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## Selected Issues In The Taxation Of Swaps, Structured Finance and Other Financial Products

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## I. INTRODUCTION

The last decade has seen an explosive growth in the use of swaps and other derivative products<sup>1</sup> as part of the asset and liability management strategies of corporations and other institutional investors. Beginning with interest rate and currency swaps, the menu of swap products has expanded to include commodity swaps, equity index swaps, equity swaps, total return swaps, basis swaps, and interest rate caps, floors and collars. According to industry sources, the market for interest rate swaps has grown in notional principal amount from an estimated \$3 billion in 1982<sup>2</sup> to over \$3.065 trillion by the end of 1991 (the most recent figures available).<sup>3</sup> Similarly, the outstanding aggregate notional principal amount of currency swaps has grown from \$182 billion in 1987 to \$807 billion by the end of 1991.<sup>4</sup>

At the same time as the swap market has been expanding, the structured finance market,<sup>5</sup> including mortgage and asset securitization,<sup>6</sup> has seen similar growth. Beginning in the 1970s, U.S. government-backed enterprises such as the Government National Mortgage Association ("Ginnie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") sponsored transactions in which pools of residential first mortgages were bundled into pass-through certificates that were then sold to thrifts, banks and other institutional investors. In 1983, Freddie Mac introduced collateralized mortgage obligations ("CMOs"). CMOs, which divided up the cashflows from

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1. A derivative product is a financial instrument that, while not itself constituting a share of stock, debt obligation or commodity, has a value derived from the values, prices or returns of or on such "underlying" assets. Examples of derivative products include swaps, options of either the cash-settled or physical-settled variety, futures contracts, forward contracts, caps, floors and collars. See generally Saul Hansell, *Is the World Ready for Synthetic Equity?*, Institutional Investor, Aug. 1990, at 54 (discussing the types and economic uses of swaps and other derivative products); Steven D. Felgran, *Interest Rate Swaps: Use, Risk, and Prices*, New England Econ. Rev., Nov.-Dec. 1987, at 22.

2. Why Bank Regulators Need a Contingency Plan, *The Economist*, Dec. 1, 1984, at 93, 94.

3. International Swap Dealers Association, *Market Survey Highlights Year End 1991* 7 (1992).

4. *Id.* Because the International Swap Dealers Association counts only the firms that participate in its survey, it may understate the true size of the market. True Size of Swap Market Approaches \$6 Trillion, With Replacement Cost of \$275BN, *Swaps Monitor*, Oct. 19, 1992, at 1. It has been estimated that the true aggregate amount of currency and interest rate swaps outstanding at the end of 1991 was \$5.7 trillion (notional principal amount). *Id.*

5. "Structured finance is a financing technique in which financial assets ... are pooled and converted into capital market instruments." Div. of Inv. Management, U.S. Sec. and Exch. Comm'n, *Protecting Investors: A Half Century of Investment Company Regulation* 1 (May 1992).

6. Securitization is the transformation of illiquid debt into standardized, marketable securities. 1 Tamar Frankel, *Securitization* 3 (1991).

an underlying pool of mortgages into separate debt securities having different maturity, interest rate and credit characteristics, dramatically broadened the market for mortgage-backed securities. With the enactment of the "Real Estate Mortgage Investment Conduit" ("REMIC") provisions<sup>7</sup> as part of the 1986 Tax Reform Act, the taxation of mortgage pass-through and pay-through securities became subject to a new, self-contained set of rules. Moreover, since the mid-1980s, structured finance techniques originally employed in securitizing mortgages have been applied to a broad range of other financial assets, including stocks, credit card receivables, auto loans, lease receivables, home equity loans, commercial and industrial loans and trade receivables.<sup>8</sup>

The development of swaps and structured finance products has given rise to a number of tax issues. Even today, many aspects of the taxation of these products remain confused and in doubt. This article explores some of those confusing and contentious issues, as well as some issues on which there is, one hopes, more universal agreement.

This article is divided into two broad parts. Part II describes and analyzes certain tax issues involving swaps. After describing the basic mechanics of swap transactions, Part II shows how swaps can be utilized to create synthetic tax-advantaged assets, to enable an investor to alter the mix of its investment assets without triggering gain recognition, and, in the case of foreign investors, to avoid withholding taxes. The emphasis in Part II is on interest rate and equity swaps, but the analysis contained therein applies more broadly to all kinds of swap products. Also discussed in Part II is whether equity swaps can be used as part of dividend capture strategies to avoid the strictures of section 246 and how swaps should be treated for purposes of the built-in gain and loss rules of section 382(h).

Part III explores a number of issues in structured finance. This Part uses an equity-based product recently developed by Merrill Lynch as a case study for analyzing structured finance techniques. As is typical of most structured finance transactions, the Merrill Lynch product maximizes economic value by achieving three goals involving both tax and non-tax considerations: (i) the dividing up of pre-tax cashflows from an underlying financial asset or assets in order to create new securities that better match the investment needs of discrete investor groups; (ii) the structuring of the investment vehicle, in this case, a state law trust, in order to avoid an entity-level tax; and (iii) the structuring of the transaction to preserve, and flow through to the investors, the tax-advantaged character of the income from the underlying asset or assets.

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7. IRC §§ 860A-860G.

8. See generally Christine Pavel, *Securitization*, *Econ. Persp.*, July-Aug. 1986, at 16.

In one sense, this article does not have a single unifying theme. Rather, it represents an outgrowth of my professional practice advising investment banking and other clients about derivative products and asset securitization, and is intended to introduce generalist tax practitioners to some of the new financial products that have been developed in the swaps and structured finance areas over the last few years, and to some of the tax issues that have arisen with respect to those new products. In another sense, however, the theme linking many of the topics discussed in this article is that of "tax arbitrage." By tax arbitrage I mean a taxpayer's simultaneously holding "long" and "short" positions in the same or similar asset(s), but where the tax treatment of one position differs from the tax treatment of the other, resulting in an after-tax return from the overall transaction that is *greater* than its pre-tax return.<sup>9</sup> Many of the transactions explored in this article raise questions about the proper scope and content of a general, unifying theory of tax arbitrage.

In particular, tax arbitrage strategies, at least in their "purest" forms, are generally viewed as abusive. Nevertheless, in discussing many of the transactions analyzed in this article with my professional colleagues, I have discovered that, in the tax world, as in so much else, one person's poison is another person's meat. Transactions that strike me as clearly troublesome appear perfectly legitimate to some of my peers and vice versa. The reason for these disagreements is not that some persons are more or less tolerant of tax arbitrage than others. Rather, the disagreements stem from differing conceptions of what makes tax arbitrage abusive and, accordingly, what particular transactions should be considered examples of tax arbitrage in the first place. Some of my colleagues believe that a *sine qua non* of tax arbitrage is the presence of debt financing. Others believe that tax arbitrage only requires the holding of offsetting "long" and "short" economic positions. Some tax lawyers seem to require a "direct" link between the "long" and "short" positions before a transaction can be considered an example of tax arbitrage. Others view this as merely a rule of administrative convenience, rather than a theoretical requirement.

My purpose in writing this article is far more modest than crafting a general, unifying theory of tax arbitrage. I do believe, however, that many of the transactions described in this article must be accounted for in developing such a theory. Thus, only when one is able to articulate clearly and cogently why the strategy involving a market discount bond and an interest rate swap discussed in Part II either is, or is not, abusive, will the analysis be complete.

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9. See generally Myron S. Scholes & Mark A. Wolfson, *Taxes and Business Strategy: A Planning Approach* 104-27 (1992); C. Eugene Steuerle, *Taxes, Loans and Inflation: How the Nation's Wealth Becomes Misallocated* (1985).

## II. SWAPS

### A. Basic Swap Mechanics

A swap, or more technically a "notional principal contract," is defined in Proposed Regulations section 1.446-3(c)(1), 56 Fed. Reg. 31,350 (1991), 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." For example, suppose A and B<sup>10</sup> enter into an interest rate swap pursuant to which A is obligated to pay B \$100, or 10% of \$1,000, on December 31st of each year, and B is required to pay A at the end of each calendar quarter an amount equal to the product of \$1,000 and the prevailing London Interbank Offered Rate ("LIBOR") for 90-day deposits for the period, as determined at the beginning of the calendar quarter.<sup>11</sup> Here, the notional principal amount is \$1,000, the specified index for A is a fixed 10% interest rate, and the specified index for B is a floating 90-day LIBOR interest rate.

A and B might enter into this swap in order to allow A to convert its LIBOR-based floating interest rate debt obligations into fixed interest rate obligations and B to convert its fixed interest rate debt obligations into floating interest rate obligations.<sup>12</sup> This is an example of a liability-based swap strategy. Alternatively, A may own a fixed interest rate asset, a General Motors debenture for example, and B may own a floating interest rate asset, a LIBOR-based bank deposit note for example, and each may wish, by entering into the swap, to convert its "real" asset into a "synthetic" floating rate asset, in the case of A, or "synthetic" fixed rate asset, in the case of B. This would be an example of an asset-based swap strategy.

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10. A and B are assumed to be accrual basis taxpayers throughout this article.

11. In practice, in order to limit B's exposure to A's credit risk, both the fixed and floating payments would generally be made on a quarterly basis and would be netted (i.e., depending on the relationship of current LIBOR rates to the 10% fixed rate under the swap, either A or B, but not both, would make a payment each quarter). The examples in the text provide for only one fixed swap payment each year in order to make the analyses somewhat easier to follow.

12. Because of market imperfections, for example, A may be unable to borrow on a fixed rate basis in the public or private debt markets, or may be able to borrow in those markets only at a rate substantially in excess of 10%. Similarly, imperfections in the debt markets may prevent B from borrowing at 90-day LIBOR rates. The use of swaps can allow both parties to borrow, on a net basis, at more attractive interest rates, thereby increasing the overall efficiency of the markets for borrowed funds.

## B. *The Use of Interest Rate Swaps to Create Synthetic Tax-Advantaged Assets*

As described in Part II(A) *supra*, swaps can be used to create “synthetic” assets. For example, suppose A owns a \$1,000 principal amount U.S. Treasury bond that pays 10% interest per year and matures in two years. A likes the credit characteristics of this bond but, because A believes interest rates will rise over the next two years, wishes to convert the fixed rate return on the bond into a LIBOR-based floating rate return. Accordingly, A enters into the asset-based interest rate swap described in Part II(A) *supra*.

Economically, A has created a synthetic two-year bond that pays interest quarterly based on current 90-day LIBOR interest rates and that provides for a bullet \$1,000 payment of principal, “guaranteed” by the U.S. government, at the end of two years. Thus, if the LIBOR-based payments made by B in a given year equal \$110 (i.e., 11% of the swap’s notional principal amount of \$1,000), A’s net economic income from the swap will equal \$10 (i.e., \$110 received from B *minus* \$100 of fixed payments made by A). This net economic income coupled with the \$100 (i.e., 10% of the bond’s principal amount of \$1,000) of interest received on the bond that year results in A’s receiving a total of \$110, equal to the amount of the LIBOR-based payments received from B. Conversely, if the LIBOR-based payments in any given year equal \$90 (i.e., 9% of the swap’s notional principal amount of \$1,000), A’s net economic income from the swap will equal a loss of \$10 (i.e., \$90 received from B *minus* \$100 of fixed payments made by A). Again, this net economic loss coupled with the \$100 of interest received by A on the bond results in A’s economic income being \$100 *minus* the loss of \$10, or \$90, the amount of the LIBOR-based payments.<sup>13</sup>

For income tax purposes, however, the interest on the U.S. Treasury bond and the net income or loss from the interest rate swap are accounted for separately.<sup>14</sup> Thus, each year A (i) includes the interest income on the bond in taxable income and (ii) includes, or deducts, as the case may be, the net

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13. The reason for these results is that A’s \$100 per year liability to B under the swap is exactly offset, as an economic matter, by A’s right to receive \$100 of interest each year on the bond, leaving A with annual net income equal to the amount of the LIBOR-based payments received from B that year under the swap.

14. Compare Regs. § 1.988-5(a) (allowing a taxpayer to integrate a nonfunctional currency debt instrument or obligation and certain types of hedges to create a synthetic asset or liability, which is then taxed as if it were a real asset or liability) with Preamble to Prop. Regs. § 1.446-3, 56 Fed. Reg. 31,350 (1991) (stating that the Internal Revenue Service “is considering whether to permit taxpayers to account for a notional principal contract and the asset or liability that the notional principal contract hedges on an integrated basis”).

swap payments in, or from, taxable income.<sup>15</sup> The combination each year of the bond interest income *plus* (or *minus*) the net swap income (or deduction) will equal the amount of the LIBOR-based payments to be made by B for such year.<sup>16</sup> Thus, A's economic income and taxable income will be the same each year, and will be the same as would have been the case if A had purchased a LIBOR-based bond having the same payment terms as the synthetic bond created through the combination of the bond and the interest rate swap.

Now assume that, rather than purchasing a U.S. Treasury bond, A purchases a municipal bond, the interest on which is excludable from A's income pursuant to section 103.<sup>17</sup> In that case, A's economic income each year will still equal the LIBOR-based payments received from B that year. But now, the combination of the tax-free interest income on the bond and the net income/deduction from the swap results in A's taxable income being \$100 less than its economic income each year. For example, if the LIBOR-based payments in a given year equal \$110, the net swap income for the year will still equal \$10. The combination of this net swap income with the \$100 of tax-free interest received on the bond results in taxable income to A of only \$10, which is \$100 less than A's economic income for that year. Similarly, if the LIBOR-based payments equal \$90, the net swap deduction for the year will equal \$10; this, plus the \$100 of tax-free interest received on the bond, results in A's recognizing a net taxable loss of \$10 for the year, which is \$100 less than A's economic income.<sup>18</sup> Thus, even though the pre-tax pay-

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15. Prop. Regs. § 1.446-3(e)(1), 56 Fed. Reg. 31,350 (1991). The swap will give rise to net income in any year in which the LIBOR-based payments received from B exceed the fixed payments made by A; conversely, the swap will give rise to a net deduction in any year in which the LIBOR-based payments are less than the fixed payments.

16. For example, if the LIBOR-based payments made by B equal \$110, A's net taxable income from the swap will equal \$10 (i.e., \$110 received from B *minus* \$100 of fixed payments made by A under the swap). Coupled with the \$100 of bond interest received by A results in A's net taxable income being \$110, the amount of the LIBOR-based payments under the swap. If, alternatively, the LIBOR-based payments equalled only \$90, A would have a net deduction of \$10 with respect to the swap (i.e., \$90 received *minus* \$100 paid), which, coupled with the \$100 of bond interest income, results in net taxable income of \$90, again, the amount of the LIBOR-based payments.

17. Also assume that A is a corporation so that net swap payments are deductible under section 162, not section 212, and section 265(a)(1) will therefore not apply.

18. As discussed in note 13 *supra*, as an economic matter, A's obligation under the swap to make a \$100 fixed payment to B each year is exactly offset by A's right to receive \$100 of coupon interest on the tax-exempt bond, resulting in A's economic income being equal to the amount of the LIBOR-based payments received from B. For tax purposes, however, the \$100 fixed payment under the swap is deductible against the LIBOR-based payments received from B (or, if B's payments are less than A's payment, from other income), which, coupled with the \$100 of excludable interest on the bond, results in A's taxable income always being

ment stream of the synthetic asset in this second example is the same as that in the first, the tax treatment of the two synthetic assets is very different. In essence, by using a tax-exempt bond as one leg of the transaction, A has been able to create a synthetic LIBOR-based bond the income from which is tax-exempt to the extent of the 10% interest earned on the tax exempt bond.<sup>19</sup>

The same strategy could be employed using other tax-advantaged assets as one part of the bond/swap strategy. For example, under the market discount rules of sections 1276-1278, an investor is not required to include market discount on a bond<sup>20</sup> in income until the bond is retired or otherwise disposed of, or until the investor receives principal payments on the bond.<sup>21</sup> The universe of outstanding market discount bonds at any given time is limited and an investor, although aware of the tax advantages of owning such a bond,<sup>22</sup> may be unable to find a bond that matches its investment profile. By buying a market discount bond and simultaneously entering into a swap, however, an investor can create a synthetic market discount bond, one that retains the tax advantages of the original but has non-tax characteristics more to the investor's liking.

For example, assume that on January 1 of Year 1 A purchases on the open market a U.S. Treasury obligation having a remaining term to maturity of two years, and that the Treasury obligation bears coupon interest of 5% at a time when prevailing Treasury interest rates are 10%. Thus, in general, the Treasury bond will sell at a market discount designed to give the holder a 10% pre-tax yield to maturity.<sup>23</sup> Assuming a remaining term to maturity of

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\$100 less than its economic income. As discussed *infra*, since payments under the swap would not constitute interest for tax purposes, section 265(a)(2) would not apply to disallow a deduction for such payments.

19. Note that under the integration approach of Regulations section 1.988-5(a), a synthetic asset is taxed as if it were a real asset, without regard to the tax treatment of its constituent parts. If this approach were applied to the examples in the text, the taxable bond/swap and tax-exempt bond/swap transactions would be taxed identically (i.e., A would not benefit from the tax exemption with respect to the bond interest and would be taxed on the full amount of the payments received from B each year).

20. Subject to a *de minimis* rule, section 1278(a)(2) defines market discount as the excess, if any, of a bond's stated redemption price at maturity over a taxpayer's tax basis in the bond immediately after its acquisition.

21. IRC § 1276(a). This assumes, of course, that the investor does not elect under section 1278(b) to include market discount in income on a current basis.

22. This ignores the fact that the bond may bear "implicit taxes," that is, that the bond may be priced at a lower pre-tax yield than comparable, newly-issued bonds to account for the benefit of being able to defer the inclusion of market discount in taxable income. See generally Scholes & Wolfson, *supra* note 9.

23. Again, this ignores the fact that the ability to defer market discount income may be capitalized into the price of the Treasury obligation, resulting in a less-than-10% pre-tax yield to maturity.



two years, a \$1,000 principal amount bond yielding coupon interest of 5% per annum (i.e., \$50.00 per year) would sell for approximately \$913.22, resulting in market discount of \$86.78. At the same time, suppose A and B enter into a two-year, \$913.22 notional principal amount interest rate swap pursuant to which (i) A is obligated to pay B \$50.00 on December 31st of Year 1 and \$136.78 on December 31st of Year 2, and (ii) B is obligated to pay A an amount on March 31st, June 30th, September 30th and December 31st, respectively, of each year equal to the product of \$913.22 and the 90-day LIBOR interest rate for the period, as calculated on the first day of the second preceding month.<sup>24</sup> The following table compares A's economic and taxable incomes each year from entering into the transaction:

A. Economic Income:

Year 1

(1) Coupon Interest:	\$50.00
(2) Market Discount:	41.32 <sup>25</sup>
(3) Net Swap Income:	Aggregate Amount of B's Payments <i>minus</i> \$91.32 <sup>26</sup>
TOTAL	Aggregate Amount of B's Payments

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24. A is effectively obligated to pay B under this "deferred coupon" swap at an overall 10% (compounded) fixed rate. Only a portion of the first year's return, equal to 5.475% of the original notional principal amount of \$913.22, however, is required to be paid in the first year; the rest accrues and, in essence, increases the notional principal amount to which the 10% rate is applied in the second year. Thus, in the first year, A's liability to B is \$91.32 (10% of \$913.22), \$50.00 (5.475% of \$913.22) of which is paid currently and the rest of which (\$41.32) accrues, effectively increasing the notional principal amount for purposes of calculating A's liability to B in the second year, but *not* B's liabilities to A, from \$913.22 to \$954.54. At the end of Year 2, then, A is required to pay B \$136.77, equal to the sum of (i) \$95.45 (10% of \$954.54), and (ii) \$41.32, the accrued but unpaid amount from Year 1. The slight difference between \$136.77 and \$136.78, the number in the text, is due to rounding error.

Under Proposed Regulations sections 1.446-3(e)(3)(ii)(A) and (e)(3)(ii)(D), 56 Fed. Reg. 31,350 (1991), A would generally be entitled to deduct \$91.32 in Year 1 (i.e., the amount that economically accrued in Year 1 with respect to A's obligations to B under the swap), and \$95.45 in Year 2 (i.e., again, the amount that economically accrued in Year 2 with respect to A's obligations to B) with respect to its obligations to pay B, and would include in income each year the amounts receivable from B in that year. Technically, under Proposed Regulations section 1.446-3(e)(1), these items would be netted to determine A's net income or deduction from the swap each year.

25. I.e., 10% (the pre-tax yield) of \$913.22 (the purchase price for the Treasury obligation), or \$91.32, *minus* coupon interest of \$50.00.

26. This takes into account the amount that accrues each year with respect to A's obligations to B under the swap. See *supra* note 24.

## Year 2

(1) Coupon Interest:	\$50.00
(2) Market Discount:	45.45 <sup>27</sup>
(3) Net Swap Income:	Aggregate Amount of B's Payments <i>minus</i> \$95.45 <sup>28</sup>
TOTAL	Aggregate Amount of B's Payments

TOTAL over two-year period: Aggregate amount of B's payments over two-year term of swap.

## B. Taxable Income:

## Year 1

(1) Coupon Interest:	\$50.00
(2) Market Discount:	0
(3) Net Swap Income:	Aggregate Amount of B's Payments <i>minus</i> \$91.32 <sup>29</sup>
TOTAL	Aggregate Amount of B's Payments <i>minus</i> \$41.32

## Year 2

(1) Coupon Interest:	\$50.00
(2) Market Discount:	86.78
(3) Net Swap Income:	Aggregate Amount of B's Payments <i>minus</i> \$95.45 <sup>30</sup>
TOTAL	Aggregate Amount of B's Payments <i>plus</i> \$41.33 <sup>31</sup>

TOTAL over two-year period: Aggregate amount of B's payments over two-year term of swap.

Thus, compared to A's economic income, A's taxable income is understated by \$41.32 in Year 1 and overstated by the same amount in Year 2. This \$41.32 is, of course, the amount of market discount that accrued on the U.S.

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27. I.e., 10% (the pre-tax yield) of \$954.54 (\$913.22 purchase price for the Treasury obligation *plus* \$41.32 of accrued but unpaid market discount from Year 1), or \$95.45, *minus* coupon interest of \$50.00.

28. See *supra* note 24.

29. See *supra* note 24.

30. See *supra* note 24.

31. Again, the difference between \$41.32 and \$41.33 is due to rounding error.

Treasury obligation in Year 1 but was not required to be included in A's taxable income until Year 2.

As in the tax-exempt bond example, the combination of the market discount bond and the swap results in the creation of a synthetic tax-advantaged asset, one that has the non-tax characteristics of a non-market discount LIBOR-based floating rate debt instrument but that preserves the favorable tax characteristics of the market discount bond. A's obligation to make fixed payments to B under the swap is fully offset as an economic matter by A's right to receive the coupon interest and market discount component of the principal payment on the bond. Nevertheless, the combination of a current deduction for the fixed swap payments and the deferred treatment of the market discount on the bond results in A's essentially being able to convert other income into tax-deferred market discount.<sup>32</sup> The combination of deferring taxable income with respect to an asset, while taking a current deduction with respect to an offsetting liability, resulting in a conversion of non-tax advantaged income into tax-advantaged income, is a hallmark of tax arbitrage strategies.<sup>33</sup>

It might be argued that there is nothing abusive about this transaction since it simply "substitutes" a synthetic market discount obligation for a real one without increasing the aggregate amount of market discount in the universe.<sup>34</sup> Nevertheless, there is something troubling about all this. In

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32. In particular, to the extent the LIBOR-based payments received from B on the swap are at least \$41.32 in Year 1, A will be able to convert \$41.32 of those payments into tax-deferred market discount. If, because of the prevailing level of the LIBOR, payments from B in Year 1 are less than \$41.32, A will be able to defer other (non-swap related) income.

Because the term of the swap and the remaining term of the Treasury obligation are only two years, the example in the text provides for only a one-year deferral. By using longer term swaps and market discount obligations, of course, synthetic assets could be created that provide for greater periods of deferral. Indeed, because changes in interest rates cause larger changes in the prices of longer-term bonds relative to shorter-term bonds, thereby maximizing the amount of resulting market discount, the strategy may be "optimized" by using longer-term swaps and market discount bonds.

33. Unlike classic tax arbitrage strategies, of course, the swap/bond examples discussed in the text require A to enter into a second long position (i.e., the right to receive LIBOR-based payments from B under the swap), which arguably makes such transactions non-abusive or, at least, far less abusive than classic tax arbitrage strategies.

34. This statement, of course, is not strictly true. More precisely, the *potential* supply of market discount bonds is limited at any given time by the level of prevailing interest rates and the payment terms of existing bonds held by investors. However, because a bond is considered a market discount bond, within the meaning of section 1278, only if the holder's tax basis in the bond is less than the bond's stated redemption price at maturity, the quantity of *actual* market discount bonds extant will be increased if "high basis" investors can be induced to sell their depreciated bonds to new "low basis" investors. Such sales will also, of course, generate deductible losses for the "high basis" sellers. Allowing investors to customize their investments through the simultaneous holding of a market discount bond and an interest

particular, inasmuch as the original decision by Congress *not* to require market discount to be included in income on a current basis was based on concerns about administrative convenience,<sup>35</sup> it seems somewhat anomalous that such concerns should prevail here where the parties are obviously economically sophisticated and the swap tax accounting rules themselves, as provided in Proposed Regulations section 1.446-3, 56 Fed. Reg. 31,350 (1991), seem to be animated more by a desire to measure income accurately than by concerns about simplicity.<sup>36</sup> Nevertheless, it is hard to identify any particular provision of the Code or the regulations that would be violated by

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rate swap should enhance the efficiency of the market discount bond "market" and result in the creation of more market discount bonds. A similar analysis would apply to the tax-exempt bond market.

35. See H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, at 1170 (1984).

36. See, e.g., Prop. Regs. § 1.446-3(e)(3)(ii)(B) and (e)(3)(ii)(C), 56 Fed. Reg. 31,350 (1991) (requiring, in certain circumstances, that "nonperiodic payments" with respect to a swap, cap or floor be spread over the life of the contract "in accordance with the values of a series of cash-settled forward contracts [or, in the case of caps and floors, option contracts] that reflect the specified index and the notional principal amount"). While it is true that the proposed regulations do provide for certain optional methods for amortizing swap, cap and floor premiums in the interest of "simplicity," see, e.g., Prop. Regs. § 1.446-3(e)(3)(ii)(D), this type of "simplicity" is clearly different than the kind envisioned by Congress when it allowed investors to defer the inclusion of market discount in income.

Two other points might also be made with respect to the examples in the text. First, one might argue that, under general principles, the right to claim the section 103 exclusion with respect to the interest on the tax-exempt bond inures to A as the (tax) owner of that bond. By entering into the swap A has *not* divested itself of such ownership, see Part II(C)(2) *infra*; taxing A on its net economic income from the overall tax-exempt bond/swap transaction, however, would effectively deny A the benefit of the section 103 exclusion. A similar argument might be made with respect to A's right to continue deferring market discount in the market discount bond/swap example. This, however, proves too much. For example, even if the owner of a tax-exempt bond borrows on a fully recourse basis, so that it is unquestionable that the investor retains ownership of the bond, section 265(a)(2) operates to prevent the owner from combining (taxable) interest deductions with tax-exempt interest inclusions to convert unrelated taxable income into tax-exempt interest income.

Second, one might analogize the combination of a bond and a swap to an interest coupon stripping transaction under section 1286. Thus, by entering into the swap, A has effectively transferred the economic benefit of the interest coupons (and, in the market discount bond example, the market discount) on the bond to B. (This is not to say, however, that the bond/swap transactions are tantamount to a stripping transaction. They are not, since in a stripping transaction, unlike a swap transaction, A would have transferred tax ownership of a portion of the bond to B. Cf. Part II(C)(2) *infra*.) In that case, however, section 1286(d) would require that the section 103 exclusion be split between the holder of the stripped coupons, B, and the holder of the stripped principal, A. In the example in the text, however, A has been able to retain 100% of the tax exemption. Similarly, the stripping of a market discount bond converts market discount into original issue discount and therefore eliminates the deferral possibilities. See IRC § 1286(a) (treating stripped bond as newly issued on purchase date for purposes of the original issue discount rules).

the transactions described above.<sup>37</sup>

For example, section 1277 defers all or a portion of a taxpayer's interest deduction with respect to indebtedness incurred or continued to acquire or carry a market discount bond. The purpose of this rule is to prevent taxpayers from converting unrelated income into tax-deferred market discount income, in other words, to prevent tax arbitrage.<sup>38</sup> Interest expense for this purpose includes not only interest incurred on borrowings, but also expenses attributable to short sales.<sup>39</sup> Nevertheless, except in certain unusual circumstances,<sup>40</sup> expense from an interest rate swap is not generally considered to be interest for purposes of the Code.<sup>41</sup> Thus, it appears that

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37. In general, any such transaction would have real non-tax significance. Thus, it is hard to see how the Internal Revenue Service (the "Service") could challenge these transactions on "substance over form," "sham transaction" or "step transaction" grounds, or on the basis that they lacked bona fide business purposes or a profit-making potential.

38. H.R. Rep. No. 432, *supra* note 35.

39. IRC § 1277(c).

40. See, e.g., Prop. Regs. § 1.446-3(e)(4)(iii), 56 Fed. Reg. 31,350 (1991) (dealing with swaps having "significant nonperiodic payments" that are treated as having "embedded loans"); cf. Regs. § 1.861-9T(b) (dealing with interest equivalents for purposes of calculating domestic and foreign source interest expense).

41. For example, the Preamble to Proposed Regulations section 1.446-3, 56 Fed. Reg. 31,350 (1991), states that "[b]ecause the notional principal amount is not exchanged by the parties, the payments due under a typical interest rate swap, cap, or floor are not compensation for the use or forbearance of money and therefore are not 'interest'."

It is possible, however, that \$4.13 of A's Year 2 payments (10% of the \$41.32 obligation accrued in Year 1 but not paid until Year 2) could be recharacterized as interest. See Prop. Regs. § 1.446-3(e)(4)(iii). Furthermore, the longer the term of the deferred coupon swap and therefore the greater the amount that is deferred and the period of deferral, the greater the amount that could be recharacterized as interest. Nevertheless, depending on the circumstances, any such recharacterization might not have a material effect on the overall transaction. Section 1277 only defers a deduction with respect to the "net direct interest expense" with respect to a market discount bond. The net direct interest expense is the excess, if any, of (i) the amount of interest paid or accrued during a taxable year on indebtedness incurred or continued to purchase or carry the bond over (ii) the aggregate amount of interest, including original issue discount, includable in gross income for the taxable year with respect to the bond. IRC § 1277(c). Only the portion of the swap payments recharacterized as interest would be taken into account for purposes of clause (i), while the full amount of coupon interest and original issue discount on the bond would be taken into account for purposes of clause (ii). For example, assuming a market discount bond paying interest of \$50 per year, swap expense recharacterized as interest would be limited only to the extent it exceeded \$50 in any given year. However, assuming deferred amounts under the swap compound at a 10% (pre-tax) yield, this would only occur if and to the extent the aggregate of the amounts deferred under the swap in earlier years exceeded \$500. Second, particularly given the separate (nonintegrated) treatment of the swap and the bond for tax purposes, it is far from clear that swap expense recharacterized as interest would be considered attributable to indebtedness incurred or continued to purchase or carry the market discount bond. Rather, one might view these amounts as attributable to loans by B to A with respect to the swap.

section 1277 does not apply to defer A's deduction for the fixed payments under the interest rate swap in the example.

Alternatively, perhaps the straddle rules of section 1092 apply. The straddle rules were enacted in 1981 in order to stop certain tax-motivated straddle transactions. These transactions generally involved the manipulation of the "realization" requirement. Thus, an investor might enter into offsetting long and short future contracts with different delivery dates on gold or some other commodity. Subsequent changes in the market price for the underlying commodity would create a built-in gain or loss in the long position, and an (almost exactly) offsetting loss or gain in the short position. Thus the overall net loss or gain in the taxpayer's economic position was likely to be minimal. Nevertheless, by disposing of the loss leg of the straddle, while retaining the gain leg, the investor could create a taxable loss that could be used to shelter unrelated income, generally, short-term capital gains.<sup>42</sup> In this way, the taxpayer was able to defer such unrelated income and frequently convert it from short-term into preferentially-taxed long-term capital gain.<sup>43</sup>

Under section 1092(a),

[a]ny loss with respect to 1 or more [straddle] positions shall be taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain (if any) with respect to 1 or more [other] positions which were offsetting positions with respect to [the] 1 or more positions from which the loss arose.

Any loss disallowed under this provision is carried forward and treated as a loss arising in the next succeeding taxable year, when it will again be subject to the rules of section 1092(a). Section 1092(d)(2) defines a "position" as "an interest (including a futures or forward contract or option) in personal property." Section 1092(d)(1) defines "personal property" to mean "any personal property of a type which is actively traded." Finally, section 1092(c)(2) provides that

[a] taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other

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42. Cf. *supra* text accompanying note 32.

43. Moreover, by entering into a new (long or short) leg to replace the (long or short) leg of the straddle that had been disposed of, the taxpayer would be able to reestablish its hedged economic position, which results from concurrently holding offsetting long and short positions.

positions with respect to personal property (whether or not of the same kind).

Application of section 1092 to the transactions described above thus involves a series of technical and definitional questions. The first question is whether an interest rate swap can be a "position" for purposes of section 1092. This question, which was in some doubt prior to the issuance of Proposed Regulations section 1.1092(d)-1(c), 56 Fed. Reg. 31,350 (1991), was addressed in that provision of the proposed regulations. It states that a notional principal contract "constitutes personal property of a type that is actively traded if similar contracts are actively traded" in an interdealer market or other financial market and that "the rights and obligations of a party to a notional principal contract constitute an interest in personal property." Proposed Regulations section 1.1092(d)-1(b)(6) states that "[a]n interdealer market is characterized by a system of general circulation which regularly disseminates price quotations or pricing information by identified dealers, brokers, or traders." The proposed regulations do not define a dealer, broker or trader, but Proposed Regulations section 1.446-4(b), 56 Fed. Reg. 31,350 (1991), issued at the same time as Proposed Regulations section 1.1092(d)-1(b)(6), states that a dealer or trader in derivative financial instruments (such as swaps) includes a person that "[m]akes a market in derivative financial instruments by regularly and actively offering to enter into, offset, assign, or otherwise terminate positions in those instruments with customers in the ordinary course of its trade or business."<sup>44</sup> Because most swap transactions are, in fact, intermediated by investment and commercial banks that regularly quote rates for entering into swaps and act as middlemen between the ultimate counterparties to the swap,<sup>45</sup> it is likely that, if this

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44. Technically, the definition contained in Proposed Regulations section 1.446-4 applies only for purposes of that section.

45. Generally, the investment or commercial bank in the middle will act in a principal capacity with respect to each counterparty. Thus, the bank will be taking each party's credit risk and will be required to perform its obligations under the swap regardless of a default or delinquency by the counterparty on the other side of the transaction. For obvious commercial reasons, a bank acting in a principal capacity will not generally reveal to either counterparty the terms of, or the identity of the counterparty with respect to, the other leg of the transaction.

The swap market is described as follows in the Preamble to the Proposed Regulations sections 446 and 1092, 56 Fed. Reg. 31,350 (1991):

A notional principal contract may be entered into directly with another principal end-user. More commonly, however, the counterparty to the contract is a commercial or investment bank that acts as a "dealer" in such contracts. The dealer typically creates a portfolio of notional principal contracts and seeks to maintain a balanced market position. Notional principal contract dealers provide liquidity for the market by standing

definition of dealer or trader were to apply for purposes of section 1092, most swaps would constitute property “of a type” that is actively traded in an interdealer market. Indeed, perhaps based on this type of analysis, the Preamble to the Proposed section 1092 Regulations concludes that “notional principal contracts are generally actively traded personal property” for purposes of section 1092.

The next question is whether the swap and the bond are offsetting positions? Certainly, the swap and the bond are, in fact, economically offsetting positions. This follows ineluctably from the fact that A is required to pay to B under the swap amounts equal to the coupon interest and the market discount component of the principal payment on the bond. Thus, if interest rates fall (rise), the value of the bond will increase (decrease), while A’s obligation to pay B fixed amounts under the swap will increase (decrease) on a present value basis by an offsetting amount. Since the bond is an asset, while A’s obligation to make payments to B under the swap is a liability, an increase in the former is offset by an increase in the latter.<sup>46</sup>

The final question, however, is whether the net deductions generated with respect to the interest rate swap constitute “losses” for section 1092(a) purposes. It is difficult to consider those net deductions as losses for tax purposes. The Regulations under section 1092 refer to “dispositions” of loss positions and define a disposition as including the “sale, exchange, cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property....”<sup>47</sup> Payments under a swap would not seem to be dispositions unless each payment is treated as a discrete obligation. In that case, however, unless the payor were a dealer in swaps (or in the rare case where the swap did not constitute personal property under section 1092), payments under the swap would give rise to capital loss deductions pursuant to section 1234A(1), which would certainly be a surprising result. More importantly, section 1092 defines losses by reference to section 165(a), the general section governing deductions for losses; payments under a swap are presumably deductible pursuant to section 162, not section 165(a).

Moreover, Proposed Regulations section 1.446-3, 56 Fed. Reg. 31,350 (1991), itself seems to distinguish between net income or deduction from a swap for each taxable year and the gain or loss recognized on a sale, termination, assignment or other disposition of the swap. For example,

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ready to enter into these contracts with any qualified party at any time.

46. The changes in the present values of the bond and swap resulting from changes in interest rates will not be exactly offsetting, of course, since A is entitled to receive all the interest and principal on the bond, while A is only obligated to pay over amounts under the swap equal to interest and the market discount component of the principal payment on the bond.

47. Temp. Regs. § 1.1092(b)-5T(a).



Proposed Regulations section 1.446-3(e)(1), 56 Fed. Reg. 31,350 (1991), states that the "net income or deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year." Throughout the proposed regulations, the phrase "net income or deduction" is used to refer to those taxable items arising from payments received or made according to the terms of the notional principal contract itself. In the examples dealing with the treatment of "termination payments" (i.e., payments made to extinguish or assign a notional principal contract), however, the proposed regulations speak uniformly of the parties recognizing gain or loss for tax purposes on the termination of the notional principal contract.<sup>48</sup> This is also consistent with other areas of the tax law. For example, rental expense incurred by a lessee would generally not be considered to be a loss with respect to the lessee's leasehold interest. Rather, the lessee would generally be considered to recognize gain or loss on a disposition of its leasehold interest. Thus, it appears to be a "stretch" to treat the net deductions from a swap as losses for purposes of section 1092.<sup>49</sup>

Finally, perhaps Proposed Regulations section 1.446-3(e)(4)(ii) applies to disallow all or a portion of the deductions with respect to A's obligations to make fixed payments under the interest rate swap. That regulation provides that "the Commissioner may require that amounts paid to or received by the taxpayer under ...[a] notional principal contract" that is hedged by the taxpayer's "purchasing, selling or otherwise entering into other notional principal contracts, futures, forwards or *other financial instruments* be treated in a manner that is consistent with the economic substance of the transaction as a whole."<sup>50</sup> Perhaps, the Service could exercise its authority under this

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48. Prop. Regs. § 1.446-3(e)(6)(vi) ex. 1-3, 56 Fed. Reg. 31,350 (1991). It is perhaps significant that the only reference to section 1092 in Proposed Regulations section 1.446-3 is in the context of terminations of notional principal contracts.

49. Section 1092 would, of course, still potentially apply to defer losses arising on the termination of a swap.

Arguably, the language of the Preamble to the Proposed section 1092 Regulations, 56 Fed. Reg. 31,350 (1991), suggests the Service intended that section 1092 cover cases other than those arising on a termination of a notional principal contract. The Preamble states:

Thus, under the proposed regulations, a loss realized with respect to a notional principal contract would not be recognized under section 1092(a) to the extent the taxpayer has an unrecognized gain in one or more offsetting positions. Further, the gain or loss realized through the termination (through extinguishment or assignment) of a taxpayer's rights and obligations under a notional principal contract would generally be treated as gain or loss from the sale of a capital asset under section 1234A.

Query whether the reference to gain or loss "realized through termination," found in the second sentence but not the first, is intended to imply that there are gains or losses that arise other than through terminations of notional principal contracts.

50. Prop. Regs. § 1.446-3(e)(4)(ii), 56 Fed. Reg. 31,350 (1991) (emphasis added).

regulation by requiring that A integrate the market discount (or tax-exempt) bond and the swap to create a (fully taxable) LIBOR-based synthetic debt obligation.

Nevertheless, it is doubtful that Proposed Regulations section 1.446-3(e)(4)(ii) should be applied in this fashion. Few endusers of interest rate swaps ever enter into unhedged, naked swap positions: interest rate swaps are almost always used as part of a liability or asset-based strategy and are therefore hedged by some other (long or short) position held by the taxpayer.<sup>51</sup> Thus, unless Proposed Regulations section 1.446-3(e)(4)(ii) was designed to swallow up the more detailed tax accounting rules set forth in the other provisions of Proposed Regulations section 1.446-3, it is unlikely that the regulation was intended to apply to integrate swaps and the assets or liabilities that they hedge for purposes of determining the taxpayer's taxable income.<sup>52</sup> This interpretation of the purpose of the provision is supported by the language of the regulation itself, as well as the examples in Proposed Regulations section 1.446-3(e)(4)(v) illustrating its application.

The regulation speaks of treating the "amounts paid to or received by the taxpayer under the notional principal contract" in accordance with their economic substance. The implication is that certain payments that are purportedly made pursuant to a notional principal contract may be recharacterized as something else if, given the overall transaction, they are more properly characterized as such.<sup>53</sup> For example, Example 4 of Proposed

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51. See Preamble to Prop. Regs. § 1.446-3, 56 Fed. Reg. 31,350 (1991) ("The Service is aware of the fact that many notional principal contracts are used to hedge assets or liabilities, and it is considering whether to permit taxpayers to account for a notional principal contract and the asset or liability that the notional principal contract hedges on an integrated basis").

52. On the other hand, the regulation is permissive, not mandatory (i.e., the Commissioner "may," but is not required to, treat the transaction according to its economic substance).

53. Proposed Regulations section 1.446-3(e)(4)(ii), 56 Fed. Reg. 31,350 (1991), also prohibits a taxpayer from using certain methods for amortizing "nonperiodic payments made or received with respect to the hedged notional principal contract." Once again, given the fact that substantially all interest rate swaps hedge some other financial asset or liability, it is hard to believe that this provision was intended to apply to the example in the text. (Note that this rule, unlike the "economic substance" rule of Proposed Regulations section 1.446-3(e)(4)(ii), is mandatory.) However, if this provision were to apply to the interest rate swap/market discount bond example discussed in the text, it is at least possible that A would be prevented from deducting in Year 1 more than \$50.00, the amount actually payable by A to B in that year. Nevertheless, if this were a problem, the fundamental economics and desired tax treatment of the transaction could be preserved by having A and B enter into (i) a "current coupon" swap, pursuant to which A would pay B each year \$91.32 and B would pay A LIBOR-based payments quarterly (based on a \$913.22 notional principal amount) and (ii) a separate loan agreement, whereby B would loan A \$41.32 at the end of Year 1, repayable with 10% interest at the end of Year 2. A similar approach could be used in the case of longer-term

Regulations section 1.446-3(e)(4)(v) applies this “economic substance” rule in a situation where a taxpayer simultaneously enters into two offmarket<sup>54</sup> swaps with different counterparties and receives an upfront payment from each counterparty. By viewing the two swaps together, Example 4 concludes that the overall transaction is equivalent to a fixed rate borrowing by the taxpayer and recharacterizes the upfront payments as loan proceeds.<sup>55</sup>

### C. Equity Swaps

1. *Basic Mechanics.*—Interest rate and currency swaps were the original types of notional principal contracts. In recent years, more sophisticated types of swap products have been developed. Many of these are equity-based. For example, assume that A and B enter into an equity swap based on the all-in return (dividend yield and net price change) in the Dow Jones Industrial Average (“DJIA”). At the end of each month, A is required to pay B (i) an amount equal to the net increase, if any, in the DJIA over the course of that month (determined by comparing the value of the DJIA at the close of the last trading day of the month (the “closing value”) with the value of the DJIA at the close of the last trading day of the preceding month (the “beginning value”) and (ii) an amount equal to the aggregate amount of dividends declared and paid during that month on the underlying stocks making up the DJIA. Similarly, each month B is required to pay A (i) an amount equal to the net decrease, if any, in the DJIA over the course of the month (determined by comparing the closing value and the beginning value) and (ii) an amount equal to the product of the 30-day LIBOR interest rate for the period (determined at the beginning of the month) and the beginning value. What if A were to enter into this swap at the same time it owned the basket of stocks making up the DJIA,<sup>56</sup> such stocks having a current aggregate fair market value of \$1,000x? By entering into the equity swap,<sup>57</sup>

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market discount bond/swap transactions.

54. An offmarket swap is one where the present values of each counterparty’s required payments under the swap are not equal, generally as a result of one counterparty’s payments being based on an interest rate index that differs from current market interest rates. In order to equalize the two legs of the swap, the counterparty entitled to receive the stream of swap payments having a greater present value is required to make an upfront payment to the other counterparty.

55. See also Prop. Regs. § 1.446-3(f) (a general anti-abuse rule allowing the Service to account for a transaction in a manner necessary to clearly reflect a taxpayer’s income where the “taxpayer enters into a transaction that is not a customary commercial transaction”). I suggest that the transaction discussed in the text *would* constitute a “customary commercial transaction.”

56. More precisely, A would own one share of each stock included in the DJIA.

57. Technically, this would be an equity index swap since it is based on a

A would have been able to insulate itself from all (positive or negative) movements in the DJIA, and would have converted the return on its \$1,000x investment in the underlying stocks from an equity-based return into a debt-like return based on LIBOR: thus, A would, in effect, have created a synthetic fixed income (debt) position. B, on the other hand, now holds a position that mimics the performance of the underlying stocks.

This raises at least three issues concerning the tax consequences to A. First, by entering into the swap, will A be considered to have disposed of the underlying stocks for tax purposes? Second, will A be entitled to deduct payments made to B with respect to positive movements in the DJIA? If it can, A may be able, once again, to create a synthetic tax-advantaged asset. Third, if A is a corporation, will A be entitled to claim the dividends-received deduction (the "DRD") under Section 243 with respect to dividends received on the underlying stocks, while at the same time deducting the swap payments made to B with respect to such dividends? If so, all sorts of tax arbitrage possibilities will have been created. The next three subparts will discuss each of these issues in turn. Then the issue of withholding taxes and equity swaps will be discussed.

2. *Deemed Disposition of the Underlying Stocks.*—Many investment bankers tout equity swaps as a convenient means for investors to alter the composition of their investment portfolios without incurring the transaction costs and taxes incident to an actual sale of the underlying stocks and the reinvestment of the proceeds in fixed income securities. This, assumes, of course, that entering into the equity swap will not constitute a disposition of the underlying stocks for tax purposes. Is this a correct view?

On the one hand, by entering into the swap, A has effectively insulated itself from the future price and dividend performance of the underlying stocks, and converted the return on its investment from an equity-based return into a debt-based return, and B has acquired a financial asset whose return (positive or negative) matches the performance of the underlying stocks. Perhaps, then, A should be treated as having sold the stocks to B in exchange for B's LIBOR-based payments. On the other hand, applying the traditional tests for determining who is the owner of assets for tax purposes and absent special circumstances,<sup>58</sup> it is hard to see how B could be treated

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recognized stock index, rather than on the performance of one or more discrete stocks.

58. For example, this assumes that (i) A has not granted B a voting proxy, or any type of call option or forward or futures contract, with respect to the underlying stocks, (ii) A is a creditworthy party and that A's obligations under the swap are fully recourse to A and its assets, and A is not required to deposit in escrow, grant B a pledge or other security interest in, or give B possession of, the stocks in order to secure its performance under the swap, (iii) A is not required to continue to own all or any portion of the existing stock portfolio, B has

as the owner of the stocks for tax purposes, or A could be treated as having ceased to be the owner of those securities.

For corporate law purposes, only A, and not B, is recognized as a shareholder of the issuers of the underlying stocks. Thus, it is A, and not B, that has the right to vote those shares, to receive dividends and to participate in liquidating distributions; all B has is a creditor's claim, unsecured or secured by assets other than the stocks, to receive payments from A based on the economic performance of those stocks. A is under no obligation to continue to hold all or any portion of the existing stock portfolio, and B has no right to obtain any or all of those shares from A; thus, there is no necessary relationship between the payments to be made by A to B under the swap and particular (or, for that matter, any) shares of physical stock.<sup>59</sup> Moreover, unlike a (non-cash settled) option or futures or forward contract, B's interest under the swap will never ripen into physical ownership of shares. A remains free to alter the basket's composition by buying new stock or selling stocks contained in the underlying portfolio and is not required to pay over any of those proceeds to B; thus, the actual return in any month on the underlying portfolio may differ dramatically from the amount A is required to pay B under the swap, and, depending on A's willingness to assume speculative risk, it can continue to benefit from favorable price movements, and may suffer the detriment of adverse price movements, with respect to the underlying stocks.<sup>60</sup> Finally, A retains a \$1,000x investment

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no power to direct A to dispose of all or a portion of the existing stock portfolio or acquire new or additional stocks, A is not required to account to B with respect to the proceeds of any such dispositions, and, regardless of any such dispositions or acquisitions, the swap continues to be based on the DJIA, rather than on any particular portfolio of stocks held by A from time to time, (iv) all payments under the swap are to be made in cash or property other than the underlying stocks, and (v) where the underlying stocks have a limited life (e.g., preferred stock having a fixed redemption date or common stock of a corporation that is in the process of liquidating or, like a fixed pool equity real estate investment trust, has a limited expected life), the term of the equity swap is not substantially coterminous with the anticipated life of the stocks. These assumptions are consistent with current market practice.

59. Cf. *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971), acq. 1972-1 C.B. 1 and Rev. Rul. 84-153, 1984-2 C.B. 383, modified and clarified, Rev. Rul. 89-110, 1989-2 C.B. 275 (stating that where a U.S. corporation makes interest payments to a foreign corporation that is obligated to make corresponding interest payments to another person, that person and not the original payee shall be treated as the recipient of the U.S. corporation's payments for withholding tax purposes); Rev. Rul. 77-137, 1977-1 C.B. 178 (holding that an assignee of the interest of a limited partner shall be treated as a substituted limited partner for federal income tax purposes).

60. This results from the fact that the swap is based on the DJIA, rather than on any particular stock portfolio owned by A, and on price changes as determined using month-end closing prices, rather than on the results of particular sale or purchase transactions. Of course, unless A is willing to bear unhedged exposure with respect to its liabilities under the swap or is able to offset that exposure using hedges other than ownership of physical stocks, it is likely

in the portfolio; thus, unlike the situation where A sells the portfolio to B in exchange for a note bearing a LIBOR interest rate, A has *not* liquidated or monetized its investment in the underlying stocks.<sup>61</sup> Under these circumstances, it is difficult to see how A could be treated as having disposed of the stock portfolio.<sup>62</sup>

3. *Deductibility of Swap Payments: Creation of Synthetic Tax-Advantaged Assets Using Equity Swaps.*—As described above, A is obligated to pay B each month under the equity swap the positive change, if any, in the value of the DJIA over the course of the month. If A is allowed to deduct those payments currently, while, at the same time, being able to apply general tax principles to defer recognizing the offsetting gain in its long position in the stocks making up the DJIA, A would have effectively been able to convert unrelated income, including all or a portion of the LIBOR-based payments received from B under the swap, into unrealized gain on the stocks.<sup>63</sup> Once again, A would have been able to create a synthetic tax-

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that A will continue to hold the underlying stock portfolio throughout the term of the swap.

61. This, of course, simply reflects the fact that B's payments under the swap are based on a notional, rather than an actual, principal amount.

62. Query, however, whether the arrangement between A and B could be construed as a constructive partnership, the assets of which are the stocks making up the DJIA, and in which A owns a preferred equity interest (having a liquidation price of \$1,000x) and B holds the common interest. In such case, A would probably be treated as having initially contributed the underlying stocks to the partnership in exchange for all the preferred and common equity interests therein and then as having sold the common interest to B in exchange for the right to receive the fixed payments from B under the swap. Query also whether, if the entering into the equity swap should be treated as if A sold the underlying stocks to B, should the swap's termination be treated as a sale of the stocks by B back to A? Obviously, both of these analyses seem strained.

63. Of course, by entering into the swap, A may suffer adverse tax consequences if the stocks making up the DJIA decrease in value. In such case, A will receive payments from B under the swap in an amount equal to such decrease, which will generally be currently taxable to A as ordinary income. While as an economic matter such payments will be offset by the unrealized loss on the stock portfolio, the latter will not give rise to a tax benefit until A disposes of the depreciated shares in a taxable transaction not subject to the wash sale rules of section 1091, at which time the resulting loss will generally be recognized as capital loss which may be unusable by A. Thus, if, at the outset, it was anticipated that the underlying shares were as likely to decrease in value as to increase in value, A might be expected to suffer from a net tax detriment, or, at the very least, not receive a net tax benefit, as a result of receiving and making payments under the swap. Any such net detriment, of course, would have to be compared to the other non-tax and tax benefits from entering into the transaction to see whether, overall, entering into the swap was more beneficial to A than alternative transactions.

This analysis might suggest that, at least under current law, securities dealers are the most likely candidates to be A. First, dealers that use the lower-of-cost-or-market-value method of accounting for their inventories are essentially able to deduct losses with respect to those

advantaged asset and, once again, the question is whether the Service can avoid this result by applying section 1092 or Proposed Regulations section 1.446-3(e). And here, even more so than is the case with the bond/interest rate swap transactions discussed above, the answer seems to be no.

In particular, section 1092(d)(3)(A) states that, except as otherwise provided in section 1092(d)(3)(B), the term personal property for purposes of section 1092 does not include stock. Section 1092(d)(3)(B) contains exceptions for (i) stock held as part of a straddle in which at least one of the offsetting positions is an option or, "under regulations, a position with respect to substantially similar or related property (other than stock),"<sup>64</sup> or (ii) "any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder." It would appear that the equity swap in our example is not part of a straddle since, while it is a position with respect to personal property for section 1092 purposes, it neither offsets, nor is offset by, another position in personal property. Accordingly, under current law, A should be able to deduct currently its payments under the equity swap.

4. *Dividend Capture and Equity Swaps.*—What are the tax consequences to A of its obligation to make payments to B under the equity swap with respect to dividends declared and paid on the underlying stocks? In particular, if A is a corporation, will A be allowed to claim the DRD with respect to dividends received on its long position in the underlying stocks, while at the same time deducting the offsetting payments to be made to B under the equity swap? If it can, a net deduction to A will result,<sup>65</sup> which

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stocks without actually disposing of them, but are not required to recognize gains with respect to those inventories until they actual sell the underlying stocks. But see H.R. 11, 102d Cong., 2d Sess. § 3001 (1992) (requiring mark-to-market accounting for securities dealers' inventories), vetoed last year by President Bush, and Prop. Regs. § 1.446-4, 56 Fed. Reg. 31,350 (1991) (providing an optional mark-to-market election for dealers and traders in derivative financial instruments, conditioned on neither the taxpayer nor any related party using the lower-of-cost-or-market-value method with respect to dealer or trading accounts in securities or commodities). The Clinton Administration has also proposed requiring securities dealers to mark their inventories of marketable securities to market value at each year-end. See Dept. of the Treasury, Summary of the Administration's Revenue Proposals 46-47 (Feb. 1993), Tax Notes microfiche Database Doc. 93-2657 (Mar. 1, 1993). Second, section 1091 does not apply to sales made in the ordinary course of business by dealers in stock or securities.

64. No such regulations have been issued to date. The legislative history to section 1092 states that Congress intended that any such regulations should only apply prospectively (i.e., to transactions entered into after the date such regulations are issued), except in the case of certain specified transactions (none of which involve equity swaps). H.R. Rep. No. 861, 98th Cong., 2d Sess. 908 (1984).

65. For example, if A were entitled to the 70% DRD with respect to dividends received on the underlying stocks while being allowed to deduct the offsetting payments made

A can then use to shelter other income, effectively converting that income into tax-advantaged dividend income.

This, of course, is like an old-fashioned dividend capture strategy, a classic form of tax arbitrage, and the Service seems to be on firm ground in disallowing a deduction for the dividend-based payments on the equity swap.<sup>66</sup> Thus, section 246(c)(1)(B) disallows the DRD “in respect of any dividend on any share of stock ... to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.” It does not seem too difficult to conclude that the equity swap should be considered a position in substantially similar or related property (indeed, the same property) for this purpose or that the dividend-based payments under the swap should be considered to be related payments for purposes of section 246(c)(1)(B).

But what if A, perhaps counselled by a clever tax lawyer, alters the overall transaction a bit. For example, suppose that the equity swap is not based on values of the DJIA, but on a selected basket of particular publicly-traded stocks (“Basket 1”). Suppose further that, instead of being required to make payments to B under the swap based on the *actual* dividends declared and paid each month on the stocks making up Basket 1, A is required to pay B an amount, fixed at the outset of the swap, which just happens to equal 1/12th of the average aggregate amount of dividends paid yearly on the Basket 1 stocks over the three-year period prior to the date on which the parties entered into the swap. Also assume that the aggregate dividend yield on the Basket 1 stocks has been relatively constant, year-to-year, over the past ten years and that it is believed that this will continue to be the case over the course of the life of the swap.<sup>67</sup> Finally, suppose that A in fact owns none of the stocks comprising Basket 1, but instead owns only particular publicly-traded shares making up a second basket (“Basket 2”), and that the overall price performance/dividend yield of the Basket 2 stocks is expected to be highly, but not perfectly, correlated with that of Basket 1.

Here, application of section 246(c)(1)(B) to dividends received on the Basket 2 stocks is more difficult and raises two issues. The first is whether the stocks making up Basket 1 should be considered substantially similar or related to those comprising Basket 2 for purposes of section 246(c)(1)(B).

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to B under the equity swap with respect to such dividends, a net deduction equal to 70% of the amount of dividends received (i.e., equal to the DRD) would have been created.

66. The perceived abuses of dividend capture strategies led to the enactment of section 246(c). See H.R. Rep. No. 775, 85th Cong., 1st Sess. 14 (1957); H.R. Rep. No. 432, supra note 35, at 1180.

67. For example, suppose the stocks making up Basket 1 are predominantly preferred stocks having fixed dividends terms.



The second is whether the fixed payments to be made by A to B under the swap should be considered related payments for purposes of that section.

The Service's position with respect to the first issue is suggested by I.R.S. Technical Advice Memorandum 9128050 (Apr. 4, 1991). In that Memorandum, the Service applied section 246(c)(1)(B) to a "preferred stock rollover" program. The taxpayer in the Memorandum had purchased multiple baskets of dividend-paying preferred stock, and, at the same time, had sold short baskets of other dividend-paying preferred stock. The taxpayer was required to make dividend-equivalent payments with respect to the stocks comprising the short baskets. There was no overlap between the stocks making up the long baskets and the short baskets; nevertheless, the stocks making up the long and short baskets had been selected so that the all-in return (price change and dividend yield) of the long and short baskets were expected to be highly (inversely) correlated over the life of the program, thereby reducing, to the greatest extent possible, the taxpayer's economic risk from entering into the transaction.

The Service, on these facts, concluded that, given the high correlation between the expected economic performance of the long and short baskets and the purpose of section 246(c)(1)(B) to prevent tax arbitrage schemes involving use of the DRD, the stocks in the short baskets should be considered substantially similar or related to the stocks comprising the long baskets, with the result under section 246(c)(1)(B) that no DRD was allowed with respect to dividends received on the stocks making up the long basket. While some might criticize the reasoning of the Memorandum as representing an overly expansive interpretation of the statute, the result is not unreasonable. And it is not difficult to see how the reasoning of the Memorandum could be applied to the facts of our equity swap transaction.

The second issue is whether the fixed payments on the equity swap constitute related payments with respect to dividends received on the Basket 2 stocks. In particular, does the fact that they are based on the historic, rather than the actual, dividend yield on the Basket 1 stocks insulate them from being related payments? Probably not. Given the expected correlation between the fixed payments on the equity swap and the dividends actually paid on the Basket 1 stocks, which, in turn, are anticipated to mimic the dividend payments on the Basket 2 stocks, and the fact that the statute merely requires that the fixed payments be related (not identical) to dividends on the Basket 1 stocks, it is likely that the Service could successfully contend that the fixed payments are indeed related payments.

*5. Equity Swaps and Withholding Taxes.*—Equity swaps can be used to achieve a variety of economic goals. Thus, an institutional investor can employ an equity swap to diversify its portfolio, effectively shifting from fixed income securities into stocks, from stocks into fixed income securities,

or from one basket of stocks into another, without incurring the transaction costs and capital gains taxes that would otherwise be incurred in actually selling and buying physical securities. Additionally, equity swaps can be used, like over-the-counter options and forward contracts, to provide a customized hedge for an existing position in stocks.

However, equity swaps can also be used for another purpose, one that is far more troubling to the Service. For example, as Scholes and Wolfson point out, equity swaps are (potentially) a convenient way for foreign investors to avoid withholding taxes on dividends.<sup>68</sup> In particular, if dividends paid on (physical) stock are subject to withholding tax, while dividend-based payments on equity swaps are not, the after-tax returns to foreign investors will be enhanced by substituting equity swaps for positions in (physical) stocks with little, if any, change in the non-tax characteristics and performance of those investors' portfolios.<sup>69</sup> Two questions thus arise: (1) are dividend-based payments on equity swaps subject to U.S. withholding taxes under current law? and (2) regardless of the result under current law, should withholding taxes be imposed on such payments as a matter of U.S. tax policy?

The answer to the first question appears to be no. Under Regulations section 1.863-7, income attributable to a notional principal contract is generally sourced according to the tax residence of the taxpayer. Thus, a non-U.S. counterparty receiving payments with respect to a notional principal contract from a U.S. counterparty will generally be considered as receiving foreign source income<sup>70</sup> not subject to U.S. withholding tax.<sup>71</sup> Like Proposed Regulations section 1.446-3, Regulations section 1.863-7 defines a notional principal contract as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated

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68. Scholes & Wolfson, *supra* note 9, at 419-425.

69. The most significant non-tax differences between entering into an equity swap and acquiring physical stocks are that, in the former case, (i) the foreign investor is taking the credit risk of the swap counterparty, which, depending on the circumstances, may or may not be material, and (ii) the foreign investor has no voting rights vis-a-vis the issuers of the underlying stocks, which may have ramifications with respect to corporate control issues. This is *not* to say, however, that entering into an equity swap is tantamount to acquiring physical stock. See discussion *supra* Part II(C)(2).

70. An exception applies, however, to notional principal contract income that, under principles similar to those set forth in Regulations section 1.864-4(c), is considered to arise from the conduct of a U.S. trade or business by the non-U.S. person. Such income is considered to be effectively connected U.S. source income. Regs. § 1.863-7(b)(3). Nevertheless, such income would still not be subject to U.S. withholding tax. IRC §§ 1441(c)(1), 1442(a).

71. Sections 1441(a) and 1442(a) apply only to U.S. source fixed or determinable annual or periodic income that is not effectively connected with a U.S. trade or business. See also IRC §§ 871(a), 881(a).

by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.” While Regulations section 1.863-7 does not explicitly state that an equity swap constitutes a notional principal contract, both the plain language of this definition and the examples given in Proposed Regulations section 1.446-3(c)(1)(ii) strongly suggest that income with respect to equity swaps is sourced according to the rules set forth in Regulations section 1.863-7. Accordingly, all payments made to non-U.S. counterparties under equity swaps, including those based on dividends declared and paid on the underlying portfolio of stocks, should generally be free and clear of U.S. withholding under current law.<sup>72</sup>

Nevertheless, the Service is clearly concerned by this conclusion. In the Preambles to both Proposed Regulations section 1.446-3 and the Proposed “securities lending” regulations,<sup>73</sup> the Service warned that it was currently studying whether or not payments on equity (and equity index) swaps “should be treated in the same manner as interest rate and commodity swaps for sourcing and withholding tax purposes.”

What is the right answer to the question of whether dividend-based payments on equity swaps *should* be subject to U.S. withholding taxes? As discussed above with respect to the question of whether entering into an equity swap should be treated as a disposition of the underlying stock, an equity swap, while similar to and derivative of the underlying stock, is not the same as the underlying stock, at least under general tax principles.<sup>74</sup> In particular, the non-U.S. investor has only a contractual right to receive certain amounts from the counterparty, who may or may not own any of the underlying stocks. Under general principles such a contractual claim would not be considered equivalent to actual ownership of the underlying stocks.

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72. Any portion of a swap payment recharacterized as interest pursuant to Proposed Regulations sections 1.446-3 (e)(4)(iii) (swap with significant nonperiodic payments treated as containing embedded loan), 1.446-3(e)(4)(ii) (hedged swaps recharacterized according to their economic substance) or 1.446-3(f) (the general anti-abuse rule) will, of course, be subject to the general rules dealing with withholding on interest payments. See generally IRC §§ 871(a)(1)(A), (a)(1)(C), (g), (h); 881(a)(1), (a)(3), (c); 1441(a), (c)(8), (c)(9); 1442(a).

73. Prop. Regs. §§ 1.861-2(a)(7), 1.861-3(a)(6), 1.871-7(b)(2), 1.881-2(b)(2), 1.894-1(c), 1.1441-2(a)(1), 57 Fed. Reg. 860 (1992).

74. I am assuming that the counterparty on the swap is not an issuer with respect to the underlying stock (i.e., we are not talking about Ford, for example, entering into an equity swap with respect to its own stock). Such a situation would probably result in a different conclusion, since it would open up all sorts of possibilities for creating “homemade corporation integration.” Query, however, whether two different corporations, both having similar economic prospects (i.e., similar business opportunities, similar financial and operational leverage, similar dividend payout ratios, etc.), should be able to enter into equity swaps with third parties on each other’s stock and deduct the payments.

Nevertheless, one might argue that this is an overly formalistic view of the issue. After all, if, since equity swaps and physical stocks are (not quite perfect) economic substitutes for each other,<sup>75</sup> and the receipt of dividend-based payments on equity swaps substitute for the receipt of dividends on the underlying stocks, perhaps dividend-based swap payments and actual dividends should be taxed in the same manner. This approach finds some support in other areas of the Code. For example, in the Regulations under section 1504(a)(5)(A), a broad range of financial instruments, including cash settlement options, are treated, under certain circumstances, as if they were stock for purposes of determining whether the stock affiliation rules of section 1504(a) are satisfied, even though, in general, such instruments would not be treated as stock for tax purposes.<sup>76</sup> Similarly, the option attribution rules of sections 382(l)(3) and 382(k)(6)(B), and the regulations promulgated thereunder, in essence, treat certain equity-flavored financial instruments as if they constituted stock for purposes of the section 382 ownership rules under certain circumstances.<sup>77</sup> Finally, the proposed securities lending regulations themselves apply “look through treatment” for withholding tax purposes to payments in lieu of interest and dividends received by non-U.S. persons in securities lending transactions.

On the other hand, this approach is more the exception than the rule in the tax law. Thus, even a relatively deeply-in-the-money option on a growth stock (i.e., one with respect to which the investor’s return is anticipated to come in the form of price appreciation, rather than dividend payments) is generally *not* treated as equivalent to the underlying stock for tax purposes, even though, for all practical purposes, the option may be an economically perfect substitute for the physical stock. Similarly, absent special circumstances, a note issued by the buyer to the seller with respect to a sale of a business is not generally considered to be a continuing equity interest in that business, and payments on the note are treated as interest, even though such payments may be based on profits earned by the business. The same might be said of money market preferred stock: even though payments thereon may be based on prevailing money market interest rates, such stock is generally considered to be equity and payments thereon are

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75. See *supra* note 69.

76. Regs. § 1.1504-4. These regulations, of course, were promulgated pursuant to an explicit statutory grant of authority to “treat warrants, obligations convertible into stock, and other similar interests as stock.” IRC § 1504(a)(5)(A).

It is also perhaps significant that options issued between persons that are unrelated to the affiliated group of which the issuing corporation is a member are not generally subject to these rules. See Regs. § 1.1504-4(c)(4)(ii)(B)(2).

77. Again, these rules are based on specific statutory provisions, and not merely on general tax principles or policies.

generally considered to be dividends for tax purposes. Indeed, the Service's treatment of income from swaps other than equity swaps supports this point. Thus, as discussed above, the Service does not treat interest rate swap income and expense as interest, even though it is based on prevailing interest rates, and the Service clearly intends to continue to apply the rules of Regulations section 1.863-7, rather than the sourcing rules for interest contained in sections 861(a)(1) and 862(a)(1), to interest rate swap payments.<sup>78</sup>

Nevertheless, the potential use of equity swaps to avoid U.S. withholding taxes may still trouble some readers. Perhaps concern should be greatest when the equity swap is with respect to only a single underlying stock, or a small group of stocks—in that case, the putative non-tax purposes for entering into an equity swap (e.g., portfolio diversification and avoidance of transaction costs) are least likely to be at issue, and the swap was likely entered into primarily to avoid U.S. withholding taxes.<sup>79</sup> Furthermore, as noted above, the policy judgment to treat dividend-based payments the same as “real” dividends for withholding tax purposes has already been made in the securities lending context, and it might be thought anomalous to have a different rule for equity swaps.

There are no definitive answers to these questions, but a few observations can be made. First, any attempt to distinguish “large basket” equity swaps from single equity or “small basket” swaps will be inevitably arbitrary. Even accepting for purposes of argument that single equity or small basket equity swaps present the greatest potential for tax abuse with the least likely presence of countervailing business purposes, how can the line be drawn in a principled manner? If one stock is too little, how about two stocks, or three? Does it matter if the price movements of all the stocks in the basket are expected to be highly correlated, thus arguably undercutting the portfolio diversification argument, even if there are a large number of stocks in the basket? And diversification is generally thought to be a function of the

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78. It is true, of course, that the drafters of Regulations section 1.863-7 did not lose much, if any, potential revenue for the fisc by treating interest rate swap payments as foreign source income, since most interest payments on real debt are not subject to withholding tax because of the portfolio interest rules of sections 871(h) and 881(c). Nevertheless, there are certain cases where interest remains subject to withholding tax (e.g., interest received by a 10% shareholder, a related controlled foreign corporation, or by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the bank's trade or business) and yet the regulations do not attempt to recharacterize interest rate swap payments as interest for purposes of applying these exceptions.

79. Of course, while the lack of a bona fide business purpose may suggest that payments on a given type of equity swap should be subject to withholding taxes, the presence of a bona fide business purpose should not necessarily insulate swap payments from tax. The acquisition of stock may be made for the most compelling of business purposes and yet dividends on the stock are subject to withholding taxes.

taxpayer's overall portfolio, rather than simply of the stocks in the particular basket underlying the equity swap. Nevertheless, if withholding taxes are to be collected by withholding agents, and if not all equity swaps are to be treated the same, some clear and objective lines must be drawn, based on the four corners of the swap contract and not on facts that may be known only to the non-U.S. swap counterparty or on the application of portfolio theory to particular facts.

Second, while the securities lending regulations do apply look-through treatment to (and therefore impose withholding tax on) dividend equivalent payments, securities lending transactions are distinguishable from equity swaps in an important way: the non-U.S. lender in a securities lending transaction actually owned physical stock prior to entering into the transaction, and will own physical stock again at the conclusion of the transaction.<sup>80</sup> This important link between the non-U.S. lender and the ownership of physical stock makes a more compelling case for imposing withholding taxes in securities lending transactions as compared to equity swaps.

Finally, perhaps it is significant that equity swaps do not have to involve physical stocks, directly or indirectly. There is no requirement that the counterparty making the equity-based payments on the swap actually hold stock.<sup>81</sup> Thus, there is at least the potential that the aggregate amount of dividend-based payments on equity swaps may exceed the aggregate amount of dividends actually paid on the underlying stock, thereby multiplying (perhaps dramatically) the amount of dividend-related income subject to U.S. tax.<sup>82</sup>

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80. Indeed, in a securities lending transaction subject to section 1058, the agreement must provide that the lender may terminate the loan, and thus reacquire the physical securities, on no more than five business day's notice. See Prop. Regs. § 1.1058-1(b)(3), 48 Fed. Reg. 33,912 (1983).

81. It is probably the case, of course, that many, perhaps most, counterparties will hedge their obligations to make equity-based payments under the swap by holding physical stocks.

82. This would not be the case, however, if the U.S. counterparty hedged its exposure on the swap by holding physical securities. In such case, while receipt of the dividend would be includable in the U.S. counterparty's gross income, the U.S. counterparty would be entitled to an offsetting deduction for the related payment made to the non-U.S. counterparty under the swap. Thus, unless the swap payment were subject to withholding tax, the dividend would have escaped U.S. tax. While this might suggest that a distinction should be drawn between a case where the U.S. counterparty hedges its exposure using physical stock, and one where it does not, it would certainly be strange if the non-U.S. counterparty's tax treatment turned on how the U.S. counterparty hedged its exposure under the swap.

Given the look-through treatment mandated by the proposed securities lending regulations, the potential for multiple U.S. taxation discussed in the text would also exist in any case where a stock lending arrangement involves a U.S. borrower and a non-U.S. lender and the borrower sells the borrowed stock short to a third party (i.e., goes unhedged). Query

#### D. Section 382 and Swaps

This subpart explores an issue that, while not directly involving the taxation of swaps, has increasing relevance to end users of swaps. As swaps have become an increasingly important tool for corporate America for purposes of managing asset and liability exposures, they have begun to appear more frequently on the balance sheets of "loss corporations" undergoing ownership changes for purposes of section 382. The question thus arises as to how swaps are to be treated for purposes of the "built-in gain and loss" rules of section 382(h).

A swap is a somewhat strange animal. Like the lessee's interest in a leasehold, it is a combination of an asset (namely, the right to receive payments from the swap counterparty) and a liability (namely, the obligation to make payments to the swap counterparty). Thus, at any given time, in relation to any given counterparty, a swap may have either a positive or a negative value, depending on the relationship between the present value of the asset leg of the swap and the present value of the liability leg.<sup>83</sup> Take, for example, the interest rate swap described earlier. Depending on the relative changes in interest rates since the inception of the swap, this swap at any time will have either a positive or a negative value to one of the counterparties, for example, A, and a negative or a positive value of an equal amount to the other counterparty, for example, B.<sup>84</sup> This is equivalent to saying that, where the swap has a negative value of \$10 to A, A would have to pay B or a third party \$10 to terminate or assign the swap; similarly, where the swap has a positive value of \$10 to A, B or a third party would have to pay A \$10 to induce A to terminate or assign the swap. How are swaps then to be treated for purposes of section 382(h)?

Section 382(h) provides that, for any year during the five-year period after an ownership change (the "recognition period"), the loss corporation's

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whether equity swaps or stock loan transactions are more likely to involve liabilities unhedged by ownership of physical stocks.

See also Tax Section, New York State Bar Association, Report No. 275: Report on Proposed Regulations on Certain Payments Made Pursuant to Securities Lending Transactions 12-16 (1992) (discussing the policy objectives underlying the proposed securities lending regulations' treatment of substitute dividend and interest payments as dividend and interest).

83. Alternatively, a swap might be viewed as a (net) asset when it has a positive value, and a (net) liability when it has a negative value. Cf. Preamble to Prop. Regs. § 1.1092(d)-1, 56 Fed. Reg. 31,350 (1991) ("There has been some question whether a financial product such as an interest rate swap, which may be either an asset or a liability depending on the movement of interest rates, constitutes an interest in personal property that is subject to section 1092 and section 1234A").

84. That is, if the swap has a \$10 positive value to A at a given time, it will have a \$10 negative value to B at that time, and vice versa.

annual limitation for section 382(a) purposes (i.e., the amount of taxable income for such year that can be offset by pre-ownership change losses) is increased by the amount of “recognized built-in gain” for that year. Conversely, any “recognized built-in loss” recognized by the loss corporation during the recognition period is treated as a pre-ownership change loss subject to the limitations of section 382(a). These rules only apply if the loss corporation had a “net unrealized built-in gain” or a “net unrealized built-in loss,” as the case may be, at the time of the ownership change. For this purpose, a recognized built-in gain means any gain recognized by the loss corporation during the recognition period on the disposition of an asset to the extent the loss corporation establishes that the asset was held by it immediately prior to the ownership change and the amount of the recognized gain does not exceed the gain inherent in the asset at that time. Subject to a de minimis and other special rules, the net unrealized built-in gain at the time of any ownership change equals the excess of the aggregate fair market value of the loss corporation’s assets immediately prior to the ownership change over the loss corporation’s aggregate tax basis in those assets at that time. Recognized built-in loss and net unrealized built-in loss are defined in an analogous manner.<sup>85</sup> The aggregate amount of recognized built-in gain or loss over the five-year recognition period cannot exceed the net unrealized built-in gain or loss, as the case may, at the time of the ownership change.

How should swaps be treated for purposes of the section 382(h) calculation of net unrealized built-in gain or loss? For example, if a swap has a positive value at the time of an ownership change, should the amount of net unrealized built-in gain be increased by an equal amount (or, conversely, should the amount of net unrealized built-in loss be decreased by such amount)? Similarly, what happens if the swap has a negative value at the time of the ownership change. Should this decrease (increase) the amount of net unrealized built-in gain (loss) for section 382(h) purposes? Alternatively, given the definitions of net unrealized built-in gain and loss (looking, as they do, to the value of the corporation’s *assets* immediately before the ownership change), should the “asset leg” (i.e., the right to receive payments from the counterparty) of the swap be valued separately from the “liability leg” (i.e., the obligation to make payments to the counterparty) and only the former taken into account for section 382(h) purposes.<sup>86</sup>

The answer to these questions is not completely clear, in great part

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85. Recognized built-in loss also includes any depreciation, amortization, or depletion deductions recognized during the recognition period to the extent such deductions reflect a loss inherent in an asset at the time of the ownership change.

86. Alternatively, should swaps be taken into account only when they have positive values and thus constitute net “assets,” but not when they have negative values and thus constitute net “liabilities”?



because the treatment of liabilities, in general, is not clear under section 382(h). Thus, low coupon debt (or, alternatively, high coupon debt) may constitute a potential economic benefit (or detriment) to the loss corporation at the time of the ownership change. More importantly, such debt represents a future source of taxable income (or deductions) that, absent the ownership change, could have been offset by the loss corporation's net operating losses in future periods (or, in the case of high coupon debt, would have increased those losses in future periods).<sup>87</sup> Thus, if, as appears likely, the purpose of the section 382(h) rules is to determine the maximum amount of taxable income or loss that the loss corporation would have generated if it had sold all its assets and paid off all its liabilities immediately prior to the ownership change, the inherent gain or loss with respect to the loss corporation's *liabilities*, as well as the inherent gain or loss in its *assets*, should be taken into account in determining net unrealized built-in gain or loss. While the statutory language, speaking as it does of the value of the loss corporation's assets immediately prior to the ownership change, seems to preclude this result with respect to "garden variety" liabilities, I believe that no damage to the statutory language will result if swaps are treated as a single instrument (i.e., the asset leg is *not* separated from the liability leg) capable of having either a positive or a negative value for section 382(h) purposes.<sup>88</sup>

Under what circumstances should the inherent gain or loss in the swap be treated as having been recognized for purposes of increasing recognized built-in gain or loss? As noted above, the definition of recognized built-in gain or loss refers generally only to gain or loss recognized on a disposition of an asset. Section 382(h)(6) expands this definition to include income or deductions recognized during the recognition period but attributable to pre-ownership change periods. While it seems clear that gain or loss recognized on the termination or assignment of a swap may constitute recognized built-in gain or loss, what if the swap is held until maturity and the gain or loss is recognized over the term of the swap as increased net income or deduction? Will this constitute recognized built-in gain or loss pursuant to section 382(h)(6)? Here, particularly given the fact that the amount of net income or deduction recognized with respect to the swap in any future period depends on the future movements of the index or indices (e.g., LIBOR) that determine each party's obligations under the swap, it seems hard to believe that this income or deduction could be viewed as attributable to pre-ownership change periods, any more than the coupon interest received in post-ownership change

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87. See, e.g., Priv. Let. Rul. 9226026 (Mar. 26, 1992) & Priv. Let. Rul. 9124053 (Mar. 20, 1991) (dealing with cancellation of indebtedness income and treating it as built-in income under section 382(h)(6)).

88. As noted above, similar issues arise under section 382(h) with respect to the lessee's interest in a leasehold, and similar mixed asset-liability contractual undertakings.

periods on a high coupon debt instrument held by the loss corporation as an asset at the time of the ownership change could be so viewed.

### III. STRUCTURED FINANCE

#### A. Basic Structure and Goals

Last year, *Corporate Financing Week* reported that Merrill Lynch had developed and was marketing a product that allowed investors to take maximum advantage of the DRD.<sup>89</sup> According to that report, the product involved creating a state law trust (the "Trust") that would acquire dividend-paying stock of U.S. issuers.<sup>90</sup> The Trust would raise the cash to buy the stock by issuing two classes of Trust certificates. Holders of the first class of certificates (the "Preferred Certificates") were entitled to receive (i) a fixed amount upon liquidation of the Trust (equal to approximately fifty percent of the purchase price for the underlying stocks) and (ii) a current return based on prevailing money market interest rates. Holders of the second class of certificates (the "Common Certificates"; the Preferred Certificates and the Common Certificates, collectively, the "Certificates") were entitled to receive, both currently and upon liquidation, any cash flow of the Trust remaining after payment of the amounts to which the Preferred Certificate holders were entitled.<sup>91</sup> Thus, the Common Certificates were effectively subordinated to the Preferred Certificates.<sup>92</sup>

Because these transactions were done as private placements, their

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89. Merrill Splits PERCs in Two, *Corp. Financing Wk.*, Aug. 3, 1992, at 1.

90. In particular, the Trust would acquire "preferred equity redeemable cumulative securities" ("PERCs"), which are preferred stocks having a relatively high dividend yield and are mandatorily convertible into the issuer's common stock after a fixed period of time.

91. Thus, if the Trust receives \$10 of dividends on the underlying stock during a given period and is required to pay \$4 with respect to the Preferred Certificates, the Common Certificates will be entitled to \$6. Because the current return on the Preferred Certificates is based on prevailing money market interest rates, the current return on the Common Certificates is inversely correlated to changes in money market interest rates. The Common Certificate-holders' position is thus akin to an "inverse floater" class in a real estate mortgage investment conduit.

Similarly, since the Common Certificates are entitled to all the liquidation proceeds from the Trust after payment of the Preferred Certificate's priority fixed liquidation amount, the Common Certificate holders enjoy 100% of the upside, and the first loss position on the downside, with respect to the underlying stocks.

92. The structure of the Trust resembles the Americus trust prime and score transactions that were done in the early 1980s. See, e.g., *Americus Trust for American Home Products Shares*, Dec. 1, 1986 Prospectus. While existing Americus trusts were treated as grantor trusts for tax purposes pursuant to a series of private rulings from the Service, similar trusts established today cannot qualify as grantor trusts. Regs. § 301.7701-4(c), ex. 3.

operative documents are not generally available. Nevertheless, it is not too difficult to “reverse engineer” these transactions from an economic and tax perspective. In particular, these transactions probably achieved three goals that are common to many, if not most, structured finance transactions today: (i) dividing up, and in some cases restructuring, the cash flows from the underlying Trust assets into multiple classes of Certificates in order to better meet the economic risk and reward profiles of different investors,<sup>93</sup> (ii) making the Trust “tax transparent” so that income from the Trust assets is subject to only a single layer of tax at the Certificate holder level (and not a second layer of tax at the Trust level), and (iii) passing through to the corporate Certificate holders the tax-advantaged character (here, the DRD) of the Trust income to the greatest extent possible.<sup>94</sup> By achieving all these goals, the sponsor of the transaction, Merrill Lynch in our case, can maximize the value of the underlying assets, thereby increasing the proceeds to the original owner(s) of those assets (who will generally be selling them to the trust or other issuing vehicle) and, hopefully, earn a big fee for itself.

#### *B. Dividing Up Cash Flows to Better Meet Investor Objectives*

How the Merrill Lynch product satisfies the first goal set forth above is relatively straightforward. The two classes of Certificates have different

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93. In part because of tax considerations (i.e., the need to ensure that the trust or other issuing vehicle is not subject to an entity-level tax), some structured finance transactions, particularly those involving auto loans or other non-equity receivables, do not appear to achieve this first goal. Instead, such transactions are structured as “pass-throughs,” in which all the cash flow from the underlying assets is passed through currently to the investors on a pro rata basis. Even in those cases, however, the seller or servicer of the assets commonly retains a subordinated interest in the assets in the form of a right to receive “excess servicing” (i.e., a right to receive amounts for servicing the assets in excess of reasonable compensation for services rendered) or of an “interest strip” which entitles the seller/servicer to all the interest on the underlying assets in excess of amounts necessary to pay pass-through interest on the investor certificates and trust expenses. Thus, even these transactions divide up the cash flows from the underlying assets to better meet the risk/reward profiles of particular investing groups.

94. Sometimes, the tax benefits attributable to the underlying assets will be more valuable to one type of investor than to another. For example, the 50% interest exclusion for Employee Stock Ownership Plan (“ESOP”) loans under section 133 is available only to banks, insurance companies, regulated investment companies, and corporations actively engaged in the business of lending money. Accordingly, structured finance transactions involving ESOP loans sometimes involve two classes of investor interests, one of which (structured in the form of equity certificates) is entitled to the section 133 exclusion and is sold to the types of qualifying financial institutions set forth in section 133, and the other of which (structured as debt obligations) is not entitled to such benefits and is sold to non-qualifying investors. This, of course, is a combination of goals (i) and (iii) described in the text, and these transactions have an obvious kinship to real estate syndications and leveraged lease transactions.

risk and reward profiles and would therefore generally appeal to different types of investors. For example, the Common Certificates, by virtue of their subordination to the Preferred Certificates, the fact that their current return is inversely correlated to changes in interest rates, and the fact that they are entitled to 100% of the upside on the underlying portfolio, bear substantially more risk and have a greater potential for reward than the Preferred Certificates;<sup>95</sup> accordingly, the Common Certificate holders should earn a greater return, on average, over the life of the transaction than the Preferred Certificate holders. In general, then, the Preferred Certificates should appeal more to risk-averse investors and the Common Certificates should appeal more to risk-taking investors. By issuing two classes of Certificates, rather than a single class of “straight up,” pro rata pass-through certificates, Merrill Lynch is able to offer a “pure play” to each class of investor; each investor is therefore able to buy the type of Certificate that best meets its particular economic needs and desires, and is willing to “pay up” for that opportunity.

### C. Tax Transparency

The second goal is that of tax transparency of the Trust. Obviously, to the extent that cash flows from the underlying stocks are subject to two layers of tax, the after-tax returns to the Certificate holders, and the amount they are willing to pay for the Certificates, will be reduced.

The analysis of whether the Trust will be subject to an entity-level tax begins with Regulations section 301.7701-4(c) (the “trust classification regulations”). Generally speaking, a state law trust used in a structured finance transaction can be taxable in one of three ways: (i) as a fixed investment trust, taxable as a grantor trust under Subpart E of Subchapter J of Chapter 1 of the Code (Sections 671, et seq.),<sup>96</sup> (ii) as a partnership, or (iii) as an association taxable as a corporation.<sup>97</sup> The first two vehicles, fixed

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95. In essence, the Common Certificates represent a leveraged investment in the underlying stocks.

Alternatively, the Preferred Certificate holders could be viewed as “owning” the underlying stock and as having sold a call to, and bought a put from (the call and put having different strike prices), the Common Certificate holders. In such case, it is unclear how the Common Certificate holders’ right to receive dividends from the stocks should be characterized. For example, should they be treated as constructive option premiums? Nevertheless, this seems a bit of substance-over-form analysis gone amok.

96. Grantor trusts are transparent entities for federal income tax purposes. Thus, each certificate holder in a grantor trust is treated as if it owned directly its pro rata share of the trust’s assets and earned, or incurred, directly its pro rata share of the trust’s income and expenses.

97. This tripartite classification scheme, of course, is something of a simplification. In particular, it overlooks such important structured finance vehicles as “real estate mortgage

investment trusts taxable as grantor trusts and partnerships, are tax transparent. The latter vehicle, an association, is not, and tax lawyers therefore generally attempt to structure transactions to avoid association status.

Under Regulations section 301.7701-4(c),<sup>98</sup> a fixed investment trust is a trust (i) in which “there is no power under the trust agreement to vary the investment of the certificate holders”<sup>99</sup> and (ii) which only has a single class of certificates. Notwithstanding (ii), multiple classes of trust certificates are permitted where “the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.” Thus, example 2 of the trust classification regulations applies the “incidental to the direct investment purpose” exception to a case where the trust, which holds a pool of residential mortgages, issues two classes of certificates. One of the classes of certificates is subordinated to the other in the case of defaults on the underlying mortgages, but each class is otherwise entitled to a straight up, pro rata share of the trust’s cash flow.<sup>100</sup> Similarly, example 4 of the trust classification regulations applies

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investment conduits” (“REMICs”) taxable under sections 860A-860G, “real estate investment trusts” (“REITs”) taxable under sections 856-859, “regulated investment companies” (“RICs”) taxable under sections 851-855, “publicly traded partnerships” taxable as corporations under section 7704, and “taxable mortgage pools” taxable as corporations under section 7701(i). In most cases, of course, tax lawyers avoid having an issuing vehicle taxed as a publicly traded partnership or taxable mortgage pool, since both of these vehicles are subject to an entity-level tax.

98. The trust classification regulations are commonly referred to as the “Sears Regulations” since they were issued in the wake of a proposed trust offering by Sears Mortgage Securities Corporation in 1983 in which there were multiple classes of ownership certificates, with different classes being entitled to receive principal payments in sequential order (i.e., 100% of the principal payments received on the underlying mortgages was paid to the earliest maturing class of certificates until they were fully retired, then 100% of the principal received was paid to the second earliest maturing class of certificates until they were fully retired, and so on). Tax counsel to Sears had opined that the trust would qualify as a fixed investment trust taxable as a grantor trust. The Service disagreed with this analysis, as set forth in the trust classification regulations.

The trust classification regulations seem to be animated by a concern that, given that the trust tax accounting rules lack the refinement, flexibility, and anti-abuse protections of section 704(b)-(c) (dealing with partnership allocations), taxable income generated by the trust assets will go untaxed at the certificate holder level (or, alternatively, will be taxed to the “wrong” certificate holders) unless fixed investment trust status is limited to relatively simple transactions. See Preamble to Regs. § 301.7701-4, T.D. 8080, 1986-1 C.B. 371.

99. Tax lawyers generally view this restriction as a prohibition on the reinvestment of cash flows from the underlying trust assets. Nevertheless, certain incidental reinvestment activity is allowed. See, e.g., Rev. Rul. 75-192, 1975-1 C.B. 384 (allowing short term reinvestment of cash flows from trust assets pending distribution of the same to certificate holders on next regularly scheduled distribution date).

100. The example reaches the conclusion that the “incidental to the direct investment purpose” exception applies by analogizing the transaction to one in which the

the exception to a case where the trust's assets consist of a portfolio of bonds, and the trust issues multiple classes of certificates to the public each of which "represents the right to receive a particular payment with respect to a specific bond." Here, the example concludes that since section 1286 treats a stripped coupon or bond as a separate, newly-issued debt obligation for federal income tax purposes and "the multiple classes simply provide each certificate holder with a direct interest in what is treated under section 1286 as a separate bond," and "[g]iven the similarity of the interests acquired by the certificate holders to the interests that could be acquired by direct investment, the multiple classes of trust interests merely facilitate direct investment in the assets held by the trust."

The Trust in the Merrill Lynch transaction has multiple classes of certificates (i.e., the Preferred Certificates and the Common Certificates). Like the trust interests at issue in example 2 of the trust classification regulations, the Common Certificates are subordinated to the Preferred Certificates. Because the bond stripping rules of section 1286 apply only to debt obligations, however, the rationale of example 4 of those regulations does not apply to the Trust. Rather, the interests held by each class of Certificate holder do, indeed, seem to differ from a direct investment in the underlying stocks, and as discussed above, are intended to so differ.

In fact, the Trust seems much closer to the transaction described in example 3 of the trust classification regulations. Example 3 involves a trust holding publicly-traded stock. There are two classes of trust certificates, one of which represents "the right to dividends and the value of the underlying stock up to a specified amount; the other certificate represents the right to appreciation in the stock's value above the specified amount."<sup>101</sup> On these facts, the example concludes that, since the two classes of certificates enable

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senior and junior certificate holders each purchased a *pari passu*, undivided interest in the mortgages, and the junior certificate holders then issued a limited recourse guaranty to the senior certificate holders secured solely by the junior certificate holders' interest in, and right to receive distributions with respect to, the mortgage pool. See also Rev. Rul. 92-32, 1992-1 C.B. 434 (sponsor creating an investment trust by transferring a pool of debt securities to a trustee in exchange for senior and subordinated certificates, both of which were sold to investors, qualified the investment trust as a trust for income tax purposes).

Whether this analogy to a limited recourse guaranty running from the junior certificate holders to the senior certificate holders should apply more generally for purposes of determining the taxation of senior and junior certificate holders in senior/subordinated grantor trust transactions has recently become a topic of some interest. See IRS Branch Chief Thomas J. Lyden, Remarks to Financial Transactions Committee of the A.B.A. Tax Section (Aug. 7, 1992); prospectus for Nissan Auto Receivables 1992-B Grantor Trust (dated Oct. 1, 1992).

101. As noted *supra* note 92, this example seems to be based on the Americus trust prime and score transactions.

investors “to fulfill their varying investment objectives of seeking primarily either dividend income or capital appreciation from the stock held by the trust” by owning certificates of one class rather than the other, “the trust is not formed to facilitate direct investment in the assets of the trust” and will accordingly not be classified as a fixed investment trust. The Trust in the Merrill Lynch transaction is not identical to that at issue in example 3: for example, the Common Certificates share in the dividends on the underlying stock, and the Preferred Certificates do not participate in the upside on the underlying stock. Nevertheless, the similarities far outweigh the differences. Thus, it is highly likely that the Service would claim that the Trust does not qualify as a fixed investment trust taxable as a grantor trust.

Given this result, it is logical to suspect that tax counsel for the Merrill Lynch transaction attempted to achieve tax transparency by qualifying the Trust as a partnership for tax purposes.<sup>102</sup> Under Regulations section 301.7701-2 as applied to the facts of the Merrill Lynch transaction, the Trust will be taxable as a partnership<sup>103</sup> if at least two of the four following conditions are satisfied: (i) there is at least one Certificate holder that is personally liable for the debts of, and claims against, the Trust,<sup>104</sup> and such Certificate holder *either* has substantial assets (other than its Certificates) *or* is not merely a “dummy” acting as an agent for the other Certificate holders, (ii) there is at least one Certificate holder whose bankruptcy will cause the Trust assets to be sold and the Trust to liquidate unless at least a majority of the other Certificate holders affirmatively vote to continue the transaction,<sup>105</sup> (iii) *each* of the Certificate holders, either alone or in combination

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102. For a recent, thorough discussion of the issues involved in characterizing an entity as a partnership for federal income tax purposes, see William B. Brannan, *Lingering Partnership Classification Issues (Just When You Thought It Was Safe To Go Back Into The Water)*, 1 Fla. Tax Rev. 197 (1993).

103. Again, this assumes that the publicly traded partnership rules of section 7704 do not apply to the Trust, either because the Trust Certificates are not publicly traded, which is apparently the case, or because at least 90% of the Trust's income consists of “qualifying income” within the meaning of section 7704(c), which is also likely the case. But see IRC § 7704(c)(3) (90% qualifying income exception from publicly traded partnership status does not apply if partnership could qualify as a RIC if it were a domestic corporation).

104. The analogy here is to the general partner of a limited partnership. In the real world, of course, it is extremely unlikely that there would be any debts of or claims against the Trust.

105. The power of a majority of the other Certificate holders to override a liquidation event is based on proposed amendments to Regulations section 301.7701-2(b)(1), 57 Fed. Reg. 32,472 (1992). The current version of Regulations section 301.7701-2(b)(1) would require all the remaining Certificate holders to vote to override a liquidation event, although this rule of unanimity clearly does not reflect current Service practice (at least in the limited partnership area). See, e.g., Rev. Proc. 89-12, 1989-1 C.B. 798, amplified, Rev. Proc. 91-13, 1991-1 C.B. 477, and supplemented, Rev. Proc. 92-33, 1992-1 C.B. 782, and modified, Rev. Proc. 92-87,

with the other Certificate holders, has the authority to manage the affairs of the Trust or, if such is not the case, those persons having such authority consist of Certificate holders owning more than an insubstantial amount of the Certificates,<sup>106</sup> or (iv) more than an insubstantial portion of the Certificates cannot be transferred without the consent of at least one of the Certificate holders.<sup>107</sup> In the context of the Trust, for example, tax counsel might have qualified the Trust as a partnership by having Merrill Lynch create a special purpose “bankruptcy remote”<sup>108</sup> subsidiary to purchase one percent of each class of Certificates.<sup>109</sup> Assuming that (a) the Merrill Lynch subsidiary is capitalized with a demand note from a creditworthy Merrill Lynch entity or with other substantial assets, (b) the subsidiary undertakes personal liability under the Trust constituent documents for any debts of, or claims against, the Trust, and (c), under those constituent documents and absent a vote of the majority of the other Certificate holders, a bankruptcy of the subsidiary will cause the Trust to sell the underlying stocks and liquidate, conditions (i) and (ii) above should be satisfied, thereby qualifying the Trust as a partnership for federal income tax purposes.

#### D. *Optimization of the DRD*

The final goal that structured finance transactions seek to achieve is the preservation of the tax-advantaged character, if any, of the underlying

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1992-42 I.R.B. 38 and Rev. Proc. 92-88, 1992-42 I.R.B. 39.

106. Based on the Service’s ruling guidelines with respect to limited partnerships, this condition should be satisfied if the “managing” Certificate holders own at least 20% of the Certificates (based on value). Rev. Proc. 89-12, supra note 105.

107. Rev. Proc. 92-33, 1992-1 C.B. 782. Based on the Service’s ruling guidelines with respect to limited partnerships, this condition should be satisfied if at least 20% of the Certificates (based on value) are nontransferable without consent. Even then, Certificates will not be considered transferable without consent if only the right to share in the Trust’s profits and cash flow, but not the right to participate in the management of the Trust’s affairs, can be assigned without consent. See Regs. § 301.7701-2(e)(1). Nevertheless, given the likely limited participation rights afforded to Certificate holders, it is not clear that this exception could apply.

108. Bankruptcy remoteness means that the subsidiary’s activities are generally strictly limited solely to owning the Certificates so as to minimize the risk that the subsidiary will ever, voluntarily or involuntarily, enter bankruptcy proceedings. As noted in the text, the Trust will be required, absent a contrary vote of a majority of the other Certificate holders, to sell the underlying stocks and liquidate if the subsidiary goes into bankruptcy. The use of a bankruptcy remote entity is to minimize the risk of this occurring.

109. The reason for the 1% is to ensure that the Merrill Lynch subsidiary owns, at all times, at least 1% of the Certificates, based on value, regardless of changes in the relative values of the Preferred and Common Certificates, and therefore qualifies as a bona fide “partner” for purposes of applying the Regulations section 301.7704-2 tests.



trust income and the “flowing through” of the resultant tax benefits to the investors. In the case of the Merrill Lynch product, that goal means that the full amount of the DRD available to a corporation that owned the underlying stocks and received dividends thereon directly should be available to the Certificate holders collectively, without diminution by virtue of the Trust structure. Under section 704(b) and the regulations thereunder, this seems to be the case. Thus, dividend income on the underlying stocks would be allocated between and among the Preferred Certificate holders and the Common Certificate holders, based on each holder’s entitlement to the cash attributable to such income. Because these allocations would correlate with real entitlements to cash income, they should have “substantial economic effect” under section 704(b). Under section 702(b), the “dividend” character of this allocated income would flow through to the Certificate holders and be preserved, and each Certificate holder would be able to claim a DRD with respect to its allocable share of the dividend income to the same extent as if it had realized such income directly, rather than through the intermediation of the Trust. Thus, without regard to any particular Certificate holder’s tax position, the aggregate DRD available to the Certificate holders would be the same as if a single corporate investor held the underlying stock directly.

There are two potential challenges to this conclusion. First, based on the subordination of the Common Certificates to the Preferred Certificates, the Service might attempt to recharacterize the Preferred Certificates as debt for tax purposes. In such case, (i) the return on the Preferred Certificates would constitute interest and therefore not be eligible for the DRD and (ii) the “debt-financed portfolio stock” rules of section 246A<sup>110</sup> would apply, thereby potentially disallowing a portion of the DRD to which the Common Certificate holders would otherwise be entitled.<sup>111</sup> Alternatively, the Service

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110. Section 246A is another anti-abuse provision—this one dealing with the leveraged acquisition of dividend-paying stock. Section 246A is designed to eliminate the tax arbitrage that would otherwise exist through the conjunction of the receipt of dividend income eligible for the DRD and the deduction against ordinary income of offsetting interest expense.

111. Under this analysis, the Common Certificate holders would be required to include 100% of the dividend income on the underlying stocks in taxable income, would be entitled to a deduction for “interest” payable on the Preferred Certificates, and would be entitled to a DRD only to the extent provided in section 246A. Until regulations are issued under section 246A(e), the Common Certificate holder’s DRD would be a function of the relative values of the Preferred and Common Certificates at the inception of the Trust, and not the relative amounts of dividend income allocated to each class of Certificate holder in any given period. See IRC § 246A(a), (d).

For example, if the Preferred Certificates constituted 60% of the aggregate value of the Certificates at the beginning of the transaction, 60% of the dividend income on the underlying stocks would be ineligible for the DRD. Thus, if \$10 of dividend income were earned on the underlying stocks, \$4 of which were allocable to the Preferred Certificate holders and \$6 of which were allocable to the Common Certificate holders, the Common

might adduce the subordination of the Common Certificate holders to the Preferred Certificate holders to support the disallowance of the DRD with respect to the Preferred Certificate holders pursuant to section 246(c)(4)(C). Under section 246(c)(4)(C), a taxpayer's holding period for purposes of satisfying the 46-day holding period requirement of section 246(c)(1)(A) is tolled "for any period ... in which, under regulations prescribed by the Secretary, a taxpayer has diminished his risk of loss by holding 1 or more other positions with respect to substantially similar or related property." If section 246(c)(1)(A) were to apply to the Preferred Certificate holders, their holding period would be tolled at the outset and they would therefore not be able to satisfy the 46-day rule.

There are a number of responses to any such possible challenge by the Service. First, while there are a number of cases holding that obligations written as debt should be treated as equity for tax purposes, there are only two cases that have held the opposite.<sup>112</sup> While the economic differences between debt and preferred equity may be slight, or even nonexistent in certain cases, such as that of an unleveraged, purely passive investment vehicle such as the Trust, the absence of a fixed maturity date and creditor's rights in bankruptcy should be sufficient to prevent the Preferred Certificates from being transmuted into debt. Here, form and substance are consistent.

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Certificate holders would have net taxable income of \$6 (the same as would be the case if the Preferred Certificate holders were considered "partners," rather than lenders), but only 40% (i.e., 100% minus 60%) of the \$10 of dividend income, or \$4, would be eligible for the DRD (*versus* \$6 if the Preferred Certificates were not so recharacterized). Thus, assuming a 70% DRD, the Common Certificate holders would be entitled to \$2.80 of deductions (i.e., 70% of \$4.00), rather than the anticipated \$4.20 of deductions (i.e., 70% of \$6.00). Obviously, in cases where, because of the level of prevailing money market interest rates, the Preferred Certificate holders were entitled to more than 60% of the dividend income in any period, recharacterization of the Preferred Certificates as debt might actually benefit the Common Certificate holders.

Pursuant to section 246A(e), under regulations, none of which have been issued to date, the reduction in the DRD under section 246A cannot exceed the amount of the interest deductions allocable to the dividend. Since the reduction in the example (which should be determined assuming that the Common Certificate holders would otherwise be entitled to a DRD with respect to all \$10 of dividend income) is \$7.00 (i.e., 70% of \$10) minus \$2.80, or \$4.20, if such regulations were to be issued the reduction in the DRD would be limited to \$4.00 (i.e., the amount of the allocable "interest" expense), resulting in a DRD for the Common Certificate holders of \$3.00. This is still less than the \$4.20 of deductions that the Common Certificate holders would be entitled to if the form of the transaction were respected. Query whether section 246A(e) is misdrafted and should limit the reduction in the amount of the dividend eligible for the DRD (i.e., 60% in our case), rather than the reduction in the amount of the allowable DRD, to the amount of the allocable interest expense.

112. See *Helvering v. Richmond, Fredericksburg & Potomac R.R. Co.*, 90 F.2d 971 (1937); *Bolinger-Franklin Lumber Co. v. Commissioner*, 7 B.T.A. 402 (1927), acq. VII-1 C.B. 4 1928.

Second, section 246(c)(4)(C) is not self-executing; it requires the issuance of regulations and no such regulations have been issued to date. Furthermore, the legislative history to section 246(c)(4)(C) states that Congress anticipated that, except in very limited circumstances not applicable to our facts, any such regulations would generally have prospective effect only (i.e., most existing transactions would be grandfathered).<sup>113</sup>

Most fundamentally, however, the transaction at issue here is simply not abusive. Sections 246(c) and 246A were designed to stop tax arbitrage schemes in which a corporate taxpayer was able to convert non-dividend income into dividend income eligible for the DRD by purchasing dividend-paying stock, including 100% of the dividends received therein in income (and taking the DRD against such income), and then deducting an offsetting loss on the sale of such stock, or an interest deduction with respect to borrowings incurred or continued to acquire or carry such stock, against non-dividend income.<sup>114</sup> In the case of the Trust, however, no such tax arbitrage potential exists. Through the section 704(b) allocation rules, neither the Preferred nor the Common Certificate holders are entitled to include all the underlying dividend income in their own incomes and claim a "deduction" (against unrelated income) for the portion of that income attributable to the other class of Certificate holders. Rather, each is only able to recognize its allocable share of the dividend income, and no tax arbitrage potential exists.<sup>115</sup>

#### IV. CONCLUSION

Swaps and structured finance techniques are powerful tools of modern corporate finance. The products analyzed in this article are just a small part of the types of products that are currently being used by corporate treasurers, fund managers, tax-exempt investors, and other institutional investors and liability managers. Nevertheless, as the discussion herein hopefully suggests,

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113. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 818 (1984). Of course, the Service might attempt to apply section 246(c)(4)(A) or (c)(4)(B), both of which are self-executing, rather than section 246(c)(4)(C), on the ground (as discussed *supra* note 95) that the Preferred Certificate holders should be treated as the owners of the underlying stock, and as having purchased from the Common Certificate holders an option to sell the stock and as having granted to the Common Certificate holders an option to buy the stock. As noted above, however, such an analysis seems strained.

114. See H.R. Rep. No. 775, *supra* note 66; H.R. Rep. No. 432, *supra* note 35.

115. Another way to view this is that each Certificate holder includes 100% of the dividend income on the underlying stocks in its own income, but then is allowed a deduction against *that* dividend income for the portion of the dividends paid out to the other Certificate holders. Because this deduction is against dividend income, and *not* against unrelated non-dividend income, no tax arbitrage potential exists.

while many aspects of the taxation of these instruments are well-settled under current law, many difficult questions remain.

The most notable of these are normative in nature. Should one be able to deduct payments on an interest rate swap while still deferring market discount on an associated market discount bond? Should one be treated as the owner of stock if she has traded away the bulk of the economics of that stock by entering into an equity swap? Should non-U.S. investors be able to avoid U.S. withholding taxes by entering into equity swaps in lieu of holding dividend-paying stocks of U.S. issuers? And so on.

The answers to these questions ultimately turn on some of the most fundamental aspects of the tax law, on questions about the proper scope of the realization requirement, on what constitutes tax arbitrage, on what are the contours of the principles of ownership of assets for tax purposes, and on how one should draw a principled distinction between debt and equity in an unintegrated corporate tax system. And therein lies perhaps the most surprising and interesting aspect of derivatives and structured finance legal practice: in a part of the world full of esoteric transactions designed to further basic economic goals of Main Street and Wall Street America, the tax lawyer is continually required to confront some of the most basic structural issues of the tax law.