume some credit risk for their counterparties, the Service’s ruling suggests that the payments received pursuant to a swap should also be considered payment for services.<sup>188</sup>

---

184. Belmore, *supra* note 7, at 223. Although Belmore sounds quite adamant in this quotation, the analogy to services is actually his second choice for the appropriate sourcing of swaps. Belmore would prefer to draw analogies from insurance contracts. While these analogies might have worked for sourcing purposes, they are not adequate for other issues arising from swaps for the reasons discussed *supra* in note 123.

185. See *supra* note 34 and accompanying text (example explaining financial benefits of a “plain vanilla” swap when one party has a comparative advantage in one capital market).

186. Because payments are contingent on the other party’s performance, exposure is limited to loss from the other party defaulting and leaving the corporation that entered into the swap without a hedge. Because there will be no exposure if each party performs, the risk has been characterized primarily as a credit risk. S. HENDERSON & J. PRICE, *supra* note 6, at 73-74.

187. Priv. Ltr. Rul. 78-22-005 (Feb. 22, 1978). See also Priv. Ltr. Rul. 85-08-003 (Nov. 9, 1984). I.R.C. section 482 (1986) regulates the allocation of costs and income between related entities.

188. Belmore, *supra* note 7, at 223, notes that the Service has also taken the position that assumption of credit risk through the factoring process is a service for sourcing purposes. Income from factoring should be sourced where that service was performed. Priv. Ltr. Rul. 83-38-043 (June 17, 1983). In the factoring process, the seller of goods or services may extend credit to a customer, giving rise to a promise to pay or a “receivable.” He will then sell the receivable at a discount to a “factor” who is in the business of assuming credit risk. When the customer pays the factor, the factor recognized income equal to the discount.

In addition to assuming the risk, the party guaranteeing a loan provides the related benefit of enabling the borrowing party to obtain financing at a more attractive rate than the borrower could procure by itself. Several of the techniques used to regulate the cost of borrowing funds share this attribute. This similarity inspired the observation that, since the Service has taken the position that the guarantee of a loan constitutes the performance of a service, it would have to assert, for the sake of consistency, that arranging a back-to-back loan to provide foreign currency at low cost does also.<sup>189</sup> Since swaps are simply another means to achieve the same objective of a back-to-back loan using slightly different mechanisms, this reasoning carries over to interest rate swaps.

This cost reduction aspect of the interest rate swap compels the conclusion that the parties receive payments from each other for the use of their respective strengths in the financial markets. A party that swaps away its favorable rate is in the same position as the broker who arranges low cost loans for parties that cannot otherwise afford to procure financing. The party's position is not altered by the fact that it simultaneously contracts to take advantage of someone else's favorable rate. The Service has recognized the broker's role as a provider of services.<sup>190</sup>

The Revenue Ruling at least tentatively supports this cost reduction conclusion. The ruling states that income from swaps falls under the United States-Netherlands Income Tax Convention category of "industrial or commercial profits."<sup>191</sup> This category is defined to include income derived from the active conduct of a trade or business, but it does not include income specifically covered by other articles of the Convention.<sup>192</sup> Therefore, it does not include interest, dividends, royalties, income from real property and natural resources, capital gains, or personal services.<sup>193</sup> It *does* include profits derived by an enterprise from the furnishing of services by employees or other personnel. Thus, this section rules out several of the most important possible treatments of swaps. The payments made pursuant to a swap are not interest. They are not gains from the sale of a capital asset. They could be gain from the sale of property that does not constitute a capital asset in the active conduct of a trade or business, but that possibility has already been considered and rejected in an earlier section of this article. The payments are not income from personal services, but they could be income derived from the rendering

---

189. Samuels, *supra* note 45, at 862.

190. United States v. Britt, 64-2 T.C. ¶ 9699, 335 F.2d 907 (5th Cir. 1964). The analogy is strengthened by the fact that entities routinely contract with their counterparties to swap rates before they issue their low interest securities. Writers familiar with financial markets have speculated that the already blurred definitions of financial services institutions will become even hazier if entities with very good credit ratings, such as the World Bank, began to be actively involved in such broker-like transactions. McGoldrick, *The Wild, Wild World of Interest Rate Swaps*, 18 INSTITUTIONAL INVESTOR No. 11, 71, 76 (1984).

191. See *supra* notes 18-19 and accompanying text.

192. Article III(5).

193. *Id.*

of services by an enterprise through its employees. This characterization is the only significant remaining possibility, and the only one that comports with the logic of the Revenue Ruling.

Although the Service may have proceeded in this case by ruling out all the other possibilities until it was left with a catch-all section, swaps do not fit under "commercial and industrial profits" merely because they fit nowhere else. The position that interest rate swaps are contracts for the rendering of services is supportable on its own. Payments made under a swap are commercial profits because they arise from the rendering of financial services by an entity. These services consist of assuming credit risk for another party. The Service has consistently treated the assumption of this risk as services. Therefore, it should treat interest rate swaps in the same manner because they are simply a new method of performing these services.

#### B. Proper Tax Treatment Upon Later Disposition

A party that decides that its position under a swap is no longer advantageous has at least three options.<sup>194</sup> First, the most direct response is to terminate the swap itself and pay what is likely to be a large settlement amount. Second, if the settlement amount is too large, the party can find someone willing to assume its rights and obligations under the swap and assign the new party into the original contract through a swap sale. Third, the party can, in effect, neutralize its original swap, without affecting the obligations themselves, by entering into a "reverse" swap with a third party. The "reverse" swap allows the party to take on obligations and receive benefits mirroring its own under its original swap.

Under either the swap closeout or swap sale, the party getting out of the swap receives or makes a lump sum payment, rather than continuing to make regular payments under the swap. These transactions do not raise the deferral questions described in the section above on "zero coupon" swaps. Nonetheless, the Service must determine the character of such transactions, since uncertainty creates the fear that the Service will determine that the party has suffered a capital loss.

The characterization of the primary swap transaction as a back-to-back contract for services, as urged above, would provide a framework for analyzing the swap closeout and the swap sale. In that case the determination of the proper treatment would then be straightforward because the practitioner could easily analogize to the payments made under more familiar types of contracts. A customer who receives services must pay for them, and the party who renders services has a right to that payment. This contractual right to payment is property which may be transferred. It can also give the right to

---

194. A good, though short, description of these three possibilities can be found in Cunningham, *Interest Rate Swaps: The Secondary Market*, in INTEREST RATE AND CURRENCY SWAPS 1986, *supra* note 7, at 23, 28-32.

damages if the other party does not fulfill its obligations under the contract.<sup>195</sup> The tax treatment of the sale of property and the receipt of damages is comparatively simple.<sup>196</sup>

Under this general analysis, a swap closeout is simply the termination of an executory contract, and the settlement fee consists of liquidated damages for the cancellation of the contract. The fact that one calculates the settlement amount in the same way one figures expectation damages tends to support this analysis. The market value of the completed performance, which determines the settlement amount, depends on interest rates.<sup>197</sup> The amount is not intended only to repay the party what it paid to its counterparty.

A swap sale is analogous to factoring<sup>198</sup> and other procedures through which a party that has rendered services or provided goods to a customer, thereby generating an account receivable, sells that account to another party who assumes the risk that the customer will not pay. This process has become quite commonplace, and the I.R.C. recognizes it in order to prevent the technique from being used to turn inventory into a capital asset. Accounts receivable, acquired in the ordinary course of a trade or business for services rendered, are not capital assets.<sup>199</sup> If the swap sale were considered the sale of an account receivable that was acquired for services rendered, then the tax treatment would be straightforward, with ordinary gain or loss recognized.<sup>200</sup>

In contrast to the swap closeout and swap sale, a party that reverses its swap does nothing more than enter into a new swap to hedge against changes in interest rates. Whatever treatment is adopted for swaps in general should

195. See *supra* note 89 and accompanying text.

196. The general methods of taxing gains from the sale of property are discussed *supra* notes 116-28 and accompanying text. Liquidated damages from a failure to perform an executory sales contract constitutes ordinary income under I.R.C. section 61. *Smith v. Commissioner of Internal Revenue*, 50 T.C. 273 (1968); see also *Binns et al. v. United States*, 672 T.C. 9720 (6th Cir. 1967).

197. A party entitled to expectation damages is entitled to recover an amount that will put him in as good a position as he would have been in had the contract been performed. *E. FARNSWORTH*, *supra* note 89, at 839. The settlement amount is intended to give the party the amount it will cost him to enter a new swap, putting him in the same position as if the old swap were performed.

198. See *supra* note 188.

199. I.R.C. § 1221(4) (1986).

200. This may work well when payments are made concurrently and are dependent on each other so there is a right to receive payment as soon as payment is made. However, the analysis is more difficult when one party will not receive payment for a long time. The party buying into a swap will not receive property in the form of an account receivable because the contract is still executory. It has rights, at the most, to damages of an unspecified amount until it has fully performed. If this were a case where only the rights to income under the contract were assigned and the original party continued to perform the obligations under the contract, it would generate a real account receivable which *is* property. Since that is not the case here, the "right" does not fall under any of the types of property in U.C.C. section 9-104(f) (1978).

While this distinction, and the omission of this type of contractual right, may appear trivial, the U.C.C. seeks to cover all the types of property, other than real property, in which one would take a security interest. The fact that one cannot take a security interest in a contract right transferred to one who must perform the obligations under the contract shows that the drafters of the U.C.C. did not consider this a form of property.

also control swap reversals. In support of this conclusion, swap reversals are often considered a part of the "primary" rather than the "secondary" swap market.<sup>201</sup>

The tax treatment of a swap reversal should be the same as that of a primary swap because the reversal of a swap consists entirely of entering into another primary swap. The reasons for entering into the swap are the same; the parties to the swap perform the same service - the assumption of risk for their counterparties. The obligations each party undertakes in a swap reversal are identical to the obligations each has undertaken in a primary swap. The only difference is that the reversing party contracts with another to assume the risk of an opposite movement in rates. This difference is not enough to justify different tax treatment.

As discussed before, many different issues arise in the analysis of interest rate swaps. In order to make a proper analysis, one must avoid the trap of placing swaps in the category of "financial instruments" because that immediately gives rise to the suspicion that swaps have a tax deferral purpose. Fortunately, the characterization of interest rate swaps as contracts for services allows for the relatively smooth analysis of those issues. As shown in this section, swaps can be analyzed as service contracts in terms familiar to most practitioners. It is reasonable to analyze interest rate swaps as service agreements since they are contracts to provide something fairly commonplace — financial services.

#### CONCLUSION

Interest rate swaps provide an exciting new opportunity for corporate financial officers wishing to reduce and regulate the cost of borrowing. Swaps can benefit every entity because they all have a comparative advantage in at least one financial market. Swaps also provide a means to arbitrage the various capital markets and produce one uniform, worldwide credit market.

Unfortunately, the mechanism used to produce these results is often seen as bizarre and difficult to understand: the parties provide this service by contracting to make streams of payments. There does not seem to be a way for a party to protect its counterparty against the risk of financial loss other than through this admittedly unusual form of contract. Although this type of contract is merely the method by which the swap's objective is achieved, the form of the swap contract makes many people suspicious of swap transactions generally.

In addition, this suspicion tends to affect the Service's resolution of the disagreement regarding the proper characterization of the payments made under a swap. The Service has an inherent distrust of all financial instruments, due to the fact that so many of those instruments have, in the past, been used to disguise interest income. Because of the rather narrow definition

---

201. Cunningham, *supra* note 194, at 29.

of interest set out in several old Supreme Court cases, the Service could not directly attack schemes to defer interest unless it was clear to courts that the parties had contracted to produce some underlying debt. Tax planners were clever enough to avoid that problem. Consequently, the Service has tended to characterize new types of contracts to fit within the restrictive and narrow definitions of existing contracts. As an unfortunate result of this practice, the Service might improperly characterize swaps as "debt instruments."

However, the Service is presently capable of attacking deferral schemes by placing a contract within a few broad categories. If the Service were to adopt this approach, it would be easier for tax professionals and even laymen to determine the proper tax treatment of swaps. To do so, they need only decide under which of three categories a party's payment fits: payment (1) for services or for rental; (2) to purchase property; or (3) to compensate someone for the use of money. These are broad categories, but no broader than the categories employed under the sourcing rules, which appear to work fairly well. The Service should decide what the essence of an interest rate swap is so that persons making swaps can be certain of their tax treatment.

Unfortunately, the commentators who have analyzed swaps to date have been unable to agree on which of broad categories properly includes swaps. Olander and Spell argue that payments made pursuant to a swap agreement constitute payments to buy the swap. This characterization is incorrect as a matter of both contract and property law; in addition, it is inconsistent with the analogy they suggest as proof. Though Reid does not commit himself, he suggests that the payments should be analogized to interest. However, Reid misinterprets a key case and ignores at least one governmental mention of the technique that disagrees with his theory.<sup>202</sup> Furthermore, payments made under a swap are neither interest under the *Old Colony* definition, nor are they equivalent to interest, even as defined in the business community, because they are not paid as a result of the time value of money. Belmore suggests that the swaps are back-to-back contracts for financial services, a claim he supports by analogy to several other financial instruments that serve similar functions.

Swaps are simpler to understand through a consistent application of the framework offered in this Article. The essence of the interest rate swap is that it allows one party to assume the credit risk and the risk of interest rate fluctuations for its counterparty. In doing this, the party will often procure a lower interest rate for its counterparty. By entering into the contract, the parties to a swap agree to render financial services to each other. Any other characterization of swaps would be thoroughly inconsistent with the Service's characterization of payments for guarantees and indemnities, factoring fees,

---

202. To be fair, it should be noted that the Revenue Ruling came out after Reid had written his piece. However, the Congressional Report which first mentioned interest rate swaps could, and probably should have been cited.

and fees paid to a broker for arranging low cost loans. In all of these transactions, one party assumes credit risk or the risk of interest rate fluctuations for the other party. The Service has designated all of them financial services. There is no rationale for characterizing interest rate swaps in any other way.

It may seem self-evident that, in order for the Service to decide the proper tax treatment of swaps, it should look at the essence of the contract and determine why the parties have agreed to make the payments under a financial instrument. However, an examination of the literature reveals that the Service is not doing this. Rather, it has taken shortcuts and analogized to other instruments which are already specifically covered under the I.R.C. But, properly characterized, interest rate swaps fall within a category treated in the I.R.C., and need not be given specific coverage. This is probably also true of other financial products that have been developed as well as of ones that have yet to be developed. If the Service and tax practitioners were to adopt this Article's approach, they would be able to develop an analysis of the tax treatment of new financial instruments which is easy to apply and coherent, as well as consistent with principles of contracts and property.