Articles

"Contingent Notional Principal Contracts: No More Wait-and-See?"

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Taxation of Financial Products
January 1, 2005

Thomas R. Popplewell and William B. Freeman III discuss the taxation of NPCs, the “wait-and-see” method typically used to account for CNPCs and the proposed rules for CNPCs, along with possible alternative strategies if the proposed regulations are adopted. Thomas R. Popplewell is a Partner in the firm of Andrews Kurth LLP in Dallas, Texas. William B. Freeman III is an Associate in the firm of Andrews Kurth LLP in Houston, Texas.

Special accrual accounting rules relating to the timing of income and deductions with respect to notional principal contracts (NPCs) are set out in Treasury Regulations that were finalized in 1993. Although the 1993 NPC regulations are comprehensive, timing rules for certain types of NPC payments were not included. In particular, so-called contingent nonperiodic payments were not addressed by the 1993 regulations.[1]

In the absence of specific rules governing the timing of income and deduction with respect to contingent nonperiodic payments, most taxpayers accounted for such payments on a “wait-and-see” basis, meaning that the accrual principles set out in the 1993 regulations were not applied to such payments. In 2001, the IRS and the Treasury put the tax community on notice that they were contemplating rules with respect to contingent nonperiodic payments. That warning came in the form of Notice 2001-44,[2] which outlined four potential methods of accounting for such payments. On February 25, 2004, the IRS issued proposed regulations (the proposed regulations) addressing the timing—and character—of income and deductions from NPCs involving contingent nonperiodic payments.

This article will first discuss background regarding the taxation of NPCs, including definitions and the current (1993) regulations dealing with NPCs not having contingent non-periodic payments. We then discuss the “wait-and-see” method typically used to account for contingent notional principal contracts (CNPCs). We next describe the proposed rules for CNPCs as set out in the proposed regulations and conclude with a discussion of possible alternative strategies if the proposed regulations are adopted substantially as proposed.

Basic NPC Definitions

For those not familiar with NPCs, a review of certain basic definitions is a prerequisite to an intelligent discussion. An NPC is a financial 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.[3] An NPC is sometimes referred to simply as a swap, although a swap is technically more narrow since the definition of an NPC includes certain caps and floors. NPCs include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps and similar agreements.[4] A specified index is a fixed rate, price or amount (which may vary by period), an index that is based on objective financial information or an interest rate index that is regularly used in normal lending transactions.[5] A notional principal amount is any specified amount of money or property that, when multiplied by the specified index, measures a party’s rights and obligations under the NPC, but is not borrowed or loaned between the parties as part of the NPC.[6]

The NPC accrual principles, as set out in the 1993 regulations, are organized by categories of NPC payments; namely, periodic payments, nonperiodic payments and termination payments. “Periodic payments” are payments made or received under an NPC that are payable at intervals of one year or less during the entire term and that are based on a specified index and one or more notional principal amounts.[7] A “termination payment” is defined for purposes of the NPC rules as a payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under an NPC. A termination payment can include a payment made between the original parties to the NPC to extinguish the contract prior to its scheduled termination or maturity date, as well as a payment made between one party to the NPC and a third party pursuant to an assignment.[8] “Nonperiodic payments” are payments that are not periodic payments or termination payments.[9] Examples of nonperiodic payments include the upfront premium paid with respect to

an "off-market" swap or the final payment due at maturity of a total return swap. Note that a payment made pursuant to the terms of an NPC is either a periodic payment or a nonperiodic payment; by contrast, a termination payment is not made pursuant to the terms of an NPC, but is instead a payment made between the parties to extinguish the contract prior to its scheduled maturity, or by one of the NPC parties to a third party to assign the rights and obligations of the NPC party to the third party.

CNPCs

A CNPC is an NPC that has one or more contingent nonperiodic payments. A contingent nonperiodic payment is defined in the negative as any payment that is not a noncontingent nonperiodic payment, which in turn is a nonperiodic payment that either is fixed on or before the end of the tax year in which an NPC commences or is equal to the sum of amounts that would be periodic payments if they are paid when they become fixed.[10] The following are some examples of CNPCs.

Total Return Swap

A total return swap is usually based upon price movements and income from a stock or debt obligation, a group of stocks or debt obligations or an index composed of stocks or debt obligations. An equity swap is a type of total return swap. In a single stock equity swap, traditionally (1) the long party (*i.e.,* the party desiring to receive payments based on a hypothetical ownership interest in the reference stock) pays a periodic amount, similar to interest in the manner in which it is computed, based upon an interest rate, typically London Interbank Offer Rate (LIBOR), multiplied by a notional amount and a final payment at the end of the contract equal to any decline in the value of the stock having an initial value equal to the notional amount; and (2) the counterparty pays periodic amounts equal to the dividends on the equivalent amount of stock and a final payment at the end of the contract equal to any increase in the value of the stock having an initial value equal to the notional amount.

Total return swaps can be used to transfer short-term or long-term economic exposure to financial assets without transferring, or owning, the underlying assets. There are significant advantages to their use. A transfer of assets sometimes involves substantial transaction costs or, in the case of financial assets representing an interest in a physical asset, such as a commodity, the cost of physically maintaining and protecting the underlying asset. One of the principal advantages of a total return swap is the ability to increase leverage. For example, a stock investor is generally allowed to borrow on margin a maximum of 50 percent of the value of the stock. In the case of a short seller, he must pledge to his broker not only all of the sale proceeds from the short sale but also maintain on a daily basis an additional 50 percent of the value of the shorted asset. By contrast, long and short positions with respect to a total return swap require much less collateral. Furthermore, the daily margin rate at a broker may be greater than LIBOR.

A total return swap can be written with respect to a debt obligation to create a "synthetic" security. For example, an investor can receive the return (periodic and final value) for five years with respect to a 20-year bond in return for periodic payments on the desired notional amount based on LIBOR.

Credit Default Swaps

Credit default swaps have developed as an advancement of a financial guarantee of a credit asset. A credit asset or simply a "credit" is the extension of credit, typically a loan, but other credits may be in the form of a financial lease or an installment contract. In a typical credit default swap, one party, the protection buyer or originator, pays either an upfront premium or periodic amount based upon a notional amount of a credit asset and receives, in return, the right to a future payment equal to the notional amount if, and only if, there is a "credit event" with respect to the credit asset. The other party to a credit default swap, the protection seller, in consideration of the upfront premium (or periodic amount), will pay the protection buyer an amount equal to the notional amount upon a credit event. A credit event is a specified event, such as a default under the specified obligation or downgrading of the financial rating of the specified obligor, who is neither the protection buyer nor protection seller. The protection buyer may or may not own any of the credit assets that are subject of the credit default swap. Thus, credit default swaps can be used to increase or decrease credit risk exposure to debt obligations

without transfer of the debt obligations.[11]

In addition to the pure credit default swap, contingent swaps can be structured to allow protection buyers and sellers to price and transfer separately one or more of the following risks:

- Responsibility for monitoring and collection activities
- Withholding tax risks
- Currency exchange risk
- Market value risk
- Prepayment risk

For example, a bank might have a $1 billion credit exposure to a customer. The bank may want to reduce its credit exposure to the customer to $200 million but not change any banking relationships or go through the complications of a bank loan syndication. The bank can accomplish this result by purchasing $800 million of protection through a credit default swap from a credit-worthy swap dealer. Alternatively, a hedge fund may have a portfolio of Treasury securities but desires to increase its yield by selling credit protection in the credit default swap market with respect to one or more specified credits.

It is not certain whether a typical credit default swap is a CNPC subject to the proposed regulations. This uncertainty is due in part to the fact that payments under a credit default swap are, in some cases, limited to an upfront (premium) payment by the protection buyer to the protection seller, and a potential payment at maturity from the protection seller. Credit default swaps of this type thus may not fall within the definition of an NPC in the first instance. Even if a credit default swap involves multiple payments by the protection buyer—potentially resulting in NPC classification—it is also not clear that application of the rules under the proposed regulations is appropriate given the low likelihood that the protection buyer will ever receive a payment in most swaps. A credit default swap may simply be the purchase of a put with the premium paid in installments or, even more simply, a type of insurance paid with periodic premiums. Taxpayers have generally not treated them under the put rules because they desire to offset income from the underlying asset with the periodic payment on a current basis,[12] a position also supported by the insurance analogy. The IRS recently issued Notice 2004-52,[13] which requests further information about credit default swaps in connection with consideration by the IRS of specific guidance on the tax treatment of credit default swaps. Presumably this will result eventually in IRS published guidance on accounting for credit default swaps.

The 1993 Regulations

The proposed regulations propose amendments and additions to the existing regulations issued in 1993 regarding NPCs (“1993 Regulations”).[14] The 1993 Regulations require accrual of the net income or deduction from an NPC allocable to a year, the amount of which is determined by adding all periodic and nonperiodic payments recognized during the year, to be included in or deducted from that year’s gross income.[15] The general rule for swaps is that a nonperiodic payment must be recognized over the NPC’s term by allocating it in accordance with the forward rates or prices of a series of cash-settled forward contracts that reflect the applicable index and notional principal amount. For purposes of this allocation, a taxpayer may use the forward rates or prices used to determine the nonperiodic payment, if reasonable.[16] Alternatively, an upfront payment on a swap may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments throughout the NPC’s term, discounted at the rate originally used to determine the nonperiodic payment. Each equal payment is divided into its interest and principal components where the sum of the principal components is equal to the upfront payment and the time component is otherwise disregarded.[17] Non–upfront payments are first discounted to a single upfront payment, and a loan between the parties is imputed for that payment. The above method for upfront payments is then applied and the deemed interest on the loan is added to the amortization of the upfront payment.[18] Similar but special rules apply to caps and floors.[19]

If there is a significant nonperiodic payment, the parties must treat the swap as two separate transactions: an on-market swap and a loan. The loan interest is treated as interest, not swap income or loss. "Significant" is not defined, but examples in the 1993 Regulations indicate that a payment having a value of 9.1 percent of the present value of the fixed payments is not significant while one that is 40 percent is significant.[20]

The following example from the 1993 Regulations illustrates the alternative method of amortization of an upfront nonperiodic payment on a swap.[21] On January 1, 1995, G enters into an interest rate swap agreement with H under which, for a term of five years, G is to make annual payments at 11 percent, and H is to make annual payments at LIBOR on a notional principal amount of $100 million. On January 1, 1995, the fixed rate for similar on-market LIBOR swaps is 10 percent. To compensate for this difference, on January 1, 1995, H pays G $3,790,786 (a nonperiodic payment). This amount was determined as the present value, at 10 percent compounded annually, of five annual payments of $1 million (1% x $100,000,000). Under the alternative method, the nonperiodic payment is recognized over the life of the swap by assuming that the $3,790,786 is repaid in five level payments. Assuming a constant yield to maturity and annual compounding at 10 percent, the ratable daily portions are computed as shown in Chart 1.

G also makes periodic swap payments to H at 11 percent, while H makes swap payments to G based on LIBOR. The net of the ratable daily portions of the 11-percent payments by G, the LIBOR payments by H and the principal component of the nonperiodic payment paid by H determines the annual net income or net deduction from the contract for both G and H. The time value components are needed only to compute the ratable daily portions of the nonperiodic payment and are otherwise disregarded.

Wait-and-See Method for CNPCs

Before issuance of the proposed regulations, it is likely that most parties to CNPCs who were not dealers, and thus not required to mark-to-market their positions,[1] used the "wait-and-see" method of accounting for contingent nonperiodic payments. Under this method, any back-end contingent nonperiodic payment is recognized as income or as a deduction only when the payment becomes fixed and determinable. In addition, such parties typically deducted the periodic payments against ordinary income and reported any back-end income (or loss) as capital gain (or loss). Notice that this result is economically the same as if the taxpayer borrowed money to purchase a capital asset, paid periodic interest, then sold the asset and paid off the loan, and this analysis is often used to support the wait-and-see method. The deductibility of the periodic payments is further supported by the 1993 Regulations, which provide for current deduction of periodic payments.[2] The deferral of the final payment is supported by general principles of accrual accounting, as well as by the absence of specific rules in the 1993 Regulations prescribing an accrual methodology for contingent nonperiodic payments.[3]

Notice 2001-44

Notice 2001-44,[4] issued on July 23, 2001, put taxpayers on notice that the Treasury was contemplating new rules for CNPCs. Notice 2001-44 sought to generate comments on methods for the inclusion into income or deduction of contingent nonperiodic payments made under NPCs and the treatment of such inclusions or deductions. The IRS and the Treasury considered rules regarding the treatment of contingent nonperiodic payments necessary to improve the ease of accounting for such payments and to prevent abuse, although many taxpayers may question the first goal, particularly in light of the methods in the proposed regulations. Notice 2001-44 proposed four methods for the inclusion into income or deduction of contingent nonperiodic payments made under NPCs. As labeled in the notice, these methods were (1) the noncontingent swap method, (2) the full allocation method, (3) the modified full allocation method, and (4) the mark-to-market method. The noncontingent swap method requires a party to an NPC to accrue contingent payments made pursuant to an NPC by converting each contingent nonperiodic payment into a noncontingent periodic amount. Next, the party creates a payment schedule that spreads the recognition of income or deduction of this noncontingent amount over the life of the NPC on a constant yield basis. An adjustment is made when the contingent payment is fixed. A much more complex version of this method, still referred to as the noncontingent swap method, is one of the two methods found in the proposed regulations. To distinguish the two methods, this discussion refers to the one found in Notice 2001-44 as the nonadjusted noncontingent

swap method.

Under the full allocation method, a party to an NPC does not account for any payments made pursuant to the NPC until the tax year in which all contingencies are resolved. Payments are treated as made or received in the year of the resolution of the final contingency under the NPC. This method—which is also referred to as the “wait-and- see” method— essentially treats NPCs according to the open transaction doctrine.

Under the modified full allocation method, parties to an NPC net noncontingent payments made against payments received in a tax year with respect to an NPC. The parties cannot claim deductions if payments are more than receipts for the tax year, and such excess deductions are deferred until all contingencies are resolved.

Under the mark-to-market method, taxpayers mark their NPCs to market and recognize gain or loss at each year-end and when the contract is terminated. The mark-to-market method along with a more complicated version of the noncontingent swap method are the two methods contained in the proposed regulations.[5]

The Proposed Regulations

The proposed regulations did not adopt either the full allocation method or the modified full allocation method, as described in Notice 2001-44. Instead, the proposed regulations mandate the use of a noncontingent swap method to account for the inclusion into income and deduction of contingent nonperiodic payments unless an election is made to use mark-to-market.

Noncontingent Swap Method

Under the noncontingent swap method set out in the proposed regulations, a taxpayer, regardless of its method of accounting, recognizes each contingent nonperiodic payment with respect to an NPC by determining the projected amount of the payment and by applying to that projected amount the level payment method described in the 1993 Regulations.[6] The projected amount of a contingent nonperiodic payment is the reasonably expected amount of the payment, which is determined by using one of the methods (described below) set out in the proposed regulations and the “risk-free interest rate” in applying the level payment method. On each anniversary date of the CNPC (referred to in the proposed regulations as a redetermination date), the taxpayer must redetermine the projected amount of each contingent nonperiodic payment, reapply the level payment method and account for any difference between amounts previously recognized and amounts that would have been recognized if the new projection had always been used. If the CNPC has significant nonperiodic payments with regard to the redeterminations, each level payment is deemed loaned by the expected recipient to the expected payor, and the related interest income and expense reported. In the tax year in which a contingent payment is made or received, the parties must make appropriate adjustments to the amount of income or deductions attributable to the NPC for any difference between projected and actual contingent nonperiodic payments.[7] However, for contingent nonperiodic payments that are fixed more than six months before paid and paid in a different tax year, the taxpayer must treat the date on which the payment is fixed (a special redetermination date) as a redetermination date and reproject the contingent payments.[8]

The reasonably expected amount of each contingent nonperiodic amount is projected using one of three methods.[9] Under the first method, if the contingent payment is determined by reference to the value of a specified index at a designated future date, the projected amount may be determined by reference to the future value of the specified index in actively traded futures or forward contracts providing for delivery or settlement on that future date. If no actively traded contract exists for such future date, the value may be derived from actively traded futures or forward contracts providing for delivery or settlement within three months of the future date.[10]

Under the second method, the projected amount may be based on the projected future value of the current market prices as established by objective financial information. The current value is converted to a future value by adding to the current value an amount equal to the accrual of interest on the current value under a constant yield method at the risk-free interest rate with compounding and by making appropriate adjustments for expected cash payments on the property underlying the specified index.[11] The proposed regulations use the applicable federal rate under Code Sec. 1274(d)(1) as the risk-free

interest rate for this purpose.[12]

Finally, if neither of these two specific methods produces a reasonable estimate of the amount of the contingent payment, the taxpayer must use a method that does. As with the two specific methods, this method must be based on objective financial information.[13] The proposed regulations do not require the two counterparties to be consistent, although one will probably be a dealer using the mark-to-method method of Code Sec. 475.

Application of this rule to a credit default swap is particularly perplexing because of the low probability that any backend payment will be made. For example, if there is a five-per- cent probability of a default on a $50 million credit, should the reasonably expected amount of the noncontingent back-end payment be 0, $2.5 million, $50 million or some other amount? Any amount greater than zero would overstate a protection buyer's income 95 percent of the time, and it is difficult to see how that would be deemed to "clearly reflect income."

The proposed regulations apply the level payment method found in the 1993 Regulations[14] to the projected amount to determine the amounts to be recognized for each contingent nonperiodic payment, using the risk-free interest rate for the discount rate. Thus, the projected amount of each noncontingent payment amount is converted to the equivalent series of level payments over the swap term such that when the level payments are compounded at the risk-free interest rate, the final amount is the contingent nonperiodic payment. The character of these payments is discussed below along with an example.

If the present value of a contingent nonperiodic payment is considered "significant" when compared to the present value of the total payments to be made by the payor, as will often be the case in a total return swap, the NPC is required to be split into an on-market swap component and a loan component. The potential payor is deemed to pay interest to the expected recipient at the risk-free rate, which interest is treated as such for all federal income tax purposes. As previously noted, the proposed regulations do not define "significant."[15]

The proposed regulations require annual adjustments to the projected amount of the contingent payment. The projected amount must be redetermined on each redetermination date[16] by reprojecting the amount of the contingent payment using the same method used at the commencement of the NPC and applying the future value of the specified index on the redetermination date. Once the contingent payment is reprojected, the level payment method and the rules for significant nonperiodic payments, if applicable, are reapplied using the new projected amount. It is unclear how to apply these rules if a projected payment that was once considered significant becomes no longer significant upon a reprojection.

Following each redetermination, a new schedule of level payments is used for purposes of determining amounts to be recognized in the current and subsequent tax years with respect to the contingent nonperiodic payments. Further, any difference between the amounts recognized in prior tax years and the amounts that would have been recognized in those years had the new level payment schedule been in effect for those years is taken into account as additional payments or receipts with respect to the contract ratably over the one-year period beginning with the redetermination date. Computationally, this is a significant complication. Any difference in amounts attributable to a difference in the interest amounts is recognized as interest for all purposes of the Internal Revenue Code.

When a contingent payment is made, the parties must make appropriate adjustments to the amount of income or deduction attributable to the NPC for any difference between the projected amount and the actual amount of the contingent payment. The adjustment to the net income or net deduction from the NPC is made in the tax year during which the payment occurs.[17]

Mark-to-Market. Under the proposed regulations, taxpayers may elect to use a mark-to-market method as an alternative to the noncontingent swap method only if (1) the NPC is of a type that is actively traded, (2) the taxpayer marks-to-market the NPC for financial accounting purposes, (3) NPC valuations are provided by a dealer or (4) the taxpayer is a regulated investment company described in Code Sec. 1296(e)(2), *i.e.,* a regulated investment company that redeems its shares at net asset value.[18]

The first of the four types of NPCs for which the mark-to-market method may be elected is an NPC that is actively traded.[19] The fair market value determination for this type of NPC is to be based on the mean between the bid and ask prices quoted for the contract on an established financial market[20] or, if bid and ask prices are not available, comparable prices determined on the basis of recent price quotations.[21]

The second type of NPC for which the mark-to-market election may be made is one that is marked-to-market for financial accounting purposes (with certain additional requirements that have yet to be provided under the proposed regulations).[22] The fair market value for mark-to-market purposes is determined according to the fair market value used for financial accounting purposes in the taxpayer's financial statements. If the NPC is actively traded for purposes of the mark-to-market method, however, the NPC is to be marked-to-market based on the actively traded method.[23]

The next eligible NPC type is one where a counterparty (*e.g.,* a dealer) supplies the value to a party.[24] The fair market value to be used for the mark-to-market valuation is the value provided by the counterparty.[25] As with the previous method, if the NPC is actively traded for purposes of the mark-to-market method, the NPC is to be marked-to-market based on the actively traded method.[26] If not actively traded, the proposed regulations are silent as to whether to use the value used for financial accounting purposes or the value supplied by a dealer, if both are available.

In the case of an eligible regulated investment company electing the mark-to-market method, the value used to determine the net asset value of the regulated investment company is used to mark-to-market the NPC, and this method must be applied if available.[27]

If the mark-to-market method is elected, inclusions in and deductions from income are determined according to the gain or loss that would be realized if the NPC were sold for its fair market value on the last business day of the relevant tax year.[28] Amounts of gain or loss subsequently realized (or calculated) are adjusted to account for the income inclusions and deductions realized under the mark-to-market method.[29]

If an NPC that is marked-to-market has one or more significant nonperiodic payments, the NPC is treated as having loans with regard to such significant nonperiodic payments on which interest accrues.[30] The Preamble to the proposed regulations, but not the proposed regulations themselves, provides that the interest payments do not need to be reprojected each year, *i.e.,* the initial projection is used to compute interest for each year.[31] However, this interest imputation rule does not apply to regulated investment companies eligible to use the mark-to-market method. The amount of the loan is generally equal to the level payment amounts of the contingent payment as determined under the methods described for the noncontingent swap method. An alternate rule is available if all payments under the NPC are fixed except for a single significant contingent nonperiodic payment. In this case, the taxpayer may project the single significant nonperiodic payment as the amount that causes the present value of all payments by the taxpayer to equal the present value of all of the payments by the counterparty. The present value of each payment on the contract is determined by applying the risk-free interest rate.[32]

An election to use the mark-to- market method will apply to all eligible NPCs to which the taxpayer is a party. The election is effective for the tax year in which it is made and all subsequent tax years unless the IRS consents to revocation.[33]

Character of Income Under Proposed Regulations. Historically, many taxpayers reported NPC payments representing the increase or decrease in the value of the assets referenced in the NPC (so-called value payments) as capital gain or loss if the referenced (notional) asset would be a capital asset if they held it.[34] The proposed regulations treat all periodic and nonperiodic NPC payments as ordinary; termination payments are capital if the referenced asset is a capital asset.

Specifically, the proposed regulations provide that, in general, the net periodic and nonperiodic payments (including mark-to-market deductions) are deductible by the payor under Code Sec. 162 as ordinary and necessary business expenses.[35] However, payments representing interest under the rules for significant nonperiodic payments, as well as termination payments, are not deductible under Code Sec. 162. A similar rule is provided for individuals but their deductions are deductible under Code Sec. 212,[36] and thus subject to the limitations on itemized deductions under Code Secs. 67

and 68. If the projected amount of a contingent nonperiodic payment varies considerably year to year, these rules introduce a significant character whipsaw potential for individual taxpayers. They could be required to include a portion of a positive projected payment in income but be limited in deducting a subsequent negative adjustment. The IRS should revise the regulations to allow such negative adjustments, as well as negative interest adjustments, to be "negative income" and to reduce income in arriving at adjusted taxable income. Gains or losses arising from termination payments made under NPCs, however, may result in capital gains or losses.[37]

The proposed regulations make it clear that periodic payments, noncontingent nonperiodic payments and contingent nonperiodic payments under NPCs are not termination payments.[38] Thus, apparently taxpayers could choose ordinary treatment or capital treatment by either holding a CNPC to maturity or terminating it early, but unless the referenced asset's value is particularly volatile, the amount subject to such elective treatment may be small due to the annual adjustments to income required pursuant to either of the two methods required under the proposed regulations. The proposed regulations treat gain or loss arising from the settlement of bullet swaps and forward contracts as gain or loss from a termination payment[39] and therefore as capital gain or loss under Code Sec. 1234A. A bullet swap is an instrument that provides for the computation of the amounts due by reference to a specific index and notional amount and provides for settlement of all parties' obligations at or close to the swap's maturity.[40]

Effective Dates. The proposed regulations provide confusing guidance with regard to effective dates. This aspect of the proposed regulations has drawn much attention and criticism from commentators.[41] The actual language of the proposed regulations provides that the noncontingent swap method and mark-to-market method "are applicable for notional principal contracts *entered into* on or after 30 days after the date a Treasury decision based on these proposed regulations is published in the Federal Register."[42] Thus, the rules do not appear to be effective until 30 days after the rules related to contingent nonperiodic payments for NPCs are finalized. However, the rules in the proposed regulations not related to these methods, which include certain definitions and examples, will apply retroactively to NPCs entered into on or after December 13, 1993.[43]

Despite the effective date rules contained in the proposed regulations, the Preamble appears to add an additional set of effective date rules. Albeit presumably not binding, these rules are troubling as indicators of the IRS's position. The Preamble states that:

With respect to NPCs that provide for contingent nonperiodic payments and that are in effect or entered into on or after 30 days after the date of publication of these proposed regulations in the Federal Register, if a taxpayer has not adopted a method of accounting for these NPCs, the taxpayer must adopt a method that takes contingent nonperiodic payments into account over the life of the contract under a reasonable amortization method, which may be, but need not be, a method that satisfies the specific rules in these proposed regulations. If a taxpayer has adopted a method of accounting for these NPCs, the Commissioner generally will not require a change in the accounting method earlier than the first year ending on or after 30 days after the date of publication of the final regulations in the Federal Register.[44]

If a taxpayer had not yet adopted a method of accounting with respect to NPCs that provide for contingent nonperiodic payments, the taxpayer apparently had to do so before March 27, 2004. The method does not have to be either the noncontingent swap method or the mark-to-market method but, at least in the view of the IRS, cannot be the wait-and-see method. If a taxpayer has adopted a method of accounting, the method is "grandfathered" to the date that is 30 days after issuance of final regulations. If the method is not sanctioned by the final regulations, a change in accounting method under Code Sec. 481 will apparently be required. The timing surrounding the adoption of a method of accounting with respect to NPCs that provide for a contingent nonperiodic payment is the source of much of the controversy surrounding the effective date rules. Generally, a taxpayer adopts a proper method of accounting by filing a tax return using the method and adopts a method deemed "improper" by filing at least two tax returns using that method.[45] Because the IRS has rejected the wait-and-see method as a proper method of accounting, and therefore rejected the accounting method used by many taxpayers for NPCs with contingent nonperiodic payments, a taxpayer using the wait-and-see method would appear to have had to file two tax returns to establish a method of accounting that is grandfathered under the Preamble. Further, this

adoption apparently had to take place on or before March 26, 2004, the date that is 30 days after the publication of the proposed regulations. Making the rather safe assumptions that most taxpayers have used the wait-and-see method and had not filed their 2003 return by March 26, 2004, the IRS appears to indicate that for an improper method, which it considers the wait-and-see method to be, taxpayers that had not reported according to the wait-and-see method until after the 2001 tax year are not protected.

Effects of the Proposed Regulations on Tax-Exempt Investors and Non-U.S. Taxpayers

Tax-exempt investors are subject to federal income tax on unrelated trade or business taxable income by Code Sec. 511. However, Code Sec. 512(b) excludes from such tax investment income, such as interest and dividends. Reg. §1.512(b)(1)(a) also excludes “income from notional principal contracts (as defined in Treasury Regulations 26 CFR 1.863-7 or regulations issued under section 446).” However, if the investment asset is leveraged through debt incurred to acquire the asset, except in certain limited situations involving leveraged real estate, a portion of the otherwise exempt investment income will constitute “debt financed income” and be subject to income tax.[46] Thus, unless the IRS makes an exception, if a tax-exempt entity enters into a CNPC in which a debt is imputed because there is a significant nonperiodic payment, then, if the tax-exempt entity is the deemed debtor, it will have debt-financed income subject to income tax. Note that this is true even if the tax-exempt entity makes the mark-to-market election. To protect against this risk, tax-exempt investors would need to invest in CNPCs through offshore entities taxable as corporations for federal income tax purposes, an additional expense that might otherwise not be incurred. [47]

Many NPCs are entered into with a non-U.S. counterparty. For the last dozen or so years, withholding on payments under an NPC made to non-U.S. counterparties has not been an issue because Treasury Regulations have provided that the source of NPC income is determined by reference to the residence of the taxpayer.[48] Thus, payments to non-U.S. counterparties were sourced outside the United States and therefore not subject to withholding taxes. However, under the proposed regulations, if a CNPC has a significant nonperiodic payment, the CNPC is bifurcated into another NPC and a loan, which is accounted for separately. For the interest payments under such a CNPC to qualify for the portfolio interest exemption[49] for payments to non-U.S. persons, the instrument under which the interest is paid generally must be in registered form.[50] An instrument is in registered form if the holder can only transfer his rights as to the issuer by one or both of the following methods: (1) surrender of the old instrument to the issuer and reissuance of the instrument by the issuer to the new holder or (2) transfer by means of a book entry system maintained by the issuer in which ownership is recorded in the issuer’s records.[51] It is doubtful that the typical CNPC agreement derived from the International Swap Dealers Association standard form agreement will be in registered form. Thus, U.S. persons entering into an NPC that might have a significant nonperiodic payment should consider either only entering into one with a U.S. person or modifying the NPC agreement to make it a registered obligation. Likewise, non-U.S. persons would only want to have non-U.S. counterparties or similarly modify the agreement. The U.S. counterparty in a cross-border NPC should also always obtain a properly completed Form W-8BEN or Form W-8EIC to avoid withholding tax requirements. Many hedge funds have non-U.S. investors. To avoid requiring the non-U.S. investors to file U.S. income tax returns, it is important that the fund not be considered engaged in a U.S. trade or business and that the non-U.S. investor not receive any income effectively connected with a U.S. trade or business. Similar issues arise as to hedge funds organized as offshore corporations that invest in the United States. One concern of these funds is that they do not want to be considered to be conducting a U.S. lending business, which would generate effectively connected income. Under the proposed regulations, the writing of a CNPC with a significant nonperiodic payment may constitute the making of a loan.[52] Although a deemed loan should not cause a fund to be considered engaged in a lending business, conservative fund managers may want to use only fully periodic NPCs or bullet swaps.

Possible Alternative Strategies

Cash Settled Forward Contracts and Bullet Swaps

As noted above, cash settled forward contracts and bullet swaps are not subject to the proposed regulations.[53] The advantages of this treatment include the avoidance of the complications of the noncontingent swap method. The bullet swap may be structured so that the economics remain the same as a CNPC, or nearly so. For noncorporate holders, a cash settled forward contract or bullet swap also offers the advantages of avoiding the deduction limitations of Code Sec. 212 for NPC periodic and nonperiodic payments, and characterizing the income at maturity as capital gain if the underlying asset is a capital asset. There is no imputed interest income or expense, and taxes on income are delayed until the final payment or disposition. Disadvantages include the obvious loss of current deductions and, from the receiver's viewpoint, the attendant loss of earlier liquidity and increased counterparty credit risk with respect to these deferred payments. For taxpayers not subject to deductibility limitations, the deduction of periodic payments as a loss is eliminated, and, if the transaction results in a capital loss, the capital loss will be increased by the otherwise deductible periodic payments deferred to maturity or disposition.

Electing Mark-to-Market

The proposed regulations would allow a taxpayer to elect to account for income and losses on many CNPCs using the mark-to- market method. This has the advantage of allowing taxpayers that otherwise mark-to-market for financial reporting purposes to use the same method for income taxes, although the imputed interest rules for significant nonperiodic payments will still need to be applied and may continue to cause book-tax differences. Even if the imputed interest rules do apply, at least the complicated noncontingent swap method is avoided. However, electing the mark-to-market method has significant disadvantages or limitations. There can be substantial swings, up and down, in income or loss reported year to year, and taxpayers can experience negative tax arbitrage because losses are subject to the two percent of adjusted gross income limitation on miscellaneous deductions. Additionally, the income will not be deferred and will typically be noncash income. For taxpayers not marking-to-market for other purposes, obtaining reliable and supportable information may be difficult. Finally, as noted above, not all CNPCs are eligible to be accounted for under the mark-to- market method.

Use Only NPCs with Periodic Payments

Taxpayers can avoid the complications of the proposed regulations by using only NPCs that have periodic payments of one year or less, which NPCs are subject to the 1993 Regulations. Note that if any contingent periodic payment is payable with respect to a period crossing the taxpayer's year end, then under the 1993 Regulations an estimate of the accrued income or loss at the end of the year is probably still required.[54] However, except for year-end accruals, cash and income should match annually, and imputed interest would not need to be computed. Unfortunately, the benefits of long-term capital gains from receipt of contingent nonperiodic payments, to the extent available under other methods, is almost eliminated. Finally, the deferral of income on the maturity payment is lost.

Example. The following example illustrates the application of the nonadjusted noncontingent swap method, the mark-to-market method, the noncontingent swap method and the wait-and-see method to a five-year total return swap. The relevant assumptions are set forth below. The "Stock Value" is the value of the referenced stock at the end of the applicable year, the "Forward Value" is the forward contract price for the stock at the end of the applicable year, and the "Forward Payment" is the projected contingent backend payment based on the $50 million notional amount and the assumed Forward Value for the applicable year. Each periodic payment is the product of assumed LIBOR, at 2.5 percent, and a $50 million notional amount.

Nonadjusted Noncontingent Swap Method

Under the nonadjusted noncontingent swap method, the level payment is equal to an amount payable annually such that the sum of each annual payment plus interest accrued on a compounded basis produces a future value at the end of the five-year term of $7.5 million, which is the projected Forward Payment at the start of the CNPC. Under the proposed regulations, no interest is taken into account for the first year.[55]

Mark-to-Market

Noncontingent Swap Method Under Proposed Regulations

The Year 1 level payment is the same as in the nonadjusted noncontingent swap method. However, in Year 2 the level payment must be recomputed assuming the projected back-end payment will be $9.5 million. Thus the accrued interest for Year 2 is determined assuming the Year 2 level payment of $1,789,368 had been made in Year 1 and is equal to three percent of $1,789,368. In addition, there is a level payment adjustment of $376,709, which is equal to the excess of the Year 2 computed level payment that is deemed to "should" have been made in Year 1 but was not over the actual Year 1 level payment of $1,412,659. In Year 3 the level payment is again recomputed assuming the projected back-end payment will be $25 million. The accrued interest is based upon the new level payment of $4,708,864 and includes compound interest. The level payment adjustment of $5,838,992 is the excess of two years of assumed level payments of $4,708,864 over the assumed level payments in Year 1 ($1,412,659) and Year 2 ($1,789,368) and the level payment adjustment in Year 2 ($376,709). The interest adjustment for Year 3 is equal to the additional interest over that actually accrued in Year 2 assuming that the prior level payments had been $4,708,864. Similar adjustments are made for Year 4 and Year 5. Also in Year 5 there is an additional adjustment of $1,499,998 equal to the final actual back-end payment of $32.5 million over the sum of all prior level payments, accrued interest, level payment adjustments and interest payment adjustments.

A graph of the cumulative income (including interest) reported under these methods and under the wait-and-see method and the actual cash flow is shown in Chart 2. Note that the actual cash and wait-and-see method are numerically identical. Thus the wait-and-see method is comparable to the installment method under Code Sec. 453: You pay tax when you get the money. It makes you wonder why the IRS is demanding these other more complicated methods. Under the assumptions in this example, the mark-to-market method accelerates income the most. The noncontingent swap method tends to trail the mark-to- market and tends to even out the accruals of income.

Conclusion

The proposed regulations, if finalized, will add significant complexity to the tax accounting for CNPCs. Even if the mark-to-market method is elected, the requirement to accrue interest with respect to significant nonperiodic payments tends to add substantial complexity for little actual effect to income reported. One can expect that in applying the noncontingent swap method taxpayers will be aggressive in their valuations and considerable effort will be expended by the IRS in finding and auditing these issues. Finally, the elimination of the wait-and-see method and the characterization of all non-termination NPC payments as ordinary are quite significant. Taxpayers may run for the cover of options, forwards and bullet swaps. Although, the IRS may decide to change the accounting for latter two also. Then taxpayers may be left only with options, the accounting for which is generally governed statutorily pursuant to Code Secs. 1234 and 1234A.

CHART 2:

Chart 2 (Continued):

Chart 3:

[1] *See* Code Sec. 475.

[2] Reg. §1.446-3(d) and (e).

[3] Reg. §1.451-1(a).

[4] *See* note 2, *supra.* For a detailed discussion of Notice 2001-44, *see* Robert A. Jacobs, *NYSBA Sends Report on Accounting Methods for Contingent Nonperiodic Payments,* 2001 TNT 221-39, Nov. 14, 2001. *See also* Mark S. Perwien and Robert Pickel, *ISDA Forwards Derivatives News Release to Treasury,* 2003 TNT 70-43, Mar. 19, 2003; and David P. Hariton, *Confusion About the Treatment of Contingent Swaps,* J. Tax'n Fin. Products, Summer 2002, at 53.

[5] Interestingly, under the proposed regulations no mark-to-market is made if and when an NPC is terminated.

[6] The level payment method is found in Reg. §1.446-3(f)(2)(iii)(A)–(B).

[7] Proposed Reg. §1.446-3(g)(6)(ii) set forth in Notice of Proposed Rulemaking, REG-166012-02, IRB 2004-13, 655.

[8] Proposed Reg. §1.446-3(g)(iv)(B).

[9] Proposed Reg. §1.446-3(g)(6)(iii)(A)–(C).

[10] Proposed Reg. §1.446-3(g)(6)(iii)(A).

[11] Proposed Reg. §1.446-3(g)(6)(iii)(B).

[12] Proposed Reg. §1.446-3(c)(5)(i). The IRS has requested comments regarding whether the risk-free interest rate is the appropriate rate to use.

[13] Proposed Reg. §1.446-3(g)(6)(iii)(C).

[14] Reg. §1.446-3(f)(2)(iii)(A) and (B).

[15] *See* discussion accompanying note 20, *supra*.

[16] The projected amount must also be redetermined on each special redetermination date, the date on which a contingent nonperiodic payment is fixed if such date is more than six months before the payment is due and the payment is fixed in a different tax year from the date the payment is due.

[17] Proposed Reg. §1.446-3(g)(6)(vi).

[18] Proposed Reg. §1.446-3(i)(2).

[19] Proposed Reg. §1.446-3(i)(2)(i). The NPC must be "actively traded" within the meaning of Reg. §1.1092(d)-(1)(c) (determined without regard to the limitation in Reg. §1.1092(d)-1(c)(2)).

[20] "Established financial market" is defined in Reg. §1.1092(d)-1(b)(1).

[21] Proposed Reg. §1.446-3(i)(3)(i). "Recent price quotations" is described in Reg. §1.1092(d)-1(b)(2).

[22] Proposed Reg. §1.446-3(i)(2)(ii). The additional requirements currently have a placeholder at Proposed Reg. §1.446-3(i)(4).

[23] Proposed Reg. §1.446-3(i)(3)(ii).

[24] Proposed Reg. §1.446-3(i)(2)(iii); the dealer must be subject to Code Sec. 475.

[25] The fair market value is the value that was used by the counterparty for purposes of Code Sec. 475(a)(2).

[26] Proposed Reg. §1.446-3(i)(3)(iii).

[27] Proposed Reg. §1.446-3(i)(3)(iv).

[28] Proposed Reg. §1.446-3(i)(1).

[29] *Id.*

[30] Proposed Reg. §1.446-3(i)(5). In the Preamble, the IRS requested comments on the appropriateness of requiring taxpayers to compute interest amounts for significant nonperiodic payments if the mark-to-market method is elected. Notice of Proposed Rulemaking, REG-166012-02, IRB 2004-13, at 658.

[31] Notice of Proposed Rulemaking, REG-166012-02, IRB 2004-13, at 659.

[32] Proposed Reg. §1.446-3(i)(5)(ii).

[33] Proposed Reg. §1.446-3(i)(6).

[34] The fact that the final payment under a total return swap is being made in connection with the lapse, expiration or termination of the NPC provided a basis upon which to conclude that Code Sec. 1234A would apply to a nonperiodic payment being made upon maturity of an NPC. Code Sec. 1234A provides that any payment attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to property that is (or on acquisition would be) a capital asset in the hands of the taxpayer is to be characterized as capital gain or loss.

[35] Proposed Reg. §1.162-30.

[36] Proposed Reg. §1.212-1(q).

[37] Proposed Reg. §1.1234A-1(a).

[38] Proposed Reg. §1.1234A-1(b).

[39] Proposed Reg. §1.1234A-1(c)(1).

[40] Proposed Reg. §1.1234A-1(c)(2).

[41] Lewis R. Steinberg, *NYSBA Seeks Immediate Guidance on Proposed Regs on Notional Principal Contracts*, 2004 TNT 67-28, Mar. 15, 2004; Thomas Prevost, *ISDA Comments On Proposed Regs Affecting Notional Principal Contracts*, 2004 TNT 62-34, Mar. 19, 2004; Mark H. Leeds, *Deutsche Bank Seeks Clarification of Proposed Regs Affecting Notional Principal Contracts*, 2004 TNT 57-32, Mar. 2, 2004; David C. Garlock, *The Proposed Notional Principal Contract Regulations: What's Fixed? What's Still Broken?* 2004 TNT 56-26, Mar. 12, 2004; Lee A. Sheppard, *News Analysis: Method in the Madness of the Contingent Swap Rules*, 2004 TNT 76-8, Apr. 19, 2004; Gina Biondo and Allison Rosier, *The Effect of the Proposed Swap Regulations on the Hedge Fund Industry: Goodbye to Total Return Swaps?* 2004 TNT 106-31, May 17, 2004; Stevie D. Conlon, *New Proposed Regulations for Contingent Swaps Add Layers of Complexity*, 101 J. Tax'n 5 (July 2004).

[42] Proposed Reg. §1.446-3(j)(2) (emphasis added).

[43] Proposed Reg. §1.446-3(j)(1).

[44] Notice of Proposed Rulemaking, REG-166012-02, IRB 2004-13, at 660.

[45] *See* §2.01(2) of Rev. Proc. 97-27, 1997-1 CB 680, *modified* by Rev. Proc. 2002-19, 2002-1 CB 696.

[46] Code Sec. 514.

[47] The distributions from the offshore corporation would be dividends, return of capital or capital gains, all excluded from unrelated business taxable income.

[48] Reg. §1.863-7(b).

[49] Code Sec. 871(h).

[50] Code Sec. 871(h)(2); Code Sec. 163(f)(1); Temporary Reg. §5f.163-1(a).

[51] Temporary Reg. §5f.103-1(c).

[52] *See* Gina M. Biondo, *Why the Origination of Loans by Foreign Distressed Debt Funds Should Not be Subject to U.S. Tax*, J. Tax'n Fin. Products, Spring 2003, at 37.

[53] These contracts do not involve multiple payments of the type described in Reg. §1.446-3(c)(1)(i) and, as such, are not NPCs subject to the accrual principles of Reg. §1.446-3.

[54] Reg. §1.446-3(e)(2)(ii).

[55] Proposed Reg. §1.446-3(g)(7), Example 6(vii).

[1] The preamble to the 1993 NPC regulations contains the following language: "The final regulations do not include any examples of how to treat nonperiodic payments that are not fixed in amount at the inception of the contract. The IRS expects to address contingent payments in future regulations." T.D. 8491, 1993-2 CB 215, 216.

[2] Notice 2001-44, 2001-2 CB 77.

[3] Reg. §1.446-3(c)(1)(i).

[4] *Id.* A Code Sec. 1256(b) contract, a futures contract, a forward contract, an option and an instrument that is debt for federal income tax purposes are not NPCs. Reg. §1.446-3(c)(1)(ii).

[5] Reg. §1.446-3(c)(2).

[6] Reg. §1.446-3(c)(3).

[7] Reg. §1.446-3(e)(1).

[8] Reg. §1.446-3(h)(1).

[9] Reg. §1.446-3(f)(1).

[10] Proposed Reg. §1.446-3(g)(6)(i)(A)–(E).

[11] For a detailed discussion of the tax issues associated with credit default swaps, *see* David S. Miller, *Credit Derivatives: Financial Instrument or Insurance? And Why it Matters,* J. Tax'n Fin. Products, Winter 2002, at 31. *See also* Thomas Prevost, *ISDA Offers Treasury Documents on Treatment of Credit Default Swaps,* 2003 TNT 232-17, Nov. 21, 2003.

[12] A put premium is not deductible until it lapses or, if exercised, reduces the amount realized from the sale of referenced asset. Rev. Rul. 71-521, 1971-2 CB 313; Rev. Rul. 78-182, 1978-1 CB 265.

[13] Notice 2004-52, IRB 2004-32, 168.

[14] *See* T.D. 8491, *supra* note 1.

[15] Reg. §1.446-3(d).

[16] Reg. §1.446-3(f)(2)(ii).

[17] Reg. §1.446-3(f)(2)(iii)(A).

[18] Reg. §1.446-3(f)(2)(iii)(B).

[19] Reg. §1.446-3(f)(iv) and (v).

[20] Reg. §1.446-3(g)(6), Examples 2 and 3.

[21] Reg. §1.446-3(f)(4), Example 5.