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Citation: 69 Tex. L. Rev. 1990-1991

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Equity Derivative Products: Financial  
Innovation’s Newest Challenge to the Tax  
System

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## I. Equity Derivative Products

### A. Overview

Viewed from the perspective of a tax practitioner, the federal income tax system has not been particularly adept at coping with financial innovation in the capital markets. Our tax system works by describing a finite number of idealized transactions and attaching to each a set of operative rules—what might be termed a set of tax cubbyholes.<sup>1</sup> Tax professionals spend a modest amount of time learning to identify these tax cubbyholes and their consequences, and a great deal of time massaging reality to fit within the desired cubbyhole. As new financial products and strategies are developed in the domestic and international capital markets, the tax system attempts to respond by assigning each new product to an appropriate cubbyhole, which in turn determines the tax consequences to users of that product.

Theoretically, the tax system should respond to financial innovation by promptly formulating clear substantive tax rules that produce after-tax results commensurate with each new product's pretax economics. Yet, as this Article will demonstrate, the analytical tools available for this task are not very powerful. The resulting tax uncertainty causes market inefficiency, which means that the tax system is failing the capital markets. This result cannot be the intended consequence of sound tax policy.<sup>2</sup>

1. This process is more formally referred to in the literature as "mapping." See, e.g., Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 393 (1989) (describing the difficulty of classifying financial products within a regulatory scheme as a mapping problem); Powers, *Formalism and Nonformalism in Choice of Law Methodology*, 52 WASH. L. REV. 27, 30-31 (1976) (explaining that the inapping problem arises when a "formal rule" is used to determine results in particular cases, because relevant information is necessarily excluded and accordingly the result in a particular case may be contrary to the policies underlying the rule).

2. During 1990, some proponents of a federal tax on transfers of securities—termed a Securities Transfer Excise Tax, or STET—argued that the tax could be justified not simply as a revenue-raiser, but also as a necessary corrective to capital markets that had become *too* efficient. Under this view, "excessive" liquidity in the stock markets had caused an increase in price volatility; by throwing "sand into the gears" of the equity markets through the introduction of a STET (which would increase the cost of transacting securities purchases and sales), short-term speculative trading could be reduced and price volatility modulated. See Summers & Sumners, *The Case for a Securities Transactions Excise Tax*, 48 TAX NOTES 879, 883-84 (1990); Sumners & Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax*, 3 J. FIN. SERVS. RES. 261, 275-85 (1989). Ironically, one of the points missed by these commentators is how easily the STET can be avoided, particularly in the international context, by the use of the derivative equity products that are the subject of this Article. These arguments were eloquently rebutted in Schaefer, *Arguments Against a STET: A Response to the Summers Paper*, 48 TAX NOTES 1187 (1990), and empirically questioned in Kiefer, *The Security Transactions Tax: An Overview of the Issues*, 48 TAX NOTES 885, 890-91 (1990). Moreover, even were taxes deliberately levied for the purpose of creating market inefficiency in an effort to modulate price fluctuations, it is impossible to imagine that creating a system of random tax uncertainties would be an acceptable means of achieving that end.

To take one example, the aggregate notional principal amount of all outstanding notional principal contracts (interest rate swaps, currency swaps, etc.) now totals roughly 2.5 trillion dollars.<sup>3</sup> Yet comprehensive tax rules governing these contracts have not yet been promulgated, and within the last few months sharp intra-agency controversy has apparently broken out over whether pension funds and other tax-exempt investors can use swaps as asset management tools without running afoul of the unrelated business taxable income (UBTI) provisions of the Internal Revenue Code.<sup>4</sup>

At the other end of the spectrum, tax uncertainty creates the opportunity for some taxpayers to use new financial products to obtain (or at least claim to obtain) after-tax results that are disproportionately better than the pretax economics of those strategies. If participants in such strategies are relatively few in number, their activities result only in a loss of tax revenues; if, however, they are numerous, their activities may actually distort the capital markets, by introducing a noneconomic incentive to enter into various transactions. The results obtained by such taxpayers typically are labelled "loopholes," and the users thereof "exploiters" of these loopholes; the notoriety surrounding these transactions usually sparks Congress's only interest in overhauling the Internal Revenue Code to respond to financial innovations.<sup>5</sup>

3. Hansell, *Is the World Ready for Synthetic Equity?*, INSTITUTIONAL INVESTOR (int'l ed.), Aug. 1990, at 54, 55.

4. Although the Internal Revenue Service initially ruled that payments received under an interest rate swap agreement by an institution exempt from federal income tax under I.R.C. § 501(c)(3) (1988) did not constitute UBTI, see Priv. Ltr. Rul. 90-42-038 (July 23, 1990), the Service later announced that the ruling is being reconsidered, see Priv. Ltr. Rul. 90-46-066 (Oct. 26, 1990); Announcement 90-134, 1990-50 I.R.B. 18. For professional reaction to both the initial ruling and the IRS's subsequent pullback, see Liebowitz, *Ruling May Open Swap Mart to Tax-Exempt Organizations*, INVESTMENT DEALERS' DIG., Oct. 29, 1990, at 17, and Liebowitz, *IRS Reconsiders Ruling on Charity's Swap Income*, INVESTMENT DEALERS' DIG., Nov. 12, 1990, at 10. See also *infra* notes 65-68 and accompanying text (noting the uncertainty in this area and arguing that swap payments probably do not involve sales or exchanges of property).

5. In each of the last two tax acts, Congress has eliminated perceived "loopholes" that arguably were the result of uncertainty in fundamental tax policy. As part of the Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7211(a), (b), 103 Stat. 2301, 2342-45, Congress enacted I.R.C. § 172(b)(1)(E), (h) (Prentice Hall 1991), which generally prohibits net operating loss carrybacks from years after a corporate equity reduction transaction (CERT) to years before the CERT. Presumably, the motivation for these provisions was general concern over the dramatic increase in the amount of corporate indebtedness generated by highly leveraged buyouts and recapitalizations. Presumably also a product of the same concern, another part of the 1989 legislation enacted I.R.C. § 163(e)(5), (i) (Prentice Hall 1991), imposing a limitation on the deductibility of interest in respect of "high yield original issue discount obligations," based in part on the excess of the yield to maturity of such an obligation over the "applicable Federal rate" plus five percentage points. See Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7202(a), (b), 103 Stat. 2301, 2330-32; see also *infra* note 129 (noting the elimination of tax consolidation benefits for "subsidiary preferred stock" offerings). Similarly, as part of the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11325(a)(2), 104 Stat. 1388-400, 1388-466, Congress repealed former I.R.C. § 1275(a)(4) (1988) in order to require issuers to recognize cancellation of indebtedness income on certain exchanges of

In the capital markets, loopholes and their exploiters thrive on an atmosphere of tax uncertainty.<sup>6</sup> Their presence is simply a symptom of a failing in the tax system, and they should no more be held responsible for the tax system's shortcomings than the insect kingdom should be blamed for spoiling improperly refrigerated meat.

This Article examines the application of the federal income tax system to an important new area of financial innovation: the development of a new generation of equity derivative products. Just as the development of derivative interest rate products, such as interest rate swaps, caps, and floors,<sup>7</sup> revolutionized liability management in the 1980s,<sup>8</sup> so too the burgeoning equity derivative marketplace will (if the interest rate swap market is a guide) revolutionize investment in, and issuance of, corporate equity in the next few years.

This Article first describes briefly the market for equity derivative products and highlights some of the policy issues these products raise for the tax system. The Article then considers in detail how the paradigmatic new equity derivative product—the equity index swap—should be analyzed under current tax law. Finally, the Article turns to the broader theme of the methodology by which the tax system currently copes with financial innovation, and how that methodology might be improved.

### B. *The Marketplace for Equity Derivative Products*

In the broadest sense, equity derivatives are not new. One recent source explains:

An equity derivative is a security or private contract whose cash value rises or falls depending on what happens to the one or more stocks or market indexes to which it is tied. A derivative can take the form of an option, a warrant, a swap, a bond, a certificate of

debt securities, as discussed further *infra* at note 91. Interestingly, former § 1275(a)(4) was itself the end product of reactions against perceived abuses. See Haims & Schaumberger, *Restructuring the Overleveraged Company*, 48 TAX NOTES 91, 95-96 (1990); New York State Bar Ass'n Tax Section, *Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges*, 51 TAX NOTES 79, 83 (1991).

6. As discussed above, "loopholes" result from the use of uncertainty in tax treatment to create unintended tax consequences. By contrast, taxpayers' ability to engage in "line-walking" to their own advantage will exist whenever there are formal rules which by their nature offer comparative certainty and thus are either "underinclusive as to purpose, overinclusive as to purpose, or both." M. KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 40 (1987); see Hu, *supra* note 1, at 398.

7. For practical definitions of options, forwards futures, and the standard "notional principal amount" products (interest rate swaps, caps, floors, and collars), see Kleinbard & Greenberg, *Business Hedges After Arkansas Best*, 43 TAX L. REV. 393, 394-95 nn.3-4 (1988).

8. For an overview of the use of derivative interest rate products and similar tools such as liability management tools, see generally MANAGEMENT OF INTEREST RATE RISK (B. Antl ed. 1988).

deposit or any manner of hybrid.<sup>9</sup>

By this definition, a convertible bond, for example, is an equity derivative product. This broad understanding of the term conforms with market practice: many market participants view the decision to invest in a convertible bond not as the acquisition of a debt obligation with a stapled opportunity to roll the dice on equity prices, but as the de facto purchase of the underlying equity at an above-market price in return for an above-market current yield. Securities firms, for example, underwrite convertible bonds through their equity syndicate desks rather than their debt syndicate desks, and the National Association of Security Dealers Automated Quotation System (NASDAQ), which operates as a computerized bid-ask pricing system for over-the-counter equity securities, lists convertible bonds (but not straight debt).<sup>10</sup>

Examples of more modern, but equally straightforward, equity derivative products are the cash-settlement put and call options on widely followed stock indices (such as the Nikkei 225 stock index<sup>11</sup>) recently issued by several United States securities firms in United States public offerings. In addition, new forms of equity derivatives (and new uses for them) have been developed recently, largely as a result of three factors: the incorporation into the equity arena of swap terminology and technology developed in the interest rate derivatives area, the increasing globalization of the equity markets, and the ability of securities firms to profit through advanced proprietary hedging techniques for equity-based products.<sup>12</sup>

As in the early years of the interest rate swap market,<sup>13</sup> many new

9. Hansell, *supra* note 3, at 55; see also Donnelly & Torres, *Sluggish Wall Street Is Rushing into 'Derivatives'*, Wall St. J., Nov. 30, 1990, at C1, col. 3 ("Derivatives are not exactly stocks, not exactly bonds. They are customized securities designed to act a certain way when an underlying security, index or commodity moves in price").

10. Interestingly, the tax law traditionally has characterized convertible bonds in precisely the opposite fashion, treating a convertible bond as debt until it actually is converted into equity. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.60, at 4-73 (5th ed. 1987) (explaining that before conversion, the debt "genes" of a convertible bond are treated as dominant and the equity "genes" are treated as recessive). For further discussion, see *infra* Part I(C). Arguably, Prop. Treas. Reg. § 1.1275-4(g), 56 Fed. Reg. 8308 (1991) represents a different view of the economics of a convertible bond. That proposed regulation, which would apply to some (but not all) convertible bonds, and to all "exchangeable" bonds (that is, bonds convertible into stock of a corporation other than the issuer of the bonds), would require that a debt instrument within its scope be bifurcated into its constituent components—in the case of a convertible bond, a discount bond and a warrant. This proposed regulation is discussed *infra* at note 105.

11. The Nikkei 225 Index is the best known index of Japanese equity securities. A number of firms have offered cash-settlement put and call options on that index. See Parker, *Index Warrant Use Grows*, PENSIONS & INVESTMENT AGE, Apr. 2, 1990, at 10.

12. The current state of the marketplace for equity derivatives is summarized in Hansell, *supra* note 3.

13. See Taylor, *Understanding Interest Rate Swaps and Contracts*, in *NEW FINANCIAL INSTRU-*

equity derivatives are designed to arbitrage differences between various capital markets. An example of such intermarket arbitrage is the "covered warrant," a hugely profitable business for some securities firms during the 1984-1989 period.<sup>14</sup> In a typical covered warrant program, a securities firm would arbitrage the difference between wholesale and retail markets for an issuer's equity warrants. To accomplish this arbitrage, the securities firm would acquire, in the secondary market, a large block of outstanding warrants to purchase the underlying equity securities of an issuer. Typically, the warrant issuer was a Japanese corporation that had issued the warrants previously as part of a bond-warrant unit in the Euromarkets. The securities firm then would issue its own warrants to purchase the same underlying securities, using the purchased warrants as a hedge (or "cover"). The new warrants would be issued in smaller denominations than the cover warrants, and might be exercisable in a different currency—such as Swiss Francs—with a higher exercise price than the underlying cover warrants (thereby reducing the up-front premium required to purchase a warrant and leaving the issuing securities firm with the potential to capture as profit the difference in strike prices).<sup>15</sup> The repackaged warrants would be sold, in the usual case, to retail investors, at substantial mark-ups from the trading price of the original large denomination, less liquid cover warrants.<sup>16</sup> By employing its capital to acquire and finance the cover warrants and using its distribution network to locate retail market customers, the securities firms were able to earn a merchant's mark-up with minimal exposure to the underlying equity risk. It has been estimated that roughly \$5 billion in covered warrant transactions were consummated in the public capital markets in 1989 and the first quarter of 1990.<sup>17</sup>

One obvious limitation on the growth of covered warrants was the finite supply of large blocks of illiquid warrants in the secondary marketplace to serve as "cover." Bankers Trust Company is widely credited with developing an innovative response to this dilemma when, in 1988, it issued the first "faux covered warrant"—a warrant whose "cover" was not a perfectly offsetting actual warrant, but rather a sophisticated mélange of actively managed financial instruments, including futures con-

MENTS AND TECHNIQUES 1989, CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES No. 630, at 493, 496 (1989).

14. See Ipsen, *The Biggest Pool in Town*, INSTITUTIONAL INVESTOR (int'l ed.), June 1990, at 100, 100-01.

15. The issuing securities firm would also hedge its currency exposure through currency forward or swap contracts.

16. See Ipsen, *supra* note 14, at 101-02.

17. *Id.* at 100.

tracts, over-the-counter options, and positions in the underlying physical securities.<sup>18</sup> Unlike a covered warrant, these complex hedges required careful monitoring and constant adjustment to respond to changes in the equity market. With the introduction of these sophisticated hedging techniques, however, securities firms could offer to investors virtually any saleable investment opportunity, and reserve for themselves the economic opportunity (and risk) of their “imperfect” hedging strategies.

Although the covered warrant and faux covered warrant programs are of little direct interest to United States tax regulators, they do illuminate several key characteristics of the developing market for equity derivatives. First, cross-border equity markets currently are relatively inefficient and cumbersome for investors. Some of these inefficiencies are attributable to information shortages and high transaction costs: for retail investors, in particular, it can be very difficult to gather information on equity issuers domiciled in foreign markets, and foreign currency transaction costs must be added to retail brokerage commissions.<sup>19</sup> Other inefficiencies are attributable to nontax regulatory constraints: regulated entities, such as pension funds or insurance companies, often are subject to limitations on investment in foreign equity securities.<sup>20</sup> Derivative instruments can be used to overcome these inefficiencies, by enabling parties to take an economic position in an equity security without actually owning it.<sup>21</sup> Canadian pension funds, for example, are not permitted to invest more than ten percent of their assets in non-Canadian equities, but that limitation does not apply to equity-indexed contingent debt arrangements.<sup>22</sup> For a securities firm—with its superior access to information and ability to manage risk—these inefficiencies give rise to arbitrage opportunities and corresponding arbitrage profits.

Second, the bulk of equity derivative counterparties, apart from the securities industry, are equity investors, rather than equity issuers. Equity derivatives are used for the most part to make efficient equity investments, to hedge existing investment portfolios, or to earn an incremental return on those portfolios. In this respect, the current state of the equity

18. *Id.*

19. See Donnelly & Torres, *supra* note 9, at C17, col. 3 (“[D]erivatives also offer investors a way to venture into unfamiliar foreign markets at a lower cost—and often lower risk—than in using the conventional route.”).

20. Cf. London, *Tailored Securities Cutting a Dash*, *Fin. Times*, Oct. 23, 1990, at 32, col. 5 (observing that United States institutional investors have turned to structured private placements because such investors are often denied access to overseas equity markets).

21. Eric Seff, Managing Director of Chase Investors Management Corp., observes: “I can use [swap-based equity derivatives] for anything I would previously have used futures, options or the stocks themselves for. In most cases it is more economical than using the listed markets, easier than the listed markets and relatively free of cumbersome regulation.” Hansell, *supra* note 3, at 56.

22. See *id.*

derivative marketplace is the opposite of the early years of the interest rate swap market, where the majority of participants were debt issuers looking to arbitrage differences in access to funds in different debt markets. Just as the interest rate swap market rapidly evolved into an asset management tool, however, so too will the equity derivative marketplace likely take on increasing importance for equity (or quasi-equity) issuers over time.

Third, the current equity derivative marketplace exhibits a remarkable symbiotic relationship between securities firms and the investor community. Although most equity derivatives are designed to appeal to one segment or another of the investor community, it nonetheless remains true that every derivative instrument requires two parties. The counterparties to many equity derivatives are securities firms, which view the equity derivatives that they market to investors as opportunities to create substantial profits through "dynamic" (read imperfect) hedges of the underlying risks. These hedges typically employ a wide range of equity and nonequity instruments, including interest rate sensitive instruments and foreign-currency contracts.<sup>23</sup> The hedges are designed with the assistance of computers and sophisticated mathematical analyses, and are constantly adjusted over their lives to respond to changing market conditions. Dynamic hedging carries considerable risks, but has been a significant source of profits for several securities firms in recent years.<sup>24</sup> Such a firm satisfies its appetite for dynamic hedge proprietary trading opportunities by acting as the issuer of equity derivatives to customers, and then using that economic exposure as the vehicle around which its proprietary hedging revolves.

In addition to equity warrants (both covered and faux), two other equity derivative products deserve special attention because of the interesting issues that they raise for tax advisors and tax authorities alike. The equity index swap is perhaps the most complex and interesting equity derivative product. The market is sufficiently new that no standard form of equity index swap has emerged. In one common variant, how-

23. See Torres, *'Synthetic' Stock: Future Stand-In for the Real Thing*, Wall St. J., Oct. 19, 1990, at C1, col. 3.

24. See Siconolfi & Power, *U.S. Securities Industry Expected to Post Worst Results Since 1974*, Wall St. J., Jan. 3, 1991, at C1, col. 3 ("One of the biggest money-makers for Wall Street firms in the fourth quarter and throughout 1990 was trading, particularly for their own accounts. So-called derivative products . . . also were lucrative for [certain] firms . . ."); see also Ipsen, *supra* note 14, at 100 ("[The] equity derivatives group [is] Bankers Trust's largest single money-churner."); Torres & Donnelly, *Rivals Challenge Bankers Trust in Derivative-Securities Business*, Wall St. J., Dec. 6, 1990, at C1, col. 5 ("[T]hrough November [of 1990] Bankers Trust racked up about \$500 million of revenue in the derivatives business," with estimated profits from derivatives "approach[ing] \$250 million . . .").

ever, one party (the “equity payor”) agrees to make periodic payments over a fixed term of (1) amounts based on the *increase* in value, if any, during each period of a specified index of equity securities (e.g., the Standard & Poor’s 500 Index), and (2) dividends on that index, in each case as applied to a notional principal investment in that index. The counterparty (the “floating-rate payor”) agrees to make periodic payments determined by applying to the same notional principal amount (1) a specified floating rate of interest (e.g., a rate based on LIBOR), and (2) amounts based on the *decrease* in value during each period of the equity index. The notional principal amount itself typically adjusts each period to reflect changes in the value of the underlying equity index. A typical equity index swap is documented in a fashion similar to an interest rate swap, and as in the case of interest rate swaps, cash flows typically are netted.<sup>25</sup>

The “money-back warrant,” or “principal-indexed note,” as its name suggests, presents unique characterization issues.<sup>26</sup> This instrument may be denominated as a warrant or as a note, and has a fixed maturity. The instrument pays no interest prior to maturity; at maturity, it pays stated principal amount together with contingent interest (if any) measured by the price fluctuation of a specified equity index or equity security.<sup>27</sup> The tax uncertainties surrounding money-back warrants are considered in more detail below.

### C. Tax Issues Raised by Equity Derivatives

The equity derivative marketplace today is not large—probably under \$100 billion in off-exchange contractual products (measured by the value of the underlying equity).<sup>28</sup> As the equity derivative market

25. The equity index swap is considered in detail in Part II below.

26. Cf. Bensman, *Tax Questions May Blur Appeal of Money-Back Warrants*, INVESTMENT DEALERS’ DIG., Feb. 22, 1988, at 48 (discussing whether a money-back warrant should be taxed like a traditional warrant or like a bond). It should be noted that the term “money-back warrant” is securities industry slang. Recent issues have used a variety of tradenames to describe these products. E.g., \$100,000,000 Stock Index Growth Notes (“SIGNs”) due August 15, 1996 issued by the Republic of Austria (Prospectus Supp. Jan. 28, 1991) (copy on file with the *Texas Law Review*).

27. An early example is the Yen Foreign Exchange Warrants Expiring February 11, 1993 issued by the Student Loan Marketing Association (Prospectus dated Feb. 2, 1988) (copy on file with the *Texas Law Review*). The “warrants” were issued to the public at \$9.25 per warrant, and paid at maturity the greater of \$9.25 or an amount indexed to relative yen/dollar values. The prospectus disclosed that counsel to the issuer thought “the better view” was that the warrants constituted debt for federal income tax purposes. *Id.* at 36.

28. Estimates vary. Compare Ipsen, *supra* note 14, at 100 (estimating that as much as \$70 billion in outstanding privately negotiated long-dated covered options were issued in 1989) with Hansell, *supra* note 3, at 54-55 (estimating that the dominant houses had booked \$30 billion to \$40 billion in equity derivatives by August 1990). One difficulty in assessing the size of the marketplace is informational: many derivatives are privately negotiated contracts, and no clearing house for data on such arrangements exists. Another difficulty is definitional: neither of the above estimates, for

matures, however, it is likely to expand dramatically in size, to the point where the United States tax system will not be able to ignore it.

It obviously is impossible to predict in advance all the pressure points on the tax system that will emerge as the equity derivative marketplace matures, but some issues are reasonably foreseeable. In the international context, and as described in detail in Part II, equity derivatives may be used by foreign investors to earn an economic return measured, in part, by dividends on an index of United States equities without incurring United States withholding tax liability.<sup>29</sup>

In the domestic context, the Internal Revenue Code often imposes certain constraints, or grants certain benefits, to taxpayers measured partly on the amount of their dividend income. It is unclear, at best, whether payments received in respect of a derivative contract (such as equity-based payments received by the floating-rate payor in the equity index swap described above) would be treated as dividend income for these purposes.<sup>30</sup> Similarly, it is not clear whether a corporate investor that was the equity payor in an index swap would lose the benefits of the dividends-received deduction<sup>31</sup> if the investor also owned the underlying stocks making up the equity index.<sup>32</sup> In the case of pension funds and

example, appears to include convertible bonds or conventional exchange-traded products. A comprehensive definition would result in a much larger estimate.

29. A similar issue would be raised if Congress were to seek to impose a capital gains tax on foreign portfolio investors in United States equities.

30. For example, a corporation's status as a "personal holding company" under I.R.C. § 542 (1988) (and therefore the applicability of the personal holding company tax under I.R.C. § 541 (1988) to that corporation) depends in part on the proportion of the corporation's income that consists of dividends, as does a corporation's status as a "regulated investment company" under I.R.C. § 851 (Prentice Hall 1991) (and therefore the availability of the deduction for dividends paid). Dividends received by a corporate shareholder are eligible for the dividends-received deduction under I.R.C. § 243 (Prentice Hall 1991) and dividends are excluded from the "unrelated business taxable income" of a tax-exempt institution under I.R.C. § 512(b)(1) (Prentice Hall 1991).

31. I.R.C. § 243 (Prentice Hall 1991).

32. Under I.R.C. § 246(c)(1)(B) (1988), a taxpayer loses the benefit of the dividends-received deduction to the extent the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property. While the payments made by the equity payor under an equity index swap are similar in amount to dividends on the underlying equities, it is uncertain whether the swap contract, which provides for bilateral payments between the parties, can be viewed as "substantially similar" to a short position on physical equities. In addition, to qualify for the dividends-received deduction, a taxpayer must have held the related stock for at least 46 days, and the taxpayer's holding period will be reduced in a manner to be prescribed under Treasury regulations for any period in which the "taxpayer has diminished his risk of loss of holding [one] or more other positions with respect to substantially similar or related property." I.R.C. § 246(c)(4)(C) (1988). Although the Service's regulatory authority under § 246(c)(4)(C) might be adequate to prohibit the dividends-received deduction in this context, the Conference Committee Report to the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, provides two specific examples of transactions within the scope of the rule for substantially similar or related property to which the regulations should be retroactive and states that, as to other transactions, the regulations should apply only on a prospective basis. See H.R. CONF. REP. NO. 861, 98th Cong., 2d Sess. 757, 818, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 1445, 1506. Because the terms of the equity index swap do not

other tax-exempt investors, certain contractual equity derivatives raise, in a new context, a UBTI issue similar to the controversy that has deterred many tax-exempt investors from using interest rate swaps and similar notional principal contracts as asset management tools.<sup>33</sup>

From the perspective of corporate issuers, the tax system also appears at risk. As noted earlier, receipt by a corporate issuer of an interest deduction on convertible debt has traditionally been tolerated, even though many market participants view that instrument as a *de facto* equity investment. Increasing sophistication in hedging techniques and investor acceptance of new equity derivative products will lead to new structures that will place even more tension on current law's frayed distinctions between debt and equity instruments.

Consider, for example, the money-back warrant and its economic identical twin, the principal-indexed note. Most tax advisors believe, with varying degrees of fervor, that money-back warrants that are denominated as debt instruments and treated as such for debtor-creditor law purposes are debt instruments under current tax law classification principles, but even the most ardent believer pauses when told that these debt instruments will be offered for sale in \$20 denominations and listed on a national options exchange.<sup>34</sup> Most issues of money-back warrants to date have involved options on commodities or currencies, and most recent interest in issuing such instruments has come from nontaxable in-

conform to either of the examples in the Conference Committee Report, any such swaps entered into before the promulgation of regulations under § 246(c)(4)(C) arguably are beyond the reach of such subsequent regulations.

33. See *supra* note 4 and accompanying text; *infra* note 68 and accompanying text.

34. The more familiar "exchangeable bonds" (*i.e.*, bonds convertible into stock other than that of the obligor) are treated for tax purposes as debt until conversion, at which point they are treated as exchanged for the stock in a taxable transaction. At least prior to Prop. Treas. Reg. § 1.1275-4(g), 56 Fed. Reg. 8308 (1991), the Internal Revenue Service has treated a holder of such a bond as recognizing gain on the exercise of the exchange privilege equal to the difference between the fair market value of the stock received and the holder's tax basis in the bond. See Rev. Rul. 69-135, 1969-1 C.B. 198; Priv. Ltr. Rul. 85-50-022 (Sept. 13, 1985); Gen. Couns. Mem. 39452 (Dec. 4, 1985); see also *Estate of Timken v. Commissioner*, 47 B.T.A. 494 (1942) (holding that the excess of the fair market value of shares received over the cost of the convertible bond was taxable income), *nonacq. on other grounds*, 1942-2 C.B. 32, *aff'd on other grounds*, 141 F.2d 625 (6th Cir. 1944). Viewed from the perspective of the obligor, such a theory would result in gain (presumably capital gain) measured by the value of the stock at the time of the exchange over the obligor's basis in that stock, and an ordinary deduction for redemption premium measured by the excess of the value of the stock over the face amount of the bonds.

In my view, this analysis gives insufficient weight to the general rules for the taxation of options transactions. A more satisfactory result would follow if the exchangeable bonds were viewed for purposes of measuring the amount and character of gain or loss as representing an option, the exercise of which on the exchange of the bonds for stock results in (1) no tax consequences to the holders, who take a basis in the stock equal to the face amount of the bonds exchanged therefor, and (2) gain recognized by the obligor in an amount equal to the excess of the face amount of the bonds over the obligor's basis in the stock. Prop. Treas. Reg. § 1.1275-4(g) radically alters the tax analysis of exchangeable bonds. See *infra* note 105.

stitutions (such as foreign entities). Very recently, however, the first public offering of an equity-based, principal-indexed note (on the Standard & Poor's 500 Index) by a United States domestic issuer was filed with the Securities and Exchange Commission.<sup>35</sup>

Finally, the Treasury Department is expected to release a study on the integration of the corporate tax system early in 1991.<sup>36</sup> Regardless of the study's conclusions, it is likely to spur debate on whether the United States should move towards a system of corporate integration, as have many other major economic powers.<sup>37</sup> Equity derivative products will raise difficult issues for many corporate integration proposals, because those products will enable taxpayers in effect to invest either in actual equity (with its attendant integration consequences) or in synthetic equity. In the absence of thoughtful policing mechanisms, taxpayers may be able to separate the tax consequences associated with the ownership of equities in an integration model (e.g., a deemed-paid tax credit) from the economic risks of such ownership.

## II. Equity Index Swaps—A Case Study

### A. Overview

Imagine the case of three hypothetical investors. The first, a foreign tax-exempt institution, wishes to invest in the United States equity market, but is constrained from doing so by its country's regulatory concerns. Moreover, as a tax-exempt institution in its home jurisdiction, the investor will suffer a pure out-of-pocket expense in respect of any United States withholding tax imposed on dividends received by it. Finally, the investor would prefer to leverage its equity investment, but is prohibited from borrowing under its articles of association. The second hypothetical investor is a United States pension plan with substantial money market investments. The pension plan wishes to move some of these assets into an investment in a broad base of United States equity securities in a cost-efficient manner, without running afoul of the UBTI provisions of the Internal Revenue Code.<sup>38</sup> Finally, the third hypothetical investor is a

35. Standard & Poor's 500 Index-Linked Notes Due 1996, to be Issued by Salomon Inc (Preliminary Prospectus Supp. Jan. 28, 1991). These proposed securities have not to date been issued, presumably at least in part because of the promulgation of Prop. Treas. Reg. § 1.1275-4(g), 56 Fed. Reg. 8308 (1991), discussed *infra* at note 105.

36. See Rosen, *Treasury's Corporate Integration Study Back on Track*, 49 TAX NOTES 956 (1990); see also *infra* note 135.

37. The United Kingdom, France, and Germany, to take but a few examples, all tax corporations and their shareholders through one variation or another of a partial integration scheme. See Gourevitch, *Corporate Tax Integration: The Corporate Tax Experience*, 31 TAX LAW. 65 (1977).

38. I.R.C. §§ 511-515 (Prentice Hall 1991). These provisions effectively impose net income tax on the income of otherwise tax-exempt institutions to the extent attributable to any "unrelated trade

United States taxpaying corporation with capital loss carryovers and with similar investment goals to that of the United States pension plan; unlike the pension plan, however, this investor is primarily interested in deriving capital gains from its investment (rather than interest or dividend income), because it can use its capital loss carryover to shelter the current year's capital gain net income from tax.<sup>39</sup>

Each of these investors can accomplish its economic purpose by entering into the floating-rate payor side of an equity index swap. The equity payor (typically a United States securities firm) will agree to make periodic payments for a specified term of (1) amounts based on the *increase* in value, if any, during each period of a specified equity index—for purposes of this case study, the Standard & Poor's 500 Index—and (2) amounts equal to dividends paid on that index. In exchange, the floating-rate payor (the hypothetical investor) will agree to make periodic payments of *X*, a floating rate of interest pegged (by way of example) to LIBOR, and *Y*, amounts based on the *decrease* in value during each period of the Standard & Poor's 500 Index. The notional principal amount against which all payments are calculated will be adjusted each period to reflect the change in value in the equity index from the prior period.<sup>40</sup>

or business," as defined in I.R.C. § 513 (Prentice Hall 1991). Broadly speaking, the purpose of the UBTI provisions is to prevent tax-exempt organizations from using their tax-favored status to compete unfairly with taxpaying business organizations.

Section 513(a) defines an "unrelated trade or business" as "any trade or business the conduct of which is not substantially related (aside from the need of such [exempt] organization for income . . .) to the exercise or performance by such organization of its [exempt] . . . purpose . . ." I.R.C. § 513(a) (Prentice Hall 1991). The Internal Revenue Service and the courts generally take the view that, in contrast to the law for individuals, any concerted profit-motivated activity by an exempt organization (*including* the active management of an investment portfolio) constitutes an unrelated trade or business for purposes of § 513(a). *See, e.g.*, Gen. Couns. Mem. 39615 (Mar. 12, 1987) (stating that stock index arbitrage activity constitutes a trade or business); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982) (finding that serving as a "middleman" between credit unions and commercial vendors of insurance, debt collection, and electronic data processing services, is motivated by profit and is thus a trade or business).

Accordingly, as a practical matter most UBTI analysis by practitioners consists of searching for an *exception* to the broad scope of the definition of an unrelated trade or business. The most useful constellation of exceptions is contained in I.R.C. § 512(b) (Prentice Hall 1991), which excludes from the scope of the UBTI rules (among other categories) interest, dividends, and gains from the sale of noninventory property.

39. *See* I.R.C. § 1212 (1988). As in the case of the foreign tax-exempt investor, the domestic pension plan and taxpaying corporation would each suffer adverse tax consequences from making a leveraged investment in equity, because of the rules treating "debt-financed income" as UBTI. *See infra* note 63 (discussing the potential classification of debt-financed income as UBTI under I.R.C. § 514 (Prentice Hall 1991)); I.R.C. § 246A (Prentice Hall 1991) (reducing or eliminating the dividends-received deduction in the case of debt-financed portfolio stock).

40. This fluctuation in notional principal amount mimics an investment in a constant quantity of "units" of the index, in which the units hypothetically are sold at the end of each period and immediately repurchased at their market value, thereby affecting the amount of deemed cash invested in the hypothetical transaction.

While the economic goals of each of the three investors can be satisfied through an equity index swap, the tax analysis applicable to each investor varies somewhat. At the outset, however, all three investors face the same fundamental dilemma: does there exist a tax cubbyhole under current law into which the equity index swap can be assigned?

### *B. Swap or Leveraged Purchase of Equities?*

The first order conceptual issue raised by an equity index swap is whether the economic analogy to a leveraged purchase of equity securities should drive the United States tax analysis, or whether, instead, the formal differences between the swap and an actual leveraged investment require that the swap be analyzed as a novel form of financial investment for tax purposes.

As an economic matter, by entering into the floating-rate payor side of an equity index swap on a domestic United States equity index, such as the Standard & Poor's 500 Index, each investor will create cash flows that closely approximate the cash flows that would be obtained if the investor actually borrowed the notional principal amount from its counterparty and then invested that amount in the equity securities that make up that equity index. Thus, each investor can be viewed in economic terms as paying amounts equal to a floating rate of interest to the equity payor counterparty in each period and receiving amounts equal to the dividends paid on the underlying equity securities. The equity-indexed payments received or made by the floating-rate payor would correspond to the economic gains or losses on a hypothetical basket of equities, if those equities were sold for cash at the end of each measurement period under the swap. Similarly, the equity payor can be viewed as having a dual role: (1) as a money lender that collects periodic floating-rate interest, and (2) as an effective custodian of the equity securities acquired by the investor, passing through to the investor at specified intervals the economic return on those securities.

Despite the similarity of cash flows, there are several important structural differences that distinguish an equity index swap from a fully leveraged purchase of actual equity securities. First, the floating-rate payor, unlike an actual equity investor, will not acquire any of the voting or other management rights of a corporate shareholder. Second, the equity-indexed amounts under the swap will be determined by reference to the performance of the specified equity index as a whole. The composition of the equity index over time, of course, is wholly outside the control

of the investor/floating-rate payor.<sup>41</sup> Third, unlike the owner of an actual basket of equity securities, the floating-rate payor will have no power to fine tune its investment portfolio by acquiring or disposing of individual equity securities in response to market charges. Fourth, dividend-equivalent amounts paid by the equity payor will not be limited to the funds legally available for the payment of dividends by the underlying equity issuers; moreover, in some equity swap contracts, such dividend-equivalent amounts are calculated by reference to historic dividend yields, not actual dividends during the term of the swap. Finally, and perhaps most important, the parties to an equity index swap face a different set of credit concerns than would arise from actually borrowing and directly investing in equity securities. The floating-rate payor, in contrast to the direct equity investor, is exposed not only indirectly to the credit quality of the corporations whose stock constitute the equity index, but also directly to the credit of the equity payor under the swap. For these reasons, the better analysis under current law is to view an equity index swap as a novel form of notional principal contract that provides for unique, equity-based bilateral payments, rather than as a disguised, fully leveraged purchase of equity securities.

The general point that follows from this conclusion is that, under current law, similarity of economic results is not sufficient to require identity of tax analysis: where there is no actual indebtedness and no actual indicia of ownership of equities, current tax law does not determine the tax consequences of an equity index swap by recasting the contract into a different (albeit economically similar) form.<sup>42</sup>

The immediate consequence of the conclusion, by contrast, is to throw into doubt the tax analysis of an equity index swap, because the appearance of a novel form of notional principal contract does not automatically stimulate the production of a comprehensive tax cubbyhole into which to place that product. Accordingly, the tax analysis of an equity index swap will consist of attempting to force that financial product into existing tax cubbyholes, where the fit may be less than perfect. The resulting tax conclusions will also vary somewhat from investor to investor. It will prove fruitful to demonstrate this point by going through that analysis (under the theory that an equity index swap is properly characterized as a novel form of "notional principal contract") for each of our three hypothetical investors.

41. See *infra* note 81 and accompanying text.

42. See *infra* Part III.

1. *The Foreign Investor*.—A foreign investor entering into an equity index swap with a United States counterparty in the first instance is interested primarily in ascertaining the *source* (United States or foreign) of income earned in respect of that swap. If the investor's income is treated as foreign-source income for United States tax purposes, then, as a general matter, income earned by the foreign investor will not be subject to United States withholding tax.<sup>43</sup> Conversely, if that income is treated as United States source income, then payments to the foreign investor by the United States counterparty to the swap conceivably could be subject to United States withholding tax.<sup>44</sup>

Prior to January 1991, foreign counterparties to equity index swaps and other exotic notional principal contracts had no source rules on which they could rely to conclude that income earned on such contracts with United States counterparties gave rise to foreign-source income. From 1989 to January 1991, the only regulatory authority that addressed the source of swap income or expense was former Temporary Treasury Regulation Section 1.863-7T,<sup>45</sup> which provided special sourcing rules for certain United States dollar-denominated notional principal contracts, such as interest rate swaps. Those rules generally sourced income from a notional principal contract by reference to the residence of the recipient.<sup>46</sup> Under this approach, notional principal contract payments re-

43. Most practitioners would conclude that a foreign investor that enters into a swap contract with a United States counterparty would not, simply by virtue of that contract, be treated as engaging in a trade or business in the United States, even without regard to the application of the "safe harbor" of I.R.C. § 864(b)(2) (Prentice Hall 1991), which treats certain securities and commodities trading as not constituting a United States trade or business. In the case of income that is not trade or business income, the Code imposes tax on non-United States persons only in respect of certain categories of United States source income. See I.R.C. § 871(a)(1) (1988) (imposing tax on nonresident alien individuals' income other than capital gains); I.R.C. § 881(a) (1988) (imposing substantive tax liability on income from sources outside the United States received by foreign corporations); I.R.C. § 1441(a) (1988) (withholding of tax on nonresident aliens); I.R.C. § 1442(a) (1988) (withholding of tax on foreign corporations). Moreover, even if a foreign investor were treated as engaged in a trade or business in the United States by virtue of entering into a swap contract, the United States imposes tax only on income "effectively connected" with the conduct of that trade or business. See I.R.C. §§ 871(b), 882(a) (1988). Foreign-source income is treated as effectively connected with the conduct of a trade or business only if, among other factors, the foreign investor has an "office or other fixed place of business within the United States to which such income . . . is attributable." I.R.C. § 864(c)(4)(B) (Prentice Hall 1991). But cf. *infra* note 51 (describing the more stringent regulations that specifically address sourcing of notional principal contracts). Accordingly, as a practical matter, if one can conclude that income earned by a foreign investor is not derived from sources within the United States, that income generally will not be subject to United States net income tax or withholding tax.

44. This risk is borne by the foreign investor as a matter of law, but typically is shifted to the United States counterparty as a matter of contract through a "gross-up" provision.

45. Temp. Treas. Reg. § 1.863-7T (1989).

46. See *id.* Section 1.863-7T was itself the successor to I.R.S. Notice 87-4, 1987-1 C.B. 416 (containing prior sourcing rules for dollar-denominated interest rate swap income and expenses). Temp. Treas. Reg. § 1.988-4T (1989) contains a similar source rule for "section 988 transactions," which, in general, include most foreign-currency transactions, including currency swaps. Those

ceived by a non-United States counterparty that had no other United States connections were treated as foreign-source income and therefore were exempt from United States withholding tax, without regard to whether the non-United States party was otherwise eligible for tax treaty benefits or other withholding tax exemptions.<sup>47</sup>

Simply denominating an equity index swap as a "swap," however, did not ensure that these favorable sourcing rules applied. In particular, the definition of "notional principal contract" in former Temporary Treasury Regulation Section 1.863-7T did *not* include equity-based notional principal contracts, such as equity index swaps, because that regulation required that payments under a "notional principal contract" be determined by reference to an *interest rate index*.<sup>48</sup>

With the promulgation of final Treasury regulations in January 1991, the uncertain sourcing rules of prior law have now been resolved favorably to foreign investors. New Treasury Regulation Section 1.863-7 expands the source rule of the former temporary regulations to any "fi-

rules generally have no application to the type of swap discussed in subpart II(A), which normally would consist solely of United States dollar flows determined by reference to United States dollar-based equity and debt indices.

47. Section 892, for example, exempts from United States taxation any income of foreign governments derived from "financial instruments held in the execution of governmental financial or monetary policy . . ." I.R.C. § 892(a)(1)(A)(ii) (Prentice Hall 1991). Temp. Treas. Reg. § 1.892-3T(a)(4) (1988) clarifies that this reference covers swaps and similar financial products.

48. More specifically, the temporary regulation defined a notional principal contract covered by its sourcing rules as

an interest rate swap, cap, floor, collar, or similar financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to an *interest rate index* upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.

Temp. Treas. Reg. § 1.863-7T(a)(1) (1989) (emphasis added). The definition was further limited to notional principal contracts denominated in, and determined by, reference to the "functional currency" of the United States party (normally United States dollars). *Id.*

An equity index swap did not come within this definition of a "notional principal contract," because the equity-indexed component of the parties' swap payments cannot properly be viewed as either calculated by reference to an *interest rate index* or as "specified consideration" for the floating-rate amounts. (I view the term "specified consideration" to mean a fixed amount of money, whether paid in one lump sum (as in the case of a typical interest rate cap or floor) or over time (as in the case of the fixed-rate leg of a standard interest rate swap).) Consequently, the residence-based sourcing principles of Temp. Treas. Reg. § 1.863-7T did not provide a safe harbor that would eliminate United States withholding tax risk for payments made by the United States securities firm as equity payor under the swap.

In the absence of a consensus view about the metaphysical nature of derivative products *not* covered by the pragmatic guidance of Temp. Treas. Reg. § 1.863-7T, practitioners had no choice but to analogize to more clearly understood categories of income. *Cf.* Bank of Am. v. United States, 680 F.2d 142, 150 (Ct. Cl. 1982) (determining source of income from "confirmation" and "acceptance" of letters of credit "by analogy to interest [sourcing rules]," even though the income was not actually interest). For example, service income generally is sourced where the services are performed, *see* I.R.C. §§ 861(a)(3), 862(a)(3) (Prentice Hall 1991), insurance premiums are sourced at the situs of the insured risk, *see* I.R.C. §§ 861(a)(7), 862(a)(7) (Prentice Hall 1991), and interest generally is sourced by the residence of the obligor, *see* I.R.C. § 861(a)(1) (Prentice Hall 1991).

nancial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a *specified index* upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.”<sup>49</sup> The preamble to the final regulations explains that the expansion of the definition to include *all* index-related payments, whatever the index, was intended to bring “commodity swaps” within the scope of the regulation’s source rules.<sup>50</sup> The preamble does not contain a similar reference to equity derivative products, and the term “index” is not defined by the regulation, but there does not appear to be any basis for excluding from its scope a well-known and heavily publicized equity index such as the Standard & Poor’s 500.

Accordingly, it would appear that our hypothetical foreign investor should now be able to conclude that any income attributable to an equity index swap with a United States counterparty will be characterized for United States tax purposes as derived from sources outside the United States, and therefore will not be subject to United States withholding tax.<sup>51</sup> Thus, a foreign investor can resolve its pragmatic United States tax concern (the possible imposition of United States withholding tax on swap payments) without ever struggling with—or needing to struggle with, for that matter—the more difficult question of the metaphysical tax cubbyhole into which equity index swaps should be placed for United States tax purposes.<sup>52</sup>

49. Treas. Reg. § 1.863-7(a)(1) (1991) (emphasis added). The new rules are effective for notional principal contract income includible in income on or after February 13, 1991, subject to a taxpayer election to apply the rules retroactively. *Id.* § 1.863-7(a)(2).

50. Explanation of Provisions, T.D. 8330, 1991-7 I.R.B. 10. “Commodity swaps” are another example of a novel form of notional principal contract. A commodity swap might look much like an equity index swap, except that one party would pay an amount of cash measured by the then-current spot price of, for example, crude oil applied to a notional quantity of that commodity, while the counterparty would pay a fixed number of dollars (or dollars measured by a floating-rate interest index).

51. As noted earlier, foreign-source income of a foreign investor will not be treated as “effectively connected” with the conduct of a United States trade or business (and hence subject to net income tax) unless, among other factors, the foreign investor maintains an office or other fixed place of business in the United States. See *supra* note 43. Treas. Reg. § 1.863-7 (1991) (as well as the predecessor temporary regulation) effectively turns the statutory rule on its head by providing that if income derived by a foreign entity from a notional principal contract “arises from” the conduct of a United States trade or business, as determined under principles “similar to” those described in Treas. Reg. § 1.864-4(c) (as amended in 1984) (which does not deal specifically with income from notional principal products), then that income will be treated as derived from sources within the United States and will be treated as effectively connected with the conduct of a United States trade or business. A foreign investor must, therefore, still be on guard that its dealings with United States counterparties not rise to the level of a trade or business in the United States.

52. One interesting question that remains is whether Treas. Reg. § 1.863-7 (1991) changes settled law in areas not within its apparent intended scope. Virtually any cash-settlement futures contract on a financial index, for example, could theoretically come within the scope of the regulation, which in turn might affect the source of income from such a contract (or its characterization as

2. *The United States Investors.*—One of the most interesting aspects of Treasury Regulation Section 1.863-7 (and its predecessor temporary regulation) is that it represents a purely pragmatic result, without all the metaphysical trappings that would be required in a comprehensive approach to the taxation of the financial products covered by the regulation. Commentators have applauded the Treasury and the Internal Revenue Service for that pragmatism, because it improves the economic efficiency of the international capital markets.<sup>53</sup> At the same time, it must be admitted that pragmatism has a price; in this case, by limiting guidance to the international capital markets in a purely pragmatic fashion, the Treasury and the Internal Revenue Service have offered no guidance at all to domestic parties entering into equity index swaps. As the discussion that follows demonstrates, the resulting lacuna compels taxpayers to follow a tortuous path through Internal Revenue Code provisions that were not drafted to deal with equity derivative products.

I began by postulating two United States investors in equity index swaps: a tax-exempt pension plan that wished to avoid the UBTI provisions of the Internal Revenue Code, and a taxpaying corporation that could increase its after-tax returns by deriving capital gains, rather than ordinary income, from an equity index swap. By coincidence, the same convoluted tax analysis can provide favorable conclusions for both investors.

Section 512(b) sets out a series of statutory exceptions from the scope of the UBTI provisions of the Internal Revenue Code.<sup>54</sup> On the theory that an equity index swap represents a novel form of notional principal contract, sections 512(b)(1) through (3), which exclude interest, dividends, rents, and royalties from the scope of UBTI, cannot help the tax-exempt investor.<sup>55</sup> Section 512(b)(5), however, is potentially relevant. That provision excludes from UBTI gain from the "sale, exchange

effectively connected with the conduct of a United States trade or business). One counterargument is that, when the regulation defines the term "notional principal contract" by reference to the "payment of amounts," that definition requires that at least one of the parties to a notional principal contract be obligated to make more than one payment to its counterparty. This hyper-literal reading in turn would transform Treas. Reg. § 1.863-7 into a quasi-elective system for forward contracts. By structuring a contract with two payments rather than one, a contract could be brought within the definition of a notional principal contract.

53. The change on sourcing rules made in the permanent regulation was itself in response to input on the shortcomings of the temporary regulation. See *Allocation of Income Attributable to Notional Principal Contracts—Final Regulations Under Section 863*, 50 TAX NOTES 237, 237 (1991); cf. Kleinbard, Duncan & Greenberg, *U.S. Reduces Tax Risk for Swaps*, INT'L FIN. L. REV., Feb. 1987, at 26, 27.

54. I.R.C. § 512(b) (Prentice Hall 1991). Whether these exceptions are exclusive or are a series of safe harbors lies at the heart of the current debate over the application of the UBTI provisions to interest rate swaps. See *infra* note 68.

55. See *supra* note 38. Phrased differently, having rejected the analysis that an equity index

or other disposition" of property other than inventory (or other property held primarily for sale to customers in the ordinary course of business).<sup>56</sup> (For the sake of clarity, inventory and property held primarily for sale to customers in the ordinary course of business hereinafter are collectively referred to as "dealer property.")

The taxable corporation, of course, has no direct interest in section 512(b)(5).<sup>57</sup> Instead, to derive capital gain from an equity index swap, the corporation must recognize "gain from the sale or exchange of a capital asset."<sup>58</sup> A "capital asset" in turn means any property held by the taxpayer, other than dealer property (and certain other types of property not relevant to the present analysis).<sup>59</sup>

Thus, both the tax-exempt pension plan and the taxable corporation can achieve their tax objectives if income from an equity index swap constitutes gain from the "sale or exchange" of property (other than dealer property).<sup>60</sup> An equity index swap (or other equity derivative product) quite clearly constitutes property under tax common law.<sup>61</sup> Moreover, in the hands of an institutional investor (whether tax-exempt or taxable), an equity index swap ordinarily will not constitute dealer property, because the investor does not hold itself out to customers as a market-maker in such contracts.<sup>62</sup> As a result, the fundamental tax issue raised by an

swap in fact is an investment in equities, a tax-exempt institution cannot then seek shelter in a statutory exclusion for actual dividends.

56. I.R.C. § 512(b)(5) (Prentice Hall 1991).

57. See *supra* note 39 and accompanying text.

58. I.R.C. § 1222(1), (3) (1988).

59. I.R.C. § 1221 (1988); see also *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988) (limiting extra-statutory exceptions to the definition of "capital asset").

60. Because I ultimately favor the "sale or exchange" solution, I do not consider the alternative argument available to a tax-exempt institution that income from an equity index swap is gain from the "other disposition" of property, within the meaning of § 512(b)(5).

61. Although contract rights do not invariably constitute property for tax purposes, financial instruments such as equity derivative products typically do. For example, a debenture is property in this sense. See *Commissioner v. Ferrer*, 304 F.2d 125, 129-30 (2d Cir. 1962); see also *Commissioner v. Gillette Motor Transport Co.*, 364 U.S. 130, 134 (1959) (describing the typical characteristic of a "capital asset" as the potential for appreciation in value over a substantial time); *International Flavors & Fragrances, Inc. v. Commissioner*, 524 F.2d 357, 360 (2d Cir. 1975) (noting the Service's withdrawal of reliance on the theory that a forward contract was *not* a capital asset for tax purposes); *Hoover Co. v. Commissioner*, 72 T.C. 206, 243-48 (1979) (holding a forward contract to be property), *nonacq.*, 1980-1 C.B. 2; *Turzillo v. Commissioner*, 346 F.2d 884, 889 (6th Cir. 1965) (finding that rights under a buy-sell agreement for stock constitute property); *Dorman v. United States*, 296 F.2d 27, 29 (9th Cir. 1961) (finding that an executory contract to acquire capital in a partnership constitutes property); *Anderson v. United States*, 468 F. Supp. 1085, 1096-98 (D. Minn. 1979) (holding a right of first refusal to be a capital asset), *aff'd mem.*, 624 F.2d 1109 (8th Cir. 1980); *Vickers v. Commissioner*, 80 T.C. 394, 405 (1983) (noting the settled law that a futures contract is a capital asset); *Estate of Shea v. Commissioner*, 57 T.C. 15, 23-25 (1971) (holding that a ship charter constitutes property, based in part on the market for the existence of such charters), *acq.*, 1973-2 C.B. 3.

62. As applied to the securities industry, both categories of dealer property (property properly includible in inventory and property held for sale to customers in the ordinary course of business)

equity index swap for both hypothetical United States investors is simply whether income from an equity index swap can be characterized as gain from the "sale or exchange" of property.<sup>63</sup>

require that a taxpayer have *customers* from which it seeks to earn a "middleman's" bid-asked profit. See Treas. Reg. § 1.471-5 (as amended in 1987) ("[A] dealer in securities is a merchant of securities . . . regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom."); *Kemon v. Commissioner*, 16 T.C. 1026, 1032-33 (1951) (distinguishing securities traders from securities dealers on the basis that, while both are engaged in a trade or business, securities traders do not have customers).

The traditional tax definition of a securities dealer cannot literally be applied to a dealer in notional principal contracts, because even the most active market participants cannot be said to actively hold out their "books" of open contractual positions for sale to customers in the ordinary course of business. Although swap dealers occasionally do sell (or consent to the assignment of) swaps in the secondary market (usually at the behest of their counterparties), the vast bulk of a swap dealer's activity consists of entering into new contracts with customers. In recognition of this fact, Temp. Treas. Reg. § 1.954-2T(a)(4)(iii) (1988) defines a "regular dealer," for purposes not directly relevant here, as a "merchant" that either functions as a merchant in the sense used by Treas. Reg. § 1.471-5 (as amended in 1987), or "makes a market in derivative financial products . . . by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business."

Under any of these definitions, an institutional investor should not be viewed as a dealer in notional principal products. Accordingly, contracts held by such an investor should not constitute dealer property—or, phrased positively, such contracts should constitute capital assets in the hands of the investor.

63. In the case of the tax-exempt pension plan, income that otherwise cannot be classified as UBTI might nonetheless be swept within those provisions if that income is "debt-financed income," within the scope of I.R.C. § 514 (Prentice Hall 1991). Essentially, § 514 treats income earned by a tax-exempt institution as UBTI to the extent that such income is attributable to the investment of the proceeds of borrowings by the tax-exempt entity.

If one proceeds on the basis that an equity index swap is a novel form of notional principal contract, rather than a leveraged investment in equities, it should follow that there can be no § 514 issue, because the contract does not create any "acquisition indebtedness." This is, of course, the correct answer. The Internal Revenue Service, however, apparently prefers to follow a more over-grown path to reach this straightforward conclusion.

In a General Counsel Memorandum, the Service considered at great length whether a simple "long" commodity futures contract (that is, an executory contract to purchase a fixed quantity of a commodity at a specified price at a fixed date in the future) contains a component of acquisition indebtedness. See Gen. Couns. Mem. 39620 (Apr. 3, 1987). The Memorandum correctly concludes that "variation margin" is not evidence of any indebtedness, but then proceeds down a path that is as novel as it is confused. To the extent that its argument can be restated, the Memorandum appears to argue that, since a futures contract is "property," entering into a long futures contract must be tantamount to purchasing property today (the futures contract itself, *not* the underlying commodity) in exchange for a promise of deferred payment (the purchase price of the *underlying commodity* at maturity of the contract).

Why a party that simply enters into an executory contract should be viewed as "buying" a bundle of contract rights at all is not explained by the Memorandum, nor is its basis for concluding that the promised future payment for the underlying commodity is itself the measure of the purchase price of these intangible rights. Cf. *Lucas v. North Texas Lumber Co.*, 281 U.S. 11, 13 (1930) (finding that an executory sales contract is not a current sale); *Commissioner v. Olmsted Inc. Life Agency*, 304 F.2d 16, 23 (8th Cir. 1962) (finding no tax consequences from the modification of an executory contract). In fact, the purchase price of these intangible rights, if meaningful at all, can only be zero—the amount paid by the parties for the privilege of entering into the contract. This bizarre confusion of the purchase price of the contract rights with the purchase price of the underlying commodity covered by that contract leads the Memorandum to conclude that there is no difference between an executory contract to sell a house in the future and a current sale of that house, with

As might be suspected, the term "sale or exchange" is charged with tax meaning. In particular, under the so-called "extinguishment" doctrine, a long line of case law has held that, in the absence of a statute to the contrary, payments from one party to a contractual counterparty in consideration of the termination of the underlying contractual arrangement are not considered to arise from the "sale or exchange" of property, because the property (*viz.*, the bundle of contract rights) does not survive the transfer.<sup>64</sup>

The application of the "sale or exchange" doctrine to notional principal contracts most charitably can be described as uncertain. The Internal Revenue Service has never explicitly addressed the issue; indeed, on those few occasions the Service has addressed cross-border swap transactions, it has specifically avoided any resolution of the question.<sup>65</sup> In the case of traditional interest rate swaps, most observers nonetheless have concluded that fixed-for-floating swap payments do not involve sales or exchanges.<sup>66</sup> The theory underlying this conclusion is that the United States dollar is not "property" for tax purposes, and therefore the "exchange" of floating-rate dollars for fixed dollars does not involve the sale or exchange of property.<sup>67</sup> One important result that follows is that interest rate swap income probably does *not* fall within section 512(b)(5)'s exception from UBTI for gains from the sale, exchange, or other disposition of nondealer property.<sup>68</sup>

the seller taking back a purchase money mortgage—a proposition that the drafters of the Memorandum, were they to implement their example, would find sorely tested on the first rainy day.

In the end, the Memorandum comes to the correct answer that executory contracts, including commodity futures contracts, do not give rise to "acquisition indebtedness," although it does so only on the grounds of the purported policy goals of the statute and an overdeveloped concern for the technical problems its analysis raises (which technical problems, of course, are simply evidence that the analysis itself is faulty).

64. See Kleinbard & Greenberg, *supra* note 7, at 436-37 & n.136; see also *Stoller v. Commissioner*, 60 T.C.M. (CCH) 1554 (1990) (holding that a fee paid to a counterparty to terminate various forward contracts to purchase and sell United States Treasury securities gave rise to ordinary, rather than capital, loss, because the party's contract rights did not survive their cancellation). *Stoller* involved a taxable year prior to the effective date of I.R.C. § 1234A (1988), described at note 69, *infra*.

65. See, e.g., Rev. Rul. 87-5, 1987-1 C.B. 180 (concluding that a traditional interest rate swap gives rise to "industrial and commercial profits" in the hands of a bank for purposes of the United States-Netherlands Income Tax Convention); I.R.S. Notice 87-4, 1987-1 C.B. 416 (refusing to take a position on whether swap income is "fixed or determinable annual or periodic income").

66. See Battle, Schultz & Mangieri, *Tax Considerations in the United States*, in THE HANDBOOK OF CURRENCY AND INTEREST RATE RISK MANAGEMENT 26-5, 26-6 (R. Schwartz & C. Smith eds, 1990); Note, *Tax Treatment of Notional Principal Contracts*, 103 HARV. L. REV. 1951, 1958 n.33 (1990).

67. For a more comprehensive discussion of the application of the "extinguishment" doctrine to payments to terminate interest rate swaps (as well as to interim swap payments), see Kleinbard & Greenberg, *supra* note 7, at 436-37.

68. An early report by the New York State Bar Association argued that an interest rate swap had substantial economic similarity to a series of cash-settlement financial futures contracts, but

The application of the "sale or exchange" doctrine to the equity index swap, however, is considerably more complex than its application to a traditional interest rate swap. Section 1234A provides in part that gain attributable to the "cancellation, lapse, expiration, or other termination of . . . a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset."<sup>69</sup> Section 1234A by its terms does not require a current or future possessory interest in underlying "personal property" for the section to apply; if bilateral cash payments are made by reference to fluctuations in the value of "personal property," and the section's other requirements are satisfied, section 1234A will create a deemed "sale or exchange" of personal property.<sup>70</sup>

even that report did not argue that an interest rate swap was in fact a series of cash-settlement futures (or forwards) contracts on existing financial instruments. See New York State Bar Ass'n Tax Section, Report on the Withholding Tax Consequences of Interest Rate Swap Agreements under the Internal Revenue Code (June 6, 1985) (unpublished) (copy on file with the *Texas Law Review*). Accordingly, the economic similarity of results (which, in any event, has never been explicitly conceded by the Internal Revenue Service) is of limited utility in constructing a "sale or exchange" argument for interest rate swap income.

I do not consider, of course, the more difficult policy question (adverted to briefly in note 54, *supra*) of whether I.R.C. § 512(b) should be read as a series of safe harbors or as a list of exclusive exceptions from the definition of UBTI. Compare Rev. Rul. 78-88, 1978-1 C.B. 163 (ruling that income from securities lending is not UBTI because it is similar in nature to other investment activities) with Gen. Couns. Mem. 36948 (Dec. 10, 1976) (stating that such income is UBTI—prior to the Internal Revenue Code's amendment to deal with this issue—because it does not fall within any statutory exception to UBTI, and "exemptions from taxation are to be strictly construed"). Gen. Couns. Mem. 37313 (Nov. 7, 1977) and the attached Conference Memorandum offer interesting insights into the deliberations that led to the effective reversal of Gen. Couns. Mem. 36948.

See *supra* note 4 for the recent history of the Service's indecision on this issue.

69. I.R.C. § 1234A (1988). Section 1234A was enacted in 1981 as one of the tax straddle provisions of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 507(a), 95 Stat. 172, 333. It was intended to "prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gains." H.R. REP. NO. 201, 97th Cong., 1st Sess. 212 (1981); see JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY ACT OF 1981, at 313 (Comm. Print 1981) [hereinafter 1981 BLUEBOOK]. Prior to the enactment of § 1234A, taxpayers would, for example, enter into largely offsetting long and short forward contracts for foreign currency or securities; the taxpayers would then claim ordinary loss (under the extinguishment doctrine) on the cancellation of the loss leg and capital gain on the sale of the gain leg.

Then, as now, § 1234A applied to "a right or obligation with respect to personal property (as defined in section 1092(d)(1))." I.R.C. § 1234A(1) (1988). As originally enacted, however, the scope of the personal property reference was narrower, because § 1092(d)(1)'s definition of personal property contained a comprehensive carve-out for stock, including stock options. See Tax Reform Act of 1984, Pub. L. No. 98-369, § 101(b)(1), 98 Stat. 494, 618.

70. It is theoretically possible to understand § 1234A as requiring a possessory interest in personal property. The argument might run as follows. First, § 1234A requires a "right" to control or "obligation" to deliver property, and a contractual right to cash based on fluctuations in the value of property arguably is not such a right or obligation. Rather, a right to cash in an amount equal to the value of specified property is a "position" or an "interest" in personal property, a formulation used in § 1092 but not in § 1234A. Second, if § 1234A did not require a possessory interest, it would govern cash-settlement equity index options. If that were the case, the "cash settlement" amend-

As applied to an equity index swap, section 1234A could be viewed as treating *each* interim swap payment as a payment in termination of a right or obligation with respect to property (either the specified equity index itself or the stocks constituting that equity index).<sup>71</sup> If section

ment made by the Tax Reform Act of 1984, Pub. L. No. 98-369, § 105(a), 98 Stat. 494, 629, to I.R.C. § 1234 (1988) (the general option provision) should have been limited to stock options not covered by § 1234A. Finally, § 1234A was enacted to deal with abuses involving contracts to deliver property. See 1981 BLUEBOOK, *supra* note 69, at 313.

Such a reading, however, would (1) be inconsistent with the breadth of § 1234A's language, (2) overlook evidence of an overlap between § 1234 and § 1234A, and (3) defeat the anti-abuse purpose for which § 1234A was enacted. As to § 1234A's language, Congress could have written a delivery requirement into § 1234A (as it originally did for § 1256) had it wished to. Instead, the provision applies to a right or obligation "with respect to" personal property, and "with respect to" is perhaps the broadest formulation that the tax law envisions.

The argument that § 1234 and § 1234A are mutually exclusive does not take account of the murky state of the law in 1984. Since "personal property" at that time included neither stock nor (in most cases) stock options, it understandably was not clear whether § 1234A applied to equity index options. Moreover, § 1234A does not apply to contracts held as a dealer (such as an options dealer); I.R.C. § 1234(c) (1988) in effect addresses the character (but not the timing) of income from that class of options contracts. Accordingly, there is no inconsistency in having some overlap between these two provisions, since both lead to capital gain or loss, and no principle of tax law mandates exclusive application of either one provision or the other.

This overlap between § 1234 and § 1234A is demonstrated by Rev. Rul. 88-31, 1988-1 C.B. 302. One part of the Ruling deals with the character, holding period, and timing of recognition of gain or loss from a contingent payment right that the Service has determined should be characterized as a cash-settlement put option. While the ruling relies primarily on § 1234 for the character issue, it also cites § 1234A specifically with respect to the character of loss to the holder on the lapse of the option. See *infra* notes 79-80 and accompanying text. This citation is incomprehensible unless § 1234A (as well as § 1234(c)) in fact applies to cash-settlement options.

Finally, perhaps the most telling argument against the unportation of a delivery requirement into § 1234A is that such a reading would thwart the purpose for which § 1234A was enacted. If § 1234A does not apply to cash-settlement contracts, then taxpayers may use cash-settlement forwards to convert capital loss into ordinary loss (and thereby evade the capital loss limitation), just as they used forwards on currency and securities to convert losses before § 1234A was enacted. While it is of course not unknown for Congress to enact a provision that turns out to be too narrow to halt the abuse at which it is directed, the anti-abuse purpose of § 1234A should guide the understanding of its language. Since it does not by its terms require a possessory interest in personal property, and since reading in such a requirement would defeat its purpose, a possession requirement should not be read into § 1234A.

71. The fact that § 1234A applies to a "termination" of a right or obligation with respect to personal property does not mean that § 1234A does not apply to each periodic payment under an equity index swap. The "termination" language of § 1234A should be understood as excluding interest, rents, and similar periodic payments for the use of property from the scope of § 1234A, not as applying to a case that, like the equity index swap, is closer to a series of discrete forward contracts.

In economic substance, the equity index swap is a series of independent periodic "bets" on an index. Each payment is made in respect of changes in the value of the equity index (and in respect of prevailing interest rates) for the period to which the payment relates. At the start of each period, the equity index benchmark effectively is reset to the current market levels, so that the performance of the index in prior or subsequent periods has no effect on the payments made with respect to the current period.

In this sense, then, each payment terminates the rights of the parties in respect of the "bet" they have made for the period to which that payment relates. One does not have to determine that an equity index swap is in fact a series of forward contracts for all tax purposes to conclude that each payment made under the swap is sufficiently independent of any other to be described by § 1234A's language as a *termination* of a right with respect to personal property (the underlying index). Any other reading would lead to the absurd result that the final payment under an equity index swap

1234A applied to the equity index swap payments, the result would be that each payment to the investor would be treated as attributable to a "sale or exchange." In turn, gain from the "sale or exchange" of nondealer property would not be UBTI to a tax-exempt investor and would be capital gain to a taxable investor.

Section 1234A imposes two prerequisites to its application. First, the underlying property (either the equity index itself or the stocks constituting that equity index) must constitute a capital asset in the hands of a counterparty: to the extent that an equity index swap serves as an investment substitute, this criterion almost invariably will be satisfied. Second, section 1234A requires that either the equity index or the basket of stocks composing the equity index constitute "personal property (as defined in section 1092(d)(1))."<sup>72</sup> This latter requirement is the source of much of the ambiguity in the analysis as applied to an equity index swap.

Section 1092(d)(1) generally defines "personal property" as "any personal property of a type which is actively traded."<sup>73</sup> An equity index swap itself will not be personal property as defined in section 1092(d)(1), because the swap is not "actively traded." In the hands of either of the hypothetical domestic investors, however, the equity index swap is "a right or obligation with respect to" the specified equity index (or to the stocks constituting that index), as required under section 1234A.<sup>74</sup> In most cases, the stocks that make up the index that serves as the basis for an equity index swap will be both "personal property" (in the vernacular sense) and "actively traded." For swaps based on a recognized index such as the Standard & Poor's 500 Index, forwards, futures, and options in that index also will be actively traded. Accordingly, payments to an investor/floating-rate payor in respect of such publicly traded equity index swaps would appear to be covered by section 1234A.

Section 1092(d)(3), however, provides: "[F]or purposes of [section 1092(d)(1)] . . . the term 'personal property' does not include stock [unless that stock is part of a straddle described in section 1092(d)(3)(B)]. The preceding sentence shall not apply to any *interest in stock*."<sup>75</sup>

could be treated as a sale or exchange under § 1234A, but that none of the preceding payments could.

In the case of interest on a bond, by contrast, each interest payment does not "terminate" any party's rights with respect to the underlying property; it is only the return of principal that is a termination event. Thus, a final interest payment on a bond is still not a termination payment (even without regard to § 1234A's carve-out for debt obligations).

72. I.R.C. § 1234A (1988).

73. I.R.C. § 1092(d)(1) (1988).

74. I.R.C. § 1234A (1988).

75. I.R.C. § 1092(d)(3) (1988) (emphasis added). The "interest in stock" language in § 1092(d)(3) stems from a technical amendment to the Tax Reform Act of 1984. Prior to 1984, stock and exchange-traded stock options were expressly excluded from the straddle rules. The 1984 Act

The application of section 1234A to an equity index swap therefore turns on two questions: (1) whether section 1234A's reference to section 1092(d)(1) is meant to include section 1092(d)(3)'s carve-out for "stock"; and, (2) assuming that the section 1092(d)(3) carve-out is relevant, whether the equity index swap should be viewed as a right or obligation with respect to "stock" (in which case section 1234A would have no application to the equity index swap, and swap payments might be UBTI), or as a right or obligation with respect to an "interest in stock" (in which case, as further described below, section 1234A would apply to create a "sale or exchange" on every swap payment, thereby causing those payments to be characterized as non-UBTI to a tax-exempt investor, and as capital gain to a taxpaying investor).

Section 1234A's cross-reference to "personal property (as defined in section 1092(d)(1))" should be read as importing the limitations of section 1092(d)(3). The stock carve-out was part of section 1092(d)(1) when that provision was originally enacted in 1981 as part of the same legislation that enacted section 1234A.<sup>76</sup> Section 1092(d) was then revised in 1984 to render the straddle rules applicable to straddles composed of stock and stock options (or substantially similar property).<sup>77</sup> Nothing in the legislative history suggests that this rewriting of section 1092(d) was intended to affect the scope of section 1234A. Furthermore, in its current form, section 1092(d)(3) applies by its terms "for purposes of" section 1092(d)(1). It is therefore difficult to separate the two paragraphs in the absence of a specific statutory directive to do so. This analysis also appears to be consistent with the Internal Revenue Service's approach to section 1234A in Revenue Ruling 88-31.<sup>78</sup>

Revenue Ruling 88-31 analyzes, in a variety of different factual circumstances, the tax consequences of payments to a holder of a cash-settlement put option on publicly traded stock of a corporate issuer.

dropped the language excluding exchange-traded stock options from the straddle rules, but did not affirmatively provide that stock options were subject to those rules (although that was clearly Congress's intent). The language excluding stock was narrowed but not dropped. See Tax Reform Act of 1984, Pub. L. No. 98-369, § 101(a), (b), 98 Stat. 494, 616-19; STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 308-11 (Comm. Print 1984). In 1986, Congress clarified § 1092(d)(3) by providing that although the straddle rules do not, in general, apply to "stock," they do apply to an "interest in stock." See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(c), 100 Stat. 2085, 2817-18; STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., EXPLANATION OF TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984 AND OTHER RECENT TAX LEGISLATION 43-44 (Comm. Print 1987). While the legislative history of this technical amendment refers only to stock options, Congress's use of the term "interest in stock" rather than "stock option" suggests that Congress intended to reach all "interests" in stock other than outright ownership.

76. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 501(a), 95 Stat. 172, 325.

77. See Tax Reform Act of 1984, Pub. L. No. 98-369, § 101(a), (b), 98 Stat. 494, 616-19.

78. See Rev. Rul. 88-31, 1988-1 C.B. 302; *supra* note 70.

Revenue Ruling 88-31 first quotes sections 1234 (the general option taxation rule), 1234A, 1092(d)(1), and 1092(d)(3) (among other provisions), and examines, in particular, the legislative history of section 1234's cash-settlement option rules.<sup>79</sup> Among its other fact patterns, the ruling then considers the tax consequences to the issuer and to a holder of a naked cash-settlement put option of a payment by the issuer at maturity of the option contract. The ruling explicitly concludes that the issuer's tax consequences are governed by the general option rules of section 1234 (not section 1234A); moreover, Revenue Ruling 88-31 appears to rely on those general option rules—not on section 1234A—for the proposition that the holder has a deemed sale or exchange on the receipt of payment from the issuer.<sup>80</sup>

Thus, publicly traded stock (unless part of certain specified straddles) is not "personal property" for purposes of section 1234A, because section 1092(d)(3) excludes stock from the term "personal property" for purposes of section 1092(d)(1). As described above, however, section 1092(d)(3) carves out from section 1092(d)(1) only "stock," and not an "interest in stock." The question remains whether an equity index swap should be viewed as a right or obligation with respect to "stock," or to an "interest in stock"—and, if the latter is correct, whether a recognized index, such as the Standard & Poor's 500 Index, itself can be said to be "actively traded" for purposes of the definition of "personal property" under section 1092(d).

The differences between a right or obligation with respect to a bundle of stocks and an index comprising that bundle can only be described as metaphysical. On balance, however, an equity index swap should be viewed as a right or obligation with respect to "an interest in stock." The specified equity index is itself an artificial construction whose constituent securities—and the relative weighting given each of them—are determined by the rules of the compilers of that index. Those compilers can

79. See Rev. Rul. 88-31, 1988-1 C.B. 302, 303-04.

80. See *id.* at 304-05. Any other reading would render superfluous Revenue Ruling 88-31's discussion of the legislative history of the general option rules of § 1234 as applied to holders of cash-settlement options. If the Service in fact believed that § 1234A looked solely to § 1092(d)(1) without regard to § 1092(d)(3), then a holder of the cash-settlement put option considered in Revenue Ruling 88-31 would have been treated as a party to a sale or exchange by virtue of § 1234A, without any need to consider the full scope of the general option rules of § 1234.

This reading of Revenue Ruling 88-31 creates in turn some uncertainty as to why the Service quoted § 1234A in setting out the statutory provisions relevant to its analysis, and in its analysis of the tax consequences to a holder of the lapse of an option. It seems to me incredible, however, that the Service would have relied on § 1234A to characterize termination payments to a holder of a naked cash-settlement put option as a "sale or exchange" without discussing the application of § 1092(d), while at the same time quoting excerpts from the legislative history to § 1234 that are relevant solely for purposes of determining that the termination payment should be characterized as a sale or exchange.

modify their own rules, or add or drop securities from the index, without directly affecting the underlying equity securities in any way.<sup>81</sup> Thus, the equity index can fairly be viewed as separate from the underlying equity securities that compose the index at any given point in time.

Moreover, a recognized index, such as the Standard & Poor's 500 Index, itself can reasonably be viewed as "actively traded" personal property. Certainly the Standard & Poor's 500 Index is actively traded in the futures and options markets. It is true that in the cash markets the Standard & Poor's 500 Index and the stocks constituting that index melted into complete identity, but the existence of actively traded, very short-dated forwards, futures, and options should be sufficient to conclude that the Standard & Poor's 500 Index (or a similar index) can itself be viewed as actively traded personal property separate and apart from the stocks composing that index at any given point in time.

Consequently, a persuasive (albeit convoluted) argument can be made that, in the case of an equity index swap, the second sentence of section 1092(d)(3) trumps the carve-out for "stock" in the first sentence of section 1092(d)(3). As a result, an equity index swap can be viewed as a "right or obligation with respect to personal property (as defined in section 1092(d)(1))"—that is, the underlying equity index itself. Accordingly, section 1234A should apply to treat each interim payment in respect of the swap as a "sale or exchange."

If the above analysis is correct, every payment under an equity index swap based on a publicly traded index is a sale or exchange. Such income therefore does *not* constitute UBTI to a domestic tax-exempt investor, and does constitute capital gain to a domestic taxable investor.<sup>82</sup> The conclusion that would follow from this analysis is that, assuming the swap's form is respected (and the transaction not recharacterized as a leveraged purchase of equities, as described above), the two hypothetical United States investors should be able to achieve their different tax objectives through entering into equity index swaps.<sup>83</sup>

81. Thus, in January 1991, when Pan Am Corporation filed for a bankruptcy reorganization under Chapter 11 of the Bankruptcy Code, the compilers of the Standard & Poor's 500 Index dropped that company from the index and substituted Blockbuster Entertainment Corporation in its place. See Wall St. J., Jan. 10, 1991, at C20, col. 3. The compilers of the Dow Jones Transportation Average also dropped Pan Am, and substituted for it Roadway Services, Inc. See Wall St. J., Jan. 11, 1991, at C1, col. 3.

82. Another logical argument against treating equity-based payments under an equity index swap as ordinary income is that the equity payments to be made under the swap economically are indistinguishable from gains (or losses) on the underlying equities. This argument comes dangerously close, however, to conceding that the equity index swap should be viewed for tax purposes as a leveraged purchase of the underlying stocks composing the relevant equity index. Accordingly, I have not relied on this argument in the above analysis.

83. Obviously, it is assumed that the taxable investor in this example recognizes gain from its

### C. *Variations on a Theme*

The above analysis considered only one type of equity index swap, and only with respect to one category of investor. Different federal income tax issues arise using equity index swaps in other contexts.

1. *Foreign Currency Denominated Swaps.*—United States parties have entered into equity index swaps on non-United States equity indices (such as the Nikkei 225). Where one party's payment obligations are in one currency, and the counterparty's obligations in a different currency, the "sale or exchange" analysis set out earlier becomes more straightforward. Since foreign currency is viewed as property for United States tax purposes,<sup>84</sup> a contract to exchange a variable amount of United States dollars for a variable number of units of a foreign currency should always give rise to a sale or exchange. Conversely, in the case of domestic tax-exempt investors or taxable investors seeking capital gains, swaps in which all cash flows are in a single foreign currency (e.g., Yen LIBOR versus the Nikkei 225) require the same section 1234A analysis as that summarized above.<sup>85</sup>

2. *Non-Publicly Traded Equity Indices.*—If an equity index swap is written on an index that is not publicly traded—for example, a securities firm's proprietary equity index—then the section 1234A analysis would lead to the opposite conclusion. In the absence of a publicly traded index, payments made under the swap would not be accorded sale or exchange treatment under section 1234A. The parties to the swap should therefore recognize ordinary income or loss (as probably also is the case in interest rate swaps<sup>86</sup>). This result might be troublesome to a United States tax-exempt investor (who might have more difficulty analyzing swap payments as non-UBTI), but might be desirable to a United States taxable institutional investor without capital losses (who would typically prefer ordinary loss to capital loss, and who would usually be indifferent

equity index swap position; a recognized loss would be characterized as a capital loss.

84. See *Hoover Co. v. Commissioner*, 72 T.C. 206 (1979), *nonacq.*, 1980-1 C.B. 2; Rev. Rul. 78-281, 1978-2 C.B. 204; Rev. Rul. 74-7, 1974-1 C.B. 198.

85. Some taxpayers have attempted to turn swaps in which all cash flows are in a single foreign currency into cross-currency transactions in order to come within the sale or exchange learning that applies to cross-currency exchanges. See Cole, *Strong Pound Offers Special Opportunities; Robert Cole Examines Why Managed Currency Funds Have Found Renewed Favour*, *The Independent*, July 14, 1990, at 25. For example, the gross cash flows under a swap might be calculated as an economic matter in a single foreign currency, and then one party's payment obligations converted into a different currency (at current spot rates) so that an actual exchange of one currency for another is made. In my view, however, this arrangement can be attacked as a single currency swap and a separate purchase or sale of currency at spot rates.

86. See *supra* text accompanying notes 65-68.

to earning capital gain as opposed to ordinary income). Different tax objectives could be satisfied, then, by using (or creating for the occasion) different equity indices.

### III. Financial Innovation and the Tax System

#### A. *Limitations of Current Law*

The above case study of equity index swaps points out some important lessons that recur in the tax analysis of many new financial products. First, and perhaps most important, identifying an economic similarity between different financial strategies does little to advance the tax analysis: where two strategies are different in fact (that is, produce similar results through different bundles of contractual rights and obligations), the tax analysis of one will not determine the tax analysis of the second.

Second, the tax system typically has no mechanism to ask, much less answer, the tax policy questions raised by new financial products. Reasonable tax policy makers might disagree whether dividend-equivalent payments made to a foreign counterparty to an equity index swap should be subject to United States withholding tax in the same manner as dividends,<sup>87</sup> whether such payments should be UBTI in the hands of a domestic tax-exempt institution, and whether they should give rise to ordinary income or capital gain. On the one hand, policy makers might not wish to create a tax system that encourages investors to purchase equity derivatives rather than the real thing; on the other hand, if an equity swap in tax reality is different from a leveraged investment in equities, why should any portion of the swap's flows be taxed, for example, as dividends? The actual tax analysis of equity index swaps, however, proceeds without regard to these policy questions. Instead, the analysis follows a highly technical route through Internal Revenue Code provisions whose purposes and premises may have little to do with the issues raised by the new instrument.<sup>88</sup> It should not be surprising, then, that this technical analysis reaches answers that appropriately reflect sound tax policy only occasionally, and then only by coincidence.

87. The same issue arises daily in the more straightforward context of income in lieu of dividends paid to a foreign lender of United States equities under a securities loan of the type generally described in I.R.C. § 1058 (Prentice Hall 1991). The Internal Revenue Service has been said to be studying the question for the last several years. See Priv. Ltr. Rul. 88-22-061 (Mar. 7, 1988); Shepard, *Tax Officials Consider Debt Securities Questions*, 47 TAX NOTES 1044, 1044-45 (1990); *IRS Makes Progress on Rules on Interest Rate Swaps*, 54 BNA'S BANKING REP. 866, 866 (1990).

88. As discussed at notes 69-70, *supra*, the background and policy behind I.R.C. §§ 1092 and 1234A concern the taxation of straddles and the elimination of specific abuses perceived by Congress in that area. It is not surprising, therefore, that the application of these provisions to equity index swaps should be technical, convoluted, and devoid of any discernible policy. This theme is discussed further in subpart III(B), *infra*.

It also should not be surprising that the tax conclusions reached through this technical analysis are easily manipulated. Complex Internal Revenue Code provisions invariably offer opportunities to opt in or out of the resulting analysis, as these provisions—tailored for highly particularized transactions—lose coherency in new and unintended contexts.

Finally, while the current tax system may answer some important tax questions raised by a new financial product incorrectly, the system does not purport to answer other important questions at all. Thus, the Internal Revenue Code may offer some suggestions as to whether income from a particular equity index swap should be treated as gain from the sale or exchange of property, but, until the recent promulgation of Treasury Regulation Section 1.863-7, offered few clues as to the source (domestic or foreign) of that income, and does not even hint as to the rules that should govern the timing of inclusion of income or loss from complex swap instruments.

### *B. Legislation and "Legislative" Regulations*

One approach to addressing financial innovation in the tax system would be for Congress simply to create new tax cubbyholes for new financial products. In theory, Congress could regularly enact legislation that defines each financial innovation and prescribes a set of operative rules for its users, but Congress in fact has done so infrequently, at best.

Congress's principal contributions to the area in the 1989 legislative process, for example, were two belated and piecemeal limitations on the deductibility of interest expense incurred in the context of leveraged buyouts—provisions that were variously described as limiting abuses or curbing loopholes,<sup>89</sup> but that in fact suggested to many outside observers that Congress was unable to formulate any consensus views as to the role that the corporate interest deduction played (or should play) in shaping the capital structure of American corporations.<sup>90</sup>

Similarly, the 1990 Congress's change to the Internal Revenue Code

89. See *Financial Products*, ABA Tax Section Panel Comments on 1989 High-Yield Debt Restrictions, Daily Rep. for Executives (BNA) No. 249, at 6-2 (Dec. 27, 1990).

90. The Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2301 enacted (1) rules prohibiting net operating loss carrybacks from years following a "corporate equity reducing transaction," see *id.* § 7211(a), (b), 103 Stat. at 2342-45 (codified at I.R.C. § 172(b)(1)(E), (h) (Prentice Hall 1991)), and (2) a limitation on the deductibility of interest in respect of "high yield original issue discount obligations," see *id.* § 7202(a), (b), 103 Stat. at 2330-32 (codified at I.R.C. § 163(e)(5), (i) (Prentice Hall 1991)), each discussed in *supra* note 5. The 1989 Act also enacted I.R.C. § 1503(f) (Prentice Hall 1991), see Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7201(a), 103 Stat. 2301, 2328-29, an "anti-loophole" provision that eliminated the tax advantages of "subsidiary preferred" offerings. See Ginsburg, Levin, Welke & Wolfe, *CERTs: The New Limitations on NOL Carrybacks*, 46 TAX NOTES 1315 (1990); Zonana, *Revenue Reconciliation Act of 1990*, N.Y.L.J., Jan. 18, 1990, at 5, col. 1; *infra* note 129.

of principal concern to the capital markets was a technical provision that redefined the implicit yield to maturity of debt obligations issued (or deemed issued) through certain exchanges or modifications of outstanding debt obligations trading at a discount.<sup>91</sup> This provision already has been roundly criticized as encouraging troubled companies to enter bankruptcy reorganization (to avoid the new rule's sting) rather than to negotiate an out-of-bankruptcy workout, for no particularly clear tax policy reason.<sup>92</sup>

Congress on occasion has attempted to deal with financial innovation through the delegation of "legislative" regulation-making authority to the Treasury Department and Internal Revenue Service, but even those expert agencies have been slow to utilize whatever authority has been delegated to them. For example, the administrative agencies have left largely untouched a large set of proposed regulations dating back nearly five years addressing, in effect, all aspects of the timing of interest income or expense for debt instruments.<sup>93</sup> These proposed regulations represent virtually the only guidance on a range of issues that affect billions of dollars of debt offerings; yet, because the regulations exist only in proposed form (and because they have been extensively criticized in the academic literature), taxpayers routinely rely on, or alternatively ignore, the proposals, as suits their circumstances.<sup>94</sup>

91. See Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11325(a)(1), 104 Stat. 1388-400, 1388-466 (codified at I.R.C. § 108(e)(11) (Prentice Hall 1991)). Although former I.R.C. § 1275(a)(4) (1988) (repealed 1990) applied specifically to original issue discount rather than cancellation of indebtedness (COD), prior to its removal by the Revenue Reconciliation Act of 1990, this provision was generally thought to imply that upon the exchange of an outstanding debt security for a new debt security having a value less than the "adjusted issue price" of the old debt security, no COD income would result to the issuer because under § 1275(a)(4) the "issue price" of the new debt security could not be less than the adjusted issue price of the old debt security. The 1990 Act amended § 1275 by deleting former § 1275(a)(4), see Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11325(a)(2), 104 Stat. 1388-400, 1388-466, and it provided explicitly in I.R.C. § 108(e)(11) (Prentice Hall 1991) that, for purposes of determining COD income in the case of a debt-for-debt exchange, an issuer is deemed to have satisfied its outstanding debt with an amount of cash equal to the fair market value of its new debt.

92. See, e.g., Cohen, *The Repeal of Section 1275(a)(4)*, Tax Forum Paper No. 464 (Dec. 1990) (unpublished) (copy on file with the *Texas Law Review*); New York State Bar Ass'n Tax Section, *supra* note 5, at 79.

I suspect that a considerable amount of the impetus for this amendment came because, during 1989 and 1990, investment banking firms began actively to intermediate debt-for-debt exchanges by buying up the discount debt of an issuer in the secondary marketplace and then negotiating an exchange with the issuer. Viewed cynically, the 1990 deletion of § 1275(a)(4) can be viewed as investment banker bashing in the guise of legislative oversight of the capital markets.

93. See Prop. Treas. Reg. §§ 1.1271-1.1275, 51 Fed. Reg. 12022-12096 (1986); I.R.C. § 1275(d) (Prentice Hall 1991).

94. See Knoll, *The Second Generation of Notes Indexed for Inflation*, 39 EMORY L.J. 499, 503 (1990); Kwall, *The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time from Space*, 49 OHIO ST. L.J. 1, 31 n.172 (1988). The recent amendment of these proposed regulations through the addition of Prop. Treas. Reg. § 1.1275-4(g), 56 Fed. Reg. 8308

Similarly, in 1983, proposed regulations were promulgated under Internal Revenue Code Section 1058, which deals with the federal income tax consequences of securities lending.<sup>95</sup> Since that time, both the volume of securities lent and the purposes for those loans have mushroomed, giving rise to a number of interesting tax questions.<sup>96</sup> Moreover, as the equity derivative market matures, stock lending activities can be expected to increase. Yet, despite the receipt of a significant number of learned proposals and comment letters from tax professionals, the administrative agencies have neither finalized nor updated the proposed regulations to reflect the experience of the last eight years.<sup>97</sup>

When pressed in private conversations, staffers at the various congressional taxwriting committees, the Treasury Department, and the Internal Revenue Service typically explain the glacial pace of legislative and regulatory responses to financial innovation as the result of a lack of adequate information about the capital markets, or a shortage of resources, or (in the case of the most cynical) the belief that the absence of regulation has a greater *in terrorem* effect than do clear guidelines.<sup>98</sup> To an outsider, however, these explanations readily distill into the observation that, as an institutional matter, tax policy makers have chosen not to invest very much energy in developing rules to ensure that after-tax

(1991) has done nothing but increase the controversy over the proposed regulations package. See *infra* note 105.

95. Prop. Treas. Reg. §§ 1.1058-1, 1.1058-2, 48 Fed. Reg. 33912 (1983). As described by I.R.C. § 1058 (Prentice Hall 1991), "securities lending" is a temporary transfer of securities, during which the transferor is entitled to receive all payments of interest, dividends, and other distributions which the owner of the securities is entitled to receive.

96. These questions include: (1) a metaphysical inquiry into whether there is any difference between a securities loan of a United States Treasury obligation and a "repo" (more formally, a "sale-repurchase agreement") thereof, and, if not, whether anyone should care; and (2) whether a non-United States lender of a United States equity security that receives a payment in lieu of a dividend from a United States borrower should be treated for United States withholding tax purposes as having earned United States-source dividend income. See *supra* note 87.

97. It is my vivid recollection that the draftsman of the proposed § 1058 regulations later was pulled off the project to turn to the more pressing problems of drafting regulations implementing I.R.C. § 278 (repealed in 1986), dealing with the amortization of certain citrus and almond grove expenditures. These regulations were in turn promulgated in proposed form in 1983, three years before § 278 was repealed, and were never finalized. Prop. Treas. Reg. § 1.278-2, 48 Fed. Reg. 51936 (1983).

To mention but a few additional examples: in 1980, eleven years after enactment of I.R.C. § 385 (Prentice Hall 1991) (authorizing the Treasury to distinguish between debt and equity by regulation), regulations under § 385 were first promulgated, see Prop. Treas. Reg. §§ 1.385-1 to 1.385-12, 45 Fed. Reg. 18957 (1980), then finalized, see Treas. Reg. §§ 1.385-1 to 1.385-10 (1980), then reissued in proposed form, see Prop. Treas. Reg. §§ 1.385-0 to 1.385-10, 47 Fed. Reg. 164 (1982), only to be withdrawn in 1983, see T.D. 7920, 1983-2 C.B. 69, and no regulations have been issued pursuant to the authorization contained in I.R.C. § 246(c) (1988), enacted in 1984.

98. It is a corollary of this last, cynical, rationale that clear guidelines can always be "gamed" by taxpayers to produce results not anticipated by the drafters of these guidelines. See *infra* note 100 and accompanying text.

results of financial innovations are consistent with their pretax economics.<sup>99</sup>

### C. *The Limitations of Tax Reasoning*

1. *The Need for a Contextual Analysis.*—No single convincing theory exists to explain why tax policy makers assign such a modest priority to responding to financial innovations. In my own experience, however, three principal factors appear to be at work. First, many tax policy makers appear to suffer from the impression that the taxation of the financial strategies and products that emerge from the process of financial innovation is a matter of interest only to a highly specialized (and geographically concentrated) industry—the banks, securities firms, and other financial intermediaries that are actively involved in developing financial innovations. From this perspective, investing precious tax policy resources in the financial innovation area appears to be only marginally more important to the national interest than, for example, taking up whatever tax accounting issues confront the legalized gaming industry.

While it may be true that the financial services industry confronts tax issues unique to it, it is also true, for example, that many of the counterparties to the \$2.5 trillion in outstanding notional principal contracts are nonindustry participants. Indeed, the view that the taxation of innovative financial strategies is a matter of concern only to the financial services industry phrases the issue precisely backwards. Many financial innovations are developed to meet the financial objectives of nonindustry participants (e.g., corporate issuers of debt or investors with special goals or restrictions); the financial services industry earns fees from selling such strategies, and exports the tax uncertainties to the capital markets generally.

99. Obviously, one must distinguish between *institutional* and *individual* commitments to advancing tax policy in this area. It is my assertion that the institutional commitment has not been sufficient to the task; conversely, every tax practitioner in the field would agree that there are many tax policy professionals in the government who have brought tremendous energy and initiative to the (frequently overwhelming) tasks assigned them.

For those regulators whose feelings nonetheless may be hurt by my assertion, I would suggest comparing the state of the rules for the taxation of international securities loans, on the one hand, with the rules under I.R.C. §§ 6038A, 6038C (Prentice Hall 1991), governing information reporting for transactions between foreign-owned United States companies and their affiliates, on the other. The first set of rules, as noted earlier, consists of eight-year-old proposed regulations of limited sophistication, *see supra* note 97; the latter rules have been addressed twice by Congress in the last two years, in the Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7403(a)-(d), 103 Stat. 2106, 2358-61, and the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11315(a), (b), 104 Stat. 1388, 1388-456 to 457, and have been the source of two complete sets of proposed regulations, Prop. Treas. Reg. § 1.6038A, 55 Fed. Reg. 50706 (1990), Prop. Treas. Reg. §§ 1.6038-2, 1.6038A-1, 48 Fed. Reg. 56076 (1983), and one complete set of final regulations since the end of 1983, Treas. Reg. §§ 1.6038-2, 1.6038A-1 (1985).

Second, a significant number of tax policy makers in fact believe that all clear tax guidelines in general, and tax rules governing financial products in particular, are easily “gamed”—that is, used by taxpayers in contexts not anticipated by policy makers to produce results of which they would not approve.<sup>100</sup> I have always thought this argument suffers from a number of defects. In the first place, it assumes away the duty of tax policy in this area of the law, which is to ensure that the capital markets are as efficient after-tax as they are pretax. Moreover, the fear of “gaming” appears to value more heavily the negative impact on the tax system of the relatively few taxpayers who may stray away from an intended result than it does the positive impact of herding the majority of taxpayers into the corral of conformity with fair tax rules. Finally, the argument reflects a bewildering admission of impotence to revise rules to respond to unanticipated issues, despite the traditional self-compulsion of the financial and legal community to tout publicly the exploitation of each newly discovered loophole in the Internal Revenue Code.

Third, and finally, there is a belief that the tax system will sort itself out. Through an incremental accretion of rulings and case law, the system, it is thought, will slowly but inexorably reduce each new financial innovation to a recognizable variant (or combination of variants) on one or more familiar tax cubbyhole themes. I would respond that this philosophy fails to address the ever-accelerating pace of financial innovation and its overall benefits to the United States economy.<sup>101</sup> Both the fisc and the taxpayers end up poorer if the utility of every financial innovation is clouded by tax uncertainties for an extended period of time.

More important, this philosophy misses two fundamental points about financial innovation. First, financial innovation can lead to entirely new categories of financial products that do not fit neatly into traditional tax cubbyholes. Thus, interest rate swaps, which were the paradigmatic financial innovation of the 1980s, have at various times and for various applications been analyzed for tax purposes as futures con-

100. For instance, Internal Revenue Service Commissioner Fred Goldberg recently remarked: “I am absolutely convinced . . . that the way to deal with the gaming-the-system problem is not more rules. It is clear that the more rules we write, the more we’re going to get gamed.” *IRS: Rules Projects, Consolidation of Organizational Changes Top Agenda*, Daily Tax Rep. (BNA) No. 10 (Jan. 15, 1991).

101. Professor Henry Hu convincingly makes this point. See Hu, *supra* note 1, at 335-39, 392-412. The volume of mortgage-backed securities issued each year has grown from a trickle in the early 1980s to approximately \$136 billion in 1990. *Kidder Rises to Top of MBS Market*, MORTGAGE-BACKED SECURITIES LETTER, Jan. 7, 1991, at 1. See generally Shenker & Colletta, *Asset Securitization: Evolution, Current Issues, and New Frontiers*, 69 TEXAS L. REV. 1369, 1383-88 (1991). Securitization of residential mortgages is widely believed to have reduced significantly the cost of such mortgages to the homeowner.

tracts, bonds, and dancing lesson contracts<sup>102</sup>—all of which acknowledge that no one analogy is particularly persuasive in all contexts. The incremental process of rulings and litigation is ill-equipped to develop a comprehensive set of tax rules governing this novel type of instrument.

The more fundamental problem in relying on an incremental approach to the taxation of financial innovation is that, at its core, this approach rests on a premise that is simply untrue in the contemporary capital markets: that financial products, once correctly placed in a given tax cubbyhole, fill the same financial role for all taxpayers in all circumstances. For example, institutional investors frequently purchase a portfolio of stocks whose performance tracks that of the Standard & Poor's 500 Index, because those investors in fact wish to invest in the index. Yet that same portfolio investment, when combined with a "short" futures position in the Standard & Poor's 500 Index, becomes what the financial industry terms a "conversion"—a synthetic money market instrument whose economic return is governed by short-term interest rates rather than equity prices.<sup>103</sup> Similarly, a taxpayer looking to borrow short-term funds can enter into a "reverse conversion," under which the taxpayer borrows a basket of stocks that closely tracks an index, sells those stocks short, and enters into an actual or synthetic futures contract to purchase the index at a future date.

102. See, e.g., New York State Bar Ass'n Tax Section, *supra* note 68, at 14-20 (analogizing interest rate swaps analogized to futures contracts); I.R.S. Notice 89-21, 1989-1 C.B. 651 (rejecting the analogy of lump sum notional principal contracts to the dancing lesson contracts in *Schlude v. Commissioner*, 372 U.S. 128 (1963)); Cantrell, Hanna & Kurtz, *Notice 89-21 Crashes the Interest Rate Swap Party*, 45 TAX NOTES 337, 338-40 (1989) (arguing that prepaid interest rate swaps should be analyzed as loans rather than sales of future income); *id.* at 340-42 (stating that if such swaps are not analyzed as loans, subject to the potential application of I.R.C. § 446(b) (1988), *Schlude* should apply to permit acceleration of income by the recipient of the lump sum prepayment, and distinguishing *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968) (holding that a lump sum prepayment need not be accelerated if the extent and the time of future performances are certain, and related items are accounted for with clarity) and *Boise Cascade v. United States*, 530 F.2d 1367 (Ct. Cl. 1976) (holding that recognition of income from prepaid payments can be deferred in accordance with generally accepted accounting principles)).

103. A taxpayer can establish a "short" futures position—that is, an obligation to sell the Standard & Poor's 500 Index—by entering into a futures contract on the Standard & Poor's 500 Index on the Chicago Mercantile Exchange. Alternatively, that taxpayer could establish a synthetic futures position by writing a call option on the Index and buying a put option on the Index with the same strike prices. If, at maturity of the option contracts, the Index's price is above the strike price, the put option will expire worthless, but the taxpayer will be obligated to satisfy the call option it concurrently wrote; conversely, if the Index's price is lower than the strike price, the counterparty to the taxpayer's call option will not exercise the call, but the taxpayer will profit by exercising its put. In either case, then, the taxpayer will sell the Index for an amount equal to the strike price, just as if the taxpayer had sold a futures contract. Moreover, under the doctrine of "put-call parity," the strike price at which the taxpayer's premium to purchase the put option offsets its income from writing the call option (so that the taxpayer has no out-of-pocket expense for the put-call pair) should be the same as the price for an at-the-money futures contract. See C. JOHNSON, AN INTRODUCTION TO OPTIONS 10-11 (1987) (published by Salomon Brothers Bond Portfolio Analysis Group, copy on file with the *Texas Law Review*).

As these simple examples demonstrate, the economic consequences of a financial product—and therefore any rational tax analysis of that product—depends entirely on context. Sometimes an equity index futures contract is a speculative investment, and sometimes it is a component of a fixed-rate, short-term borrowing. The available analytical tools simply cannot cope with the need for context-specific analysis.

2. *The Pitfalls of Reasoning by Analogy.*—One of the favorite pastimes of tax professionals and policy makers is reasoning by analogy, in which new financial products or transactions are compared to simpler and better understood financial arrangements. Thus, for six hundred years the common law has recognized that what purports to be a lease of real property sometimes in fact is a mortgage. When applied in the tax context, at least one court—fortunately overturned—has directed taxpayers to resolve this conundrum of lease or loan by an adult version of the children's game of pick-up sticks, in which analogies are drawn between the transaction in question and more paradigmatic loan and lease arrangements. Each correspondence that can be identified is awarded a stick, and whichever category has the larger bundle of sticks at the conclusion of the analysis is declared the cubbyhole into which the transaction is placed.<sup>104</sup>

Reasoning by analogy is a potent tool when applied to incremental variations on a familiar theme, but it fails miserably when applied to genuine innovations. First, as noted above with respect to the example of interest rate swaps, reasoning by analogy simply cannot expand the number of tax cubbyholes to deal with a genuine innovation. Instead, reasoning by analogy works best to make binary categorization decisions between two well-known and preexisting cubbyholes (e.g., Is this instrument debt or equity? Loan or lease?).

Second, as the discussion in Part II with respect to equity index swaps suggests, it proves too much to claim that reasoning by analogy means that bundles of transactions that are different in fact but that yield economically similar results should be taxed identically. This argument leads imperceptibly into an argument for a tax common law of economic integration, a theme that is taken up below.

3. *Deconstruction.*—If reasoning by analogy cannot cope with genuine financial innovation, what analytical tools are left? Perhaps the most popular is “bifurcation”—or, more generally, “deconstruction,”—

104. See *Frank Lyon Co. v. United States*, 536 F.2d 746, 751 (8th Cir. 1976), *rev'd*, 435 U.S. 561 (1978).

in which one complex financial instrument is split into many simpler and better understood instruments. Under a deconstructionist approach, by way of example, a convertible bond should be analyzed for tax purposes as a combination of the simpler building blocks of a bond and a separate warrant.<sup>105</sup>

A description of the many problems caused by an over-reliance on deconstruction theory is beyond the scope of this Article.<sup>106</sup> It is worthwhile noting, however, that deconstructionism suffers one fundamental flaw, in that it is totally insensitive to context. Thus, to return to the earlier example of a "conversion"—a simple combination of the ownership of stocks and a forward contract to produce a synthetic money market instrument—no amount of deconstruction will produce a tax analysis

105. The proponents of deconstructionism have scored a very recent triumph of ideology with the release of Prop. Treas. Reg. § 1.1275-4(g), 56 Fed. Reg. 8308 (1991). Very briefly, that proposed regulation would take a debt instrument with contingent payments and bifurcate the instrument into its constituent parts. Those constituent parts then would be taxed "in accordance with their economic substance" as if they were separately issued instruments.

More specifically, Prop. Treas. Reg. § 1.1275-4(g) generally would apply to any debt instrument that (1) is issued for cash or publicly traded property, (2) provides for noncontingent payments at least equal to the instrument's issue price, and (3) provides for one or more contingent payments determined, in whole or in part, by reference to the value of publicly traded stock, securities, commodities, or other publicly traded property. Under an important exception, the proposed regulations would not apply to a debt instrument "merely because" the instrument may be converted into stock or another debt instrument of the issuer. (The preamble to the proposed regulations warns, however, that this exception for "plain vanilla" convertibles may be revisited.)

Debt instruments within the scope of the proposed regulations would be bifurcated into noncontingent and contingent components. The noncontingent payments would be taxed as a separate hypothetical debt obligation, which generally would be treated as having been issued with significant original issue discount. As noted above, the contingent components would be taxed according to their economic substance. For example, the contingent components could be taxed as options or swaps, among other possibilities.

The early reviews of the proposed regulations have been mixed. See, e.g., Hariton, *New Rules Bifurcating Contingent Debt—A Mistake?*, 51 TAX NOTES 235 (1991); Lawrence, *New Rules Bifurcating Contingent Debt—A Good Start*, 51 TAX NOTES 495 (1991). Some of the objections are technical; others can be said to go to the heart of whether bifurcation is feasible or desirable.

Prop. Treas. Reg. § 1.1275-4(g) is the first attempt to apply a deconstructionist approach to a wide range of financial instruments, and many observers believe that the proposed regulation is at least as much a trial balloon for the whole proposition of deconstructionism as it is an attempt to resolve the five-year-old impasse of the former proposed regulations' unsatisfactory treatment of contingent payment obligations. See, e.g., Lawrence, *supra*. As a result, practitioners and academics alike can be expected to follow closely the evolving debate as to the success or failure of Prop. Treas. Reg. § 1.1275-4(g) to produce feasible and appropriate results. If the proposed regulations are judged workable (or fixable), subsequent regulations (and legislation) can be expected to expand the scope of deconstructionist analysis. If, conversely, the proposed regulations are judged too broken to fix (or are judged fixable only by adopting so many simplifying assumptions that the original purpose is lost), then the current ideological triumph of deconstructionist thinking will fade into a historical curiosity.

106. See Kau, *Carving Up Assets and Liabilities—Integration or Bifurcation of Financial Products*, 68 TAXES 1003 (1990), and Kleinbard, *Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System*, 67 TAXES 943, 947-52 (1989), for discussions of some of the principal shortcomings of aggressive reliance on deconstructionism as a means of coping with financial innovation.

consistent with the transaction's economics. What is wanted in this case is tax fusion, not fission.

4. *The Missing Doctrine of Tax Integration.*—The above discussion has sought to suggest that both reasoning by analogy and deconstructionism ultimately fail as analytical tools for financial innovation, because they do not treat a bundle of transactions as a synthetic whole. The importance of contextual analysis obviously suggests the need for a doctrine of integration, in which courts and the Internal Revenue Service analyze the federal income tax consequences of financial strategies by considering the overall economic result achieved, rather than by engaging in an instrument-by-instrument analysis. Yet a doctrine of financial product integration certainly does not exist in current tax law, at least not by that name.<sup>107</sup> Phrased generally, I am not aware of any case or ruling in which a court or the Internal Revenue Service has determined the federal income tax analysis of several real transactions entered into by one taxpayer with *different* counterparties by considering the synthetic result achieved by that taxpayer.<sup>108</sup> This point is made forcefully in a recent article by Randall Kau, where he sets out twelve alternative ways of replicating the cash flows of an investment in a United States dollar fixed-rate debt instrument, none of which is uniformly treated as an investment in synthetic fixed-rate debt for tax purposes.<sup>109</sup>

One simple example of this premise is the established tax treatment of a "short against the box" transaction. If a taxpayer holds appreciated securities and wishes to defer recognition of gain on the disposition of those securities, the taxpayer can enter into a short sale of identical securities. The taxpayer thereby has sold its securities in an economic

107. This assertion presents the classic problem of trying to prove the negative. Cf. Kau, *supra* note 106, at 1007-09; McCawley, *Tax Aspects of Interest and Currency Exchange Rate Hedging Transactions*, 31 TAX MGMT. MEMORANDUM 119, 128 (1990) (describing the problem of tax integration and concluding that "[t]he validity of these arguments has been recognized to a limited extent by the IRS where it has been specifically authorized by Congress to provide rules implementing them").

108. One arguable exception to this assertion is *Monfort of Colorado, Inc. v. United States*, 406 F. Supp. 701 (D. Colo. 1976), *aff'd*, 561 F.2d 190 (10th Cir. 1977), in which gains and losses from futures contracts used to hedge inventory prices were integrated into the cost of that inventory. *Monfort* is contrary to a long line of other authority, which treats hedges as separate from the property being hedged. See, e.g., *Edward R. Bacon Grain Co. v. Reinecke*, 26 F.2d 705 (N.D. Ill. 1928) (holding that sales of futures and the hedging contracts for such sales should be treated separately for tax purposes if they are closed out in separate years), *aff'd mem.*, 54 F.2d 1078 (7th Cir. 1929); Rev. Rul. 74-227, 1974-1 C.B. 120, 121 (stating that potential losses or gains from futures contracts have no effect on the cost of the physical inventory created when the commodity which is the subject of the futures contracts is on hand at the end of the year); Rev. Rul. 74-223, 1974-1 C.B. 23, 24 (stating that "speculative" futures transactions not offset by actual spot or cash transactions may not be included or taken into income in any manner until such futures transactions are actually closed).

109. Kau, *supra* note 106, at 1004-05.

sense, by locking in the current value and insulating itself from future price fluctuations. The taxpayer nonetheless will recognize gain for tax purposes only when the taxpayer closes out its short position, because tax law requires a separate analysis of the taxpayer's offsetting long and short positions.<sup>110</sup>

Similarly, sophisticated corporate issuers routinely issue complex debt instruments which they then hedge (through swaps, options, and other instruments) into "plain vanilla" debt obligations. Yet, outside the narrow scope of certain recent regulations concerning specified foreign currency hedges, the issuer's tax results are determined without regard to the issuer's synthetic objectives.<sup>111</sup> "Conversions" and "reverse conversions" are another straightforward example; while taxpayers have argued that the economic similarity of these instruments to short-term loans and borrowings should determine the *character* of any gain or loss recognized by the taxpayer, no one has suggested that such strategies constitute loans and borrowings for all tax purposes.<sup>112</sup> Indeed, to the extent that the Supreme Court's decision in *Arkansas Best Corp. v. Commissioner*<sup>113</sup> can be said to divorce the determination of the character of gain or loss recognized in respect of a financial instrument from the use to which that instrument is put, the cause of a doctrine of integration of financial instruments has suffered a considerable setback.<sup>114</sup>

A general doctrine of the tax integration of financial products also cannot be read into current law by recourse to either "substance-over-form" or "step-transaction" learning. As the term "substance-over-form" is generally used, it is a shorthand for the issue of whether a transaction is real or fictitious, and whether it has pretax economic consequences.<sup>115</sup> The substance-over-form doctrine can be applied to financial innovation to determine whether each component of a complex financial strategy is real, but once the reality of those components has been confirmed, the substance-over-form doctrine has not been invoked to merge

110. See Treas. Reg. § 1.1233-1(a)(1) (as amended in 1980).

111. See Kleinbard, *supra* note 106, at 952-54; Kleinbard & Greenberg, *supra* note 7, at 432-36.

112. Taxpayers that enter into a "reverse conversion," for example, are at risk that the locked-in loss on their "long" stock futures position (which is economically analogous to interest) will be characterized as capital loss under the principles of *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). Indeed, an individual Internal Revenue agent's memorandum reaching just that conclusion has been widely circulated among Wall Street tax professionals.

113. 485 U.S. 212 (1988).

114. See Kleinbard & Greenberg, *supra* note 7, at 432-40 (discussing the different tax treatment of liability hedges before and after *Arkansas Best*).

115. For example, in applying the doctrine of substance-over-form in *Frank Lyon Co. v. United States*, the Supreme Court rejected the claim of the Internal Revenue Service that a sale/leaseback was a sham disguising a loan and mortgage agreement, because the parties' risks, rights, and obligations were different from those of a loan and mortgage, and the transaction therefore had economic substance. 435 U.S. 561, 581-84 (1978).

these separate and real components into a different synthetic financial instrument.<sup>116</sup>

Similarly, the step-transaction doctrine cannot be used to supply the missing doctrine of tax integration. The step-transaction doctrine typically is invoked when a taxpayer, dealing in effect with himself (or one other party), engages in a circuitous series of transactions in the hopes of accomplishing a tax objective that would not have been available had the taxpayer structured his affairs more straightforwardly. Two common versions of the step-transaction test have been formulated: whether the steps taken were "interdependent" steps towards an agreed-upon conclusion, and whether the "end result" was preplanned.<sup>117</sup> The effect of the doctrine is that where the intended and actual result of a sequence of steps is clear, the courts view the transaction as a whole for tax purposes, rather than fragmenting the sequence into its individual steps and applying the tax laws to each step individually.<sup>118</sup>

The step-transaction doctrine is not, however, applied to collapse the tax consequences of what in fact are separate transactions into a single, integrated transaction. In the leading tax straddle case of *Smith v. Commissioner*,<sup>119</sup> for example, the Tax Court found that a taxpayer that entered into a typical commercial straddle on a bona fide exchange created legally binding rights and obligations that would have ripened into the obligation to make and take delivery of the underlying commodity in different months had the taxpayer not independently later entered into offsetting trades.<sup>120</sup> The government argued for disallowing the loss recognized by the taxpayer in closing out one leg of its straddle and replac-

116. It is precisely the absence of this result that has bedeviled corporate issuers engaged in liability hedging strategies.

117. See generally Chirelstein & Lopata, *Recent Developments in the Step-Transaction Doctrine*, 60 TAXES 970, 970 (1982) ("The step-transaction doctrine is a judicially developed concept which . . . permits a series of separate steps to be recharacterized and treated as a single integrated transaction if the steps are closely related and focused toward a particular end result."); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. ANN. INST. ON FED. TAX'N 247, 250 (1954) ("Under [the 'end result'] test, a given intended result would have the same tax effect whether achieved directly or by circuitous steps."). A third test, the "binding commitment" test used in *Commissioner v. Gordon*, requires the transaction to be characterized as a single integrated whole if the organization makes a binding contractual promise, at the time the initial step in the transaction is taken, to complete the remaining steps to accomplish the end goal of the transaction. 391 U.S. 83, 96 (1968). The same analysis would apply for this test as for those discussed above.

118. See, e.g., *Kuper v. Commissioner*, 533 F.2d 152 (5th Cir. 1976) (holding that a transaction in which a corporation became a wholly owned subsidiary for one day, followed by exchange of its shares for shares in the parent, was in substance an exchange by the shareholders of shares in both corporations); *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570 (2d Cir. 1949) (finding that the distribution of stock by a corporate taxpayer to the parent company, and subsequent sale of that stock by the parent company, was in substance a sale of the stock by the corporate taxpayer, rather than a dividend to, and a sale by, the parent company).

119. 78 T.C. 350 (1982).

120. *Id.* at 385. The economic theories and tax objectives of straddle transactions are summa-

ing it with a new leg obligating (presumably) a different ultimate counterparty.<sup>121</sup> The government's argument relied in part on a step-transaction argument.

The Tax Court summarized the step-transaction doctrine as follows:

The step transaction doctrine generally applies in cases where a taxpayer seeks to get from point A to point D and does so stopping in between at points B and C. The whole purpose of the unnecessary stops is to achieve tax consequences differing from those which a direct path from A to D would have produced. In such a situation, courts are not bound by the twisted path taken by the taxpayer, and the intervening stops may be disregarded or rearranged.<sup>122</sup>

The Tax Court held, however, that the doctrine does not apply to a tax straddle that produces losses in one year and a corresponding amount of income in a subsequent year, noting that the doctrine had never been applied to tax shelters simply because they were tax shelters and that "such an argument would go far toward undermining the very system of annual tax accounting."<sup>123</sup>

A very recent tax straddle case also helps to make this point. In *Stoller v. Commissioner*,<sup>124</sup> the Tax Court considered a complex series of tax straddles involving long and short forward and futures positions in United States Treasury bonds and GNMA certificates. Although the case is interesting for a number of reasons,<sup>125</sup> what is particularly relevant in this context is that the Tax Court correctly concluded that the economic substance of the taxpayer's trading strategy in forward contracts was to create the economic equivalent of short-term loans and borrowings:

For example, by entering into a contract to purchase 15-year T-

rized in the case; those tax objectives, in turn, have been substantially eliminated by the introduction of I.R.C. § 1092 (1988). See *supra* notes 75-81 and accompanying text.

121. *Smith*, 78 T.C. at 370.

122. *Id.* at 389 (citing *Gregory v. Helvering*, 293 U.S. 465 (1935)).

123. *Id.*

124. 60 T.C.M. (CCH) 1554 (1990).

125. The case is relevant, for example, to the continuing scope of the extinguishment doctrine, discussed *supra* at text accompanying note 64. The case clearly holds that one \$10,000 payment made by the taxpayer to cancel four related long and short forward contracts gave rise to ordinary loss, by virtue of the extinguishment doctrine, but then concludes that the other terminations by the taxpayer gave rise to capital loss, apparently because those positions, once terminated, were replaced with new positions (called "switch transactions" by the court). See *id.* at 1566-67. The Tax Court concluded that these contracts were not "closed by cancellation," but rather were "closed by offset." *Id.* at 1566. A more straightforward way of expressing this conclusion would be to state that where, as here, the taxpayer purported to cancel existing contracts for a fee and then immediately replaced those contracts with the same counterparty, and where the contracts were not separately valued, but rather were priced to preserve the preexisting spread between the two legs of the straddle, the substance-over-form doctrine requires the conclusion that the taxpayer exchanged a new contract (and cash) for the old contract.

Bonds for delivery on a specified date and simultaneously entering into a contract to sell 15-year T-Bonds for delivery six months later, Holly created the economic equivalent of a contract to purchase a six-month T-Bond. Holly then arbitrated that [effectively, locked in the financing to carry that synthetic six-month "T-Bond"] against simultaneous contracts to sell GNMA's on that specified date and purchase them six months later.<sup>126</sup>

Although the Tax Court found the "integrated" economic substance of the taxpayer's trades highly relevant in determining whether the taxpayer had the requisite pretax profit motive (so that its losses would be recognized as bona fide for tax purposes), it never occurred to the Tax Court to treat these transactions in forward contracts as *actual* short-term loans and borrowings for purposes of determining the character of payments made to terminate those contracts.

Even if a generalized doctrine of the tax integration of financial instruments did exist, it is by no means clear that the doctrine could be sufficiently responsive to the pace of financial innovation. The dynamism of contemporary financial strategies means that a financial position might appropriately be viewed as part of a larger synthetic unity today, and a stand-alone position tomorrow. Similarly, contemporary "dynamic hedge" technologies deliberately seek enhanced profitability through imperfect syntheses; a securities firm intentionally might create, for example, an agglomeration of positions that performs roughly like an investment in an equity index, but outperforms or underperforms that index, depending on Treasury interest rates. A sophisticated tax analysis, then, should address in a dynamic fashion the context in which a financial instrument is employed, to respond to rapid changes in context and to synthetic results that are similar, but not identical, to more straightforward instruments.

### IV. Moving Forward

The tax system to date has been slow to respond to financial innovation. A simple acceleration of existing extra-statutory methodologies will not resolve the problem, because those methodologies do not offer a basis for dynamic and contextual analysis.<sup>127</sup> The result is economic inefficiency. In many cases, economically rational transactions are not entered into for fear of tax costs disproportionate to economic returns.<sup>128</sup>

126. *Id.* at 1558.

127. I include as a "statutory" approach the promulgation of "legislative" regulations, such as Temp. Treas. Reg. § 1.988-5T (1989), dealing with the integration of nonfunctional currency debt instruments and hedging transactions. See *supra* note 46 and accompanying text.

128. Many well-advised taxpayers, for example, no longer enter into "reverse conversions" for fear that the transaction will generate capital, rather than ordinary, loss. See *supra* note 112.

In other cases—in my own experience much less common than tax policy makers typically believe—taxpayers can use the current approach to the tax analysis of complex financial instruments to produce, through synthetic arrangements, after-tax results superior to more straightforward transactions. In either case, the current tax system distorts the capital markets.

These issues raise a frightening and depressing prospect for the future: the specter of a wave of sophisticated new equity derivative products further blurring the already frayed distinction between debt and equity, and underscoring the impotence of current analytical tools to handle that onslaught. Fear and depression among tax policy makers, however, appear to be the prerequisites to the radical revisions required to make the tax system responsible to financial innovation.

The first step toward revising the tax system to address the looming problems of financial innovation is to recognize that symmetry of tax result between issuers and investors is a false goal. The capital markets in general increasingly are dominated by tax-exempt or tax-insensitive institutions, and the markets have proved themselves extremely efficient at matching up the tax profiles of issuers and investors to reduce the overall tax burden imposed on investment capital.<sup>129</sup> These problems are compounded, of course, by some of the strategies described earlier, in which a series of separate transactions are combined to achieve a completely different synthetic economic result; in such cases, there is no relationship between the overall results achieved by the taxpayer and the economic position of its various counterparties.<sup>130</sup>

In light of market realities, then, symmetry of tax result imposes little meaningful tax discipline. Conversely, by abandoning the false comfort of symmetry of result between issuers and investors, it is possible to develop more useful tax policy strategies to deal with the problems unique to each.

129. The most common cases are straightforward corporate bonds issued by taxpaying corporations and held largely by tax-exempt investors. More elegant examples were the "subsidiary preferred" offerings of the 1980s. Subsidiary preferred stock transactions took advantage of the dividends-received deduction under I.R.C. § 243 (Prentice Hall 1991) to maximize tax efficiency where the investor was a tax-paying corporation and the issuer did not currently pay tax, typically because of net operating loss carryforwards. See generally Warren, *Recent Corporate Restructuring and the Corporate Tax System*, 42 TAX NOTES 715, 715-17 (1989); Jassy, *Issuances of Floating Rate Preferred Stock by Special Purpose Subsidiaries of Loss Corporations*, 39 TAX LAW. 519 (1986). The subsidiary preferred structure effectively was eliminated by I.R.C. § 1503(f) (Prentice Hall 1991), enacted in 1989.

130. For a long-winded example of a complex series of transactions through which a corporate issuer might achieve low-cost funds and investors an equity-based return, see Kleinbard, *supra* note 106, at 954-55.

### A. *The Taxation of Corporate Issuers*

Corporate issuers have been substantial users of derivative interest rate financial products (such as interest rate swaps), primarily as devices to hedge or otherwise manage their liabilities.<sup>131</sup> Issuers increasingly find, however, that many sophisticated liability strategies currently being developed, while appearing very elegant on a pretax basis, simply cannot be implemented once tax costs are taken into account, because the instrument-by-instrument approach required by current law leads to a wide variety of anomalous (and expensive) results. As applied to corporate issuers, current tax law also places enormous stress on whether a particular capital market instrument is deductible debt or nondeductible equity, again without regard to the overall economic result achieved by that instrument in the context of the issuer's other positions. As the equity derivative product marketplace matures, corporate issuers can be expected to use those products more frequently, not only to manage their cost of equity capital but also to seek to convert nondeductible equity expenses into deductible derivative payments.

These anomalies and tensions could be resolved, and a source of substantial inefficiency in the capital markets eliminated, if the current tax system for corporate issuers were entirely scrapped, and replaced by a statutory Cost of Capital Allowance (COCA) system.<sup>132</sup> Under the COCA system, a corporation would be allowed to deduct each year an amount equal to the product of (1) its "Invested Capital," and (2) a statutory COCA. A corporate issuer would not recognize deductions, loss, income, or gain in respect of its actual interest expense *or* in respect of cash flows payable or receivable on any liability management tool. Thus, for example, gain or loss recognized by an issuer on an interest rate swap that related to the issuer's outstanding liabilities, or gain or loss on an equity index swap used as a cost of equity management tool, would be excluded from net income. The COCA system thus would provide a corporate taxpayer with a uniform annual deduction for all the capital employed by that corporation in its income-producing activities, regardless of whether that capital is denominated debt or equity.

"Invested capital" in effect would include an issuer's outstanding equity as well as debt. Since balance sheets, by definition, balance, a corporation's outstanding capital (*i.e.*, the right side of its balance sheet) must equal its assets (*i.e.*, the left side). Accordingly, under the COCA

131. See generally *id.* at 952-55.

132. I first made this proposal in an earlier article. See *id.* My summary here is a condensation of the arguments presented therein.

system, a corporation's invested capital in each year would equal the aggregate adjusted tax bases of all its assets.<sup>133</sup>

The COCA would be an annual percentage determined pursuant to a statutory formula based on that year's current Treasury obligation yields.<sup>134</sup> An issuer's annual deduction in respect of its cost of capital would equal its Invested Capital multiplied by this cost of capital allowance. The deduction, like interest, would fully offset ordinary income, and would be subject to the current rules that allocate interest for foreign tax credit purposes.

The statutory formula would remain constant from year to year, but a corporation's annual cost of capital allowance would fluctuate with changes in prevailing Treasury interest rates and changes in the corporation's investment in assets. Because United States corporations generally borrow at a spread over Treasury rates for comparable maturities, the annual cost of capital allowance would generally move in tandem with changes in a taxpayer's actual borrowing costs (or the implicit interest costs of its actual equity capital).

No separate or additional deduction would be allowed for a taxpayer that incurred actual interest or equity expense in excess of the cost of capital allowance. Similarly, a taxpayer whose actual cost of capital was lower than the statutory allowance nonetheless would be entitled to its full annual COCA deduction.

Since the whole purpose of the COCA system would be to substitute an arbitrary annual deduction for all the various components of a corporate taxpayer's actual annual cost of capital, under the COCA system corporations would not recognize gain or loss on any liability management transaction, just as corporations currently recognize no gain or loss on trading in their own stock. Similarly, gain or loss attributable to any designated liability management tool employed by a corporate issuer to manage capital costs (e.g., an equity swap, or an interest rate swap, cap, or forward contract), once identified as part of a taxpayer's cost of capital "account," would simply generate tax-free cash flows.

It is interesting to note that the COCA system produces results that

133. See *id.* at 958 for a discussion of some ancillary issues relating to the definition of Invested Capital, such as the application of the rule to affiliated groups.

134. For example, the formula could be a specified weighted average of each year's average short-term, medium-term, and long-term federal rates, multiplied by a specified percentage (presumably less than 100%). The federal rate is a monthly computation of the average yields on selected short-, medium-, and long-term Treasury securities. See I.R.C. § 1274(d) (Prentice Hall 1991); Prop. Treas. Reg. § 1.1274-6, 51 Fed. Reg. 12077 (1986). The purpose of multiplying the Treasury rate by a factor of less than 100% would be to ensure revenue neutrality at the time the COCA system is introduced.

are more consistent with various corporate integration goals than are achieved under the current tax system.<sup>135</sup> Specifically, the COCA system tends to assure that at least some tax burden is shouldered by corporate debt (by functioning like a partial interest expense disallowance system), and that at least some relief from double taxation is afforded corporate equity (through the cost of capital allowance on equity). At the same time, because the COCA system by itself would change very little in the current taxation of investors, the COCA system should prove to be more politically feasible than would a more explicit integration agenda. Moreover, regardless of one's feelings about corporate integration, the COCA system resolves the absence of substantive tax rules and the lack of contextual analysis for new financial products—issues that traditional integration models leave untouched.

In the year since I first made this specific proposal, no objection has been raised to it that has deterred me from repeating it. Proponents of corporate integration have observed, in private conversations, that the proposal is no more than a mediocre success when measured solely against the objectives of comprehensive corporate integration schemes. In response, it can be observed that the COCA system would perform a great deal better as a corporate integration model than any such corporate integration scheme would perform as a vehicle to resolve the current tax system's inability to deal with financial innovation. Moreover, because the COCA system by itself does not require a revision of the tax rules governing investors, it has at least a glimmer of political feasibility to it—a point to which some proponents of corporate integration seem curiously insensitive.

In a recent and thoughtful article, two economists distinguish between an issuer's cost of *capital* and its cost of *funds*; under their definition, the proposal should be retained a Cost of Funds Allowance System.<sup>136</sup> I am delighted to accept this emendation if doing so would

135. "Corporate integration" refers, of course, to proposals that have as their goal the elimination (or reduction) of the double tax burden that the current "classical" system imposes on corporate profits. Corporate integration should be distinguished from the doctrine (or, more accurately, nondoctrine) of the integration of financial instruments, discussed in section III(C)(4), which addresses the issue of the combination of different financial instruments to produce a synthetic unity.

For an extensive and thoughtful review of the competing arguments for various forms of corporate integration, see Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965 (1989). That article neatly summarizes the financial theory underpinning the COCA system, *id.* at 1037-38, and points out the similarities between that proposal and the work of other authors, *id.* at 1243 n.995. Professor Rudnick ultimately concludes that corporate issuers should be permitted a deduction for the "interest component of the return to equity capital"—a result that moves in the same direction as the COCA system proposal. *Id.* at 1268.

136. McCauley & Zimmer, *Explaining International Differences in the Cost of Capital*, FED. RES. BANK N.Y. Q. REV., Summer 1989, at 7, 8.

advance the cause, although a more terminologically precise "COFA" system offers fewer opportunities for amusing acronyms than does the original proposal.

### *B. The Taxation of Investors*

By definition, a COCA system does not purport to address the taxation of investors, except that it would contemplate the elimination of the intercorporate dividends-received deduction.<sup>137</sup> Most radical and systematic solutions on the investor side would require investors to be taxed on some imputed or theoretical return on investment—a result that I have assumed to be politically infeasible. If this assumption is correct, a different, less systematic approach is required to deal with the taxation of financial innovation at the investor level.

Most investor-level tax policy concerns can be addressed by a three-pronged strategy: (1) the amendment of the Internal Revenue Code to eliminate some existing statutory anomalies and to delegate comprehensive rule-making authority to the Treasury Department and the Internal Revenue Service, (2) the regular use by those agencies of that delegated authority, and (3) the increased reliance on taxpayer identification to resolve tax integration problems.

Some suggested amendments to the Internal Revenue Code follow directly from the particular problems identified in this Article: for example, Section 1234A should be amended to eliminate the extinguishment doctrine in all contexts,<sup>138</sup> and Section 512 should be amended to broaden the base of investment vehicles that tax-exempt institutions may hold<sup>139</sup>—ideally, by granting authority to the Internal Revenue Service to designate the new financial products whose economic purposes are consistent with the current exceptions to the definition of UBTI.

More generally, Congress should confront the realities of the torrid pace of financial innovation and the institutional sophistication required to address many new financial products by delegating to the Treasury Department and the Internal Revenue Service comprehensive authority to address all the relevant aspects of financial innovation—the *character* (capital or ordinary, interest or noninterest, etc.) of income or loss, the *source* (foreign or domestic) of that income or loss, and the *timing* of income or expense recognition. Congress has already delegated the authority to determine the source of financial product income or ex-

137. See Kleinbard, *supra* note 106, at 960.

138. See *supra* text accompanying note 64; *supra* note 125.

139. See *supra* notes 54-55 and accompanying text.

pense,<sup>140</sup> but in the absence of comprehensive authority to address all the tax aspects of financial products, the Treasury and the Internal Revenue Service have been slow to use this limited authority.<sup>141</sup>

It goes without saying that the delegation of authority will accomplish little good if that authority is not regularly and thoughtfully exercised. It is my hope, however, that if the administrative agencies were empowered with comprehensive authority, their current institutional frustration at being able to address only fragments of the questions raised by financial innovation would disappear, and the agencies would expand their institutional ability to understand and give appropriate guidance to the capital markets.

These solutions still do not deal terribly satisfactorily with the problem of contextual analysis. I would suggest that the person best equipped to supply that context is the taxpayer himself. Accordingly, the Internal Revenue Service should develop procedures (relying on the delegation of authority described above) to enable taxpayers to identify tax components of synthetic investments and to have the transaction taxed in accordance with that synthetic result. (Such a rule would not be required for synthetic *liabilities*, because corporate liabilities would be governed by the COCA system.<sup>142</sup>) The Internal Revenue Service already has gained significant experience with just such an approach in the foreign-currency arena,<sup>143</sup> where the principal taxpayer comment has been a chorus of requests to expand the identification-election program still further.<sup>144</sup> Such an election should be available on a synthetic investment-by-investment basis, but required to be made at the outset of each such investment to preclude "gaming" opportunities.

By electing into such a system—perhaps termed an "Investment Account"—a taxpayer could be assured that its tax results would be commensurate with its pretax economic strategy. Conversely, if a taxpayer sought to avoid being taxed by reference to the synthetic instrument it had created, the Internal Revenue Service would retain the authority in

140. See I.R.C. § 865(j)(2) (1988) (enabling the Secretary of the Treasury to prescribe regulations applying the rules of § 865 to income derived from trading in futures contracts, forward contracts, and other instruments).

141. See *supra* notes 93-97 and accompanying text. It goes almost without saying that, even if the COCA proposal were dismissed, Congress nonetheless could—and should—grant broad regulatory authority along the lines suggested in the text.

142. One exception would be the debt-financed income rules of I.R.C. § 514 (Prentice Hall 1991); if, for example, a pension fund enters into a "reverse conversion," that synthetic borrowing should be subject to the special constraints of § 514.

143. See Temp. Treas. Reg. § 1.988-5T (1989); Temp. Treas. Reg. § 1.861-9T(b)(6) (as amended in 1989).

144. *NYSBA Tax Section Reports on Foreign Currency Temporary Regulations*, Highlights & Documents, May 21, 1990, at 1753.

the audit process to place the taxpayer's positions in an investment account—just as is true today in the foreign-currency arena.<sup>145</sup> In response to the objection that this would impose strains on the audit process, one can only observe that the result cannot help but be better than the current system, under which the Internal Revenue Service generally is powerless to treat most integrated series of transactions in accordance with their overall economic results, even if taxpayers gain a significant advantage by treating the different components of such strategies separately for tax purposes.

145. See Temp. Treas. Reg. § 1.988-5T(a)(8)(ii) (1989).