

ISDA

International Swaps and Derivatives Association, Inc.

360 Madison Avenue
16th floor
New York, NY 10017
United States of America
Phone: (212) 901-6000
Fax: (212) 901-6001
Email: isda@isda.org
Web: www.isda.org

October 13, 2004

Mr. Gregory F. Jenner
Acting Assistant Secretary for Tax Policy
U.S. Department of the Treasury
Room 31 20 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Comments on Proposed Regulations Relating to Notional Principal Contracts with Contingent Nonperiodic Payments

Gentlemen:

On February 25, 2004, the Department of Treasury (the *Treasury*) and the Internal Revenue Service (the *IRS*) issued proposed regulations (the *Proposed Regulations*) addressing the tax treatment of notional principal contracts (*NPCs*) with contingent nonperiodic payments (*CNPCs*). In a letter dated March 19, 2004 (a copy of which is attached), we previously commented on the effective date and retroactive application issues raised in the preamble to the

Proposed Regulations (the *Preamble*) and requested that the Treasury and the IRS, in order to mitigate the concerns in the marketplace, quickly issue interim guidance providing that all taxpayers (other than those accounting for income under a mark-to-market method) may continue to use the wait-and-see method for contingent nonperiodic payments in CNPCs entered into prior to the effective date of the final regulations (regardless of whether they have established a method of accounting by the date 30 days after the Proposed Regulations were issued). In this letter, we address the substantive rules provided in the Proposed Regulations.

SUMMARY

1. The vast majority of CNPCs are entered into for nontax business reasons, but the Proposed Regulations treat all CNPCs as if they were tax-motivated.

- The experience of our member firms indicates that the overwhelming majority of CNPCs are entered into for nontax business reasons. In fact, with respect to individual investors, CNPCs are sometimes taxed less favorably than an economically similar leveraged investment in the underlying security due to the limitations on the deductibility of swap payments (because they constitute itemized deductions).
- Moreover, the Proposed Regulations evidently are focused primarily on trying to prevent perceived abuses of the current wait-and-see approach, which we believe are rare and unusual and which can be dealt with readily under current law or, if necessary, with an enhanced anti-abuse provision.
- We strongly believe that as a tax policy matter the general approach to any tax regime for a broad class of transactions should be driven by the most appropriate tax treatment for the overwhelming majority of transactions that routinely occur in the marketplace, and not by the relatively few abusive transactions.

2. The Proposed Regulations fail to satisfy the sound tax policy objectives set forth by the Treasury and the IRS in Notice 2001-44.

- The Proposed Regulations inaccurately reflect the economics of a CNPC to its counterparties. In addition, for those CNPCs for which forward pricing principles are applicable, because the forward price of property is not a prediction of its future price, there is a fundamental contradiction in the noncontingent swap method between the use of forward pricing principles and the overarching requirement that any estimate of a contingent payment be “reasonable”.

Moreover, the imputation of interest payments on an on-market CNPC *contradicts* its economic reality.

- Neutrality is not achieved by the Proposed Regulations, as the method proposed thereunder differs from the tax treatment of a leveraged investment in the security underlying a large class of CNPCs (i.e., total return swaps), which is the closest economic equivalent to such CNPCs. Moreover, the proposed method differs from each of the existing methods for taxing financial products.
- The Proposed Regulations do not provide certainty or clarity as to the tax treatment of a large class of CNPCs — those that have contingent nonperiodic payments for which forward pricing principles are not applicable, such as credit default swaps (*CDSs*) or other CNPCs where both the timing and amount of the contingent payment is unknown.
- The Proposed Regulations are very complex and would be difficult for taxpayers to administer and comply with — particularly the annual redetermination of the projected contingent payments, the deemed interest payments, and the recapture of prior amounts.
- The Proposed Regulations are not flexible because their principles cannot readily be applied to accommodate new financial instruments. In fact, the Proposed Regulations do not even provide sufficient guidance for most of the transactions that currently exist.
- Theoretically, the Proposed Regulations would apply symmetrically to both counterparties to a CNPC, but as a practical matter symmetry generally is not achievable with CNPCs, because one of the counterparties usually is a derivatives dealer that marks its CNPC positions to market.

3. Our Recommendations.

- As we have indicated in previous correspondence, we believe that current law (i.e., the “wait-and-see” method under which a contingent nonperiodic payment is not taken into account for tax purposes until the contingency is resolved and the amount of the payment is fixed) clearly reflects the economics of CNPCs, and should be retained. However, in the event that you ultimately decide otherwise, we believe that the “wait-and-see” method should at least be retained for (i) all CNPCs with terms of five years or less and (ii) longer-dated CNPCs with contingent payments that are indeterminable as to both timing and amount when entered into (e.g., *CDSs*). Maintaining current law for such CNPCs should cover the overwhelming majority of CNPCs, and therefore minimize the market disruptions and tax distortions that will occur if current law is changed for such CNPCs.
- For CNPCs with terms greater than five years (but not those with contingent payments that are indeterminable as to their timing and amount), in light of your concerns about taxpayers achieving “inappropriate” tax deferral through the use of such CNPCs (by deducting net periodic payments currently), the full allocation

method should be adopted, under which all income and deductions are deferred until the contingent payment is made.

- Regardless of the term of the CNPC, taxpayers should be permitted to elect to mark to market their CNPCs along with any positions that hedge or are hedged (in the general sense and not as defined by Treasury Regulation § 1.1221-2) by a CNPC that is marked to market and contemporaneously identified as such. This election should be available separately for two classes of CNPCs: those with terms of up to five years (subject to the wait-and-see method under our recommendations) and those with terms greater than five years (subject to the full allocation method under our recommendations).
- 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 payments that are not contingent.
- Section 1234A of the Internal Revenue Code (the *Code*)¹ should apply to all contingent payments under a CNPC that reference capital assets, regardless of whether the payment is periodic or nonperiodic (except to the extent a special rule provides for ordinary treatment, such as the mark-to-market rules under section 475 and the hedging transaction rules under section 1221).
- The Treasury and the IRS should issue interim guidance regarding the effective date issues, as previously requested in our March 19, 2004 letter.

COMMENTARY OUTLINE

Part I of this comment letter discusses the reasons that taxpayers enter into equity swaps (a common form of CNPCs), and why the Proposed Regulations (if adopted in their current form) would curtail the use equity swaps and other total return swaps that have contingent nonperiodic payments. Part II describes in very general terms the substantive rules of the Proposed Regulations, and Part III provides our comments on the Regulations. Specifically, Part III describes why the Proposed Regulations do not conform to the fundamental tax policy principles that the IRS delineated in Notice 2001-44. Part III also comments on selected other issues raised by the Proposed Regulations; for example, the problems inherent with characterizing a portion of significant nonperiodic payments as interest for all purposes of the

Code, the reduction in liquidity of equity interests in selected securitization vehicles that utilize CNPCs, the problems associated with treating all contingent nonperiodic payments as ordinary (as opposed to capital), and the disparity in tax treatment between CNPCs and hedges of (or transactions hedged by) CNPCs. Lastly, Part IV contains our recommendations (which are summarized above).

I. The Use of Equity Swaps

Although the Proposed Regulations would apply to all forms of CNPCs, it may be informative to discuss the market for total return equity swaps, not only because they are one of the more common forms of CNPCs, but also because we understand that the Treasury and the IRS view the current wait-and-see treatment of contingent nonperiodic payments under equity swaps as inappropriate.²

The purpose of the description of the benefits of using swaps (provided below) is to demonstrate that, contrary to what appears to be a common perception among observers outside of the swaps business, the vast majority of equity swaps are not entered into for tax benefits. We understand that there is concern that equity swaps are being structured with a single contingent, nonperiodic payment at maturity to defer income (while deducting the periodic swap payments currently) and realize long-term capital gain. As discussed herein, we do not think that such a result is inherently objectionable, since it is the result that would occur from leveraged stock investments. Moreover, given the fact that nondealer taxpayers enter into short equity swaps where there is generally net periodic income, and the fact that taxpayers often lose money on

¹ Unless otherwise indicated, all section references are to the Code or to the Treasury regulations issued thereunder.

² Although the following discussion focuses on equity swaps, the principles are applicable to total return swaps on debt as well.

their long equity swaps because the stock or equity index declines in value (which loss is deferred until the swap matures or is terminated),³ it is difficult for us to see how equity swaps are providing an inappropriate tax advantage to investors. Further, there are many circumstances in which the Proposed Regulations would accelerate deductions, even for taxpayers entering into long equity swaps.⁴ Consequently, the Proposed Regulations, in the above-mentioned circumstances, would not eliminate tax deferral.

Investors enter into equity swaps with dealers for a number of nontax reasons. More than any other reason, investors use equity swaps to obtain more economic leverage than they could get by borrowing money to finance an investment in stocks. Obtaining more leverage through the use of equity swaps is possible because (i) swaps are not subject to “Regulation T”,⁵ which limits margin loans to 50% of the value of the financed stock, (ii) cash flows from all derivative contracts with the same counterparty covered by a single ISDA Master Agreement may be offset, and (iii) amounts payable under such derivative contracts are not subject to the automatic stay in bankruptcy. Consequently, swap dealers view only their net credit exposure to a customer in deciding how much leverage to provide. This facilitates the substantially higher economic leverage achievable through equity swaps than through leveraged investments in stocks. In other words, swaps allow parties to obtain the desired leveraged economic exposure for a customer while minimizing credit exposures for the swap dealer, and these benefits for the counterparties grow as a portfolio of swaps grows and diversifies (in terms of underlying stocks).

³ Five years ago, at the end of 1999, the S&P 500 index stood at approximately 1450. Since then, the S&P 500 index has declined every calendar year, except in 2003. Today, the index hovers at around 1100.

⁴ See note 22, below.

⁵ Regulation T of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 220.

In addition, the ability to net offsetting payments under ISDA Master Agreements allows counterparties to reduce their administrative and cash management burdens when they have a large number of swaps with each other.

Finally, under GAAP, the notional principal amounts of swaps are not recorded on a company's balance sheet. This off-balance sheet treatment is preferable to the on-balance sheet treatment of a leveraged investment in stock. A leveraged stock investment would require the debt and the stock to be recorded on a company's balance sheet, making certain balance sheet ratios appear less favorable.

The benefits of higher implicit leverage and netting of payments make a compelling case for the use of equity swaps (as compared to leveraged stock investments) for those investors that either employ significant leverage (such as hedge funds) or do not wish to incur debt to finance their investments (such as insurance companies).

For example, under a standard margin loan to finance the purchase of stock, an investor is only permitted, as a matter of law, to borrow 50% of the value of that stock, and will be required to maintain that 50% loan-to-value ratio on a daily basis.⁶ Similarly, if an investor sells stock short, all of the short sales proceeds plus assets equal to an additional 50% of the value of the short position must be maintained as collateral for the short position.

By comparison, an equity swap, in theory, allows an investor to make a 100% leveraged investment in stock or a stock index – no “margin” for the swap is required by law. In practice, a swap dealer normally requires some amount of “margin” (i.e., collateral) from investors as a prudent, credit risk management matter, but the amount of that margin generally is substantially less than 50%. In addition, if an investor has a portfolio of swaps with a particular dealer, then

⁶ See section 220.12 of Regulation T.

all of the payments between the counterparties under the swaps will be netted in determining the internal margin requirement.

To illustrate further the higher economic leverage available through the use of equity swaps, assume that a hedge fund with \$200 million in investable capital wants to acquire long and short positions in stocks. If the fund physically purchases certain stocks on margin and sells others short, the value of its portfolio initially cannot exceed \$400 million.

If, however, the fund were to obtain all of its exposure (both short and long) to a portfolio of stocks through equity swaps, and if the swap dealer required, for example, 20% “margin” on the total notional amount, then the fund could obtain the economic exposure to a portfolio of stocks with a notional value of \$1 billion. This higher leverage is possible because the leverage exists only in determining the notional amount of the contract. When an equity swap is entered into, no cash is loaned to the fund, and so no debtor-creditor legal relationship is created in respect of the notional amount. The dealer’s credit risk is thus limited to the fund’s actual payment obligations under the swap (which are substantially less than the notional amount).

The diversification and netting effects of having a portfolio of swap positions also boost the credit risk reduction benefits of using swaps. As a dealer diversifies its portfolio of equity swaps with a counterparty, the risk of unusually large counterparty exposure is reduced. Moreover, if the counterparty is trading other derivatives covered by a master agreement, these positions may provide additional credit risk reduction benefits through diversification and netting. Given these benefits, it is no surprise that equity derivatives have been growing in volume.⁷

⁷ According to a survey of our members, as of yearend 2003, the total notional amount of all equity derivatives, including swaps, options and forward contracts, was approximately \$3.44 trillion,

The nontax purposes of CNPCs is further evidenced by the fact that non-U.S. counterparties are as likely as U.S. counterparties to enter into CNPCs with a single payment at maturity. These counterparties, which may be foreign entities with foreign investors, are often indifferent to, and obtain no benefit from, tax deferral (including in their home tax jurisdictions).

If equity swaps generally are not tax-driven transactions, the question naturally arises as to why investors, such as hedge funds, would enter into an equity swap that has a single contingent payment at maturity, rather than periodic contingent payments. In fact, many equity swaps do feature periodic contingent payments and adjustments to the notional principal amounts. Those investors, particularly hedge funds, that choose to have a single contingent payment at maturity typically do so in order to (i) simplify their cash flow management and administrative functions, (ii) maintain their desired level of leverage (in the face of price fluctuations on the underlying stocks), and (iii) minimize the cost of maintaining that desired level of leverage. Having periodic contingent payments would complicate all three of these objectives.

As described above, payments under all swaps with one counterparty covered by a master agreement that are payable on the same day are netted into a single payment. Hedge funds sometimes arrange their swaps such that periodic payments for multiple swaps occur on the same day to reduce the number of payments required under all of their contracts. This netting mechanism makes it easier for a fund to manage the periodic cash flows on a portfolio of equity swaps. If the contingent payments on a portfolio of equity swaps are paid at maturity, then the only periodic payments to settle would be the LIBOR-based payments (and, in some cases, payments in respect of dividends). Since such periodic payments are based on interest rates, they

which reflects a 41% increase over the total as of yearend 2002. For more detailed statistics, please see our website at www.isda.org.

are much less volatile than contingent payments tied to changes in the value of the underlying equities. The periodic payments based on interest rates are also generally set in advance, so the amount of such payments can be determined in advance and the cash flows in respect thereof more easily managed. In fact, the netting of LIBOR-based payments on long and short equity swap positions further reduces the amounts payable between the counterparties. If the contingent payments were also paid periodically, the cash flows would be far more volatile and more difficult to manage.

Settling contingent payments periodically on a portfolio of equity swaps would require greater administrative resources to confirm that the calculations and payments are correct (because the amount of the contingent payment will vary with each swap on a different stock, whereas the amount of the LIBOR-based payment is the same regardless of the underlying stock).

Further, settling contingent payments periodically would reset the notional amount of the swap, and thus alter the amounts of LIBOR-based payments to be made or received. In the situation where a long equity swap position has appreciated in value (because the underlying stock has appreciated), settling the contingent payment periodically would increase the notional amount of the swap, thereby increasing the future LIBOR-based payments calculated off of the increased notional amount (which includes a dealer's spread). Even though cash would also be received by the long counterparty for the periodic contingent payment, there is still an additional cost to that counterparty, because it would now be required to pay the dealer a periodic payment based on the increased notional amount (including the dealer's spread), whereas the return on the invested cash may not be enough to fund such additional LIBOR-based payments. If the contingent payment were made at maturity, the notional amount would not be increased. As a

result, the desired level of leverage could be maintained, and the LIBOR-based payments would remain unchanged, which avoids additional leverage costs.

If the swap declines in value (because the stock depreciates) and the swap requires the contingent amount to be settled periodically, the hedge fund would be required to make a payment to the dealer for the equity depreciation. Although the hedge fund would be required to make smaller LIBOR-based payments in the future, because the notional amount would be adjusted downward, the hedge fund may find this undesirable, because it will have reduced the embedded leverage amount for the underlying stock. Thus, in order to maintain its leverage benefits (in both rising and falling markets), a hedge fund may prefer to have a single contingent payment at maturity of the swap.

The Proposed Regulations, for the reasons discussed below, will likely act as a *de facto* prohibition on using equity swaps with contingent nonperiodic payments, and we are at a loss as to why that would be considered desirable. That is not to say that there are no aggressive, tax-motivated uses of swaps that attempt to exploit the current NPC rules (such as the one described in Revenue Ruling 2002-30). But we do believe that such abuses are an infinitesimally small part of the overall market for swaps. Moreover, we believe that adopting general rules that adversely affect the vast majority of bona fide swaps in order to thwart the very small minority of transactions that are abusive is not sound tax policy. Rather, any abusive transaction would be better addressed by an enhanced anti-abuse provision.

II. General Description of the Proposed Regulations

A. Noncontingent Swap Method. The cornerstone of the Proposed Regulations is the “noncontingent swap method.”⁸ Under this method, the taxpayer calculates a projected amount for each contingent nonperiodic payment and amortizes that projected amount under a level payment method (discounting the projected amount using the Applicable Federal Rate (the *AFR*)). If the present value of the projected amount is considered to be “significant,” additional rules (as described in Part II.B., below) apply.

Under the Proposed Regulations, the projected amount of a contingent payment is to be determined in accordance with either of two specified methods and an overriding “reasonableness” requirement. Specifically, the projected amount must be either:

- (a) The actively traded futures or forward price (if any) for the specified index settling on, or within 3 months of, the date that the contingent nonperiodic payment is to be made, or
- (b) The current value of the specified index that is compounded by the *AFR* (less expected cash flows from the property underlying the index) to the date of payment.

If neither of the two methods above results in a reasonable estimate of the contingent payment, the taxpayer must use another method based on objective financial information that results in a reasonable estimate.

On each successive anniversary of the commencement date of the *CNPC* (each, a *redetermination date*), the taxpayer must: (1) redetermine the projected amount using current values on the redetermination date and the method that was used on the commencement date of the *CNPC*, and (2) reapply the level payment method (and, if applicable, the rules for significant

⁸ The Proposed Regulations also permit taxpayers to elect to mark to market many *NPCs* (including certain *CNPCs*). If the election is made, it would apply to all of a taxpayer’s *NPCs* that qualify for the election, not just *CNPCs*.

nonperiodic payments, discussed in Part II.B., below) as of the commencement date of the CNPC on the basis of the new projected amount and the AFR in effect on the redetermination date. Any difference between the amounts that would have been recognized in prior years under the new schedule and the amounts actually recognized in those prior years is (A) recognized ratably over the one-year period beginning with the redetermination date as if it were an additional payment (or receipt) on the CNPC, and (B) if the rules for significant nonperiodic payments (discussed in Part II.B., below) are applicable, to the extent the difference is attributable to a difference in interest amounts accrued on the deemed level payment loan advances, recognized as a net interest income (or expense) adjustment over such one-year period.

When the contingent payment is made or received, the net income (or deduction) on the CNPC for the taxable year in which the payment occurs is adjusted to reflect any difference between amounts previously recognized on the projected basis and the actual payment (as opposed to an adjustment to interest income or expense).

Under the Proposed Regulations, all payments made (or deemed made) under an NPC (including CNPCs), other than termination payments and interest expense related to significant nonperiodic payments, are treated as ordinary expenses under section 162 or section 212, and not as capital losses from the sale of property under section 1234A. The Proposed Regulations include a new regulation under section 1234A providing that any gain or loss arising from an NPC termination payment is treated as capital gain or loss.⁹ This regulation provides that periodic payments, noncontingent nonperiodic payments and contingent nonperiodic payments,

⁹ Proposed Regulation § 1.1234A-1.

including any final scheduled payment on an NPC, are not considered termination payments for purposes of section 1234A.¹⁰

B. CNPCs with Significant Nonperiodic Payments. Existing regulations require that a significant nonperiodic payment¹¹ on a swap be treated as two separate transactions — an on-market swap and a level payment loan.¹² Payments attributable to the deemed on-market swap are included in the net income (or deduction) for the swap. The deemed loan must be accounted for independently of the swap, and interest on the deemed loan is not netted with net income (or deduction) for the swap, but recognized as interest for all purposes of the Code.¹³

The Proposed Regulations build on the existing rule and provide that a CNPC with a significant contingent nonperiodic payment — e.g., a CDS¹⁴ or a total return equity swap —

¹⁰ In the case of a bullet swap or a forward contract, Proposed Regulation § 1.1234A-1(c) provides that any gain or loss from the settlement of obligations under the contract (including a payment pursuant to the terms of the obligations) is treated as a gain or loss from a termination of the contract.

¹¹ A contingent payment would be considered to be significant if the present value of the projected amount of the payment (determined as described above) is significant when compared to the present value of the total payments due from the counterparty making the contingent payment. The Proposed Regulations do not, however, provide any definitive guidance as to what constitutes “significant” for this purpose. Where the payment obligation of one counterparty to a CNPC is only to make the contingent payment, the projected amount of that contingent payment at inception will invariably be significant.

¹² Treasury Regulation § 1.446-3(g)(4). Both the existing regulations and the Proposed Regulations provide that, for purposes of section 956 (investment in U.S. property by controlled foreign corporations), the IRS can treat any nonperiodic swap payment (whether or not it is significant) as one or more loans.

¹³ For example, interest on the deemed loans is treated as interest for purposes of (i) the withholding tax on interest under sections 871 and 881 and (ii) the treatment of income from debt-financed property as unrelated business taxable income under section 514. It is uncertain whether, for purposes of the debt-financed property rules, the deemed on-market swap would be considered property and the deemed loan considered acquisition indebtedness. However, because the consequences of such treatment is significantly adverse to a tax-exempt investor, in the absence of further IRS guidance, tax-exempt investors are likely to assume such treatment.

¹⁴ For purposes of this letter, we assume that a CDS qualifies as an NPC under Treasury Regulation § 1.446-3, although we understand that this issue is under consideration by the Treasury and the IRS. See Notice 2004-52.

must be treated as if (1) the “long” counterparty that is expected to receive the contingent payment makes a series of annual level payment loan advances, equal to the present value of the projected contingent payment, to the “short” counterparty expected to make the contingent payment, and (2) the short counterparty uses the level payment loan advances to make annual level payments on the contingent payment obligation. If the significant nonperiodic payment is contingent, the noncontingent swap method requires not only that future interest income (and expense) on the deemed loans be redetermined in accordance with the new level payment stream resulting from the reprojected contingent payment, but also that interest income (and expense) previously realized on account of the deemed loans be adjusted to reflect the amount of interest income and expense that would have been realized if (1) the redetermined level payment stream had been utilized since the inception of the swap, and (2) interest income accruals on the deemed loans were calculated based on the current interest rate (as opposed to the one in effect at the inception or prior redetermination date of the swap). Interest income and expense are adjusted by reversing prior inclusions. For example, if the long counterparty previously was deemed to receive \$100 of interest income from the short counterparty, but as of the redetermination date, the long counterparty should only have received \$60 (based on the redetermined level payment stream), the long counterparty will be deemed to *pay* \$40 of interest expense to the short counterparty, which correspondingly will be deemed to receive \$40 of interest income.

In addition, the determination of whether any contingent payment is significant is made on each redetermination date. Consequently, there may be years in which the projected contingent payment is significant, even though in other years the projected contingency is not significant. In all years in which the contingency is not deemed to be significant, all prior interest inclusions (and deductions) must be reversed (as shown in the example above).

The deemed loan must be accounted for independently of the swap, even if a taxpayer otherwise elects (pursuant to the Proposed Regulations) to mark to market the swap. If a mark-to-market election is made, however, a taxpayer generally is not required to readjust the initial calculations of interest income and expense that will be deemed to be received and paid by each party.

III. Comments on the Proposed Regulations

A. General Observations. Under current law, payments made or received on financial products are, in very general terms, taxed according to one of several existing methods of accounting. First, holdings of physical securities are taxed under general realization and cash or accrual method principles. Second, certain debt instruments, including those with contingent payments, are taxed under a constant yield method where income and deductions are recognized at a fixed yield, with adjustments to be made when an amount is received to account for differences in the amount recognized and the amount actually received. Third, some financial products, such as options and forward contracts, are taxed under an open transaction method whereby a payment is not included in, or deducted from, income until the transaction lapses or is settled or terminated. Fourth, swaps are generally taxed under traditional accrual method principles reflected in Treasury Regulation § 1.446-3. Finally, securities and derivatives positions held by dealers and electing traders, as well as certain derivatives traded on exchanges or interbank markets,¹⁵ are taxed under a mark-to-market method, whereby the taxpayer recognizes gain or loss each year equal to the change in market value of such positions.¹⁶

¹⁵ See section 1256.

¹⁶ Certain anti-abuse rules, such as the constructive ownership rules in section 1260, are designed to tax certain derivative financial contracts in a manner that more closely matches the taxation of the underlying assets.

The method of taxing CNPCs in the Proposed Regulations is none of the above.¹⁷ It is also not one of the methods specifically described in Notice 2001-44, in which the IRS solicited comments on the appropriate method for accounting for income and deductions for CNPCs.¹⁸ While the Treasury and the IRS are not limited to those methods outlined in Notice 2001-44 or any of the existing methods of taxation, we believe that, in the absence of significant abuse of current law or other similarly compelling reasons, the proliferation of new tax accounting methods for financial products does not advance sound tax policy. We are not aware of any abusive transaction that would be prevented by the Proposed Regulations that the Treasury and the IRS do not already have authority to address under Treasury Regulation § 1.446-3(i) and Revenue Ruling 2002-30, 2002-1 C.B. 971.¹⁹

B. Guiding Tax Policy Principles. In Notice 2001-44, the IRS delineated the fundamental tax policy principles that should guide the assessment of any new method of accounting for CNPCs. They are economic accuracy, neutrality, certainty/clarity, administrability, flexibility, and symmetry. We submit that the noncontingent swap method in the Proposed Regulations fails to satisfy most of these important tax policy principles.

¹⁷ In addition, it does not have the effect of causing CNPCs to be taxed in a manner that closely matches the taxation of the assets or transactions of which they are derivative.

¹⁸ Notice 2001-44, 2001-2 C.B. 77. Notice 2001-44 set out four different methods under consideration by the IRS, each of which was different from the wait-and-see method under current law. The proposed 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 in the Proposed Regulations is not the same method as the noncontingent swap method described in Notice 2001-44; rather, it is somewhat of a hybrid between that method and the mark-to-market method described in the Notice.

¹⁹ Please see our corrected anti-abuse letter dated June 2, 2003, which is attached. We acknowledge that the proposed language in the letter may need some modification to fully and accurately address potentially abusive transactions without inadvertently affecting nonabusive transactions, and we would be pleased to work with the Treasury and the IRS to modify the language accordingly.

(i) **Economic accuracy.** The principle of *economic accuracy* is arguably the most important guiding principle in crafting new tax rules. While it may not be possible to measure economic income perfectly, tax laws should strive to measure income as accurately as possible and, at a minimum, avoid systematic distortions in such measurements. We believe not only that the Proposed Regulations fail to measure income from CNPCs accurately, but also that they materially distort the true economic income of the counterparties thereto.

The Proposed Regulations rely on forward pricing principles (where such principles are applicable) to project a contingent payment. The assumption in doing so is that the forward price of property is an estimate of what the future value of that property will be. That is clearly not the case. Forward pricing principles (where applicable) are premised simply on a “no arbitrage” assumption — that is, the price determined by such principles is the price at which no one could profit from a risk-free arbitrage.²⁰ If forward pricing were believed to predict future values, then future stock values would be predictable, which certainly is not the case.²¹ Otherwise, why would equity analysts bother to publish their research and “target prices” for stocks, if forward prices represented the best estimates of the future prices of stocks?

²⁰ If, for example, a potential forward buyer of stock offered a price higher than the price determined under forward pricing principles, then an arbitrageur could acquire the stock and sell it forward for a guaranteed profit. Similarly, if a forward seller offered the stock at a price lower than the price determined under forward pricing principles, then an arbitrageur could short the stock and buy it forward to make a guaranteed profit – *not* because he thinks the stock price will be higher on the forward purchase date, but because the proceeds from the short sale and his return on such proceeds will exceed the forward purchase price in this case.

²¹ We note that current Treasury Regulation § 1.446-3(f)(2)(ii) applies forward pricing principles as one permissible method to allocate a nonperiodic payment that is *not* contingent. Using forward prices for purposes of allocating a *noncontingent* nonperiodic payment under an off-market swap over the term of the swap is distinguishable from the use of forward pricing principles by the Proposed Regulations to project a *contingent* nonperiodic payment. The existing use of forward pricing principles in the NPC regulations is appropriate, because it attempts to amortize a known payment from one counterparty to the other (the nonperiodic payment) over the term of the swap — not, as in the Proposed Regulations, to project and amortize the amount of an indeterminable

The forward price of property is not a prediction of its future price. Rather, it is nothing more than its current price, compounded by the net cost of carrying that property for the term of a forward contract (that is, in the case of stock, the price of stock plus the cost of financing the investment in stock less the expected dividends over the course of the contract).²² Given that the forward price of a stock is nothing more than the current price compounded by a known financing rate (and an assumed dividend rate, which may be zero), it reveals nothing more about the future price of a stock than its current price reveals.²³ Thus, there is a fundamental contradiction in the noncontingent swap method between the use of forward pricing principles and the overarching requirement that any estimate of a contingent payment be “reasonable”. If, however, the objective is to estimate reasonably the “break-even” amount of a contingent payment, then forward pricing principles are appropriate in the context of some CNPCs (such as

contingent payment, the actual payment of which might deviate from the projected payment in terms of both amount and direction of payment.

²² A security has negative net carrying value when the income from the security is less than the cost of financing an investment in the security. For example, a total return equity swap that references a stock that does not pay a dividend would have a negative net carrying value. The forward price for such a stock would be higher than its current price. Conversely, a security has positive net carrying value when the income from the security is greater than the cost of financing an investment in the security. This situation can occur, for example, with a forward contract or total return swap on a bond or stock, where the referenced security has a coupon or dividend rate, respectively, that is higher than the rate to finance an investment in such security. In this situation, the forward price of such a security would be less than its current price.

Given today’s very low interest rate environment and the fact that companies are generally increasing dividends, in part due to the favorable tax treatment of dividends, it is likely that the forward price of some stocks will be *less* than their current price (which, under the Proposed Regulations, would result in a projected contingent payment *from* the long counterparty *to* the short counterparty). Consequently, in these situations, the Proposed Regulations would certainly not eliminate tax deferral.

²³ This is also evident from the fact that forward pricing principles would project the price of stocks of all companies with the same dividend rate to change by exactly the same percentage in one year — regardless of the businesses conducted by the companies, their positions in their industries, their expected earnings, the volatility of their earnings, or many other factors that are considered to affect stock prices.

total return swaps on fungible property), but still inappropriate for many other CNPCs (such as CDSs).

Even where forward pricing principles are appropriate to apply, the Proposed Regulations use the AFR, which, being a risk-free rate, is not the correct rate to use in determining either the projected contingent payment or the amount of the level payments that are taken into (or deducted from) income. For example, as described above, forward prices are based on the net cost of carrying the underlying property for the term of a forward contract. The cost of funds for any participant in the forward markets (or for anyone other than the U.S. Treasury) exceeds the risk-free rate, so using the AFR to project a contingent payment amount will underestimate such amount. Similarly, if the projected contingent payment is determined based on available futures prices, the Proposed Regulation's use of the AFR will be inconsistent with the financing rate implicit in such futures prices. In any case, the AFR is not the correct rate to use. The appropriate rate to use would be the fixed or floating financing rate that is used under the CNPC itself.

Furthermore, due to the fact that actively traded futures and forward contracts only exist with respect to a very small number of the wide range of assets and indices that CNPCs reference, taxpayers generally will have to either extrapolate the future price of a security by using the AFR and the current market price (the *extrapolation method*), or choose some other method, although, as indicated above, the Proposed Regulations offer no guidance on what other method (or even under what circumstances the extrapolation method) may be considered to be reasonable.

The most substantial economic inaccuracy of the Proposed Regulations, however, is the imputation of interest on a deemed embedded loan between the counterparties to an on-market

CNPC in which there is no fixed nonperiodic payment (only a contingent nonperiodic payment). For example, in a typical total return equity swap, the long counterparty pays LIBOR (plus a spread) and undertakes to pay any negative change in the value of a stock or stock index, in exchange for the right to receive payments equal to the dividends paid on the referenced stock or stock index plus a payment equal to any positive change in value of the stock or the stock index. The long counterparty is in a position economically similar to an investor that has purchased stock by *borrowing* 100% of the purchase price. Inexplicably, the Proposed Regulations treat the long counterparty as a *lender*, which reverses the economic reality of the financial relationship of the counterparties.²⁴

If, as an economic matter, there were any type of embedded loan from the long counterparty to the short counterparty, then one would expect that the prices quoted for an equity swap (that is the LIBOR-based rate) with a single contingent payment at maturity (which supposedly has the embedded loan and provides a benefit to the short counterparty) would differ from the price quoted for a swap with periodic contingent payments, but in fact dealers will quote the exact same price regardless of when the contingent payment is payable. As the saying goes, there is no free lunch (especially in the competitive swaps markets). We believe that this is conclusive evidence that there is no implicit or embedded loan in any on-market swap. This resulting economic inaccuracy under the Proposed Regulations is a by-product of simply extending the deemed loan rules applicable currently to significant *noncontingent*, nonperiodic

²⁴ We note that, under the current significant nonperiodic rules in Treasury Regulation § 1.446-3(g)(4), the counterparty that the regulations treat as a borrower is economically the borrower and the lender is the leverage provider – that is, the deemed lender advances a significant amount of cash to the deemed borrower. In contrast, under the Proposed Regulations, a counterparty is deemed a borrower even though it is the economic lender – it is the one receiving the LIBOR-based periodic payments. In addition, under the contingent payment debt instrument rules of Treasury Regulation § 1.1275-4 (the only other set of rules that require current accrual of a

payment in the current NPC regulations to significant *contingent* nonperiodic payments. We appreciate the desire of the Treasury and the IRS to craft rules that fit within the current framework for taxing NPCs generally, but forcing CNPCs into the current framework where they economically do not fit undermines the integrity of that framework.

(ii) Neutrality. The Proposed Regulations violate the principle of *neutrality*, and we believe that neutrality is also one of the paramount principles in crafting new tax rules. As stated in Notice 2001-44, “... in the financial products area, it is particularly important to pay attention to the neutrality principle [— that is,] consistent treatment of different instruments with similar economic characteristics.” The Proposed Regulations are not neutral, because the noncontingent swap method for CNPC taxation is substantially different from the methods that apply to other leveraged positions in debt and equity securities or futures and forward contracts thereon — financial transactions that are economically the most similar to CNPCs.²⁵

In fact, in terms of the timing of its net cash flows, a long position under a total return swap is economically similar to the purchase of the underlying property with 100% leverage. Thus, the most neutral method of taxation would permit the deduction of all periodic payments (subject to the limitations on deductibility of interest expense) and the recognition of gain or loss (which, to be neutral, would be capital in character) on any appreciation or depreciation in the value of the reference property when realized. Under the Proposed Regulations, however, the income (or deductions) arising from the contingent payment would be accelerated and (other than the portion treated as interest) treated as ordinary income (or expense). In the case of an

contingent payment), the purchaser of the note has actually advanced cash to the issuer of the instrument and is thus the economic lender.

²⁵ In our letter dated September 26, 2003 (a copy of which is attached), we provided examples illustrating how the noncontingent swap method (as well as the full allocation method) is also not neutral in the case of total return swaps on debt instruments and CDSs.

individual or partnership not engaged in a trade or business, this result is particularly adverse, since the deductibility of ordinary investment expense is severely limited (and such deductions are not permitted at all for alternative minimum tax purposes).

While the Treasury and the IRS appear to view the tax treatment of contingent payment debt instruments (*CPDIs*) as the paradigm for the taxation of CNPCs, we believe that CPDIs are not economically similar to CNPCs. An investor interested in obtaining the economic exposure and leverage provided by a total return equity swap may consider entering into a forward purchase of the underlying equity as an economically similar alternative. But that investor would not consider purchasing a CPDI for the simple reason that, among others, the taxpayer would have to finance the investment in a CPDI, whereas the equity swap and forward purchase contract require no upfront investment (and in that sense provide the investor with financing as an economic matter). A CPDI also provides for return of principal, which fundamentally differs from the economic exposure provided by an equity swap. Further, even if CPDIs were the appropriate paradigm, the noncontingent swap method under the Proposed Regulations (in particular, the annual redetermination and recapture requirements) deviates significantly from the noncontingent bond method for CPDIs and *every* other financial product currently in the marketplace.

(iii) Certainty/clarity. It is difficult to conclude that the Proposed Regulations are *clear*, given the extraordinary complexity of the annual redetermination and the recapture provisions. In addition, even ignoring these issues, we do not believe that the Proposed Regulations satisfy the principle of *certainty/clarity*, because the rules for determining projected amounts provide guidance for only a limited class of CNPCs (i.e., only those that have contingent payments that can be reasonably projected based on forward pricing principles).

Thus, given the wide range of assets and indices that CNPCs reference, the Proposed Regulations provide only limited guidance on determining what is a “reasonable estimate” of the amount of the contingent payment. The “actively traded futures and forwards” method²⁶ has very limited application, and it is unclear that the “extrapolation” method,²⁷ though more widely applicable, results in a “reasonable estimate.”²⁸ In all other cases, the Proposed Regulations require that the taxpayer must use “another method that ... result[s] in a reasonable estimate ... and that is based on objective financial information.”²⁹ That statement raises difficult questions (even for underlying property to which forward pricing principles could be applied), because there is no guidance on what constitutes a “reasonable estimate” of the contingent payment.

For example, there are no listed forward prices for single stocks and very few single stock futures.³⁰ Similarly, there are no listed forward prices for debt instruments. Thus, for the overwhelming majority of total return swaps and CDSs, there are no actively traded futures or forward prices available for purposes of projecting the amount of a contingent payment under Proposed Treasury Regulation § 1.446-3(g)(6)(iii)(A). Consequently, for the vast majority of

²⁶ Proposed Treasury Regulation § 1.446-3(g)(6)(iii)(A).

²⁷ Proposed Treasury Regulation § 1.446-3(g)(6)(iii)(B).

²⁸ See Proposed Treasury Regulation § 1.446-3(g)(6)(iii)(C) (neither the actively traded futures and forwards method nor the extrapolation method may be used if it does not result in a reasonable estimate).

²⁹ Proposed Treasury Regulation § 1.446-3(g)(6)(iii)(C).

³⁰ Single stock futures are available for only approximately 85 stocks out of a universe of thousands of publicly traded stocks. Moreover, the longest maturity of single stock futures currently is eight months. Thus, even for the very few stocks that have actively traded single stock futures, the “actively traded futures” method could only be applied to project a contingent payment no more than 11 months in the future (three months beyond the longest maturity single stock future). See http://www.onechicago.com/040000_trading/oc_041000.html

CNPCs, taxpayers will be required to use either the extrapolation method or some “other method”³¹ to arrive at a reasonable estimate.

It is far from clear, however, that using the extrapolation method results in a reasonable estimate of the contingent payment for total return swaps. There is no guidance to help taxpayers understand when their assumptions will be respected. As described above, using the AFR to project the forward price does not reflect the real cost of carrying the security underlying the CNPC, so the extrapolation method by its terms will generally underestimate the contingent payment. Would such an underestimate be a “reasonable estimate”? For example, if the risk-free rate were lower than the prevailing swap rate by a significant percentage, would the projected amount using the extrapolation method be unreasonable? Similarly, in the case of a CNPC referencing a stock or equity index, the extrapolation method requires an assumption about future dividend rates. How is one to determine whether the dividend rate assumption will result in a reasonable estimate of the contingent payment?³² Would it be reasonable if the taxpayer assumes that the rate will be the same rate that existed when the last dividend was paid?

The Proposed Regulations also do not address, for example, whether the reasonably expected amount of a contingent payment is (1) the amount most likely to be paid or (2) the probability-weighted average expected amount.³³ Another question unanswered by the Proposed Regulations is *whose* projections should be used under the noncontingent swap method: should

³¹ See Proposed Treasury Regulation § 1.446-3(g)(6)(iii)(C).

³² Microsoft announced this year that it will double its annual dividend from \$0.16 a share to \$0.32 a share. Moreover, Microsoft also announced a special, one-time \$3 per share dividend. Obviously, both of these announcements would substantially change the estimated forward price of Microsoft stock (and make prior estimates off-market).

³³ For example, consider a CDS on a single, highly-rated, reference obligor. The expected amount of the contingent payment is zero if measured as the amount most likely to become payable. However, an expected amount that reflects the probability and magnitude of a payment required to be made in the case of a credit event would be greater than zero.

each taxpayer make its own projections, or where a counterparty is a derivatives dealer, should its projections be used?

More generally, the Proposed Regulations give no guidance on how to determine the reasonably expected amount where the contingency is remote or incidental or, as in the case of CDSs, where there is a single resolution of the contingency (such as there ultimately being *no* payment) that is more likely to be the outcome than all other potential resolutions. Furthermore, the Proposed Regulations provide no guidance on how to account for (1) payments that are contingent as to timing as well as amount, (2) compound contingencies (for example, a payment that reflects the difference between two contingent amounts),³⁴ or (3) contingencies with optionality (where the formula used in determining the contingent amount may take account of hypothetical options that one of the counterparties may have).³⁵

(iv) Administrability. It is difficult to view the Proposed Regulations as being consistent with the principle of *administrability* given the complexity associated with: (1) the annual redeterminations, which take into account not only changes in the value of the expected contingent payment, but also changes in interest rates and (2) the significant

³⁴ For example, consider an equity swap, where the contingent payment is the difference between the change in values of two stocks in the same industry. It is unclear under the Proposed Regulations whether this type of swap would be viewed as providing for a single netted contingent payment or two contingent payments (one from each counterparty).

³⁵ For example, the change-in-value payment made by the long counterparty on an equity swap (in the event that the reference security actually declines in value) may be subject to a cap (i.e., the long counterparty has limited its potential loss), and, in return, the periodic payments that the long counterparty is required to make is greater than they would be for an equity swap without a loss cap. It is unclear under the Proposed Regulations whether it is necessary to take account of the embedded put by either (1) adjusting the projected forward price to take account of its value or (2) deferring, in part, the accrual of the periodic payments to reflect the fact that the periodic payments were “priced” to take account of the value of the embedded put.

nonperiodic payment rules, which require a portion of the accrued inclusions and deductions to be treated as interest and the remaining portion as section 162 or section 212 expenses.³⁶

We submit emphatically that it is not the case that, as the preamble to the Proposed Regulations assumes, counterparties to CNPCs are capable of understanding and administering these rules. The noncontingent swap method's annual redetermination requirement imposes a significant administrative burden on taxpayers and the dealers in CNPCs that will effectively be required to determine and provide the relevant information.³⁷ Our members do not have the operational capability to calculate redeterminations on a daily basis for potentially hundreds or thousands of long and short CNPCs positions — nor are they capable of reporting such payments. We do not believe that dealers could develop systems at a reasonable cost and within a reasonable timeframe to provide for such complex calculations and reporting. It is also unreasonable to assume that investors could successfully establish the systems necessary to track these calculations. In effect, the complexity and compliance challenges of the Proposed Regulations likely will serve as a *de facto* prohibition against entering into CNPCs.

The annual redeterminations make the proposed noncontingent swap method a quasi-mark-to-market approach. It is more complex than a traditional mark-to-market method, however, because the amount recognized in each year is based on a redetermined projected amount of the contingent payment (not a redetermined fair market value of the swap). Adding to

³⁶ Although the existing significant nonperiodic payments rules reclassify a portion of swap payments as interest income and expense, they do not require annual redeterminations (which, as indicated below, are very complex). The current rules for significant nonperiodic payments do not raise similar administrability concerns, because significant *noncontingent*, nonperiodic payments are unusual in the context of most swaps. In contrast, contingent payments are likely to be significant in all typical CNPCs.

³⁷ While redeterminations for each CNPC by themselves would be burdensome if required at the end of each taxable year, requiring anniversary redeterminations will require many taxpayers and virtually all dealers to make redeterminations daily (as every day will be a redetermination date for dealers that routinely enter into swaps on a daily basis).

the complexity is that the new projected amount is taken into account over the remaining term of the CNPC after the redetermination date, while the difference between (i) the annual projected payment amortization and deemed interest amounts under the redetermined schedule for prior years and (ii) the actual prior year amortization and deemed interest amounts is taken into account over a one-year period following the redetermination date. And if the rules for significant nonperiodic payments are applicable (which generally will be the case for the most common types of CNPCs), amounts treated as accrued interest on the deemed level payment loan advances are not netted with the deemed payments (or receipts) on the CNPC, but instead are recognized as interest income (or expense) for all purposes of the Code.

In addition, the significant nonperiodic payment rules (which will generally apply to most forms of CNPCs), requiring a portion of the accrued inclusions and deductions to be treated as interest for all purposes of the Code, will severely strain the resources of the dealers in CNPCs, if they will be required to track and undertake information reporting in respect of deemed interest payments for all of their CNPCs, and recalculate these deemed amounts on an annual basis.³⁸ Furthermore, in the case of information reporting, systems currently in place are typically designed to track and report *net payments*; changing to a method that reports calculated amounts not tied to actual payments would be an expensive and time consuming task. This is particularly true since the Proposed Regulations could treat a CNPC holder as having both deemed and actual payments in both directions — that is, an investor could be viewed as both making and receiving

³⁸ Treasury Regulation § 1.6041-1(d)(5) currently requires amounts characterized as interest in respect of a significant nonperiodic payment to be reported only when paid and at that time, only as a swap payment and not as interest. It is conceivable that such rule would be amended to require that the counterparty projected to make the contingent payment provide more extensive information reporting. In addition, even if not obligated under the Code, it is likely that dealers will effectively be required to provide such information to their customers, who invariably can be expected to demand it so that they can comply with the Proposed Regulations.

payments in a year. Unlike periodic and nonperiodic swap payments that are netted, deemed interest and swap payments are not netted.

(v) **Flexibility.** The principle of *flexibility* is not satisfied because the principles of the Proposed Regulations cannot readily be applied to accommodate new financial instruments, such as new types of CNPCs. In fact, the Proposed Regulations do not even provide sufficient guidance for many of the CNPCs that currently exist. As discussed in Part III.B.iii., above, the Proposed Regulations specifically address only CNPCs that have contingent payments that can be projected based on forward pricing principles and do not provide guidance for the majority of CNPCs, the contingent payments on which cannot be projected based on such principles — that is, CNPCs, such as CDSs, in which both the timing and amount of the contingent payment are indeterminable.

(vi) **Symmetry.** The principle of *symmetry* is, as a practical matter, not satisfied, because most CNPCs are entered into with dealers in securities (within the meaning of section 475) that mark to market their CNPC positions. For this reason, the principle of symmetry generally will not be satisfied under any methodology other than a mark-to-market method, but we believe that symmetry is the least important of the enumerated tax policy principles.

C. **Other Issues Raised by the Proposed Regulations.**

(i) **Deemed interest payments.** Under the Proposed Regulations, interest on the deemed loans resulting from a significant, contingent nonperiodic payment is characterized as interest for all purposes of the Code. Besides the administrative burdens associated with deemed loans and interest payments, they raise several substantive tax issues.

(a) Debt-financed income. Pension plans and other tax-exempt investors are subject to tax on debt-financed income.³⁹ The deemed interest payments under the Proposed Regulations raise the concern that income derived from the CNPC would be debt-financed income.⁴⁰

(b) Withholding tax. It is generally understood that CNPCs documented with terms generally found in standardized master agreements (such as ISDA Master Agreements) are in “registered form”, but this conclusion is not absolutely clear.⁴¹ Thus, where a U.S. person is obligated to make a contingent payment under a CNPC to a non-U.S. person, the imputed interest portion of such payment could be subject to withholding, since the counterparties may not benefit from either (i) the rule that determines source of income on an NPC by reference to the payee (in this case, foreign)⁴² or (ii) the exemption from withholding for portfolio interest on registered debt obligations.⁴³

(c) Asymmetric treatment of deemed interest. The prohibition against netting a deemed interest payment (or receipt) with the corresponding swap payment has the potential effect of causing the income and expense on a single financial instrument that offset each other economically to not offset each other for tax purposes, because different limitations apply to the deductibility investment expenses and interest expense. Furthermore, interest income in one year may be “reversed” with an interest deduction the next year, but there is no provision in the Proposed Regulations to permit interest expense to be deducted to the extent it

³⁹ See section 514.

⁴⁰ See note 13, above.

⁴¹ See Treasury Regulation § 5f.103-1(c)(1) (definition of registered form). See also Treasury Regulation § 1.871-14(c).

⁴² Treasury Regulation § 1.863-7(b). See also Treasury Regulation § 1.1441-4(a)(3) (generally no withholding on NPCs).

⁴³ Section 871(h)(2)(B).

does not exceed the deemed interest previously received (as permitted by the net negative adjustment rules in the CPDI regulations).⁴⁴ Rather, the normal limitations of deductibility of interest would apply.

(d) Interest allocation. Section 864(e) and Treasury Regulation § 1.861-9T contain rules for allocating and apportioning a taxpayer's deductible interest expense in order to determine the taxpayer's foreign tax credit limitation under section 904(a). Under these rules, a taxpayer's aggregate interest expense generally is ratably apportioned to a taxpayer's foreign source gross income based on the portion of the taxpayer's assets that generate foreign source income. Thus, the deemed interest accrual requirement may have the effect of reducing the foreign tax credit limitation for a taxpayer in a situation where it is not otherwise appropriate to allocate payments made on the CNPC to reduce foreign source gross income.

In addition, if a counterparty to a CNPC is a U.S. branch of a foreign bank (which would not be unusual, as foreign commercial banks are active participants in the U.S. derivatives markets), the amount of its interest deductions would be limited by the rules under Treasury Regulation § 1.882-5.

(e) Subpart F. Under Subpart F of the Code, a U.S. shareholder in a controlled foreign corporation is required generally to include in income currently, among other items, its pro rata share of the corporation's passive income for the year, such as interest income, regardless of whether the corporation makes any distribution to the shareholder in that year. Where a controlled foreign corporation is counterparty to a CNPC under which the deemed loan provisions require it to recognize deemed interest, a U.S. shareholder in the corporation would generally be required to include in income the deemed interest payment in a situation where

⁴⁴ See Treasury Regulation § 1.1275-4(b)(6).

neither the corporation nor the shareholder actually receives such payment. Furthermore, such Subpart F inclusions may not be subsequently reversed, even if the interest income is reversed in future years due to a redetermination of the projected contingent payment.

Similarly, the deemed loan provisions of the Proposed Regulations are likely to create deemed dividends under section 956 for a U.S. parent corporation that enters into an on-market CNPC with its foreign subsidiary, even though an on-market CNPC transfers no value to the U.S. parent when entered into (unlike an off-market CNPC which, under the current NPC regulations, can create a deemed loan to the parent).

(f) Mark-to-market accounting. As indicated in Part I, above, if a taxpayer elects to mark to market a CNPC that has a significant contingent nonperiodic payment, the taxpayer must still bifurcate the CNPC into an on-market, level payment CNPC and a loan, and must account for the loan separately for all purposes of the Code. As a practical matter, requiring taxpayers to split their CNPC between a loan and a NPC makes the election effectively unavailable. First, it will be very difficult to get market values for the bifurcated pieces. They certainly will not be readily available. Customers will expect the dealer counterparties to provide this information, which dealers are currently not equipped to handle. Moreover, the calculations will be very complicated if taxpayers are not allowed to mark to market the debt component of the contract. Given our understanding that a significant purpose of the mark-to-market election is to allow taxpayers to account for their CNPCs in an administratively easier fashion than the noncontingent swap method, we do not think this goal can be achieved if the deemed loan treatment remains in place.

(ii) Liquidity of securitization investments. Generally, a taxpayer's direct holdings of CNPC positions are not directly transferred; rather, liquidity is provided by the

derivatives dealer who is the counterparty to the CNPC and stands ready to terminate the CNPC at a customer's request. In the very large securitization market, however, special purpose securitization vehicles often use CNPCs (particularly CDSs to create synthetic collateralized debt obligations), and equity interests in such vehicles are transferable and intended to be liquid. Use of the noncontingent swap method may accelerate deductions in an uneconomic matter for the protection seller in a CDS (as well as for holders of short positions in other types of CNPCs), creating phantom losses in early years followed by phantom income in later years. While the initial acceleration of deductions may seem favorable to taxpayers, this acceleration will likely reduce the liquidity of equity interests in securitization vehicles that hold CNPC positions. Liquidity will be reduced because subsequent holders will be adversely impacted by either the phantom income when it arises or by the inability to deduct the full amount of a loss (because the prior holder has already deducted some of that loss).⁴⁵

(iii) Character of contingent payments. The treatment of all payments made (and deemed made) under CNPCs (other than termination payments, the definition of which is modified in the Proposed Regulations) as ordinary in nature is inconsistent with the economics of most equity swaps and CDSs. In the case of an equity swap, the contingent payment is in respect of the change in value of stock (or equity index) that, if held directly, generally would give rise to capital gain or loss. Similarly, the contingent payment on a CDS is in respect of the change in value of a debt instrument that, if held directly, generally would give rise to capital gain or loss.

The preamble to the Proposed Regulations provides:

Because of their recurring nature, periodic payments should be treated as ordinary income items, whether or not the payments are made at the expiration of an NPC.

⁴⁵ For an explanation (with examples) of this problem, see the letter, dated April 20, 2004, from Mark H. Leeds, Managing Director and Senior Tax Counsel for Deutsche Bank AG New York (a copy of which is attached).

The same rationale applies to nonperiodic payments, which are required to be spread over the term of an NPC.

Because contingent nonperiodic payments do not have a “recurring nature,” we fail to see why the rationale applicable to periodic or fixed nonperiodic payments should apply to contingent nonperiodic payments. The gain or loss attributable to the final contingent payment on most CNPCs is “attributable to the ...expiration...of a right or obligation...with respect to property which is (or on acquisition would be) a capital asset” and thus should (as a policy matter) be capital gain or loss under section 1234A.

Furthermore, we think there is sufficient statutory authority supporting the position that a scheduled payment made at the maturity of a contract comes within the scope of section 1234A since, by its terms, section 1234A applies to lapses and expirations of rights and obligations. The fact that section 1234A was amended by the Taxpayer Relief Act of 1997 to extend its application from actively traded property to all capital assets further supports this position. Congress believed that the prior law was deficient because it taxed economically similar transactions differently — it effectively provided taxpayers (with some minor exceptions, e.g., securities dealers) with the ability to elect capital or ordinary treatment, and its lack of certainty made the law unnecessarily difficult to administer.⁴⁶ Taxing the contingent payment made at maturity differently from economically similar transactions would frustrate Congress’ intention to extend the scope (and eliminate the whipsaw potential) of section 1234A. In fact, taxpayers could simply elect whether they wanted to receive ordinary or capital treatment with respect to the final payment on a CNPC, merely by holding the CNPC to maturity, if it wants ordinary treatment, or by terminating the CNPC prior to maturity, if it wants capital treatment.

⁴⁶ See Joint Committee Report, JCS-23-97, “General Explanation of Tax Legislation Enacted in 1997,” December 17, 1997.

(iv) Positions hedging or hedged by CNPCs. If the Proposed Regulations are adopted, transactions that a taxpayer may enter into that hedge or are hedged (in the general sense and not as defined by Treasury Regulation § 1.1221-2) by a CNPC will be taxed differently than CNPCs. This disparity will likely result in character and timing mismatches, which will create additional tax costs to taxpayers that use CNPCs for important operational (and non-tax motivated) objectives. For example, suppose a taxpayer bought Company A's debt (which is not actively traded) for \$100, but subsequently decided to hedge itself from a portion (or all) of its exposure. The taxpayer may (for nontax reasons) enter into a CDS, in which it will pay a credit spread payment to its swap counterparty, in return for a payment (of an amount intended to approximate any loss) if and when a credit event occurs with respect to Company A. If, due to a credit event, Company A's debt is now worth \$70, the taxpayer, if it sells the debt, will have a \$30 capital loss (which will be long-term if the taxpayer held it for over one year). Under the Proposed Regulations, however, the amount paid by the swap counterparty to the taxpayer (assume it is \$30 and, for simplicity, that the payment is taken into account only upon the occurrence of the credit event) will constitute ordinary income. Thus, the taxpayer will have a \$30 capital loss (which may be long-term) and \$30 of ordinary income, even though economically the taxpayer has lost only the amount of the credit spread payments made to the counterparty. This mismatch, which will have an adverse effect on many taxpayers, will inevitably induce taxpayers to structure their transactions as other than swaps.

IV. Recommendations

A. Retain Wait-and-See Method for CNPCs with Terms of Five Years or Less.

In light of the foregoing issues with the Proposed Regulations, we continue to believe that current law's wait-and-see approach for contingent payments is the most appropriate method for

taxing CNPCs. As we have discussed in our prior letters and during our meeting of September 30, 2003, we continue to believe that this approach best satisfies the fundamental tax policy principles that the Treasury and the IRS announced in Notice 2001-44 (except for *symmetry*, which as a practical matter, no method other than mark-to-market method will satisfy) — *certainty/clarity, administrability, economic accuracy, flexibility, and neutrality*. We continue to believe that any abuses of current law’s wait-and-see approach could be addressed by an appropriately crafted anti-abuse provision.

Nonetheless, if you decide that the current wait-and-see approach cannot be maintained, we recommend in that case that the wait-and-see treatment continue to apply only to (i) CNPCs that have a term of five years or less (which will include the vast majority of all CNPCs)⁴⁷ and (ii) CNPCs that have a contingent payment that is indeterminable as to both the timing and the amount thereof as of the date entered into (e.g., credit derivatives such as CDSs). Because the practical value to the taxpayer (and cost to the government) resulting from income deferral depends on interest rates and the length of the deferral, we do not believe that five years of deferral is significant.⁴⁸ As for CNPCs with contingent payments that are indeterminable as to their timing and amount, such as CDSs (where a credit-related payment often is not even expected to be made), application of any method of taxation other than wait-and-see will create tax timing and character mismatches and disrupt many existing transactions.

⁴⁷ For example, according to the Office of the Comptroller of the Currency, as of the second quarter of 2004, approximately 90% of the total over-the-counter equity derivatives entered into by commercial banks (as measured by notional amounts) had terms of five years or less. See <http://www.occ.treas.gov/deriv/deriv.htm>.

⁴⁸ The current wait-and-see approach does not invariably result in income deferral. Taxpayers with a short position under an equity swap are currently taxable on the swap payments they receive, but defer any deduction in respect of any contingent payment until made at the maturity of the swap. Similarly, even for a long counterparty to an equity swap, any potential loss payment it may be required to make is not recognized until made at the maturity of the swap.

With regard to the concern that taxpayers may be able to convert what would otherwise be ordinary income as an economic matter (reflecting time value of money) to capital gain by utilizing a swap (such as the swap described in Revenue Ruling 2002-30), we believe that the Treasury and the IRS already have sufficient authority to prevent taxpayers from achieving such conversions. Of course, if the Treasury and the IRS think otherwise, we suggest that the anti-abuse provisions of the notional principal contract rules be strengthened, and we would be glad to assist in that effort.

The wait-and-see method — particularly for CNPCs with terms of five years or less and those with contingent payments that are indeterminable as to both timing and amount — is more sensible than the full allocation method, because it avoids the timing and character mismatch (and phantom income, resulting from the inability to deduct swap payments when made) that results from the full allocation method. At the same time, the use of the wait-and-see method for these CNPCs should not result in any significant loss to the Treasury. However, in order to limit any potential benefits of retaining the wait-and-see method for these classes of CNPCs, and because CNPCs typically resemble leveraged purchases, we recommend that solely for purposes of section 263(g) (disallowing deductions for interest and carrying charges properly allocable to personal property that is part of a straddle) and section 163(d) (limiting investment interest deductions in any taxable year to net investment income for that year), net periodic payments be treated as interest.

B. Full Allocation for CNPCs with Terms Greater than Five Years. For CNPCs with a term greater than five years (again, other than those with contingent payments that are indeterminable as to both timing and amount), we recommend that the full allocation method be adopted, under which the income inclusions and deductions of both noncontingent and

contingent payments by the counterparties would be deferred until the contingent payment is received (or paid) (with perhaps an exception for remote or incidental contingencies and contingencies that are fixed more than six months prior to the maturity of the CNPC). Although the full allocation method may not fully satisfy the tax principles of *economic accuracy* and *neutrality* (except with respect to forwards and options), it satisfies the principles of *certainty/clarity*, *administrability* and *flexibility*.⁴⁹

In its June 4, 2004 Report on Proposed Notional Principal Contract Regulations (the *June 4th NYSBA Report*), the New York State Bar Association Tax Section recommended that the full allocation method be employed for capital asset CPNCs that have a maturity of no more than five years.⁵⁰ However, we see no reason (for all of the reasons given above) why this method should not be used for CNPCs that have a maturity of greater than five years. It is simple, flexible, and is at least neutral with the taxation of forward contracts and options. There are no timing or character advantages to taxpayers, because all payments would be taken into account for tax purposes at maturity and would be netted to determine a single capital gain or loss (thus no payments would offset ordinary income).

C. Elective Mark-to-Market Treatment for all CNPCs and Positions Hedging or Hedged by Them. We recommend that taxpayers be given not only an election to mark to market all of their CNPCs (regardless of their maturities), but also, an election to mark to market all identified positions that hedge or are hedged by such CNPCs.⁵¹ We expect that taxpayers electing to mark to market a CNPC will generally do so in order avoid the potentially detrimental

⁴⁹ The preference for the full allocation method over any other method (other than the wait-and- see method) is discussed in our letter dated September 26, 2003 (a copy of which is attached).

⁵⁰ The June 4th NYSBA Report may be found at www.nysba.org (Report #1062 of the Tax Section).

⁵¹ Identification methods are well established under several regulations. See, e.g., Treasury Regulation §§ 1.1092(b)-3T(d), 1.1221-2(f), 1.1275-6(e), and 1.1256(e)-1.

new character and timing regime. Thus, we believe that they should be permitted to mark to market all related positions in order to prevent the very mismatch (in timing and character) that they are (in part) attempting to avoid by marking to market their CNPCs.

Under our recommendation, two separate mark-to-market elections should be available to taxpayers: one for CNPCs with terms of up to five years (which would otherwise be subject to the wait-and-see method under our recommendations) and one for CNPCs with terms greater than five years (which would otherwise be subject to the full allocation method under our recommendations).

As with the elective mark-to-market provisions under section 475(f), mark-to-market gains or losses should be ordinary in character. We would also note that, consistent with its character as a loss, any mark-to-market loss for an individual taxpayer should not be treated as an investment expense under section 212 (and thereby subject to the limitations on deductibility of itemized deductions).

D. Section 1234A's Application to all Contingent Payments. Subject to existing special character rules, such as section 475 and Treasury Regulation § 1.1221-2, we believe that section 1234A should apply to all contingent payments — both periodic and nonperiodic — under a CNPC, provided that such payments reference capital assets. We do not believe there is any policy reason for treating them otherwise; doing so is a trap for the unwary and an opportunity for abuse. Furthermore, we do not believe that determining that an event is not a termination for purposes of section 446, a timing rule, should have any implication for section 1234A, a character rule.⁵²

⁵² We note that the New York State Bar Association Tax Section also believes that section 1234A should apply to such payments and that the Treasury and the IRS have the authority to issue regulations to that effect. See the June 4th NYSBA Report.

E. Effective Date. The Proposed Regulations state that they are only effective for CNPCs entered into on or after 30 days after final regulations are issued.⁵³ The Preamble, however, provides:

The wait-and-see method, however, is inconsistent with the existing specific timing rules for periodic and nonperiodic payments and with the general rule in §1.446-3(f)(2)(i) respecting recognition of nonperiodic payments over the term of the contract....The back-loaded timing of tax consequences that results from the wait-and-see method is also inconsistent with the timing regime that §1.1275-4(b) provides for contingent debt instruments subject to the noncontingent bond method....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....

Absent this language in the Preamble, we would have little concern about the effective date of the Proposed Regulations. For the very important practical and technical/policy reasons that are discussed in our letter dated March 19, 2004 (a copy of which is attached), we believe that the Treasury and the IRS should immediately issue interim guidance that clarifies the fundamental issues that are impacting the marketplace, specifically that (1) the effective date of all provisions of the Proposed Regulations will be the date specified in the Proposed Regulations themselves (and not the Preamble) and (2) pending the promulgation of the final regulations, all taxpayers may use the wait-and-see method for contingent nonperiodic payments (regardless of

⁵³ Proposed Regulation §1.446-3(j)(2).

whether they have established a method of accounting by the date that the Proposed Regulations were issued).⁵⁴

Because we have already provided detailed comments on the effective date issue in our letter of March 19, 2004, and our meeting of April 8, 2004, we do not repeat them here. We do note, however, that the wait-and-see method for contingent nonperiodic payments has been the established practice in the market for many years and is a fundamental principle of the accrual accounting method. This has been recognized not only by respected commentators, but also by Congress and by the Treasury and the IRS.⁵⁵ The wait-and-see method is also the tax treatment of foreign currency swaps (in respect of the exchange gain or loss on the notional principal amounts), which are a form of total return swaps. Consequently, we believe that it is inappropriate to prohibit taxpayers from using the wait-and-see method prior to giving them an

⁵⁴ Certain aspects of the Proposed Regulations thought less controversial by the Treasury and the IRS are proposed to be retroactive and apply to NPCs entered into on or after December 13, 1993. See Proposed Regulation § 1.446-3(j)(1). However, because it is likely that the substantive portions of the Proposed Regulations may be changed prior to their finalization, and require conforming changes to other (retroactive) portions of the Proposed Regulations, we believe that all aspects of the Proposed Regulations should be effective only after final regulations are issued.

⁵⁵ See, e.g., David C. Garlock, “The Proposed Notional Principal Contract Regulations: What’s Fixed? What’s Still Broken?,” 102 Tax Notes 1515 (March 22, 2004) (“most taxpayers and practitioners [have concluded] that, absent further guidance, [a party could deduct the periodic payments on an equity swap and] take into account the entire amount of the payment at the maturity of the swap in the year of the payment.”); Mark Leeds “Deutsche Bank Seeks Clarification of Proposed Regs Affecting Notional Principal Contracts,” 2004 TNT 57-32 (March 2, 2004) (same); New York State Bar Association, Tax Section, “Report on Notional Principal Contract Character and Timing Issues,” 79 Tax Notes 1303 (June 8, 1998) (“The Committee believes that, under current law, gain or loss with respect to a contingent nonperiodic payment is deferred until it is fixed under the wait-and-see approach”). See also section 1260(d)(1)(A) and (d)(3) of the Code (inclusion of total return swaps, such as equity swaps, as “constructive ownership transactions” subject to recharacterization of long-term capital gain to ordinary income and an interest charge), which would not have been necessary if the wait-and-see method did not apply to contingent payments on CNPCs. Moreover, in Revenue Ruling 2002-30, the Treasury and the IRS held that where a nonperiodic payment on a swap is comprised of a contingent component and a noncontingent component, the two components must be treated separately and the taxpayer “must recognize the *noncontingent component* of the nonperiodic payment over the term of the NPC...” (emphasis added). While perhaps not explicit, it is clear from the Revenue

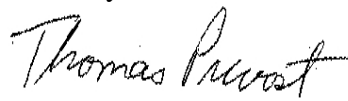
opportunity to comment on the prohibition and the method proposed to be used in its place. Although we believe that all CNPCs should be subject to any such interim guidance, in light of your concern that the wait-and-see method permits “inappropriate” tax deferral (a concern that we do not share), we suggest that, if necessary, such interim guidance could limit the use of the wait-and-see method to CNPCs with terms of five years or less since. As we have noted herein, the taxpayer benefit and cost to the government, if any at all, from applying the wait-and-see method to CNPCs with five-year and shorter terms (which would include the overwhelming majority of CNPCs in the marketplace today) would be relatively insignificant.

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Ruling that the Treasury and the IRS expected the taxpayer to use the wait-and-see method for the contingent nonperiodic amount (which was not challenged).

Thank you for giving consideration to the recommendations made in this letter. We would like to arrange a meeting to discuss these concerns further with you. In the meantime, we would be happy to answer any questions you may have or provide you with any additional information that you may need in determining whether to issue the requested guidance. You can reach me at 212/325-7486 or our tax counsel, David Nirenberg, at 212/506-5085.

Sincerely,



Thomas Prevost
Thomas Prevost
Chair, North American Tax Committee

cc: Eric Solomon, Deputy Assistant Secretary, Regulatory Affairs, Department of Treasury
Helen M. Hubbard, Tax Legislative Counsel, Department of Treasury
Michael S. Novey, Associate Tax Legislative Counsel, Department of Treasury
Emily A Parker, Acting Chief Counsel, Internal Revenue Service
Nicholas J. DeNovio, Deputy Chief Counsel (Technical), Internal Revenue Service
Robert M. Brown, Associate Chief Counsel, Income Tax & Accounting
Lon B. Smith, Associate Chief Counsel, Internal Revenue Service, Financial Institutions and Products
Dale Collinson, Special Counsel to the Associate Chief Counsel, Financial Institutions & Products
Kathleen Sleeth, Assistant to Branch Chief, Internal Revenue Service, Branch 1
Viva Hammer, Attorney Advisor, Department of Treasury