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Mr. Gregory F. Jenner
Acting Assistant Secretary (Tax Policy)
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: Request for Clarification of Effective Date Statements in Preamble to Proposed Regulations
on Notional Principal Contracts with Contingent Nonperiodic Payments

Gentlemen:

On February 26, 2004, the Department of Treasury (the *Treasury*) and the Internal Revenue Service (the *IRS*) issued proposed regulations (the *Proposed Regulations*) relating to notional principal contracts with contingent nonperiodic payments (*CNPCs*). ISDA intends to provide an extensive submission on these regulations in the near future and looks forward to working with the Treasury and the IRS on this matter. However, because there are effective date and retroactive application issues raised in the preamble to the Proposed Regulations (the

Preamble) that are having an immediate impact on the market, we are providing an abbreviated, expedited submission on these issues and requesting that the Treasury and the IRS issue interim guidance quickly to mitigate the concerns in the marketplace.

The Preamble language causing the concerns is the following:

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, there would not be any effective date or retroactive application concerns because the actual Proposed Regulations state that they are only effective for CNPCs entered into on or after 30 days after final regulations are issued¹ and, for the reasons explained in more detail below, tax practitioners have historically concluded that the wait-and-see method is an acceptable accounting method for CNPCs.

For very important practical and technical/policy reasons that are discussed below, ISDA believes that the Treasury and the IRS should issue interim guidance that clarifies the fundamental issues that are impacting the marketplace — specifically that all taxpayers (that do not mark their swaps to market) may continue to use the wait-and-see method for contingent

¹ Proposed Regulation § 1.446-3(j)(2).

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 that the Proposed Regulations were issued). We understand that the Chairman of the Tax Section of the New York State Bar Association issued a letter on March 15, 2004 to the Treasury and the IRS, which also discussed similar concerns. While ISDA shares the concerns discussed in the Chairman’s letter, we also request that the Treasury and the IRS issue more specific guidance on certain fundamental issues raised by the Preamble, as discussed below.

Technical/Policy Comments

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,² but also by Congress (in enacting the constructive ownership rules of section 1260),³ and by the Treasury and the IRS

² See, e.g., 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”).

³ Section 1260(d)(1)(A) and (d)(3) of the Internal Revenue Code (inclusion of certain total return equity swaps as “constructive ownership transactions” subject to recharacterization of long-term capital gain as ordinary income and to an interest charge) evinces a Congressional recognition that the wait-and-see method applies to contingent payments on CNPCs. Further, it is worth noting that section 1260 only applies to a limited class of CNPCs that provide for contingent payments (those that reference equity in a pass-thru entity) and its character conversion rules and interest charge only apply to a portion of the income from an equity swap (the portion that would have been ordinary income or short-term capital gain and recognized currently if the reference property were owned directly). Thus, we believe that section 1260 demonstrates Congressional acceptance of the wait-and-see method other than in the limited cases where the use of derivatives has the effect of deferring ordinary income and short-term capital gain and converting them into long-term capital gain. The Proposed Regulations and the Preamble language, however, would deny the use of the wait-and-see method for *all* CNPCs, even where the income on the reference property, if directly held, would not have been recognized on a current basis and would have been treated as long-term capital gain.

(in issuing Treasury Regulation §1.988-2(e)(2) and Revenue Ruling 2002-30).⁴ Consequently, we believe that it is inappropriate to prohibit taxpayers from using the wait-and-see method prior to giving them an opportunity to comment on the prohibition and on the method proposed to be used in its place.⁵ In addition, we believe that it is inequitable to treat taxpayers differently merely because one had previously entered into a CNPC (and therefore adopted a method of accounting for such swaps) and another had not.⁶

As stated in the Preamble, the Treasury and the IRS's rationale for the immediate ban on the use of the wait-and-see method for certain taxpayers seems to be that the method does not clearly reflect income and, accordingly, is unreasonable. However, a method of accounting for a class of transactions cannot be viewed as unreasonable when it has been acknowledged as

⁴ In Treasury Regulation § 1.988-2(e)(2), the Treasury and the IRS have concluded that foreign currency swaps should be taxed under a wait-and-see method. Given that foreign currency swaps are economically similar to other total return swaps, taxpayers understandably concluded (absent contrary guidance) that the Treasury and the IRS approved of the wait-and-see method. Moreover, in Revenue Ruling 2002-30, 2002-1 C.B. 971, 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 Ruling that the Treasury and the IRS expected the taxpayer to use (and, except with respect to the noncontingent component, did not challenge the taxpayer's use of) the wait-and-see method for the contingent nonperiodic amount.

⁵ See the Preamble (if, and only if, a taxpayer has adopted a method of accounting for contingent nonperiodic payments, it can continue to use it at least until the first year ending on or after 30 days after the Proposed Regulations are finalized).

⁶ We note that the continued use of the wait-and-see method would not necessarily be favorable to taxpayers. While the advantages of continuing to use the wait-and-see method are obvious, disadvantages arise as well. For example, for a taxpayer receiving current cash payments under, for example, a short equity swap, a CDS, or some bond swaps, the "amortization" method would have the effect of offsetting such cash received with deductions (and, thus, effectively deferring the recognition of income). Thus, for these CNPCs, the requirement that a taxpayer that has not previously established a method of accounting must use the amortization method would have the strange effect of permitting newly formed taxpayers (and any other taxpayer that has not previously entered into a CNPC) to accelerate deductions (and, thus, defer income), while requiring a taxpayer that has previously entered into a CNPC (and, thus, has previously established a method of accounting) to be treated less favorably.

appropriate for that same class of transactions by Congress, the Treasury, and the IRS. Further, the wait-and-see method is a long established method of accounting for contingent payments in other financial instruments. It is still the required approach for accounting for contingent payments on a multitude of financial instruments and transactions—for example, options,⁷ forward contracts,⁸ certain installment sales,⁹ and, most analogously, certain foreign currency NPCs.¹⁰ It is therefore clear that the wait-and-see method currently is considered to satisfy the clear reflection of income standard for a wide variety of financial products.¹¹ Finally, the general accrual method tax principles under section 451 of the Internal Revenue Code mandate that no income shall be accrued prior to the date when all events have occurred to fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.¹² Consequently, absent a specific regulatory requirement to the contrary, the wait-and-see method

⁷ See, e.g., *Koch v. Commissioner*, 67 T.C. 71 (1976) *acq.*, 1980-2 C.B. 1.

⁸ See, e.g., *Lucas v. North Texas Lumber Co.*, 281 U.S. 11 (1930); *Stanley v. U.S.*, 599 F.2d 672 (5th Cir. 1979) (taxpayer's holding period for debentures commenced on its date of purchase, not the date it agreed to purchase them). See also Revenue Ruling 2003-7, 2003-5 I.R.B. 363.

⁹ See Treasury Regulation §15A.453-1(c)(3)(i) and (c)(ii), Example (1) (where there was no maximum sales price but a maximum period of time over which payments may be received, the amount realized on the sale effectively was taken into account under a wait-and-see method).

¹⁰ See Treasury Regulation §1.988-2(e)(2)(iv).

¹¹ As a matter of fact, although the Treasury and the IRS eventually adopted a different approach, it even proposed such a method when it was determining the method of accounting for contingent payment debt instruments. See Proposed Regulation § 1.1275-4(e) and (f), as published in 51 F.R. 12807. Such method, had it been enacted, would have conformed generally to prior law, which had embraced the wait-and-see method. See, e.g., *Utility Trailer Manufacturing v U.S.*, 212 F. Supp 773 (S.D. CA, Central Division 1962) (original issue discount does not accrue on an inflation-indexed debt instrument).

¹² See Treasury Regulation § 1.451-1(a) (“Under an accrual method of accounting, income is included in gross income when all the events have occurred which fix the right to receive such income and *the amount thereof can be determined with reasonable accuracy.*” (Emphasis added.) See also Treasury Regulation § 1.461-1 (similar with respect to deductions). We note that with respect to many CNPCs, the contingent nonperiodic payment is made by a taxpayer that is not a dealer for tax purposes and does not use a mark-to-market method for accounting for CNPCs and, thus, the effect of the rule in the Preamble is to accelerate deductions as compared to the wait-and-see method.

of accounting for contingent nonperiodic payments appears not only to be an acceptable method, but also to be mandated by the law.

In fact, the Treasury and the IRS included the wait-and-see method for contingent nonperiodic NPC payments in some of the methods of accounting they were considering for such contingent payments in Notice 2001-44.¹³ While the fact that the Treasury and the IRS considered requiring the use of the wait-and-see method of accounting for contingent nonperiodic payments does not mean that the Treasury and the IRS must permit the use of that method in the future, it should indicate that such method of accounting is permissible for transactions entered into prior to the effective date of the final regulations.

Comments on Practical Issues

The overwhelming majority of CNPCs consist of the following types of swaps: (a) equity swaps, (b) debt swaps, and (c) credit default swaps (“CDSs”), and taxpayers that are not dealers in CNPCs enter into a significant amount of both long and short positions in each of these types of swaps.¹⁴ Of these types of swaps, CDSs are the most common.¹⁵ CDSs (as well as other CNPCs that are not long equity swaps) are often acquired by single-purpose securitization vehicles, which means that new securitization transactions that involve these CNPCs will involve investors or vehicles that have not previously adopted a method of accounting for CNPCs. In

¹³ 2001-2 C.B. 77. Two of the four methods that the Treasury and the IRS said it was considering in Notice 2001-44 would have applied the wait-and-see method to contingent nonperiodic payments (with corresponding adjustments to the noncontingent payments).

¹⁴ We realize that the Treasury and the IRS have not issued any guidance stating whether a CDS qualifies as an NPC under Treasury Regulation §1.446-3. However, because one of the likely characterizations of a CDS is an NPC, we assume it is treated as such for purposes of this letter.

¹⁵ As of June 30, 2003, the notional principal amount of credit default swaps outstanding was approximately \$2.69 trillion and grew by 25% for the prior six months. By comparison, the total notional amount of all equity derivatives, including equity swaps as well as options and forward contracts, which are not taxed as notional principal contracts, was \$2.78 trillion and grew by only 14% in the same period. For more detailed statistics, please see our website at www.isda.org.

this regard, the Preamble language may (for a number of reasons) cause considerable market disruption, even though there does not appear to be any compelling reason why this class of taxpayers, or taxpayers generally, must immediately adopt a radically new method of accounting.¹⁶

First, any change or significant uncertainty in the tax treatment of CNPCs will affect the marketability and financial viability of many existing types of securitization structures. Such uncertainty regarding the tax consequences of investing in CNPCs, directly or through securitization transactions, may reduce the value of taxpayers' existing positions and, in any event, may reduce the liquidity of both existing and new positions as taxpayers wait to see what rules the final regulations adopt. In addition, there are currently planned public securitization offerings that financial sponsors will be forced to restructure to take into account the effect of the Preamble language (and in some cases, even where restructuring is not necessary, new tax consequences must be disclosed to investors), which then requires the registration statement relating to the offering to be amended and reviewed again by the Securities and Exchange Commission at considerable cost and delay. In any event, disclosure provided to investors that indicates that the tax treatment of the principal financial product held by a securitization vehicle is expected to change when final regulations are issued (but cannot clearly describe what the changes will be) may well make the securities unmarketable.

Second, taxpayers that have not yet adopted a method of accounting do not know whether they should terminate CNPCs that they have already entered into. Similarly, taxpayers that have adopted a method of accounting for CNPCs do not know whether in the future they will be

¹⁶ If the pre-effective date provisions in the Preamble are an effort to thwart abusive transactions, we note that the Treasury and the IRS already have regulatory authority to attack such transactions. See, e.g., Treasury Regulation § 1.446-3(i); Revenue Ruling 2002-30, 2002-1 C.B. 971.

required, as a practical matter, to terminate CNPCs that they have entered into prior to the effective date of the final regulations.

Third, given the uncertainty of what is a “reasonable amortization method,” taxpayers will have a difficult time in concluding that they have complied with the requirement of the Preamble.¹⁷

Finally, if taxpayers attempt to follow not only a “reasonable amortization method” as prescribed in the Preamble but also the method described in the Proposed Regulations, they would be faced with numerous implementation issues that are not currently addressed by the Proposed Regulations, such as information reporting. For example, it is unclear whether the unilateral adoption of an amortization method by one party to a CNPC would cause the rule for significant nonperiodic payments to apply and, thus, whether the *other* party to the CNPC may be treated as paying or receiving interest (either before or after final regulations are published) — particularly where the other party may not even know of the first party’s adoption of an amortization method. The application of those rules could either cause a withholding tax to apply to payments received by the other party or cause the other party to be a paying agent required to withhold on the payments that it makes. It could also have other secondary consequences for the other party (e.g., it could affect its foreign tax credit calculations, or, if it is a tax-exempt investor, it could subject it to tax under the rules for debt financed income).

¹⁷ For example, it is unclear under the Preamble whether, in applying a reasonable amortization method, a taxpayer may treat a contingent payment as a positive (non-zero) number when there is only a remote chance that any payment will in fact be paid. This is the situation with many CDSs. It is also not clear how to take account of contingent payments on CNPCs in many other situations such as (i) CNPCs that have payments that are contingent, not only as to amount, but also as to the time of payment and (ii) CNPCs that have payments that may be affected, not only by contingencies not in the control of the parties, but also, by options that are within the control of one of the parties.

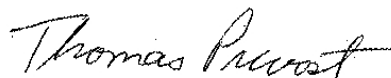
Given the significant practical concerns raised by the Preamble language, the strong technical/policy arguments for why the wait-and-see method is widely considered a method that meets the clear reflection of income standard, and the existing authority of Treasury and the IRS to attack abusive transactions, we do not understand why taxpayers must be required to adopt a radically different accounting method prior to the effective date specified in the actual Proposed Regulations. We therefore respectfully request that the Treasury and the IRS publish interim guidance quickly which provides that all taxpayers (not on mark-to-market) 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 that the Proposed Regulations were issued).

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Thank you for giving consideration to the request 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.

Thank you.

Thomas Prevost



Chair, North American Tax Committee

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