Equity Swaps As Sales: What, Me Worry?

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The September 28, 1994 issue of *The Wall Street Journal* contained an article addressing the treatment of equity swaps. Among other aspects of these transactions, the article considered the tax treatment of this increasingly popular device. Typically, an equity swap involves an agreement by which an investor with a large position in a single stock hypothetically "exchanges" that stock for a basket of stock provided by a brokerage firm or other financial intermediary. This hypothetical (but not actual) exchange can have the effect of locking in the investor's gain (or loss) in the underlying stock position.

The reason? With some equity swaps, the arrangement guarantees no fluctuations in the value of the holding regardless of market conditions. This guarantee is possible because as part of the swap the investor agrees to forego any appreciation in the stock; the brokerage firm, on the other hand, agrees to pay the investor any depreciation. The arrangement, in short, involves a classic spreading of risk.

There has been other publicity of late concerning the equity swap. In an article in *Tax Notes*, ubiquitous tax commentator Lee Sheppard exposes the practice of the equity swap as an executive tax shelter. See "Equity Swaps as an Executive Tax Shelter," *Tax Notes*, October 17, 1994, p. 266. The factual setting for that technique, according to the author, involves company executives who are heavily invested in the stock of their employer. In that context, the equity swap may offer even greater advantages of risk spreading, thus making the argument for taxability—at least on an emotional level—somewhat greater.

But Is It Taxable?

Unfortunately, the *Journal's* article, (and Lee Sheppard's *Tax Notes* article) present the viewpoint that this arrangement should be taxed as a sale. The *Journal* attributes a quote to Schuyler Moore, a noted tax commentator known for extreme opinions, to the effect that once an investor becomes inpervious to changes in market conditions (via the equity swap), he has in effect, sold the stock. In reality, though, this approach is inconsistent with the law in this area

For instance, consider a similar condition that arises when an investor goes short against the box. Notwithstanding the fact that an investor is equally insulated through this strategy, it has long been accepted that a short sale is not consummated until the delivery of the long position to close out the corresponding short position. In fact, the IRS just recently reaffirmed its position that delivery of the long position is more than a ministerial act, and that tax consequences would not arise until such delivery occurred. See Letter Ruling 9436017.

Given the traditional importance of the legal ownership of property—whether it is leased or pledged to someone else—the argument that something is a sale where it is not cast as such would seem to be defeated by the case law. Indeed, in the context of sale/leasebacks, we have *Frank Lyon v. U.S.*, 435 U.S. 561 (1978). And with margin account securities (as to which it could be argued that the securities firm holding the margined securities might really be the owner), we have *Richardson v. Shaw*, 209 U.S. 365 (1908), holding that the margin account customer still owns the stock.

At first glance, this no-sale viewpoint might appear to be in question given the announcement more than twenty years ago in Revenue Ruling 73-92, 1973-1 C.B.208. There, the IRS did conclude that a so-called short against the box transaction, or the acquisition of a put option, offsetting stock acquired through the exercise of a qualified stock option, would be considered a disposition of the option stock. However, Revenue Ruling 73-92 did not impose sale treatment on the optionee. It simply said that when the option stock was ultimately disposed of, a potion of the gain would be considered ordinary income. The reason for the ordinary income element was due solely to the fact that the requisite holding period for long-term capital gain treatment was not satisfied. Therefore, even this precedent would not support the notion that an equity swap is tantamount to a sale of the underlying stock.

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Indeed, viewed against this authority concerning short sales against the box—in which the short seller against the box has totally eliminated the economic risk of owning the underlying stock—the equity swap clearly is a transaction of lesser degree. The argument for treating an equity swap as a sale seems considerably weaker. Incidentally, in addition to the favorable authority concerning the non-sale treatment of short sales against the box, the Service has ruled that there can be a step-up in basis under Section 1014 for stock borrowed and pledged as collateral for such a short sale, where the individual dies before the sale is closed. See Letter Ruling 9436017.

Executive Swaps?

In the case of equity swaps in the executive suite, the program may be quite structured. According to Lee Sheppard (see *Tax Notes*, October 17, 1994, p. 266), Bankers Trust now offers executives a variety of investments into which shares in their employer may be swapped. The executive may choose to swap into a mixture of equities with smaller capitalizations, foreign equities, or even some other single issue. The analog to receiving cash may be fairly close, with some executives transferring into the Standard & Poor's 500, Treasuries, etc. A loan on the shares received in the swap may even be available, which once again may make the emotional appeal of taxability high.

Risk Reduction

It is hard to look at the equity swap, of course, without acknowledging that there is risk reduction involved. The device would not otherwise exist. Nonetheless, the question is whether this means a sale has occurred for tax purposes. Judged against existing authority, the answer should be a definite no. And apart from authority, the question is whether there is any justification for accepting the "equity-swap-is-a-sale" viewpoint. The arguments against sale treatment far outweigh the arguments for such treatment. Furthermore, the Service has made no public movement to adopt such a stance. Until such time as the law changes, it seems unnecessary to regard this as a serious threat. ■

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