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## The Recharacterization of Cross-Border Interest Rate Swaps: Tax Consequences and Beyond

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## I. INTRODUCTION

The interaction of domestic tax policies and double taxation treaties has created unintended and potentially serious impediments to the fair and efficient functioning of international financial markets, with particularly significant consequences for cross-border interest rate swaps. The importance of interest rate swaps is well-documented: They reduce and transfer interest rate risk, and they contribute substantially to the liquidity of the world's capital markets.<sup>1</sup> Accordingly, any tax-related interference with interest rate swap markets may have materially negative and unforeseen consequences on many types of domestic and international capital transactions.

An apparently inadvertent example of tax-related interference arises from the U.S. Treasury regulations on notional principal contracts, promulgated in 1993, under which an off-market interest rate swap with a "large" non-periodic payment is recharacterized as a package consisting of a swap and an embedded loan bearing interest.<sup>2</sup> The resulting conversion of swap income into interest income (for all U.S. tax purposes) creates a variety of tax issues under domestic law and has especially significant and complex ramifications in cross-border cases. In these cases, a withholding tax may be imposed on the interest, and double taxation of the interest is a possibility even in the presence of a tax treaty.<sup>3</sup> The withholding tax on U.S. source interest paid to a non-U.S. entity is not necessarily eliminated by the portfolio interest exemption, as may generally be thought, because the exemption does not apply to interest paid to banks, which make up a large portion of swap participants.

Tax and regulatory authorities in the United States were correct in recognizing that large nonperiodic payments in interest rate swaps were often

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1. See U.S. Gen. Accounting Office, Report No. GAO/GGD-94-133, *Financial Derivatives* (1994) [hereinafter GAO Report]. This report contains a detailed analysis of swaps, as well as of many types of derivatives, and describes their use both in the United States and in other countries.

2. Regs. § 1.446-3. The regulations address notional principal contracts generally, but swaps are the most common type of notional principal contract. See *infra* Part II.A. Further, the regulation provisions most extensively analyzed in this article apply specifically to swaps. Thus, § 1.446-3 is referred to as the "swap regulations" in this article. See *infra* Parts II-III for definitions and discussion of notional principal contracts, embedded loans, "large" nonperiodic payments, and off-market interest rate swaps.

3. According to the Commentary to the OECD Model Convention, the "harmful effects [of double taxation] on the exchange of goods and services and movements of capital, technology and persons, are so well known that it is hardly needed to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries." Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital* at I-1, para. 1 (1994) [hereinafter 1994 OECD Model].

used to avoid or abuse tax, accounting, or financial disclosure policies. Thus, the swap regulations address a real problem. However, in the event of large and relatively quick changes in interest rates, many participants in swaps may wish to alter or terminate their swap obligations. To do this, they may be required to use large nonperiodic payments in order to terminate existing swaps or to hedge them with new off-market swaps. In this situation, confusion and uncertainty created by the swap regulations and the potential for double taxation may have a material effect on swap liquidity and pricing and, consequently, on the proper and efficient operation of the interest rate swap market.

In brief, double taxation may result from fundamental conceptual differences among countries as to the nature of the income resulting from nonperiodic payments. Where two countries consider the same nonperiodic swap payment to be two different forms of income, potentially fatal double taxation may arise, even if there is a tax treaty between them.

The international network of bilateral tax treaties generally alleviates such tax barriers to cross-border transactions. However, as new financial products develop, they often do not fit smoothly into the double-taxation-eliminating treaty provisions. Such is the case with off-market interest rate swaps, as well as with other complex financial derivatives.<sup>4</sup>

This article first analyzes the U.S. treatment of off-market interest rate swaps as established by the swap regulations.<sup>5</sup> It critically examines the re-

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4. Efforts are now being made to develop internationally-accepted treatments of derivatives, including swaps. The Organization for Economic Co-operation and Development (OECD) is exploring in its Working Group on Innovative Financial Instruments means of handling derivatives under its Model Tax Convention. Also, the taxation of derivatives was one of the main themes at the International Fiscal Association Congress in September 1995. The General Report for that Congress pointed out, however, that international efforts "have only just begun to attempt the task of forming some international consensus regarding the tax issues and problems that these new types of transactions present." Charles T. Plambeck et al., *Tax Aspects of Derivative Financial Instruments: General Report*, LXXXb Cahiers de Droit Fiscal International [C.D. Fisc. Int'l] ¶ 1.1 (1995). See GAO Report, *supra* note 1, at 116 (discussing international projects related to derivative regulatory and tax harmonization).

An examination of the taxation of internationally-traded financial products is currently being undertaken by the U.S. Treasury Department in an effort to solve problems such as those discussed in this paper. See Michael Cosgrove, *Treasury Undertaking Broad Review of Financial Services*, Beerbower Says, *Daily Tax Rep. (BNA)* No. 98, at G-2 (May 22, 1995) (reporting on the speech of Treasury Deputy Assistant Secretary Cynthia Beerbower to the ABA Section of Taxation on May 19, 1995). In addition, the Treasury plans to issue a new U.S. model income tax treaty, which is expected to address financial instruments.

5. See also Steven D. Conlon & Vincent M. Aquilino, *U.S. Tax Considerations for Institutional Investors Acquiring Derivative Products: A Methodology for Evaluating Tax Risks*, in *The Handbook of Derivatives & Synthetics* 759 (Robert A. Klein & Jess Lederman eds., 1994) (detailing U.S. taxation of derivative products). For the taxation of another type of derivative product, options, see Bruce Kayle, *Realization Without Taxation? The Not-So-Clear Reflection of Income from an Option to Acquire Property*, 48 *Tax L. Rev.* 233 (1993);

characterization process and explains how recharacterization, while addressing a real problem in some cases, also lays the foundation for the imposition of unexpected, and unwanted, double taxation of cross-border swaps with a U.S. counterparty. The remainder of the article is a broader examination of how and why double taxation of the income resulting from these swaps may arise when one of the contracting parties is a resident of the United States or of another country that were to tax income from such swaps in a manner similar to that of the swap regulations. The final section presents some potential solutions to the double taxation problems discussed in the article.

## II. NOTIONAL PRINCIPAL CONTRACT AND SWAP DEFINITIONS

### A. *What are Notional Principal Contracts and Swaps?*

The swap regulations define a notional principal contract as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts."<sup>6</sup> More concisely, a notional principal contract is an executory contract whereby two parties agree to make future payments based on an agreed upon index and notional principal amount. Types of notional principal contracts include commodity swaps, basis swaps, equity swaps, interest rate caps, collars, floors, currency swaps, and interest rate swaps.<sup>7</sup> Of these, interest rate swaps are among the most common.

An interest rate swap is a contract by which two contracting parties (the counterparties) agree to exchange sets of cash flows with one another. In a typical interest rate swap, the payments from one party are determined by reference to a floating interest rate on a stated principal amount (the notional principal), while the other party bases its payments on a specified

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for taxation of equity swaps, Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System*, 69 *Tex. L. Rev.* 1319 (1991); for analysis of the taxation of other types of swaps, Lewis R. Steinberg, *Selected Issues in the Taxation of Swaps, Structured Finance and Other Financial Products*, 1 *Fla. Tax Rev.* 263 (1993); for discussion of policy approaches towards the taxation of financial products, see Alvin C. Warren, Jr., *Financial Contract Innovation and Income Tax Policy*, 107 *Harv. L. Rev.* 460 (1993); for taxation of dispositions of interest rate swaps, see Eugene Y. Ferrer, *Comment, Tax Treatment of Interest Rate Swaps at Disposal: Should Swap Participants Have Their Cake and Eat it Too?*, 26 *U.S.F. L. Rev.* 283 (1992). See generally Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 *Tex. L. Rev.* 243 (1992).

6. Regs. § 1.446-3(c)(1)(i).

7. For a comprehensive treatment of financial products, see generally Andrea S. Kramer, *Financial Products: Taxation, Regulation, and Design* (rev. ed. 1991 and Supp. 1994) [hereinafter *Kramer, Financial Products*]. For a discussion of the various types of derivatives and their underlying economics, see generally John C. Hull, *Options, Futures, and Other Derivative Securities* (2d ed. 1993).

fixed rate on the same notional principal amount. The distinctive factor is that the principal is never exchanged. It is merely used as the basis for the two sets of payments and is never borrowed or loaned between the two parties.<sup>8</sup> For example, in a standard interest rate swap between counterparties *N* and *M*, *M* agrees to make annual fixed-rate payments to *N* equal to 10% of the notional principal amount of \$100 million (\$10 million annually), and *N* agrees to make annual payments equal to the floating interest rate on the payment dates multiplied by the \$100 million notional principal.<sup>9</sup> The net amount owed each year varies with the floating interest rate, which often equals the fixed rate when the contract is made.

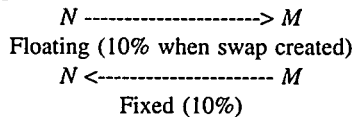
### B. Classification and Taxation of Payments Under Notional Principal Contracts

Under the swap regulations, most payments under notional principal contracts are netted, and the net amount recognized for any year is gross income for the year (if it is a net receipt) or is a deduction (if it is a net payment).<sup>10</sup> The regulations provide separately for periodic payments, non-periodic payments, and termination payments, with certain nonperiodic payments distinguished as “embedded loan” payments.

Periodic payments under a notional principal contract are those “that are payable at intervals of one year or less during the entire term of the

8. “Notional principal” is defined in Regs. § 1.446-3(c)(3).

9. The basic swap scenario may be depicted as follows, with payments based on a \$100 million notional principal:



This type of swap is generally entered into because of comparative advantages in borrowing rates. See Hull, *supra* note 7, at 112.

In most swaps, a financial institution such as a bank serves as an intermediary. The bank has separate contracts with each party, and *N* and *M* are not aware of the other. Conceptually, however, it is easier to think of *N* and *M* dealing directly with one another, or of *M* simply being a bank. See Robert W. Kolb, *Financial Derivatives* 130-37 (1993) (discussing standard swaps in more detail).

10. Regs. § 1.446-3(d). In the example from the previous footnote, if the floating rate is 9% on the first payment date:

$$\begin{array}{l}
 N \text{ owes: } 9\% \times \$100 \text{ million} = \$9 \text{ million} \\
 M \text{ owes: } 10\% \times \$100 \text{ million} = \$10 \text{ million}
 \end{array}$$

The net amount for the taxable year is the difference between the two gross amounts. Accordingly, *N* has net income of \$1 million from this swap for the taxable year (\$10 million received, less \$9 million paid) and *M* has a corresponding net deduction. If the payment dates for the two parties are the same, *N* makes no payment in this year, as only the net amount of \$1 million is paid from *M* to *N*.

contract” and are either fixed in amount or based on a specified index and notional principal amount.<sup>11</sup> In most cases, they are the annual or semi-annual payments under the swap based on the interest rates agreed upon by the parties. A periodic payment is prorated among the days in the period, and the amount allocated to each day is recognized as gross income or deduction for the year that includes that day.<sup>12</sup>

Payments are “nonperiodic” if they are made “with respect to a notional principal contract” but are not periodic payments.<sup>13</sup> Examples of nonperiodic payments include the premium for a cap or floor agreement, the premium for an option that is exercisable into a swap, and a lump sum payment for an off-market swap agreement.<sup>14</sup> A nonperiodic payment under a swap is usually allocated over the term of the swap agreement, based on market prices for analogous forward contracts, and the portion allocated to each year is recognized as gross income or deduction for that year.<sup>15</sup> A termination payment—“[a] payment made or received to extinguish or assign . . . rights and obligations . . . under a notional principal contract”—is also classified as a nonperiodic payment,<sup>16</sup> but the original parties to a notional principal contract recognize a termination payment as gross income or deduction when it is received or made.<sup>17</sup> Types of termination payments include “a payment made between the original parties to the contract (an extinguishment), a payment made between one party to the contract and a third party (an assignment), and any gain or loss realized on the exchange of one notional principal contract for another.”<sup>18</sup>

If “too large,” lump-sum payments for off-market swaps and certain termination payments no longer fall under the main taxation scheme for swap payments but are treated as embedded loans bearing “interest.” This “interest” is not taxed as swap income, but is characterized as interest for all purposes of U.S. tax law. The term “embedded loan” payment describes a lump sum payment that is recharacterized under the swap regulations because a “loan” bearing interest is deemed to be included, or embedded, in the payment. It is mentioned as a separate category of swap related payments because it is subject to its own tax provisions and creates the problems discussed in this article.<sup>19</sup>

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11. Regs. § 1.446-3(e)(1).

12. Regs. § 1.446-3(e)(2).

13. Regs. § 1.446-3(f)(1).

14. *Id.*

15. Regs. § 1.446-3(f)(2).

16. Regs. § 1.446-3(f)(1).

17. Regs. § 1.446-3(h)(2).

18. Regs. § 1.446-3(h)(1).

19. See Regs. § 1.446-3(g)(4). Embedded loans are discussed extensively in Parts

In a cross-border transaction, income under a notional principal contract is sourced in the country of the income recipient.<sup>20</sup> Since U.S. withholding taxes apply only to U.S.-source income of foreign persons,<sup>21</sup> swap payments to a foreign person are not subject to U.S. withholding taxes, even if the payments are made by a U.S. counterparty. However, interest income generally has its source at the residence of the debtor,<sup>22</sup> and payments by a U.S. person to a foreign person under a swap agreement may therefore be subject to U.S. withholding taxes to the extent the payments are recharacterized as interest.

### C. Reasons for Off-Market Swaps and Nonperiodic Payments

In new swap agreements, large nonperiodic payments are generally motivated by tax, accounting, or disclosure considerations and, consequently, are often assumed by the counterparties to be little more than disguised loans.<sup>23</sup> Before the swap regulations were issued, large nonperiodic payments were the basis of several abusive tax practices, including recognizing an up-front payment as income when received in order to roll net operating losses forward and deducting the up-front payment immediately to offset other taxable income.<sup>24</sup> It was to curb such abuses that the IRS undertook to regulate large nonperiodic payments.<sup>25</sup>

Off-market interest rate swaps with large nonperiodic payments may also be used when a counterparty wants to pay or receive fixed-rate amounts differing from current market rates in order to match the cash-flow on an asset or liability (e.g., a bond).<sup>26</sup> In addition, they may be used to obtain "off balance sheet" or undisclosed financing and by parties unable to borrow

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20. Regs. § 1.863-7(b)(1).

21. IRC §§ 871(a)(1), 881(a).

22. IRC § 861(a)(1).

23. Nonperiodic payments for off-market interest rate swaps are often made when the contract is made and thus are called "up-front" payments. However, similar nonperiodic payments may also be made later during the term of the contract.

24. See Lee A. Sheppard, *Safe Harbor Leasing Revisited: Using Swaps to Avoid NOL Limitations*, 41 *Tax Notes* 485 (Oct. 31, 1988). According to Notice 89-21, 1989-1 C.B. 651, including such up-front payments in income when received is not an accurate reflection of income. An acceptable method of accounting is one that recognizes the payment "over the life" of the swap contract. This led to Regs. § 1.446-3(g) and the recharacterization discussed in this article. For discussion of Notice 89-21, see Jeffrey P. Cantrell et al., *Notice 89-21 Crashes the Interest Rate Swap Party*, 45 *Tax Notes* 337 (Oct. 16, 1989); Thomas K. Kopp & Achim C. Pross, *U.S. National and International Taxation of Interest Rate Swaps*, 1994 *Intertax* 365, 370.

25. Notice 89-21, *supra* note 24.

26. See Peter C. Canellos et al., *Report on Tax Accounting for Notional Principal Contracts*, N.Y. St. B. Ass'n Tax Sec. Comm. on Financial Instruments [hereinafter N.Y. St. B. Ass'n Report], Sept. 28, 1989, at 21.

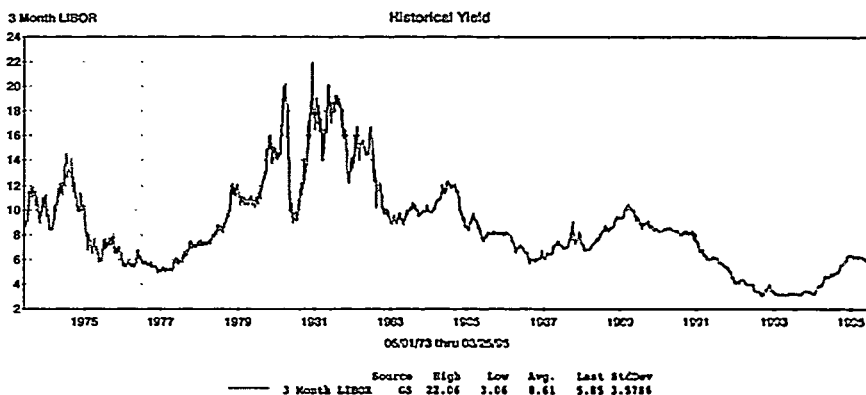


money for reasons such as restrictive credit agreements, indenture restrictions, or regulatory disclosure considerations. For instance, an off-market swap might be made to evade contractual limits placed on a company's borrowing while on-going debt is being serviced. In these examples the parties are treating the nonperiodic payment as a substitute for a loan, even though the swap contains no contractual obligation for the repayment of the "loan" to the "lender."<sup>27</sup>

However, interest rate swaps with large nonperiodic payments do not always derive from abuse or evasion, and such swap payments are necessary to ensure the liquidity of the swap markets. Specifically, following a substantial change in market interest rates (e.g., the floating interest rate used in a swap rises from 6% to 10% while the fixed rate remains at 6%),<sup>28</sup> participants in interest rate swaps that were originally priced at current market rates, without nonperiodic payments, may find that they are making or losing substantially more money on the swap than they expected when they entered into the swap. Many of those participants then chose to terminate, "lock in," or alter their existing or potential economic gain or loss, or to completely realize at that time their economic gain or loss. A swap participant may not wish to incur additional losses, or it may desire to ensure its gains on the initial swap. This may be done by terminating its position by extinguishment or assignment, by assigning one leg of its swap position, or by entering into a new offsetting swap.<sup>29</sup> Because of the substantial interest rate change since the original swap was established, many of these new contractual arrangements are off-market and require large nonperiodic payments. A winning party wishing to realize its profits immediately must receive a large nonperiodic

27. See *infra* Part V for extensive discussion of this issue.

28. The chart below graphically indicates several periods where interest rate movements of 3-month LIBOR would have created a problem similar to the one described here.



29. Combinations of other swaps, derivatives, and financial instruments may also be used to hedge an existing swap.

payment, and a losing party wishing to fix and pay its swap losses at that time must make a large nonperiodic payment.

Only in the case of a payment for extinguishment made between the original parties to the swap is it certain under the swap regulations that a large termination payment is not subject to recharacterization as a significant nonperiodic payment.<sup>30</sup> However, the swap party with the other side of the contract may have no desire to terminate. Moreover, if this party recognizes that extinguishment is the only means for the other party to end its swap obligations without the tax problems associated with recharacterization, it could demand a higher than current market price or other unreasonable terms.

Payments in connection with termination by assignment, as well as payments to assign one leg of the swap, are considered nonperiodic payments subject to recharacterization.<sup>31</sup> An offsetting swap with a nonperiodic payment is also susceptible to recharacterization, as is any new off-market swap. These transactions are the true economic necessity of large nonperiodic payments, as opposed to the more deceptive practices discussed at the beginning of this section.

### III. U.S. TAXATION OF OFF-MARKET INTEREST RATE SWAPS

#### A. Example from Swap Regulations

Example 3 in Regulations section 1.446-3(g)(6) (the Example) is an off-market swap with a significant nonperiodic payment. The Example, given in full below, is followed throughout this article, with the stipulation that counterparty *M* is not a U.S. resident.

On January 1, 1995, unrelated parties *M* and *N* enter into an interest rate swap contract. Under the terms of the contract, *N* agrees to make five annual payments to *M* equal to LIBOR times a notional principal amount of \$100 million. In return, *M* agrees to pay *N* 6% of \$100 million annually, plus \$15,163,147 on January 1, 1995. At the time *M* and *N* enter into this swap agreement the rate for similar on-market swaps is LIBOR to 10%, and *N* provides *M* with information that the amount of the initial payment was determined as the present value, at 10% compounded annually, of five annual payments from *M* to *N* of \$4,000,000 (4% of \$100,000,000).<sup>32</sup>

30. Regs. § 1.446-3(h)(4), (5) ex. 1.

31. Regs. § 1.446-3(h)(4), (5) exs. 2 & 4.

32. Regs. § 1.446-3(g)(6) ex. 3 (emphasis added). Graphically, the contract calls for:

*N* -----> *M*  
 LIBOR (10% when contract signed)  
*N* <----- *M*  
 Fixed (6%) + \$15,163,147 cash

The payment of \$15,163,147 on the date of the contract's signing—the up-front nonperiodic payment—compensates for the difference between the fixed 6% *M* will pay annually and the market rate of a fixed 10% in exchange for the LIBOR. The spread between the two interest rates need not be so large, but the spread's size is the element of the swap that leads to the tax problems discussed here. According to the swap regulations, a swap with "significant nonperiodic payments" is treated as two separate transactions consisting of an on-market, level payment swap and a "loan" bearing interest.<sup>33</sup> The time value component of the loan—interest—is "not included in the net income or net deduction from the swap . . . but is *recognized as interest for all purposes of the Internal Revenue Code*."<sup>34</sup> This rule is known as the "embedded loan" rule because a loan is seen as being embedded in the nonperiodic payment. The embedded loan must be accounted for by the parties to the contract on a self-amortizing basis, "independently of the swap."<sup>35</sup> Further, the principal is only used to compute the time value, or interest, component and does not otherwise impact the parties' net income or net deduction under the swap.<sup>36</sup>

According to the regulations, the Example is a swap with a "significant" nonperiodic payment, and it is therefore recharacterized as including a loan bearing interest.<sup>37</sup> This interest is potentially subject to double taxation.<sup>38</sup>

#### B. Recharacterization Under Regulations Section 1.446-3(g)(4)

1. "Significant."—Although the regulations recharacterize a non-periodic payment only if it is "significant," they do not directly define the

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LIBOR is the London Interbank Offer Rate and is often the reference rate of interest for floating rate loans in international financial markets. See Hull, *supra* note 7, at 112.

33. Regs. § 1.446-3(g)(4).

34. *Id.* (emphasis added).

35. *Id.*

36. Regs. § 1.446-3(g)(6) ex. 3(d).

37. The swap counterparties are summarized as follows:

*N* is a: -U.S. counterparty who  
           -receives the nonperiodic payment,  
           -is thus the "borrower,"  
           -and makes the "interest" payments.

*M* is a: -non-U.S. counterparty who  
           -makes the significant nonperiodic payment,  
           -is thus the "lender,"  
           -and receives the "interest" payments.

38. Other possible treatments of interest rate swap premiums, which would not lead to these particular tax problems, are discussed extensively in the N.Y. St. B. Ass'n Report, *supra* note 26, at 21-22.

term "significant."<sup>39</sup> However, examples in the regulations indicate that a nonperiodic payment is not considered significant if it is less than 9.1% of the discounted present value of the fixed payments due under the swap contract,<sup>40</sup> but is considered significant, and therefore subject to recharacterization, if it is 66.7% or more of the present value of the fixed payments (as is the case with the \$15,163,147 paid in the Example).<sup>41</sup> Thus, any swap with a nonperiodic payment between 9.1% and 66.7% of the present value of the fixed payments is potentially subject to recharacterization as including a loan bearing interest.<sup>42</sup>

## 2. Initial Consequences of Recharacterization

a. *"The loan must be accounted for independently of the swap."*<sup>43</sup>—Where recharacterization applies, the significant nonperiodic payment is considered to be an interest bearing, self-amortizing loan. The principal of the loan element is considered to be repaid as the loan is amortized under the constant yield method.<sup>44</sup> The primary function of the principal component is to compute the "interest" that accompanies the repayment of the loan. It is the tax treatment of this interest that may lead to withholding taxes and double taxation in cross-border swaps.

b. *"The time value component associated with the loan is not included in the net income or net deduction from the swap . . . , but is recognized as interest for all purposes of the Internal Revenue Code."*<sup>45</sup>—This sentence establishes that the "interest" payments from *N* to *M* resulting from the loan element of the recharacterized significant nonperiodic payment are treated as interest, not as payments of swap income to *M*,<sup>46</sup> although origi-

39. The Treasury's failure to provide a bright line test was apparently intentional. See Lee A. Sheppard, Financial Products, The Switchboard Approach, 60 Tax Notes 942, 943 (Aug. 16, 1993) (reporting on a speech of IRS attorney Alan B. Munro, Jr. to the ABA Financial Transactions Committee on Aug. 6, 1993).

40. Regs. § 1.446-3(g)(6) ex. 2. The theoretical basis for the embedded loan concept suggests that every up-front payment under a swap, regardless of its size, is an embedded loan. When the payments are less than 9.1%, they are simply not recharacterized.

41. See *supra* text accompanying note 32.

42. Depending on how one interprets the regulations and calculates these percentages, the spread could be between roughly 10% and 40%, rather than 9.1% and 66.7%.

43. Regs. § 1.446-3(g)(4).

44. Regs. § 1.446-3(g)(6) ex. 3(c). See also Stanley C. Ruchelman, U.S. Tax Considerations in International Derivative Products, 47 Bull. Int'l Fiscal Documentation 235, 241 (1993).

45. Regs. § 1.446-3(g)(4).

46. The net income or deduction from a notional principal contract, including a swap, is the sum of the periodic payments for the taxable year and the portions of the nonperiodic payments that are allocated to the year. Regs. § 1.446-3(d).

nating in a swap. Therefore, the payments are subject to the general rules on the taxation of interest, rather than the regime established in the swap regulations for swap income. This difference is of importance when both counterparties are U.S. persons.<sup>47</sup> In a cross-border swap, particularly when non-U.S. counterparty *M* makes the significant nonperiodic payment, the impact of the recharacterization is even more critical since withholding tax and related double taxation issues are then raised.

3. *The Complicating Factor: The Contrasting Sourcing Rules for Swap and Interest Income.*—The importance of the distinction in cross-border swaps between a payment being treated as swap income or as interest arises from differing income source rules for these types of income. Foreign persons are subject to U.S. taxation only on income from U.S. sources and income effectively connected with the conduct of a U.S. trade or business (ECI).<sup>48</sup> Thus, a foreign swap participant not engaged in business in the United States is subject to U.S. taxation only on U.S.-source income.<sup>49</sup>

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47. Provisions whose application might be affected by the recharacterization include the straddle rules of § 1092 and the business hedging regulations of Regs. § 1.1221-2 and § 1.446-4, which generally treat interest differently from swap income. Other impacted issues include restrictions on interest deductions, the allocation of interest expense for purposes of the foreign tax credit, OID information reporting requirements (Regs. § 1.1275-3(e)), the reporting of interest payments and accruals on OID instruments (§ 6049), and “backup” withholding on payments to U.S. persons (§ 3406). See Conlon and Aquilino, *supra* note 5, at 782; Andrea S. Kramer, *The Tension Between Straddle Rules and Investment Objectives*, Address at the Institute for International Research, (Jan. 24, 1995), in 2 *Tax'n of Investors & Investments* (1995); Charles W. Wheeler, *Accounting for Business Hedges*, Address at the Institute for International Research, (Jan. 23-24, 1995), in 2 *Tax'n of Investors & Investments* (1995).

48. Various types of U.S.-source income of foreign taxpayers, including interest, is taxed by §§ 871(a) and 881(a), which impose a 30% withholding tax on the income unless it is effectively connected (ECI) with the conduct of a U.S. trade or business. In the latter case, it is taxed on a net basis under § 1 or § 11 and is not subject to withholding taxes. IRC §§ 871(a)(1), (b); 881(a); 1441(c)(1); Regs. § 1.1441-4(a)(1). These ECI principles apply to income from notional principal contracts. Regs. § 1.863-7(b)(3).

49. For a general discussion of what constitutes effectively connected income and the trade or business concept, see Paul R. McDaniel & Hugh J. Ault, *Introduction to United States International Taxation* 53 (1989). The terms are defined in § 864 and Regs. § 1.864-4. For the application of the effectively connected income tax to financial-market activities, see Charles T. Plambeck, *The Taxation Implications of Global Trading*, 44 *Bull. Int'l Fiscal Documentation* 527, 534-35 (1990); Kopp & Pross, *supra* note 24. However, § 864(b)(2) excludes many forms of trading in securities or commodities from being a U.S. trade or business.

A foreign taxpayer believing that its income should be treated as ECI, rather than subjected to withholding, must file a Form 4224 with the U.S. withholding agent declaring that it is in fact ECI. Absent receipt of such a form, the U.S. payor should withhold. For a discussion of this requirement, see Robert H. Dilworth et al., *New United States Source Rules for Notional Principal Contract Income*, 69 *Taxes* 343-44 (1991).

Swap income, and notional principal contract income in general, is sourced under the regulations to the residence country of the income recipient, *M* in the Example.<sup>50</sup> Thus, if non-U.S. counterparty *M* receives swap income from U.S. party *N*, the swap income is not from U.S. sources and is not subject to U.S. taxation unless it is effectively connected with a business carried on by *M* in the United States.

In contrast, interest is generally sourced to the residence of the payor of the interest.<sup>51</sup> In the Example, the interest is from U.S. sources because the payor is U.S. party *N*. U.S. source interest may be subject to a U.S. withholding tax when paid to a non-U.S. person, at the statutory rate of 30% or at a lower rate provided by treaty.<sup>52</sup> Thus, a nonperiodic payment by a non-U.S. counterparty which is greater than 9.1% of the present value of the fixed payments due under the swap may be recharacterized as a loan bearing interest which may be subject to a withholding tax of up to 30%.

In sum, recharacterization will transform swap income that was beyond the scope of U.S. taxation into interest income that will be subject to U.S. withholding, unless exempted by treaty or other Internal Revenue Code provisions. Income that appeared to be unencumbered by the demands of U.S. taxation will be drawn into the web of the U.S. tax system.

#### IV. CONSEQUENCES OF RECHARACTERIZING A NONPERIODIC PAYMENT

The withholding tax on U.S.-source interest paid abroad may be eliminated or reduced by two frequently relied upon means: the statutory portfolio interest exemption and double taxation treaties. However, the effectiveness of both of these means is limited in the context of nonperiodic payments in an off-market swap which are recharacterized as including a loan bearing interest. As a result, double taxation may often arise even in the presence of a tax treaty.

The portfolio interest exemption to withholding and its possible applicability in the off-market swap context are assessed next, followed by a discussion of the withholding issues associated with interest resulting from recharacterized nonperiodic payments. The remainder of the article addresses why many tax treaties do not effectively eliminate double taxation of these deemed interest payments.

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50. Regs. § 1.863-7(b)(1) (stating that the "source of notional principal contract income shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i)"). See also the regulations under § 988.

51. IRC § 861(a)(1).

52. IRC §§ 871(a)(1)(A), 881(a)(1), 1441(a). See *infra* Part VII for tax treaties.

### A. Portfolio Interest

The deemed interest income payments to *M* in the Example are exempt from withholding tax if they qualify as portfolio interest.<sup>53</sup> It appears that the portfolio interest exemption is most often relied on to avoid withholding from the interest element of large nonperiodic swap payments. The IRS was aware before promulgation of the swap regulations that the portfolio interest exemption would play an important role in eliminating withholding on this interest.<sup>54</sup> However, no firm determination has been rendered by the IRS on the portfolio interest exemption's applicability to these payments. It is unlikely that the exemption extends to all cases that could potentially arise under the swap regulations.

The portfolio interest exemption applies only if the interest-bearing obligation is in registered form or complies with elaborate requirements designed to keep the obligation out of the hands of U.S. investors.<sup>55</sup> Since most swaps are in registered form, it is possible for many nonbank participants in cross-border swaps to comply with the technical portfolio interest

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53. Sections 871(h)(1) and 881(c)(1) exempt "portfolio interest" from tax under §§ 871 or 881. Section 1441(c)(9) confirms that "[i]n the case of portfolio interest (within the meaning of section 871(h)), no tax shall be required to be . . . withheld from such interest."

54. See Letter from Vincent M. Aquilino, Esq., Chapman and Cutler, & Steven D. Conlon, Esq., Chapman and Cutler, to the Commissioner of the Internal Revenue Service (Sept. 20, 1991) [hereinafter Aquilino & Conlon Letter]; Letter from Stephen L. Gordon, Esq., Cravath, Swaine & Moore, to Karl T. Walli, Esq., Internal Revenue Service (Sept. 27, 1991) (commenting on the proposed regulations on tax accounting for notional principal contracts). The absence of explicit mention of portfolio interest in the swap regulations may be an indication that the IRS is skeptical as to whether or to what extent the portfolio interest exemption applies to deemed interest payments.

55. More specifically, interest qualifies as portfolio interest only if it is paid on an obligation that either (1) is not in registered form and is described in § 163(f)(2)(B); or (2) is in registered form and the U.S. withholding agent has received a statement that the beneficial owner of the obligation is not a U.S. person. IRC § 871(h)(2).

To meet the first test, § 163(f)(2)(B) requires that the obligation (1) be subject to measures designed to ensure its sale or resale to a non-U.S. person; (2) pay interest only outside of the United States; and (3) bear a legend on its face stating that a U.S. holder will be subject to U.S. tax laws. IRC § 163(f)(2)(B). Regulations § 1.163-5(c)(2)(i) elaborates on the (1) restrictions on transferability; (2) restrictions on payment of interest; and (3) the certification of the obligation required for portfolio interest treatment.

An obligation is "registered" in the sense of the second portfolio interest test if (1) the instrument is registered as to both principal and interest; (2) rights to the principal and interest on the obligation may be transferred only through a book-entry system; or (3) the obligation is registered with the issuer (or its agent) as to both principal and any stated interest and may be transferred through both methods above. Temp. Regs. § 5f.103-1(c)(1). Also, the second portfolio interest test is satisfied only if the U.S. withholding agent receives a statement (Form W-8) that the beneficial owner is not a U.S. person. IRC §§ 871(h)(2)(B)(ii), 881(c)(2)(B)(ii).

requirements. However, if all the requirements are not properly fulfilled, withholding obligations arise and could in turn lead to liability for failure to withhold.<sup>56</sup> To avoid such potential problems, it was suggested to the IRS in 1991 that guidelines be provided regarding the extent to which the registration and certification rules must be complied with in the case of an embedded loan from a foreign person.<sup>57</sup> No clear answer has yet been provided.

Even if counterparties are able and willing to comply with the portfolio interest requirements, many swaps involve non-U.S. banks as counterparties, either in the creation or termination of the swap.<sup>58</sup> The term "portfolio interest" does not include interest "received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business."<sup>59</sup> Since a recharacterized non-periodic payment is deemed by the IRS to contain a loan, it is likely that foreign banks which are active swap dealers cannot use the portfolio interest exemption. An informal survey of the leading non-U.S. bank swap dealers indicates that many of them have established specially-designed affiliated entities, in jurisdictions with suitable domestic policies and treaty relationships to the United States, to avoid withholding tax requirements on swaps and other derivatives.<sup>60</sup>

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56. Withholding is discussed at length *infra* Part IV.B. For the portfolio interest requirement to apply, the U.S. counterparty must receive a signed IRS Form W-8 from the foreign counterparty. Regs. § 35a.9999-5(b), Q & A 9.

57. Aquilino & Conlon Letter, *supra* note 54, at 4.

58. See Sean Beckett, *Are Derivatives Too Risky for Banks?*, *Econ. Rev. Fed. Reserve Bank Kansas City*, Third Quarter 1993, at 27 (detailing the significant use of derivatives, and of interest rate swaps in particular, by banks). This article states that in 1992, the notional value of bank holdings of derivatives was \$8.6 trillion and growing. *Id.* at 33. Another measure used was the replacement cost of their holdings, which is an estimate of the real economic value of the derivatives held. *Id.* In 1992, this cost was \$150 billion for bank holdings of interest rate and foreign exchange derivatives. *Id.*

Banks are well suited to serve as counterparties because they are readily able to address the important element of counterparty creditworthiness: Bank creditworthiness is well known, and evaluating the credit of others is an essential aspect of their business. Banks thus play an important role in achieving liquidity in swap markets by serving as intermediaries, generally as a counterparty. Banks also use interest rate swaps to hedge their own risks as end-users. *Id.* at 32. For further discussion, see Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, *Derivative Product Activity of Commercial Banks* (1993).

59. IRC § 881(c)(3)(A).

60. *Priv. Let. Rul.* 9421027 (Feb. 24, 1994) involves a case that is basically identical factually to the one followed in this article. A foreign bank was attempting to secure a reduced withholding rate under a particular tax treaty for the interest resulting from a significant nonperiodic payment that it made to a U.S. counterparty. While the issue in the Letter Ruling was that of residence under the treaty, it underscores the importance of the treaty issues discussed *infra* Part VII and provides a concrete example of this situation.



To recapitulate, the portfolio interest exemption is not a uniformly effective method of eliminating withholding on interest payments under embedded loans.

### B. Withholding

Withholding is the means used to collect tax on foreign taxpayers' nonbusiness income from U.S. sources.<sup>61</sup> Unless exempted by treaty or the portfolio interest rule, U.S. source interest income is subject to the withholding tax,<sup>62</sup> and since the time value component of the embedded loan is "interest" for all purposes,<sup>63</sup> the "interest" payments from U.S. counterparty *N* to foreign counterparty *M* may be subject to withholding. In every swap with a nonperiodic payment greater than 9.1% of the present value of the total fixed payments due under the swap, then, *N* may be required to withhold tax on deemed interest payments to *M*.

The obligation to withhold is imposed on all persons "having the control" of such payments.<sup>64</sup> The term "persons" is not limited to individuals, but includes all types of entities.<sup>65</sup> *N* has the requisite control of *M*'s income under the swap and is therefore the "withholding agent."<sup>66</sup> As such, *N* is liable for the U.S. withholding tax of *M* arising from the interest on the embedded loan.<sup>67</sup> If *N* does not withhold, it is liable for the full amount of the tax that it should have withheld.<sup>68</sup> If *M*, in a generous mood, later pays the tax, the agent is only liable for interest on the delayed payments. Civil penalties<sup>69</sup> and accuracy-related and fraud penalties<sup>70</sup> may also apply if *N* fails to withhold.<sup>71</sup>

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61. Sections 1441 and 1442 require withholding from specified payments to non-resident aliens (including foreign partnerships) and foreign corporations. For a detailed discussion of U.S. withholding requirements, see Michael Rosenberg, *The U.S. International Tax Withholding Nightmare*, *Tax Plan. Int'l Rev.*, Apr. 1995, at 3.

62. IRC §§ 1441(b), 1442(a). More broadly, these provisions also require withholding on "fixed or determinable annual or periodical gains." IRC § 1441(b).

63. Regs. § 1.446-3(g)(4).

64. IRC §§ 1441(a), 1442. Withholding may be reduced or eliminated by treaty. Regs. § 1.1441-6(a). See *infra* Part VII for a discussion of tax treaties.

65. *Van Iderstine v. Commissioner*, 24 B.T.A. 291, 296 (1931).

66. "Withholding agent" is defined in § 7701(a)(16) and Regs. § 1.1441-7(a).

67. The withholding agent "inherits virtually all the tax obligations and liabilities of the ultimate taxpayer." 1 Joseph Isenbergh, *International Taxation* ¶ 14.2, at 415 (1990). See also David I. Kempler, *Dilemmas of a Withholding Agent: United States Tax Mgmt. Int'l F.*, June 1995, at 47 (addressing this issue under the laws of the United States).

68. IRC § 1463; Regs. § 1.1441-7(b)(2).

69. IRC § 6672; Regs. § 301.6672-1.

70. IRC §§ 6662, 6663.

71. Withholding agents are required to file Forms 1042 and 1042S for income subject to withholding. Regs. § 1.1461-2(b), (c). If the agent has not withheld, it must cite the

A withholding agent fails to withhold at its own risk. To be certain to avoid liability for failure to withhold, U.S. counterparty *N* should withhold on every swap-related payment made to foreign counterparty *M* if the swap entails a nonperiodic payment greater than 9.1% of the present value of the fixed payments, as every such swap-related payment could be seen as containing interest if the nonperiodic payment is recharacterized. This precaution may turn out not to have been necessary if the swap is not recharacterized. Further, it may diminish *M*'s return on the swap, and if so, it may adversely impact the relationship between *M* and *N* and perhaps *M*'s attitude towards future off-market swaps with U.S. counterparties.

Many swap contracts, including ones based on the International Swap Dealers Association (ISDA) model, contain a "gross-up" clause, which requires the counterparty making an income payment (*N* in the Example) to pay the full amount owed to the payee without reduction for any withholding taxes. The income payor must pay the tax from its own funds. Because a gross-up clause shifts the economic cost of the withholding tax from the payee to the payor, *N* should take its higher costs into account when negotiating the terms of the swap contract. In addition, since *N* bears the cost of withholding, it may also want to limit the transferability of *M*'s rights and obligations under the swap in order to control its withholding liability, as the ISDA model contract does. This has the consequence of limiting the available counterparties and potential transferees, burdening the efficient functioning of cross-border financing. Because of the tax consequences, otherwise promising swaps may be foregone, costs to the parties may be increased, or *N* may use an offshore subsidiary located in a country with a more favorable interest taxation regime to conclude the contract.

## V. TIME VALUE DETERMINATION

For a swap counterparty liable to withhold 30% or a treaty-stipulated reduced percentage of an interest payment, the critical question is, how much is the interest? The initial problem is that there are only "deemed installment payments" of interest;<sup>72</sup> none of the cash payments is designated in the swap contract as "interest." The only money changing hands is that owed by one counterparty to the other on account of the market interest rate movement. Thus, the "interest" is a part of the swap payments.

The regulations' explanation of the Example presents the following amortization schedule to be used to account for the significant nonperiodic payment of \$15,163,147 made by *M* when the swap contract is entered into

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authority for its failure to do so. Regs. § 1.1461-2(c)(2)(ii). Section 6302 and the accompanying regulations govern the deposit by the agent of the tax withheld.

72. Regs. § 1.446-3(g)(6) ex. 3(d).

(January 1, 1995).<sup>73</sup>

	Level Payment	Interest	Principal
1995	\$ 4,000,000	\$1,516,315	\$ 2,483,685
1996	4,000,000	1,267,946	2,732,054
1997	4,000,000	994,741	3,005,259
1998	4,000,000	694,215	3,305,785
1999	4,000,000	363,636	3,636,364
	\$20,000,000	\$4,836,853	\$15,163,147

The schedule is based on a constant yield to maturity of 10% compounded annually, which is the interest rate used by the parties in determining the amount of the nonperiodic payment. However, none of the payments in the schedule actually occurs.

*M*'s interest income throughout the swap term consists of the amounts in the interest column of the table. The scheduled amount is recognized as interest for each year of the swap, regardless of the amounts of the cash payments between the parties. This leads inescapably to the conclusion that withholding is required even if, for a particular year, the interest component is greater than the net swap payment owed by *N*—or even if *N* makes no net cash payment to *M*. The following examples demonstrate how this can occur.

If the floating interest rate remains unchanged at 10% throughout the first year of the swap, the net swap payment to *M* is \$4 million (the 10% floating rate times \$100 million, less the 6% fixed rate times \$100 million), and the interest component, according to the schedule, is \$1,516,315.<sup>74</sup> But, if the floating interest rate drops to 6% on the payment date, no net payment is made because the floating and fixed rates are both 6%.<sup>75</sup> However, *M* still recognizes interest income of \$1,516,315, and this amount is subject to withholding by *N*. Because the schedule determined at the time the swap was created controls throughout the life of the swap, *N* must withhold up to 30% of the \$1,516,315 interest in year 1 even though no cash payments are made.

Under the regulations, the recharacterized swap is deemed to consist of an on-market swap and a loan, with the gross swap payments being

73. Regs. § 1.446-3(g)(6) ex. 3(c).

74. Without a treaty reduction, the withholding tax is 30% of the interest amount, \$454,896.

75. A drop to 6% is most illustrative of the unusual result. However, any decrease in the floating rate leads to the same problem, though to a different degree. If the floating rate drops to 8% during the first year, the net payment from *N* to *M* is \$2 million, of which \$1,516,315 is interest subject to withholding.

applied, in order, to deemed interest, deemed principal, and then to the on-market swap. The off-market swap in the Example is thus bifurcated into two transactions—an on-market swap of 10% fixed payments in exchange for the LIBOR (which is 10% when the swap is made) and an embedded loan of \$15,163,147, which is amortized by five annual payments of \$4 million each. Under this view, if the LIBOR is 6% on the first payment date, the payments for the first year are deemed to consist of a swap payment from *M* to *N* of \$4 million (10% fixed interest on \$100 million, less 6% floating interest) and a loan payment from *N* to *M* of \$4 million. That the parties have agreed to net the two payments against each other does not relieve *N* of the obligation to withhold tax from the interest element of the loan payment.<sup>76</sup> For example, if *N* owned *M* stock and *M* owned a bond issued by *N*, *N*'s obligation to withhold from interest on the bond would not be negated merely because the parties agreed to offset the interest against an equal dividend on the stock, resulting in no cash changing hands between *N* and *M*.

Nevertheless, there is no actual, economic loan as there is no contractual obligation to repay even a minimum amount of the up-front payment.<sup>77</sup> For example, if the LIBOR falls to 6% during the first year and remains at that level for the remainder of the swap term, *M* will receive no net cash payments under the swap contract, even though it will have interest income each year of the swap in accordance with the amortization schedule. Furthermore, if the LIBOR were to fall to 3.5% and remain there, even the gross payments will not be sufficient to repay the deemed principal.<sup>78</sup> In

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76. "Swap income" is taxed under the swap regulations, and is generally paid, on a net basis. Only the difference between the gross amounts owed by *N* and *M* actually changes hands as swap income. However, the swap regulations also establish that the deemed interest amounts are not included in this net calculation and are not swap income. Therefore, the gross amounts of swap income owed between the counterparties, though not exchanged, convey the interest resulting from a recharacterized nonperiodic payment thus providing a payment for withholding purposes.

77. IRC § 163. Interest is a charge "for the use or forbearance of money." See *Deputy v. Du Pont*, 308 U.S. 488, 498 (1940).

78. Even with no cash payment from *N* to *M*, *N* will probably not be relieved of its withholding obligation. The Tax Court has rejected the "assertion that withholding responsibility under section 1441(a) requires actual payment and receipt." *Casa de la Jolla Park, Inc. v. Commissioner*, 94 T.C. 384, 392 (1990). The court found that interest had been "constructively received" in that case, and thus there was the requisite control for the withholding obligation of § 1441(a) to apply. *Id.* at 393. Presumably, there could be a "constructive payment" made by U.S. counterparty *N* which would also trigger § 1441.

With the opportunity in 1994 to again address the issue of what degree of "payment" is necessary for §§ 1441 and 1442 withholding purposes, the Tax Court reserved judgment on whether a deemed payment under § 482 triggers the withholding obligation. *Central de Gas de Chihuahua, S.A. v. Commissioner*, 102 T.C. 515, 519 (1994). Although arguably limiting slightly the scope of *Casa de la Jolla Park*, the overall tenor of the decision is that with-

sum, even if the cash flow deviates greatly from the amortization schedule, a counterparty acts at its peril in failing to withhold based on the interest amounts prescribed by the schedule.

Thus far, the “time value component associated with the loan” has been discussed simply as “interest”—as the regulations refer to it.<sup>79</sup> The repayment schedule for the recharacterized significant nonperiodic payment in the Example, though, is similar to that for indebtedness (a bond) with original issue discount interest (OID).<sup>80</sup> However, since the “loan principal” may fluctuate with the market interest rate, the time value component is not really OID. With OID, the stated redemption price at maturity (corresponding to the embedded loan principal plus interest in the swap context) is an amount to which the lender is contractually entitled.<sup>81</sup>

The potentially unstable nature of the time value component in a recharacterized nonperiodic payment illustrates concerns highlighted by Professor Alvin Warren—that financial derivatives pose severe difficulties for the U.S. realization-based income tax system because of the reliance on the distinction between fixed and contingent payments.<sup>82</sup> However, these concerns have not been fully addressed in the policy behind recharacterization. Because the “principal” of the embedded loan and deemed interest can fluctuate, return of, and on, the embedded loan portion of the swap is a contingent return, not a fixed return. Generally, contingent returns are not taxed until disposition of the asset. As Professor Warren says, “the rationale for this result is straightforward: whether or not any payments will be received is uncertain.”<sup>83</sup> A swap does not provide fixed returns, thus underscoring that a recharacterized nonperiodic payment is not really either a fixed-

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holding is necessary to support § 482 transfer pricing adjustments. As no payments are actually made under § 482 to withhold from, the rationale is applicable to the “interest paid” under an off-market swap. The one difference is that there are no payments of any kind made under § 482 allocations, while in the embedded loan context there are generally payments made, albeit of swap income. Thus, if withholding could be required when no cash at all changes hands under § 482, it is even more likely that withholding is required in the embedded loan context since there is generally some cash exchanged. For a discussion of this case, though generally disagreeing with its holding, see Richard C. Stark & Michael E. Baillif, *Do Section 482 Allocations to Foreign Entities Trigger a Withholding Obligation?* 82 J. Tax'n 178 (1995).

79. Regs. § 1.446-3(g)(4).

80. OID is the difference between the issue price of a debt instrument and its stated redemption price at maturity. IRC § 1273(a)(1).

81. For OID purposes, “the term ‘debt instrument’ means a bond, debenture, note, or certificate or other evidence of indebtedness.” IRC § 1275(a). Yet, indebtedness is an unconditional, reasonably ascertainable and legally enforceable obligation for the payment of money. See *Autenreit v. Commissioner*, 115 F.2d 856 (3rd. Cir. 1940). As seen, *N* does not owe *M* anything meeting this definition.

82. See Warren, *supra* note 5.

83. *Id.* at 463.

return asset or a contingent-payment asset as traditionally conceived. Professor Warren is correct in saying that in order to respond to new financial products, income tax policy must develop to reduce this reliance on the fixed return/contingent return distinction.<sup>84</sup>

Aware of such actual and potential problems with a variety of contingent return debt obligations, the Treasury has promulgated new proposed regulations on contingent debt.<sup>85</sup> Most other contingent payment debt obligations are now subject to the proposed regulations, which could well have provided a coherent scheme to tax recharacterized nonperiodic swap payments. However, the proposed regulations specifically deny this possibility for notional principal contracts containing embedded loans and establish that the swap regulations are controlling.<sup>86</sup> Absent new regulations on the taxation of recharacterized swap payments, there really is no coherent way to tax a recharacterized nonperiodic payment so that the economics of the swap always match the tax liabilities.<sup>87</sup>

Even inclusion under the new proposed contingent debt regulations would only have solved one of the problems—providing a system for determining a time value component which more accurately reflects the economics of the transaction. However, whatever means are eventually used to achieve a more accurate reflection of economics within the framework of recharacterization, the time value component would still be interest, subject to withholding and potentially to double taxation.<sup>88</sup>

## VI. SUMMARY OF THE U.S. TAX TREATMENT

By recharacterizing an off-market swap with a significant nonperiodic payment as including an embedded loan bearing interest, the swap regulations create at least two major tax impediments to cross-border, off-market swaps: withholding tax and the resulting potential for double taxation. Interest is

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84. See *id.* at 473 for a discussion of possible policy changes.

85. Prop. Regs. § 1.1275-4, issued by the IRS on December 16, 1994. For a detailed discussion of these proposed regulations, see Edward D. Kleinbard et al., Proposed Regulations Affecting Contingent Payment Debt Obligations, 66 Tax Notes 723 (Jan. 30, 1995).

86. Prop. Regs. § 1.1275-4(e). The Preamble to the swap regulations states that “[t]he IRS is working on a project dealing more generally with off-market and prepaid financial instruments.” Preamble to Regs. § 1.446-3.

87. The swap regulations permit the IRS to provide alternative methods for nonperiodic payments by revenue ruling or procedure. Regs. § 1.446-3(f)(2)(vi). None has so far been provided.

88. In light of the policy behind withholding on certain payments of interest—to ensure the collection of taxes by placing the responsibility on the U.S. person subject to enforcement rather than relying on voluntary payment by a foreign taxpayer beyond the scope of domestic law—any payment similarly representing the time value of money should also be subject to withholding.

deemed to exist for all U.S. tax purposes, and withholding tax on the interest is required even when there is no net cash payment from which to withhold. Double taxation treaties do not always alleviate double taxation on the deemed interest payment.

The following example depicts why double taxation can greatly distort international capital transactions and lead to extensive measures to avoid it. Assume a \$100 payment is seen as "interest" under the swap regulations, and U.S. tax is withheld at a treaty-established rate of 15%; the payee's country of residence, disagreeing that this income is interest, applies its corporate income tax at 35% to the \$100. The income is thus subject to taxes of \$15 by the United States and \$35 by the payee's country of residence (subject to unilateral double taxation relief); the \$100 is subject to \$50 in taxes, producing an effective rate of 50%. In contrast, if both parties to the transaction were residents of either the United States or the other country, the effective rate of tax would be 35%.

This is double taxation. As seen from this brief example, double taxation can impose unacceptable tax burdens on otherwise viable transactions. A network of bilateral tax treaties between countries around the globe has been developed in an effort to remove these additional barriers to cross-border trade, commerce, and financing. While tax treaties are generally effective in combatting double taxation, in the particular case of off-market swaps, double taxation may nonetheless persist with the consequences of potentially significant reductions in the swap's utility and of reduced liquidity in the swap market. This double taxation is not necessarily limited to situations where the interest is from U.S. sources because it could arise with respect to any country that were to follow a recharacterization policy similar to that of the swap regulations. Thus, it is a problem of concern to all countries where financial products are traded internationally. Why double taxation may apply to these off-market swaps despite the existence of a treaty is the subject of the remainder of this article.

## VII. DOUBLE TAXATION OF OFF-MARKET INTEREST RATE SWAPS

### A. *Introduction*

In 1989, the New York State Bar Association predicted that recharacterizing a significant nonperiodic payment in an off-market interest rate swap into a loan bearing interest "would reintroduce the U.S. withholding tax issues for cross-border swaps that [regulations assigning swap income to sources in the recipient's country of residence were] designed to eliminate."<sup>89</sup> This was a prescient assessment, for, as seen, this is precisely what

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89. N.Y. St. B. Ass'n Report, *supra* note 26, at 33. The source rule is found in Regs. § 1.863-7.

has occurred. Withholding on interest income payments in these types of cross-border swaps would not necessarily be problematic but for the fact that a large percentage of tax treaties around the world, including many U.S. treaties, do not effectively alleviate double taxation of income payments originating from a nonperiodic payment recharacterized by one country into a loan bearing interest; in other words, the full amount of the "interest" payment may be subject to tax in both contracting states,<sup>90</sup> a case of juridical double taxation.<sup>91</sup> This type of double taxation primarily arises when, as under the OECD Model Convention, the tax treaty between the states of residence of the swap counterparties, *N* and *M*, does not grant the exclusive right to tax interest to the residence state of the interest recipient.<sup>92</sup>

If no tax treaty is in force between the state of source (the United States in the Example) and *M*'s state of residence, the tax treatment of the "interest" payments is entirely determined by domestic laws. Many states subject interest paid abroad to considerable withholding taxes, such as the United States at 30% of gross payments made and Canada at 25%.<sup>93</sup> The interest payment is also subject to income taxation in *M*'s state of residence unless this state unilaterally credits all or part of the tax withheld in the source state. Double taxation of any amount of swap payments, let alone such a high percentage, materially impacts the viability of many swaps. Absent a treaty, such results are of concern, but could be anticipated. More problematic, however, is that even the existence of a tax treaty between the residence

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90. Tax treaties refer to the two signatory countries as the "contracting states." Thus, the term "state" as used in the remainder of this article means "country" unless otherwise specified.

91. Describing the circumstances giving rise to double taxation, Professor Vogel states that "[d]ouble taxation mainly arises today because the vast majority of States, in addition to levying taxes on domestic assets and domestic economic transactions, levy taxes on capital situated and transactions carried out in other countries to the extent that they benefit resident taxpayers." Klaus Vogel, *On Double Taxation Conventions*, at 2 (2nd ed. 1991) [hereinafter Vogel DTC]. This is what occurs with the interest element of off-market swaps.

92. *N* and *M* from the Example, supra Parts III-VI, continue to be followed for clarity and continuity. That is, *N* receives the nonperiodic payment and thus becomes the "interest" payor and *N*'s state of residence is the source state of the "interest." *M* made the nonperiodic payment and thus is the recipient of the income which *N*'s state of residence (the United States) labels "interest." *M*'s state of residence does not call that income "interest." See supra Part III.A for the full text of the Example; infra Part VII.B.3-VII.F for the characterization of the income by *M*'s state of residence. The OECD Model Convention is cited supra note 3.

93. In the United States, the withholding tax does not apply if the interest is effectively connected with a U.S. business or is treated as portfolio interest. See supra Parts III.B.3, IV.1. Part XIII of the Canadian Income Tax Act imposes the withholding tax on interest, subject to exceptions. See John M. Ulmer and John A. Zinn, *Foreign Investment in Canada*, 22 *Tax Planning Int'l Rev.* 3 (1995).



states of the swap counterparties may often not eliminate double taxation of all of the payments made under an off-market interest rate swap contract.<sup>94</sup>

### B. Interest Under the Model Conventions

1. *Definition.*—Interest is defined under Article 11 (the interest article) of both the OECD Model Convention and the U.S. Treasury Model Convention as “income from debt-claims of every kind.”<sup>95</sup> The OECD Model states that “[i]nterest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State”<sup>96</sup> (i.e., in the residence state of the interest recipient *M*). The OECD Model further states: “However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State. . . .”<sup>97</sup> Thus, under the OECD Model, the source state is also not prohibited from taxing interest, although the amount of tax may be limited by the interest article.<sup>98</sup> This is the regime for the taxation of interest followed in a significant number of tax treaties currently in force around the world.<sup>99</sup>

2. *Rationale for the Sharing of Tax on Interest.*—Reduced source state taxation on interest is a recognition that passive foreign investment is to be welcomed in the source state, yet since the source state is used to generate the income, it is entitled to a part of it. This sharing of tax revenue by the contracting states is exemplary of the sine qua non of tax treaties, which is, as Professor Klaus Vogel says, that “by concluding tax treaties, [states] agree to restrict their substantive law reciprocally.”<sup>100</sup> Further, as he continues, “in those situations in which substantive tax law is expected to

94. For discussion of the problems facing OECD Member States in their taxation of a variety of financial instruments, see Organization for Economic Co-operation and Development, *Taxation of New Financial Instruments* (1994) [hereinafter 1994 OECD Report].

95. 1994 OECD Model, *supra* note 3, art. 11, para. 3; United States Model Income Tax Treaty, June 16, 1981, art. 11, para. 2 [hereinafter 1981 U.S. Model].

Both the 1981 U.S. Model and an earlier model promulgated in 1977 have been withdrawn because they are significantly out of date. Treasury Department News Release, IVB-1900, July 17, 1992. However, the Treasury has not yet issued a new model.

96. 1994 OECD Model, *supra* note 3, art. 11, para. 1.

97. *Id.* at art. 11, para. 2.

98. *Id.* If a treaty provides that interest is to be taxed only by the residence state of the interest recipient, double taxation of the interest component is avoided.

99. Slightly fewer than one-half of the U.S. tax treaties follow this pattern as well, although the U.S. Model Convention does provide that interest is to be taxed exclusively by the residence state. Article 11(1) uses the phrase “shall be taxable only” to attribute exclusive taxation of interest to the residence state of the interest recipient. See Vogel DTC, *supra* note 91, at 22 for discussion of the differences between the terms “may be taxable” and “shall be taxable”; see also 1994 OECD Model, *supra* note 3, commentary on art. 23, paras. 6-7.

100. Vogel DTC, *supra* note 91, at 19.

overlap, the contracting States decide which of them shall be bound to withdraw its tax claim,<sup>101</sup> or, as with interest, limit its tax claim, so that the income is not taxed fully twice.

3. *Origins of Double Taxation Under an Off-Market Swap.*—The proper functioning of double taxation conventions is predicated on a common characterization of a particular income item under the substantive tax laws of the contracting states. The interest article of a tax treaty typically defines interest as originating from a debt-claim and apportions the taxation of income that both countries characterize as interest. However, the treaty definition of interest is not sufficiently specific and detailed to ensure agreement among states on the characterization of the income from off-market swaps involving large nonperiodic payments. Is the income “interest” since it derives from a loan bearing interest, i.e. is it “remuneration on money lent”<sup>102</sup> as in the United States and perhaps in other countries, or is it swap income other than interest? This conflict exists because, as the OECD Report explains, “[t]he treatment of payments relating to interest rate swaps under double taxation treaties is dependent upon the characterisation of those payments under the domestic law of the countries concerned.”<sup>103</sup> Since the characterization of the payments by one contracting state is generally considered not to bind the other,<sup>104</sup> a gap in treaty coverage may arise caused by conflicting characterizations resulting from fundamental, differing perceptions of the essence of nonperiodic swap payments.<sup>105</sup> This income could fall under at least four different articles of many tax treaties, or outside of a treaty altogether. In other words, there may not be a substantive overlap of the domestic laws of the two states as envisioned at the treaty’s creation and the treaty may not be able to establish which country shall withdraw or limit its claim.<sup>106</sup>

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101. *Id.*

102. 1994 OECD Model, *supra* note 3, commentary on art. 11, para. 1.

103. 1994 OECD Report, *supra* note 94, part I, para. 29.

104. But see John F. Avery Jones et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model-I*, 1 *Brit. Tax Rev.* 14 (1984), discussed *infra* Part VII.F.

105. Professor Vogel recognizes that double taxation is possible and not contrary to accepted principles of international law in this situation, because “[d]ouble taxation, resulting from the interaction of domestic laws of two (or more) States, will be consistent with international law as long as each individual legislation is consistent with international law.” Vogel DTC, *supra* note 91, at 4.

106. This does not even account for distinctions among countries based on the nature of the underlying transaction or on the type of taxpayer involved, both of which may also differ between states and which may impact the characterization of the swap in the residence state. See 1994 OECD Report, *supra* note 94, part I, paras. 25, 29, and 138.

### C. Nonperiodic Payment Characterization

Regular periodic swap payments, including those from an interest rate swap, are generally not considered to be interest income either in the United States or elsewhere, though there is less agreement on what these payments are.<sup>107</sup> There is even less agreement on the characterization of lump sum payments. The OECD Report concludes, “[w]here a payment stream is commuted as a single payment, . . . there is a wide variety of treatments prevailing.”<sup>108</sup>

As the OECD Model Commentary notes, “the definition of interest in the first sentence of paragraph 3 [of Article 11] is, in principle, exhaustive. . . . [T]he definition covers practically all the kinds of income which are regarded as interest in the various domestic laws.”<sup>109</sup> In other words, for a nonperiodic swap payment to be under Article 11(3), there must be a debt claim, but whether a debt claim exists depends on the domestic law treatment of nonperiodic payments. Absent a recharacterization under domestic law, as in the United States under the swap regulations, there is no debt claim.<sup>110</sup>

By recharacterizing a significant nonperiodic payment as a loan and stating that *M*, the maker of the nonperiodic payment, must recognize interest income whether or not any net payments are received by *M*, the swap regulations have basically defined a significant nonperiodic payment as including a debt claim, albeit a unique one. This dictates that the United States apply the interest article to this income.<sup>111</sup>

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107. The accepted rationale for this policy is that there is no underlying debt obligation. See Kramer, *Financial Products*, supra note 7, at 1434. The term “notional principal” reflects that there is actually no principal involved. For the characterization of interest rate swaps in some of the OECD Member States, see 1994 OECD Report, supra note 94, at 60.

108. *Id.* at part I, para. 25. This disparate treatment of nonperiodic payments is likely to continue due to conflicting domestic interests. One such interest is the capital import/export dichotomy. Capital importing states are more likely to see interest in a nonperiodic payment because, under tax treaties following the interest article of the OECD Model, they are entitled to tax outgoing interest payments. Conversely, capital exporting states may prefer that the exclusive right to tax swap profits belong to the taxpayer’s residence country, and thus would see all elements of the swap as falling under a treaty article that precludes taxation at source.

109. 1994 OECD Model, supra note 3, commentary on art. 11, para. 21.

110. See supra Parts III-VI for discussion of swap payment characterization. If both states view all swap payments as interest, there is also a common application of the interest article.

111. *Priv. Let. Rul. 9421027* (Feb. 24, 1994) involves a case that is basically identical to the one followed in this article. See supra note 60. The taxpayer, a foreign bank, requested a ruling that it was a resident of a particular U.S. treaty partner, thereby causing the interest article of the treaty to apply to interest received from a U.S. counterparty as a result of a significant nonperiodic swap payment the taxpayer had made to that U.S. party. While

For several reasons, comparable recharacterization in other states is improbable, though it may occur. Under the taxation and accounting regimes of some countries, there may be no need for recharacterization. The recharacterization and amortization scheme was adopted in the United States in part to preclude income accelerations intended to absorb expiring net operating losses, but operating losses do not expire under some tax systems. Further, the recharacterization in the swap regulations may be seen as a product of the U.S. policy to view substance over form.<sup>112</sup> This practice is not universally followed; some national laws require that the form of every transaction be followed.<sup>113</sup> Moreover, among countries utilizing a substance-over-form approach, the approach may not always be invoked with respect to the same nonperiodic payment. Absent recharacterization for any one of these reasons, a nonperiodic payment is not seen as containing a debt claim. Applying the requirement of Article 11(3) that there be a debt claim for the interest article to be applicable,<sup>114</sup> a country that does not consider a nonperiodic payment to include a debt claim will not apply the interest article.

The OECD Model Commentary to Article 11 also specifies that "references to domestic laws should as far as possible be avoided."<sup>115</sup> This statement is intended to eliminate the inclusion under a treaty's interest article of an item of income which is not from a debt claim. Again, absent recharacterization or another means of viewing a nonperiodic swap payment as a loan with interest, there is no debt claim and the interest article does not apply. Following recharacterization, there is a debt claim.

To recapitulate, if the source state recharacterizes a nonperiodic payment to include a loan bearing interest, as the United States does, it maintains that the interest article is the treaty provision that determines the taxing rights of the treaty partners with respect to interest associated with a significant nonperiodic payment made as part of an off-market interest rate swap. If the other state does not recharacterize, it maintains that another treaty article should be applied to determine the taxing rights to this payment. Under tax treaties following Article 11 of the OECD Model, this disagreement leads to double taxation, absent unilateral relief by the residence country.

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the ruling does not address whether this interest falls under the interest article, it appears to be an implicit premise of the ruling that it does. It might be inferred from this premise that the Service intends to use treaties as the primary means of reducing or removing tax on these interest payments.

112. This policy is apparently accepted by the OECD Model Commentary. See 1994 OECD Model, *supra* note 3, commentary on art. 1, para. 24.

113. 1994 OECD Report, *supra* note 94, part I, para. 139.

114. See *supra* text accompanying note 109.

115. 1994 OECD Model, *supra* note 3, commentary on art. 11, para. 21. The quoted words are meant to distinguish the current version of the Model Convention from the 1963 version, which included a reference to domestic law.

#### D. Potentially Applicable Tax Treaty Articles

The OECD Report notes that “there is no consistency in the way countries classify [swap] payments when applying treaties.”<sup>116</sup> The possibilities, in addition to Article 11, include Article 7 (Business Profits), Article 21 (Other Income); Article 13 (Capital Gains), and no suitable treaty article at all.<sup>117</sup> Unlike OECD Model Article 11, Articles 7 and 21 assign the exclusive right to tax the income falling under them to the residence state of the income recipient unless the profits are “attributable” to a permanent establishment in the source state.<sup>118</sup>

1. *Article 11: Interest.*—It is possible that a large nonperiodic payment in an interest rate swap could be recast under both states’ laws, following provisions similar to the swap regulations; if so, the interest article can readily be applied. However, if the criteria used to determine when to recharacterize a payment are as loose in these states as under the swap regulations, it is unlikely that the states would consistently agree on when a nonperiodic payment should be viewed as a loan, particularly in borderline cases.<sup>119</sup> Therefore, even the existence of similar recharacterization policies in both countries does not ensure the proper functioning of the relevant tax treaty. A swap payment could be treated as a loan by one state but not by the other, resulting in a “debt-claim” and “interest” for treaty purposes in the former state and treatment as regular swap income in the latter—the same problem as just discussed where one state does not have a recharacterization policy.

2. *Article 7: “Business Profits.”*—Article 7, which generally applies to income from “active business operations,”<sup>120</sup> allows source taxation of business profits only if they are attributable to a permanent establishment of

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116. 1994 OECD Report, *supra* note 94, part I, para. 29. See *id.* at 60 for a table summarizing the Member States’ classifications of payments when applying tax treaties.

117. Article 13 is a less likely alternative because swap payments are commonly made and received in the ordinary course of the participants’ businesses and because swap income usually does not consist of appreciation in property value and is not realized by a sale of property.

118. 1994 OECD Model, *supra* note 3, art. 7, para. 1 and art. 21, paras. 1-2. It is assumed here that the cross-border off-market swaps under discussion are not attributable to a permanent establishment. For discussion of the consequences of using a permanent establishment in a swap, see Kopp & Pross, *supra* note 24, at 378-79. The permanent establishment concept in treaty law is similar to the concept of income effectively connected with a U.S. trade or business under U.S. domestic law. See *supra* Part III.B.3 for discussion.

119. In the United States, any nonperiodic swap payment between 9.1% and 66.7% of the present value of the fixed payments under the swap contract must be considered borderline. See *supra* Part III.B.

120. Isenbergh, *supra* note 67, ¶ 38.7, at 354. See also Vogel DTC, *supra* note 91, at 321 (discussing the term “business profits”).

the taxpayer in the source country. It is the most likely article to be applied for regular swap income payments. However, income from passive investments unrelated to the enterprise's business is not intended to fall under Article 7. This line is often unclear, though, such as in the case of banks, which are frequent interest rate swap participants. A bank's interest income results from investments, yet earning interest is the bank's business. To avoid conflict between treaty articles, Article 7 "gives priority" to the investment income articles of tax treaties, such as Article 11.<sup>121</sup> Specifically, Article 7(7) provides that "[w]here profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."<sup>122</sup> However, for a state to give priority to Article 11 over Article 7, it must recognize that there is interest income, and whether it recognizes the presence of interest returns the analysis to the state's treatment of nonperiodic payments under domestic law.<sup>123</sup> Barring a state's characterization of such payments as a loan and their repayment as including interest, Article 7 may be applied without difficulty when interest rate swap payments are part of the business profits of an enterprise, as the OECD Report confirmed.<sup>124</sup> There can then be a conflict between the residence state of *M* applying Article 7 and a source state that follows the U.S. approach applying Article 11.

3. *Article 21: "Other Income."*—A similar, if not more important, conflict arises if *M*'s state of residence considers an income payment under a swap to be neither a "business profit" under Article 7 nor interest under Article 11. A decision that Article 7 does not apply would most likely be due to the nature of the swap counterparty, such as a corporate manufacturer end user or even a bank in some situations. If the residence state does not treat large nonperiodic payments as loans bearing interest, neither Article 7 nor Article 11 is applied by that state. Unless the swap payment is treated under

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121. Vogel DTC, *supra* note 91, at 377.

122. 1994 OECD Model, *supra* note 3, art. 7, para. 7.

123. For the treatment of nonperiodic payments as interest under domestic law, see *supra* Part VII.B.3.

In the United States, the initial indication of how standard interest rate swaps were to be treated was Rev. Rul. 87-5, 1987-1 C.B. 180, which found that swap income was an "industrial and commercial profit" as the term was used in the particular treaty under review. Though the 1981 U.S. Model now refers to such profits as "business profits" under Article 7, the distinction is not significant because the term still means income "derived from the active conduct of a trade or business." *Id.*, 1981 U.S. Model, *supra* note 95, art. 7, para. 7. Rev. Rul. 87-5 establishes that normal interest rate swap income is not interest, whatever else it may be. For a detailed discussion of why this income is not interest in the United States, see Kramer, *supra* note 7, at 1434-35.

124. 1994 OECD Report, *supra* note 94, part I, para. 140.

domestic law as a capital gain (Article 13),<sup>125</sup> Article 21 (Other Income) becomes applicable in that state by default.<sup>126</sup> Article 21, which assigns exclusive tax jurisdiction to the residence state, may often be relied on in this situation in light of the OECD Report's conclusion that "it is not as yet generally accepted that all [swap-related] payments are covered by [Article 7], the Business Profits Article."<sup>127</sup>

The distinction between treaty articles is important even though, in the absence of a permanent establishment in the source state, Articles 7 and 21 both grant the exclusive right to tax an item of income to the residence state.<sup>128</sup> This is because a large number of tax treaties lack an other income article.<sup>129</sup> In such a case, the swap-related payment may not be covered under the treaty at all. If the residence state of the income recipient, *M*, finds that the income is not covered by the treaty, the obligation of the source state to follow the treaty becomes less certain. If neither state follows the treaty, the income could be subjected to full taxation in both states, ameliorated only by unilateral relief in the residence state.

#### *E. The Manifestation of Double Taxation*

Double taxation arises when treaty partners apply conflicting treaty articles in determining who may tax payments under a cross-border, off-market interest rate swap with a large nonperiodic payment. Where interest payor *N* is a resident in the United States, thus making the United States the source state of the interest, the United States asserts its right under Article 11 to tax the deemed interest payment arising from the nonperiodic payment. As discussed earlier, the U.S. withholding agent must withhold tax from the "interest" component of its payment to *M* at the rate specified by the treaty.<sup>130</sup>

If the other contracting state, the residence state of *M*, does not recharacterize the nonperiodic payment and thus views the swap payment as business or other income, it applies Article 7 or 21, which provide that there

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125. See Isenbergh, *supra* note 67, ¶¶ 41.4-41.5, at 421-24 and Vogel DTC, *supra* note 91, art. 13, at 729 for discussion of the treatment of capital gains.

126. Article 21 applies to an item of income "not dealt with in the foregoing articles" of the treaty. 1994 OECD Model, *supra* note 3, art. 21, para. 1; 1981 U.S. Model, *supra* note 95, art. 21, para. 1. See Vogel DTC, *supra* note 91, art. 21, at 911 (discussing Article 21's applicability).

127. 1994 OECD Report, *supra* note 94, part I, para. 157.

128. 1994 OECD Model, *supra* note 3, art. 7, para. 1 and art. 21, para. 1; 1981 U.S. Model, *supra* note 95, art. 7, para. 1 and art. 21, para. 1.

129. 1994 OECD Report, *supra* note 94, part I, para. 157. Approximately one-half of the U.S. tax treaties lack an other income article. See Klaus Vogel et al., *United States Income Tax Treaties* art. 21-13 tbl. 1 (1993) [hereinafter Vogel et al., USITT].

130. See *supra* Part IV.B for a discussion of withholding in the United States.

should be no withholding in the source state and that only the residence state may tax the income. Further, unless the residence state, upon examination of the treaty, finds that source taxation is justified, it may not credit the tax at source or exempt the income from residence taxation.<sup>131</sup>

The basic treaty method for avoiding double taxation is stated in Article 23, which generally provides the residence state of the income recipient, *M* in the Example, with a choice between exempting or crediting the taxes levied in the source state.<sup>132</sup> However, for interest, Article 23 generally provides that any source state tax is to be credited in the residence state of the recipient.

Unlike Article 11, Articles 7 and 21 independently avoid double taxation by declaring that only the residence state of the recipient may tax the income falling under them. Therefore, when *M*'s state of residence applies Article 7 or 21, it may not resort to Article 23 to avoid double taxation, even though *N*'s state expects *M*'s to avoid double taxation by applying Article 23 in conjunction with Article 11. An implicit prerequisite for the use of Article 23 is agreement by the residence state that the income falls under the interest article or some other provision allowing taxation at source.<sup>133</sup> In this instance, Article 23 is not applicable since it is unlikely that there will be agreement by *M*'s state of residence that the interest article applies, at least when the income's source state is the United States. In short, if the residence state of *M* does not apply the interest article, it will not arrive at Article 23 as the means to alleviate double taxation.

As mentioned earlier, recharacterization treats a nonperiodic payment as creating a debt claim. To remain consistent with that treatment, the United States can be expected to call for the interest article to apply to the interest element. However, as discussed previously in part V of this article, there is no fixed debt claim in reality. That means that if *M*'s state of residence maintains that the interest article should not apply because there is no interest, that state is theoretically correct. Further, *M*'s state of residence could feel that the interest article does not apply because the "interest" is not paid as interest, a prerequisite for the application of the interest article.<sup>134</sup> For both

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131. Vogel DTC, *supra* note 91, at 128-29.

132. See *id.*, art. 23. The OECD Model Commentary states that "[a]s regards two classes of income (dividends and interest), . . . insofar as these provisions confer on the State of source or situs a full or limited right to tax, the State of residence must allow relief so as to avoid double taxation; this is the purpose of Articles 23 A and 23 B." 1994 OECD Model, *supra* note 3, commentary on intro., para. 19.

133. Vogel DTC, *supra* note 91, art. 23, at 961.

134. Klaus Vogel, *On Double Taxation Conventions*, art. 11, ¶ 67.1 (3d ed. forthcoming 1996). See Vogel DTC, *supra* note 91, at 655, for discussion of the "paid as interest" requirement.



of these reasons, *M*'s state of residence likely will not accept the use of the interest article. Therefore, the interest component of the payment made to *M*, which was withheld against in the source state by *N*, may also be fully taxed in the residence state of *M*, resulting in unameliorated double taxation.

#### F. *Qualification Problem*

The preceding analysis concerning the appropriate treaty article for income from large nonperiodic payments in off-market swaps has been addressing the "qualification" problem of treaties. Qualification is the term used to describe how income is characterized for treaty purposes and is one of the most fundamental and long debated issues of treaty law.<sup>135</sup> Article 3(2) of the Model Conventions attempts to solve the qualification problem by specifying that terms undefined in the treaty should be interpreted in accordance with the meaning of the term in the domestic law of the state applying the treaty.<sup>136</sup>

However, Article 3(2) is subject to different interpretations. The interpretation implicitly followed in this article is the one more likely to be followed by revenue authorities.<sup>137</sup> Namely, both states characterize income independently under their respective domestic laws.<sup>138</sup> However, as seen, a consequence of this approach in this instance is double taxation. In the case of income resulting from a large nonperiodic payment, the undefined treaty term is "debt-claim." Double taxation arises because one of the contracting states considers "debt-claim" to include large nonperiodic payments, while the other state does not. As a result, conflicting treaty provisions are applied.

The other leading interpretation of Article 3(2) maintains, in essence, that the residence state of the income recipient should accept the source state's qualification of the income as binding.<sup>139</sup> Thus, if the source state taxes the income from a large nonperiodic payment as interest for treaty purposes, the residence state should follow that interpretation. In this instance,

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135. See Vogel DTC, *supra* note 91, at 134-35 (enumerating literature on the debate); the other leading exposition on the qualification issue is A. Jones et al., *supra* note 104.

136. 1994 OECD Model, *supra* note 3, art. 3, para. 2; 1981 U.S. Model, *supra* note 95, art. 3, para. 2. Article 3(2) in both models states that a term not defined in the treaty shall have the meaning which it has under the law of that State concerning the taxes to which the convention applies.

137. See Klaus Vogel, *Double Tax Treaties and Their Interpretation*, 4 *Int'l Tax & Bus. Law* 1 (1986).

138. See Vogel DTC, *supra* note 91, at 135-42 (supporting this interpretation of Article 3(2) and analyzing at length possible ways to avoid double taxation within the context of Article 3(2)).

139. See J.F. Avery Jones, *Treaty Interpretations*, *Apirc Bull.*, Aug. 1993, at 282; Jones et al., *supra* note 104.

this means that both states should apply Article 11 so that the residence state credits the taxes paid in the source state, thereby avoiding double taxation.

While this approach is appealing in that it avoids double taxation, its utility is limited because it is unlikely to be followed by revenue authorities, particularly in the case of swaps with large nonperiodic payments. By accepting the source state's qualification, the residence state effectively cedes its sovereignty. While this is conceivable in simpler cases, such as where the source state merely has a broader definition of a term so that acceptance of the source state's qualification is not a great infringement on the residence state's authority, the process used by the source state to arrive at the interest qualification of substantial nonperiodic payments is more complicated.<sup>140</sup> The complexity of the recharacterization procedure and its extreme subjectivity make this interpretation of Article 3(2) inappropriate as well as unlikely to find acceptance.

As neither approach to Article 3(2) effectively eliminates double taxation of payments under a swap with a recharacterized nonperiodic payment, the mutual agreement procedure found in most treaties could be used in an effort to resolve the problem. However, as seen in the next section, this procedure may also be of limited effectiveness with respect to income under a swap with a large nonperiodic payment.

### G. Mutual Agreement Procedures

Most double taxation treaties provide for a mutual agreement procedure (Article 25 of the Model Conventions), which entitles a taxpayer to request that the competent revenue authorities of the two states consult on the taxpayer's situation if the taxpayer feels that it is being taxed "not in accordance with the provisions" of the tax treaty.<sup>141</sup> Juridical double taxation qualifies as taxation "not in accordance" with the treaty.<sup>142</sup> As mentioned previously in Part VII, the swap-based recharacterized interest payment to taxpayer *M* is subject to juridical double taxation. That is, tax is withheld in the source state from the interest—which is part of *M*'s profits from the underlying swap transaction—and the income is taxed again in *M*'s state of residence.<sup>143</sup>

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140. See *supra* Parts II-V on the recharacterization process in the United States.

141. 1994 OECD Model, *supra* note 3, art. 25, para. 1.

142. See J.F. Avery Jones et al., *The Legal Nature of the Mutual Agreement Procedure under the OECD Model Convention-I*, 1979 *Brit. Tax Rev.* 333, 336; Sanford H. Goldberg, *Competent Authority*, 40 *Bull. Int'l Fiscal Documentation*, 431, 433 (1986); Vogel et al., *USITT*, *supra* note 129, at 25-71 (pointing out that Article 25 does not apply in certain cases where the treaty acknowledges that double taxation is possible).

143. This is a case of juridical double taxation even if the swap contract contains a gross-up clause. Such a clause is merely a contractual arrangement between the counter-

1. *Availability*.—A taxpayer may apply for a mutual agreement procedure to the competent authority of its state of residence.<sup>144</sup> This generally means that interest recipient *M*, as the party whose profits are subject to double taxation, must apply to the competent authority of *M*'s state of residence—not to the authority of the state imposing the withholding tax (the United States in the Example).<sup>145</sup> If *M* believes that it is being taxed not in accordance with the treaty, it may apply for a “specific case” type of mutual agreement procedure. This type allows the competent authorities the broadest discretion in deviating from national law in an effort to alleviate double taxation.<sup>146</sup> Any relief granted is generally only applicable to the particular case. However, relief is not guaranteed, and there are potential drawbacks to consider.<sup>147</sup>

Two other types of mutual agreement procedure are established in Article 25.<sup>148</sup> These are the interpretative provision and the legislative provision.<sup>149</sup> They provide the competent authority with less flexibility than

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parties establishing which one of them will bear the cost of the withholding tax on swap payments. In any event, because of the widespread acceptance of economic double taxation as a basis for invoking a mutual agreement procedure (as in the case of transfer pricing), the double taxation discussed in this paper qualifies for Article 25.

144. 1994 OECD Model, supra note 3, art. 25, para. 1; 1981 U.S. Model, supra note 95, art. 25, para. 1.

145. For a U.S. resident, the mutual agreement procedure follows Rev. Proc. 91-23, 1991-1 C.B. 534, as it may be amended by the revenue procedure proposed in Announcement 95-9, 1995-7 I.R.B. 57 (Feb. 13). See Joseph L. Andrus et al., *Competent Authority Assistance in Tax Controversies under the New IRS Procedures*, 50 *Tax Notes* 1279 (Mar. 18, 1991); Robert T. Cole and James E. Croker Jr., *U.S. IRS Proposes to Update Competent Authority Procedures*, 10 *Tax Notes Int'l* 541 (Feb. 13, 1995).

146. See Jones et al., supra note 142, at 335-46; Vogel et al., *USITT*, supra note 129, at 24-30.

147. Drawbacks to a mutual agreement procedure are discussed *infra* Part VII.G.2.

If the contract has a gross-up clause, an interesting question arises as to which counterparty should apply for the mutual agreement procedure. While the payments to *M* are the items being taxed not in accordance with the treaty, *M* is receiving its full payments undiminished by withholding tax and is not feeling the pinch of double taxation. *N*, by virtue of the gross-up clause, is paying the withholding tax from its pocket, yet is not being taxed in contravention of the treaty. The economic cost to the swap is real and may be felt by *M* in the form of less favorable swap terms offered by *N*. Thus, though *M* should apply for the mutual agreement procedure, it is unlikely to undertake such a procedure with its potential drawbacks for *N*'s benefit. It is possible that neither *N* nor *M* is qualified or interested to apply for a “specific case” type of mutual agreement procedure despite the presence of double taxation.

148. There are generally considered to be three types of mutual agreement procedures contained in Article 25 of the model conventions. See Jones et al., supra note 142, at 335; Vogel et al., *USITT*, supra note 129, art. 25.

149. 1994 OECD Model, supra note 3, art. 25, para. 3; 1981 U.S. Model, supra note 95, art. 25, para. 3, first two sentences.

the specific case procedure.<sup>150</sup> However, they need not be requested by a taxpayer, but may be undertaken by a competent authority itself to resolve “difficulties or doubts arising as to the interpretation or application” of the treaty.<sup>151</sup> The benefit of such a ruling is its potential prospective effect.<sup>152</sup> The interpretative provision under the U.S. Model applies to the double taxation of recharacterized, swap-related interest; the Model states that the competent authorities may engage in such a procedure in an effort to agree on “the same characterization of particular items of income.”<sup>153</sup> The OECD Model Commentary states that this procedure is appropriate in cases of “relief from tax deducted from . . . interest.”<sup>154</sup> Thus, under both Model Conventions such a procedure is possible.

2. *Drawbacks to Mutual Agreement Procedures.*—Despite the potential benefit from a mutual agreement procedure, several factors weigh against a swap counterparty requesting, or fully cooperating in, a mutual agreement procedure. One is that the desired relief in a particular case may not be large enough to warrant the costs involved in the procedure. While the competent authority does the negotiating and bears the related costs, the taxpayer must apply for the procedure, file copious amounts of information, and follow the case to its conclusion.<sup>155</sup> Further, the procedure will likely take at least two years,<sup>156</sup> and in the quickly evolving world of derivatives, the subject of a prospective ruling may already be outdated by the time it is issued.

A potentially weightier hindrance, though, is a counterparty’s fear of retaliation by the tax authorities. Mutual agreement procedures place taxpayers and revenue authorities in an unusual posture; the taxpayer must rely on the authorities to advocate its case. While the revenue authorities require disclosure of various information in a mutual agreement procedure, it is also in the taxpayer’s interest to cooperate as fully as possible if it hopes for a favorable resolution of the case. Yet, the disclosure of necessary information may result in the counterparty’s tax returns for previous years being scrutinized once again, possibly resulting in the “raising of new issues,

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150. Vogel et al., USITT, supra note 129, at 24-30.

151. 1981 U.S. Model, supra note 95, art. 25, para. 3.

152. For discussion of the legal effect of “interpretative provisions,” see Jones et al., supra note 142, at 335; Vogel et al., USITT, supra note 129, at 25-141.

153. 1981 U.S. Model, supra note 95, art. 25, para. 3(c).

154. 1994 OECD Model, supra note 3, commentary on art. 25, para. 33; see also id. para. 32 for its scope of applicability. Vogel et al. states that mutual agreements “are intended to clarify how national (domestic) tax law is to apply in both states in particular situations.” Vogel et al., USITT, supra note 129, at 25-31.

155. See Rev. Proc. 91-23, supra note 145 (listing procedural requirements).

156. See Vogel et al., USITT, supra note 129, at 25-20 (providing statistics on processing time and frequency of relief in U.S. cases).

reopening issues from a closed year, or more intensely auditing of positions taken by the taxpayer in an open year."<sup>157</sup> While the United States does not reopen closed years,<sup>158</sup> no similar assurances exist concerning open years. The positions of the revenue authorities of many other countries—to whom counterparty *M* would apply—are even more uncertain.<sup>159</sup> Thus, it is not irrational to be wary.<sup>160</sup>

Even beyond these risks, there is the consideration that mutual agreement may not be reached. Article 25 of the model conventions only requires the competent authorities to negotiate; it does not obligate them to arrive at an agreement.<sup>161</sup> The OECD Commentary observes that this is a point of dissatisfaction among taxpayers.<sup>162</sup>

While the mutual agreement procedure is often a useful tool to alleviate double taxation, it should only be seen as a potential back stop to prevent such taxation. Even when a back stop is needed, it may not always be used or be effective. Thus, more direct unilateral or treaty measures must be developed and implemented to alleviate double taxation on income resulting from large nonperiodic swap payments.<sup>163</sup>

## VIII. POTENTIAL SOLUTIONS AND THE CONSEQUENCES OF DOUBLE TAXATION

### A. *Potential Solutions*

For a swap participant looking for a sure method of avoiding double taxation of payments under a cross-border interest rate swap with a large

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157. *Id.* at 25-41.

158. See Rev. Proc. 91-23, *supra* note 145, § 3, para. 6. An exception could arise in extraordinary circumstances. *Id.*

159. Vogel et al., USITT, *supra* note 129, at 25-41.

160. Another fear of taxpayers is the potential disclosure to competitors of confidential information. See *id.* at 25-41.

161. 1994 OECD Model, *supra* note 3, commentary on art. 25, para. 2; 1981 U.S. Model, *supra* note 95, art. 25, para. 2; 1994 OECD Model, *supra* note 3, commentary on art. 25, para. 26.

162. 1994 OECD Model, *supra* note 3, commentary on art. 25, para. 45.

163. Rev. Proc. 91-22, 1991-1 C.B. 526 (undergoing revision in 1995) provides a procedure for advance pricing agreements (APAs), which often entail mutual agreement between competent authorities. These agreements are to resolve profit allocation issues between related taxpayers and have been used in the context of global trading. However, it is assumed throughout this article that foreign taxpayer *M* does not use a U.S. permanent establishment in connection with the swap, but is nonetheless taxed on it. APAs are not appropriate in this situation. For discussion of APAs and global trading, see Notice 94-40, 1994-4 C.B. 351 (discussing global trading APAs); Kathleen Mathews, U.S. and Canadian Officials Discuss APAs in the Global Trading Context, 8 *Tax Notes Int'l* 1362 (May 23, 1994); Kopp & Pross, *supra* note 24, at 380; Plambeck, *supra* note 49; Ruchelman, *supra* note 44, at 253.

nonperiodic payment made to a U.S. counterparty, there are few certain answers. Ensuring that the nonperiodic payment is not significant (i.e. is no greater than 9.1% of the discounted present value of the fixed payments under the swap) avoids recharacterization under the swap regulations.<sup>164</sup> However, economic necessity, such as terminating or offsetting an existing swap, may dictate a larger payment. In that case, double taxation may be avoided by doing the swap through a bank that is a resident of a country whose income tax treaty with the United States provides a zero rate of withholding tax on interest, doing the swap entirely inside of the United States, or not involving a U.S. counterparty at all. Each of these alternatives excludes a significant number of potential counterparties, which may reduce the liquidity of swaps. Swap participants, therefore, should carefully price and structure new swaps and their trading strategies for terminating existing swaps in order to minimize the impact of unexpected recharacterization. For example, swap participants wishing to use an interest rate swap with a large nonperiodic payment which might be subject to recharacterization could bifurcate that swap into an on-market swap and either a real loan or a consulting or other fee. Although the economic consequences of such a structure are slightly different from the originally intended swap, the tax consequences are more certain.

Several measures could be taken by revenue authorities to alleviate double taxation. In the United States, the Service could decide that the portfolio interest exemption applies to interest resulting from a recharacterized nonperiodic payment, even if the interest is paid to a foreign bank. Such an interpretation could conceivably be supported by construing section 881(c)(3)(A) to mean that a bank does not “extend credit” in a swap since the principal may not be repaid. However, since recharacterization is an effort to combat hidden extensions of credit, it seems unlikely that the Service will adopt this construction.

Another possible measure is to alter the swap regulations. Specifically, the phrase “except for the interest sourcing rules” could be added to section 1.446-3(g)(4), so that it would read “the time value component . . . is recognized as interest for all purposes of the Internal Revenue Code *except the interest sourcing rules.*” The interest, like all swap income, would then have its source in the recipient’s country of residence,<sup>165</sup> U.S. withholding tax would not apply, and the issue of whether the interest article applies to the recharacterized payments would be sidestepped. This revision might be supported by focusing on the purpose behind Regulations section 1.863-7,

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164. See Regs. § 1.446-3(g)(4), (6); see also *supra* Part III. However, even under the 9.1% level there could be recharacterization because § 1.446-3(g)(4) allows for the recharacterization of any nonperiodic swap payment by using IRC § 956.

165. Regs. § 1.863-7(b)(1); see *supra* Part III.B.3 (discussing sourcing rules).

finalized two years before the swap regulations, which sources income "attributable" to notional principal contracts to the residence of the income recipient. Clearly, the policy inherent in this provision is to preempt any U.S. taxation on such income paid abroad. As the regulations now stand, interest income deriving from a large nonperiodic payment, while originating in a swap contract, is not "attributable" to the swap because the swap regulations plainly state that the time value of money component of the recharacterized loan is interest for "all" purposes of the Code.

Double taxation would also be alleviated if the residence state of *M*, the "interest" recipient, adhered to the source state qualification of the income, as discussed in Part VII.F. However, for reasons already discussed, this approach by residence state revenue authorities seems unlikely.

Conversely, the state of interest payor *N*, despite recharacterizing the income as interest under domestic law, could conclude that the interest article is not the appropriate treaty article to apply. Such a position is theoretically possible by acknowledging that the interest is not "interest" for treaty purposes, supported by the realization that there is no "debt-claim" certain to be repaid. However, this position does not seem likely under the U.S. swap regulations as it is contrary to the theory of the embedded loan recharacterization. Nevertheless, if *N*'s state took this approach, it could apply Article 7 or 21 and assume that the residence state of the income recipient would apply one of them as well, thus alleviating double taxation. This is a more realistic expectation than hoping that they both apply the interest article.

However, this approach could also lead to an absence of treaty coverage on the payment by *N* and the imposition of withholding tax by the source state. If the transaction is not part of an active business operation of *M* and thus not under Article 7, which applies only to business profits, and if the treaty does not contain an article on other income (Article 21 of the models), there would be no treaty coverage. This would even be the case where the treaty provided for exclusive taxation of interest in the residence state of the interest recipient (as under the U.S. Model) because, as noted, the interest article would not be applied by *N*'s state. Thus, a source state policy of viewing the recharacterized "interest" as not interest for treaty purposes is a double-edged sword.

New treaty provisions seem to be a promising means of eventually eliminating double taxation on payments under a swap with a large nonperiodic payment. For instance, a treaty provision could be developed establishing a basic framework for swap payments akin to that currently found in the interest article. The term "swap related payments" could be defined to include any payment resulting from a swap transaction or associated with one. Thus, even if a country characterizes a swap related payment as interest, as in the Example, it would still fall under the swap article. As under the interest article, swap related payments arising in a

contracting state could be taxed in that state and according to the laws of that state, but the tax could not exceed a maximum negotiated rate (which could be zero).<sup>166</sup> If the source state imposes tax, the residence state of the recipient would alleviate that tax in conjunction with Article 23.

In light of the various domestic qualifications possible for this type of swap related payment, a comprehensive treaty provision would greatly reduce the likelihood of double taxation. Such a measure would be most useful for new treaties, as insertion into existing ones would require that they be renegotiated.<sup>167</sup> However, any new treaty provision should be broadly applicable to a variety of financial instruments, which this proposal is probably not. Therefore, for the present, tax authorities should develop logical domestic tax regimes for financial products with an awareness of their treatment in other countries and of the likely qualification of such instruments under existing treaties.

Absent measures taken by countries with more developed regulatory and tax systems for financial instruments to promote rational, certain taxation of swaps and to avoid double taxation, the situs of many swaps can readily be moved to countries with more favorable tax systems. Relocating is currently the best solution to avoiding the tax and associated liquidity problems discussed in this article. However, for financial markets as a whole and for governments desiring to regulate those markets, swap relocation may have undesirable consequences.

### B. *Consequences of Double Taxation*

Just as tax laws are seldom the reason for undertaking a commercial transaction, tax laws should also not be a reason for foregoing one. Nor should tax consequences determine the choice of jurisdiction where a transaction is closed or, with swaps, booked. Yet, this will occur if there continues to be a significant likelihood of withholding taxes being imposed, with resultant double taxation, on a swap booked in one country, while there is no chance of such taxation on swaps booked elsewhere. Since the swap markets need liquidity, swaps will be relocated as necessary.

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166. Swap related payments defined as "swap income" in the United States under Regs. § 1.446-3(d) are sourced in the country of the payment recipient as provided in Regs. § 1.863-7(b)(3) and thus are not subject to any withholding under such a swap provision. This is because, as with the interest article, under the "Swap Article," the swap related payments are taxed according to the laws of the state in which they arise. If the United States, as the state in which they "arise," says that "swap income" is sourced in the state of the payment recipient, according to U.S. law they are not subject to U.S. taxation.

167. It may be easier to insert an other income article (Article 21 of the models) into existing treaties. However, if a state insists that the interest article be applied to the "interest" element of swap related income, Article 21 would not prevent double taxation. See *supra* Parts VII.D and E.



A consequence of driving swaps out of some jurisdictions and into others on tax grounds may be a decrease in regulatory oversight of swaps and an increase in danger to the financial system as a whole. Many jurisdictions into which the transactions might move may not only levy fewer, or at least more certain, taxes, but they may well have less developed, or no, active oversight systems for financial products.

While those in the financial industry may protest that there is already adequate protection of investors and markets in the derivatives' area,<sup>168</sup> recent history shows that man-made disasters are all too possible. More oversight will not prevent all such damage in the derivatives' market, though there are certainly steps that can be taken to mitigate the number of victims.<sup>169</sup> There has been significant discussion in the United States, for instance, of the risks posed by this market and about measures that may be taken to reduce them without interfering with the usage of complex financial products. It has further been recognized that because of global trading, concentration of markets in relatively few hands, and linkages between market participants, these products pose risks to the international financial system as a whole.<sup>170</sup>

However, regulatory measures taken in response to these concerns by the United States and other countries with more developed financial markets could be undercut if tax issues force market participants to relocate outside of the regulatory jurisdiction of these countries. If, because of more coherent or favorable tax laws, tax havens or other countries with less sophisticated financial market controls became the regular situs of swaps, a pirate environment could develop with respect to parts of the derivatives industry.

## IX. CONCLUSION

As seems regularly to be the case in the tax field, fiscal authorities and tax laws are constantly under pressure to implement suitable tax pro-

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168. See *Derivative Financial Markets, (Part 1), 1994: Hearings on H. 361 Before the Subcomm. on Telecommunications and Finance of the House Committee on Energy and Commerce, 103d Cong., 2d Sess., (May 10, 1994)* (statement of Richard C. Breeden, E. Gerald Corrigan, and Dennis Weatherstone).

169. See GAO Report, *supra* note 1. The Report contains extensive and detailed discussion of all facets of the risks involved with derivatives, including current risk management techniques, accounting problems, and gaps in the regulation of the derivatives industry. *Id.* at 103. The Report also includes many recommendations, and points out a need to restructure the U.S. financial regulatory system in light of the increasing global nature of financial markets. *Id.* at 123-29.

170. *The Risks and Regulation of Financial Derivatives, 1994: Hearings on S. 241 Before the Comm. on Banking, Housing, and Urban Affairs of the Senate, 103d Cong., 2d Sess. (May 19, 1994)* (statement of Charles A. Bowsher, Comptroller General of the United States).

visions to keep pace with rapidly developing business practices.<sup>171</sup> In the face of this challenge, it is particularly important for the United States and other countries with the most sophisticated oversight of their financial systems to continue to construct tax laws concerning swap and related income that clarify, standardize, and guarantee tax treatment and eliminate the burden of double taxation. Such tax laws are necessary to discourage swaps and other financial products from being moved outside of their tax and regulatory jurisdictions.

A good example of such a law and one to be followed elsewhere is that of the United States sourcing swap income to the state of the recipient's residence. With this provision, the United States unilaterally prevents double taxation of swap income paid abroad. In contrast, a policy to be less quickly copied is the recharacterization of a large nonperiodic payment under an off-market swap into a loan bearing interest. As discussed in the first part of this article, though implemented to combat a real problem, many tax uncertainties and unusual results arise from this policy, including not knowing when there will be recharacterization, and thus not knowing when withholding is required. Further, when a nonperiodic payment has been recharacterized, it seems unusual indeed that withholding may be due even absent any net cash payment to subject to withholding. In addition, it is this imposition of source state taxation that may lead to unacceptable double taxation. Prospective swap participants may understandably shy away from carrying out a swap in a jurisdiction with such a recharacterization provision.

When a system for the avoidance of double taxation on income resulting from derivatives is finally developed and incorporated into the tax treaty network, double taxation of such income will regularly be avoided. Until then, however, it is the task of domestic policymakers to look for ways to establish a coherent and predictable scheme for the domestic taxation of derivative products that meshes with other practices around the world and avoids tax-related interference with the international flow of capital.

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171. Recognizing that this is especially true for financial instruments, the Treasury Department is presently conducting a broad review of the U.S. taxation of financial services in an effort to improve the taxation of both existing and future services, particularly in light of the global nature of the financial industry. See Cosgrove, *supra* note 4, at G-2 (reporting on a speech of Treasury Deputy Assistant Secretary (Tax Policy) Cynthia Beerbower to the ABA Section of Taxation on May 19, 1995).