

ISDA North American Tax Committee

Comments on Swaps with Contingent Nonperiodic Payments
and
Proposed Treasury Regulations In Respect Thereof

Meeting with Representatives of Treasury Department
Washington, DC
February 8, 2005

Proposed Outline of Discussion

Most of the points outlined below are discussed in more detail in ISDA's comment letter of October 13, 2004 on the proposed regulations on swaps with contingent nonperiodic payments.

1. Description of Swaps Market

- a. Vast majority of swaps are not entered into to avoid tax
- b. Vast majority of nondealer swap counterparties are funds and institutions (relatively few individuals) that use swaps primarily to pursue leveraged trading strategies
- c. Swap positions of traders are both long and short, and are viewed as alternatives to physical positions or forward contracts or put/call option combinations. Thus, there is a strong economic neutrality rationale for taxing swaps in the same manner as either physical positions or forwards/options.
- d. General benefits of swaps for traders
 1. Implicit leverage not subject to Reg T limitations (which is 50% maximum leverage) so higher leverage possible
 2. Lower funding rates available with bank swap counterparties
 3. Master netting agreements with dealer counterparties for easier cash flow management and minimization of collateral requirements
 4. Netting of bilateral payment obligations eliminates risk of unilateral stay of payment obligation in case of counterparty bankruptcy
- e. Periodic LIBOR-based payments: swap dealers prefer swaps over forward contracts to minimize counterparty credit exposures (or reduce need for collateral)
- f. Contingent nonperiodic payments: traders prefer a single contingent nonperiodic payment (for the change in value of the underlying property)
 1. Primarily because overall cash flows on a swap portfolio are more predictable and manageable in this manner, as most of the periodic cash

flows are tied to LIBOR. Single contingent payments at maturity help traders control interest rate risk related to periodic cash receipts and payments.

2. Efficient cash flow management is important for swap counterparties that are funds, because they must be ready to redeem investors on a regular basis
3. Traders also use swaps as hedge or arbitrage with physical positions, so use of contingent nonperiodic payments permit them to match timing and character of cash flows with dispositions of physical positions

g. Although there may be abusive swap transactions, they are not commonplace

1. Swaps such as those described in Revenue Ruling 2002-30 and Notice 2002-35 are the anomalies – not the norm -- and represent a very small fraction of the total notional amounts involved in the swap markets
2. None of the Committee members has ever participated in swaps such as those described in the Ruling or the Notice

2. Anti-Abuse Concerns

a. The Committee members agree that the bifurcation approach to taxing the swap described in Revenue Ruling 2002-30 is appropriate

1. The analysis in the Ruling focused on the fact that the nonperiodic payment in the swap included an explicitly noncontingent component and a contingent component (the sum of both could be zero)
2. The economics of that same swap could be replicated with a wholly contingent nonperiodic payment
 - a. The nonperiodic payment could have been made equal to the ending value (not change in value) of an initial \$8,000,000 notional amount reference to the index, plus \$280,000
 - b. In this case, one could argue that the entire nonperiodic payment (except for \$280,000) is contingent, and it is unclear that the Ruling would apply to such a swap
3. Economically, if the counterparty under the swap described above (or the swap described in the Ruling) is permitted to deduct the LIBOR-based payments as periodic payments under the current swap regulations, it is effectively deducting not only amounts economically equivalent to interest (which we view as appropriate) but also amounts economically equivalent to principal (which is inappropriate)

4. The IRS attacked the swap in the Ruling by concluding that the noncontingent component of the nonperiodic payment had to be accrued over the life of the swap. But this approach is difficult to apply to a wholly contingent nonperiodic payment, such as one tied to the ending value (not change in value) of a notional investment in the referenced property or index.

b. ISDA supports the promulgation of more specific anti-abuse rules for swaps

1. IRS does not need the proposed contingent swap regulations to prevent such abusive swaps
2. The Ruling, the Notice, and the recent Coordinated Issue Paper demonstrate the authority and ability of the IRS to attack abusive swap transactions
3. A more specific anti-abuse rule would also assist the IRS in preventing abusive swap transactions
4. An approach that ISDA recommends is to deny current deductions to the extent that any portion of periodic swap payments that economically represents an actual principal investment (not a purely notional investment), and apply current rules to the interest-equivalent amounts

3. Technical Issues with Proposed Regulations

- a. Forward pricing: the proposed noncontingent swap method is based on forward pricing principles, which suffers from several flaws.
 1. Forward pricing principles are based on the “no arbitrage” assumption and do not predict future stock prices
 2. Moreover, it cannot be applied to very large segments of the swaps markets, such as credit default swaps and any other swaps where both the timing and the amount of the nonperiodic payment are indeterminable
- b. The paradigm: the noncontingent bond method of the contingent payment debt instrument (“CPDI”) regulations appear to be the paradigm for the noncontingent swap method
 1. But swaps are not economically equivalent to CPDIs. CPDIs promise to repay principal, whereas commercially standard total return swaps provide no promise to pay any amount in respect of the contingent payment
 2. In fact, it is indeterminable in which direction the contingent nonperiodic payment will be made (the long counterparty may have to make, rather than receive, the nonperiodic contingent payment)

3. ISDA believes that the appropriate economic paradigm for taxing total return swaps is a leveraged investment in the referenced property or index
4. Thus, the question remains as to why the unpredictable change in value of the referenced property or index under a swap should be taxed any differently than the change in value of such property directly held (given the contingencies are identical)? The IRS has never proposed accelerating the taxation of leveraged stock ownership (other than in the context of a theoretical broad overhaul of the tax system by applying mark to market treatment for all financial products).

c. Imputed loan and interest

1. Current rules for imputing a loan and interest when a swap contains a noncontingent, nonperiodic payment are economically accurate, because upfront or backend nonperiodic *fixed payments* under a swap economically constitute lending transactions
2. But that rationale does not exist for treating the long counterparty under a total return swap as the “lender” under the noncontingent swap method. In fact, the economic reality is precisely the reverse, since the long counterparty is making periodic payments that are economically equivalent to interest
3. The imputed loan and interest raise numerous ancillary tax issues, such as UBIT, interest allocations for foreign tax credit purposes, interest deductions under Treas. Reg. § 1.882-5, and deemed dividends under section 956

d. Annual rejections and recapture of prior amounts

1. Nondealer swap counterparties will expect their dealers to provide the information needed to comply with the proposed noncontingent swap method
2. Major swaps dealers enter into numerous swaps daily. It will be prohibitively expensive to create systems to reproject and recalculate the deemed payments on a daily basis for customers. This calculation contradicts the new rules for reporting of swap payments under the information reporting regulations, based solely on cash payments, which were costly to implement.
3. The practical effect will be to shut down most of the market for total return swaps as currently structured. The market will switch to forwards (or “bullet swaps”), but ISDA does not see any compelling reason for a *de facto* tax prohibition on current forms of total return swaps.
4. Note that as a technical matter, the annual rejections and recapture method described in the proposed regulations will not eliminate the

“character” conversion that appears to concern the IRS, and may in fact exacerbate such conversion (see Appendix)

5. In addition, swap counterparties can reverse their deemed lender and borrower tax treatment under the proposed noncontingent swap method, which will raise, among other issues, UBTI concerns for tax-exempts

e. Character of contingent nonperiodic payment

1. Concerns over the character of contingent nonperiodic payments appear to be the rationale behind the required annual rejections, recalculations and recapture of prior amounts under the noncontingent swap method
2. The IRS appears to view all “scheduled payments” under a swap as ordinary in character (even a contingent payment referencing the change in value of property that would be a capital asset in the long counterparty’s hands), and appears to view section 1234A’s capital treatment for gain or loss as applying only to “unscheduled” terminations, etc., of swaps referencing capital assets
3. The annual reprojection requirement attempts to minimize this inconsistency in character treatment, by attempting to adjust tax basis on an annual basis under an inaccurate, quasi-mark to market method (which, as noted in the Appendix, will not eliminate the “character” conversion that appears to concern the IRS, and may in fact exacerbate such conversion)
4. ISDA believes that section 1234A provides authority for treating scheduled “terminating” contingent payments as capital in character, which would eliminate the potential character whipsaw arising from the IRS’s current view. Section 1234A could apply to scheduled terminating payments under a swap based on:
 - a. Plain language of statute. The term “termination” as used therein is not limited to early or unscheduled termination, and “lapse” and “expiration” are both included in the statute – both of which are “scheduled” terminations of the contract
 - b. Also, section 1234A excludes from its scope a “retirement” of a debt instrument, which indicates that scheduled retirements generally are within its scope (otherwise excluding debt retirements would be superfluous)
 - c. Legislative history. In 1997, Congress expanded scope of section 1234A to apply to all property, which indicates it was intended to prohibit investors from whipsawing the IRS, and supports applying the statute broadly to carry out this purpose

- f. Thus, the proposed noncontingent swap method violates the guiding principles of tax rule-making (as enunciated in Notice 2001-44)

1. Economic accuracy: there is no economically equivalent loan being made by the long counterparty, and the annual reprojections do not track the actual changes in the value of the contingent payment
2. Neutrality: no other financial instrument or transaction is taxed in the manner of the proposed noncontingent swap method
3. Clarity: unclear how to apply the noncontingent swap method to swaps with contingent payments where timing of payment is indeterminable
4. Administrability: taxpayers, including swaps dealers represented by Committee members, cannot implement the method without incurring prohibitively high expenses (generally not affordable with the competitively thin spreads earned by swap dealers)

4. ISDA's Recommendations

- a. Maintain current rules for taxation of swaps, but bolster anti-abuse rules as discussed above
- b. If current rules must be amended, then we strongly urge that the proposed noncontingent swap method not be adopted at all for the reasons given above
- c. Instead, ISDA advocates that the "full allocation" method described in Notice 2001-44 (also known as the "open transaction" method, which currently applies to options and forwards) should apply to:
 1. Swaps with terms greater than 5 years, and
 2. Any abusive swaps, such as the one described in Revenue Ruling 2002-30 (which would have been prevented by the use of the full allocation method)
- d. However, the "wait-and-see" method should continue for swaps with contingent payments whose timing is indeterminable (such as credit default swaps)
- e. If the current rules are amended, taxpayers should be permitted to elect to mark to market their swaps along with any positions that hedge, or are hedged by, (in the general sense) such swaps. Separate elections should be permitted for those swaps that are subject to the full allocation method as a class and those that are not.
- f. Contingent nonperiodic payments should not be treated as significant nonperiodic payments for purposes of the deemed loan and interest rules currently applicable to significant nonperiodic payment that are not contingent
- g. Section 1234A should apply to all contingent payments under swaps that reference capital assets, regardless of whether such payments are periodic or nonperiodic (except to the extent a special rule provides otherwise, such as section 475 or Treasury regulation section 1.1221-2)

APPENDIX

The illustration below is based on the example provided in the proposed noncontingent swap method regulations: a 3-year total return equity swap on a notional amount of \$50,000,000 with annual LIBOR-based payments and a single contingent payment due at maturity. This illustration examines the tax consequences under the proposed regulations if the swap were terminated at the end of year 2, based on two different stock price movement scenarios (but with the same ending stock price in both scenarios).

- a. With a 10% risk-free rate, the amortization schedule would be as follows:

Year	Principal	Interest
1	\$5,000,000	\$0
2	\$5,000,000	\$500,000
3	\$5,000,000	\$1,050,000
Total	\$15,000,000	\$1,550,000

- b. At start of year 2, the risk-free rate is 10.5% (compared to 10% at swap's inception). Also, the value of the reference equity is now \$60,000,000 (compared to \$50,000,000 at swap's inception).
- c. The new amortization schedule would be as follows:

Year	Principal	Interest
1	\$6,993,784	\$0
2	\$6,993,784	\$734,347
3	\$6,993,784	\$1,545,801
Total	\$20,981,352	\$2,280,148

- d. The projected payment amount is \$23,261,500, which equals \$60,000,000 (the current value of the underlying stock at start of year 2) compounded at 10.5% for two years, minus the \$50,000,000 notional amount
- e. Note that amortizing this projected amount over the three-year term of the swap and recapturing prior year amounts over the following year lead to an adjusted tax basis that does not reflect or even approximate the change in value of the underlying stock

- f. If the swap were terminated at the end of year 2 and the notional value of stock at that point equals \$55,000,000, the long counterparty would receive a payment of \$5,000,000 (the appreciation of the underlying stock above \$50,000,000), but the counterparty's tax basis in that payment would be \$13,987,568 (taken into account as ordinary income by the long counterparty). The long counterparty would have a capital loss of \$8,987,568.
- g. In this case, the reprojection and recapture requirements **create capital loss (or reduce capital gain) by increasing ordinary income**, as compared to the current rules
- h. Alternative scenario: Instead of above, at start of year 2, the risk-free rate falls to 10% from 10.5%. Also, the value of the reference equity declines to \$40,000,000.
- i. The new amortization schedule would be as follows:

Year	Principal	Interest
1	\$483,384	\$0
2	\$483,384	\$48,338
3	\$483,384	\$101,510
Total	\$1,450,152	\$149,848

- j. The projected payment amount is a **negative** \$1,600,000 – that is, a projected payment from the long counterparty to the short counterparty – which is \$40,000,000 (the current value of the underlying stock at start of year 2) compounded at 10% for two years, minus the \$50,000,000 notional amount
- k. Note that amortizing this projected amount over the three-year term of the swap and recapturing prior year amounts over the following year lead to an adjusted tax basis that does not reflect or even approximate the change in value of the underlying stock. Note also that the deemed borrower and lender have reversed. The long counterparty is now the deemed borrower and the short counterparty is the deemed lender.
- l. If the swap were terminated at the end of year 2 and the notional value of stock at that point equals \$55,000,000, the long counterparty would receive a payment of \$5,000,000 (the appreciation of the underlying stock above \$50,000,000), but the long counterparty would have deducted already \$5,966,768 against ordinary income (recapture of \$5,000,000 under the prior year's amortization schedule, plus \$966,768). The long counterparty would presumably have long-term capital gain of \$10,966,768.
- m. In this case, the reprojection and recapture requirements **increase capital gain by creating ordinary deductions**, as compared to the current rules