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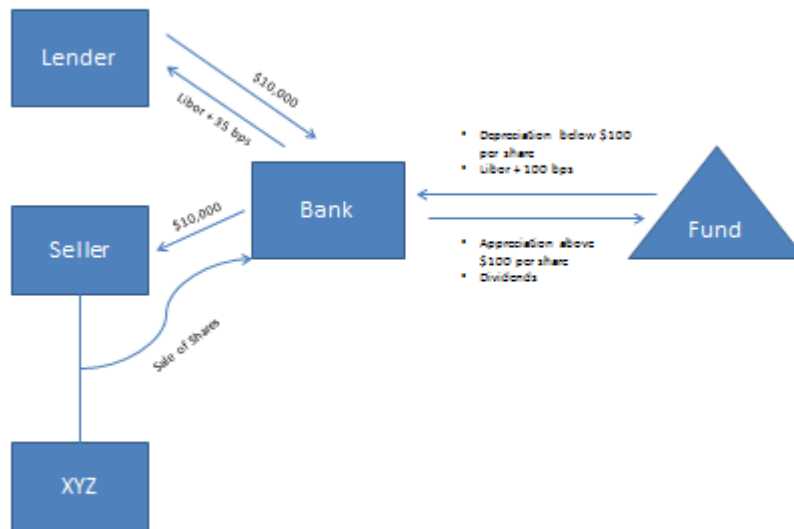
Foreign Banks, U.S. Branches, and Equity Swaps

When foreign banks doing business in the U.S. calculate gain or loss from equity swaps, they would do well to pay attention to common law doctrines of beneficial ownership. This is the case even though these doctrines have recently lost much of their relevance for withholding tax purposes.

In a typical equity swap, one party (in our example, the Bank) enters into an agreement with another party (the Fund), pursuant to which the Bank will “pay performance” with respect to certain shares (reference shares) to the Fund, and the Fund will make periodic fixed or floating payments to the Bank. Under the arrangement, the Bank will pay to the Fund amounts equal to all dividends paid on the reference shares, and both parties will exchange payments on periodic “reset dates,” equal to increases or decreases in the reference shares’ value, above or below the swap’s “strike price,” or (after the first reset date), the previous reset price. Payments from the Fund to the Bank are calculated by multiplying the notional amount of the reference shares by a funding rate. In order to hedge its position under the swap, the Bank will generally buy the reference shares from a third party with borrowed funds.

Diagram 1 depicts a standard equity swap:

Diagram 1: Equity Swap



Economically, this is similar to an arrangement whereby the Bank lends the Fund money to purchase the reference shares, and then holds the shares as custodian for the Fund. In both cases, the Fund obtains economic exposure to the reference shares, and pays a funding fee, and in both cases, the Bank has possession of the shares. In fact, it is so similar that courts need to examine all of the facts and circumstances surrounding an equity swap in order to determine whether it is better characterized as a true swap, or as a custodial arrangement.

Generally, a swap is characterized as a custodial arrangement if, under general common law doctrines of tax ownership, the fund is deemed to be the beneficial owner of the referenced shares. These rules treat liquid and illiquid assets differently. Under applicable doctrines, the party who has the legal right and economic power to control and dispose of a liquid, fungible asset is treated as the owner thereof, while the party who has economic exposure to an illiquid asset is treated as the owner thereof:

- > **Example 1:** Bank and Fund enter into a swap, pursuant to which Bank pays performance on 100 shares of stock of XYZ Corporation to Fund. XYZ shares are liquid and publicly traded. Fund did not own shares of XYZ prior to entering into the swap, and does not plan to buy them after it terminates the swap. Bank will likely hedge its position by purchasing shares of XYZ stock in the open market, but it can (and may) hedge through the use of other instruments. Because Bank will have full control over any XYZ shares it may hold as a hedge, the better view is that Fund should not be treated as the owner of any such shares.
- > **Example 2:** The facts are the same as in Example 1, except XYZ is privately held, and only has 150 shares of stock issued and outstanding. In order to hedge its position under the swap, Bank is economically compelled to purchase and hold 100 shares of XYZ stock, and to deliver them to Fund at termination. Because Bank is economically compelled to hold the shares as a hedge and to deliver them at termination, Bank does not have the power to dispose of the shares. Because of this, and because the Fund has full economic exposure to the shares, the better view is that Fund, rather than Bank, is the beneficial owner of the shares.

- > **Example 3:** The facts are the same as in Example 1. XYZ shares are liquid and publicly traded. Fund owns 100 shares of XYZ, which it sells to Bank for \$50 per share on the date on which the swap is entered into. The swap has a “strike price” of \$50 per share. Upon termination of the swap, the shares will be sold back to Fund at the same price as the swap termination price. Because the effect of this arrangement is to insulate Bank from all economic risk, as long as they do not dispose of the shares during the term of the swap, the better view is that Fund remains the beneficial owner of the shares during the swap.

Until recently, dividend-equivalent payments on an equity swap made to foreign residents were not subject to withholding tax, provided the swap was respected as a true swap, or a true derivative under the foregoing doctrines. However, these doctrines became moot for withholding tax purposes with the promulgation of regulations under Code section 871(m) in September of this year. Under these regulations, all dividend equivalent payments on “equity linked instruments” that reference shares of United States – resident issuers are subject to withholding tax regardless of whether they are treated as custodial arrangements or as true derivatives.

So – since withholding tax will apply to dividend equivalent payments on a swap regardless of whether the swap is respected as a true swap, nobody cares about the beneficial ownership rules any more - right?

Wrong.

The beneficial ownership rules as applied to equity swaps remain relevant in two contexts that are particularly relevant to banks doing business in the United States in branch form:

- > **Taxability of Reset Payments.** If a swap is treated as a true swap for United States federal income tax purposes, reset payments are taxable payments made on a notional principal contract (essentially, a swap). By contrast, if a swap is merely a custodial arrangement, whereby the Bank holds the hedge for the account of the Fund for federal income tax purposes, reset payments are better characterized as payments made to “true up” a margin loan. As such, they ought not be taxable. Therefore, if a swap is booked in a bank’s U.S. branch, the bank will need to determine whether the swap is better treated as a custodial arrangement or as a true swap for United States federal income tax purposes, in order to calculate gross income attributable to the branch.
- > **Allocation of Interest Expense.** Under the interest expense allocation and apportionment rules, a U.S. branch of a foreign bank can deduct an amount of interest expense from the bank’s United States net taxable income that is calculated with regard to the bank’s “U.S.-connected liabilities” for the tax year. The value of a bank’s U.S.-connected liabilities is an amount equal to the bank’s worldwide liabilities multiplied by a fraction, the numerator of which is the bank’s United States assets, and the denominator of which is the bank’s worldwide assets. If an equity swap is respected as a true swap, United States assets will include any shares held by the Bank to hedge the swap. However, if a swap is treated as a custodial arrangement, hedge shares will not be included in United States assets, instead, a deemed margin loan from the Bank to the Fund will be included therein. Depending on the relevant numbers, this could have a significant impact on the calculation of the amount of interest expense that the branch is allowed to deduct in computing net U.S. taxable income attributable to the bank’s branch business.

For these reasons, banks doing business in the United States are advised to proceed with caution if they enter into equity swaps through their U.S. branch.

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