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Outline of United States Tax Considerations of Currency and Interest Rate Swaps

by
Robert H. Dilworth†
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I.

THE EVOLUTION OF SWAPS FROM PARALLEL AND BACK-TO-BACK LOANS

Currency and interest rate swaps are financial products that allow parties to transfer the risk of exchange rate and interest rate fluctuations. Swaps evolved from the parallel and back-to-back loans that U.K. corporations used during the 1960s and 1970s to provide dollar financing to their U.S. subsidiaries while circumventing U.K. exchange controls.

A. *Parallel Loans*

In a typical parallel loan, a U.K. corporation lent pounds to the U.K. subsidiary of a U.S. corporation in exchange for which the U.S. corporation lent dollars of an equivalent value to the U.S. subsidiary of the U.K. corporation. Each loan would bear a market interest rate for the currency lent. The pound and dollar loans would be structured as separate transactions, but the parties often attempted to grant each other the right to offset obligations under the two loans in the event of default under one of the loans.

B. *Back-to-Back Loans*

Back-to-back loans were similar to parallel loans except that, in the back-to-back format, both loans were between the same two parties. A U.K. corporation seeking dollar financing borrowed dollars from a U.S. party, and the U.S. party simultaneously borrowed an equivalent amount of pounds from the U.K. corporation for the same term. The interest rates on each loan corresponded to the prevailing market rate in its respective currency. The

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back-to-back loans allowed the U.K. corporation to obtain dollar financing without resorting to the foreign exchange markets, in which U.K. parties were required, under U.K. exchange controls, to pay a premium for dollars. An example of a back-to-back loan is diagramed as Exhibit I.¹

C. Commercial Problems with Parallel and Back-to-Back Loans

Both parallel and back-to-back loans suffered from two commercial disadvantages: it was difficult to assure the parties legally enforceable offset rights in case of bankruptcy or insolvency, and the fact that the transactions had to be carried on each party's balance sheet.

1. Uncertainty as to Offset Rights

If one party to a back-to-back or parallel loan became bankrupt, it was feared that a bankrupt party, after suspending payments under its loan, would continue to be entitled to receive payments from the counterparty under the offsetting loan. The problem was especially acute in the case of parallel loans because the loans were between separate sets of borrowers and lenders. Although the parties endeavored to protect themselves by providing each other with contractual offset rights, it was doubtful that such contractual offset rights would be respected under the bankruptcy laws of the relevant jurisdictions.

2. Effect on Balance Sheet

Because the parallel and back-to-back loans were structured as borrowings, they had to be shown as liabilities on the balance sheet of the borrowers, even though each borrowing was offset by a like amount owed to the borrower by the counterparty. The use of parallel and back-to-back loans therefore made the parties appear more heavily leveraged than they really were and reduced their borrowing capacity.

D. Development of the Foreign Currency Swap

Sometime before 1980, parties began to realize that they could achieve precisely the same economic result achieved by a back-to-back loan, yet avoid the problems discussed above, simply by using a different legal description for the relationship between the parties. What had been legally described as two loan obligations could now be described as a series of forward exchange contracts or "swaps." Instead of one party agreeing to borrow and repay dollars and the other party agreeing to borrow and repay pounds, the parties agreed to exchange equivalent amounts of dollars and pounds at the outset of the agreement and to reexchange the initial pound and dollar amounts at the

1. For Exhibits I-V see Appendix, *infra*.

expiration of the agreement. Instead of paying each other interest on offsetting loans during the term of the agreement, the parties agreed to exchange periodically dollar and pound amounts calculated to equal interest on the dollar and pound amounts originally exchanged. Exhibit II illustrates exactly the same cash flows as Exhibit I, but this transaction is structured as a swap rather than as parallel loans.

1. Offset Rights Effective

Because each party's obligation to perform each exchange is contingent on the counterparty's simultaneous performance, the uncertainty regarding the ability of the parties to offset obligations in the event of default is avoided.

2. Off Balance Sheet Transactions

Because each party's liability to make payments under the swap agreement is contingent, the liabilities do not have to appear on their balance sheets.

II.

TYPES OF SWAPS AND RANGE OF APPLICATIONS

From its origin as an improved alternative to back-to-back loans, the swap has developed into a flexible financial instrument with a broad range of applications. The basic concept of parties agreeing to exchange payments equal to the interest accrued on notional principal amounts has become an important tool in managing liquidity and hedging a wide variety of financial risks.

A. Foreign Currency Swaps

The basic currency swap is most often used by borrowers to reduce the risk of exchange rate fluctuation when they borrow in currencies other than their functional currency. In the absence of such a hedge, the actual interest expense could be substantially greater or less than the nominal interest rate, and the amount of foreign currency principal repaid could be worth substantially more or less than the original functional currency equivalent of the amount borrowed. A lender in a nonfunctional currency can also use a currency swap to hedge its currency exposure with respect to anticipated foreign currency interest receipts and principal repayments. If anticipated interest and principal cash flows are fully covered by related swaps, a borrowing or loan in one currency can be effectively connected into a "synthetic" financial debt or loan in another currency. Currency swaps can also be used to hedge foreign currency liabilities or assets other than borrowings or loans.

1. Hedge of Cost of Foreign Currency Borrowing

One of the most common uses of foreign currency swaps is to hedge the dollar cost of foreign currency borrowings. If, for example, a U.S. corporation issues yen denominated Eurobonds, it can simultaneously enter into a swap agreement to convert the yen proceeds into dollars and, thus, hedge the dollar cost of making yen coupon and principal payments. For the initial swap exchange, it agrees to deliver the yen received on the bond issuance to the swap counterparty in exchange for the counterparty delivering a specified number of dollars. Periodic swap exchanges are scheduled to coincide with the coupon payment dates of the bonds. The U.S. corporation agrees to deliver a specified number of dollars on each periodic exchange date in exchange for the amount of yen required to make the coupon payment on the bonds. The final exchange date falls on the redemption date for the bonds. On that date the U.S. corporation pays the original dollar notional principal amount to the counterparty in exchange for a payment from the counterparty of the yen notional principal amount. The U.S. corporation then uses the yen received to redeem the bonds.

a. Fixed Dollar Borrowing Cost

By combining the yen borrowing with a foreign currency swap, the U.S. corporation will have transformed the bond issuance into the practical equivalent of a dollar denominated obligation. The U.S. corporation receives dollars from the yen denominated Eurobond offering coupled with a swap, and the total dollar cost of paying the principal and interest on the Eurobonds is fixed. The cost in dollars of borrowing is known from the outset. Except for the credit risk borne by the U.S. corporation with respect to possible default by the swap counterparty (if the yen appreciates against the dollar), for financial purposes it is exactly as if the U.S. corporation had issued a dollar obligation with a principal amount equal to the dollar amount it received on the initial swap exchange and with coupon payments equal to the dollar amounts to be paid it on the periodic swap exchange dates. Such a transaction may be described as a synthetic dollar borrowing by the U.S. borrowing corporation.

b. Comparison with Use of Forward Contract Hedges

Foreign currency borrowings can also be hedged in some cases by using interbank foreign currency forward contracts, but foreign currency swaps provide a much more flexible instrument.² A foreign currency swap can be

2. It is difficult to find counterparties willing to enter into foreign currency forward contracts with delivery dates more than three or four years in the future. Even if forward contracts are available over the entire maturity of the borrowing, there will generally be a different exchange rate for each payment date. For currencies bearing interest at rates lower than dollar interest rates, the dollar cost for a fixed amount of currency will increase with the term of the contract. For currencies bearing interest at higher rates, the dollar cost will decrease. Under a

viewed as the economic equivalent of an integrated series of foreign currency forward contracts in which all of the exchanges are priced as parts of a single agreement.

2. Hedge Risk of Foreign Currency Denominated Assets or Liabilities

Currency swaps can also be used to hedge the dollar value of foreign currency denominated assets or liabilities not specifically related to borrowings.

a. No Need for Initial Exchange

If the parties do not need to obtain or dispose of foreign currency at the outset of the swap, there is no need for an initial exchange of the notional principal amounts under the swap. The swap can call only for periodic exchanges of interest on the notional principal amounts and the exchange of the notional principal amounts on termination of the swap.

b. Synthetic Dollar Assets

If an investor holds a deutsche mark denominated bond, the investor can effectively convert the bond into a dollar denominated asset by entering into a foreign currency swap. If the investor agrees to deliver on the coupon payment dates deutsche marks equal to the coupon amounts and agrees to deliver on the bond redemption date the deutsche mark principal amount of the bond, all for specified dollar amounts, it will have locked in, or guaranteed itself, a fixed dollar cash flow.

c. Hedge of Foreign Currency Denominated Cash Flows

A parent corporation can hedge the dollar value of an expected foreign currency dividend stream from a foreign subsidiary by entering into a swap under which it delivers foreign currency in amounts approximating the expected dividend flow in exchange for fixed dollar amounts. Similarly, a corporation that issues dual currency Eurobonds, which have interest payable in foreign currency but principal payable in dollars, may wish to hedge its interest expense by entering into a swap under which it takes delivery of foreign currency at times, and in amounts, corresponding to the bond coupon amounts.

swap agreement, all of the exchanges can be priced as parts of a single agreement. A constant exchange rate can, therefore, be used for the periodic exchanges, producing a level dollar interest expense for the U.S. borrower. Forward contracts are similar to futures contracts, except that they are entered into by the parties on a principal-to-principal basis rather than on a regulated futures exchange.

B. Interest Rate Swaps

The concept of agreeing to exchange amounts equivalent to the interest on notional principal amounts can also be applied to transactions denominated entirely in a single currency (typically dollars). A party which has a floating rate obligation can effectively convert it into a fixed rate obligation by entering into a swap with a party which has a fixed rate obligation and which wants to establish a synthetic floating rate obligation. The use of such interest rate swaps has grown explosively over the last five years, and their volume now far surpasses the volume of foreign currency swaps.

1. Interest Rate Swap Mechanics

Interest rate swaps are sometimes called coupon swaps because the parties agree to pay amounts corresponding to periodic interest obligations on like principal amounts.³ One party (the "floating rate borrower"), for example, may have borrowed \$50,000,000 from a bank at prime for a seven-year term. The other party (the "fixed rate borrower") may have \$50,000,000 in outstanding bonds bearing interest at a yearly rate of eight percent over a seven-year term. If the floating rate borrower agrees to pay to the fixed rate borrower an annual amount equal to eight percent interest on \$50,000,000 (i.e., \$4,000,000) in exchange for the fixed rate borrower paying a sum equal to the prime rate of interest on the same \$50,000,000 notional principal amount, the floating rate borrower will effectively convert its net liability into a \$50,000,000 borrowing at a fixed eight percent annual rate. The swap payment it will receive from the fixed rate borrower will precisely cover its interest expense under its loan, and its expense will equal the swap payment to the fixed rate borrower, the eight percent interest. Similarly, the fixed rate borrower will have effectively converted its fixed rate obligation under the bonds into a floating rate obligation. The \$4,000,000 annual swap payment received from the floating rate borrower will offset the fixed rate borrower's interest expense on the bonds, and its expense will be its annual payment to the floating rate borrower, the prime rate on \$50,000,000.

a. Only Net Amount Actually Paid

Under an interest rate swap there is no need for the gross amount of each offsetting payment to be paid. The parties generally agree that only the net amount remaining, after the amounts due are offset, is to be paid. In the above example, if the prime rate is seven percent for the first year of the swap, the floating rate borrower would pay the fixed rate borrower the excess of the fixed interest of \$4,000,000 over the floating prime interest of \$3,500,000 (seven percent of \$50,000,000), or \$500,000. If in the following year the

3. The term "coupon swap" is often used because each party to an interest rate swap can be thought of as agreeing to pay the other's interest obligations on like amounts of debt, as if each party had agreed to make the coupon interest payments on the other's bonds.

prime rate rose to ten percent, the fixed rate borrower would pay \$1,000,000 to the floating rate borrower (i.e., the excess of the \$5,000,000 prime rate interest payment due to the floating rate borrower under the swap over the \$4,000,000 fixed rate payment due to the fixed rate borrower). This transaction is diagrammed in Exhibit III.

b. No Exchanges of Notional Principal Amounts

In contrast to foreign currency swaps, there are no exchanges of notional principal amounts under interest rate swaps, because it would be pointless for the parties to exchange like amounts of the same currency. The notional principal amounts are only computational devices by which the amounts exchanged are calculated. No credit is actually extended by either party.

2. Use of Interest Rate Swaps to Hedge Interest Rate Risk

Interest rate swaps can be used to control interest rate exposure much as currency swaps are used to control foreign currency exposure.

a. Floating Rate Borrower Can Lock in Interest Rate

As illustrated in the above example, a floating rate borrower can lock in its interest expense using an interest rate swap and, thus, eliminate its exposure to future interest rate fluctuations. This possibility is attractive to many borrowers that have difficulty obtaining long-term fixed rate financing but want a fixed interest expense.

b. Swaps as an Alternative to Matching Funding

One basic method of interest rate exposure management is to match fixed rate assets with fixed rate funding and floating rate assets with floating rate funding. Banks that earn most of their income from floating rate loans, for example, generally prefer to fund those loans on a floating rate basis. A fixed-to-floating interest rate swap can enable a bank to raise funds on a fixed rate basis (e.g., by selling fixed rate bonds) and to eliminate undesirable interest rate exposure between its floating rate income-producing assets and related fixed rate liabilities by converting the fixed rate bonds into synthetic floating rate bonds.

3. Use of Swaps as a Form of Interest Rate Arbitrage to Obtain the Lowest Cost Financing

A corporation that has a strong credit rating and is seeking floating rate financing can often obtain the equivalent of such financing at a lower cost by issuing fixed rate obligations in combination with a fixed-to-floating interest rate swap. A corporation with a comparatively lower credit rating seeking

fixed rate financing can often obtain the equivalent of such financing by issuing floating rate debt and entering into the fixed-to-floating interest rate swap with a corporation having a comparatively stronger credit rating.

a. Comparative Advantages in Fixed and Floating Rate Markets

The above result is a function of the fact that a borrower with a strong credit rating in the capital markets may have a greater borrowing advantage over a lower credit borrower in the fixed rate market than in the floating rate market. The borrower having the stronger credit rating might, for example, be able to borrow at fixed rates for a full 100 basis points less than the lower credit borrower, but at a comparative rate reduction of only twenty-five basis points in the floating rate market. The lower differential for floating rate borrowing may result from the fact that floating rate lending has traditionally been dominated by banks, which are in the business of evaluating and assuming credit risks. The fixed rate lending market, on the other hand, is dominated by investors in bonds, who are less able to evaluate credit risk and are willing to pay a premium for the bonds of an issuer with strong creditworthiness.

b. Swap Enables Borrower to Borrow in Market Where It Has Comparative Advantage

A swap enables each borrower to borrow in the market where it has the greatest advantage over another borrower (or, in the case of the lower credit borrower, the least disadvantage) and, by swapping obligations with that borrower, to convert that obligation into the type of financing it seeks. Because each borrower borrows where its advantage is greatest (or disadvantage is least), the aggregate savings on the two borrowings is equal to the difference between the stronger party's advantage in the fixed rate market and that party's advantage in the floating rate market. This net savings can be split between the two parties to the swap in the pricing of the swap payments.

c. Example

Assume that the stronger credit borrower can borrow in the fixed rate market at 8.5 percent while the lower credit borrower must pay 9.5 percent. Assume further that the stronger credit borrower can borrow in the floating rate market at LIBOR, the London Interbank Offered Rate, while the lower credit borrower can borrow at LIBOR + 0.25 percent. The stronger credit borrower therefore has an advantage of one percent in the fixed rate market and an advantage of 0.25 percent in the floating rate market. Its advantage is therefore 0.75 percent greater in the fixed rate than in the floating rate market (i.e., a "comparative advantage" of 0.75 percent in the fixed rate market). If the stronger credit borrower wants floating rate financing, while the lower credit borrower wants an equal amount of fixed rate financing, the sum of their interest expenses, if they borrowed directly in their desired market,

would be LIBOR (the stronger credit borrower's floating rate expense) plus 9.5 percent (the lower credit borrower's fixed rate expense), or LIBOR + 9.5 percent. If each borrower instead borrows in the market of its greatest advantage (or its least disadvantage) and then enters into an interest rate swap, the sum of their interest expenses would be 8.5 percent (the stronger credit borrower's fixed rate expenses) plus LIBOR + 0.25 percent (the lower credit borrower's floating rate expense), or LIBOR + 8.75 percent. This represents an aggregate interest savings of 0.75 percent. The parties can divide this savings by the pricing of the swap agreement. Exhibit IV provides an example of such a calculation. The stronger credit borrower is, in effect, selling part of the benefit of its credit rating advantage to the lower credit borrower. Both parties are able to achieve the desired type of financing at a cost that neither could achieve in the absence of the swap.

III.

UNITED STATES WITHHOLDING TAX TREATMENT OF SWAP PAYMENTS TO FOREIGN COUNTERPARTIES

The evolution of swaps is a case of the development of sophisticated financial instruments far outstripping the development of the tax law. Prior to the Tax Reform Act of 1986 [hereinafter the 1986 Act], there was a complete lack of authority on the U.S. tax treatment of swaps. Even with the changes introduced under the 1986 Act, substantial areas of uncertainty remain. One such area is the U.S. withholding tax treatment of swap payments to foreign counterparties.

A. Withholding Tax on Fixed or Determinable Income

In the absence of a tax treaty, the United States imposes a thirty percent withholding tax on the gross amount of "fixed or determinable, annual or periodical" income paid to foreign persons to the extent that the payments are from U.S. sources and are not effectively connected with a U.S. trade or business.⁴

1. Fixed or Determinable, Annual or Periodical Income

The Internal Revenue Code [hereinafter Code] does not define "fixed or determinable, annual or periodical income" [hereinafter FDAPI] exhaustively. Interest payments are specifically included, except to the extent that they constitute interest on portfolio debt instruments described in section 871(h) or original issue discount on obligations having initial maturities of 183 days or less. FDAPI is defined more fully in Treasury Regulations which state that "[t]he term 'fixed or determinable annual or periodical' income is merely descriptive of the character of a class of income." Income is "fixed"

4. I.R.C. §§ 871(a)(1)(A), 881(a)(1), 1441(a), 1442(a) (1986).

when it "is to be paid in amounts definitely predetermined." Income is "determinable" "whenever there is a basis of calculation by which the amount to be paid may be ascertained." "Periodical" is defined as "from time to time, whether or not at regular intervals."⁵

a. High Gross Income Component

There is some authority to the effect that payments will be considered FDAPI only if they ordinarily are comprised of a high proportion of net income (that is, they do not normally have associated expenses that would reduce gross income to a relatively small amount of net income). On this basis, payments of insurance premiums were ruled not to constitute FDAPI subject to withholding.⁶

b. Gains from Sale of Property Are Not FDAPI

Treasury Regulations specifically provide that gains from the sale of property do not constitute FDAPI.⁷

c. Gambling Winnings Constitute FDAPI

The Court of Claims has held specifically that gambling winnings of a foreign person in the United States constitute FDAPI. Furthermore, the amount won on each bet was held to be a separate item of FDAPI subject to withholding tax on the gross amount won. Winnings could not be offset by losses from other bets for purposes of calculating the withholding tax.⁸

2. From U.S. Sources

Payments of FDAPI are subject to U.S. withholding tax only if they constitute U.S. source income. In determining the source of swap income, taxpayers and the Internal Revenue Service [hereinafter Service] have had to rely on analogies to the source rules for other types of income.

a. Interest

Interest generally has its source at the residence of the obligor.⁹ An exception is made for payments by U.S. corporations that earn more than eighty percent of their gross income abroad.¹⁰

5. Treas. Reg. § 1.1441-2(a)(1)-(2) (1984).
6. See Rev. Rul. 80-222, 1980-2 C.B. 211.
7. Treas. Reg. § 1.1441-2(a)(3) (1984).
8. *Barba v. United States*, 2 Cl. Ct. 674 (1983).
9. I.R.C. § 861(a)(1) (1986).
10. See *id.* § 861(a)(1)(A).

b. Service fees

Service fees have their source in the jurisdiction where the service is rendered.¹¹ Under this rule, loan commitment fees have a source in the jurisdiction of the bank providing the loan commitment.¹² Similarly, the fees for negotiating a letter of credit are sourced where the letter of credit is negotiated.¹³

c. Insurance Income

The income from the insurance of risks is sourced at the situs of the risk insured.¹⁴ It appears that the same rule applies to gambling winnings.

d. Winnings From Solving Puzzles

The winnings from a puzzle solving contest are treated as having their source in the jurisdiction where the winner engaged in the puzzle solving activities, rather than the jurisdiction from which the prize is paid.¹⁵

e. Foreign Currency Gains

Under amendments made by the 1986 Act, the source of foreign currency gain or loss is the residence of the party on whose books the financial asset or liability giving rise to the gain or loss is reflected.¹⁶ Thus, the same transaction can give rise to gain or loss with a source in different jurisdictions for different taxpayers.

B. Application to U.S. Dollar Denominated Interest Rate Swaps

In Treasury Notice 87-4¹⁷ and Revenue Ruling 87-5,¹⁸ the Service addressed the U.S. withholding tax treatment of basic dollar denominated interest rate swaps.

1. Characterization as Fixed or Determinable, Annual or Periodical Income

In Treasury Notice 87-4, the Service specifically reserved judgment on the issue of whether swap payments constitute FDAPI. It states, "[n]othing in this notice should be read as foreclosing the Internal Revenue Service from asserting in any case that swap income is properly characterized as FDAPI

11. *See id.* §§ 861(a)(3), 862(a)(3).

12. *See Priv. Ltr. Rul.* 78-08-038 (Nov. 25, 1977).

13. *Bank of America v. United States*, 680 F.2d 142 (1982).

14. I.R.C. §§ 861(a)(7), 862(a)(7) (1986).

15. *Rev. Rul.* 66-291, 1966-2 C.B. 279.

16. *See I.R.C.* § 988(a)(3) (1986).

17. I.R.S. Notice 87-4, 1987-3 I.R.B. 7.

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

income.”¹⁹ Although there is no authority directly on point, the Service would be able to take the position that swap income constitutes FDAPI by analogy to the treatment of gambling and other similar types of income.

2. *Source of Swap Income*

The Service announced in Treasury Notice 87-4 that income from dollar denominated interest rate swaps will be sourced at the residence of the recipient of the swap income. In cases where the income is effectively connected with a U.S. trade or business of a foreign recipient, however, the income will be treated as U.S. source income to the recipient. These source rules apply only to income from dollar denominated interest rate swaps received on or after December 24, 1986. A taxpayer may elect to apply these rules to all, but not part, of its swap income received prior to December 24, 1986.

3. *No U.S. Withholding Tax on Basic Payments Under Simple U.S. Dollar Denominated Interest Rate Swap*

Under Treasury Notice 87-4 there should be no U.S. withholding tax on the basic payments to a foreign counterparty under a simple U.S. dollar denominated interest rate swap. If the payments are not effectively connected with a U.S. trade or business of the foreign counterparty, the counterparty's income will be foreign source income not subject to the U.S. withholding tax. If the payments are effectively connected with a U.S. trade or business, the income will be subject to U.S. income tax on net income under section 882, but will not be subject to withholding tax on the gross payments under section 1442.

4. *Remaining Areas of Withholding Tax Exposure With Respect to Dollar Denominated Interest Rate Swaps*

Although Treasury Notice 87-4 resolves most of the withholding tax issues with respect to simple U.S. dollar denominated interest rate swaps, a number of areas of potential withholding tax exposure remain.

a. *Form 4224*

Treasury Notice 87-4 does not purport to modify the regulations under sections 1441 and 1442 that require a U.S. payor of FDAPI to withhold unless it has received an effective Form 4224 signed by the recipient. If the U.S. counterparty has not received a Form 4224, but has reason to suppose that the swap is connected with a U.S. trade or business of a foreign counterparty, Treasury Regulation 1.1441-4 appears to continue to require withholding.

19. Notice 87-4, 1987-3 I.R.B. 7. The withholding tax issue was not raised in this case because the foreign party was exempted from it under a tax treaty. See *infra* note 32 and accompanying text.

The foreign counterparty would then have to claim a refund of withheld tax.²⁰

b. Payments of Default Interest, Facility Fees, Etc.

Although the basic periodic payments under a dollar denominated interest rate swap should be free of withholding, other types of payments under the swap agreement may receive different tax treatment; therefore, they have to be analyzed separately. If, for example, the swap agreement calls for default interest on late payments, any payments of default interest would presumably be subject to the general withholding tax provisions for interest. Payments of facility fees and the like also have to be analyzed separately for potential withholding tax exposure.

c. Swaps With Uneven Payment Schedules

Treasury Notice 87-4 appears to deal only with simple interest rate swaps under which neither party effectively extends credit to the other. Its general rule probably does not apply to a swap under which a foreign party effectively lends funds to a U.S. counterparty and is compensated for the use of the funds. For example, a U.S. party that has a fixed interest debt that must be amortized by level payments over five years may wish to convert it into a floating rate debt with the principal payable only at the end of five years. The U.S. party can achieve this objective by entering into a swap with a foreign counterparty that has a five-year "bullet" maturity floating rate debt for a like principal amount which the foreign counterparty wants to convert into the economic equivalent of a fixed rate self-amortizing debt. The foreign party makes large net payments to the U.S. party during the first four years, because its payments include the amortization of the "notional" principal amount. The U.S. party, in effect, repays this amount with interest in the last swap exchange. Because such a swap actually involves the extension of credit and payment for the use of money, the Service could treat a portion of the final payment as a payment of interest subject to withholding tax.

C. Application to Foreign Currency Swaps

Treasury Notice 87-4 does *not* address the withholding tax treatment of foreign currency swaps. In evaluating the withholding tax exposure with respect to foreign currency swaps, taxpayers can rely only on the foreign currency provisions added to the Code by the 1986 Act and on certain preexisting decisions.

20. Treas. Reg. § 1.1441-4 (1984).

1. *Regulations to be Issued under Section 988*

The foreign currency provisions of the 1986 Act do not directly address the U.S. withholding tax treatment of foreign currency swaps. The Conference Committee Report states, "[t]he conference agreement contemplates that the Secretary will address the appropriate treatment of payments made to a counter-party under a swap transaction for purposes of withholding under sections 871 and 881."²¹ It should be noted that the Report gives no hint of what the "appropriate treatment" of swap payments might be.

2. *Characterization as Fixed or Determinable, Annual or Periodical Income*

Currency swap payments could fall within the literal definition of "other" FDAPI in Treasury regulations, because the amounts are payable "from time to time" and "there is a basis of calculation by which the amount to be paid may be ascertained."²² It can be argued that only a portion of each gross payment under a foreign currency swap constitutes net income and that, like insurance premiums, the payments are, therefore, not of the type intended to be subject to withholding tax. One can also argue that payments under a currency swap represent purchases and sales of foreign currency and should, therefore, be exempted from classification as FDAPI, under the exception for payments received from the sale of property.²³ Neither of these arguments, however, appear sufficient to prevent the Service from using its regulatory authority to classify currency swap payments as FDAPI, if it chooses to do so. It should again be noted that, in Treasury Notice 87-4, the Treasury specifically preserved its option to treat interest rate swap payments as FDAPI, and the same reservation can arguably be extended to currency swap payments.²⁴

3. *Source of Currency Swap Income*

It is clear that Congress intended to include foreign currency swaps within the definition of "section 988 transactions" for purposes of section 988.²⁵ The foreign currency gain or loss with respect to such transactions will generally have its source at the tax residence of the person realizing the gain or loss.²⁶ Therefore, the portion of a foreign counterparty's gain or loss on a foreign currency swap payment attributable to a movement in exchange rates will generally constitute foreign source income not subject to U.S. withholding tax. It should be noted, however, that not all of the gain or loss on a

21. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 668 (vol. II) (1986).

22. Treas. Reg. § 1.1441-2(a)(1)-(2) (1984).

23. See *id.* § 1.1441-2(b).

24. See *supra* note 19 and accompanying text.

25. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 663 (vol. II) (1986) and S. REP. NO. 313, 99th Cong., 2d Sess. 460 (1986).

26. I.R.C. § 988(a)(3) (1986).

currency swap payment is necessarily attributable to exchange rate movements. Because currency swaps are priced as a series of integrated transactions rather than on a payment-by-payment basis, the annual exchanges under the swap usually do not correspond to the market prices for forward contracts for those amounts on those exchange dates. As a result, individual exchanges under a currency swap usually produce gains and losses even in the absence of exchange rate movement. With respect to the portion of gain on foreign currency swap payments attributable to exchange rate movements, there is some risk of withholding tax based on the Treasury's regulatory authority to provide "appropriate" treatment of swap payments.²⁷ The legislative history of section 988 also states that the Treasury may issue regulations providing special source rules for fully hedged transactions. The committee reports suggest that income from the foreign currency swap that is part of a fully hedged transaction would be sourced "consistently" with the income, gain or loss on the item being hedged.²⁸ It, therefore, appears that the withholding tax treatment of payments to foreign counterparties under currency swaps could conceivably depend on the counterparty's motivation for entering into the swap. Pending issuance of regulations, however, the source of a cross currency swap should be at the tax residence of the recipient and, thus, should not be subject to withholding tax if the recipient has its residence outside the United States.

*D. Elimination of Remaining Withholding Tax Risk
Through Choice of Counterparty*

The Treasury appears to be attempting to find a rationale for exempting payments under both currency and interest rate swaps from U.S. withholding tax. Nevertheless, the technical basis for such an exemption under the present Code and authorities remains somewhat uncertain for all but simple dollar denominated interest rate swaps. Until regulations are issued clarifying the issues, the conservative approach for parties entering into swaps (other than simple dollar interest rate swaps) is to structure the transactions so that there will be no withholding even if the payments constitute U.S. source FDAPI. Potential withholding tax liability can be avoided completely by entering into a swap with one of three types of counterparties.

1. United States Persons

Because withholding tax under sections 871, 881, 1441, and 1442 applies only to payments to foreign persons, swap agreements between two U.S. corporations involve no withholding tax risk. A U.S. corporation can, therefore, safely enter into swap arrangements with U.S. banks, including the foreign

27. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 668 (vol. II) (1986).

28. *Id.*

subsidiaries of U.S. banks. It should be noted, however, that U.S. withholding tax may apply to swap payments to a foreign *subsidiary* of a U.S. bank because the foreign subsidiary is a foreign corporation.²⁹

2. *U.S. Branches of Foreign Banks or Corporations*

Withholding tax is not applicable to payments to foreign persons if the payments are effectively connected with a U.S. trade or business of the foreign person.³⁰ A U.S. corporation can, therefore, safely enter into swaps with U.S. branches of foreign banks or corporations, if the counterparty agrees to report the swap income as effectively connected with its U.S. trade or business. To establish a withholding tax exemption based on the income being effectively connected with a U.S. trade or business, the U.S. payor should obtain from the foreign counterparty a properly executed Internal Revenue Service Form 4224.³¹

3. *Treaty Benefitted Counterparty*

In Revenue Ruling 87-5, the Service ruled that payments to a Netherlands bank under a simple U.S. dollar denominated interest rate swap qualified for exemption from U.S. withholding tax under the industrial and commercial profits provisions of the United States-Netherlands income tax treaty.³² Although the ruling dealt with an interest rate swap, it is difficult to formulate any rationale for reaching a different result in the case of a currency swap with a bank counterparty. In the case of a non-bank counterparty, however, obtaining a withholding tax exemption for swap payments is troublesome under most of the U.S. income tax treaties, because it is not clear that swap income falls within one of the specified categories of treaty benefitted income. The closest categories appear to be "interest," "industrial and commercial profits," and "capital gains."

a. *Interest*

Payments of interest are exempted from source country withholding tax under the treaties with several major countries, including France, Germany, the Netherlands, and the United Kingdom.³³ Tax treaties with Japan and Switzerland, in contrast, provide only a reduced rate of withholding tax and

29. I.R.C. §§ 881(a), 1442(a) (1986).

30. *See id.* §§ 882(a)(1), 1442(b).

31. Treas. Reg. § 1.1441-6 (1984).

32. Rev. Rul. 87-5, 1987-3 I.R.B. 6; Convention with Respect to Taxes on Income and Certain Other Taxes, April 28, 1948, United States-Netherlands, art. III, 62 Stat. 1757, T.I.A.S. No. 1855.

33. *See, e.g.*, Convention for the Avoidance of Double Taxation on Income and Capital Gains, Dec. 31, 1975, United States-United Kingdom, art. 11, 31 U.S.T. 5668, T.I.A.S. No. 9682; Convention with Respect to Taxes on Income and Property, July 28, 1967, United States-France, art. 10, 19 U.S.T. 5280, T.I.A.S. No. 6518, *amended by* Protocol Respecting Taxes on Income and Property, Nov. 24, 1978, United States-France, para. 5, 30 U.S.T. 5109, T.I.A.S. No. 9500;

not complete exemption (ten percent in the case of Japan and five percent in the case of Switzerland).³⁴ For most swaps it would, in any event, be difficult to characterize swap payments as interest because no credit is actually extended from one party to the other, even though the swap payments are calculated by analogy to the computation of interest on a notional principal amount.³⁵

b. Business Profits or Industrial and Commercial Profits

Most U.S. tax treaties exempt foreign corporations resident in a treaty jurisdiction from withholding tax on U.S. source industrial or commercial profits not effectively connected with a U.S. permanent establishment of the foreign corporation. The Senate Finance Committee Report on the 1986 Act specifically states that there is an unsettled question of law as to "whether an exemption from withholding is available under an income tax treaty to which the United States is a party on the ground that swap payments constitute . . . industrial and commercial profits."³⁶ As discussed above, the 1986 Act does not directly resolve the issue, but instead authorizes the Treasury to issue regulations on the withholding tax treatment of swaps.³⁷ Even if swap payments can generally constitute "commercial profits," there is a further complication because several treaties provide that interest and capital gains cannot qualify as industrial or commercial profits unless effectively connected with a U.S. permanent establishment.³⁸ Although unlikely, it is possible that a comparable limitation of FDAPI can be implied under the French or other treaties, to the effect that only profits of that class that are effectively connected with a U.S. permanent establishment will constitute industrial and commercial profits. Pending issuance of withholding regulations for swap payments, the parties to a swap should not plan transactions with non-bank counterparties on the assumption that swap payments constitute industrial or commercial profits for purposes of exemption under standard U.S. tax treaties.

Convention for the Avoidance of Double Taxation, July 22, 1954, United States-Federal Republic of Germany, art. VII, 5 U.S.T. 2768, T.I.A.S. No. 3133; United States-Netherlands Convention, *supra* note 32, art. III.

34. Convention for the Avoidance of Double Taxation of Income, May 24, 1951, United States-Switzerland, art. VII, 2 U.S.T. 1751, T.I.A.S. No. 2316; Convention for the Avoidance of Double Taxation of Income, March 8, 1971, United States-Japan, art. 13, 23 U.S.T. 967, T.I.A.S. No. 7365.

35. See *Deputy v. Dupont*, 308 U.S. 488, 497-98 (1940); S. REP. NO. 313, 99th Cong., 2d Sess. 442 (1986).

36. S. REP. NO. 313, 99th Cong., 2d Sess. 441-42 (1986).

37. See *supra* Part III.C.1.

38. See, e.g., United States-France Convention, *supra* note 33, art. 6, para. 5, 19 U.S.T. at 5290-91.

c. *Capital Gains*

In some cases it may be possible to argue that the payments under a swap constitute capital gains income for treaty purposes and should be exempt from withholding under the capital gains provision of the relevant tax treaty. As discussed above, there remains a considerable risk that the periodic payments under a swap will be treated as FDAPI rather than capital gains. In the case of a swap that is, for the foreign counterparty, an ordinary income hedge, the capital gains position is difficult to defend.

d. *Residual Clause Under U.K. and French Treaties*

Both the U.K. and the French tax treaties contain residual clauses that provide that income of a type not otherwise covered by the treaties is taxable only by the recipient's country of residence.³⁹ Therefore, if a swap payment to a U.K. or French counterparty fails to qualify, for purposes of the treaty, as interest, industrial or commercial profits, or capital gains, the payment will still be free of U.S. withholding tax under the residual clause. U.S. corporations can, therefore, enter into swaps with U.K. and French counterparties with assurance that the swap payments will be free of withholding tax. It is important to note that U.K. and French *branches* of foreign banks organized in other foreign countries are *not* entitled to the benefits of the U.K. or French tax treaties. It is a surprisingly common mistake to assume that payments to a London branch of a bank organized outside the United Kingdom are entitled to the benefits of the United States-United Kingdom income tax treaty.⁴⁰

e. *Claiming Treaty Benefits — Form 1001*

If a U.S. party relies on a tax treaty for exemption from withholding on swap payments, it should obtain from the counterparty a duly executed Internal Revenue Service Form 1001 prior to making any swap payments.⁴¹

4. *Summary*

Given the remaining uncertainties discussed above, a prudent U.S. corporation can avoid withholding tax exposure by entering into swaps only with the following types of counterparties: (i) U.S. persons; (ii) U.S. branches of foreign banks or corporations, if the foreign counterparty reports its income from the swap as effectively connected with a U.S. trade or business; (iii) foreign banks entitled to the withholding tax exemption under the commercial and industrial profits clause of an applicable tax treaty; and (iv) enterprises entitled to the benefit of the U.K. or French tax treaties.

39. See, e.g., *id.* art. 22, para. 1, 19 U.S.T. at 5307; United States-United Kingdom Convention, *supra* note 33, art. 22, para. 1, 31 U.S.T. at 5685, T.I.A.S. No. 9682 at 18.

40. Rev. Rul. 72-378, 1972-2 C.B. 662.

41. I.R.S. Notice 87-11, 1987-5 I.R.B. 6.

IV.

UNITED STATES INCOME TAX TREATMENT OF SWAPS

The U.S. income tax treatment of swaps becomes an issue whenever one of the parties to the swap is a U.S. person, a foreign person with a U.S. trade or business, or a foreign person otherwise subject to U.S. income taxation. The relevant issues are the amount, timing, character, and source of the gain or loss under a swap. These issues should be analyzed in accordance with the fundamental premise that a swap is an exchange: one party purchases the right to receive a defined stream of payments by agreeing to make a different stream of periodic payments to the counterparty. Each party's assumption of the obligation to make a defined set of payments should provide it with a tax basis which can apply against the stream of payments it receives in return. Because foreign currency swaps are transactions in foreign currency, one must analyze their income tax treatment in light of the foreign currency provisions of new subpart J., discussed below. Where a currency or interest rate swap is entered into as a hedge, its income tax treatment must also be analyzed in light of existing case law relating to hedging transactions.

A. Income Tax Treatment of Foreign Currency Swaps

Under the provisions of new subpart J, added to the Code as part of the 1986 Act, currency swaps are divided into three categories. First, currency swaps not constituting hedges are addressed by the general rules contained in Code section 988(a)-(c). The other two categories — those swaps that are both fully hedged and fully integrated and those that are hedging transactions *not* entered into as part of a fully integrated financial package [hereinafter other hedging transactions] — are described and initially addressed in section 988(d). The Treasury has issued a "notice" prescribing narrow safe-harbor rules for fully integrated transactions on which taxpayers can rely, pending issuance of more comprehensive regulations.⁴²

1. Currency Swaps Not Constituting Hedges

Currency swaps not constituting section 988 hedging transactions are governed by the general provisions of section 988.

a. Currency Swaps as Section 988 Transactions

It is clear that Congress intended to include all currency swaps within the definition of section 988 transactions. Section 988 transactions are defined to include, among other things, "entering into or acquiring any forward contract, futures contract, option, or similar financial instrument if such instrument is not marked-to-market . . . under section 1256."⁴³ Most taxpayers take the position that currency swaps are not subject to the marked to market

42. Treas. Reg. § 1.1441-4(a)(2) (1985).

43. I.R.C. § 988(c)(1)(B) (1986).

rules of section 1256.⁴⁴ Both the Conference Committee Report and the Senate Committee Report use foreign currency swaps as an example of a "similar financial instrument."⁴⁵

b. Gain or Loss Treated as Ordinary Unless Otherwise Elected

Section 988(a)(1)(A) generally provides that foreign currency gain or loss will be treated as ordinary gain or loss. Section 988(a)(2) further provides that the Treasury may issue regulations treating this gain or loss as interest income or expense. The Code also sets forth a special rule that, if a foreign currency forward, futures, or option contract is not part of a "straddle" within the meaning of section 1092(c),⁴⁶ the holder may elect to treat the gain or loss on the contract as capital gain or loss.⁴⁷

c. Amount of Foreign Currency Gain or Loss

The amount of foreign currency gain or loss on a currency swap or other section 988 transaction is defined to equal the amount of gain or loss recognized on the transaction, to the extent such gain or loss does not exceed the gain or loss realized as a result of changes in the exchange rates between the date the agreements are entered into and the dates payments are made.⁴⁸ This rule is difficult to apply in the case of currency swaps, because the exchange under the swap may not trigger the recognition of the gain and even if gain or loss is recognized, the gain or loss on a given exchange may be attributable to factors other than exchange rate movements.

(i) Swap Exchange Not Necessarily a Recognition Event.

Under present law, it appears that a dollar functional currency taxpayer who, under a swap exchange, takes delivery of foreign currency in exchange for a dollar payment is treated as purchasing the foreign currency. No gain or loss is realized on the purchase, and the taxpayer acquires a dollar cost basis in the foreign currency. Gain or loss is recognized only when the taxpayer disposes of the currency in a subsequent transaction. Although section 1256(c) provides that the receipt of the currency under a section 1256 contract is an event of recognition, currency swaps are generally not considered section 1256 contracts.⁴⁹ There is no analogous provision for deliveries under contracts other than section 1256 contracts, and the Code provides for the carryover of the taxpayer's basis and holding period under the contract to the

44. See *infra* Part IV.A.5.

45. See H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 663 (vol. II) (1986) and S. REP. NO. 313, 99th Cong., 2d Sess. 460 (1986).

46. Straddles are defined as offsetting positions in actively traded personal property. A taxpayer therefore cannot elect capital gains treatment for a foreign currency forward futures or option contract that hedges the value of actively traded property, including foreign currency and foreign currency denominated financial instruments.

47. I.R.C. § 988(a)(1)(B) (1986).

48. *Id.* § 988(b)(1).

49. See *infra* Part IV.A.5.

property received under the contract.⁵⁰ The taxpayer takes a cost basis in the property received, which generally equals the purchase price under the contract. Similarly, a dollar functional currency taxpayer who delivers foreign currency in exchange for dollars under a currency swap should probably be viewed under current law as selling the foreign currency. The amount of gain or loss recognized will equal the difference between the taxpayer's dollar basis in the currency delivered and the dollars received. This gain or loss need have no relation to the movement of exchange rates during the term of the swap.

(ii) *Gain or Loss Can Be Attributable to Factors Other Than Exchange Rate Fluctuations.*

Currency swaps are almost never designed so that each individual exchange under the swap is expected to be an exchange of equivalent values. The periodic payments are usually determined by reference to the interest rates for the currencies paid. The differences between these interest rates reflect the market's expectation as to future exchange rate movements. In a typical U.S. dollar-Swiss franc swap, for example, notional Swiss franc and U.S. dollar principal amounts have an equivalent value at the prevailing exchange rate for the date of the closing. Periodic payments are determined by reference to the market interest rate for the respective currencies. The Swiss franc periodic payments equal market interest on the Swiss franc notional principal amount, and the dollar periodic payments equal market interest on the dollar notional principal amount. Because the Swiss franc is presently stronger than the dollar, the market interest rate for Swiss francs will be lower than the rate for dollars. The Swiss francs paid in an early periodic payment under the swap will, therefore, likely be worth considerably less than the dollars received. The party making the Swiss franc payments under the swap will likely have a significant economic profit on the early swap exchanges, and this profit is a result of exchange rate fluctuations that have taken place since the inception of the swap. The parties expect this profit to be eliminated by a loss to the Swiss franc payor on the exchange of notional principal amounts on the swap termination date. Because the Swiss franc is the stronger currency, it is expected to appreciate against the dollar over the term of the swap, and the dollar notional principal amount received by the Swiss franc payor is not expected to be worth as much as the Swiss franc notional principal amount paid at the then prevailing exchange rate. Although the two payment streams under a swap are of equal present value, the individual swap exchanges are not intended to be of equivalent values. Therefore, if gain or loss is measured on an exchange-by-exchange basis, a portion of the gains or losses incurred will be the result of the way the transaction is priced rather than movements in exchange rates.

50. I.R.C. § 1223(8) (1986).

(iii) *Proposed Technical Correction.*

Section 112(t) of the pending technical correction bill⁵¹ addresses some, but not all, of these discrepancies. It would provide that the entire amount of gain or loss under any future, option, forward or swap contract that is a section 988 transaction is to be characterized as foreign currency gain or loss regardless of whether it is attributable to exchange rate fluctuations. In addition, making or receiving delivery of currency pursuant to such a contract would constitute a recognition event. A party receiving currency under a swap would, therefore, recognize gain or loss on the delivery and adjust its basis in the currency to reflect the gain or loss. The proposed technical corrections do not address the fact that swaps are priced as a whole, rather than on an exchange-by-exchange basis, and that the exchanges will not reflect market prices if they are viewed separately.

d. *Source of Gain or Loss*

The source of gain or loss on a currency swap that is not a section 988 hedging transaction will be the residence of the party realizing the gain or loss.⁵²

e. *Timing of Recognition of Gain or Loss*

As discussed above, most currency swaps are not structured so that equivalent values are exchanged at every exchange date. The weak currency payor expects to have economic losses on the early exchanges, which losses are offset by gains on the final exchange. The strong currency payor expects to have economic gains on the early exchanges to offset his expected loss on the final exchange, due to depreciation in the value of the weak currency notional principal amount. Neither party can know whether it has an overall profit or loss from the swap until the final exchange of notional principal amounts. For this reason it makes little sense to measure gain or loss on an exchange-by-exchange basis by simply converting gross payments at spot exchange rates. One alternative would be to treat the swap as an open transaction and defer reporting the gains and losses on the individual exchanges until the year of the final exchange, when the offsetting gains and losses could be netted. Given the long terms of many swaps, such an "open transaction" treatment could be cumbersome and might be vigorously opposed by the Service or by taxpayers. A more sensible rule for the timing of gain recognition would be to calculate the expected exchange rate for each exchange date implicit in the interest rates used to price the swap and to recognize gain or loss on each exchange to the extent that the spot rate differed from the implicit expected rate.

51. H.R. 2636, 100th Cong., 1st Sess. (1987).

52. I.R.C. § 988(a)(3)(A) (1986).

2. *Fully Integrated Synthetic Dollar Transactions*

If the currency swap is part of a fully integrated transaction designed to lock in a cash flow that will not vary with exchange rates, the entire integrated package will be treated as a single transaction for tax purposes and taxed according to its substance.⁵³ The swap, therefore, will not be viewed as a separate transaction giving rise to separate gains or losses. Although regulations will be required to define the precise scope of this category of fully integrated transactions, the most obvious examples are fully hedged foreign currency borrowings and synthetic dollar assets.

a. *Fully Hedged Foreign Currency Borrowings*

If a U.S. corporation borrows foreign currency and simultaneously enters into a foreign currency swap to dispose of the foreign currency and to lock in the future dollar cost of its principal and interest payments for the foreign currency borrowing, then, for U.S. tax purposes, the entire transaction should be treated as a synthetic dollar borrowing.

(i) *Transaction Reported in Dollars*

The borrower should treat the dollars received on the initial swap exchange as the amount borrowed. It should report the dollar amount paid under the swap (to obtain the foreign currency used to make its interest payments on the foreign currency borrowing) as its interest expense. The dollar amount paid on the final swap exchange for the foreign currency notional principal amount should be treated as the cost of repaying the debt. These rules appear to apply whether or not the currency acquired under the swap is the currency actually used to make the interest and principal payments.

(ii) *Original Issue Discount Provisions Apply to Recharacterize Payments*

Once the borrowing and swap are integrated into a dollar denominated transaction for tax purposes, the original issue discount rules can apply to that transaction for purposes of calculating the accrual of interest. Under Temporary Treasury Regulation section 1.1273-1(b), the entire series of dollar payment obligations will be treated as a non-self-amortizing installment obligation for purposes of the original issue discount provisions.⁵⁴ The issue price of the synthetic dollar obligation will be the dollar amount received by the borrower under the initial swap exchange, and the redemption price will be the sum of the dollar payments to be made by it under the swap. The internal rate of return (or constant yield) of the dollar cash flows is calculated first; the amount of interest deductible under section 163(e) during each accrual period is determined by multiplying the constant yield so determined by

53. *Id.* § 988(d)(1).

54. Temp. Treas. Reg. § 1.1273-1(b)(2) (1987).

the principal amount outstanding during the relevant accrual period.⁵⁵ Exhibit V illustrates the application of these provisions to a synthetic dollar borrowing.

b. Synthetic Dollar Securities

A similar integration rule should apply to swaps that are part of a fully integrated set of transactions creating a synthetic dollar asset. An example is the acquisition of a foreign currency denominated bond by a U.S. person who simultaneously enters into a currency swap to exchange the foreign currency denominated interest and principal payments from the bond for a locked-in dollar cash flow. The combination of the foreign currency denominated bond and currency swap should be treated as if it were a single dollar denominated instrument, and the U.S. person should report the dollar cash flows under the swap agreement as its receipts from the investment.

c. Synthetic Nonfunctional Currency Assets and Obligations

Just as swaps and other hedging techniques can convert foreign currency transactions into synthetic dollar transactions, dollar transactions can be converted into synthetic foreign currency transactions. A U.S. corporation that needs yen financing, for example, can borrow dollars and enter into a yen-for-dollar currency swap. Similarly, the holder of a dollar denominated debt obligation can transform it into the equivalent of a deutsche mark denominated obligation by agreeing to deliver the dollar interest and principal payments under a currency swap in exchange for specified deutsche mark amounts. A taxpayer should be able to treat either type of transaction as a fully integrated synthetic foreign currency transaction under section 988(d)(1).

d. Requirements Under Notice 87-11 For Fully Integrated Treatment

In order to allow taxpayers to rely on the provisions of section 988(d)(1) dealing with fully integrated hedging transactions pending the issuance of regulations, the Treasury issued Notice 87-11,⁵⁶ providing certain safe harbors. If a "qualifying transaction" (i.e., the underlying transaction which the taxpayer wants to hedge) and the corresponding "qualified hedging transaction" (i.e., the hedging transaction) meet the requirements of Notice 87-11, the taxpayer may integrate the transactions for U.S. tax purposes.

(i) Perfect Symmetry Between Hedge and Underlying Transaction Required

To expedite the release of the Notice, the Treasury avoided addressing a number of technical issues by dealing only with transactions where the hedge is perfectly symmetrical with the transaction being hedged. For guidance on

55. I.R.C. § 163(c) (1986); Treas. Reg. § 1.1272-1(b), 1.1272-1(e)(2)(ii) (1986).

56. I.R.S. Notice 87-11, 1987-4 I.R.B. 6.

the treatment of hedging transactions where the symmetry is less than perfect, one must await future regulations. To qualify for the safe harbor provisions of Notice 87-11, (a) the hedge must be entered into and priced as the underlying transaction, (b) both the underlying transaction and the hedge must be entered into by the *same* corporation (members of an affiliated group filing a consolidated tax return are not treated as a single corporation for this purpose), (c) the entire amount of the underlying transaction, including both principal and interest, must be hedged, (d) both the underlying transaction and the hedge must have the same maturity date, and (e) neither the underlying transaction nor the hedge may be terminated prior to maturity. The safe harbor provisions of Notice 87-11 do *not* apply to: transactions involving related parties, transactions involving debt instruments with principal and interest denominated in more than one currency, and synthetic obligations or assets in highly inflationary currencies.⁵⁷

(ii) *Identification Requirements*

To be entitled to treat an underlying transaction and hedge as a fully integrated hedging transaction under Notice 87-11, the party entering into the transactions must identify them as such on its books and records. Before midnight on the date the transactions are entered into, the taxpayer must record the following in a separate "Qualified Hedging Account": (a) a description of the underlying transaction, including the interest rate and the date on which the interest rate was set; (b) a description of all elements of the hedge, including the exchange rates and the date on which the exchange rates were fixed; and (c) a summary of the cash flows resulting from the combination of the underlying transaction and the hedging transaction.⁵⁸ In addition, the taxpayer's records must contain independent verification that the underlying transaction and the hedge were priced on the same day. Such verification would normally be in the form of written confirmations, received from the counterparty, or a written contract signed and dated by the parties. The taxpayer has the burden of proof to demonstrate that the interest rate on the underlying transaction and the exchange rate on the hedge were fixed on the same date.

(iii) *Failure to Properly Designate Not Necessarily Fatal*

If a taxpayer does not designate a transaction as a hedging transaction, the Service is not bound by that failure and may treat the transaction, at the time of audit, as a fully integrated transaction.⁵⁹

(iv) *Advantages of Designation*

The major benefits of designating a swap as a hedging transaction are that the loss deferral rule under section 1092 for straddles and the marked-to-market rules of section 1256 do not apply to designated foreign currency hedges.

57. *Id.*

58. *Id.*

59. *Id.*

3. *Other Hedging Transactions*

Section 988(d)(1) contemplates treatment as integrated transactions of "section 988 hedging transactions" but only "to the extent provided in the regulations." Section 988(d)(2) broadly defines section 988 hedging transactions to include any transaction entered into primarily to reduce the risk of foreign currency fluctuations with respect to property held or to be held or obligations incurred or to be incurred. The Conference Committee Report states that regulations are expected to be issued on the treatment of another type of hedging transaction, one that is not part of a fully integrated financial transaction.⁶⁰ An example of such a transaction is a U.S. corporation entering into a foreign currency swap to hedge the dollar value of its future sales income. The Conference Committee Report states that the regulations could treat the underlying transactions and the hedge as separate transactions in which offsetting gains and losses would be separately reported.⁶¹ Any such regulations could then provide rules for the characterization and source of the gain or loss on the swap in a manner consistent with the treatment of the income being hedged. The regulations will need to address the distinction(s) between "fully integrated" hedging transactions and "other" hedging transactions and should also discuss the treatment of both types.

4. *Treatment of Termination Payments*

Most swaps have termination clauses that provide for a payment from one party to the other in the event the swap is terminated prior to its maturity. This payment is designed to preserve the benefit of the bargain in the case of an early termination by marking the swap to market and having the party with the unrealized loss pay that amount to its counterparty, who has an equal and offsetting unrealized gain. An equitable way to calculate the amount of the termination payment is to compare the present values of the two payment streams under the swap using the spot exchange rate on the termination date. Each payment stream is discounted using the then prevailing market interest rate for the currency and maturity involved. The amount of the termination payment equals any difference between the two present values of the two payment streams when compared at the spot exchange rate.

a. *Terminations of Non-Hedge Currency Swaps*

It appears that Congress intended that the gain or loss on termination of a currency swap would generally be treated as ordinary section 988 income unless the taxpayer had elected to treat the swap as a capital transaction under section 988(a)(2).⁶² The Code language does not achieve this result, however, because foreign currency is not excepted from the definition of a

60. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 666 (vol. II) (1986).

61. *Id.*

62. *See supra* note 45 and accompanying text.

capital asset in section 1221. A swap appears to be a right with respect to personal property that would constitute a capital asset within the meaning of section 1234(a). It, therefore, appears that section 1234(a) treats the gain or loss on the termination of a swap that is not part of a hedge as a capital gain or loss. Section 112(t) of the pending technical corrections bill provides that any gain or loss from a transaction described in section 988(c)(1)(B)(iii), which includes currency swaps, will be treated as ordinary foreign currency gain or loss. This proposed amendment appears broad enough to include gains or losses on termination payments and hence would align the Code provisions with Congressional intent.

b. Termination of a Swap that is a Fully Integrated Hedge

There is no direct authority on the treatment of the termination of a fully integrated hedge, and Notice 87-11 specifically reserves judgment on the issue.⁶³ Where the swap is terminated simultaneously with the transaction being hedged, one approach would be to treat the termination on an integrated basis according to its substance. Assume, for example, that a taxpayer enters into a synthetic dollar borrowing by borrowing foreign currency then swapping it for dollars. If the swap is terminated and the loan repaid simultaneously, one might report any termination payment required under the swap as a deductible retirement premium on the early redemption of the synthetic dollar debt.⁶⁴ Any payment received on termination of the swap might be treated as a reduction in the redemption price of the synthetic dollar debt instrument, giving rise to discharge of indebtedness income.

c. Termination of Other "Broken" Hedges

The treatment of terminations is even less clear when the hedge and the underlying transaction are not terminated simultaneously. The issue should be resolved in future regulations. One approach such regulations could take would be to treat the integrated transaction as if both halves of the transaction had been terminated simultaneously by marking to market the half that remains in place. This treatment is analogous to the provisions in the mixed straddle regulation that treat the creation of an identified mixed straddle as a recognition event with respect to any preexisting positions that become part of the straddle.⁶⁵ This principle could, for example, be extended to the early repayment of a fully hedged foreign currency borrowing. If the foreign currency borrowing were repaid before maturity but the swap were left in place, one might mark the swap to market and treat the resulting gain or loss as a

63. I.R.S. Notice 87-11, 1987-4 I.R.B. 6.

64. See, e.g., Treas. Reg. § 1.163-4(c) (1973).

65. See, e.g., Temp. Treas. Reg. § 1.1092(b)-3T(b)(6) (1985).

reduction in the redemption price of the synthetic dollar security or as a deductible retirement premium, respectively. The gain or loss would create positive or negative basis in the swap which would then be recovered over its remaining life.

5. *Currency Swaps as Section 1256 Contracts*

Section 1256 provides a marked-to-market regime for exchange traded futures contracts, certain exchange traded option contracts, and certain defined "foreign currency contracts" not entered into on an exchange. At the end of each taxable year, the unrealized gain or loss on exchange traded futures contracts and off-exchange "foreign currency contracts" is recognized for tax purposes, and the holder's basis is adjusted accordingly. Such gains and losses are treated as sixty percent long term and forty percent short term capital gains or losses and not as ordinary income items.

a. *Definition of Section 1256 Foreign Currency Contract*

Section 1256(g)(2) defines a foreign currency contract as "a contract — (i) which requires delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts, (ii) which is traded in the interbank market, and (iii) which is entered into at arm's length at a price determined by reference to the price in the interbank market."⁶⁶ The intent of section 1256(g)(2) is to tax foreign currency forward contracts on the same basis as exchange traded futures contracts where both futures and forward contracts are traded for the currency.⁶⁷ Futures contracts are currently traded for the Japanese yen, Canadian dollar, British pound, German mark, Swiss franc, Dutch guilder, and the European Currency Unit (ECU). Proposals to list a futures contract for the Australian dollar are also currently pending.

b. *Currency Swaps Probably not Section 1256 Foreign Currency Contracts*

Currency swaps are clearly contracts that require delivery of a foreign currency or the settlement of which depends on the value of a foreign currency. Therefore, a currency swap calling for delivery of one of the currencies for which futures contracts are traded would constitute a swap if "entered into at arm's length at a price determined by reference to the price in the interbank market." Most taxpayers have taken the position that swaps do not satisfy this last requirement because they are priced differently than interbank forward contracts. As discussed above, the exchanges constituting a swap are generally priced as a whole, and the individual exchanges, therefore,

66. I.R.C. § 1256(g)(2)(A)(iii) (1986).

67. H. REP. NO. 986, 97th Cong., 2d Sess. 15, reprinted in 1982 U.S. CODE CONG. & ADMIN. NEWS 4203.

do not correspond to the market prices for simple forward contracts for delivery on the exchange dates. Most taxpayers have taken the position that this distinction in pricing mechanics is sufficient to prevent currency swaps from being included in the definition of foreign currency contracts in section 1256. This argument has lost much of its strength, however, since the terms of currency swaps have become more standardized and the possibility of a separate interbank market for foreign currency swaps approaches.

B. *Income Tax Treatment of Interest Rate Swaps*

There is no direct authority on the income tax treatment of payments and receipts under interest rate swaps. Although the principles of section 988 do not apply to interest rate swaps because such swaps do not involve foreign currency, one would expect that interest rate swaps will be treated in a manner consistent with the treatment of currency swaps. Until the treatment of interest rate swaps is clarified in future regulations and rulings, they must be analyzed under the general principles of tax law and by analogy to the treatment of similar financial instruments.

1. *Interest Rate Swaps Entered into as Hedges*

The vast majority of interest rate swaps are entered into as hedges of future interest income or expense. Many are entered into simultaneously with a borrowing or lending transaction in order to produce an integrated transaction with a determinable series of cash flows. Others are entered into as hedges of the net interest rate exposure of a taxpayer, rather than as hedges of a single specific transaction.

a. *Treatment of Periodic Swap Exchanges*

Unless terminated prior to maturity, the typical interest rate swap will consist entirely of the periodic "exchanges," in which one party pays to the counterparty a sum equal to the notional principal amount multiplied by the specified fixed rate in exchange for the counterparty paying a sum equal to the notional principal amount multiplied by the specified floating rate. Instead of payment on a gross basis, the offsetting amounts are generally netted and only the difference is paid. Under the principles of *Corn Products Refining Corp. v. Commissioner*,⁶⁸ if the swap is a hedge of interest income or expense, these net payments or receipts should represent ordinary expense or income in the years paid or received. Most taxpayers entering interest rate swaps probably report the net payments under the swaps as direct adjustments to their interest income or expense in the year received or paid. Even a swap entered into to convert a fixed rate debt obligation into a floating rate

68. 350 U.S. 46 (1955) (futures contracts entered into as an integral part of taxpayers business as a hedge against a price increase in needed raw material, rather than as speculative transaction, result in ordinary, not capital, gain or loss).

obligation, which would not be a hedge in the normal sense of the word, might reasonably be treated as a transaction giving rise to ordinary gain or loss under an integration theory. The economic substance of the combination of the fixed rate debt and the fixed-to-floating swap is a floating rate debt, and the net periodic cash flow from the combined transactions could reasonably be treated as interest expense.

The recent Supreme Court decision in *Arkansas Best Corp. v. Commissioner*⁶⁹ raises issues as to whether taxpayers will continue to be able to rely on the *Corn Products* doctrine. The Supreme Court stated in *Arkansas Best* that the gain or loss on the sale or exchange of property will always be capital in nature unless the property falls within one of the enumerated exceptions under section 1221. The court explained that the corn futures contracts in the *Corn Products* case were property, but that because they were hedges of the taxpayer's inventory, they were assimilated into the specific exception from capital asset status provided for inventory. Assuming that an interest rate swap, like a futures contract, is a financial instrument that is itself property, one might read *Arkansas Best* as requiring interest rate swap gains or losses to be treated as capital gains or losses where the swap hedges income or expense rather than inventory. One might take the position that gains and losses on periodic exchanges are nevertheless ordinary on the basis that making or receiving a periodic payment is not a sale or exchange of an interest in the swap. This position would be supported by analogy to the Tax Court ruling in *National Standard v. Commissioner*⁷⁰ that the repayment of principal of a foreign currency debt was not a sale or exchange of currency by the debtor. While a lack of sale or exchange might prevent periodic interest rate payments from giving rise to capital gains or losses even if the swap constitutes a capital asset, this reasoning becomes more tenuous in the case of a termination payment and inapplicable in the case of a sale of one's interest in a swap.

2. *Interest Rate Swaps Not Constituting Hedges*

While most parties enter into interest rate swaps as hedges, swaps are also entered into by dealers making markets in swaps and by parties seeking to speculate on interest rate movements. There is no reported direct authority on the treatment of such swaps.

a. *Character*

In the case of a bank or dealer making a market in swaps in the ordinary course of its business, net periodic payments made or received under the swaps would presumably constitute ordinary loss or income. In the case of a swap entered into as a speculation on interest rate movements, it is arguable

69. 108 S. Ct. 971 (1988).

70. 80 T.C. 551 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984).

that the swap should be viewed as analogous to a series of financial futures contracts, giving rise to capital gain or loss on each exchange. The periodic receipt of swap payments in exchange for the specified counter-payment could be viewed as a sale or exchange. If the contractual right to receive each periodic payment were not found to be a capital asset or the net periodic payment were not found to constitute a sale or exchange of that asset, any gain or loss would presumably be treated as ordinary, analogous to gambling income.

b. Timing and Amount

In the case of a simple interest rate swap not constituting a hedge, it would appear reasonable to treat the entire net payment constituting the difference between the "exchanged" fixed and floating payments as income or loss in the year of each exchange. The potential distortion of income from reporting the exchanges in this manner is much smaller than in the case of a currency swap, where the notational principal amounts exchanged on the termination date of the swap are of an order of magnitude larger than the periodic exchanges. In unusual cases, where the exchanges are not related solely to interest income or expense, the transaction could be characterized as creating, for each party, a tax basis in its entitlement to future receipts that is equal to the fair market value, at the time the contract was formed, of the party's offsetting payment obligation. Unless the open transaction doctrine were to be applied, one would allocate this basis among the periodic exchanges, and recognize gain or loss on each exchange to the extent that the amount received differed from the basis allocated to the exchange. The method by which basis is allocated would depend on how the exchanges are structured.

c. Source

Treasury Notice 87-4 provides that the source of income from a simple U.S. dollar interest rate swap is generally the residence of the recipient.⁷¹

3. Treatment of Termination Payments

Like currency swaps, many interest rate swaps contain termination clauses designed to preserve the economic benefits of the contract if either party terminates the swap prior to its scheduled termination date. A common form of termination clause provides that, in the event of an early termination, the net present value of each payment stream under the swap is to be determined using the corresponding market interest rate prevailing on the termination date. The difference between these net present values is then paid by the party obligated to make the more valuable payment stream to the party obligated to make the less valuable payment stream. To date, there is

71. See *supra* Part III.B.3.

no reported ruling, regulation, or other authority on the proper treatment of such a contractual payment by either the payor or the recipient.

a. Termination of an Interest Rate Swap Entered Into as a Hedge

In the case of an interest rate swap entered into as an integrated hedge, however, a taxpayer might reasonably rely on an integration approach to treat the termination according to its economic substance. Assume, for example, that a taxpayer entered into a floating rate borrowing and an integrated floating-to-fixed interest rate swap to create a synthetic fixed rate debt. If the borrowing and the swap are simultaneously terminated prior to maturity, any net termination payment under the swap might be treated as a retirement premium with respect to the synthetic fixed rate debt, which is deductible under Treasury Regulation section 1.163-4(c). Any swap termination payment received might be treated as income from the partial discharge of the synthetic fixed rate debt. Even in cases where such an integration approach is not applicable, a party paying a swap termination payment could reasonably deduct the payment as an ordinary and necessary business expense by analogy to decided cases dealing with payments for release from burdensome business contracts.⁷²

b. Termination of a Swap Not Constituting a Hedge

Termination payments made or received by a dealer or bank making a market in swaps in the ordinary course of its business presumably constitute ordinary loss or income. The treatment of termination payments made or received by a party entering into an interest rate swap as a speculative investment is less clear. If such a party makes a termination payment to its counterparty, the termination arguably does not constitute a sale or exchange, even if the party's rights under the agreement constitute a capital asset. It does not appear that section 1234(a) treats the termination as a sale or exchange because the swap agreement is not a section 1256 contract.⁷³ Also, it is arguably not a "right or obligation with respect to personal property" because it only contemplates the delivery of money. Similarly, the termination payment would not be treated as a sale or exchange to the recipient under section 1271(a)(1) because the swap does not constitute a debt obligation. In the absence of such a sale or exchange, any gain or loss on the termination would be ordinary.

c. Contrast — Sale of Rights of Assumption Transactions

If, instead of terminating the swap, a party entering into the swap as a speculative investment sold its rights under the swap or paid a third party to

72. See, e.g., *Pressed Steel Car Co. v. Commissioner*, 20 T.C. 198 (1953).

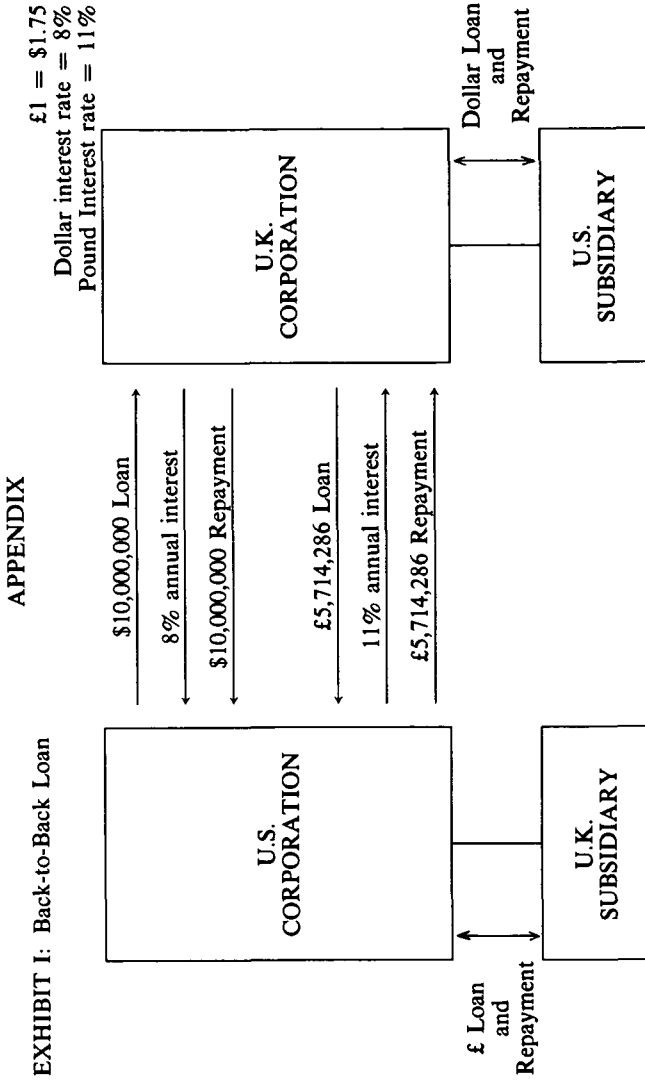
73. See *supra* Part IV.B.4.

assume its obligation under the swap, the disposition of the swap would constitute a sale or exchange, and the party could reasonably report the resulting gain or loss as capital. A third party assuming the obligations of an initial party under the swap in exchange for a lump-sum payment runs some risk of having the entire amount of the payment treated as income in the year received on the basis that the offsetting payment obligation would be too contingent to afford a basis to reduce the amount of taxable gain. Even in such a case, however, current inclusion might be avoided by treating the assumption transaction as analogous to a short sale by the assuming party and by deferring the recognition of the amount received on the assumption until the net cost of performing the assumed obligations under the swap is known.⁷⁴

4. *Interest Rate Swaps Are Not Section 1256 Contracts*

There is some risk that currency swaps constitute section 1256 contracts, which must be marked to market at the end of the taxable year. However, there is no such risk with respect to interest rate swaps. Interest rate swaps are clearly not exchange traded options or futures contracts. The only remaining class of section 1256 contracts consists of foreign currency contracts traded in the interbank market. Although there is some risk that currency swaps might constitute such foreign currency contracts, interest rate swaps denominated solely in U.S. dollars clearly do not constitute such contracts.

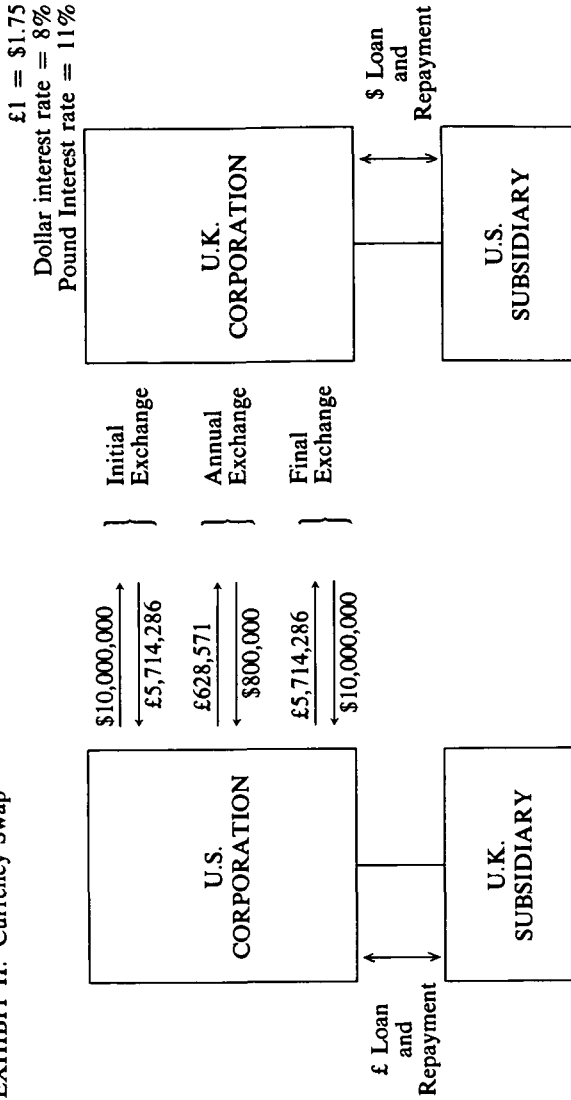
74. It is interesting to note that interest rate swaps have been marketed as an income acceleration device. These swaps are structured so that the party wishing to accelerate income receives the present value of the fixed payment stream at the outset but makes the floating rate payments over the term of the swap agreement. Alternatively, the party wishing to accelerate income will sell its right to receive fixed rate swap payments to a third party for cash. Both structures assume that the gross annual cash flows under the swap should be treated as income to the recipient and that the party with the right to receive fixed rate payments under an interest rate swap does *not* have a basis in that right equal to the fair market value of its obligation to make floating rate payments.



CASH FLOWS

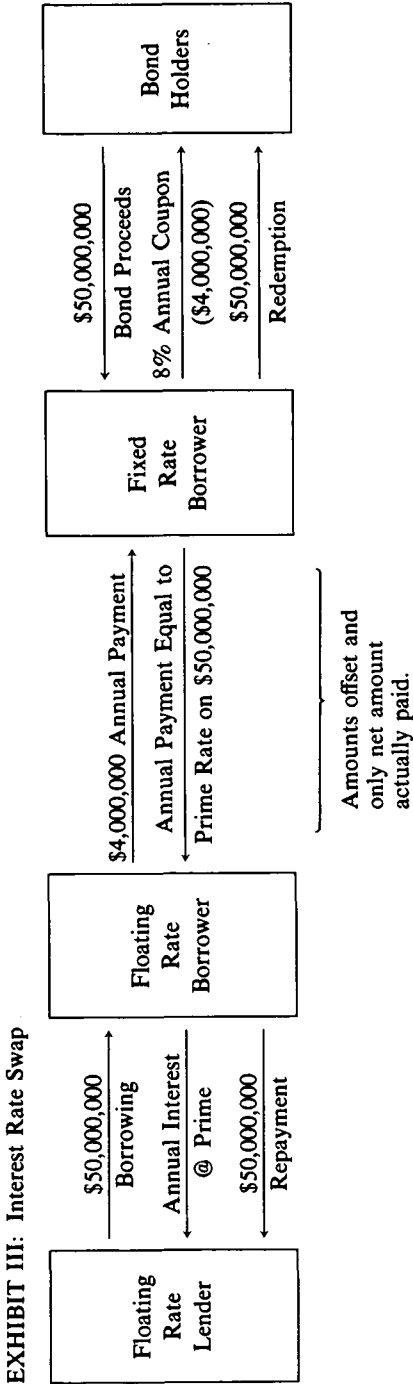
- At Outset:**
 U.S. Corporation pays \$10,000,000 to U.K. Corporation.
 U.K. Corporation pays £5,714,286 to U.S. Corporation.
- Annually:**
 U.S. Corporation pays £628,571 to U.K. Corporation.
 U.K. Corporation pays \$800,000 to U.S. Corporation.
- On Termination:**
 U.S. Corporation pays £5,714,286 to U.K. Corporation.
 U.K. Corporation pays \$10,000,000 to U.S. Corporation.

EXHIBIT II: Currency Swap



CASH FLOWS

- At Outset:
 - U.S. Corporation pays \$10,000,000 to U.K. Corporation.
 - U.K. Corporation pays £5,714,286 to U.S. Corporation.
- Annually:
 - U.S. Corporation pays £628,571 to U.K. Corporation.
 - U.K. Corporation pays \$800,000 to U.S. Corporation.
- On Termination:
 - U.S. Corporation pays £5,714,286 to U.K. Corporation.
 - U.K. Corporation pays \$10,000,000 to U.S. Corporation.



Floating Rate Borrower would pay Fixed Rate Borrower \$500,000 (i.e. \$4,000,000 - 7% of \$50,000,000). The Floating Rate Borrower would have a net interest cost equal to the fixed 8% rate, while the Fixed Rate Borrower would have a net interest cost equal to the floating prime rate.

Fixed Rate Borrower would pay Floating Rate Borrower \$1,000,000 (i.e. 10% of \$50,000,000) - \$4,000,000). The Floating Rate Borrower would still have a net interest expense equal to the fixed 8% rate, while the Fixed Rate Borrower would have a net interest expense equal to the floating prime rate.

If in year 1
prime rate equals 7%:

If in year 2
prime rate equals 10%:

EXHIBIT IV: Interest Rate Swap to Lower Net Borrowing Cost.

	<u>Fixed Borrowing Cost</u>	<u>Floating Borrowing Cost</u>
Strong Credit:	8.5%	<u>LIBOR</u>
Lower Credit:	<u>9.5%</u>	<u>LIBOR + 0.25%</u>
Comparative Advantage of Strong Credit:	1%	0.25%
	<hr/>	
	Strong Credit has a 0.75% greater comparative advantage in fixed market than in floating market.	

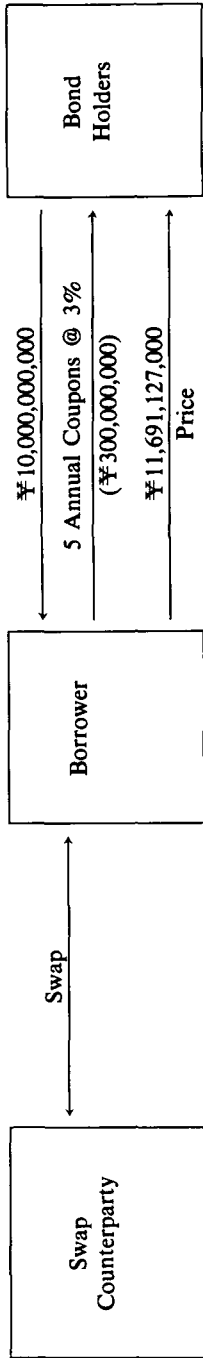
If strong credit seeks \$100,000,000 floating rate financing and lower credit wants \$100,000 fixed rate financing and each borrows directly, their interest expense would be as follows, assuming LIBOR equals 7.5%:

Strong Credit:	\$100,000,000 at LIBOR (7.5%)	= \$ 7,500,000 per annum
Lower Credit:	\$100,000,000 at 9.5% fixed	= <u>\$ 9,500,000 per annum</u>
		\$17,000,000 per annum

If the strong credit instead borrowed at fixed rates and the lower credit borrowed at floating rates and the borrowers then entered into a swap, the total interest expense would be:

Strong Credit:	\$100,000,000 @ 8.5% fixed	= \$ 8,500,000 per annum
Lower Credit:	\$100,000,000 @ 7.75% fixed (LIBOR + 0.25%)	= <u>\$ 7,750,000 per annum</u>
		\$16,250,000 per annum

EXHIBIT V: Applications of OID Provisions to Synthetic Dollar Borrowing

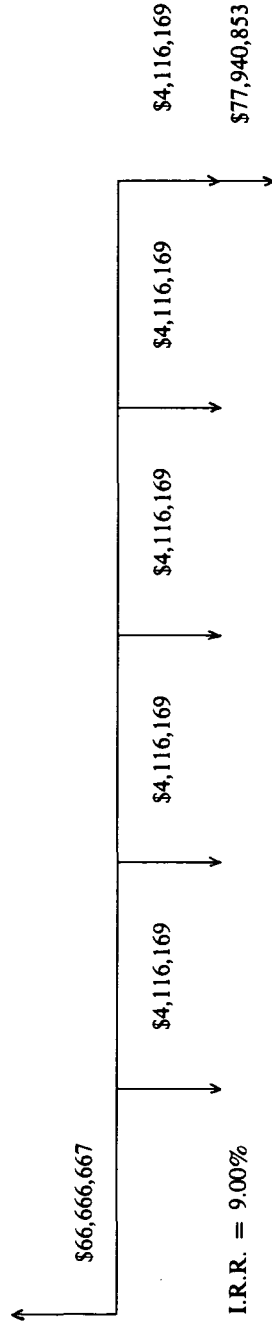


Assume that a U.S. corporation issues 5-year yen bonds for an issue price of ¥10,000,000,000, with a 3% annual coupon payable in yen, and redeemable for ¥11,691,127,000 on maturity. If the exchange rate on issue is ¥150 = \$1, the yen proceeds will be worth \$66,666,667. Further assume that the borrower enters into the following currency swap to lock in its dollar borrowing cost.

Initial Exchange	:	Borrower pays ¥10,000,000,000 in exchange for \$66,666,667.
End of Year 1	:	Borrower pays \$4,116,169 in exchange for ¥300,000,000.
End of Year 2	:	Borrower pays \$4,116,169 in exchange for ¥300,000,000.
End of Year 3	:	Borrower pays \$4,116,169 in exchange for ¥300,000,000.
End of Year 4	:	Borrower pays \$4,116,169 in exchange for ¥300,000,000.
End of Year 5	:	Borrower pays \$82,057,022 in exchange for ¥11,991,127,000.

EXHIBIT V. (cont.):

Under the section 988 hedging provisions, the combination of the foreign currency bonds and the swap will be treated as a dollar denominated borrowing. The temporary original issue discount regulations will treat the borrowing as a single installment obligation with an issue price equal to the \$66,666,667 received on the initial swap exchange, a redemption price of \$77,940,853, and an annual coupon of \$4,116,169. The internal rate of return on the cash flows is calculated, and interest and original issue discount is deductible by the borrower under section 163(e) based on this rate:



Year	Adjusted Issue Price	Periodic Interest Payment	Accrued OID	Notional Principal Payment
1	\$66,666,667	\$4,116,169	\$1,883,831	- 0 -
2	\$68,550,498	\$4,116,169	\$2,053,376	- 0 -
3	\$70,603,874	\$4,116,169	\$2,238,180	- 0 -
4	\$72,842,054	\$4,116,169	\$2,439,617	- 0 -
5	\$75,281,671	\$4,116,169	\$2,659,182	\$77,940,853