

Clients & Friends Memo

Proposed Treasury Regulations Regarding Swaps and Other Notional Principal Contracts Providing for Contingent Nonperiodic Payments

March 16, 2004

I. Introduction and Overview.

On February 26, 2004, the Treasury Department and the Internal Revenue Service issued proposed regulations addressing the timing of income, gain, loss and deductions in respect of swaps and other “notional principal contracts”¹ that provide for one or more “contingent nonperiodic payments,” such as equity swaps that provide for a single appreciation or depreciation payment at maturity, credit default swaps that provide for a payment upon a “credit event” with respect to one or more reference securities, and other similar contracts. The proposed regulations also address the character of gain and loss in respect of swap “value payments,” such as an appreciation or depreciation payment on an equity swap.²

¹ A notional principal contract is defined as “a financial instrument that provides for payments from one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount, in exchange for specified consideration or a promise to pay similar amounts.” Treasury Regulations section 1.446-3(c)(1)(i). Notional principal contracts include interest rate swaps, equity swaps and credit default swaps, but do not include futures contracts, forward contracts, options, or debt. Treasury regulations section 1.446-3(c)(1)(ii). Thus, options and forward contracts are not affected by the proposed regulations.

Although the proposed regulations apply to all notional principal contracts, this memorandum refers only to swaps. Moreover, this memorandum refers to any swap or other notional principal contract providing for a contingent nonperiodic payment as a “contingent swap.”

All references to section numbers are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated or proposed thereunder.

² This memorandum refers to the payment at maturity in this swap as a “value payment” because the amount of the payment is determined by reference to the value of property. A contingent nonperiodic payment is defined in the proposed regulations as any payment under a swap or other notional principal contract that is **not** (i) paid at least annually (*i.e.*, a “periodic payment”), (ii) made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of a party to the contract (*i.e.*, a “termination payment”) or (iii) fixed at or before the end of the taxable year in which the contract commenced or equal to the sum of amounts that would be periodic payments if they were paid when they became fixed (*i.e.*, a “noncontingent nonperiodic payment”). Therefore, a value payment at the maturity of

In short, the proposed regulations dramatically change current practice regarding the timing of income, gain, loss and deduction in respect of contingent swaps. The Preamble to the proposed regulations declares that the “wait-and-see” approach of accounting for contingent swaps – which is used by virtually all “mainstream” (i.e., non-mark-to-market) taxpayers – is “inconsistent” with existing authorities. The Preamble therefore requires all mainstream taxpayers that are a party to a contingent swap on or after March 27, 2004 to accrue the contingent payment under a “reasonable amortization method” unless the taxpayer has previously entered into a contingent swap and adopted a method of accounting for contingent swaps (presumably including the wait-and-see approach).³ In addition, under the Preamble, the “grandfather period” for these taxpayers that have previously adopted a method of accounting for contingent swaps will end in the first taxable year ending on or after 30 days after the regulations are finalized, at which time the IRS may require amortization.

The proposed regulations will adversely affect mainstream taxpayers entering into long equity swaps that provide for a single appreciation payment at maturity; these taxpayers will now be required to accrue currently (i.e., as “phantom income”) the contingent payment, rather than waiting until maturity to recognize any gain, unless they have previously adopted the wait-and-see method.

On the other hand, the regulations may provide a windfall tax benefit (i.e., “phantom deductions”) for certain mainstream taxpayers that enter into “short” equity swaps that provide for a single depreciation payment at maturity or write protection under a credit default swap. However, individuals that enter into these “short” swaps directly may not be able to use the benefit because all or a significant portion of any deductions would be miscellaneous itemized deductions, which are subject to limitations.

The proposed regulations propose two alternative methods of accrual for contingent nonperiodic payments. First, the proposed regulations provide for an extremely complicated “noncontingent swap method” that generally requires the potential recipient of a contingent payment to accrue, and the potential payor to deduct, the projected amount of a contingent payment (and, generally,

the contract is generally treated as a contingent nonperiodic payment. See proposed Treasury regulations section 1.446-3(g)(6)(i).

³ In general, a taxpayer adopts a proper method of accounting by filing a return reflecting that method. Treasury regulations section 1.446-1(e)(1). However, if the method is impermissible, the taxpayer is considered to have adopted a method of accounting only if the taxpayer has filed two returns reflecting the method. Treasury regulations section 1.446-1(e)(2)(i); temporary Treasury regulations section 1.446-1T(e)(2)(ii).

It is unclear whether the IRS views the wait-and-see method of accounting as impermissible and therefore would require that it be reflected on two tax returns before it is adopted. It is also unclear from the Preamble whether a taxpayer has until March 27, 2004 to adopt the wait-and-see method of accounting or must have adopted it in returns filed prior to February 26, 2004 (the date the proposed regulations were published in The Federal Register). Finally, it is unclear whether a taxpayer that has not adopted a method of accounting for contingent swaps but has terminated all outstanding swaps on or before March 26, 2004 is required to use a reasonable amortization method for these terminated swaps.

interest) over the term of the swap, and to readjust the projection (and the accrual) in each subsequent year.⁴

The proposed regulations would also permit taxpayers to mark-to-market their contingent swaps if (i) the contingent swap is of a type that is actively traded (as specially defined), (ii) the taxpayer marks the swap to market for financial accounting purposes (subject to certain additional requirements that are not specified in the proposed regulations), (iii) a securities dealer agrees to provide valuation information, or (iv) the taxpayer is an “open” regulated investment company (i.e., one that offers its shares) or a closed regulated investment company that redeems its shares at net asset value.⁵

The noncontingent swap method and mark-to-market method are not mandated until 30 days after the proposed regulations are finalized.⁶ However, taxpayers that have not previously adopted a method of accounting for contingent swaps must immediately begin accruing contingent nonperiodic payments under any “reasonable amortization method” (including the noncontingent swap method or the mark-to-market method).

Finally, the proposed regulations would change the predominant view that “value payments” under an equity swap (i.e., the appreciation or depreciation payments under an equity swap) give rise to capital gain or loss. Instead, if finalized in their proposed form, the proposed regulations would treat all net periodic and nonperiodic payments under a swap as giving rise to ordinary income or loss. However, terminations of swaps prior to their scheduled maturity will continue to give rise to capital gain or loss, as under current law.

The balance of this memorandum describes the proposed timing rules, the proposed character rules and offers some observations.

II. The Proposed Timing Rules.

A. The Noncontingent Swap Method.

In short, the noncontingent swap method requires a projection of the amount of the contingent nonperiodic payment, and a conversion of that projected payment into a series of level payments that are treated as paid to (and must be accrued by) the expected recipient. If the present value of the contingent nonperiodic payment is “significant,” then the method further deems each level payment to be loaned by the expected recipient to the expected payor, and the expected recipient must additionally accrue and the expected payor will deduct interest on these amounts.

⁴ Proposed Treasury regulations section 1.446-3(g)(6).

⁵ Proposed Treasury regulations section 1.446-3(i).

⁶ Proposed Treasury regulations section 1.446-3(j)(2).

In each subsequent year the contingent nonperiodic payment must be reprojected and reconverted into a new series of level payments that take into account current financial information. Any difference between the amounts actually recognized in prior years and the amounts that would have been recognized had the new projection been in place is accounted for in the year of the readjustment.

The balance of this Part II.A. describes the noncontingent swap method in greater detail. The Appendix to this memorandum provides an example of its application.

1. **Projection of the Contingent Nonperiodic Payment.** Under the “noncontingent swap method,” a taxpayer first projects the “reasonably expected amount” of each contingent nonperiodic payment using one of three elective methods.⁷

First, if the contingent payment is determined by reference to the value of a specified index on a designated future date (e.g., a contingent payment based on the value of the S&P 500) the projected amount of the contingent payment may be determined based upon the future value for the specified index in actively traded futures or forward contracts providing for settlement or delivery on such future date (i.e., the forward price of the S&P 500).⁸

Second, if there exists a current value of the specified index that is determined by “objective financial information,”⁹ the projected payment amount may be determined by converting the current value of the specified index into a future value for the index on the designated future date by adding to the current value an amount equal to the accrual of interest on the current value at the risk-free interest rate under a constant yield method (taking into account appropriate compounding and appropriate adjustments for any expected cash payments on the property underlying the specified index).¹⁰ The regulations permit taxpayers to choose between these two methods.

⁷ Proposed Treasury regulations section 1.446-3(g)(6)(iii).

⁸ Proposed Treasury regulations section 1.446-3(g)(6)(iii)(A). If no such contract exists for the designated future date, the taxpayer may base the projection upon the future value for the specified index in actively traded futures or forward contracts providing for settlement or delivery on a date within three months of such date.

⁹ “Objective financial information” is defined as “any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties’ circumstances” (e.g., a broadly-based equity index or an outstanding pool of mortgages, but not the value of a party’s stock). Treasury regulations 1.446-3(c)(4)(ii).

¹⁰ Proposed Treasury regulations section 1.446-3(g)(6)(iii)(B). The risk-free rate is a rate determined by the IRS based on the average market yield on outstanding marketable obligations of the U.S., determined separately for obligations with maturities of less than 3 years, 3-9 years and longer than 9 years. The taxpayer would use the risk-free rate appropriate for the term remaining on the swap. Proposed Treasury regulations section 1.446-3(c)(5).

If neither of these two methods result in a reasonable projection of the contingent payment, the taxpayer must use another method based on objective financial information that does result in a reasonable projection.¹¹

Projecting the contingent nonperiodic payment will be relatively easy and not generally subject to manipulation if the payment is based on the value of a publicly-traded index or equity security, but will be difficult or impossible in other cases. Moreover, because the regulations under the third method permit the projection to be equal to any “reasonable estimate of the amount of the contingent payment,” rather than an amount that is reasonable in light of the consideration paid,¹² taxpayers can be expected to project contingent payments that minimize accruals and maximize deductions.¹³ Finally, the proposed regulations do not impose any consistency requirements. Therefore, one party to a swap may apparently use the first method and the other may use the second method. Moreover, if the parties are using the third method, each party may use different “reasonable” projections.

2. Conversion of the Projected Contingent Payment into a Series of Level Payments. Second, the projected amount of any noncontingent payment is converted into a series of level payments that extend for the term of the swap and that, when compounded at the risk-free rate, have a value equal to the projected amount of the contingent nonperiodic payment.¹⁴ Under the proposed regulations, the parties to the swap treat the level payment amounts as

For example, if a taxpayer enters into a three year equity swap that provides for a payment at maturity based on the value of a share of stock that is currently trading for \$100, and the risk-free rate for a 3-year obligation is 10%, the projected payment amount would equal \$33 (the return on \$100 compounded at 10% for 3 years).

¹¹ See proposed Treasury regulations section 1.446-3(g)(6)(iii)(C). The proposed regulations do not indicate what other methods would result in a “reasonable estimate.”

¹² In contrast, under the noncontingent bond method used for contingent payment debt instruments, the projected amount of the contingent payments must produce the comparable yield. This requirement effectively acts as a governor on the amount of the projection.

¹³ For example, assume that a taxpayer writes protection under a credit default swap for a \$100 million notional amount of reference securities. Assume that there is a 90% likelihood that the taxpayer will not be required to make any contingent payment and a 10% likelihood that the taxpayer will be required to pay \$90 million. Taxpayers entering into these and similar swaps could be expected to take the position that a 10% likelihood is a “reasonable estimate of the amount of the contingent payment” and project a payment of \$90 million. However, this projection will overstate the taxpayer’s economic deductions because the projection is not “risk-weighted”. Moreover, if there is no requirement that both parties establish the same projected payment amount, the counterparty could take the position that, because, there is a 90% chance that there will be no payment, the projected contingent payment is zero and therefore would not report any income inclusions (at least for the first year).

¹⁴ Proposed Treasury regulations section 1.446-3(g)(6); Treasury regulations section 1.446-3(f)(2)(iii). For example, if the reasonably expected amount of the contingent nonperiodic payment on a three-year swap is \$16.5 million, and the applicable discount rate is 10%, the \$16.5 million projection would be converted into three level payments of \$5 million each because the value of three annual \$5 million payments compounded at 10% is \$16.5 million.

periodic payments that are deemed to be paid by the expected payor to the expected recipient on each date on which a periodic payment is to be made by the expected payor.¹⁵ These level payments must be accrued in income by the expected recipient and, subject to the limitations on miscellaneous itemized deductions for individuals, deducted by the expected payor.¹⁶

3. **Additional Accrual of Interest If the Present Value of the Projected Payments Is “Significant.”** In addition, if the present value of the projected contingent nonperiodic payment is “significant”¹⁷ when compared to the present value of the total payments to be made by the potential payor,¹⁸ the expected recipient is deemed to loan the amount of each of the level payments to the potential payor, and the potential payor is deemed to pay interest to the expected recipient at the risk-free rate.¹⁹ This deemed interest is treated as interest

¹⁵ However, if no periodic payments are payable to the expected recipient, the level payments are deemed to be paid on each of the dates for which the swap provides for a periodic payment by the expected recipient of the nonperiodic payment to the expected payor.

¹⁶ For example, if the projected amount of the contingent nonperiodic payment on a three-year swap is converted into three level payments of \$5 million each, the expected recipient of the contingent nonperiodic payment would accrue, and the expected payor would deduct, \$5 million in each year, subject to subsequent annual adjustments.

¹⁷ The regulations do not define “significant.” However, one example in the existing regulations treats a payment equal to 66.7% of the net present value of the fixed payments on the swap as significant. A second example concludes that a payment equal to 9.1% of the present value of the fixed payments on the swap is not significant. See Treasury regulations section 1.446-3(g)(6), Examples (2) and (3).

¹⁸ If the only payment to be made by the party that is expected to make a contingent payment, is the contingent payment, this payment will always be significant. If the party that is expected to make a contingent payment also makes noncontingent or periodic payments, the contingent payment will be a “significant nonperiodic payment” only if it is “significant” when compared to the total payments to be made by that party expected to make a contingent nonperiodic payment (i.e., the projected contingent nonperiodic payment is in the numerator and the denominator of the fraction). In contrast, the current regulations determine the significance of a noncontingent payment by comparing it to all fixed payments (i.e., the nonperiodic payment is not in the denominator of the fraction).

¹⁹ The aggregate amount of the interest is equal to the difference between the projected amount of the contingent nonperiodic payment and the sum of the level payments. Thus, assume that the projected amount of the contingent maturity payment on a swap is \$16.5 million, and the risk-free rate is 10%. In this case, the present value of the payment would be \$15 million. If this amount is “significant” when compared to the net present value of the fixed payments on the swap, there will be deemed interest payments. The aggregate amount of interest is \$1.5 million (\$16.5 million - \$15 million). The amount of interest payable in each year is the interest that would accrue on the current year’s level payment amount and on level payment amounts from previous years, calculated as if each level payment was a loan bearing interest at the risk-free rate.

Thus as mentioned above, the \$16.5 million contingent nonperiodic payment would be converted into three level payments of \$5 million each. If the contingent nonperiodic payment is treated as significant, each of these \$5 million payments are treated as loaned by the expected recipient to the expected payor and used by the expected payor to make each of the \$5 million level payments. Interest at the risk-free rate on each of these deemed loans must be accrued by the expected recipient. The amount of the interest therefore would be \$500,000 in year 2 and \$1.05 million in year 3.

for all federal income tax purposes. Thus, this deemed interest is potentially subject to U.S. federal withholding tax in any case where a U.S. person is the expected payor, a foreigner is the expected recipient and the present value of the projected conveyance is "significant."²⁰

4. **Annual Redeterminations and Adjustments.** On each anniversary date of the swap, the parties to the swap must reproject the projected contingent nonperiodic payment using current values as of the anniversary date and using the same determination method used initially, and then must reconvert the projected contingent payment into level payments for the entire term of the swap (i.e., including prior years) using the new projected payment and the risk-free rate in effect on the redetermination date.²¹

If, on any readjustment date, there is a difference between the amounts recognized in prior years and the amount that would have been recognized in those years had the current level payment schedule been in effect for such years, this difference is accounted for as additional payments or receipts with respect to the swap that accrue ratably over the one-year period beginning with the readjustment date.²² If an adjustment is necessary with respect to the deemed loan and interest amount, the adjusted amount is recognized as interest for all federal income tax purposes.²³

In addition, if a contingent nonperiodic payment becomes fixed more than six months before it is due and during a different tax year than the tax year in which the payment is due, then the date the payment becomes fixed is a special redetermination date and the taxpayer must treat the fixed amount as the projected payment amount and then apply the level payment method and perform the necessary adjustments as if on any other redetermination date.²⁴

²⁰ To be exempt from U.S. federal withholding tax, the U.S. person must receive an IRS Form W-8BEN from its foreign counterparty and the interest otherwise must qualify for the portfolio interest exemption under section 871(h) or 881(c).

²¹ Proposed Treasury regulations section 1.446-3(g)(6)(iv)(A).

The Preamble requests comments on how the reprojection process should respond to the availability of new market data between redetermination dates. For example, the Preamble requests comments on the situation where, at inception of the swap there is no current value, or no future or forward contracts, on the specified index and the parties project a payment amount using the third method, and on the redetermination date a current value or future or forward contracts do exist. The proposed regulations as currently drafted apparently require the consistent use of the initial method even if new market data would permit use of another method in a future year.

²² Proposed Treasury regulations section 1.446-3(g)(6)(v).

²³ Proposed Treasury regulations section 1.446-3(g)(6)(v).

²⁴ Proposed Treasury regulations section 1.446-3(g)(6)(iv)(B).

Assume that, on January 1, 2005, one party enters into a value payment equity swap in which it must pay its counterparty on December 31, 2007 the increase, if any, on a \$50 million notional amount of an equity

5. **Final Adjustment When Contingent Nonperiodic Payment Is Received or Fixed.** If there is any difference between the amounts taken into account using the noncontingent swap method and the actual amount of the contingent nonperiodic payment, the difference is treated as an adjustment to the net income or deduction on the swap for the taxable year during which the payment occurs.²⁵

6. **Record Retention Requirements.** The taxpayer must maintain records containing a description of the methods used to determine the projected payment amounts, the projected payment schedules, adjustments following redeterminations and adjustments resulting from differences between projected and actual payments.²⁶

B. The Mark-to-Market Method.

The proposed regulations provide for an elective mark-to-market method in lieu of the noncontingent swap method if (i) the notional principal contract is of a type that is actively traded (as specially defined),²⁷ (ii) the taxpayer marks the swap to market for financial accounting purposes (subject to certain additional requirements that are not specified in the proposed regulations),²⁸

basket between January 1, 2005 and December 31, 2006. Because December 31, 2006, the date that the contingent payment becomes fixed, is both more than six months before the date it is due, and is in a different tax year than the due date, December 31, 2006 is a special redetermination date. Therefore, on December 31, 2006, the parties must redetermine the level payment amount and perform any necessary adjustments using the newly-fixed amount as the projected payment amount and the current risk-free rate as the parties would do on any regular redetermination date.

The Preamble to the proposed regulations indicates that the IRS is considering an alternative to the noncontingent swap method for swaps that provide for deferred payment of contingent nonperiodic payments after they are fixed. This alternative regime would provide for current deductions and inclusions so long as the deferred payment accrues interest under the terms of the swap at a "qualified rate."

²⁵ Proposed Treasury regulations section 1.446-3(g)(6)(vi).

²⁶ Proposed Treasury regulations section 1.446-3(g)(6)(vii).

²⁷ A swap is "actively traded" if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on a national securities exchange, an interdealer quotation system registered under section 15A of the Securities Act of 1934, a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission, a foreign security exchange or board of trade that satisfies analogous requirements, an interbank market or an interdealer market characterized by a system of general circulation that provides a reasonable method to determine fair market value by disseminating other recent price quotations of identified brokers, or actual prices of recent transactions. See Treasury regulations section 1.1092(d)-1(b).

²⁸ In Announcement 2003-35, the IRS proposed that financial accounting valuations might be acceptable to taxpayers on a mark-to-market method of accounting under section 475 if the valuations (i) comply with certain threshold requirements, (ii) the taxpayer has a strong incentive to report the valuation fairly, which generally would be established if the valuation is reported to the SEC, and (iii) certain records are retained. The Preamble suggests that if taxpayers are permitted to use financial accounting valuations under section 475, they will also be permitted to use these valuations under the proposed regulations (and the requirements will be consistent).

(iii) a securities dealer agrees to provide valuation information, or (iv) the taxpayer is an “open” regulated investment company (i.e., one that offers its shares), or redeems its shares at net asset value.²⁹

The mark-to-market election must be made in the time and manner that will be set forth in the final regulations.³⁰ If the mark-to-market method is elected, it must be used for all eligible swaps to which the taxpayer is a party for the taxable year in which made and all subsequent taxable years, unless revoked with the consent of the IRS.³¹

If a taxpayer elects mark-to-market treatment, the taxpayer will not be subject to the noncontingent swap method, but instead will determine income inclusions and deductions by reference to the gain or loss that would have been realized if the swap were sold for its fair market value on the last business day of the taxable year.³²

If the swap is actively traded, its fair market value is determined based on the bid and asked prices quoted for the contract on an established market.³³ If the swap is not actively traded but is marked to market by the taxpayer for purposes of determining the taxpayer's financial income, the fair market value is the value used by the taxpayer for purposes of preparing its financial statements.³⁴ If the swap is not actively traded but is subject to an agreement by a section 475 mark-to-market taxpayer that is a party to the contract to supply the taxpayer the value necessary to mark-to-market the contract under section 475(a)(2), the fair market value is the mark-to-market value that the counterparty uses for determining its own gain or loss under section 475(a)(2).³⁵ If the notional principal contract is marked to market by a regulated investment company, the fair market value is the value used by the regulated investment company in determining its net asset value.³⁶

If a swap that is marked-to-market provides for one or more significant nonperiodic payments, the swap is treated as containing one or more loans on which interest accrues.³⁷ The amount of the

²⁹ Proposed Treasury regulations section 1.446-3(i)(2). The IRS and Treasury request comments as to whether taxpayers who are eligible to elect a mark-to-market method under section 475 but do not do so should be permitted to elect mark-to-market treatment for their contingent swaps.

³⁰ Proposed Treasury regulations section 1.446-3(i)(6).

³¹ Proposed Treasury regulations section 1.446-3(i)(6).

³² Proposed Treasury regulations section 1.446-3(i).

³³ Proposed Treasury regulations section 1.446-3(i)(3)(i).

³⁴ Proposed Treasury regulations section 1.446-3(i)(3)(ii).

³⁵ Proposed Treasury regulations section 1.446-3(i)(3)(iii).

³⁶ Proposed Treasury regulations section 1.446-3(i)(3)(iv).

³⁷ Proposed Treasury regulations section 1.446-3(i)(5)(i).

The Preamble explains that this calculation is necessary to ensure that an accrual is properly

loan is generally equal to the level payment amounts of the contingent payment as determined under the noncontingent swap method.³⁸ However, if all payments on the swap — other than a single significant contingent nonperiodic payment — are fixed, the taxpayer may project the contingent nonperiodic payment as the amount that causes the present value of all payments by the taxpayer to equal the present value of all of the payments by the counterparty.³⁹

C. Character of Payments in Respect of Notional Principal Contracts.

Many taxpayers take the position that so long as the asset referenced in the swap would be a capital asset in their hands, the value payments representing appreciation and depreciation give rise to capital gain or loss under the theory that each payment represents gain or loss attributable to the termination of the right or obligation to receive or make the appreciation or depreciation payment within the meaning of section 1234A.⁴⁰ This result is sensible as a tax policy matter because section 1234A was intended by Congress to prevent taxpayers from choosing the character of gain or loss (*i.e.*, as ordinary or capital) on contracts by either terminating them early or holding them to maturity.

The proposed regulations, if finalized, would invalidate the position taken by many taxpayers that gain or loss in respect of value payments is capital gain or loss and would treat all net payments received or made under a swap (including value payments) as ordinary income or expense. However, under the proposed regulation, any net payments made by an individual would give rise to miscellaneous itemized deductions, which are subject to limitations on deductibility.⁴¹ Nevertheless,

characterized as interest. However, in the Preamble, the IRS request comments as to whether an interest accrual is appropriate under a mark-to-market methodology and the effect that an interest accrual would have on the usefulness and administrability of the mark-to-market methodology.

³⁸ Proposed Treasury regulations section 1.446-3(i)(5)(ii).

³⁹ Proposed Treasury regulations section 1.446-3(1)(5)(ii).

⁴⁰ Section 1234A provides that gains or losses attributable to the cancellation or termination of a contract with respect to an asset that would be a capital asset in the hands of the taxpayer are treated as capital.

⁴¹ Individuals may deduct miscellaneous itemized deductions only to the extent that the aggregate of their miscellaneous itemized deductions exceeds 2% of the adjusted gross income. Section 67(a). Thus, an individual taxpayer with \$10 million dollars of adjusted gross income would be permitted to deduct accrued notional principal contract expenses only to the extent that his or her total miscellaneous itemized deductions exceed \$200,000. The first \$200,000 of disallowed miscellaneous deductions is permanently denied. In addition, if an individual's adjusted gross income exceeds a threshold amount (which for 2004 is \$142,700), the total amount of itemized deductions is reduced by the lesser of (i) 3% of the excess of taxpayer's income over the threshold amount and (ii) 20% of the total itemized deductions. Section 68. Accordingly, in the preceding example, a taxpayer with \$10 million of adjusted gross income would also be permanently denied itemized deductions in 2004 equal to the lesser of (i) \$295,719 and (ii) 20% of his or her total itemized deductions. Finally, miscellaneous itemized deductions are not deductible for purposes of the alternative minimum tax. Section 56(b)(1)(f).

under the proposed regulations any gain or loss upon the termination of a swap that constitutes a capital asset continues to be treated as a capital gain or loss.⁴²

Moreover, under the proposed character rules, gain or loss at maturity of a swap that references a specified index and provides for settlement of all of the parties' obligations to one another at or close to the maturity of the contract (i.e., a "bullet swap" or a forward contract) would be characterized as capital gain or loss.⁴³

No apparent tax policy justifies the ability of a taxpayer to choose to recognize any gain on a swap as capital gain (by terminating an appreciated swap early) or as ordinary loss (by holding a depreciated swap until maturity), and this result is inconsistent with the policy underlying section 1234A and not otherwise compelled by the statute. If this aspect of the proposed regulations is finalized, taxpayers would be expected to terminate a swap early, or hold it to maturity, solely for tax purposes. Moreover, taxpayers would be expected to engage in "character arbitrage" by entering into offsetting swaps that do not technically constitute a straddle, terminating the appreciated swap early (and recognizing capital gain) and holding the depreciated swap until maturity (and recognizing an ordinary loss). Finally, if this aspect of the proposed regulations is finalized, the question will arise as to whether a termination payment that is close in time to the swap's scheduled maturity date qualifies as a termination (giving rise to capital gain or loss) or is treated as pursuant to the original terms of the swap (giving rise to ordinary income or loss).

These character rules would be effective for any notional principal contracts entered into on or after 30 days after the finalization of the proposed regulations.⁴⁴

D. Removal of the Anti-Abuse Rule.

The current rules contain an anti-abuse rule that permits the IRS to depart from the notional principal contract rules as necessary to reflect the appropriate timing of income and deduction if a taxpayer enters into a transaction with a principal purpose of applying the swap rules to produce a material distortion of income.⁴⁵ The Preamble anticipates that if the proposed regulations are

⁴² Proposed Treasury regulations section 1.1234A-1. This would enable a taxpayer to choose the character of its gains and losses. For example, if a notional principal contract has appreciated in value, a taxpayer may recognize a capital gain by terminating the contract before maturity. On the other hand, if a notional principal contract has depreciated in value, the taxpayer may hold the notional principal contract until maturity and thereby recognize an ordinary loss.

⁴³ Proposed Treasury regulations section 1234A-1(c).

⁴⁴ Proposed Treasury regulations sections 1.162-30(b), 1.212-1(q)(2) and 1.1234A-1(d).

⁴⁵ Treasury regulations section 1.446-3(i).

finalized, taxpayers will no longer have the ability to commit abuse with swaps. Therefore, the proposed regulations would remove the anti-abuse rule.⁴⁶

III. Observations and Comments.

As mentioned above, the wait-and-see method of accounting for contingent swaps - under which gain or loss in respect of a nonperiodic contingent payment is deferred until the payment is fixed - has been used by virtually all mainstream taxpayers since the swap regulations were issued in 1993. The declaration in the Preamble that this method is "inconsistent" with existing authorities after eleven years of silence represents a startling new interpretation of law. In this light, the grandfather provision, which protects prior swaps only for taxpayers that have adopted wait-and-see as a method of accounting, is arbitrary, and merely encourages the filing of early tax returns. A more equitable approach would extend the grandfather provisions to all taxpayers entering into swaps prior to March 27, 2004.

On the other hand, by grandfathering all future swaps entered into by taxpayers that have already adopted the wait-and-see method of accounting (at least until the regulations are finalized), the proposed regulations are generous. Moreover, the regulations apparently permit a grandfathered taxpayer to form a new subsidiary or partnership that is not grandfathered, and effectively choose which method will apply to new swaps: the wait-and-see method for contingent swaps entered into by the grandfathered taxpayer, or the noncontingent swap or mark-to-market method under the proposed regulations for the subsidiary or partnership. These aspects of the grandfather provision place tremendous pressure on the Treasury Department and the IRS to finalize the regulations before year-end. Any delay would increase the arbitrariness of the grandfather provisions and the ability of grandfathered taxpayers to elect which rules to use.

Second, by dramatically changing the timing of income and deductions on contingent swaps, the proposed regulations will cause taxpayers to readjust the preferred form of their transactions solely for tax purposes. Thus, taxpayers that would expect to receive a contingent payment will enter into forward contracts or options, rather than swaps, to escape the amortization requirements of the proposed regulations; conversely, taxpayers that would expect to make a contingent payment will enter into swaps, rather options or forward contracts, to claim deductions in respect of the contingent nonperiodic payment. Moreover, because the proposed regulations offer taxpayers more choices than currently exist, permit taxpayers flexibility in projecting contingent payments, do not require conformity by the parties to a swap, and remove the anti-abuse rule, taxpayer opportunities and arbitrage will increase.

The increased discontinuities between contingent swaps (no more wait-and-see) and forward contracts and options (continued wait-and-see) are so obvious that the likely effect of the proposed

⁴⁶ It is unclear why the IRS would remove this rule and possibly allow taxpayers to apply the literal language of the notional principal contract regime in an abusive manner.

regulations cannot have been entirely lost on their drafters. Therefore, it can reasonably be expected that the Treasury Department and the IRS intend to change the current method of accounting for pre-paid forwards, and possibly even traditional forward and option contracts, to more closely align their tax accounting treatment with the treatment of contingent swaps. In light of the grandfather provisions in the proposed regulations, taxpayers may wish to consider adopting methods of accounting for these contracts.

The proposed character rules, which would treat even value payments on swaps as giving rise to ordinary income and loss, but would continue to permit taxpayers to terminate their swaps early and claim capital gain, is particularly surprising as a matter of sound tax policy, and does not appear mandated by the statute. If these proposed rules are finalized, taxpayers will deliberately and with apparent approval of the IRS hold their swaps until maturity, or terminate them early, in order to choose the character of their gain or loss. Moreover, taxpayers that had previously treated losses from value payments on swaps in open tax years as capital losses might try to amend their returns and claim ordinary losses on the basis of the proposed regulations. The proposed regulations do not indicate whether these claims will be allowed.

Finally, as is the case with every significant change in tax law (and particularly those changes that are not components of a unified regime), unforeseen collateral consequences and unintended results will arise. For example, U.S. taxpayers entering into on-market swaps with foreign counterparties will be required to insure that any deemed interest on a contingent swap qualifies for the portfolio interest exemption;⁴⁷ conversely, tax-exempt taxpayers entering into contingent swaps will be required to evaluate whether on-market contingent swaps cause them to incur “unrelated debt-financed income.”

* * *

Questions regarding the proposed contingent swap regulations should be addressed to David S. Miller, Linda Z. Swartz or Shlomo M. Boehm at 212-504-6000 or Mark P. Howe or Daniel J. Mulcahy at 202-862-2200.

⁴⁷ Accordingly, taxpayers that currently enter into master agreements with foreign counterparties should ensure that they will receive IRS Forms W-8BEN and appropriate representations to ensure that interest deemed paid for swaps entered into after the proposed regulations are finalized will qualify for the portfolio interest exemption.

Appendix

Example of the Noncontingent Swap Method (Derived From Examples (6)-(9) of Proposed Regulations Section 1.446-3(g)(7))

On January 1, 2005, unrelated parties V and W enter into a swap under which V will make three annual payments to W equal to 1-year LIBOR times a notional principal amount of \$50 million. In return, on December 31, 2007, W will make a one time value payment to V equal to the appreciation over the term of the swap, if any, on a \$50 million investment in a basket of publicly-traded equity securities or V will make a one time value payment to W equal to the depreciation over the term of the swap, if any, on the same basket of equities. Assume that on January 1, 2005, 1-year LIBOR is 9.5% and the short-term applicable federal rate is 10%.

1. Projected Payment Amount.

Under the “noncontingent swap method,” a taxpayer first must project the “reasonably expected amount” of each contingent nonperiodic payment. If there exists a current value of the specified index that is determined by “objective financial information,” the projected payment amount may be determined by converting the current value of the specified index into a future value for the index on the designated future date under a constant yield method (taking into account appropriate compounding and appropriate adjustments for any expected cash payments on the property underlying the specified index).⁴⁸

The specified index is a basket of publicly-traded equities and therefore its current value is determinable by “objective financial information.” Accordingly, the projected payment amount may be determined by converting its current value (\$50 million) into a future value for the index on the designated future date (December 31, 2007). The risk-free rate is equal to the applicable federal rate and therefore is 10%. The accrual of interest at the 10% risk-free rate under a constant yield method on a \$50 million value equity basket (taking into account appropriate compounding and appropriate adjustments for any expected cash payments on the property underlying the specified index) results in a projected payment at maturity of \$16.5 million.

2. Apply the Level Payment Method.

The projected amount of the noncontingent payment (\$16.5 million) is then converted into a series of level payments that extends for the term of the swap and that when compounded at the risk-free rate that was used to determine the nonperiodic payment amount (10%), have a value equal to the projected amount of the contingent nonperiodic payment. The level payment amounts are therefore

⁴⁸ Alternatively, the taxpayer in this example could project the payment amount based on future or forward contracts on the specified index if these contracts exist.

three annual payments of \$5 million because \$5 million compounded at 10% for three years results in a value of \$16.5 million.

Under the proposed regulations, the parties to the swap treat the \$5 million level payment amounts as periodic payments that are deemed to be paid by the expected payor (W) to the expected recipient (V) on each date on which a periodic payment is to be made by the expected recipient.⁴⁹ These \$5 million level payments must be accrued as income by the expected recipient (V) and (subject to the limitations on miscellaneous itemized deductions for individuals), deducted by the expected payor (W).

In addition, under the proposed regulations, if the present value of projected contingent nonperiodic payment is "significant," the amount of each level payment is deemed to be loaned by the expected recipient of the payment (V) to the potential payor (W), and the potential payor (W) is deemed to pay interest to the expected recipient at the risk-free rate.⁵⁰

Under these facts, the \$15 million projected contingent payment amount would be significant because it represents all of the payments to be made by W to V.⁵¹ Therefore, V would be deemed to loan to W \$5 million (the level payment amount) each year. Interest would accrue on these deemed loans at the risk-free rate of 10%. This deemed interest is treated as interest for all federal income tax purposes. No deemed interest is taken into account for 2005 because the loan is not deemed as made until the first payment date on December 31, 2005.

Therefore, on December 31, 2005, V pays \$4.75 million to W (LIBOR at 9.5% times \$50 million) and W would be deemed to make a payment of \$5 million (the level payment amount) to V. The net of the ratable daily portions of these payments determine the annual net income or deduction on the notional principal contract for V and W.

⁴⁹ Since no periodic payments are payable by W to V, the level payments are deemed to be made on each of the dates that V is to make a periodic payment to W.

⁵⁰ Where the projected payment amount is insignificant with respect to the total payments between the parties, the taxpayer still must determine the present value of the projected payment so as to establish the level payment amount, but then ignores the time value component of the projected payment and essentially receives an interest free loan.

⁵¹ The regulations do not define "significant." However, one example in the existing regulations treats a payment equal to 66.7% of the net present value of the fixed payments on the swap as significant. A second example concludes that a payment equal to 9.1% of the present value of the fixed payments on the swap is not significant. See Treasury regulations section 1.446-3(g)(6), Examples (2) and (3).

December 31, 2005

	Deemed Received	Deemed Paid	Actually Received	Actually Paid	Net Accrual/Deduction
V	\$5 million			<\$4.75 million>	\$250,000
W		<\$5 million>	\$4.75 million		<\$250,000>

3. Redetermination Dates.

On each anniversary date of the swap, the parties to the swap must redetermine the projected contingent nonperiodic payment using the same determination method used initially and then reconvert the projected payment into level payments for the entire term of the swap using the risk-free rate in effect on the redetermination date.

On January 1, 2006, the first anniversary of the swap, the parties must redetermine the projected payment amount and the level payment amount using the current values on that date. Assume that the current value of the equity basket is \$60 million, one-year LIBOR has changed to 10%, and the risk-free rate has changed to 10.5%. The parties would convert the current value of the specified index (currently \$60 million) into a future value for the index on the designated future date using the risk-free rate (currently 10.5%), under a constant yield method. Under this method, the final value at maturity is \$73,261,500 and therefore W is projected to pay \$23,261,500 upon the maturity of the swap. This amount is converted into three annual payments of \$6,993,784 which, when compounded at the risk-free rate of 10.5%, have a future value equal to \$23,261,500.

Since on the readjustment date there is a difference between the amounts deemed paid in the prior year (\$5 million) and the amount that would have been deemed paid in that year had the current level payment schedule been in effect (\$6,993,784), the difference (\$1,993,784) is accounted for as an additional ordinary inclusion for V and an ordinary deduction for W. Accordingly, on December 31, 2006, W is deemed to pay V \$8,987,568 (the current level payment of \$6,993,784 plus an adjustment of \$1,993,784), and W may deduct the ratable daily portion of \$3,987,568 (which represents the difference between the deemed payment and an actual receipt of a \$5,000,000 LIBOR payment plus an adjustment of \$1,993,784) and V must include as income the ratably daily portion of this amount.

December 31, 2006

	Deemed Received	Deemed Paid	Actually Received	Actually Paid	Net Accrual/Deduction for Tax Purposes
V	\$8,987,568			<\$5 million>	\$3,987,568
W		<\$8,987,568>	\$5 million		<\$3,987,568>

Additionally, the parties must determine whether the January 1, 2005 present value of the currently projected payment is significant when compared to the present value of the total payments due from the contingent payment payor under the swap. Since the contingent payment remains the only payment to be made by W, it is clearly significant. Therefore, V is deemed as making loans to W on each payment date equal in amount to the level payment amounts of \$6,993,784. Interest accrues on the loan at the current risk-free rate (10.5%). Therefore, \$734,347 of interest has accrued on the \$6,993,784 loan that was deemed to have been made on December 31, 2005. This amount is interest for all federal income tax purposes and does not affect the net income inclusions or deduction on the swap for the parties.

The next redetermination date is on January 1, 2007, which is the second anniversary of the contract. Assume that the current value of the equity basket on that date is \$55 million and that one-year LIBOR and the risk-free rate are both 11%. Accordingly, the parties would convert the current value of the specified index (currently \$55 million) into a future value for the index on the designated future date using the risk-free rate (currently 11%), under a constant yield method. Under this method, the final value at maturity is \$61,050,000 and therefore W is projected to pay \$11,050,000 upon the maturity of the swap. This amount is converted into three annual payments of \$3,306,304 which, when compounded at the risk-free rate of 11%, have a future value equal to \$11,050,000. The taxpayers must then perform adjustments based on the payments that would have been made if the current level payment amounts had been in effect for the life of the contract (i.e., \$3,306,304 per year). V has previously recognized \$6,993,784 for the prior two years (\$6,993,784 in 2006 and \$5 million in 2005 plus the \$1,993,784 adjustment amount in 2006). If the current level payment method (\$3,306,304) would have been in place in the prior two years, the payments from W to V would have been \$3,306,304 in each year (instead of \$6,993,784 each year). The difference of \$7,734,960 is taken into account as a deemed payment from V to W. So, on December 31, 2007, V pays W \$5.5 million (11% times \$50 million) and is deemed to make a payment to W equal to the adjustment amount of \$7,734,960, and W is deemed to pay V the level payment amount of \$3,306,304. The net of the ratable daily portions of these payments determine the annual net income or deduction on the notional principal contract for V and W.

December 31, 2007

	Deemed Received	Deemed Paid	Actually Received	Actually Paid	Net Accrual/Deduction for Tax Purposes
V	\$3,306,304	<\$7,734,960>		<\$5.5 million>	<\$9,928,656>
W	\$7,734,960	<\$3,306,304>	\$5.5 million		\$9,928,656

Additionally, the taxpayers determine whether the January 1, 2005 present value of the currently projected payment is significant when compared to the present value of the total payments due from the contingent payment payor under the swap. Since the contingent payment is the only payment to be made by W, it is clearly significant. Therefore, V is deemed as issuing loans to W on

each payment date equal in amount to the level payment amounts of \$3,306,304. Interest accrues on the loans at the current risk-free rate (11%). Therefore, \$767,793 of interest accrues in 2007 (on the \$3,306,304 loan that was deemed made on December 31, 2005 and on the \$3,306,304 loan that was deemed made on December 31, 2006). This amount is interest for all federal income tax purposes and does not affect the net income inclusions or deduction on the swap for the parties. The taxpayers must also make an adjustment for the amount of interest that would have accrued had the new level payment amounts been in effect for the previous years. If the current level payment amount of \$3,306,304 had been in effect in 2006, the deemed loan amount would have been \$3,306,304 instead of \$6,993,784 and the interest accrued would have been \$363,693 instead of \$734,347. The difference of \$370,654 is included as a net interest expense for V and a net interest inclusion for W. Therefore, V has a net income inclusion and W has a net interest deduction of \$396,739 for 2007 (\$767,393-\$370,654).

4. Adjustment for Actual Payment at Maturity.

Any difference between the amounts taken into account using the noncontingent swap method and the actual amount of the contingent nonperiodic payment must be treated as an adjustment to the net income or deduction on the swap for the taxable year during which the payment occurs.

Assume that, upon maturity of the contract on December 31, 2007, the equity basket is worth \$75 million and W makes a payment to V of \$25 million (the “value payment” on the underlying \$50 million basket of equities). Since the actual payment is different than the projected payment amount as of January 1, 2007, the parties must adjust their net income and deductions accordingly for the taxable year that includes December 31, 2007. The projected payment amount accounted for a final payment of \$11,050,000 and amortized that amount over the term of the swap. The \$13.95 million difference between the actual payment amount of \$25 million and the 2007 projected payment amount of \$11,050,000 was not accounted for and will be included in the net income or deductions of the taxpayers as income for V and a deduction for W.

December 31, 2007 adjusted for actual payment

	Deemed Received	Deemed Paid	Actually Received	Actually Paid	Net Accrual/Deduction for Tax Purposes
V	\$17,256,304 ⁵²	<\$7,734,960>	\$25 million	<\$5.5 million>	\$4,021,344
W	\$7,734,960	<\$17,256,304> ⁵³	\$5.5 million	<\$25 million>	<\$4,021,344>

⁵² <\$3,306,304> plus <\$13,950,000>

⁵³ <\$3,306,304> plus <\$13,950,000>