

ISDA

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The Honorable Pamela F. Olson
Assistant Secretary for Tax Policy
U.S. Department of the Treasury
Room 1334
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

September 26, 2003

Dear Ms. Olson:

Thank you for agreeing to meet with us this Tuesday, September 30, to discuss the taxation of notional principal contracts that provide for contingent payments (“contingent swaps”) and the various proposed alternatives to current practice that the Treasury and Internal Revenue Service (the “IRS”) are considering. In anticipation of that meeting, we have attached a discussion, with examples, of common, non-tax motivated, contingent swap transactions and how they would be adversely affected by certain of the proposed alternatives.

Under current market practice, noncontingent periodic payments are includable in, or deductible from, gross income as they accrue. Contingent nonperiodic payments are not includable in income or deductible until paid (or earlier if the contingency is resolved prior to payment).

In IRS Notice 2001-44, the Treasury and IRS announced that they were soliciting comments on the appropriate method for accounting for income and deductions on contingent swaps. The Notice indicates that the Treasury and IRS are currently considering four different methods of accruing income and deductions on contingent swaps, each of which is different from current practice. These methods are (1) the Noncontingent Swap Method, (2) the Full Allocation Method, (3) the Modified Full Allocation Method, and (4) the Mark-to Market Method.

In very general terms: (1) under the Noncontingent Swap Method, a contingent payment is required to be accrued into income over the life of the contingent swap by replacing the contingent payment with a hypothetical noncontingent payment, the amount of which is determined with reference to the cost of hedging the actual contingent payment, and then accruing income on the hypothetical noncontingent swap under a constant yield method; (2) under the Full Allocation Method, no income or deduction is taken into account on a contingent swap until the final contingency is resolved; (3) under the Modified Full Allocation Method, each year noncontingent payments made and received are netted, and any net positive number is included in income currently but net negative numbers do not give rise to an immediate deduction but are instead deferred until the final contingency is resolved; and (4) under the Mark-to-Market Method, contingent swaps are marked to market each year, and the built-in gain or loss is recognized at the end of the year. In addition, the New York State Bar Association Tax section has proposed a fifth method, the Modified Noncontingent Swap Method which is similar to the Full Allocation Method except that deviations in actual payments from projected payments would be currently includible or deductible.

As we have discussed in our prior letters (copies of which are attached) and in the attached discussion, ISDA believes that none of the proposed alternatives is satisfactory and that current practice better achieves the Treasury's and IRS's stated policy principles (certainty/clarity, administerability, neutrality, symmetry, economic accuracy and flexibility) better than any of the other methods.

From Notice 2001-44 and conversations with personnel at the Treasury and IRS, we have come to believe that the driving force behind the proposals is a desire to defer deductions on long positions in equity swaps so as to make their tax accounting more like that of forward contracts (rather than that of leveraged purchases of equity).¹ We note, however, that investors (and not merely dealers) enter into both short and long positions in equity swaps and other total return swaps, and any fair and balanced change in the contingent swap rules that has the effect of deferring deductions for some taxpayers will have the effect of deferring income inclusions for others. More importantly, regardless of the appropriateness of changing the accounting treatment for equity swaps, the proposals would apply to all contingent swaps, including fixed income derivatives such as debt total return swaps and credit default swaps. Although we do not have exact numbers, it is clear from recent market surveys that the market for these latter swaps is significantly larger and growing faster than the market for equity swaps.²

¹ In a traditional equity swap, (1) the long party pays periodically to the counterparty LIBOR and, at the termination of the swap, the amount of any decline in the value of the reference equity, and (2) the counterparty pays periodically to the long party any dividends on the reference equity, and at the termination of the swap, the amount of any increase in value of the reference equity.

² Our statistics do not precisely measure the relative sizes of the fixed income swap and equity swap markets. However, as of June 30, 2003, the amount of credit default swaps outstanding, which represents a substantial majority of, but significantly less than, the total outstanding amount of all contingent swaps referencing fixed income assets (other such swaps include total return debt swaps), was approximately \$2.69 trillion in notional principal amount and grew by 25% for the prior six months. By way of comparison, the total amount of *all* equity derivatives, including options and forward contracts, that are not taxed as notional principle contracts, in addition to equity swaps, is \$2.78 trillion and grew by only 14% in the same period. For more detailed statistics, please see our website at www.isda.org.

Thank you for agreeing to meet with us. We look forward to meeting with you this Tuesday.

Sincerely,

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

Tom Prevost
ISDA, North American Tax Committee Chair

**Current Law Clearly Reflects the Economics of
Each Counterparty to a Contingent Swap, and is Consistent with the
Tax Treatment of its Physical Equivalents.**

Current Uses of Total Return Swaps.

Investors (including taxpayers that are not dealers and that are not subject to the mark-to-market rules of section 475) enter into both long and short positions using Total Return Swaps (“TRSs”) to obtain long or short economic exposure to financial assets, or to alter the risk profile of their investments, in transactions that have no tax motivation.³ One inherent advantage that TRSs offer investors over traditional investments is greater ability to leverage returns. For example, an investor generally is permitted to borrow a maximum of 50% of the value of an equity security under a margin loan. Similarly, investors are required not only to pledge 100% of the proceeds of a physical short sale of an equity security with their broker-dealer, but also are required to pledge an additional 50% of the value of that short position on a daily basis. By contrast, both long and short positions under TRSs require collateral posted with the counterparty at levels substantially below the margin required for physical securities positions. In addition, “synthetic” leverage, that is, the economic leverage embedded in a TRS, often will provide cheaper funding to the investor as the counterparty, often a financial institution, passes on the benefit of its lower cost of funds in the form of a lower periodic rate on a TRS than the interest the investor would pay on actual acquisition indebtedness.

Notice 2001-44 appears to focus solely on the taxation of long TRS positions entered into by investors in respect of equity securities (often referred to as “equity swaps”), although equity swaps represent only a small portion of the contingent swap market.⁴ A substantial portion of the TRSs entered into by taxpayers are not in respect of equity securities, but rather, are on debt securities, where (as demonstrated in the examples below) concerns about inappropriate “deferral” of income under the current rules do not apply. Furthermore, a very substantial portion of TRSs on equity securities entered into by taxpayers represent derivative *short* positions on such securities. Any fair and balanced change in the contingent swap rules that has the effect of deferring deductions for some taxpayers (see Example 2, below) will have the effect of deferring income inclusions for others (see Example 1, below).

³ References to sections herein are to sections of the Internal Revenue Code of 1986.

⁴ Our statistics do not precisely measure the relative sizes of the contingent swap market as a whole and the equity swap market in particular. However, as of June 30, 2003, the amount of credit default swaps outstanding, which represents a substantial majority, but significantly less than the total outstanding amount, of all contingent swaps referencing fixed income assets (other such swaps include total return debt swaps), was approximately \$2.69 trillion in notional principal amount and grew by 25% for the prior six months. By comparison, the total amount of *all* equity derivatives, including options and forward contracts that are not taxed as notional principal contracts, in addition to equity swaps, was \$2.78 trillion and grew by only 14% in the same period. For more detailed statistics, please see our website at www.isda.org.

As discussed above, a large portion of the TRSs currently in the market are in respect of debt securities. For example, an investor may prefer to invest in a bank loan through a long position in a TRS (where it receives the total return on the loan) rather than acquire the loan directly, because, (1) while it wants the economic/investment exposure to the loan, it does not want (a) the responsibility for servicing the loan or, (b) where the loan is not yet fully funded, the obligation to fund future advances on the loan, or (2) simply to avoid the delay inherent in transferring title to a bank loan. (Bank loans generally require substantial paperwork in connection with their transfer and, in the case of a syndicated loan, may require consent of the lead bank.) Similarly, a bank that has originated a loan to a customer may wish to reduce its economic exposure to the customer (and diversify its risk) but may wish to maintain its business relationship with the customer. Rather than sell the loan, which would cause the transferee/investor to have privity with the borrower and establish a relationship with it, the bank enters into a short position in a TRS on the loan (where it *pays* the total return).

TRSs are also used by fixed income investors to acquire economic exposure to a particular borrower where the outstanding debt of the borrower has a maturity that is longer than the maturity permitted under the investor's investment policies. For example, many investors, including securitization vehicles, are not permitted to invest in debt instruments that mature later than a specified date (often tied to the maturity of the investor's own debt obligations). However, a longer maturity instrument may be necessary, when taking account of other investments, to create a portfolio with a desired weighted average maturity or duration. When coupled with an investment in a "risk-free" debt instrument, a TRS can be used to create a synthetic investment of any desired maturity, and which has the economic performance of a debt instrument of a different maturity. See Example 1, below.

Short positions in TRSs ("short TRSs") comprise a substantial percentage of equity TRSs, and are used as an alternative to short sales for many non-tax reasons. First, as discussed above, margin required on a physical short position may be substantially greater than collateral required under a TRS. In fact, certain financial institutions may provide investors with the ability to net collateral requirements across all ISDA based positions, potentially providing for "negative" collateral (collateral to be posted by the financial institution with the investor). Second, entering into a short TRS allows investors to more effectively manage their interest rate exposure. While the rebate (the income earned on collateral posted) on physical short positions is calculated at a daily rate, often it is not specifically tied to LIBOR. On the other hand, short TRSs nearly always provide for LIBOR-based periodic payments to the investor, which will likely match its LIBOR-based liabilities on other borrowings and swap transactions. Further, for an investor that already holds securities "long" through a TRS, the most efficient way to obtain short exposure to such securities would be to enter into short TRS positions with the counterparty on the long TRS and thereby reduce its credit exposure to that counterparty. For an example of the use of a short TRS, please see Example 2, below.

Current Uses of Credit Default Swaps.

Investors (including taxpayers that are not dealers and that are not subject to the mark-to-market rules of section 475) enter into both long and short positions in Credit Default Swaps (“CDSs”) to gain (or reduce) credit exposure to debt instruments, without transferring market exposure generally, in transactions with no tax motivation.

Because an investor may use its capital to purchase Treasury securities, from an economic point-of-view, the interest paid on any other debt instrument reflects: (1) compensation at a risk-free rate of return for the use of the principal amount of the instrument, plus (2) compensation for taking: (a) credit risk, (b) market value risk and, where applicable (c) prepayment risk, (d) currency exchange risk, (e) tax risk (for example withholding tax risk in the case of a foreign investor), (f) responsibility for servicing/monitoring/collection activities, and (g) similar risks and costs not present with Treasury securities. Contingent swaps allow investors to separately price and acquire or dispose of these risks (and costs). CDSs allow investors to separately price and acquire or dispose of credit risk. See Examples 3 and 4, below.

Current Law Clearly Reflects the Economics of Each Counterparty to a Contingent Swap, and is Consistent with the Tax Treatment of its Physical Equivalents.

Under current law, (1) periodic payments are includible in (or deductible from) income as they accrue and (2) the income (or expense) attributable to a nonperiodic contingent payment is deferred until received (or paid). ISDA would like to restate its view, as more fully set forth in its letter dated November 20, 2001, that the current methodology best satisfies the fundamental tax policy principles set forth in Notice 2001-44.⁵ The principle of *certainty/clarity* is satisfied because the investor would know to include periodic payments as they accrue and to include contingent payments when they become fixed. The principle of *administrability* is satisfied due to the simplicity of the current method in both calculating tax inclusions as well as providing accurate information reporting of TRS payments. Financial institutions have systems in place to information report net cash payments. The principle of *economic accuracy* is satisfied because the income or expense taken into account for tax purposes reflects actual income earned or expenses incurred, and not estimates of potential future cash flows. The principle of *flexibility* is satisfied, in that the tax treatment under current law could apply to most, if not all, contingent swaps providing for periodic payments (as opposed to deferred cash flows). As to *symmetry*, because most TRSs are entered into with financial institutions that are dealers in securities under section 475 and are, therefore, on a mark-to-market method of tax accounting, the goal of symmetry generally will not be satisfied under any methodology other than mark-to-market.

Most importantly, however, is the policy principle of *neutrality*. As stated in Notice 2001-44, “... in the financial products area, it is particularly important to pay attention to the

⁵ ISDA, “Re: Contingent Non-Periodic Payments Under Notional Principal Contracts,” (November 20, 2001), available on ISDA’s website at <http://www.isda.org/index.html>.

neutrality principle, i.e., consistent treatment of different instruments with similar economic characteristics.” ISDA believes that the methodology under current law best satisfies this policy principle. Current law treatment, under which inclusion of the nonperiodic contingent payment is deferred until it becomes fixed is completely consistent with physical ownership of an asset, as well as with the current tax treatment of cash-settled forwards and options. Current deductibility of the synthetic funding costs is equally consistent with current treatment for physical ownership and accurately reflects the change in economic position of the investor. See Examples 1-4, below.

The Effect of Current Law, the Full Allocation Method, and the Modified Noncontingent Swap Method on the Timing of Income on Common Fixed Income Derivative Transactions.

ISDA does not believe that any of the proposed methodologies in Notice 2001-44 satisfy the policy principles as comprehensively as does the current law method. We note that other than with respect to the mark-to-market method, Notice 2001-44 itself notes, with respect to each method, that the “method does not [accurately] reflect the change in economic position over time” of a taxpayer as a result of being a party to a contingent swap. Moreover, the largest market by far for fixed income contingent swaps (i.e., total return swaps on debt instruments and credit default swaps) is the multi-trillion dollar securitization industry, which provides the most efficient means for investors and financial institutions alike to take on or hedge credit exposure. The efficiency of these securitization structures (as described in the examples below) depends in large part on the current tax regime for contingent swaps, which generally taxes them (with respect to both timing and character) in a manner consistent with the tax treatment of physical debt positions that are synthetically replicated by the contingent fixed income swaps. Any of the proposed alternatives to the current tax regime for contingent swaps would severely impair the efficiency of the securitization structures, which play a critical role in the efficient allocation of credit risks and in the reduction of the cost of financing.

Under the full allocation method (essentially taxing swaps as if they were forward contracts), the inclusion in income (or allowance as a deduction) of both noncontingent and contingent payments is deferred until the contingent payment is received (or paid). As such, the full allocation method results in the taxation of common contingent swap transactions that, not only differs materially from the taxation of the equivalent physical transactions, but also causes receipts (and payments) to be included in income (or allowed as a deduction) in a manner that fails to match their economic effect.⁶ (The full allocation method does tax contingent swaps in a manner similar to forward contracts; but swaps differ materially from forward contracts—with a forward contract, the interest equivalent is built into the forward price and thus paid at the termination of the contract, whereas with a contingent swap, the interest equivalent is paid

⁶ Further, after noting that “[t]he full allocation method does not reflect the change in economic position over time of either counterparty ... because all tax consequences are postponed until the contract matures, is terminated, etc.,” Notice 2001-44 indicates that, “[t]his result is particularly open for manipulation to the extent taxpayers have the ability to terminate a contract if it has decreased in value but can retain the contract if it has increased in value.”

periodically.) Because taxpayers enter into both long and short positions in these derivative products, neither the current law method nor the full allocation method is inherently favorable to the government or to the taxpayers; the current law method, however, reaches the correct result. Thus, as we have indicated in our past correspondence, we strongly believe that current law should be maintained.

Importantly, we would like to reiterate our view that the noncontingent swap method is the least desirable of the proposed alternatives because it fails to satisfy any of the policy principles. The methodology is complex and will be both difficult to understand as well as to administer. Because TRSs and many other contingent swaps may not be hedged with forward contracts, the information on forward pricing may not be available to the financial institutions, which can enter into thousands of such transactions each day. It will therefore be extremely difficult, if not impossible, to recreate the calculation for purposes of information reporting. The method does not provide for any neutrality with other financial products, and should not be compared with the noncontingent bond method for contingent payment debt instruments, which involve the investment of capital and are comprised of a clear debt components that are distinct from the contingent components. Adoption of this method will add additional burdens to the tax compliance process and likely will discourage taxpayers from entering into notional principal contracts. We note that the underlying intent of the contingent payment debt instrument rules was to prevent the deferral of income from an investment in a debt instrument; no such issue exists with contingent swaps because there is no embedded debt instrument. Further, if a taxpayer were to attempt to embed a debt instrument into a contingent swap, Treasury Regulation § 1.446-3(g)(4) (notional principal contracts with significant nonperiodic payments) would bifurcate the swap into a notional principal contract and a separate debt instrument.

We note that the New York State Bar Association has recommended a modified version of the “noncontingent swap method” described in Notice 2001-44.⁷ Consistent with our comments herein, we do not support the modified noncontingent swap method, which is in large part comparable to the full allocation method, but with the additional requirements that projected payment schedules be prepared and that payments to the extent that they deviate from such schedules be taxed. We believe that the full allocation method reflects income more clearly than the modified noncontingent swap method, because the full allocation method more accurately reflects the conceptual underpinning of the noncontingent swap method—that the contingent payment under a swap may be equated with the cost of hedging that contingent payment. Under forward pricing principles, the cost of hedging the contingent payment in a TRS referencing a physical security is the net cost of carrying that security. In the case of stock, that net cost of carry is the financing cost (represented by the long swap counterparty’s LIBOR-based payments) less any dividends received (which are paid by the short counterparty to the swap). Stated differently, the perfect hedge of the contingent payment under such a TRS would be an exact mirror swap, and the full allocation method in effect reflects the combined cash flows of the TRS and its mirror swap, whereas the modified noncontingent swap method (and the contingent swap

⁷ NYSBA, “Report Responding to Notice 2001-44 on the Timing of Income and Loss from Swaps Providing for Contingent Payments,” 2001 TNT 221-39 (November 14, 2001), or available on NYSBA’s website at <http://www.nysba.org/taxreports/> (report number 1001) (hereinafter *NYSBA Tax Section Report No. 1001*).

method proposed in Notice 2001-44) deviate from this notion. We therefore believe that the modified noncontingent swap method should not be adopted because the full allocation method more clearly reflects income, if the contingent payment is to be taken into account currently by equating the amount of that payment to the cost of hedging such contingency. Furthermore, whatever the relative merits of the two methods, ultimately, the timing differences between the modified noncontingent swap method and the full allocation method generally can be expected to be relatively minor. Thus, adopting the modified noncontingent swap method would not be worth the substantial administrative efforts and burdens it would require.

For ease of presentation, Examples 1-4, below, compare current law solely with the full allocation method. Example 5, below, demonstrates why we believe that the marginal benefits of the modified noncontingent swap method are too insignificant to be worth the added complexity and burdens of utilizing such method.

Examples.

Example 1: Using a TRS to Create a Synthetic Long Position. To complement the balance of its bond portfolio, an investor (the “Investor”) seeks exposure to 10-year, 6% XYZ Bonds but needs an investment that will actually mature in 7 years.

The Investor creates a synthetic \$1,000 XYZ debt by:

- buying a \$1,000, 7-year AAA-rated floating rate debt security paying LIBOR and
- entering into a 7-year long TRS with a notional principal amount of \$1,000 on a 10-year, 6% XYZ Bond under which:
 - (a) periodically, the Investor pays LIBOR to the Counterparty and the Counterparty pays interest earned on the XYZ Bond to the Investor, and
 - (b) at the maturity of the TRS, the Investor pays the Counterparty the decline in value, if any, on the XYZ Bond and the Counterparty pays the Investor the increase in value, if any, on the XYZ Bond.

The net cash flow to the Investor is the same as if it bought a \$1,000 6% XYZ Bond and sold it at the end of 7 years—each year prior to the maturity of the TRS, the Investor earns 6% on \$1,000 (taking account of both the AAA-rated debt and the TRS). This is because each year (a) the Investor earns LIBOR on the floating rate debt, (b) pays LIBOR on the TRS, and (c) receives 6% on the TRS.⁸

Under current law, the Investor would accrue income at that same 6% rate (it would accrue income at LIBOR on the debt security and accrue additional income (or deduction) on the TRS of [6% - LIBOR]). Under current law, taxable income accrues at

⁸ In practice, the payments referred to in clauses (b) and (c) in the text are netted and only a net payment is made. The description refers to the gross payments for ease of presentation.

the same rate as economic income and at the same rate it would have for tax purposes had the Investor acquired a physical 6% XYZ Bond.

At the maturity of the TRS, the Investor would have gain (or loss) equal to the increase (or decline) in value of the XYZ Bond. Under current law, the Investor would recognize that gain (or loss) at the same time as it realizes it economically.

Under the full allocation method, the Investor would have periodic income, taking the transaction as a whole, that would accrue, for tax purposes, at a rate that differs with the level of LIBOR, even though its net cash flow is unaffected by changes in the level of LIBOR. The rate of income accrual for tax purposes would be slower than economic accrual at times when LIBOR is below 6%—since the income received on the TRS would be deferred—and faster when LIBOR is above 6%—since the expense on the TRS would be deferred—in each case with income on the floating rate debt being taxed as it accrues. This result does not clearly reflect income.⁹

The result under the full allocation method does not clearly reflect income, because it tends, in the case of an investor that is synthetically long the XYZ Bond, to defer income because at the inception of the transaction, LIBOR (a short-term floating rate) generally will be less than the interest rate on a long-term, fixed rate bond.

Example 2. Using a TRS to Create a Synthetic Short Position. In order to capture economic arbitrage between two bonds, the Investor buys a 6% ABC Bond and enters into a short TRS on an XYZ Bond. Under the TRS, periodically, the Investor (a) pays 6% to the Counterparty, and (b) receives LIBOR from the Counterparty. Under current law, the net payment would be deductible, which results in taxation that mimics the taxation of the equivalent physical position — here, a short sale.¹⁰ Under the full allocation method, the deduction for that net payment would be deferred, even though it represents a true, current out-of-pocket cost for the Investor.

⁹ Hedge accounting or integration would eliminate this noneconomic result, but hedge accounting is not available for investments, and integration is not available in numerous contexts. For example, integration is not permitted where the debt is subject to section 1272(a)(6), which, while unclear, might be the case with many asset-backed securities, which make up the vast bulk of the AAA-rated dollar denominated, floating rate securities currently in the market. Further, under section 1272(a)(6)(C)(iii), any debt instrument may become subject to section 1272(a)(6) if it is part of a pool of debt instruments some of which are repayable (which includes many traditional corporate bonds).

¹⁰ In an actual short sale, (a) the Investor typically would be required to post collateral and would earn LIBOR thereon (for ease of presentation we use LIBOR but in practice it generally is some other short-term rate), and (b) get a current deduction for in-lieu-of payments it would make in respect of interest on the Bonds. The Investor would have a net periodic cash flow equal to the difference between the LIBOR earned and 6% paid, which generally would be an expected net payment. That net payment would be deductible (more technically, the gross amount of the interest would be included in income and the gross amount of the in-lieu-of payment would be deductible).

Example 3. Protection Seller in a CDS:

- The Investor buys a \$1,000, 7-year Treasury or AAA-rated debt security, which may bear interest at a fixed or floating rate, and
- The Investor enters into a 7-year CDS with a notional principal amount of \$1,000 on XYZ with a Counterparty under which:
 - (a) periodically, the Counterparty pays 100 basis points (1.00%) per annum to the Investor on a notional amount of \$1,000, and
 - (b) if, but only if, XYZ becomes insolvent or defaults on any of its material debt obligations, the Investor either pays the Counterparty the decline in value of a reference XYZ Bond or takes delivery of \$1,000 par amount of an XYZ Bond (of Counterparty's choice) in return for \$1,000.

Thus, the Investor has taken the credit risk of XYZ and has been compensated for it. And that compensation, together with the return on the AAA-rated debt security, gives it a return akin to the return on an XYZ Bond. This is a very common transaction in the derivatives market, and when done with a pool of CDS (or a CDS on a pool of reference credits), forms the assets for securities known as “synthetic collateralized debt obligations.” Under current law, the Investor takes the periodic payment received on the CDS into income as it accrues. This is the same as if it had earned the same amount as interest on a physical XYZ Bond. Under the full allocation method, on the other hand, the income received periodically is deferred until the maturity of the CDS, even though it is received and is economically earned periodically and is a substitute for interest on a physical XYZ Bond, which would have accrued currently.

Example 4. Protection Buyer in a CDS.

- Same facts as Example 3, but from the perspective of the Counterparty. Counterparty owns an XYZ Bond and, in order to hedge the credit risk on the Bond, enters into the CDS discussed in Example 3.

Under current law, the Counterparty's periodic payments would be deductible. This is the same result as if the Counterparty had purchased bond insurance. The net tax result would be essentially the same as if the Counterparty had accepted a lower rate of interest on an XYZ Bond that had less credit risk because, for example, (1) XYZ pledged collateral to secure the Bond, or (2) XYZ obtained bond insurance for the Bond in connection with its original issuance.¹¹ Under the full allocation method, the deduction

¹¹ For a variety of reasons beyond the scope of this submission, traditional CDSs are not credit insurance for tax (or regulatory) purposes. However, for purposes of the timing of income, they should be treated similarly by investors. In each case, the amounts paid over the life of the contract are paid by one party periodically (for periods of one year or less) and represent compensation for the right to receive a contingent payment upon the occurrence of a contingent event that happens, or fails to happen, during the year-or-less period to which each periodic payment relates and which, if it happens, generally terminates the contract as to the event covered (after payment is made by that other party).

for the periodic payment would be deferred, even though it represents a true, current out-of-pocket cost for the Counterparty.

Example 5. Modified Noncontingent Swap Method.¹²

- Under a three-year swap, A agrees to pay B LIBOR plus 200 basis points per annum on a notional principal amount, and B agrees to pay A an amount that is wholly contingent at the end of year 3. LIBOR plus 200 basis points equals \$7x when the swap is entered into.

Under the modified noncontingent swap method, the parties to this swap would prepare a projected payment schedule under which A would pay B \$7x in years 1 and 2, and B would pay A \$14x at the end of year 3.

Any deviation of actual payments from the projected payment amounts—\$7x in years 1 and 2, and \$14x in year 3—would be includible/deductible in the year of payment.

The only timing difference between the modified noncontingent swap method and the full allocation method is that the amount of change in LIBOR would be taken into account for tax purposes each year, as opposed to deferring the entire amount of the LIBOR-based payments until the contingent payment amount is fixed in year 3.

As discussed above, we believe that the full allocation method more clearly reflects income than the modified noncontingent swap method in terms of reflecting on a current basis the cost of hedging the contingent payment. Whatever the relative merits of the two methods, however, as demonstrated by this example, the timing differences generally can be expected to be relatively minor. Thus, adopting the modified noncontingent swap method would clearly not be worth the substantial administrative efforts and burdens would require.

Character of Payments made under a Contingent Swap.

Under current law, the character of periodic noncontingent payments as ordinary income is clear. Similarly, the character of a contingent payment made upon the early termination of a swap as capital is clear. We believe that these rules should not be changed.

On the other hand, there is a fair degree of disagreement among our members regarding whether, under current law, contingent payments give rise to capital gain or loss under section 1234A when made at the scheduled termination of a notional principal contract. We believe, however, that, to further the policy principle of neutrality, treatment similar to other capital asset terminations under section 1234A must apply equally to contingent payments under notional

¹² This example is Example C-2 in the NYSBA Tax Section Report No. 1001.

principal contracts, whether made upon an early termination or a payment at maturity of the contract. And, at least in the context of contingent payments tied to the value of property, we believe that section 1234A supplies statutory authority for that position.¹³ In each of Examples 1-4, above, ordinary income or deduction treatment for periodic payments and capital gain or loss for contingent payments is clearly appropriate as the net periodic payments are economically comparable to net financing costs, and contingent payment reflects the return on an investment in the underlying security.

Because the full allocation method defers the taxation of the periodic payments, we have considered whether the adoption of such a method would make an alternative set of characterization rules more appropriate. We believe not. We see three possible alternatives in respect of the character of payments under the full allocation method.

(1) One alternative would be to treat the character of the net amount of all payments—consisting of all contingent payments together with all noncontingent payments (including periodic payments) that are deferred, as ordinary in its entirety. In order to prevent unwarranted taxpayer electivity, the rules should make clear that the character of any net gain or loss upon an early termination or disposition of the swap would be ordinary as well. We, however, do not support such an “all ordinary” rule, because it would be inconsistent with the economic character of the payments under a TRS, would treat contingent swaps differently from other rights in property, and, in light of section 1234A, would likely be beyond the authority of the Treasury and the Internal Revenue Service.

(2) Another alternative would be to treat the character of the net amount of payments on the swap—consisting of all contingent payments together with all noncontingent payments (including periodic payments) that are deferred, as capital in its entirety. In order to prevent unwarranted taxpayer electivity, any net gain or loss upon an early termination or disposition of the swap would be capital in character, as well. We, however, do not support such an “all capital” rule, because it would be inconsistent with the economic character of the noncontingent periodic payments made under a TRS and would treat economically similar transactions in significantly different ways.

(3) The third alternative, which we support, would be to treat the entire amount of the contingent nonperiodic payment as capital in character, and the entire amount of deferred periodic noncontingent payments as ordinary in character. Accordingly, the total amount of deferred payments would not offset any contingent payments received, but could be deducted against other ordinary income. Upon an early termination or disposition of the swap, the total net periodic payments deferred up to that date would be taken into account as ordinary income or deductions, and any gain or loss on the swap itself would be capital in character. We support this alternative for characterizing payments under a TRS, because net periodic payments are economically comparable to net financing costs, and contingent payments are economically

¹³ We note that with respect to some contingent swaps, such as weather swaps and catastrophe swaps, while the contingency may be determined with reference to objective financial information, it is not determined specifically with respect to property.

equivalent to the return on an investment in the underlying security. In addition, as described above, given the typical uses of contingent swaps, this is the alternative that would have the smallest negative tax impact on typical derivatives transactions involving credit risk that are a critical part of the securitization markets.

Previously filed ISDA letters:

