REPORT #571

TAX SECTION

New York State Bar Association

COMMITTEE ON U.S. ACTIVITIES OF FOREIGN TAXPAYERS
REPORT COMMENTING ON ADVANCE NOTICE 87-4, RELATING
TO INTEREST RATE SWAPS

October 06, 1987

Table of Contents

Cover Letter 1: i
I. INTRODUCTION. 1
II. DISCUSSION. 2
A. General Overview of the Notice. 2
B. Limitation to U.S. Residents. 4
C. Restricted Definition of Residence. 6
D. Limitation to U.S. Dollar Transactions. 7
E. Limitation to Traditional Interest Rate Swap Transactions. 10
III. RECOMMENDATIONS. 12
A. Eliminate U.S. Residence Requirement. 12
B. Extend The Notice to Qualified Business Units. 12
C. Extend the notice to Non-Dollar Transactions. 13
D. Expand Types of Transactions Covered by the Notice. 13

REPORT # 571

TAX SECTION
New York State Bar Association

October 6, 1987

BY FEDERAL EXPRESS

Hon. Laurence B. Gibbs
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Gibbs:

I am enclosing a report commenting on Advance Notice 87-4 relating to interest rate swaps prepared by the U.S. Activities of Foreign Taxpayers Committee of the Tax Section of the New York State Bar Association. The report was written by Cynthia Beerbower, one of the Co-Chairs of that Committee, together with Joseph Giannola, Suzanne Greenberg, James Kalb and R.J. Ruble. Helpful comments were received from Gustavo Brillembourg, Stephen Gordon and Christine Vickery. The report was approved by the Executive Committee of the Tax Section.

The report discusses the technical problems with the Notice as currently drafted and further suggests an approach for expanding application of the Notice to provide guidance on U.S. withholding tax issues for a broader class of interest rate and currency ledging transactions.

Sincerely,

Donald Schapiro

Copies of this letter and report
to the persons on the attached list.

William F. Nelson, Esq.
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Hon. O. Donaldson Chapoton
Acting Assistant Secretary for Tax Policy
Treasury Department
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dennis Ross, Esq.
Tax Legislative Counsel
Treasury Department
3064 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Hon. David H. Brockway
Chief of Staff
Joint Committee on Taxation
1015 Longworth Building
Washington, DC 20515

Robert J. Leonard, Esq.
Chief Counsel
House Ways and Means Committee
1102 Longworth Building
Washington, DC 20515

James Clark, Esq.
Minority Tax Counsel
House Ways and Means Committee
1106 Longworth Building
Washington, DC 20515

William Wilkins, Esq.
Chief of Staff and Chief Counsel
U.S. Senate Committee on Finance
205 Dirksen Office Building
Washington, DC 20510

John Colvin, Esq.
Minority Chief Counsel
U.S. Senate Committee on Finance
G-08 Dirksen Office Building
Washington, DC 20510

NEW YORK STATE BAR ASSOCIATION TAX SECTION COMMITTEE ON U.S. ACTIVITIES OF FOREIGN TAXPAYERS REPORT COMMENTING ON ADVANCE NOTICE 87-4, RELATING TO INTEREST RATE SWAPS[1]

I. INTRODUCTION.

On December 24, 1986, the Internal Revenue Service released Advance Notice 87-4 (the "Notice"),[2] which, for the first time, provides administrative guidance concerning the U.S. withholding tax treatment of certain cross-border interest rate swaps. While leaving unresolved certain other issues relating to the U.S. federal income tax treatment of interest rate swaps, the Notice substantially clarified what, for many participants in the interest rate swap market, had been the single most pressing unsettled issue: the U.S. withholding tax consequences of making interest rate swap payments to non-U.S. counterparties. As a result, the Notice makes it possible for U.S. participants in the interest rate swap market to abandon or modify measures previously considered necessary to reduce exposure to U.S.

---

[1] This report was prepared by a subcommittee composed of Cynthia G. Beerbower, Joseph Giannola, Suzanne F. Greenberg, James Kalb, and R.J. Ruble. Helpful comments were received from Gustavo E. Brillembourg, Stephen L. Gordon and Christine Vickery.

[2] 1987-3 I.R.B. 6.

withholding tax, and thereby permits U.S. companies to participate more freely in this multi-billion dollar market.[3]

Certain technical requirements included in the Notice, however, seriously limit its useful application in a number of situations. In addition, it is not clear why the special sourcing rules provided by the Notice apparently apply only to the transactions described therein as "interest rate swaps"; similar U.S. withholding tax concerns exist for U.S. parties under a variety of cross-border transactions with terms and economic effects similar to those under a traditional interest rate swap. This report discusses the technical problems under the Notice as currently drafted and, further, suggests an approach for expanding application of the Notice to provide guidance on U.S. withholding tax issues for a broader class of interest rate and currency hedging transactions.

II. DISCUSSION.

A. General Overview of the Notice.

The Notice generally provides that the source of interest rate swap income ("swap income") will be determined

[3] According to a survey conducted for the International Swap Dealers Association by Touche Ross Financial Services Center, there were 14,082 interest rate swap transactions outstanding at year-end 1986 with an aggregate notional principal amount of $313 billion -- an 84% increase over year-end 1985. Non-U.S. counterparties accounted for 47 percent of the swap market in 1986.

by reference to the residence of the party receiving interest rate swap payments and the source of interest rate swap expense ("swap expense") by reference to the party making such payments.[4] The Notice also confirms that swap income and expense that is "attributable" to a "U.S. trade or business" of a non-U.S. counterparty is taxable in the United States on a net income basis, and so is not subject to U.S. withholding tax.

Under the source rule of this Notice, interest rate swap payments received by a non-U.S. counterparty will not be considered U.S.-source income unless the payments are "attributable" to a U.S. branch or office of the non-U.S. counterparty. Since income earned by a non-U.S. company is subject to U.S. withholding tax only if it is considered to

---

[4] In this regard, the Notice is consistent with the recent trend toward residence-based sourcing rules for U.S. federal income tax purposes. See, e.g., Internal Revenue Code sections 865 (income from sale of personal property generally sourced at taxpayer's residence) and 988(a)(3) (discussed below in the text), both of which were introduced by the Tax Reform Act of 1986. In particular, it should be noted that section 865(i) directs the Secretary of the Treasury to issue regulations carrying out the purposes of section 865 in the case of income from trading in futures contracts, forward contracts, options contracts and other instruments. While the Notice takes no position as to the nature of swap income, economically it is identical to income from interest rate futures contracts. See "Report on the Withholding Tax Consequences of Interest Rate Swap Agreements under the Internal Revenue Code" (June 6, 1985), New York State Bar Association, Tax Section.

be derived as fixed or determinable annual or periodical income from U.S. sources, the effect of this sourcing rule is to eliminate concerns about the application of U.S. withholding tax to payments made by a U.S. party under a cross-border interest rate swap, without regard to the treaty status (or other withholding tax exemption) of the non-U.S. counterparty.

B. Limitation to U.S. Residents.

As stated in its introductory paragraph, the Notice applies only if transactions involve at least one party which uses the U.S. dollar as its functional currency (as defined in section 988(b))[5] and has its residence (as defined in section 988(a)(3)(B)(i)) in the United States.[6] In most cases, interest rate swap transactions that involve a U.S. taxpayer will comply with these requirements.

---

[5] In this report, section references are to the Internal Revenue Code of 1986 and the regulations thereunder.

[6] Section 988(a)(3)(B)(i) provides that, in general:

> The residence of any person shall be –
>
> (I) in the case of an individual, the country in which such individual's tax home (as defined in section 911(d)(3)) is located,
>
> (II) in the case of any corporation, partnership, trust, or estate which is a United States person (as defined in section 7701(a)(30)), the United States, and
>
> (III) in the case of any corporation, partnership, trust, or estate which is not a United States person, a country other than the United States.

However, the definition of U.S. residence for this purpose does not include the special rules for "qualified business units" under section 988(a)(3)(8)(ii).[7] As a result, swap parties that are U.S. branches of foreign corporations and that otherwise are subject to U.S. taxation will not qualify as "U.S. residents". For example, the U.S. branch of a foreign bank or other foreign corporation[8] will not be considered to have its residence in the United States for purposes of the Notice, despite the fact that the income of such a U.S. branch generally will be subject to U.S. net income taxation. Absent the protection of the Notice, swap payments made by such a U.S. branch to a non-U.S. counterparty will continue to be subject to the risk of U.S. withholding tax. No reason is apparent for this distinction, and our experience shows that these taxpayers, predominantly U.S. branches of foreign banks, continue to suffer the need for extensive documentation to establish treaty eligibility for foreign counterparties and, thus, are placed at a competitive disadvantage in the swap market.

---

[7] Section 988(a)(3)(B)(ii) provides:

> In the case of a qualified business unit of any taxpayer (including an individual), the residence of such unit shall be the country in which the principal place of business of such qualified business unit is located.

[8] It should be noted that the sourcing rules contained in the Notice would be relevant in applying the look-through rules of section 904(g) in the case of payments made by a controlled foreign corporation.

C. Restricted Definition of Residence.

The Notice defines residence for purposes of applying the new sourcing rules only by reference to the general rule of section 988(a)(3)(B)(i). While the Notice addresses some of the sourcing concerns of U.S. branch operations of foreign corporations (by providing that swap income and expense "attributable" to a U.S. trade or business will be treated as U.S. source), it reserves on the extension of the sourcing rules to qualified business units forcing foreign branches of U.S. companies to treat income and expense as U.S. source. The Notice states that the Internal Revenue Service is "studying" the manner in which the special sourcing rules of the Notice should be applied to qualified business units such as U.S. branches.

The committee is unable to discover any situation in which extension of the sourcing rules set out in the Notice to qualified business units would create adverse tax consequences, either for taxpayers or for the Internal Revenue Service. Extension of the Notice to qualified business units would, of course, mean that a U.S. taxpayer's overseas business would have non-U.S. source income and expense from a swap. Failure to provide these equivalent sourcing rules for qualified business units of U.S. taxpayers would increase the potential for transactions designed to exploit differences in the treatment of foreign branches and foreign subsidiaries. For example, under the

Notice as currently drafted, a U.S. corporation would have an incentive to hedge its overall foreign interest rate exposure by entering into transactions expected to generate gains through a foreign subsidiary and transactions expected to generate losses through a foreign branch. In this way, the U.S. corporation could expand its anticipated U.S. foreign tax credit by increasing both anticipated foreign-source income (from the subsidiary transactions) and anticipated U.S. losses (from the branch transactions).

Applying the same residence rules under the Notice to branches and corporations would reduce the attractiveness of such potentially abusive structures. In addition, conforming the definition of residence for purposes of the Notice to the definition used for currency transactions under section 988(a)(3)(B) would help rationalize the treatment of various types of hedging income and expense.

D. Limitation to U.S. Dollar Transactions.

The Notice is applicable only to swap transactions denominated in U.S. dollars. This requirement prevents U.S. parties from relying on the Notice to eliminate U.S. withholding tax risk in the huge global market for swaps and similar hedging transactions involving non-dollar payments, including such common transactions as foreign currency-denominated interest rate swaps, currency swaps and cross-currency swaps. Consequently, this requirement substantially diminishes the useful scope of the Notice.

A currency swap differs from an interest rate swap in that the payments made by each party generally represent a fixed rate, but are computed with respect to a notional principal amount expressed in a different currency. For example, consider the case of a 5-year fixed-rate, annual pay, dollar/sterling currency swap with a notional principal amount of $75,000,000 entered into when sterling is at $1.50, the 5-year dollar interest rate is 10% and the 5-year sterling rate is 12%. The parties would make 5 annual exchanges of $7,500,000 for L6,000,000. In addition, the parties may, at the end of five years, make a reverse exchange of L50,000,000 for $75,000,000. A currency swap may thus be viewed as an interest rate swap denominated in two different currencies, possibly combined with a forward purchase and sale of currency. A cross-currency swap combines the features of a traditional fixed-to-floating interest rate and a currency swap -- for example, floating rate dollars against fixed rate sterling.

It is not clear why the Notice was drafted to exclude currency swaps and other swap-type transactions partially or wholly denominated in a foreign currency. Under new section 988(a)(3), any income or expense in respect of a non-functional currency denominated transaction that is attributable to currency fluctuations will be sourced according to the residence of the taxpayer in a manner similar to that provided by the Notice for swap income and swap expense. It is therefore unlikely that extension of the sourcing rules set out in the Notice to non-

dollar denominated swap transactions would create additional sourcing complexities or increase the potential for abusive situations.[9] In addition, it is the view of our committee that consistency in the application of the sourcing rules that have been or will be developed regarding the treatment of foreign currency transactions requires that those rules also apply to swap transactions. Extension of the Notice would be a convenient way for the Internal Revenue Service to comply with the legislative mandate, set out in the Conference Report accompanying the Tax Reform Act of 1986, for clarification of the withholding tax treatment of cross-border swap payments.[10] Moreover, failure to extend the Notice to non-dollar denominated transactions would have clearly anomalous results, especially if swap income is ultimately determined to be FDAP. For example, a Japanese taxpayer with the Yen as its functional currency would have non-U.S. source income and no withholding if it entered in to a swap transaction denominated in dollars with a U.S. counterparty, but could have U.S. source income and with holding if it entered in to an identical transaction denominated in its own currency or in another currency which is (as to it) also a foreign currency.

---

[9] Transactions involving currencies other than the U.S. dollar may reflect the potential variations in local interest rates for payments state-d in the relevant currency or currencies. As discussed below in the text, the committee recommends that the Internal Revenue Service separately address situations deemed to involve hyperinflationary currencies with a potentially significant interest element by utilizing an objective standard.

[10] Conference Report at 668. Significantly, this statement appears as part of the discussion of the sourcing rules for foreign currency gain or loss under new section 988. Since currency swaps are economically equivalent to a series of currency forward contracts, extension of the Notice also would be consistent with the legislative mandate of section 865(i). See footnote 4 above.

E. Limitation to Traditional Interest Rate Swap Transactions.

The Notice, by its terms, applies only to “interest rate swaps” as defined therein. This Notice states

> “[g]enerally a United States dollar interest rate swap consists of an exchange pursuant to a single contractual arrangement between two parties of fixed rate amounts for floating rate amounts, or floating rate amounts measured by different indices, denominated in United States dollars. These amounts are calculated by reference to a mutually agreed notional principal amount.”

The precise scope of this definition is unclear. It is not certain whether it is intended to extend to swap-derivative financial products.

For example, instead of entering in to a contractual arrangement that provides for netting of a fixed interest stream of payments by one party against a floating stream of payments of the other, which is characteristic a garden variety interest rate swap, a party might enter into an “interest rate cap” or an “interest rate floor” transaction. Like an interest rate swap, an interest rate cap or an interest rate floor involves a contractual arrangement between two parties for payments based on the difference between a fixed-rate and a floating-rate amount as applied to an agreed notional principal amount. Under a cap or a floor, however, the notional fixed-rate payor often makes a single upfront payment and periodic payments are made only by the notional floating-rate payor in an amount measured by the extent to which the floating rate exceeds (in the case of a cap) or falls below (in the case of a floor) the fixed rate. In many cases, a party will enter into both a cap and a floor transaction to effectively “collar” its interest rate exposure. If the value

of the obligations on both sides of such a collar are believed to be equal, no upfront payments are required by either party, a transaction known as a "zero cost collar". It is not clear whether these transactions would be covered by the Notice.

Similarly, a party may enter into a "corridor" whereby payments are made only by the notional floating-rate payor to the extent that the floating rate is within a range (e.g., between 12% and 15% but not above 15%) agreed upon by the parties. This "capped cap" is somewhat less expensive than an interest rate cap and in our experience is increasing in popularity as a swap product. Alternatively, a corridor may be structured as a "floored floor", i.e., the notional floating rate payor pays to the extent the floating rate falls with a low range of interest rates, e.g., between 5% and 7%. Caps and floors can be combined with swaps (sometimes known as "swaptions") such that the interest differential specified in the swaption between the fixed and floating rate is limited to a maximum differential.

All of these swap products have sourcing and withholding tax concerns indistinguishable from those clearly addressed in the Notice with respect to interest rate swaps.[11] No apparent reason exists for restricting the development of such economically efficient new hedging products in favor of encouraging swaps by restricting applicability of the Notice to traditional swap transactions. Such a policy would seem

---

[11] Any upfront payment made to purchase, for example, a cap or floor generally represents as an economic matter the present value of periodic notional payments at a specified fixed rate that offset the periodic floating-rate payments. It can also be argued that caps, floors, collars and corridors are economically identical to a series of options sold for an upfront premium, and in our experience these products are often documented as options. If treated as options, section 865(i) would provide an additional argument for residence-based sourcing. See footnote 4 above. It is the view of our committee that the method of documentation used should not govern the withholding consequences.

incongruous, in light of the clear sourcing rules under new section 988 for transactions, however unique, that hedge foreign currency risks. It would be unfortunate if confusion over sourcing issues restricted the use of equally efficient interest rate hedging transactions that happened to be denominated in U.S. dollars.

III. RECOMMENDATIONS.

A. Eliminate U.S. Residence Requirement.

The committee recommends that the requirement under the Notice that at least one of the parties have its residence in the United States he eliminated. This change will ensure that the Notice's new sourcing rules, and the associated U.S. withholding tax protection, apply to any parties that otherwise are subject to U.S. net income taxation (including controlled foreign corporations and U.S. branches of foreign corporations). Transactions between parties that are not subject to U.S. tax principles obviously will be unaffected by the provisions of the Notice, regardless of its scope. Alternatively (although less preferably) the committee suggests that the definition of U.S. residence for purposes of determining application of the Notice be broadened to include the qualified business unit rules of section 988(a)(3)(B)(ii) (so that U.S. branches of foreign corporations clearly are included).

B. Extend The Notice to Qualified Business Units.

The committee recommends that the residence of a party for purposes of the sourcing rules provided by the Notice be determined by applying special rules for qualified business units such as those in section 988(a)(3)(B)(ii). As noted above, such a

result would provide the same clear and consistent tax treatment for income and expenses attributable to cross-border interest rate hedging Transactions that now exists in respect of currency hedging Transactions under section 988.

C. Extend the notice to Non-Dollar Transactions.

The committee recommends that the Notice be extended to cover swaps and similar transactions that are denominated in a currency or currencies other then U.S. dollar and that these rules relating to the source of income be consistent with those developed regarding the treatment of foreign currency transactions. If the Internal Revenue Service has concerns about non-dollar hedging transactions that reflect a potentially significant interest element such as transactions that provide for payments in a currency considered to be “hyperinflationary”, the committee recommends that the service separately address these transactions under an objective standard. For these purposes, use of an approach similar to that set out in Advance Notice 87-11 with respect to fully integrated currency hedges would appear to be sensible.[12]

D. Expand Types of Transactions Covered by the Notice.

The committee recommends that the sourcing rules set out in the Notice be applied to a broad class of interest rate hedging transactions that resemble, in an economic sense, a traditional interest rate swap. Because any list of specified transactions inevitably would inhibit the development of new and

[12] 1987-4 I.R.B. 6. Advance Notice 87-11 effectively excludes from its scope transactions denominated in a currency other than the U.S. dollar if the equivalent of the U.S. Federal short-term rate in that currency is at least 20 percentage points higher than the U.S. Federal short-term rate at the time of entering into the transaction.

efficient hedging products, a better approach would be to establish a set of economic and structural criteria for transactions designed to be governed by the Notice.

For example, the following features could be used to distinguish cross-border transactions that would be subject to the sourcing rules of the Notice:

(1) The transaction is structured as a private contractual arrangement between two or more unrelated parties. As under Advance Notice 87-11, "related" could be defined by reference to section 267(b) and section 707(b)(1);[13]

(2) The contract may provide for an upfront payment by one party or exchanges of currency at maturity equal to the notional principal amount; and

(3) The transaction is entered into primarily to shift the risk of fluctuations in interest rates, currency exchange rates or indices sensitive to interest or exchange rate movements.

---

[13] In some cases, regulatory or other considerations may prevent a U.S. party from entering into a hedging transaction directly with an "unrelated" party. It is common in such situations for the transaction to be structured as (i) a contract between the U.S. party and one of its affiliates and (ii) a simultaneous back-to-back contract between the affiliate and an unrelated party. Any requirement that parties to a qualifying hedging transaction be "unrelated" should include a provision which clarifies that such back-to-back arrangements will be disregarded, and that, for purposes of the Notice, the hedging transaction will be deemed to exist directly between the unrelated end parties.