ISSUES IN THE TAX TREATMENT OF INTERNATIONAL INTEREST RATE AND CURRENCY SWAP TRANSACTIONS

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During the eighties, new financial instruments known as "swaps" or "notional principal contracts" were developed in the world financial capital markets. Basically, these instruments are agreements between two parties to exchange cash flows. The most commonly used types of swaps today are the interest rate and currency swaps which allow parties to shift the risks of interest rates and exchange rates fluctuations. Major events in the seventies contributed to create highly volatile interest and exchange rates in the financial markets. First, the collapse of the Bretton Woods agreement in 1971 opened the door to floating exchange rates. Second, the oil price shock of 1973 was followed by huge variations in inflation rates among countries. Third, the change in the monetary policy of the U.S. Federal Reserve Board in 1979, which decided to focus on the control of money supply instead of targeting interest rates, added to the overall volatility of the environment. The resulting increased exchange and interest rates fluctuations were a decisive factor for the emergence of the swap market. Since the legendary major currency swap transaction in 1981 between the World Bank and IBM, the global market for swaps has grown from about 3 billion dollars at the beginning of 1982 to more than 20 billion dollars in 1983. By mid-1987, it is estimated that there was in the market an outstanding volume of notional principal amount of 500 billion dollars of interest rate swaps and of 100 billion dollars of currency swaps. Since then, the swap market has evolved further to reach an amount of outstanding swaps of above two trillion dollars by the end of 1989. The objective of the paper is to analyze the tax treatment of swap transactions in an international perspective. It is divided into five parts. After describing the interest rate and currency swap transaction and the economic functions it fulfils (part I), we will explore the tax treatment given to swap transactions in the United States (part. II) and in Switzerland (part III). Our analysis of the tax treatment in both countries will not only emphasize the current tax treatment, but will also try to propose some solutions on a policy perspective. We will then concentrate on the treatment of international swap transactions under the OECD Model of 1977. Finally, after a brief comparison of the different approaches followed by the above-mentioned two countries in the taxation of swap transactions, we will conclude with some observations pertaining to the taxation of cross-border swap transactions. I. The swap transaction II. The U.S. tax treatment of international swap transactions III. The Swiss tax treatment of international swap transactions IV. Swap transactions under the OECD model V. Conclusion : an international perspective