

# ISDA

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May 12, 2003

**CORRECTED 6/2/03**

Internal Revenue Service  
P.O. Box 7604  
Ben Franklin Station  
Washington, D.C. 20044

Re: Suggested Anti-Abuse Rule for Use with the Wait-and-See Method of Accruing Contingent Payments on Notional Principal Contracts

As we discussed at our meeting on April 2, ISDA continues to believe that the most proper way to account for contingent payments on notional principal contracts is under the so-called “wait-and-see method” whereby contingent payments are not accrued and included in or deducted from gross income until paid (or until fixed, if the contingent amount is fixed significantly prior to payment).<sup>1</sup> You indicated that one significant concern with the wait-and-see method was the difficulty drafting an effective anti-abuse rule to take account of contingencies that as a practical, business or economic matter were not of sufficient significance to warrant non-accrual of the related payment. We offered to suggest an appropriate anti-abuse rule and hereby propose the following.

Anti-abuse Rule – Contingent Nonperiodic Payments

- (a) Remote and incidental contingencies. A payment is not a contingent payment merely because of a contingency that, as of the issue date of the contract, is either remote or incidental. A contingency is remote if there is a remote likelihood either that the contingency will or that the contingency will not occur. A contingency relating to a payment is incidental if, under all reasonably expected market conditions: i) the potential amount of the payment is insignificant relative to the total amount of payments expected under the contract, or ii) the expected range of or variability in the amount of the payment is insignificant relative to the expected amount of the payment.
- (b) Contingent payment subject to a minimum payment treated as a non-contingent payment. If a contingent payment is, or could be, described as the sum of a non-contingent payment (the minimum payment) and a separate contingent payment that cannot be less than zero, only that portion of the contingent payment that is in excess the minimum payment shall be treated as a contingent payment and the minimum payment shall be treated as a separate non-contingent payment.

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<sup>1</sup> The meeting was to follow up our letter, dated November 20, 2001 entitled “Contingent Non-periodic Payments Under Notional Principal Contracts”, a copy of which is attached.

- (c) Contingent payment with significant non-contingent component. If (i) a contingent payment is, or could be, described as a non-contingent payment (the non-contingent component) plus or minus a contingent payment and (ii) the portion of the initial fair market value for the stated contingent payment allocable to such non-contingent component is significant, the non-contingent component shall be treated as a separate non-contingent payment and only the contingent component shall be treated as a contingent payment. The non-contingent component is significant if its initial fair market value equals or exceeds [20%] of the initial fair market value for the stated contingent payment based on an allocation of the stated contingent payment between the non-contingent component and the contingent component using the relative fair market values of each amount.
- (d) Changes in notional principal amount. A payment is not a contingent payment merely because in determining the amount of such payment, the notional principal amount of the contract to which a specified index is applied increases and/or decreases over the life of the notional principal contract (unless the increases and/or decreases are determined in a manner designed to avoid the purposes of this section).

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Thank you for this opportunity to provide these comments. We would welcome the opportunity to speak with you further on these matters and would be happy to provide you with further explanations of any of the suggested language. Please feel free to call David Nirenberg at (212) 506-5085 or Thomas Prevost at (212) 325-7486.

Sincerely,



Thomas Prevost  
Chair, North American Tax Committee

cc: Michael Novey  
Associate Tax Counsel  
Department of the Treasury

Helen M. Hubbard  
Tax Legislative Counsel  
Department of the Treasury

Viva Hammer  
Tax Litigation Counsel  
Department of the Treasury

Thornton Matheson  
Financial Economist  
Department of the Treasury

Matthew Stevens  
Special Counsel to the Chief Counsel  
Internal Revenue Service

## EXHIBIT A

November 20, 2001

Room 4300  
Internal Revenue Service  
P.O. Box 7604  
Ben Franklin Station  
Washington, D.C. 20044

Re: Contingent Non-Periodic Payments  
Under Notional Principal Contracts

Ladies and Gentlemen:

This letter summarizes the views of the International Swaps and Derivatives Association, Inc. (“ISDA”) concerning four alternative methods of accounting governing the timing of income inclusions and deductions under notional principal contracts (“NPCs”) that provide for contingent non-periodic payments. Comments on these four methods, and certain related issues, were requested by the Internal Revenue Service (the “Service”) in Notice 2001-44, I.R.B. 2001-30 (July 3, 2001).

ISDA is an international organization with more than 540 members from over 41 jurisdictions throughout the world. ISDA’s members include most of the world’s leading dealers in swaps and other off-exchange derivatives transactions (collectively “OTC derivatives”). The membership of ISDA also includes many of the businesses, financial institutions, governmental entities and other end users that rely, as do ISDA’s dealer-members, on OTC derivatives to manage the financial, commodity and other risks inherent in their core economic activities with a degree of efficiency and effectiveness that would not otherwise be possible. A list of ISDA’s members is attached to this letter and additional information with respect to ISDA and its programs is available on the ISDA website at [www.isda.org](http://www.isda.org).

I.

**General Statement of ISDA’s Position**

Section 446 of the Internal Revenue Code of 1986 (the “Code”) governs the methods of accounting to be used by taxpayers in computing taxable income and generally requires that the method of accounting used “clearly reflect” the taxpayer’s income. See section 446(b). Section 1.446-3 of the Regulations prescribes rules applying the “clear reflection of income” standard to amounts received and paid under NPCs. These regulations do not, however, provide specific guidance with respect to the timing or character of contingent non-periodic payments under such contracts.

In practice, income inclusions and deductions attributable to contingent non-periodic payments under NPCs generally are deferred by taxpayers until the contingency has been resolved (i.e., the amount of the payment has been fixed), but periodic payments under such contracts typically are deducted (and included) currently by taxpayers in accordance the provisions of existing regulations. See Regs. 1.446-3(e). ISDA believes that this approach to the timing of income inclusions and deductions with respect to NPCs that provide for contingent non-periodic payments is readily administrable by both taxpayers and the Service and produces results which are reasonable from a tax policy point of view.

In Notice 2001-44, the Service described four specific alternatives to current practice and suggested that one of these methods might be prescribed for use by all taxpayers in determining the timing of deductions and inclusions for payments under NPCs that provide for contingent non-periodic payments. ISDA does not believe that any of these alternative methods, as they are described and illustrated in Notice 2001-44, is preferable to current practice. If, however, the Service does elect to mandate use of one of these methods by all taxpayers, ISDA believes that the so-called “full allocation” method is preferable, but only when compared to the other three methods described in Notice 2001-44. As discussed more fully below, the other methods described in Notice 2001-44 (the “non-contingent swap” method, the “modified full allocation” method and the “mark-to-market” method) are sufficiently deficient on tax policy grounds that their use should not be mandated by the Service.

In Notice 2001-44, the Service also requested comments with respect to the principles that should govern the determination of the character of payments under NPCs. In ISDA’s view, the character of income received under an NPC should generally be determined by reference to the primary purpose for which the NPC is entered into. ISDA recognizes, however, that legislation may be required to achieve such a result. In this connection, ISDA would also support legislation, recommended by others, excluding payments under NPCs from the so-called “two percent floor” on miscellaneous itemized deductions and amending section 163(d) of the Code to treat any ordinary expense with respect to a contingent NPC as investment interest solely for purposes of section 163(d).

## II.

### **Timing Issues**

#### A. Current Practice.

As noted above, under current practice, taxpayers generally defer recognition of gain or loss attributable to contingent non-periodic payments under NPCs until the contingency is

resolved, but periodic payments under such NPCs generally are taken into account on a current basis. In ISDA's view, these are appropriate results. For example, current practice generally equates the tax treatment of a contingent equity swap with the treatment of the actual purchase of the underlying stock on the margin (i.e., interest on the margin debt is deducted currently and capital gain or loss is realized upon the ultimate disposition of the stock).

Moreover, ISDA is not aware of any potential for abuse or manipulation under current practice with respect to timing (as opposed to source and character) that is sufficiently meaningful to warrant mandating the use of one of the four alternative methods described in Notice 2001-44. Moreover, to the extent that specific concerns can be identified, most if not all of them can be addressed either under existing regulations or through additional guidance. For example, if the parties to an NPC placed a floor (or minimum) on the amount of the contingent non-periodic payment at the inception of the NPC, the existing regulations would likely be interpreted to require ratable accrual of this "non-contingent" amount.

ISDA also believes that mandatory use of any one of the four alternatives described in Notice 2001-44 could place some OTC derivatives at a disadvantage vis-à-vis other transactions (such as a contingent equity swap and the purchase of stock on margin). For example, while the "non-contingent swap" method described in Notice 2001-44 would provide treatment that parallels that applicable to contingent debt, it would result in different tax accounting for contingent equity swaps than is applicable to the purchase of stock on margin. In ISDA's view, these discontinuities should be avoided where possible because they are at odds with the tax policy principle of neutrality noted by the Service in Notice 2001-44.

## **B. Full Allocation Method.**

If the Service mandates the use by all taxpayers of one of the four methods described in Notice 2001-44, the full allocation method is the preferable method of the four (although it would be less preferable than current practice). As described in Notice 2001-44, if the full allocation method is adopted:

“. . . taxpayers would not include or deduct any payment that is required to be made under the NPC (periodic, nonperiodic, contingent and non-contingent) until the taxable year in which all contingencies are resolved. When the final contingency is resolved, the parties would treat all payments as made or received in the year of resolution of the contingency.”

Under this method, as described by the Service, all inclusions and deductions with respect to an NPC providing for contingent non-periodic payments apparently would be deferred until the contingency is resolved .

ISDA believes that, when compared to the other three methods described in Notice 2001-44 (but not when compared to current practice), the full allocation method generally produces results that are more consistent with sound tax policy considerations and that this method can reasonably be administered by taxpayers and the Service. Nevertheless, the full allocation method is not without its deficiencies. While it would in theory result in the matching the timing of inclusions and deductions by the counterparties to the NPC, this will not be likely be true where, as is frequently the case, one of the counterparties is a dealer (using the mark-to-mark method). Since mandatory use of the mark-to-market method by all taxpayers would, as described below, be inappropriate, the fact that dealers are counterparties to such a large percentage of these transactions suggests that the goal of timing matches is likely to be unattainable in any event. Moreover, by postponing all deductions and inclusions, the full allocation method fails to reflect changes in the economic positions of the counterparties during the term of the NPC and thus produces results that are inconsistent with the realization principle.

Notice 2001-44 indicates that the Service is concerned that the inconsistency with respect to timing between contingent NPCs and non-contingent NPCs that would result from adoption of the full allocation method potentially could lead to attempts at manipulation by taxpayers. ISDA agrees with the suggestion in Notice 2001-44 that this issue could be addressed in a satisfactory manner through inclusion of an anti-abuse rule in the regulations. Such a regulatory rule could readily target obvious situations (e.g., those involving the inclusion of contingencies that have little or no economic significance to the transaction underlying the NPC). The regulations could also state that the Service will apply the regulatory anti-abuse rule to such future (and as yet undefined) attempts at converting non-contingent NPCs into contingent NPCs as are subsequently specified in revenue rulings and revenue procedures.

### III.

#### Other Proposed Alternatives

ISDA believes that the other three methods discussed in Notice 2001-44 are sufficiently deficient as they are described therein (vis-à-vis both the full allocation method and current practice) that their use should not be mandated. At first blush, the “non-contingent swap” method, as described in Notice 2001-44, has much to commend it in principle. On the positive

side, the non-contingent swap method takes into account on annual basis changes in the actual economic income of the counterparties during the term of the NPC, a benefit which is not available under the full allocation method (since no payments are taken into account under that method until the contingency is finally resolved). In this respect, the non-contingent swap method produces results with respect to timing that are similar to current practice.

On the negative side, however, the non-contingent swap method, as described and illustrated in Notice 2001-44, would not provide neutrality of tax treatment in many instances (e.g., it would create disparities between the treatment of contingent equity swaps and the direct purchase of stock on margin). As noted, ISDA believes that such discontinuities should be avoided where possible. Moreover, the non-contingent swap method would always require that taxpayers estimate the contingent payment that will ultimately be paid and received. Such estimates may be more “art” than “science” in many cases. To the extent the estimate is erroneous, the method does not produce the economically “correct” result and the potential for audit disputes between the Service and taxpayers will in all events be increased. Requiring new estimates at periodic intervals during the term of the NPC could in many cases impose substantial administrative burdens on both taxpayers and the Service. For these reasons, ISDA believes that the non-contingent swap method, as described in Notice 2001-44, is sufficiently deficient that its use should not be mandated by the Service.\*

ISDA believes that the third method discussed in Notice 2001-44, the “modified full allocation” model is also objectionable. Under this method, non-contingent payments made by a counterparty to an NPC during a taxable year could be offset against payments received during the year, but net deductions would be deferred until all contingencies with respect to that deduction are resolved. This method would “create” potentially substantial timing mismatches between counterparties, including non-dealers, to the same NPC as net deductions are deferred while net inclusions are not. The discussion of policy considerations in Notice 2001-44 suggests that the Service itself recognizes the broader deficiencies inherent in this method; for example, it

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\* ISDA has reviewed the comments on Notice 2001-44 filed by the New York State Bar Association Tax Section ("Report Responding to Notice 2001-44 on the Timing of Income and Loss from Swaps Providing for Contingent Payments," November 14, 2001) (the "NYSBA Report"). The NYSBA Report suggests a new method, described as similar to the non-contingent swap method, as an alternative both to current practice and the four methods described in Notice 2001-44. In ISDA's view, this new method is not preferable to current practice. Moreover, while ISDA would support retention of current practice vis-a-vis any of the four methods described in Notice 2001-44, it believes that the full allocation method would be the most preferable alternative to current practice despite its policy deficiencies and, as noted in the NYSBA Report, the possible need for legislative authorization for its implementation.

does not provide neutrality and it does not accurately reflect changes in the economic positions of the counterparties during the term of the NPC. ISDA urges that this method not be mandated.

The fourth method discussed in Notice 2001-44, the “mark-to-market” method has much to commend it in principle and it has been observed by other commentators that this method almost always “clearly reflects” income. At the same time, however, this method has practical difficulties. For example, in the case of OTC derivatives transactions, establishing market values may often be difficult and this difficulty could both result in inaccurate results and increased controversies between taxpayers and the Service. Moreover, it is uncertain whether the Service currently has statutory authority to mandate the use of mark-to-market accounting by all taxpayers. As a result, ISDA believes that the mark-to-market method should not be mandated. In principle, however, ISDA would have no objection to permitting taxpayers to use mark-to-market accounting on an elective basis.

#### IV.

##### Character Issues

As noted in Notice 2001-44, the current regulations do not provide specific rules governing the character as capital or ordinary of the various types of payments that could be made pursuant to an NPC. Notice 2001-44 also notes that, in developing rules governing the character of such payments, opportunities for selective “cherry picking” should be minimized and efforts should be made to provide consistent treatment for different instruments that have similar economic characteristics.

ISDA agrees with these goals and believes consideration should be given to a regime in which the character of the payments is based on the economic function an NPC is structured to serve. For example, if a swaps contract is entered into primarily to hedge the price of stock, “capital” treatment would appear generally to be appropriate. In contrast, if the NPC is entered into primarily to hedge an option on compensatory stock, “ordinary” treatment would appear generally to be appropriate. Under such a regime, taxpayers could be required to identify the purpose or economic function of the NPC at the outset. This approach to the issues of character would in all likelihood require legislation and ISDA is prepared to work with the Service, and other interested parties, in the development and implementation of rules prescribing the character of payments under NPCs.

#### V.

##### Conclusions

ISDA believes that the current practice with respect to the timing of inclusions and deductions for contingent non-periodic payments under NPCs produces results that are consistent with sound tax policy, are not open to abuse and can readily be administered both by the Service and taxpayers. Thus, ISDA believes that the Service does not need to mandate the use by all taxpayers of one of the four methods discussed in Notice 2001-44

If the Service nevertheless does decide to mandate the use of one of these four methods by all taxpayers, the full allocation method appears to be the most reasonable of the four methods, although ISDA believes that the current practice produces the more appropriate results. While the non-contingent swap method may have much to commend it in principle, it does have substantial tax policy deficiencies and it would inevitably present substantial issues of administration and taxpayer burden. Neither the modified full allocation method nor the mark-to-market method are appropriate as a mandatory method, although ISDA has no objection in principle to the use of the mark-to-market method on an elective basis.

As noted, the Service has to date not prescribed any method of accounting for contingent non-periodic payments under NPCs. If one is to be prescribed, the process should be accomplished through regulations, with full opportunity for public comment by all interested parties, and the method ultimately selected by the Service should be applied only on a prospective basis to NPCs entered into after the date on which the final regulations are promulgated.

ISDA believes that the character of payments under an NPC should generally be determined by reference to the underlying economic function for the NPC is structured, but recognizes that this may require legislation. In this connection, ISDA would support legislation recommended by others to exclude payments under NPCs from the “two percent floor” on miscellaneous itemized deductions. Similarly, ISDA would also support legislation recommended by others to amend section 163(d) of the Code to treat any ordinary expense with respect to a contingent NPC as investment interest solely for purposes of section 163(d).

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ISDA would welcome the opportunity to discuss these issues of timing and character with representatives of the Service and stands ready to respond to any questions that may arise in connection with the Service’s review of these comments.

Sincerely,

Mark S. Perwien  
Chair, North American Tax Committee

Robert Pickel  
Executive Director and Chief Executive Officer