

ISDA

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April 27, 2004

Ms. Viva Hammer
Attorney Advisor
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Proposed Regulations Regarding Notional Principal Contracts with Contingent
Nonperiodic Payments – Effective Date Issues

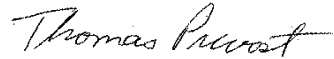
Dear Ms. Hammer:

On behalf of the members of the North American Tax Committee of the International Swaps and Derivatives Association, I would like to thank you for arranging our meeting on April 8, 2004 to discuss the effective date issues raised by certain statements in the preamble to the proposed regulations on the tax treatment of notional principal contracts with contingent payments (REG-166012-02), and thank you and each of your colleagues who attended the meeting for taking the time to meet with us. Our discussion at the meeting touched upon quite a few issues, and we thought that it may be helpful to provide you and your colleagues with the enclosed outline that summarizes the points that we made. One point that we would like to reiterate is that we would be very grateful if clarification on the effective date issues were provided as soon as possible, given the confusion that the preamble language is causing in the market.

We sincerely welcome the opportunity to discuss further any of the points summarized in the outline or provide you and your colleagues with any additional information that would assist you in addressing the issues we discussed. If you or your

colleagues have any questions, please feel free to contact me at 212-325-7486 or our tax counsel, David Nirenberg, at 212-506-5085.

Very truly yours,

A handwritten signature in cursive script that reads "Thomas Prevost".

Thomas Prevost
Chair, North American Tax Committee

cc: Helen M. Hubbard, Tax Legislative Counsel, Department of Treasury
Michael S. Novey, Associate Tax Legislative Counsel, Department of Treasury
Dale Collinson, Special Counsel to the Associate Chief Counsel, Financial
Institutions & Products
Kathleen Sleeth, Assistant to Branch Chief, Internal Revenue Service, Branch 1
Clay Littlefield, Office of Associate Chief Counsel, Internal Revenue Service
Andrew Froberg, Attorney Advisor, Department of Treasury

OUTLINE OF ISDA'S POINTS DISCUSSED IN MEETING WITH TREASURY AND
IRS ON APRIL 8, 2004 REGARDING EFFECTIVE DATE ISSUES FOR PROPOSED
CONTINGENT SWAP REGULATIONS

- I. **Background: Prior to the publication of the proposed regulations on notional principal contracts with contingent nonperiodic payments (“CNPCs”), most if not all nondealer taxpayers accounted for such payments under the “wait-and-see” method of accounting.**
- II. **The preamble to the proposed regulations creates uncertainty for CNPCs entered into prior to the effective date of the final regulations.**
 - A. The proposed regulations state that the final regulations will be effective for CNPCs entered into on or after the date that is 30 days after the final regulations are published.
 - B. Certain statements in the preamble cast doubt as to whether “wait-and-see” is an acceptable method of accounting for CNPCs prior to the effective date of the final regulations.
 - C. Moreover, the preamble states that taxpayers who have not already established a method of accounting (e.g., newly established securitization vehicles) for new and existing CNPCs must take contingent nonperiodic payments into account over the life of the contract under a “reasonable amortization method.”
 1. Depending on whether or not “wait-and-see” is currently a permissible method of accounting, taxpayers may have to amend their treatment of CNPCs for both 2002 and 2003.
 2. As set forth below in greater detail, the proposed regulations leave many unanswered questions as to what is a “reasonable amortization method” and, accordingly, how CNPCs should be treated prior to the effective date of the final regulations.
 - D. The preamble states that, for taxpayers who have established a method of accounting, the Commissioner generally will not require a change in the accounting method earlier than the first year ending on or after the effective date of the final regulations.
 1. Although it implies that a change in accounting method will generally be required, the preamble does not explicitly state that the Commissioner will in fact require a change of accounting method for existing CNPCs — only that if one is required, such a change will not be imposed until after the regulations become final.

2. If a change in accounting for existing CNPCs is ultimately required by the Commissioner, the preamble does not indicate whether the required change will be a “cut-off” method (under which some pre-existing CNPCs will be permitted to continue to use “wait-and-see”) or a method requiring a section 481(a) adjustment for some or all pre-existing CNPCs.

III The “reasonable amortization method” stipulated in the preamble creates much uncertainty as to how CNPCs should be accounted for in this interim period.

- A. The preamble does not define what this method is or how it is to be applied.
 1. The preamble does not stipulate how the method should be applied where the timing and amounts of contingent payments are not known (such as in the case of credit default swaps or swaps with knock-out options or early termination provisions).
 2. It is unclear whether the reasonable amortization method requires annual rejections (as required by the proposed regulations).
 3. The character of the amortization amount is unclear.
 4. The preamble does not state whether a reasonable amortization method requires imputing a loan (and thus interest) in respect of the contingent nonperiodic payment being amortized. Imputing a loan raises many other ancillary issues and uncertainties, including:
 - a. withholding tax and information reporting;
 - b. UBIT;
 - c. interest allocation;
 - d. interest capitalization/disallowance under sections 263(g) and 265;
 - e. subpart F; and
 - f. investment in U.S. property under section 956.
- B. Uncertainty surrounding the treatment of CNPCs will adversely affect liquidity and share values of existing securitization vehicles as well as newly formed SPVs with CNPCs.

- C. Because the proposed regulations, if adopted in their current form, would raise many difficult and complex implementation issues for the derivatives industry, it seems likely that they will be modified to address taxpayer concerns as well as other issues. This uncertainty about the form that the final regulations will take adds to the current uncertainty about how to treat existing CNPCs as well as new CNPCs being entered into during this interim period.

IV. Conclusion: Since the proposed regulations represent a major departure from the current method of accounting for CNPCs and the preamble leaves many unanswered questions as to the treatment of CNPCs prior to the effective date of the final regulations, Treasury and the IRS should issue a notice clarifying that the final regulations will be prospective with certain limited exceptions. Without such guidance, existing segments of the financial markets that have been functioning efficiently to date, and that are not tax abusive, will be adversely affected.

- A. Contracts entered into prior to March 27, 2004 (the date that is 30 days after the February 26th publication date of the proposed regulations) should be fully grandfathered — that is, any reasonable method of accounting, including the “wait-and-see” approach, should be a permissible method of accounting for this purpose.
- B. Contracts entered into on or after March 27, 2004 but prior to the effective date of final regulations should be either:
 - 1. fully grandfathered, or, alternatively,
 - 2. (a) fully grandfathered (that is, allowed to use “wait-and-see”) to the extent they have an original term of 5 years or less; and

(b) grandfathered until the effective date of final regulations to the extent they have a term of more than 5 years. On or after the effective date of final regulations, such contracts should be accounted for under the method prescribed by the final regulations.
- C. The Commissioner should explicitly retain the right to challenge a taxpayer’s treatment of a CNPC where necessary to prevent abuse.