REPORT #705

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED REGULATIONS ON

METHODS OF ACCOUNTING FOR NOTIONAL PRINCIPAL CONTRACTS

January 6, 1992

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January 6, 1992

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
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Dear Commissioner Goldberg:

Please find enclosed a report prepared by our Committee on Financial Instruments on Proposed Regulations on Methods of Accounting for Notional Principal Contracts. The report was prepared by Cynthia G. Beerbower, Micah W. Bloomfield, Daniel Breen, Erin Callan, Dan Chung, Edward C. DuMont, Suzanne F. Greenberg, Edward D. Kleinbard, Erika W. Nijenhuis and Esta E. Stecher.

We would be pleased to discuss the report with you or members of your staff.

Very truly yours,

James M. Peaslee
Chair

Enclosure

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Tax Report #705

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON FINANCIAL INSTRUMENTS

REPORT ON PROPOSED REGULATIONS ON METHODS OF ACCOUNTING FOR NOTIONAL PRINCIPAL CONTRACTS

January 6, 1992

New York State Bar Association Tax Section

Committee on Financial Instruments

Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts[1]

I. INTRODUCTION.

This report comments on proposed Treasury regulations released on July 8, 1991, relating to the federal income tax treatment of notional principal contracts (the “Proposed Regulations”).[2] Part II of this report is a summary of the Proposed Regulations. Part III is a summary of our recommendations. Subsequent parts discuss in more detail our comments concerning the scope of the definition of notional principal contracts (Part IV), the application of the Code's source rules to notional principal contracts (Part V), the Proposed Regulations' rules for periodic payments (Part VI), the rules for nonperiodic payments (Part VII), assignments of notional principal contracts (Part VIII), straddle issues (Part IX), character of termination and assignment payments (Part X), mark-to-market accounting for dealers and traders (Part XI),

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1 This report was prepared by a subcommittee composed of Cynthia G. Beerbower, Micah W. Bloomfield, Daniel Breen, Erin Callan, Dan Chung, Edward C. DuMont, Suzanne F. Greenberg, Edward D. Kleinbard, Erika W. Nijenhuis, and Esta E, Stecher. Helpful comments were received from Dickson Brown, Peter C. Canellos, John A. Corry, Bruce Kayle, James M. Peaslee, Michael L. Schler, Jeffrey S. Sion and Po Y. Sit.

2 The Proposed Regulations add new sections 1.446-3, 1.446-4, 1.988-2T(h) and 1.1092(d)-l and make conforming amendments to regulation sections 1.61-14(b), 1.162-l(b), and 1.451-1 and to proposed regulation sections 1.461-4 and 1.1275-4.

All section references are to the Internal Revenue Code of 1986, as amended (the “Code”), and to the Treasury regulations promulgated thereunder.

and integration of notional principal contracts with other transactions (Part XII).

II. SUMMARY OF PROPOSED REGULATIONS.

A. Scope of Definition of Notional Principal Contracts.

The Proposed Regulations provide an expansive definition of the term “notional principal contract.” As under current regulation section 1.863-7, the Proposed Regulations define a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a “specified index” applied to a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[3] The Proposed Regulations, unlike regulation section 1.863-7, then proceed to define in considerable detail what constitutes a “specified index.” Under the Proposed Regulations, a specified index may include, for example, commodity prices, fixed and floating interest rates, equity indices, the price of an individual publicly traded stock or security, and amounts reflecting the total return on one or more publicly traded stock or securities. The Internal Revenue Service (the “Service”) has the authority to designate additional indices as “specified indices” for purposes of the Proposed Regulations.[4]

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[3] Cf. Reg. § 1.863-7(a)(1) (source rules for notional principal contracts). Regulation section 1.863-7 does not define the term “specified index,” but the Preamble to that regulation states that the regulation applies to interest rate and commodity notional principal contracts. Regulation section 1.863-7 is understood by most observers to apply as well to equity-based notional principal contracts.

[4] Prop. Reg. § 1.446-3(c)(2)(viii).

The Proposed Regulations then set out detailed "descriptions" of common notional principal contracts. Interest rate swaps, for example, are described as swaps in which the notional principal amount is expressed in dollars and the specified index is an interest rate or interest rate index.

Through an amendment to the temporary regulations promulgated under the foreign currency provisions of section 988, the timing (but not characterization) rules of the Proposed Regulations also apply in general to notional principal contracts that are foreign currency contracts within the scope of section 988 (such as yen-yen interest rate swaps).[5] The Proposed Regulations do not, however, supersede the special rules contained in the section 988 regulations dealing with the timing or character of gain or loss from currency swaps (that is, swaps that provide for the exchange of both interest and principal payments in two different currencies).[6]

The Proposed Regulations treat collars and other financial instruments that are composed of multiple notional principal contracts as multiple separate contracts. Options and forwards on notional principal contracts remain subject to the general rules of taxation for options and forwards, and are not treated as notional principal contracts under the

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[5] Prop. Reg. § 1.988-2T(h).

[6] The temporary regulations under section 988 define a notional principal contract as including only instruments based on interest rate or currency indices. Temp. Reg. § 1.988-lT(2)(iii)(B)(2). Certain foreign currency denominated instruments, such as yen-pay Nikkei swaps, therefore are outside the scope of the section 988 rules. Presumably, these instruments now are covered by the Proposed Regulations to the extent those instruments constitute "notional principal contracts."

Proposed Regulations. Thus, for example, a premium paid for an option on a swap is not currently includible or deductible, but is taken into account when the option is exercised (as premium on the resulting swap) or lapses.

B. Periodic and Nonperiodic Payments.

1. Periodic Payments. The Proposed Regulations divide payments made or received with respect to notional principal contracts into three categories: periodic payments, nonperiodic payments and termination payments. Periodic payments are defined by the Proposed Regulation as "payments made or received ... that are payable at fixed periodic intervals of one year or less during the entire term of the contract, and the amounts of which are based on a single specified index."[7] Nonperiodic payments are all other payments pursuant to a notional principal contract other than termination payments. Cap and floor premiums and fees paid or received to enter off-market notional principal contracts are examples of nonperiodic payments.

Each year, a party to a notional principal contract must include as income or deduction the net amount of all periodic and nonperiodic payments related to that notional principal contract that are "recognized" for that taxable year.

[7] Prop. Reg. § 1.446-3(e)(2)(i).

Periodic payments are "recognized" under a ratable daily accrual method.[8] The ratable daily accrual method applies regardless of the taxpayer's method of accounting.

In the case of variable rate indices that are set in arrears, the Proposed Regulations require a taxpayer to calculate the ratable daily portion of a periodic payment that relates to a taxable year by treating the last day of the taxable year as the date on which the index is determined; any difference between that amount and the actual amount due for the period (determined on the actual reference date) is treated as income or deduction in the following year.

2. Nonperiodic Payments. The Proposed Regulations would replace prior guidance regarding the inclusion of income or deductions in respect of nonperiodic payments contained in Notice 89-21, 1989-1 C.B. 651. Notice 89-21 provided that, in the case of lump-sum payments made or received with respect to notional principal contracts, a method of accounting clearly reflects income only if the payments are taken into account over the life of the contract using a reasonable method of amortization. The Preamble to the Proposed Regulations confirms that payments made or received with respect to notional principal contracts entered into prior to the effective date of final regulations may be amortized under any reasonable method, regardless of whether the taxpayer's method of accounting for notional principal contracts satisfies the rules of the Proposed Regulations.

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[8] For example, a calendar-year taxpayer that enters into a market-rate swap on September 1, 1991, that provides for semi-annual or annual payments by the parties will recognize net income or loss at year-end based on the accrual over four months of the parties' net payment obligations. If the first period to which swap payments relate does not begin until October 1, 1991, however, the accrual period will be three months.

Under the Proposed Regulations, if a nonperiodic payment that is not “significant” is made with respect to a notional principal contract, that nonperiodic payment in effect is allocated over the term of the contract, using a method that reflects the “economic substance” of the contract. The Proposed Regulations require a party to the contract to “recognize” the amount of such nonperiodic payment allocable to each period under the contract as income or deduction under the same ratable daily accrual method applicable to periodic payments.

Although the Proposed Regulations are not entirely clear in this regard, it appears that a nonperiodic payment that relates to a swap generally must be allocated in accordance with the values of a series of cash-settled forward contracts, and a nonperiodic payment that relates to a cap or floor must be allocated in accordance with the values of a series of cash-settled options. (The issue of what these requirements mean is discussed in Part VII below.)

The values of these forward or option contracts may be determined by the pricing model, interest rate, and compounding methods used by the parties, if reasonable.[9] The Proposed Regulations are clear that straight- line amortization of swap, cap or floor premium is not permitted.

A party to an interest rate swap has the option to allocate a nonperiodic payment under a level payment constant yield to maturity method (i.e., as though a swap were two offsetting bonds), using for a discount rate either the interest rate provided in the Internal Revenue Code (the "Code") for overpayments of tax or the rate actually employed by the parties in computing the nonperiodic payment. For interest rate caps and floors, the Proposed Regulations contemplate that a table will be provided by a Revenue Procedure (that presumably will be updated regularly) that may be used to allocate premiums. In both cases, however, the optional method is available only if the contract or agreement is not hedged, either directly or through a related

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[9] The parties' option pricing model will not be considered reasonable if it is an accelerated amortization method or if the model allocates decreasing rather than increasing portions of the premium to the later years of the contract.

Apart from this guidance on options, the Proposed Regulations do not provide guidance on what models or rates will be considered reasonable, other than that those models or rates must conform to the economic substance of the transaction.

party, by another notional principal contract or other financial instrument.[10]

A "significant" nonperiodic payment on a notional principal contract is subject to different rules than the ones stated above for nonsignificant payments. The Proposed Regulations require a "Significant" nonperiodic payment made by a party to an off-market swap to be treated as a loan. The Proposed Regulations do not define the term "significant," but the examples contained in the Proposed Regulations imply that a nonperiodic payment equal to roughly 10 percent of the present value of the payment stream of the fixed-rate payor under a swap (including both payments made during the term of the swap and the nonperiodic payment, whether made or received) is not significant, while a payment equal to roughly 40 percent of the present value of that payment stream is significant.[11]

[10] If the optional method is not available, then the parties to a notional principal contract must allocate any nonperiodic payment in accordance with the economic substance of the contract, as described above.

[11] Compare Prop. Reg. § 1.446-3(e)(4)(v), Ex. 2 (40%) with Prop. Reg. § 1.446-3(e)(3)(iii), Ex. 5 (10%). The Proposed Regulations do not set out a precise methodology for comparing "the amount of a nonperiodic payment to the present value of the total amount of fixed payments due under the contract." Prop. Reg. § 1.446-3(e)(4)(v), Ex. 2. We derived our 10% figure, for example, by (i) computing the present value of the fixed stream of payments set out in Example 5 of proposed regulation section 1.446-3(e)(3)(iii) at the above-market rate set out in the contract: $11 million/year for 5 years at 11 percent compounded annually ($40,654,867)(ii) subtracting (because the fixed rate payor received the premium) the amount of the premium ($3,695,897) and (iii) dividing the resulting present value of payments made and received by the fixed rate payor under the swap ($36,958,970) by the amount of the premium. In this respect, however, Example 5 contains a technical error, by implying that the appropriate discount rate is the above-market rate specified in the contract (11 percent) rather than the prevailing market rate (10 percent). If the example is corrected in this respect, the present value of the payments made and received by the fixed rate payor would have been $37,907,867 (= $41,698,654 (the present value of the fixed stream of payments) - $3,790,787 (the correct amount of the premium)); dividing this figure by the correct amount of the premium again gives a 10 percent figure.

The deemed loan must be amortized over the term of the swap using the level payment constant yield to maturity method. The time value component of the deemed loan payments is treated by both parties as interest for all purposes of the Code. Accordingly, one party will have interest income and the other will have corresponding interest expense. The deemed loan payments do not directly affect the income or loss to a party from a swap; however, the swap is recharacterized as a market-rate swap and amounts equal to the deemed loan payments are treated as paid under that swap.[12]

Similarly, a portion of the premium for a cap or floor must be recharacterized as a loan if the cap or floor is significantly in-the-money. Under the Proposed Regulations, an interest rate cap or floor will be considered as "significantly" in-the-money if the index is in-the-money by more than 25 basis points. The time value component of the loan is treated by both parties as interest for all purposes of the Code, and is not included in the income or loss from the cap or floor.

[12] Presumably such deemed payments will constitute periodic payments.

Any nonperiodic payment, whether or not significant, may be treated by the Service as a loan under section 956.[13]

C. Terminations and Assignments.

1. Definition of Termination Payment. The Proposed Regulations define a "termination payment" as a payment made or received that extinguishes or assigns all or a proportionate part of the rights and obligations of any party under a notional principal contract.[14] Accordingly, contrary to what we understand to have been the general market practice prior to the issuance of the Proposed Regulations, a party that assigns its interest in a notional principal contract will trigger a taxable event for its counterparty.[15]

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[13] Under section 956, any increase in the amount of a controlled foreign corporation's earnings "invested" in the "obligations" of the corporation's U.S. parent is taxable under subpart F, to the extent the amount of earnings invested in such obligations would have constituted a dividend if distributed. Section 951(a)(1)(B). Accordingly, if the Service treats a nonperiodic payment paid by a controlled foreign corporation to its U.S. parent as a loan under section 956, the U.S. shareholder of that corporation may be currently taxable on the amount of that payment under subpart F.

[14] A foreign currency-denominated notional principal contract that is integrated with property or debt under section 988(d) is not subject to the Proposed Regulations' rules on the timing of terminations.

[15] A counterparty that recognizes gain when the other side of its notional principal contract is assigned will treat that gain as includible in income in the year of termination; that gain in turn will give the counterparty basis in the contract, which the counterparty can treat as a nonperiodic payment amortizable over the remaining life of the contract.

The converse should apply in the case of a recognized loss. If, however, the notional principal contract in the hands of a counterparty is part of a straddle, as discussed in Part IX, infra, then any realized loss may be deferred either under the straddle loss deferral rules or the special straddle wash sale rules.

Entering into an offsetting notional principal contract with the same counterparty generally is not treated as a termination under the Proposed Regulations, unless the taxpayer "monetizes" any locked-in gain, through, for example, a bank loan collateralized by the netted contracts.[16]

In general, both the assigning party and its counterparty must recognize both the termination payment and any unrecognized portion of any nonperiodic payments in the taxable year of the termination.[17] An assignee must treat a termination payment made or received as a nonperiodic payment relating to the notional principal contract that is in effect after the assignment.

2. Character of Termination Payments. Section 1092(d)(1) defines "personal property" generally as personal property of a type that is actively traded. Offsetting positions in section 1092(d)(1) personal property (other than offsetting positions as to which the taxpayer is permitted to elect out of section 1092) are subject to the straddle rules, which may require the deferral of loss recognition on those positions. In addition, under section 1234A, a termination payment made in respect of a right or obligation with respect to personal property as defined in section 1092(d)(1) that is (or on acquisition would be) a capital asset is treated as the sale or exchange of a capital asset.

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16 Prop. Reg. § 1.446-3(e)(6)(iv), citing Reg. § 1.988- 2T(d)(2)(ii)(B).

17 For example, if the holder of a cap extinguishes or assigns the cap during the term of the cap, the holder will recognize both any payment made or received to terminate its interest in the cap and the unrecognized portion of the cap premium allocated to the year of termination and subsequent years.

The Proposed Regulations expand the definition of personal property of a type that is actively traded for section 1092 purposes to include most standardized interest rate swaps, caps and floors and certain other notional principal contracts. The Proposed Regulations accomplish this result by defining the phrase "actively traded" personal property in the case of notional principal contracts to include any contracts for which there exists an active interdealer market that disseminates quotations or information from identified dealers relating to the prices at which such dealers are willing to enter into "similar" new contracts.

The Preamble to the Proposed Regulations states that, as a consequence of bringing notional principal contracts within the scope of section 1092(d)(1), gain or loss realized through the termination (through extinguishment or assignment) of a taxpayer's rights and obligations under a notional principal contract would generally be treated as gain or loss from the sale of a capital asset under section 1234A. The statement stands out in light of an earlier statement in the Preamble that the regulations generally do not address the character of income, loss or deductions with respect to notional principal contracts, and of the general focus of the Proposed Regulations on timing rather than character.

a. Consequences to End-Users. For end-users, two principal consequences flow from the conclusion that standardized interest rate swaps, caps, floors (and other notional principal contracts for which price quotes are available in interdealer quotation systems) constitute personal property of a type that is actively traded for purposes of section 1092(d)(1).

First, if such contracts are not excluded from the definition of capital asset under one of the exceptions in section 1221 (as the Preamble to the Proposed Regulations appears to assume), termination payments on notional principal contracts generally will give rise to capital gain or loss under section 1234A.[18]

The second consequence that flows from the extension of section 1092's definition of "personal property" to encompass most interest rate swaps and other "plain vanilla" notional principal contracts is that such contracts now constitute "positions" in personal property to which the

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[18] A different conclusion might be reached in the case of contracts that hedge a party's inventory or receivables.

Some taxpayers, particularly non-U.S. investors not engaged in a trade or business in the United States and tax-exempt investors seeking to avoid unrelated business taxable income, may find that the expanded definition of personal property of a type that is actively traded works to their advantage. If by virtue of section 1234A investors may treat gain from the termination of a notional principal contract as gain from the sale or exchange of a capital asset, then in the hands of a foreign investor such gain should be exempt from U.S. withholding tax (regardless of its source), and in the hands of a tax-exempt investor such gain should be treated as income that does not constitute unrelated business taxable income.

straddle rules of section 1092 can apply.[19] Since a U.S. dollar indebtedness is not subject to the straddle rules in respect of a borrower whose functional currency is the U.S. dollar,[20] the extension of the straddle rules to cover standardized interest rate swaps and similar notional principal contracts may have only modest relevance to liability hedging. Asset-based swaps will, however, present more difficult straddle patterns.

b. Consequences to Dealers. The potential consequences of the Proposed Regulations' amendments to the regulations under section 1092 also are uncertain for dealers in notional principal contracts. If notional principal contracts were treated as capital assets to dealers as well as to end-users, then under the Proposed Regulations income or loss incurred by notional principal contract dealers in terminating contracts in the normal course of business would be capital income or loss,

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[19] Very generally, the straddle rules provide that, if a taxpayer has offsetting positions with respect to personal property, then any loss realized in respect of one position may not be recognized for tax purposes if the taxpayer at year-end has unrealized gain in respect of the other position. Because sections 1092(e) and 1256(e) provide an election out of the straddle rules for hedging transactions in which all gain or loss is ordinary, the straddle rules apply as a practical matter to offsetting positions one or both of which give rise to capital gain or loss. To the extent that section 1234A renders termination payments on standardized notional principal contracts capital gain or loss, therefore, the expanded definition of "personal property" brings contracts that would otherwise be outside the ambit of the straddle rules within the scope of those rules.

[20] See Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 289 (1981) (U.S. currency is not section 1092(d) personal property).

and dealers would be subject to the straddle rules.[21]

D. Mark-to-Market Accounting for Dealers and Traders.

The Proposed Regulations create a new category of financial instruments, termed "derivative financial instruments," and provide that dealers and traders in such instruments may elect to account for those instruments and related hedges under a mark-to-market method of accounting. A dealer in derivative financial instruments is defined as any taxpayer with an established place of business that makes a market in derivative financial instruments by regularly and actively offering to enter into, offset, assign, or otherwise terminate positions in these instruments with customers in the ordinary course of its trade or business. A trader in derivative financial instruments is defined as any taxpayer with an established place of business that regularly and actively engages in the frequent and substantial trading of derivative financial instruments

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[21] The potential for this result stems from the lack of any express authority under current law dealing with the character of gain or loss on the termination of notional principal contracts in the hands of dealers. Section 1221(1) excludes "inventory" or "property held ... primarily for sale to customers" from the definition of capital assets; as a technical matter, the argument could be made that notional principal contracts are not inventory or "sold" to customers. This argument must be reconciled, however, with the recognition under current law, confirmed by the proposed Regulations, that a taxpayer may be a "dealer" in notional principal contracts. See Temp. Reg. § 1.954-2T(a)(4)(iii)(B) (defining "dealer" for those purposes as including notional principal contract dealers by virtue of special rules with respect to a merchant with an established place of business that makes a market in derivative financial products of property by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business); Prop. Reg. § 1.446-4(b) (proposing similar definition).

On the other hand, it may well be that, if notional principal contracts are now held to constitute actively traded personal property, then a fair reading of section 1221(1) that is consistent with this determination would require the conclusion that notional principal contracts must also be viewed as "inventory" or as property "held for sale" to customers.

for the principal purpose of deriving gains and profits from trading these instruments rather than from periodic income such as dividends, interest, net income from notional principal contracts, or long term appreciation.[22]

The use of the term "taxpayer" to define dealers and traders requires that the terms "dealer" and "trader" be applied on an entity-by-entity basis, even within an affiliated group filing consolidated returns.[23] Accordingly, the presence of a corporation that is a dealer in an affiliated group of corporations does not render each member of the affiliated group a "dealer," and the mark-to-market election may be made on a taxpayer-by-taxpayer basis.

"Derivative financial instruments" are defined to include options, forward contracts, futures contracts, notional principal contracts, short positions in securities and commodities, and other similar financial instruments. In practice, this definition includes virtually every dealer position of a typical securities dealer or bank, other than net long physical positions. A dealer in derivative financial instruments therefore may be a securities dealer that deals in over-the-counter stock options, or a bank that deals in currency forwards, as well as a dealer in notional principal contracts.

The mark-to-market election is permitted only with respect to derivative financial instruments held or entered into in a dealer or trader capacity,

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22 Prop. Reg. § 1.446-4 (b).

23 A "taxpayer" is any person subject to any internal revenue tax. Section 7701(a)(14). An individual, partnership, association, company, or corporation is a "person." Section 7701(a)(1). Accordingly, each individual corporate (or other) entity in a affiliated group is a person subject to the federal income tax.

or as hedges of certain instruments held in a dealer or trader capacity. Consequently, the election is not permitted with respect to derivative financial instruments entered into for the purpose of deriving gains from periodic income or long-term appreciation, or with respect to financial instruments other than derivative financial instruments (such as long positions in securities and commodities) used to hedge derivative financial instruments. A rule of consistency requires that mark-to-market valuation be used both for financial and tax accounting purposes.

A condition of the election is that neither the dealer or trader nor any related person may account for securities and commodities held in a dealer capacity under a lower-of-cost-or-market method of accounting; only cost or mark-to-market are permissible for such securities and commodities. Both affiliates that are dealers in securities and commodities, and dealers in derivative financial instruments that are also dealers in securities and commodities, may therefore be required to change their method of accounting for such securities and commodities. Because the mark-to-market election is on a taxpayer-by-taxpayer basis, affiliates of an electing dealer or trader will not be required to change their method of accounting for derivative financial instruments (although, as noted above, they may be required to abandon lower-of-cost-or-market for their physical inventory positions).

In sum, as a result of the breadth of the definition of derivative financial instruments, for an electing dealer or trader that is not also a dealer in securities or commodities, all financial instruments (if held in a dealer or trader capacity), other than net long positions in physical securities or commodities utilized as hedges of those derivative contracts, will be placed on mark-to-market,

while net long physical positions will be carried on a cost method of accounting. The consequences are similar for an electing dealer or trader that is also a dealer in securities or commodities, except that net long physical positions may be accounted for under either a cost or a mark-to-market method of accounting.

Once the mark-to-market election is made, it must be used consistently in subsequent years, and cannot be changed without the consent of the Service. The Preamble to the Proposed Regulations states that the Service anticipates that procedures similar to those generally applicable to changes of permissible methods of accounting will be provided for dealers and traders in derivative financial instruments-Those procedures generally permit adjustments to income required to be taken as a result of the change of method to be spread over several years. The Service also anticipates that the rule that the election must be made within 180 days after the beginning of a taxpayer's taxable year will be waived, so that dealers and traders may elect mark-to-market for the taxable year in which final regulations become effective. A cut-off transition is expected to apply to changes in methods of accounting for securities and commodities.

E. Integration.

The Preamble to the Proposed Regulations notes that taxpayers frequently use notional principal contracts to minimize exposure to adverse changes in interest rates, commodity prices and currency exchange rates, but the Proposed Regulations do not permit taxpayers to integrate notional principal contracts to assets or liabilities hedged. The Preamble states that such integration is under consideration and solicits comments from interested taxpayers.

The Proposed Regulations, however, grant to the service power to recharacterize transactions and to require that amounts paid or received by a party be treated in a manner "consistent with the economic substance of the transaction as a whole."[24] The sole example given by the Proposed Regulations is the case where Party A enters into off-market interest rate swaps with unrelated counterparties B and C. Party A is a floating rate payor under the B swap and a fixed rate payor under the C swap, the swaps have the same notional principal amount, and Party A receives significant upfront premium payments under each of the two swaps. The Proposed Regulations recharacterize the transaction as a fixed rate borrowing by Party A; counterparties B and C are unaffected by this characterization.[25]

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[24] Prop. Reg. § 1.446-3 (e)(4)(i),(ii).

[25] Prop. Reg. § 1.446-3(e)(4)(v), Ex. 4.

The Proposed Regulations do not set any limit other than "economic substance" on the Service's power to integrate separate transactions. Additionally, the Proposed Regulations give the Service separate authority to disregard the otherwise-mandatory timing rules of the Proposed Regulations if a taxpayer enters into a "noncommercial" transaction to obtain the benefits of a material distortion to its taxable income that would otherwise result from the application of those timing rules.[26]

F. Effective Dates.

The Proposed Regulations, if adopted in final form without further amendment, generally will apply to the timing of income and deductions of notional principal contracts entered into on or after the date final regulations are promulgated, and to the character of termination payments on notional principal contracts entered into on or after July 8, 1991. The mark-to-market rules for dealers and traders in notional principal contracts are proposed to apply to taxable years ending on or after the date final regulations are promulgated.

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[26] Prop. Reg. § 1.446-3 (f)

III. SUMMARY OF RECOMMENDATIONS.

As a preliminary matter, the Committee believes that it is unfortunate that the Proposed Regulations were drafted without including a mechanism for taxpayers to integrate notional principal contracts with the financial instruments those contracts hedge. Together with a well-crafted mark-to-market election for dealers in notional principal contracts, an integration scheme for end-users could have reduced substantially the importance of a number of difficult technical issues, including those relating to the amortization of nonperiodic payments, assignments of notional principal contracts and the character of termination payments. The Committee therefore urges the Service to incorporate integration by taxpayers into the final regulations. Some of our more specific recommendations follow.

A. Definition of Notional Principal Contract.

The definition of a notional principal contract should be clarified to make explicit the distinction between such contracts and other financial instruments. We also suggest clarifications to the terms “specified consideration” and “notional principal amount” and additions to the list of “specified indices.”

B. Source of Notional Principal Contract Income.

The Proposed Regulations' definition of “notional principal contract” generally should apply for source purposes. We discuss possible rationales for and against a special rule carving out certain equity-based notional principal contracts.

C. Definition of Periodic Payment.

The definition of periodic payment should be clarified by analogy to the definition of "qualified periodic interest payment" for original issue discount purposes.

D. Allocation of Nonperiodic Payments.

The Proposed Regulations' rules on the allocation of nonperiodic payments should be revised. In particular, we recommend that the allocation methods for swaps not be based on the values of a series of future contracts but instead be based on either a single blended interest rate method of allocation, such as a level payment constant yield to maturity method, or a zero-coupon-bond-like method of allocation, at the option of the taxpayer. The primary method for caps and floors should be straight-line allocation.

E. Assignments.

A party whose counterparty assigns a notional principal contract should not be subject to tax by reason of the assignment. If the rule in the Proposed Regulations is retained, an exception should be provided with respect to certain nonrecognition transactions.

F. Straddle Issues.

In view of the very thin secondary market trading of notional principal contracts, those contracts should not be treated as "actively traded" personal property within the meaning of section 1092(d).

G. Character of Termination Payments.

If a single uniform rule for the character of termination payments is considered necessary, gain or loss on terminations of interest rate-based notional principal contracts should be uniformly ordinary rather than capital.

H. Mark-to-Market Election.

The mark-to-market election should apply only with reference to a dealer or trader's "book" of notional principal contracts and the financial instruments those contracts hedge or are hedged by. Further, the mark-to-market election should not be tied to a requirement that the electing dealer or trader and its affiliates use a method of accounting other than lower-of-cost-or-market for net long securities or commodities inventory.

I. Integration.

In addition to the comments made above, we suggest that further examples be added to clarify the kinds of transactions considered abusive and therefore subject to the Service's power to integrate.

IV. DEFINITION OF NOTIONAL PRINCIPAL CONTRACT.

A. Overlap Issues.

We applaud the Treasury for taking a broad and (through the contemplated index designation process) flexible approach to the definition of "notional principal contract." However, a broad definition brings with it the possibility of an overlap between notional principal contracts and other financial instruments.

For example, most forwards and over-the-counter options, other than forwards and options to enter into notional principal contracts and interbank foreign currency forwards, are not expressly excluded from the definition of notional principal contracts.[27] Further, the expansion of the term "specified index" to include individual stocks and securities may increase the potential for overlap.

1. Forward Contracts. It is surprisingly difficult to determine whether forward contracts are inside or outside the scope of the current definition of "notional principal contract." The definition of "notional principal contract" requires the payment of "amounts" at "specified intervals."[28] Accordingly, a traditional forward contract arguably cannot constitute a "notional principal contract," because such a contract does not require either party to make multiple payments at specified intervals.

Consider, however, a contract under which one party agrees to deliver one million barrels of oil a year for 5 years, and the counterparty agrees to pay $20 million/year (i.e., $20/barrel) for that oil. The contract has multiple payments at specified intervals, but most observers would think of it as a forward sale of oil, not a notional principal contract. It is also true that $2 0 million (or $20/barrel) by itself is not determined by applying a specified index to a notional principal amount, but the figure easily could be restated, for example, as 10 percent of a notional principal amount of $200 million.

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[27] Proposed regulation section 1.446-3(c)(ii) excludes contracts described in section 1256 -- including regulated futures contracts, listed non-equity options and foreign currency interbank forwards -- from the definition of notional principal contracts.

[28] Prop. Reg. § 1.446-3(c)(i)

The characterization of multiple period forward contracts and similar hybrids is an important issue, because the Proposed Regulations provide answers different from current law.[29] One possible solution is to resolve the overlap in favor of the Proposed Regulations: in that case, the definition of "notional principal contract" should be explicitly expanded (by way, perhaps, of several examples) to include multiple period forwards, without regard to whether payments are described as fixed dollar (or other currency) amounts or as a fraction of a purported notional principal amount.

If, by contrast, it is felt that the extension of the definition of "notional principal contract" to include some (or all) forward contracts goes beyond the intended scope of the Proposed Regulations, then it will be necessary to carve out a defined class of forward contracts (in addition to single delivery contracts, assuming they are not now notional principal contracts). For this purpose, a forward contract could be defined as an agreement that requires or permits delivery of a specified quantity of goods at one or more specified dates in the future in exchange for a specified amount (expressed in dollars or another

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[29] Compare. e.g., Reg. § 1.451-5 (suggesting that prepaid forward contracts produce immediate income in most cases) with Prop. Reg. § 1.446-3(e)(4)(requiring amortization of upfront payments received in respect of notional principal contracts). Also, the delivery of property would not be a taxable event in the case of a conventional forward contract, but would be if the delivery were a payment under a notional principal contract.

currency, whether fixed or determined by reference to a formula) per unit of goods.[30] In any event, the demarcation line between forward contracts and notional principal contracts should be illustrated with several examples.

Another possible distinction between traditional forward contracts and notional principal contracts is that forwards are not "notional," in the sense that a forward buyer has the right to receive the actual property that is the subject of the forward contract (or the cash value thereof). This distinction might prove useful, if the Proposed Regulations were revised to expand their discussion of what constitutes a "notional" amount. At the moment, however, this distinction seems contradicted by the Proposed Regulations' treatment (consistent with market practice) of currency swaps, in particular,

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[30] The Service may wish to consider whether a definition of forward contracts should be exclusive (i.e., no contract other than one meeting that definition would be treated as a forward) or inclusive. An inclusive definition may not satisfactorily mark the demarcation line between a forward contract and a notional principal contract, however; for example, the definition we offer, if exclusive, would prevent straightforward fixed-for-floating commodity swaps from being swept into the definition of forward contracts because of the requirement that physical delivery is possible or required.

as “notional” principal contracts, despite the fact that “principal” typically actually is exchanged at maturity of a currency swap.[31] Also, as suggested above, a contract that does not have a “notional” component could be rewritten to provide for one.

In the Committee's view, this implicit uncertainty of what constitutes a “notional” amount will take on even greater importance in the near future. There already exist in the derivatives marketplaces examples of “prepaid” forward contracts and other synthetic instruments that are similar to traditional notional principal contracts in their documentation and in the fact that they are simple contracts between counterparties (one of which typically is a financial institution), but that differ from most notionals (other than option-type products) in that one party makes a fixed investment in the contract (typically on execution),

[31] Cf. Prop. Reg. § 1.988-2T(h), parenthetically describing a currency swap as a notional principal contract (although subject to the special timing rules of Reg. §1.988-2T(e)(2)).

and receives in exchange a synthetic return on that investment that economically is similar to a current possessory interest in property.[32]

2. Debt Instruments. The Proposed Regulations should specify that an instrument otherwise properly characterized as debt for federal income tax purposes does not constitute a "notional principal contract."[33] While this point is implicit in the recharacterization rules for significant non-periodic payments, discussed below, the matter should be faced explicitly.

3. Options. The timing of income from caps and floors under the Proposed Regulations differs from the taxation of options, which the Proposed Regulations do not alter. In particular, under the Proposed Regulations, the premium allocable to each period on a cap or floor is required to be recognized on a ratable daily basis over that period.[34] Under the tax rules applicable to options, option premium is generally recognized upon the lapse, exercise, or other termination of the option (except in the case of a party who takes delivery of the optioned property,

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[32] Some "prepaid" forward contracts, of course, economically are more similar to a forward purchase of goods at a discount (to reflect early payment) rather than to a current possessory interest in those goods. In either case, the payments by the counterparty represent a market return on an actual (rather than notional) investment.

[33] In our view, an instrument otherwise properly characterized as debt for federal income tax purposes cannot constitute a notional principal contract, because the principal on such an instrument is not "notional." See Prop. Reg. § 1.446-3(c)(3). Principal may be contingent without being notional: the difference is that contingent principal may be paid, while notional principal never is.

[34] Prop. Reg. § 1.446-3(e)(3)(ii)(C).

who generally realizes income or loss attributable to the option as income or loss from such property).[35] The character of income or loss from a cap or floor may also differ under the Proposed Regulations from the treatment of options. Accordingly, taxpayers otherwise indifferent to entering into, for example, a three-year cap or a set of three options effectively may elect the tax treatment preferred, subject to various anti-abuse rules.[36] If this result is not intended, the Proposed Regulations must be amended to draw a bright line distinction between caps and options that does not look to the taxpayer's choice of terminology.

B. Descriptions of Common Notional Principal Contracts.

Proposed Regulation section 1.446-3 gives "descriptions" of common notional principal contracts. We understand that these "descriptions" are not intended to serve as exclusive definitions of the instruments in question. Since several of the operative rules of the Proposed Regulations require taxpayers to identify a notional principal contract as, for example, an interest rate swap, it is important to clarify that these descriptions are intended to be illustrative only.

In particular, we note that the description of interest rate swaps, caps and floors as contracts in which the notional principal amount is expressed in dollars does not accord with the common understanding of interest rate swaps,

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35 Section 1234; Rev. Rul. 58-234, 1958-1 C.B. 279. This distinction creates timing differences only to the extent that the period to which a cap or floor relates straddles a year end.

36 Cf. Prop. Reg. § 1.446-3(e)(4)(v), Ex. 1 (implying that certain put options are not identical for tax purposes to caps).

In this regard, we note that instruments termed multiple-year options have been created in the past. Cf. Reg. § 1.1234-3(e).

caps and floors as including contracts based on an interest rate index but denominated in a single foreign currency (such as a yen-yen interest rate swap). In light of the importance of this product in particular, the description of interest rate swaps, caps and floors should be modified accordingly.

C. Contracts with Qualified Business Units.

The Proposed Regulations retain the limitation of regulation section 1.863-7 that a contract between a taxpayer and a "qualified business unit" (as defined in section 989(a))("QBU") of the taxpayer, or between QBU's of the same taxpayer, is not a "notional principal contract," on the theory that "a taxpayer cannot enter into a contract with itself." As a tax policy matter, the Committee believes that more appropriate results would be achieved, and in a straightforward manner, if, instead, interbranch swaps were treated for tax purposes as bona fide contracts.[37]

If the rule is retained for branch offices, however, the final regulations should make clear that separately constituted partnerships are not covered by the rule, even if one is a partner in the other or the two share one or more

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[37] The conceptual difficulty raised by a taxpayer contracting with itself has not prevented the taxation of U.S. branches of foreign corporations on a stand-alone basis, including the construction of fictional loan transactions between such branches and their corporate "parents." See section 884.

common partners.[38] These clarifications are necessary to prevent the difficulties that would arise if, for example, a U.S. partnership (particularly one that acts as a dealer in notional principal contracts) and a related foreign partnership were not allowed to account separately for contracts concluded with foreign counterparties by the foreign partnership which then transferred the responsibility for centralized risk management and hedging to the U.S. partnership by use of "back-to-back" transactions.

D. Other Definitional Issues.

1. Specified Consideration. The Proposed Regulations define a notional principal contract as a financial instrument that "provides for the payment of amounts by 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."[39] The Committee believes that it would be helpful to clarify that the term "specified consideration" includes: (i) a fixed dollar (or other currency) amount payable at the outset of the transaction, (ii) a fixed dollar (or other currency) amount payable at any specified time or (iii) a number of fixed dollar (or other currency) amounts payable at different times.

2. Notional Principal Amount. The definition of notional principal contract refers to "a" notional principal amount. The phrase "notional principal amount" in turn is defined,

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38 See Reg. § 1.989(a)-1(b)(2)(i).

39 Prop. Reg. § 1.446-3(c)(1)(i).

in part, as "any specified amount of money or property."[40] These definitions imply that the notional principal amount is a fixed amount that cannot change. This is unduly restrictive. An interest rate swap is often used to convert a floating rate on a debt instrument to a fixed rate (or vice versa). With any debt instrument that amortizes or prepays, there will not be a single fixed amount that can be used as the notional principal amount. So-called "mortgage swaps," for example, are written with notional principal amounts that are intended to track the balance of the mortgages being hedged, which will decline as mortgages in the pool are prepaid. Accordingly, the definition of a notional amount should be broadened explicitly to include swaps whose notional amount is based on the (amortizing) principal of one or more debt instruments.

3. Specified Index. The Proposed Regulations' definition of "specified index" is critically important. If the definition is too narrow, important classes of financial instruments will remain without adequate tax rules; if the definition is too broad, these rules may overlap (and conflict with) preexisting rules for other financial instruments.

As suggested above, some of the overlap potential can be reduced by explicitly carving out certain products from the scope of the Proposed Regulations. We also propose giving additional consideration to whether it is appropriate to treat a single equity security, in particular, as a "specified index." Single equity notional principal contracts raise significant collateral issues; they bring more sharply into focus than do most other notional principal contracts the tension inherent in according different treatment to financial instruments

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[40] Prop. Reg. § 1.446-3(c)(3).

with similar economic effect but different legal form.[41] In our view, however, for the reasons developed more fully in Part V, below, the best approach is to keep a broad definition of "specified index," and deal with unintended ancillary consequences through specific anti-abuse rules.

Turning to instances where the Proposed Regulations' definition of "specified index" appears to us to be too narrow, a number of problems may arise in applying Proposed Regulation section 1.446-3(c)(2)(v), which provides that "an amount or index of amounts that reflects the total return on one or more publicly traded stocks or securities" constitutes a specified index. The determination of whether stocks or securities are "publicly traded" for tax purposes is an issue of intense debate in other areas, such as the application of the original issue discount rule of section 1275 to debt-for-debt exchanges. We think that the definition of specified index should include not only indices based on publicly traded instruments but also publicly disseminated indices relating to stocks or securities.

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[41] For example, it is not clear whether section 1032 would apply to payments received by a corporation under an equity swap in which it paid amounts based on dividends and price increases on its own stock. If section 1032 were to apply, on the theory that the contract was analogous to a purchase by the counterparty of the corporation's stock, then the corporation would presumably have no income with respect to at least some payments received from its counterparty. As discussed in Part V, the Committee believes that a notional principal contract generally should be treated as a separate instrument, not as an embodiment of a transaction in the corporation's stock. In that case, however, the Service should consider whether it is appropriate for a corporation to be able to deduct swap payments to the extent that they are determined by the amount of dividend payments on the corporation's own equity.

It might be possible to design instruments that would approximate a stock investment, redeemed over time, while falling within the regulatory definition of a notional principal contract. Such instruments -- which could be keyed to the return on a corporation's own stock or to the return on the stock of a subsidiary -- would raise more serious concerns.

Accordingly, we suggest that any publicly-disseminated index prepared by a private compiler of (i) interest or dividend rates or (ii) debt or equity instrument total rates of return be included within the scope of Proposed Regulation section 1.446-3(c)(2)(v). For example, under this approach, a "tax-exempt" interest rate swap (i.e., a swap of fixed-for-floating tax-exempt rates of return) would be treated as based on a specified index if the floating rate side were determined by reference to (for example), the Merrill Lynch tax-exempt money market rate index for 3 0-day variable rate obligations, or the J.J. Kenny Index, regardless of whether the underlying obligations were themselves publicly traded.

We further suggest that the initial list of specified indices be expanded to include three additional categories: (i) the consumer price index (and similar broadly-based measures of inflation), (ii) publicly-disseminated indices of commercial or residential real estate (based on statistically significant samples) prepared by private compilers, and (iii) publicly-advertised rates for certificates of deposits of one or more identified financial institutions.

V. SOURCE RULES FOR NOTIONAL PRINCIPAL CONTRACTS.

The Committee believes that the benefits of consistency and simplicity to be gained from using a uniform definition of "notional principal contract" for all purposes under the Code, with specific carve-outs for areas of potential abuse, make such an approach preferable to the use of varying definitions of the term for different purposes. We are therefore troubled by the inapplicability of the Proposed Regulations' definition of

notional principal contract to the source rules of regulation section 1.863-7 (which generally source notional principal contract payments based on the tax residence of the recipient).

With respect to the statement in the Preamble-of the Proposed Regulations that the Service is considering whether equity and equity index swaps should be treated in the same manner as interest rate and commodity swaps for source and withholding purposes, we assume that the Service is concerned that payments by a U.S. person to a foreign counterparty based on the dividend yield on one or more U.S. equities (a "dividend equivalent payment") might appropriately be subject to U.S. withholding tax. We do not believe that this report is the appropriate venue for an extended discussion of this issue, which is outside the timing (and character) focus of the Proposed Regulations, and indeed, is part of a far broader issue -- the proper scope of withholding tax on dividend-like payments other than actual dividends on actual equities. Nonetheless, given the statement in the Preamble, we offer a few comments with respect to equity-based notional principal contracts.

In our view, the extent to which it is appropriate to impose withholding tax on dividend equivalent payments depends in part on the investment alternative(s) to the particular equity or equity index swap. Thus, the clearest case for imposing a withholding tax may be with respect to payments made on single-equity swaps, for which the most obvious investment alternative is a simple stock purchase that would subject a foreign investor to dividend withholding.[42] Conversely,

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[42] Another alternative would be a securities loan that meets the requirements of section 1058. There is currently no authority on the application of withholding tax to payments with respect to such loans, although regulations addressing the issue are expected to be issued in the near future.

the least compelling case for the imposition of withholding tax may be with respect to payments on equity index swaps where the specified index is a broadly based U.S. equity index with respect to which other derivative contracts (such as regulated futures contracts) are actively traded. In such a case, a foreign counterparty could easily buy regulated futures contracts, the cash settlement of which would include amounts equivalent to dividends during the term of the contract, but would not be subject to withholding.[43] Other boundaries between payments sufficiently dividend-like so as to be subject to withholding and payments insufficiently dividend-like could also be drawn.

The availability (or lack thereof) of an investment alternative upon which no withholding tax is imposed is not be the sole issue of concern, however. Other reasonable arguments can be made both for and against the policy of imposing withholding tax on dividend equivalent payments.

An argument against, the tax is that both regulation section 1.863-7 and, for the most part, the Proposed Regulations treat notional principal contracts as a class of instruments separate from, although obviously related to, other instruments such as debt, stock, options and forward contracts. The Committee believes that, as a general matter, this is appropriate: the use of, for example, interest rates in calculating payments under interest rate swaps should not obscure the fact that swap payments are not interest. Similarly, the calculation of payments on equity or equity index swaps by reference to interest rates, dividends or gains or losses on stocks should not obscure the fact that an equity or equity index

[43] See sections 1256(a)(3)and 1234A.

swap is not a leveraged purchase of stock.[44] The recognition that notional principal contracts are a distinct class of instruments suggests that equity and equity index swaps should be treated uniformly with all other notional principal contracts, rather than singling them out for source and withholding treatment based on the character of the index on which some portion of their payment flows may be based.

In addition, it is important to acknowledge that concern over withholding is confined to a limited class of payments. Such concern arises only with respect to that portion of payments made by a U.S. counterparty to a foreign counterparty that is based on the dividend yield on U.S. equities (and even then, only to the extent those "dividends" are taxable distributions paid out of earnings and profits). It may be unduly complicated to endeavor to separate equity swap payments into their "U.S. equity dividend" and other components. Even where possible, such bifurcation might lead to absurd results. On a total return swap, for example, a small amount owed by one party based on dividends might be netted against a larger amount owed by the other party based on a rate index and a decline in stock value. In this circumstance, would the party receiving the net swap payment nevertheless be required to "withhold" tax on the dividend-based amount?

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[44] As in an interest rate swap, there is no actual borrowing. Similarly, there is no purchase of shares: the "long payor" has, for example, no voting or other ownership rights with respect to any issuer of shares, and must look to the credit quality of its counterparty, rather than solely to the business prospects of any issuer, to ensure fulfillment of its contract. These distinctions can be seen in a contract based on the shares of one company; they apply even more forcefully to contracts on baskets or indexes of stocks, and to contracts that do not include payments corresponding to all dividends, appreciation and depreciation on the stock, stocks or index used for calculating payments.

On the other hand, an argument in favor of imposing withholding tax is that affording foreign investors an opportunity to avoid the imposition of dividend withholding tax by means of equity-based notional principal contracts could jeopardize the continued viability of the dividend withholding tax.[45] While it is true that foreign investors can, even without such contracts, find surrogates whose economic performance tracks that of a particular equity or basket of equities without being subject to U.S. withholding tax, notional principal contracts, it can be argued, should not provide a means for expanding existing methods of avoiding dividend withholding tax. Pending a comprehensive review of the scope of dividend withholding tax, therefore, it may be appropriate to provide special rules with respect to equity and equity index notional principal contracts.

We note, however, that if it were thought to be appropriate to impose dividend withholding tax on outbound dividend equivalent payments,

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[45] Interest rate-based notional principal contracts do not raise the same level of concern because of the portfolio interest exceptions of section 871(h) and section 881(c), which exempt many outbound interest payments from withholding tax.

amending regulation section 1.863-7 to carve out certain equity swaps would not necessarily accomplish this result.[46] Even if such payments are sourced in the United States, the payments may not be subject to U.S. tax under the "industrial and commercial profits" or "business profits" articles of U.S. income tax treaties. In addition, to the extent that payments on equity-based notional principal contracts may be treated as capital gain, as discussed in Part X. A., such payments would also generally be exempt from U.S. withholding tax.

In light of the breadth of the policy concerns summarized above, the Committee believes that the Proposed Regulations, whose primary purpose is to provide timing rules for notional principal contracts, are not an appropriate setting for addressing the issue of the application of dividend withholding tax to notional principal contracts. The Committee agrees, however, that the issue is one of immediate concern, and that the Service should actively explore the alternatives available.[47] The Committee makes no recommendation in this report as to which alternative would be preferable.

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[46] Because regulation section 1.863-7 does not define the term "specified index," it is not absolutely certain that the regulation now applies to equity index notional principal contracts, although that has generally been understood to be the case. The application of the regulation to equity-based notional principal contracts other than those based on equity indices is still more uncertain.

[47] The forthcoming regulations on the application of withholding tax to payments with respect to securities lending may provide an appropriate forum for conducting a comprehensive review of the efficacy of withholding tax on portfolio equity investments.

VI. PERIODIC PAYMENTS.

We welcome the Proposed Regulations' explicit statement that income or expense from notional principal contracts is to be recognized on a net basis. We suggest that the Proposed Regulations clarify that the net income from a notional principal contract is determined on a transaction-by-transaction basis, and does not, for example, require the netting of all contracts concluded under a single master agreement between two counterparties. With respect to payments that are determinable as of the end of the taxable year, we also believe that the Service has made an appropriate decision to require ratable daily inclusion of income and expense, thereby rendering tax-neutral the frequency with which payments under a notional principal contract are made.

The concept of “periodic payments” appears to be directly analogous to the definition of “qualified periodic interest” in Proposed Regulation section 1.1273-1(b)(ii). That latter definition is more precise, however, and the clarity of the term “periodic payments” could be improved by use of the concepts developed in the section 1273 regulations. In particular, we suggest that the definition be drafted to apply to amounts calculated by applying a constant rate (including a “good” variable rate)

or quantity to a single specified index or notional principal amount in respect of each period.[48] From the other perspective, the Committee commends the Service's treatment of a payment during both a short and a long first or last period as a periodic payment,

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[48] On some occasions, the economic substance of a notional principal contract may be consistent with this definition of periodic payments, while the form of documentation is less clear. For example, an equity index swap may provide that one party's payments are based on the total return of a stock index, while the counterparty's payments are based on a floating rate interest index, such as the London Interbank Offered Rate ("LIBOR"). The first party's payment obligations should constitute periodic payments, because they represent a fixed quantity applied to a total return index. The documentation of such swaps may provide, however, that one party pays amounts based on any increase in the index, plus dividends, while the counterparty's payments are based on any decrease in the index, plus LIBOR,

For such a swap, the requirement of the definition of periodic payments that the payments be based on a "single specified index" is satisfied if the definition is based on economic substance of the swap. If, however, the parties are bound by the form of the transaction, it is not clear that the definition of periodic payments is satisfied, because the counterparty's payment obligations could be construed as relating to two specified indices. The problem is easily resolved by clarifying that the definition of periodic payments encompasses negative as well as positive amounts, and further providing that compliance with the definition of "periodic payments" is determined by reference to the economic substance of the transaction.

and recommends retention of this treatment as one modification to the definition of qualified periodic interest payments,[49]

VII. NONPERIODIC PAYMENTS.

A. Allocation and Amortization of Nonperiodic Payments.

1. General. In the Committee's view, the concept of dividing nonperiodic payments into significant and nonsignificant payments draws an appropriate line between notional principal contracts entered into on normal commercial terms and instruments the purpose of which is primarily to substitute for a borrowing. The application of loan recharacterization solely to significant nonperiodic payments, and not, for example, to any arguable implicit loan element present in premiums paid for caps and floors generally, is an appropriate choice that comports with the economic assumptions made by parties when pricing notional principal contracts.

We disagree with the Proposed Regulations, however, in their assumptions about the "economic substance" of the methods used by taxpayers to construct and price contracts, and believe that the resulting disparity between the manner in which taxpayers value notional principal contracts economically and the manner in which the Proposed Regulations would require notional principal contracts to be taxed would lead to considerable complexity in the taxation of swaps. This disparity, and the resulting complexity, are described below with respect to interest rate swaps.

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49 Cf. New York State Bar Association Tax Section Report, Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations § III.4.B. (January 29, 1987)(recommending that long periods be permitted for purposes of the definition of qualified periodic interest payments).

(The Proposed Regulations do not create complexity of the same order with respect to caps and floors, but, as also described below, they fail to tax caps and floors in accordance with their use.)

The discussion that follows, like the Proposed Regulations, focuses on nonperiodic payments that relate to the fixed payment side of a notional principal contract. It is possible (although certainly unusual) for a nonperiodic payment to relate to the floating rate side of a contract. The Proposed Regulations could deal with many such circumstances by, in effect, adjusting the floating rate side to market norms and treating the premium as relating to the fixed rate side of the contract, or possibly by breaking a swap into more than one notional principal contract.[50]

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[50] For example, interest rate swaps usually are quoted off a benchmark floating rate index, such as LIBOR. If two parties entered into an interest rate swap that provided that the floating rate payor would pay LIBOR plus 100 basis points and receive, say, 8 percent fixed (a market rate for swaps at LIBOR), the floating rate payor would receive a premium. That premium could be analyzed for tax purposes as if the floating rate payor paid LIBOR and received 7 percent fixed (i.e., 100 basis points less than the market fixed rate).

More difficult problems would arise, of course, in respect of more exotic "roll-up" swaps, in which floating rate payments are accrued and compounded. Such cases could be usefully addressed by reference to the manner in which the proposed original issue discount regulations handle cases of original issue discount floating rate obligations.

If a fixed/floating interest rate swap accrued floating rate payments at different rates in different periods (e.g., 100% of LIBOR for two years and 110% of LIBOR thereafter), perhaps the increased payments should be treated as a separate swap under Proposed Regulation Section 1.446-3(e)(4)(i) (separation of swaps into components). This approach would require an allocation of the fixed swap payments between the two swaps.

2. Interest Rate Swaps. In most cases, the fixed leg of a notional principal contract represents a single specified rate applied to the notional principal amount for the term of the contract. The single fixed swap rate, like the interest coupon on a fixed-rate par debt security, is a blended term rate for the life of the contract. Moreover, interest rate swaps typically are used to hedge actual debt instruments, whose income (or expense) is calculated under constant yield principles. Accordingly, for timing purposes, the most straightforward manner to analyze an interest rate swap is to treat it as if it were two offsetting bonds (treating the "notional" principal amounts as real for this purpose only) and then to apply standard constant- yield bond math to amortize any nonperiodic payments. Precisely for this reason, the Proposed Regulations' rules for periodic swap payments in effect require accrual as if the "economic substance" of a swap were offsetting bonds.

This same offsetting-bond analysis should apply to nonperiodic payments. The premium made or received to enter into an off-market swap represents simply the present value of a stream of payments, i.e., the difference between the payments that a party would make with respect to a par swap and the higher (or lower) payments the party will make with respect to an off-market swap. This stream of payments is similar to an annuity. Viewed in this straightforward manner, the amortization of nonperiodic payments in respect of interest rate swaps is a simple exercise in amortizing this annuity, using any standard constant-yield methodology.

End users typically value this annuity as if it were in fact a series of coupons on a single bond, under a single blended interest rate constant yield to maturity method (just as would apply to an original issue discount low-coupon bond).[51] Some dealers, on the other hand, value this annuity as a series of separate zero-coupon obligations: the basic methodology is identical to that employed by end-users (i.e., a constant yield method applied to a stream of payments representing the difference between the off-market swap payments and payments on a par swap), but a different discount rate is applied to each payment, to reflect the shape of the swap yield curve.[52] In our view, either discounting approach (i.e., one blended discount rate or several zero-coupon rates) should be allowed, at the taxpayer's election.

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[51] Some end users employ a simplistic straight-line methodology, but in the Committee's view the Proposed Regulations are correct to reject that approach (just as taxpayers may not accrue original issue discount on a straight-line basis).

[52] The zero curve used by swap dealers is generally a curve that reflects the yields implicit in the pricing of swaps of the type in question and is not, therefore, identical to (or even a fixed number of basis points above) the U.S. Treasury zero curve. The methodology employed by dealers is not more accurate than that employed by end-users; it is simply a different approach that reflects the economic needs of dealers. Breaking all swap flows (periodic and nonperiodic alike) into separate zero-coupon instruments enables a dealer to calculate more efficiently its net economic exposure from hundreds or thousands of swaps in its swaps “book.” Viewing the zero curve approach as “better” than the standard amortization methods employed by end-users is tantamount to the conclusion that current law's interest accrual method for all fixed-rate interest (and original issue discount) is wrong, because it uses a blended constant yield over the term of a debt instrument -- a view that is advanced from time to time by academics, but that has been roundly rejected by the Code itself.

The Proposed Regulations do not follow the straightforward approach described above, but rather instruct taxpayers to amortize nonperiodic payments in respect of swaps "in accordance with the values of a series of cash-settled forward contracts." In the Committee's view, this method for allocating nonperiodic payments is flawed because it (1) is fundamentally different from the approach used for allocating periodic payments, (2) does not accurately reflect the economic reasons why nonperiodic payments are made, and (3) is too complex.

To explain these points, let us examine how the forward contract analysis would work. Suppose that a par swap (i.e., a swap entered into with no premium payments) provides for six semiannual payments of six-month LIBOR (set at the beginning of the six-month period) against a fixed rate of 5.70%. Under the Proposed Regulations, the net of LIBOR and the fixed rate would accrue ratably over each six-month period.

This swap is economically equivalent, from the standpoint of the recipient of the fixed payments, to a series of six separate contracts to buy, on the date the swap is entered into and at the beginning of the five succeeding six-month periods, a six-month debt instrument providing for interest at the fixed swap rate (assuming that six month LIBOR is the cost of raising the funds required to buy that debt instrument). For convenience, each of these contracts will be referred to as a "forward contract" although the first one requires an immediate purchase. Since we have assumed that no payment is made to enter into the swap, it must be the case that the present values of the six forward contracts sum to zero. It is not true, however, that each forward contract would be individually valued at zero.

Instead, at any time, each separate forward contract would have a value equal to the present value at that time of the difference between the fixed payment actually required on the debt instrument to be acquired under the contract calculated at the swap rate of 5.70%, and the payment that would be made if that forward contract had then current market terms (i.e., were entered into as a separate arm's length contract with no up front payment by either party).[53] Appendix A contains an example showing the relative values of the forward contracts comprising the 36 month swap described above, based on illustrative prices for par swaps reflecting actual market conditions on December 24, 1991. The Appendix shows that the first three forward contracts have positive values, and the last three negative values, with the sum being zero. (These relative values are based on market prices and could change significantly with changes in the yield curve and other market factors.)

It is obvious from this discussion that the basic method used in the Proposed Regulations for allocating periodic payments on an interest rate swap is not based on the relative market values of, or market rates for, the series of forward contracts economically comprising the swap, because periodic payments are always spread evenly over the life of the swap regardless of how such contracts would be priced. This approach makes sense, since a swap is entered into as a single contract,

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[53] Determining these forward rates is complex, and generally involves comparing the pricing for swaps of different lengths. For example, the price for a forward contract to purchase a six-month fixed-rate debt instrument in 30 months could be derived mathematically by comparing the pricing of a 36 month swap with the pricing of a 30 month swap (since the difference represents a six-month swap commencing in 30 months, which is equivalent to such forward contract).

and from the end user's perspective most likely hedges a single debt instrument (which for tax purposes is considered to bear interest at a single constant rate). Why then should a fundamentally different approach be applied in allocating nonperiodic payments?

Further, as explained above, a swap premium represents economically a payment for the difference in payments under a market and off-market swap. Thus, the economic components of the whole swap are essentially irrelevant in analyzing the premium. Indeed, based on the illustration in Appendix A, allocating a swap premium based on the relative values of the forward contracts comprising the swap would seem to front load the premium (because the first three contracts start out, as components of the par swap, being worth more than the last three). We doubt that the drafters of the Proposed Regulations intended this result.

Finally, basing allocations on forward contract prices would be extremely complex to apply in practice, because those prices are not set forth on the face of a notional principal contract, and in most cases are not directly quoted in the market, but can only be derived through complex calculations from par swap prices. As discussed immediately below, we do not believe that this practical problem can be solved by exchanging pricing information.

Along with their instructions to use an amortization method for swaps based on the values of a series of forward contracts, the Proposed Regulations appear to contemplate that counterparties to notional principal contracts in fact agree on a methodology to amortize nonperiodic payments for pricing

purposes, and that this agreed methodology will form the basis for tax amortization. Putting aside the issue of conflicts between the Proposed Regulations' prescribed methodologies and the methodologies to which taxpayers might agree in practice, the meeting of the minds on which the proposed Regulations seek to rely in fact does not always occur as a commercial matter.

Investors in notional principal contracts select a financial intermediary as a counterparty on the basis of the total price quoted by that intermediary. Each financial intermediary uses its proprietary modeling systems to determine the prices and terms it will quote; only those prices and terms, and not the assumptions inherent in the modeling system, generally are quoted to customers. Accordingly, there often is no implicit or explicit agreement between the parties to most notional principal contracts on the models, rates, and methods used to arrive at the prices and terms agreed to.

We are concerned that reliance upon a purported agreement between the parties as the primary method for determining the allocation of nonperiodic payments, when such an agreement may not exist, would invite an end-user to seek a counterparty that will provide an allocation schedule favorable to the end-user's tax objectives. Major end-users may compare not only the allocation schedules offered by dealers, but also the safe harbors provided under the optional methods of allocation, where applicable. Dealers that use the mark-to- market method of accounting for notional principal contracts permitted by the Proposed Regulations will be in a particularly advantageous position to provide schedules favorable to an end-user's tax objectives, as the schedules will not bind the dealers.

Accordingly, reliance upon the agreement of the parties as a primary method of determining the allocation of nonperiodic payments invites non-economic tax-driven allocation methods.

3. Other Swaps. The Committee further recommends that the constant yield amortization method discussed in connection with interest rate swaps above apply to all types of swaps -- not just interest rate swaps. Regardless of the index involved, the method for pricing and determining initial premium is the same for all types of swaps, i.e., derived from generic discounting procedures.[54] For example, if market conditions would cause parties to enter into a five-year at-the-market oil swap based on a fixed rate of $10 per barrel on 100,000 barrels, an equivalent five-year swap that provided for a fixed rate of $12 per barrel would be considered to have off-market payments in each period of $200,000 ($2 per barrel x 100,000). The off-market cash amounts attributable to each period then are discounted (at an appropriate interest rate or rates) just as for an interest rate swap to determine a total initial premium. No reason therefore exists to apply different amortization rules for nonperiodic payments on interest rate and other types of swaps.[55]

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[54] Anomalies in the prices of the underlying commodity -- for example where the forward price actually is less than current spot prices -- will influence the shape of the long-term curve, and therefore the appropriate fixed rate on the swap. These market anomalies do not, however, change the calculation method for determining nonperiodic payments.

[55] See Submission to the Treasury Department by Sullivan & Cromwell on behalf of the Securities Industry Association, Re: Tax Accounting for "Premium" Paid or Received by Non-Dealers in Interest Rate Caps and Floors (July 12, 1990). We assume here, as in the preceding section, that the nonperiodic payments in question relate only to the fixed payments on the swap.

4. Caps and Floors. Proposed Regulation section 1.446-3(e)(3)(ii)(C) requires, that nonperiodic payments under a cap or floor contract be allocated over the contract's term "in accordance with the values of a series of cash-settled option contracts." The amount of a nonperiodic payment allocated to each deemed option under the cap or floor then is taken into account (as income or deduction) only in the period during which that deemed option is scheduled to expire. Straight-line and "accelerated" amortization methods are specifically disallowed.[56]

These amortization rules reflect the economic resemblance of a cap or floor contract to a series of option contracts. The practical effect of these rules, however, will deviate from the tax treatment of traditional options in several ways. First, as indicated above (Section IV.A.3.), the substantive rules in the Proposed Regulations (once allocations have been made) differ in some respects from the rules governing options. Second, unlike a series of separately stated options, the initial premium paid for a cap or floor contract is stated as a single lump sum. The requirement that this single sum be allocated to each period under the contract in accordance with the values of a series of options means that end-users must rely on dealers to provide the necessary pricing information. To the extent that dealers withhold this information, or alternatively

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[56] In our 1989 report concerning tax accounting issues for notional principal contracts, the Committee argued that "economic substance" requires premium in respect of caps and floors to be amortized by taking into account each year a portion of the premium amount allocated to each deemed option, rather than holding each period's premium amount totally in suspense until "exercise" or "expiration." New York State Bar Association Tax Section, Committee on Financial Instruments, Report on Tax Accounting for Notional Principal Contracts § III.C.2 (September 28, 1989). The Proposed Regulations reject that approach in favor of traditional option taxation. While we continue to believe in the economic merit of our earlier suggestions, we understand the policy considerations that may have persuaded the drafters to favor an approach more consistent with long-standing option rules.

view allocations as a marketing tool, compliance with the Proposed Regulations' economic theories could suffer.

Proposed Regulation section 1.446-3(e)(3)(D)(2)provides for an optional amortization method for premium on interest rate cap or floor contracts to be specified in a separate revenue procedure.[57] A draft revenue procedure included in the Preamble to the Proposed Regulations sets out a table of factors that taxpayers (other than dealers or traders) can elect to use in determining the appropriate portion of cap or floor premium to be taken into account for each period under the contract. These tables apparently have been derived by applying certain generalized assumptions concerning the shape of the dollar interest rate yield curve and anticipated interest rate volatilities.

We applaud the spirit of this proposed revenue procedure, in conceding a degree of tax “purity” in favor of practical administrability. Even with tables, however, the option pricing approach will involve substantial complexity for both taxpayers and the Service. For example, the tables are limited to U.S. dollar caps and floors. Will tables also be provided for a variety of non-dollar interest rate caps and floors, as well as for non-interest rate-based caps and floors (e.g., commodity-based caps)? Also, will the factors be updated periodically to take account of underlying trends in the shape of the respective yield curves and associated rate volatilities?

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[57] As with the optional amortization method for swaps under Proposed Regulation section 1.446-3(e)(3)(ii)(D), the optional amortization method for cap and floor premium may not be used where the cap or floor hedges, or is hedged by, another financial instrument.

Even with continuous updating, the tables' generalized factors at best will only roughly approximate the actual pricing of cap and floor contracts.

We believe that end users normally enter into a cap or floor to hedge against the effect of rate movements on underlying liabilities or assets, and view the premium paid for the cap or floor as an adjustment to the annual cost or return of the hedged items. For these taxpayers a straight-line amortization method for the cap or floor premium most closely conforms to the "economic substance" of the transaction as a whole.[58] In addition, a straight-line method would have the substantial merit of allowing taxpayers to amortize cap or floor premiums using information available on the face of the contract -- without reliance on information provided by a dealer. In the Committee's view, the overall savings in compliance and audit costs through the use of a simpler straight-line method for end-user's caps and floors would far outweigh any possible loss of tax revenue through "accelerated" deductions for premium paid.

If our recommendation is adopted, the series-of-options approach set forth in the Proposed Regulations might be employed as an elective secondary method for those who have access to the necessary information.

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58 In the case of an interest rate cap or floor that hedges a debt instrument, the premium might be viewed as a debt premium or discount that should be amortized under a constant yield method. However, as a practical matter, the difference between a floating rate instrument with and without caps or floors is likely to be reflected in the margin over the index rather than a discount or premium. An adjustment in the margin would be taken into account under a straight-line method. In any event, a constant yield method of amortization would offer many of the same advantages as a straight-line method, and we would not object if such a method were adopted in lieu of a straight-line method as the primary method of allocation.

B. Interest Component of Deemed Loan.

The Proposed Regulations provide an explicit bright-line test for determining whether interest rate caps and floors are "significantly" in-the-money and, through examples, an implicit test for making that determination with respect to swaps. The Committee suggests that a bright-line test should also be adopted for other caps and floors, and that the final regulations contain examples illustrating the calculation of the interest component on a cap or floor.

C. Recharacterization for Section 956 Purposes.

The Committee is concerned about the Service's discretion to treat a nonperiodic payment, regardless of its size, as a loan for purposes of section 956. Under such treatment, U.S. shareholders of controlled foreign corporations ("CFCs") will be currently taxable on nonperiodic payments made by their CFCs, under the "subpart F" rules of sections 951-964. Accordingly, foreign subsidiaries that engage in significant notional principal contract activity, such as notional principal contract dealer affiliates, are at risk of generating substantial currently taxable income to U.S. parent companies from notional principal contracts entered into in the normal course of business.

A nonperiodic payment by a CFC to a U.S. parent is most likely to be made where both entities are dealers in notional principal contracts -- for example, in a case where the CFC is hedging a contract entered into with a customer through a back-to-back swap with the CFC's parent.

The primary effect of a section 956 loan recharacterization therefore is likely to be that U.S. dealers in notional principal contracts will be taxed currently on active business income of their foreign dealer subsidiaries.

The Committee does not believe that the Proposed Regulations' rule is appropriate in the case of nonsignificant nonperiodic payments. If payments are not significant, a swap would need to be very large in order for such payments to embody a material loan, and we think it very unlikely that taxpayers would enter into large swaps for this purpose given the collateral consequences of such transactions, particularly if they are unhedged.[59] The line in the Proposed Regulations between significant and nonsignificant payments is a useful means of distinguishing regular commercial trades from those entered into for tax avoidance reasons. In any event, if the rule is retained, it should be made binding on both the Service and taxpayers, rather than an option on the part of the Service, and a cross-reference to the rule should be added to the regulations under section 956.

VIII. ASSIGNMENTS.

In the experience of Committee members, normal commercial practice to date has assumed that a nonassigning party does not recognize gain or loss on the assignment of a notional principal contract,

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[59] Although an intragroup swap could be neutralized economically (except for a disguised loan) through two offsetting swaps with third parties, such a transaction would be subject to recharacterization under the Service's integration rule.

regardless of whether the nonassigning party's consent is required.[60] Consents to assignments have been routinely given without concern over the impact of such assignments on the tax position of the consenting party. This should be contrasted, for example, with the elaborate procedures regularly employed to assure that the legal defeasance of an obligation pursuant to its terms does not generate adverse tax consequences to the holders.

The practice of assuming that assignments have no tax consequences for the nonassigning party has developed over the roughly ten years in which the notional principal contract marketplace has existed. Although tax results are not dictated by commercial practice, the Committee does not see

[60] Standard International Swap Dealers Association (ISDA) documentation contemplates that a nonassigning party's consent is required, but that such consent may not unreasonably be withheld. The nonassigning party (except, perhaps, cap and floor writers) typically has a vital interest in the identity of its counterparty, because of the credit exposure inherent in most notional principal contracts. There is generally no payment to the consenting party to obtain its consent to assignment.

any clear statutory or tax policy reason for treating an assignment of a notional principal contract as a taxable event for nonassigning parties.[61]

Pursuant to section 1001, a taxpayer is required (in the absence of an applicable nonrecognition rule) to recognize gain or loss from sales "or other dispositions of property."[62] The Committee believes, however, that no general rule emerges from an analysis of the authorities under section 1001 that requires the assignment of a swap to be treated as a taxable disposition of property for the nonassigning party. The outcome depends on the particular analogy used.

In the case of a financial instrument that is not an executory contract but solely an obligation of one party, such as a conventional debt instrument, the payor or debtor generally does not realize income or loss as a result of a sale or assignment of the financial instrument by the original payee or debtholder to a third party. The change in the payee or debtholder alone is not material to the obligor; it simply owes the same money, property or other duties to someone else.

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[61] The issue of taxing nonassigning parties also arises with respect to foreign currency transactions of the type described in the final regulations promulgated under section 988 of the Code. The section 988 regulations, however, do not state that a nonassigning party recognizes gain or loss by virtue of an assignment. Instead, they simply cross-reference section 1001.

[62] Section 1001(a).

On the other hand, a change in the obligor is ordinarily a "material change" requiring recognition under section 1001 by the obligee.[63] This rule was applied to debt instruments by the Supreme Court in its recent decision in Cottage Savings Association v. Commissioner, 111 S. Ct. 1503 (1991). The case held that a savings and loan association that exchanged a pool of mortgages for an "economically identical" mortgage pool of another savings and loan could recognize its loss under section 1001 since the exchange resulted in "legal entitlements

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63 Rev. Rul. 69-142, 1969-1 C.B. 107; Priv. Ltr. Rul. 8848051 (assumption of bond obligations). Cf. Reg. § 1.163- 5(c)(2)(i) (treating certain assumptions as not constituting a new issuance for purposes of the Code1s procedural requirements on the issuance of bearer obligations, but implying that the assumption would be a new issuance in the absence of administrative relief.) Note, however, that private rulings have held that the assumption of a subsidiary's debt obligation by its parent is not a recognition event under section 1001 where the debt holders in substance continued to rely on the same corporate assets for payment. See Priv. Ltr. Rul. 8738073; Priv. Ltr. Rul. 8734042; Priv. Ltr. Rul. 8731046. Cf. G.C.M. 39225 (material change under section 1001 where operating subsidiary's obligations are assumed by holding company). Similarly, other authorities have held that a substitution of collateral or change in security is not a material change under section 1001. See Rev. Rul. 73-160, 1973-1 C.B. 365 (subordination of major noteholder's lien to other noteholders); Priv. Ltr. Rul. 8346104 (substitution of government obligations for real property collateral); Priv. Ltr. Rul. 8753014 (reduction in reserve fund requirements); Priv. Ltr. Rul. 9037009 (subordination of bonds).

A comparison to tax-exempt obligations is interesting. Tax-exempt obligations are not treated as reissued when the original obligor of such obligations (and user of the tax-exempt facilities in question) sells its interest to a third party who assumes its obligations with respect to the tax-exempt obligations and the facility. Rev. Rul. 79-262, 79-2 C.B. 33; Priv. Ltr. Rul. 8236047 (no reissuance where facility financed by tax-exempt bonds of a section 501(c)(3) organization sold to a non-exempt person). But see Rev. Rul. 81-281, 1981-2 1981-2 C.B. 18 (renegotiated tax-exempt bonds with lower principal amount, higher interest rate, shorter term). In such situation, however, the nominal obligor has not changed f (i.e., the state or local issuing authority). But, perhaps, the real basis of such rulings is that the economic position of the bondholders has not changed, that is, the income-producing facility remains the source of payment for the bonds and the basis for their qualification as tax-exempt. Cf. Rev. Rul. 85-42, 1985-1 C. B. 36 (no change of ownership where there is no legal defeasance).

that are different in kind or extent."[64]

In some cases, the Code, for various policy reasons, provides specific exceptions to the foregoing realization requirement for one-sided obligations, such as the provisions governing reorganizations, wash sales, installment obligations,[65] and securities lending transactions.

While the tax treatment of assignments of debt instruments is well settled, a notional principal contract (other than a cap or similar option product) is not exactly analogous to a debt instrument, because it is an executory contract for each counterparty. Stated differently, the contract is both an asset (the right to receive payments) and a liability (the obligation to make payments) during its term,

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[64] Cottage Savings, 111 S. Ct. at 1510.

[65] Under section 453, the substitution of a new obligor on an installment obligation does not constitute a disposition of the obligation that would require the holder to recognize gain. In Rev. Rul. 82-122, 1982-1 C.B. 80, an assumption of the original purchaser's note in connection with its purchase of the property was determined not to be a material change under section 453, although the note holder also received an increased interest rate in exchange for consent to the assumption. Rev. Rul. 82-122 concluded that:

> "Actions of the obligor that result in a change in the installment obligation, such as a transfer to a third party ... are not ordinarily treated as a disposition because the effect is merely to continue the seller's right to receive installment payments, without substantially changing the rights arising from the original transaction."

See also Rev. Rul. 75-457, 1975-2 C.B. 196. This result under section 453 preserves its function of matching recognition of the holder's gain to the holder's receipt of actual note payments with which to pay such taxes. Further, this result under section 453 is directly opposite to the result of a change in obligor or interest rate under section 1001. See, e.g., Rev. Rul. 89-122, 1989-2 C.B. 200; Rev. Rul. 87-19, 1987-1 C.B. 249 (waiver of interest adjustment pursuant to terms of bonds held a material change).

and each counterparty is both an obligor and an obligee.[66] Where a financial instrument is a one-sided obligation, it is not that hard to conclude that a change in obligors is material; the result is less obvious where the arrangement involves mutual obligations and there is a change on only one side.

For purposes of applying section 1001, contracts that are both assets and liabilities provide better analogies to a notional principal contract than do debt instruments. For example, as to a lessee, a lease represents both a liability (the obligation to pay rent) and an asset (the right to occupy the premises, of if the leased space is subleased, a right to collect rent) which may be assigned, in whole or part (e.g., by assigning the lease). As to the lessor, a lease represents both certain obligations to the lessee and the right to receive rent payments from the lessee. The Committee is aware of no authority, however, holding that the assignment of a lease by a lessee to a third party is a realization event for the nonassigning lessor; similarly, a sale of property subject to a lease

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[66] The Proposed Regulations are consistent in one regard with the view that a swap contract is both an asset and a liability. The Proposed Regulations do not treat the assignment of a party's rights (but not obligations), or vice versa. as a termination for these purposes, and provide that such an assignment does not affect the original parties' tax accounting for a notional principal contract. Prop. Reg. § 1.446-3(e)(6)(vi), Ex. 4. In the Committee's view, such an assignment converts the notional principal contract into a loan with respect to the assigning party, and that party should be required to treat payments pursuant to the assignment as termination payments and to treat the contract as its borrowing thereafter. Cf. Mapco, Inc. v. United States, 556 F.2d 1107 (Ct. Cl. 1977).

would not result in any taxable gain or loss to the lessee.[67] In contrast, a taxable transaction to either the lessor or lessee results generally where, as in Hort v. Commissioner. 313 U.S. 28 (1940), there is an actual or constructive payment between lessor and lessee in consideration of a lease cancellation.[68]

More broadly, swaps may be considered analogous to a wide range of executory agreements involving obligations on both sides. The Committee is not aware of authorities which treat the substitution of one party to an executory contract without other changes as a realization event for the other party. Substitutions of this type regularly occur in connection with mergers, or sales of all of the assets of a business. Yet such substitutions would seem to involve a "change in legal entitlements" if it were thought that the test for debt instruments set forth in Cottage Savings applied and yet would not appear to be protected by a statutory nonrecognition rule (executory contracts are not "securities" under section 354 and depending on the nature of the contract, section 1031 may not apply given the exceptions in section 1031(a)(2)). Does the Treasury believe such substitutions to be realization events? If not, why are swaps a different case?

If, as we believe, the Treasury is not bound to treat a change in obligors as a taxable event, the question must still be faced as to when, if ever, the change in obligors with respect to an executory contract is sufficiently material to result in a realization event.

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[67] Cf. Metropolitan Building Co. v. Commissioner, 282 F.2d 592 (9th Cir. 1960) (payment by sublessee to lessee/sublessor to obtain lessee's cancellation of head lease taxable to lessee).

[68] A principal issue in the cited case is whether such a payment is ordinary income (i.e., rents) or capital gain. See discussion in Section X, infra.

In that regard, we note that, in the usual case where no payment, or modification of contract terms, is made to obtain consent, no substantial change takes place as to a nonassigning party when a notional principal contract is assigned. The critical factors that enter into the selection of a counterparty, namely, the terms and conditions of a swap, and the credit risk of the counterparty (since the nonassigning party will not waive or grant consent if credit risk would increase), have not changed. Furthermore, by contrast with the changes in obligors in Cottage Savings which resulted from a purely voluntary exchange of loans, under standard swap documentation, a counterparty cannot unreasonably withhold consent to an assignment.[69] At least before the Proposed Regulations created the specter of adverse tax consequences to a nonassigning party, it would have been difficult for a counterparty to "reasonably" withhold consent to an assignment to a creditworthy party.

Moreover, the proposed rule is asymmetrical: while a nonassigning party must recognize gain on an assignment, loss may be deferred under the straddle rules, in a context where the abuse contemplated by the straddle rules is not present (as the nonassigning party has not taken any steps to substitute one position in personal property for another).

An additional disadvantage of the proposed rule is that it would create a divergence in the taxation of notional principal contracts, on the one hand, and other derivative products, on the other: the assignment of either side of a forward contact, for example, generally is not believed

[69] See footnote 60 above.

to be a recognition event to the nonassigning counterparty.[70] Further, and somewhat paradoxically given the Proposed Regulations stand on the treatment of swaps as "actively traded" property for purposes of section 1092, the Proposed Regulations will decrease liquidity in what already is a "thin" secondary market in notional principal contracts, as nonassigning parties demand tax indemnification as their price for consenting to the assignment of notional principal contracts that are in-the-money as to them.

In the Committee's view, the Proposed Regulations' decision to treat assignments as taxable events to the nonassigning party is particularly perplexing as a tax policy matter in light of the Proposed Regulations' conclusion that entering into an offsetting swap with the same counterparty generally is not a taxable event -- even though for U.S. bankruptcy law purposes those two contracts are netted against one another. The Committee does not see any logic in treating a transaction that substantially terminates economic and credit risk as not constituting a termination, while treating a continuation of a contractual arrangement with a new counterparty (typically with comparable credit risk to that of the assigning party) as a taxable event to the continuing party.

On balance, therefore, the Committee believes that an analysis of authorities under section 1001 leads to no clear answer; that the issue of whether an assignment should be treated as a taxable event to the nonassigning party is therefore a

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[70] Futures contracts are not assigned to third parties, but instead are terminated with the clearing corporation that serves as the counterparty to every transaction. Through this intermediation function, futures exchanges avoid the issue of the tax consequences of assignments to the nonassigning party.

matter of tax policy; and that the right tax policy choice is that there is no taxable event in such a case.

If the proposed assignment rule is retained, the Committee recommends that final regulations be modified in certain respects. First, the rule should provide that the straddle rules do not apply to a nonassigning party that realizes loss on an assignment by an unrelated party, so that the rule is symmetrical and both gain and loss are recognized.[71] The final regulations should also provide an exception for assignments caused by the merger, consolidation, acquisition of substantially all of the assets, or other transaction of a counterparty within the nonrecognition provisions of sections 332, 354, 355, 356, 361 and 368. (Such an assignment would not ordinarily fall within section 354, because the notional principal contract would not be a "security".) Such an exception could be based on the theory that, in the case of an executory contract where the substitution of obligors is less significant than, for example, for debt instruments, a transfer to a successor entity is not material. This argument would be particularly forceful where the nonassigning party cannot prevent the assignment.[72] Without clear guidance in this important area, nonassigning parties with losses on their notional principal contracts will claim them, while taxpayers with gains may decide not to report them.

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[71] Straddle issues are discussed more generally in Section IX. The Treasury has broad regulation authority under section 1092(b)(1). The justification for the proposal is that the assignment is not initiated or controlled by the nonassigning party.

[72] With respect to an assignment of a swap contract pursuant to a merger or acquisition of a counterparty, the ISDA standard contract generally does not require consent or result in a termination of the transferred swap unless the acquisition will cause additional taxes to be imposed on the swap or the creditworthiness of the surviving entity is "materially weaker" than the original counterparty's.

Finally, if the final regulations continue to tax assignments to nonassigning parties in assignment transactions, like a merger or acquisition, where non-cash consideration is involved, the Proposed Regulations should state how the nonassigning party determines the amount of the termination payment. Even where cash consideration is involved, the Proposed Regulations' premise that the amount of the termination payment always equals the nonassigning party's gain or loss on the notional principal contract is questionable. The amount of a termination payment negotiated between the assignor and its assignee may reflect a netting of the assignor's and assignee's positions with respect to other notional principal contracts or transactions between them, the assignor's hedging position, the need for the assignor to limit its exposure in the particular currency or interest rate or index of the assigned notional principal contract, or other factors unrelated to the gain or loss that would be realized by the nonassigning party if it sought to assign its position. Even if the amount that would be attributable to the assignment of a particular contract is determinable by the assignor apart from these factors, the nonassigning party has no way to compel the assignor to provide this information. Nonassigning parties may therefore be forced to use only an estimate of the amount of gain or loss to be recognized. A simple rule that does not depend on the amount of gain or loss recognized by the assignor -- for example, a rule that looks to a market rate of interest -- is therefore desirable.

IX. STRADDLE ISSUES.

A. Background.

Because an active secondary market for notional principal contracts currently does not exist, most observers believed, prior to the Proposed Regulations, that notional principal contracts were not themselves personal property of a type that was actively traded, and therefore did not themselves constitute section 1092(d)(1) personal property. In addition, U.S. dollar interest rate swaps, caps, floors and similar products could not be viewed as interests in underlying "personal property" in the section 1092(d)(1) sense, because the U.S. dollar is not "personal property" for section 1092 purposes.[73] Accordingly, so long as U.S. dollar interest rate swaps and similar contracts were not themselves treated as "actively traded," those contracts were not subject to section 1092 (because neither the contracts themselves nor their underlying indices constituted personal property of a type that was actively traded). As a result, prior to the Proposed Regulations, most commentators believed that U.S. dollar interest rate notional principal contracts were not subject to the straddle rules. The Proposed Regulations reverse this understanding of prior law by treating interest rate swaps, and other products quoted on interdealer quotation screens, as themselves actively traded, and therefore as "personal property" in the section 1092(d)(1) sense.

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[73] See Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 289 (1981).

B. Definitional Problems.

In the Committee's view, the Proposed Regulations stand on doubtful statutory authority in treating notional principal contracts as "actively traded." Notional principal contract dealers conduct the vast bulk of their activities by holding themselves out as available to enter into such contracts with customers. This willingness to enter into new contracts, and the wide dissemination of price quotations for those contracts, a substantial portion of which are in standardized form, is evidence of an active marketplace for new contracts. It does not, however, mean that existing contracts are traded (or tradeable).[74]

Dealers generally do not hold their "books" of open contractual positions primarily for resale to customers. As contracts entered into between counterparties directly (rather than through an exchange), notional principal contracts are difficult to transfer, because the counterparty must evaluate the credit of the transferee. The standard clause in the International Swap Dealers Association contract allowing counterparties to block the assignment of an interest rate or currency swap by reasonably withholding consent is both evidence of this market reluctance to sell (i.e., assign) notional principal contracts,

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74 Cf. New York State Bar Association Tax Section, Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges § VI (March 25, 1991) (discussing trading of debt securities and concluding that "screen" trading is not itself a market), reprinted at 51 Tax Notes 79, 95-105 (April 8, 1991).

and a constraint on those counterparties that do wish to transfer their contracts.[75] The Proposed Regulations thus assume the existence of a liquid secondary market which does not exist at present, while serving to render less likely the possibility that liquidity will increase: counterparties for whom consenting to an assignment is a taxable event generally will be less likely to grant that consent.

Moreover, the adverse consequences that generally will flow from subjecting certain notional principal contracts to section 1092 will put considerable pressure on definitional issues for which the Proposed Regulations offer little guidance. The expanded definition of personal property of a type that is actively traded will apply only to notional principal contracts that are "similar" to contracts for which an interdealer price quotation "system" exists. The meaning of these terms will not always be clear.

Dealers quote prices both by means of computerized on-screen listings and through negotiation with individual investors. On-screen prices are generally quoted only for "AA" credit counterparties seeking standardized terms for "plain vanilla" notional property contracts. While notional principal contracts identical to those quoted on-screen may be assumed to fall within the Proposed Regulations' definition of actively traded personal property, notional principal contracts

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[75] As discussed above, the consent requirement ensures that in those cases where assignments do occur the assignee is economically indifferent to the assignment. However, the need to demonstrate that the counterparty should be indifferent greatly restricts transferability. The lackluster response by the marketplace to the interest rate swap futures introduced by the Chicago Board of Trade in June 1991 also demonstrates the absence of liquidity in the secondary marketplace for notional principal contracts. See Volume of Swap Futures Below Original Expectations, Swap Monitor 2 (Sept. 9, 1991).

other than those quoted on-screen may vary both in credit quality and in terms from contracts quoted in the interdealer "system". The Proposed Regulations offer no guidance as to the degree of similarity required to make one contract "similar" to another, or as to how formalized the exchange of price data among dealers must be before an interdealer price quotation "system" is held to exist.

C. The Straddle Problem.

Finally, the need for subjecting notional principal contracts to the straddle rules of section 1092 is doubtful. The Committee is not aware, for example, that either investors or dealers are manipulating the recognition of loss on notional principal contracts primarily for tax avoidance reasons -- whether through "straddle swaps" or otherwise.[76] It might be argued that, if straddle swaps are uncommon, then the extension of straddle principles to swaps will prove to be, at most, an unnecessary prophylactic. In practice, however, this extension of straddle principles will cause great hardships, because virtually every swap entered into by a large corporate taxpayer can be viewed as a "hedge" of some asset held by that taxpayer. The result will be widespread opportunities for Internal Revenue agents selectively to attempt to recharacterize swaps — even those used as liability hedges -- as in fact relating to a taxpayer's assets,

[76] A "straddle swap" has been described as balanced positions consisting of an interest rate swap in which the taxpayer pays fixed and receives variable payments, on one side and either (i) an offsetting interest rate swap or (ii) an offsetting long-term bond with principal equal to the notional principal amount of the swap, which bond is funded by a rolling series of short-term loans, on the other side. Carlisle and Howe, "Notional Principal Contracts as Straddle Opportunities," 8 J. Tax'n Invest. 73 (1990). This article does not, however, cite any examples of real-life straddle swaps.

and thereby to seek to apply the asymmetrical loss (but not gain) deferral rules of the Code's straddle provisions.

We believe that the perceived abuse of "straddle swaps" can be dealt with in a far more straightforward fashion through examples amplifying the scope of the Service's powers to integrate notional principal contract transactions to reflect their economic substance. The Proposed Regulations contemplate that two swaps involving upfront premiums, whose floating rate payments cancel each other out, can be integrated into a level payment loan.[77] We would argue that two swaps, whose cash flows perfectly (or nearly perfectly) cancel each other out, similarly can be integrated by regulation into a tax nullity. Examples to this effect will preclude true "straddle swaps," assuming that they exist, without importing all the collateral problems associated with the approach adopted by the Proposed Regulations.

In sum, the decision to bring notional principal contracts within the definition of section 1092 "personal property" can be criticized on three grounds. First, even without regard to the adverse collateral characterization problems discussed in Part X, below, the plain meaning of the statute does not appear to support the reading given it by the Proposed Regulations. Second, that decision will spawn considerable uncertainty in the application of the expanded definition of section 1092 "personal property." Third, the decision appears aimed at preventing a taxpayer abuse that in our experience is largely theoretical. Accordingly, the Committee recommends that Proposed Regulation 1.1092(d)-l be revised to provide that an instrument is actively traded only where there is significant secondary market trading in such instruments.

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[77] Prop. Reg. § 1.446.3(e)(4)(v), Ex. 4.

X. CHARACTER OF TERMINATION AND ASSIGNMENT PAYMENTS.

A. Background.

As the Preamble to the Proposed Regulations makes clear, one of the most important consequences intended to result from treating some notional principal contracts as actively traded personal property within the meaning of section 1092(d)(1)is to trigger the application of section 1234A to the terminations of such contracts, thereby (it is intended) treating such contracts as giving rise to capital gain or loss. On their face, the Proposed Regulations are intended to deal only with timing issues. Given this intended narrow scope, the Committee believes that it is extremely unfortunate that an issue as important as the character of gain or loss from the termination of notional principal contracts should be addressed in passing through a brief reference in the Preamble. More substantively, as the discussion that follows shows, the conclusion reached in the Preamble raises numerous technical issues and comes to the wrong conclusion as a policy matter.

Section 1234A treats gain or loss on the termination of a right or obligation with respect to "personal property" as capital gain or loss if that "personal property" is or would be a capital asset in the hands of the taxpayer. Prior to the Proposed Regulations, most commentators believed that a payment to extinguish a U.S. dollar interest rate notional principal contract (as contrasted to assigning the contract to a third party) did not give rise to gain or loss from the sale of a

capital asset under section 1234A.[78] As a result, commentators concluded that income or loss from the termination of interest rate notional principal contracts was ordinary income or loss, in spite of the broad reading of

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[78] For the reasons explained earlier, prior to the Proposed Regulations, notional principal contracts generally were not themselves viewed as constituting "personal property," and section 1234A was therefore considered inapplicable. (A notional principal contract can, however, constitute a "right or obligation" with respect to "personal property," because the underlying index relates to "personal property" in the section 1092 sense. Thus, for example, in the case of a taxpayer in whose hands crude oil would constitute a capital asset, a termination payment in respect of a crude oil swap probably is treated as a sale or exchange (by virtue of section 1234A) without regard to the Proposed Regulations, because the swap is a "right or obligation" with respect to underlying personal property (crude oil) that is of a type that is actively traded.)

Even with respect to assignments, it has been argued that gain or loss may be ordinary, on the grounds that notional principal contracts are not property within the meaning of section 1221, but rather claims or rights to ordinary income. Arkansas Best Corp. v. Commissioner. 485 U.S. 212, 217 n.5 (1988) (citing Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) and Hort v. Commissioner. 313 U.S. 28 (1941)).

"capital asset" arguably adopted in Arkansas Best Corp. v. Commissioner. 485 U.S. 212 (1988).[79] For dealers in notional principal contracts, the ordinary character of gain or loss from those contracts served to exempt dealers from the straddle rules altogether under section 1256(e).[80]

End-users generally enter into notional principal contracts in order to hedge assets or liabilities as to which those taxpayers incur interest rate or other risk. Prior to Arkansas Best, if the hedge was entered into for ordinary business purposes, taxpayers and the Service alike assumed the character of any gain or loss on the hedge would be ordinary, thereby offsetting any corresponding loss or gain on the instrument hedged. Arkansas Best, however, raises significant concern as to whether taxpayers can continue to claim ordinary character for gain or loss from notional principal contracts used to hedge, particularly with respect to hedges of liabilities.

Prior to the Proposed Regulations, however, two lines of argument (of varying degrees of merit, in the eyes of different analysts) potentially remained open to taxpayers, depending on their particular circumstances:

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79 See, e.g., Cartusciello, "Coping with IRS Guidance on Notional Principal Contracts," 72 J. Tax'n 24 (January 1990).

80 Section 1256(e) defines hedging transactions not subject to the straddle rules as transactions that hedge interest rate and currency rate and other risk in the normal course of business, the gain or loss from which transactions is ordinary income or loss.

the assignment of income doctrine,[81] and, with respect to terminations,

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[81] United States v. Gillette Motor Co., 364 U.S. 130 (1960); Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Hort v. Commissioner. 313 U.S. 28 (1941); see also Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (termination of the right to participate in certain excess receipts from motion pictures that the taxpayer was obligated to produce); United States v. Woolsey, 326 F.2d 281 (5th Cir. 1963) (assignment of a management contract with an insurance company that had 19 more years to run); Bisbee-Baldwin Corp. v. Tomlinson. 320 F.2d 929 (5th Cir. 1963) (right to receive servicing commissions under a mortgage servicing contract that was terminated).

But compare Estate of John F. Shea. 57 T.C. 15, 25 (1971) (sale of ship charter contact providing for above-market charter rates; gain is capital gain); United States v. Dresser Industries. Inc., 324 F.2d 56 (5th Cir., 1963) (sale of exclusive feature of a patent license; gain is capital gain); Louis J. Michot, T.C. Memo. 1982-128 (sale of right to receive royalties; gain is capital gain because due to market forces rather than services).

the extinguishment doctrine.[82] While the Proposed Regulations do not purport to deal comprehensively with character issues as such/ they appear to be intended to foreclose those avenues of relief. As a consequence, if a taxpayer uses an interest rate

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[82] Additional arguments are open to dealers, to the extent that the Proposed Regulations call into question the character of termination payments made or received by dealers. One plausible argument is that, in the case of dealers in notional principal contracts, the character of gain or loss on the termination of such contracts is governed by section 1221(4), as interpreted by case law and leavened by common sense. Cf. Burbank Liquidating Corp. 39 T.C. 999 (1963), acq. 1965-1 C.B. 5, modified on other grounds, 335 F.2d 125 (9th Cir. 1964) (mortgage notes originated by a savings and loan institution are section 1221(4) receivables in its hands). It is true that section 1221(4) applies only to receivables, and swaps, in particular, can partake of the qualities of both receivables and payables at different points in time. In our view, however, this point ought not to prevent a pragmatic reading of section 1221(4). Similarly, under section 582(c), banks realize only ordinary income or loss from dealing or trading in debt obligations. It would be anomalous, to say the least, to conclude that a bank's traditional financial assets can give rise to only ordinary income or loss, but notional principal contracts used as hedges thereof can give rise to capital gain or loss.

Alternatively, the termination of a swap that is a net payable from the perspective of a dealer should give rise to ordinary income or loss, on the grounds that the dealer's payment is made to release it from a burdensome contractual liability. Cf. Olympia Harbor Lumber Co., 30 B.T.A. 114 (1934), acq. XIII-1 C.B. 12 (ordinary deduction allowed for payment to cancel contract requiring taxpayer to pay another company to dispose of waste from taxpayer's sawmill); Rev. Rul. 69-511, 1969-2 C.B. 24 (lessee that makes payment to obtain release from lease entitled to deduction under section 162).

In sum, we believe that the Proposed Regulations were not intended to change the character of gain or loss on the termination of notional principal contracts in the hands of dealers, which would treat dealers in notional principal contracts in a manner unlike that of any other business that regularly deals with customers with respect to that business's merchandise. The problem arises solely from the Proposed Regulations' efforts to sweep notional principal contracts into the net of section 1092 personal property, an effort that we believe is misguided. Nonetheless, if the basic approach of the Proposed Regulations is not abandoned, the Committee strongly urges that the Proposed Regulations be amended and the Preamble revised (or, perhaps, companion regulations be promulgated under section 1221) expressly to provide that the character of such income is ordinary in the hands of dealers in notional principal contracts.

swap to hedge a liability of the taxpayer, any loss recognized on terminating that swap would be characterized as capital loss (while any gain on the retirement of the offsetting liability would constitute ordinary discharge of indebtedness income).

B. Technical Issues.

As noted earlier, according to one part of the Preamble to the Proposed Regulations, the Proposed Regulations are intended to require standardized notional principal contracts to be treated as capital assets on termination by virtue of sections 1092(d)(1) and 1234A. The definition of payments made with respect to assignments as "termination payments" appears to be intended to bring assignments within the scope of those rules as well.[83] In spite of this apparent intent to make the character of payments made both to extinguish and to assign a notional principal contract clearly capital, however, the actual effect of the Proposed Regulations is unclear.

First, and acknowledging that different analysts have differing views as to the merits of the argument, the Proposed Regulations do not foreclose the assignment of income argument that notional principal contracts should be viewed as rights to streams of ordinary income, rather than as property within the purview of section 1221. Second, the definition of a payment made or received in connection with the assignment of a notional principal contract as a "termination" for purposes of section 446 does not necessarily bring assignments within the term "termination" for section 1234A purposes.

[83] Prop. Reg. § 1.446-3(e)(6)(i).

Section 1234A applies to the "cancellation, lapse, expiration, or other termination" of specified actively traded contract rights. The legislative history of section 1234A makes clear that the drafters had in mind cases where the contract in question disappeared, as contrasted to cases in which one party to the contract changes. As a result, in the absence of section 1234A regulations, it is certainly arguable that section 1234A should not apply to assignments (regardless of section 446's definition of such assignments as terminations), in which the contract continues to exist.

Third, it may be questioned whether the Proposed Regulations cause a payment made to assign an "out-of-the-money" contract to be a capital rather than ordinary loss to the payor,

in light of the authorities holding that payments to be relieved of a burdensome contract are ordinary deductions or losses.[84]

Fourth, it is not clear that section 1234A applies to interest rate swaps and most other U.S. dollar interest rate based notional principal contracts that are the Proposed Regulations' intended target. The Proposed Regulations, as noted earlier, would treat U.S. dollar interest rate swaps and similar contracts as section 1092(d)(1) personal property. This is enough for straddle purposes, because the straddle rules apply to any "interest in" section 1092(d)(1) personal property, and holding the actively traded personal property (the swap contract) must be an "interest" therein.

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[84] Olympia Harbor Lumber Co. v. Commissioner, 360 B.T.A. 114 (1934), acq. XIII—1 C.B. 12 (equipment and service contract); Rev. Rul. 69-511, 1969-2 C.B. 24 (lease); cf. Priv. Ltr. Rul. 8807065 (lease assignment).

One authority arguably to the contrary is Stavisky v. Commissioner. 291 F.2d 48 (2d Cir. 1961), aff'g 34 T.C. 140 (1960), which held that a loss Stavisky realized on the assignment of a contract was capital. Stavisky had entered into two offsetting contracts, one to buy "when issued" securities of a particular issuer, and one to sell those same securities. Stavisky subsequently transferred 40 percent of each contract to a third party, and claimed capital gain on the transfer of the purchase contract but ordinary loss on the transfer of the sale contract. The courts rejected application of the extinguishment doctrine to the transfer of the sale contract, and held that the loss was a capital loss.

While the Tax Court in particular used expansive language that, read literally, would bring the assignment of notional principal contracts within Stavisky's holding, the case can be distinguished on several grounds. First, it is likely that the courts were influenced by Stavisky's attempt to claim capital gain and ordinary loss on transactions that were essentially identical. A more fundamental distinction is that the property -- the securities, when issued -- to which Stavisky's contracts related would have been capital assets in his hands, so that permitting an ordinary loss would have opened the door to widespread conversion of capital loss (from selling the securities) to ordinary loss. By contrast, the "property" underlying an interest rate swap, for example, is the U.S. dollar, the transfer of which does not give rise to capital gain or loss. Finally, Stavisky has not generally been treated as precedent outside the area of when issued contracts. See G.C.M. 37332 (Nov. 25,1977) (when issued contracts); cf. G.C.M. 36601 (Feb. 26,1976) (oil and gas lease applications); G.C.M. 35475 (Sept. 11, 1973) (exchange-traded options) and G.C.M. 35749 (March 27, 1974) (rejecting premise behind G.C.M. 35475).

Section 1234A, however, requires more; section 1234A applies only to a "right or obligation with respect to" section 1092(d)(1) personal property. The failure to use the same language as section 1092 can arguably be read as meaning that section 1234A applies only to instruments that are themselves derivatives of underlying section 1092(d)(1) personal property: swaptions, for example, but not interest rate swaps. In many cases this distinction is without difference, because the instrument in question is both personal property and an interest in underlying personal properly (a regulated futures contract on Treasury bonds, for example). In the case of interest rate swaps, however, for the reasons described in Part IX, there is no underlying personal property, and the question of whether entering into a contract is a "right or obligation with respect to" that contract becomes critically important.

In addition to these threshold issues, the new tax consequences of termination payments put great pressure on the issue of precisely what constitutes a termination payment for section 1234A purposes. Obviously, a payment made to induce a counterparty to cancel an existing contract is a termination payment; the principal technical difficulty arises in respect of what otherwise might be thought of as periodic payments.[85]

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[85] The Proposed Regulations define a termination payment as a payment that extinguishes or assigns all or a proportional part of the rights and the obligations of a party under a notional principal contract if the contract is considered to be actively traded personal property under the standards of Proposed Regulation section 1.1092(d)-1. The Committee assumes that the Service intended capital treatment to apply only to payments made to extinguish or assign rights and obligations during the term of the contract. The final regulations should therefore clarify that the last scheduled periodic payment on a notional principal contract will not be considered a "termination payment," even though it could be viewed as "extinguishing" all rights and obligations under the agreement. The final regulations should also provide that to the extent income or expense on a contract has accrued, but not been paid, as ordinary income or an ordinary deduction, the payment of such amount should be treated as a dollar for dollar recovery of the accrued amount.

We believe, for example, that the Proposed Regulations are not intended to imply that every periodic payment on an interest rate swap is a termination payment believe, for example, that the Proposed Regulations are not intended to imply that every periodic payment on an interest rate swap is a termination payment, but the Proposed Regulations do at one point argue that the "economic substance" of an interest rate swap is a series of cash settled forward contracts.[86] A series of cash settled forward contracts in fact would give rise to periodic termination payments; the Proposed Regulations obviously should be clarified in this regard, to prevent taxpayers from claiming that periodic payments on interest rate swaps give rise to capital gain.

A different analysis may apply to "total return" swaps, such as equity index swaps, that are economically similar to a series of "bets," in which the relevant starting point for the next period's bet is reset to market levels: in those cases, each periodic payment could be viewed as terminating a bet that covers only the period to which the payment relates, and each purported periodic payment would constitute a "termination" payment. A separate issue would exist at present as to whether either the underlying index or the contract itself is "actively

[86] Prop. Reg. § 1.446-3(e)(3)(ii)(B).

traded."[87] Again, no authority exists on the point, and the Proposed Regulations increase the importance of the issue.

C. Policy Issues.

The foregoing discussion has sought to demonstrate that neither current case law nor the regulatory scheme contemplated by the Proposed Regulations is particularly clear as to the character of gain or loss from the termination or assignment of notional principal contracts. While the Committee sympathizes with the instinct that assignments and termination should have identical tax consequences, that result cannot be achieved by a simple cross reference to section 1234A, itself a Code section bereft of regulatory or case law interpretation.

More important, the conclusion implicitly reached by the Proposed Regulations -- that end users (at least) should always recognize capital gain or loss on the termination or assignment of a notional principal contract -- appears to the Committee to be precisely backward. If consistency in character is desirable, then that consistent result should be one that itself is appropriate as a policy matter. The Committee believes that a consistent result of ordinary income or loss for terminations and assignments of interest rate-based notional principal contracts is far more sensible than a capital gain/loss pattern. Such a result comports with the taxation of U.S. dollar liabilities that those notional principal contracts might hedge. An explicit ordinary income/loss regime for such contracts would also reduce the problem of the possible application of Arkansas Best to business hedges.

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[87] If at some future date the terms for total return swaps became as standardized and as widely quoted as interest rate swaps, then the analysis on this last point would converge.

If there is a view that Treasury lacks the regulatory authority to achieve a consistent result that makes the most policy sense, then Treasury should tolerate some inconsistency until it can obtain the requisite statutory authority to deal with the issue in a comprehensive and fair manner.

XI. MARK-TO-MARKET ACCOUNTING FOR DEALERS AND TRADERS.

Notice 89-21 indicated that the Service was considering the adoption of a mark-to-market tax accounting method for dealers in notional principal contracts. The use of a mark-to-market method of accounting for tax purposes would simplify the reconciliation of a dealer's tax and financial accounting books, as mark-to-market is required under U.S. generally accepted financial accounting principles for "derivative financial instruments" and related hedges held by dealers. Mark-to-market tax accounting for notional principal contracts also has the potential to eliminate the timing lottery caused by significant and unpredictable variances between tax and economic income from (generally long-term) notional principal contracts and their (generally short-term) hedges under realization principles.

We believe that the election provided in the Proposed Regulations achieves some of that potential, although the parameters of the election are drawn in such a way that the election can create a new timing lottery, as discussed in more detail below.

The discussion below considers first the scope of the mark-to-market election in the Proposed Regulations, and then

discusses the linkage of the election with a prohibition on the use of lower-of-cost-or-market for securities and commodities held in a dealer capacity by electing taxpayers and their affiliates.

A Scope.

1. Dealer and Trader. The Committee welcomes the inclusion in the Proposed Regulations of general definitions of dealers and traders in derivative financial instruments. Current law provides a definition of a dealer in derivative products only in one limited context, and the definition of a trader in derivative products is the first such definition.[88] The extension of the mark-to-market election to traders as well as dealers is also welcome, as the same benefits of conforming tax and financial books and of reducing or eliminating the timing lottery will be realized for traders as for dealers.

2. Derivative Financial Instruments. The definition of "derivative financial instruments" is a sweeping definition that encompasses the major instruments used to hedge the risk of changes in prices and interest rates. Some aspects of the definition are unexpected. In particular, short positions in securities and commodities have not previously been treated as financial instruments that can be dealt or traded in,

[88] A dealer in derivative financial products is defined for purposes of the subpart F rules in regulation section 1.954-2T(a)(4)(iii)(B). The definition differs from that in the Proposed Regulations both in its wording, in minor respects, and with respect to the financial instruments as to which a taxpayer may be a dealer. As these differences do not serve any visible purpose, the Committee suggests that the definition in regulation section 1.954-2T(a)(4)(iii)(B) be replaced with a cross-reference to the definition in the Proposed Regulations.

or generally as property.[89] As both short positions and other financial instruments included in the definition may have either positive or negative value at any point in time, the definition appears to confirm that financial instruments retain their character as property even when they have negative value.[90]

3. Consistency. Proposed Regulation section 1.446-4(a)(2) requires that an electing dealer or trader value the derivative financial instruments to which the election applies at market for purposes of computing net income or loss on its "applicable financial statement," as defined in regulation section 1.56-l(c), as well as for tax purposes. The financial statements of foreign subsidiaries are prepared using foreign law, which may not permit the use of mark-to-market. Accordingly, we recommend that Proposed Regulation section 1.446 4(a)(2) be modified with respect to foreign subsidiaries to provide that the conformity requirement is met for a foreign subsidiary if its applicable derivative financial instruments are accounted for at market in the financial reports of the subsidiary used to calculate the consolidated income or loss of the worldwide group to which it belongs.

4. Hedges. The scope of the mark-to-market election is overbroad in that it applies to derivative financial instruments that serve as hedges of inventory and other non-derivative positions, as well as to the positions in a dealer core market-making business in derivative instruments.

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89 We are aware of only one authority that treats a short sale as property. See Private Letter Ruling 8714023 permitting a partnership that had made a section 754 election to allocate basis to a short position with unrealized gain).

90 The tax law generally does not recognize negative basis, and no general rules have been developed addressing the transfer of instruments with negative basis. Cf. Reg. §§ 1.1502-14, 1.1502-19, 1.1502-32 (excess loss accounts).

As discussed below, the timing problems that created the call for allowing mark-to-market tax accounting are limited primarily to a dealer's long-term notional principal contracts and related hedges. Inventory and related hedges typically turn over sufficiently quickly to avoid timing mismatch issues.

5. The Timing Lottery Problem. A swap dealer that enters into a long-term notional principal contract may hedge its exposure with a variety of instruments -- government securities, futures, forwards, options, or other notional principal contracts, alone or in combination -- some of which have much shorter terms than the swap, and others of which may prove to be more expensive than the alternatives available during later years and therefore will be replaced. Under current law, changes in value of the notional principal contract normally will not be realized on a current basis, but the dealer will recognize gain or loss from hedges that mature or are disposed of during the contract's term. Whether these hedges will produce gain or loss cannot, of course, be predicted in advance.

The dealer is indifferent from an economic viewpoint as to whether the hedges or the notional principal contract produces gains, because gains or losses on the notional principal contract are matched economically by losses or gains on the hedges. The distribution of gains or losses becomes significant for tax purposes, however, when gains and losses on the hedges are realized without corresponding realization of notional principal contract losses and gains. In view of the size of a typical dealer's positions, the mismatch in tax and economic income may be in the millions of dollars.

Accordingly, in any one taxable year, a swap dealer may find its taxable income to be either far greater or far less than its economic income.[91] This tax lottery poses serious problems both for taxpayers and for the fisc, particularly when magnified by the sums involved in the trillion dollar notional principal contract market.

Marking both sides of a notional principal contract and hedge transaction to market would eliminate the tax lottery. The Proposed Regulations achieve that end in large measure for taxpayers that exclusively are dealers or traders in derivative financial instruments (or which conduct these activities in separate entities from dealers and traders in securities and commodities). Dealers and traders in derivative financial instruments may elect to use the mark-to-market election, and thereby place all instruments and their hedges, with the exception of long positions in securities and commodities, on the same method of accounting, while the securities and commodities dealers and traders may remain on a cost method of accounting.

In the case of taxpayers that conduct through the same entity a dealer or trader business in derivative financial instruments and a dealer business in securities or commodities, the Proposed Regulations create a new timing lottery problem. If such a taxpayer elects the mark-to-market method of accounting for derivative financial instruments, that taxpayer's market-making derivatives "books" will lead to economically rational

[91] A securities dealer that uses a cost method of accounting for its inventory conceptually faces a similar problem. Because the turnover of securities inventory is generally very rapid, however, the extent of year-end timing mismatches on inventory and inventory hedges is smaller.

taxable income (except with respect to long positions in securities and commodities held in conjunction with that derivatives business). The securities and commodities dealer activity, however, will be subject to a new timing lottery, because the inventory of actual physicals and securities is likely to be on a cost method of accounting, while the derivatives (including short positions) that hedge the inventory will be on mark-to-market. The result is the exportation of current law's timing lottery from the dealer's notional principal contracts book to its physical inventory book (albeit with generally less severe consequences because of the greater turnover of inventory and its associated hedges).

A securities dealer in this position has two ways to address the problem. First, the dealer can resort to "self-help," which is to say that at year-end that dealer may sell inventory to generate gains or losses as necessary to balance gains or losses realized from inventory hedges under the mark-to- market system. In our view, self-help is not a course the Service should encourage: it is purely tax-driven behavior, and the potential billions of dollars of inventory that could be liquidated at year-end under such a scenario could seriously disrupt the world's securities markets. A second method of addressing the timing lottery problem would be for the securities dealer to change from the cost method of accounting to mark-to-market. This course is equivalent to imposition of a mandatory mark-to-market method of accounting for taxpayers that conduct business as securities dealers and notional principal contract dealers through the same entity. In the Committee's view, a mandatory mark-to-market method of accounting for all positions held by such taxpayers is inappropriate.

The issues addressed above indicate a simple problem: the scope of the elective mark-to-market system is overbroad. There is no need to apply mark-to-market rules for derivatives that hedge inventory, and attempts to do so cause significant problems for many dealers. The Committee strongly urges the Service to adopt a mark-to-market system that would permit dealers and traders to use mark-to-market for all identified positions (including long physicals) held in a segregated derivatives dealer "book," and permit the taxpayer's current method of accounting for derivative positions that hedge securities or commodities inventory outside that identified book.

B. Linkage to Lower-of-Cost-or-Market.

As discussed in the previous section, the timing lottery problem generates taxable income that may be either far greater or far less than economic income, and the direction of that variance is not predictable. The issue is therefore a problem not only for taxpayers, but also for the government, which may find in any one taxable year that taxable income reported by a taxpayer is millions of dollars less than its economic income. It is therefore in the interest of both taxpayers and the government to address the timing lottery problem.

In light of this common interest, it is wholly inappropriate to condition the use of a mark-to-market method of accounting for derivative financial instruments to a detriment for the securities and commodities business of that entity and its affiliates.

The rationale behind the lower-of-cost-or-market method of accounting is beyond the scope of this report; but lower-of-cost-or-market has been a permissible method of accounting for over seventy years.[92] If the Service judges that lower-of-cost-or-market is no longer an acceptable method of accounting and that the Service has the authority to abolish it, the only just course for the Service to take is to revise the inventory accounting regulations under section 471 as to all taxpayers. Prohibiting the use of lower-of-cost-or-market only for dealers in derivative financial instruments and their securities and commodity dealer affiliates is unfair and falls disproportionately on different taxpayers, depending on how large their physical securities or commodities business is relative to their derivatives business. Accordingly, the Committee strongly urges the Service to drop the lower-of-cost-or-market linkage to the mark-to-market election with respect to derivative financial instruments.

XII. INTEGRATION OF NOTIONAL PRINCIPAL CONTRACTS WITH OTHER TRANSACTIONS.

A. Integration by the Service.

The Committee recognizes that the power to integrate is a useful tool in the Service's efforts to prevent abusive transactions. We recognize as well that flexibility is necessary to the exercise of the Service's discretion. At the same time, taxpayers should be able to determine with some certainty what kinds of transactions will be considered abusive and are subject to the Service's power to integrate.

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[92] See T.D. 2609 (Dec. 19, 1917), 19 Treasury Decisions Under Internal Revenue Laws of the United States (January-December 1917), at 401 (1918).

In the Committee's view, the Proposed Regulations do not provide enough guidance in this respect.

The sole example of an abusive transaction given bears a strong resemblance to the “matched book” of swap contracts carried by many dealers in swaps, which include both par and off-market swaps.[93] While we assume that the example was not intended to characterize all matched books as abusive to the extent they include off-market swaps, the example does not make clear what aspect of the transaction is abusive for which taxpayers. Accordingly, the Committee suggests that the example be revised to state the extent, if any, to which it applies to dealers and requests that the Service provide additional examples of transactions that the Service considers abusive. Additionally, taxpayers often use interest rate swaps to hedge exposure to rate fluctuations in their borrowings. It is unclear whether the Service's authority to integrate is intended to apply to such transactions. Because taxpayers should be able to determine the tax treatment of such transactions, the Committee suggests that the final regulations clarify whether and when such routine transactions will be integrated by the Service if integration by taxpayers is not permitted.

B. Integration by Taxpayers.

As the Preamble to the Proposed Regulations acknowledges, many dealers and end-users enter into notional principal contracts in order to hedge exposure to adverse changes in interest rates, commodity prices, and currency exchange rates.

[93] Prop. Reg. § 1.446-3(e)(4)(v), Ex. 4.

We believe that most parties to notional principal contracts do not enter into such contracts unless the party in question has an offsetting asset or liability, current or anticipated. As an economic matter, therefore, end-users of notional principal contracts usually view the contracts as part of an integrated package with other instruments, in the sense that they are intended in some fashion to hedge or modify the cash flows payable on those instruments.[94]

In the Committee's view, a rule that would allow taxpayers to treat notional principal contracts and identified other instruments as integrated for tax purposes would enhance the conformity of the tax system to the underlying economics of hedging transactions -- thereby limiting the potential for distortive results. In addition, an integration system (together with a workable mark-to-market system for dealers) would remove much of the pressure to develop economically justifiable and administrable timing rules for notional principal contracts generally. The lack of integration rules in the Proposed Regulations is all the more difficult to understand given the successful experience under temporary regulation section 1.988-5T(a) with integration for foreign currency contracts used to hedge debt instruments into or out of nonfunctional currencies (the “foreign currency hedging rules”) and under temporary regulation section 1.861-9T(b)(6) with respect to derivative financial products used to hedge interest rate risk (the “interest allocation hedging rules”).

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[94] The instruments may not be fully hedged by the notional principal contract, however, as a party to a notional principal contract may use the contract as only a partial hedge.

Accordingly, the Committee strongly urges the Service to rethink its caution with respect to integration/ and to provide an integration election along the lines described below.

Integration can take one of two forms: a "narrow" system, in which perfectly matched cash flows are combined into a single synthetic instrument, and a "broad" system, in which positions subject to the integration regime are subject to uniform rules of character (capital vs. ordinary), source (domestic vs. foreign) and timing, but otherwise retain their separate identity. The foreign currency hedging rules are an example of the former, and the interest allocation hedging rules are an example of the latter (at least in respect of source).[95]

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[95] Mixed straddle accounts under section 1092 also provide integration with respect to timing, by means of a daily mark-to-market of all positions in the account, and character, with respect to the holding period of positions in the account, by netting gains and losses from section 1256 contracts and non-section 1256 contracts.

We are not aware of any problems of tax administration associated with the current "narrow" integration system of the foreign currency hedging rules, and we therefore urge that, at a minimum, the same system be adopted for functional currency borrowings (or loans) and their associated notional principal contract hedges.[96]

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[96] It will be necessary to develop specific rules dealing with the character of gain or loss on the "legging out" of a functional currency hedge. (Section 988 itself eliminates most character mismatch issues by treating foreign currency gain or loss as ordinary.) Assuming that the foreign currency hedging rules are followed with respect to timing, "legging out" will also trigger gain or loss on whichever position the taxpayer retains. We suggest that gain (or loss) on the notional principal contract position (whether assumed or retained) be matched against the character of loss (or gain) from the debt obligation position. Since the legging out and mark-to-market may show net gain or loss, an ordering rule is required: we suggest that gain (or loss) from the notional principal contract position be characterized as capital to the extent of capital loss (or capital gain) on the debt obligation position, with any excess gain (or loss) on the notional principal contract side being characterized as ordinary.

A narrow integration system also offers a solution to the issue of the consequences to a non-assigning party of an assignment by a counterparty. Under such a system, a notional principal contract should not be treated as having a separate existence, apart from the financial instrument with which the contract is integrated; the unilateral actions of a counterparty to the contract (other than termination) should therefore have no effect.

Such a system can be criticized as not going far enough, which ultimately is true, but such an approach would, in our judgment, bring the bulk of functional currency interest-rate sensitive notional principal contracts (which is to say the vast preponderance of notional principal contracts) employed by end-users into a simple and economically rational tax accounting regime.[97] The lack of a comprehensive solution for all cases should not serve as a rationale for inaction with respect to a large category of transactions for which a feasible solution already has been developed. This approach would include an even greater percentage of end-users' straightforward debt obligation hedges if it were extended to apply to all "derivative financial instruments" (as defined in Proposed Regulation section 1.446-4(c)), which would bring into the integration system forwards, options and short positions.

It has been suggested that the Service lacks the statutory authority to provide for general integration rules covering functional currency notional principal contracts. We believe that the broad "clear reflection of income" standard in section 446 allows the Service adequate flexibility to implement a regulatory integration regime for timing purposes -- to the

[97] The desire of taxpayers for such a rational tax accounting regime is demonstrated by the fact that many taxpayers have achieved the results advocated in the text through cumbersome foreign currency "sandwich" structures, in which taxpayers enter into and then hedge out of foreign currency risk solely to provide the basis for electing integrated treatment under the foreign currency hedging rules of a U.S. dollar debt obligation and a related U.S. dollar hedge.

same degree it authorized the initial issuance of preliminary timing guidance for notional principal contracts through Notice 89-21.[98]

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[98] The Proposed Regulations do not address the character of payments (other than termination payments) on notional principal contracts. To the extent that these payments are ordinary income or loss, however, an integration regime that is limited to hedges that affect the ordinary interest flows on debt securities should not produce significant character mismatch issues.

Appendix A
Deconstruction of Swap into Forward Contracts

Illustrative fixed/six month LIBOR par swap rates (based on market conditions on December 24, 1991) are as follows:

6 Months	12 Months	18 Months	24 Months	30 Months	36 Months
4.30	4.42	4.72	5.02	5.36	5.70

Table 1: Approximate Par Swap Rates on December 24, 1991

Based on these rates, the following swap zero prices (i.e., appropriate present values, expressed as a percentage, for single payments due after a specified number of months) can be derived:*

0 Months	6 Months	12 Months	18 Months	24 Months	30 Months	36 Months
100	97.895	95.721	93.23	90.528	87.54	84.346

Table 2: Zero Prices

The discount rates that produce the present values in Table 2 are as follows:

6 Months	12 Months	18 Months	24 Months	30 Months	36 Months
4.30	4.42	4.728	5.038	5.394	5.756

Table 3: Zero Rates

The present values in Table 2 are derived assuming that a payment is reinvested at the end of each six months at the appropriate market fixed rate for the next six months, which is the forward rate for that period. Thus, the forward rates for any six month period can be computed as two times (to account for semiannual periods) the following: the present value of a payment (as shown in
Table 2) due at the beginning of the period divided by the present value of a payment due at the end of the period, minus one. For example, the forward price for month 30 is 2x(87.54/84.346 minus 1), or 7.57%. The forward rates computed in this manner are as follows:

0 Months	6 Months	12 Months	18 Months	24 Months	30 Months
4.30	4.54	5.34	5.97	6.83	7.57

Table 4: Forward Rates

Consider now a three year par swap. According to Table 1 the three year par swap rate is 5.70. Therefore, based on this par rate and the forward six month rates set forth in Table 4, the nominal values of the forward contracts comprising the swap can be computed, as the difference between the fixed payment due at 5.70% and the fixed payment at the forward rate. These values are as follows:

6 Months	12 Months	18 Months
(5.70-4.30)/2=0.70	(5.70-4.54)/2=0.58	(5.70-5.34)/2=0.18
24 Months	30 Months	36 Months
(5.70-5.97)/2=-0.14	(5.70-6.83)/2=-0.56	(5.70-7.57)/2=-0.94

Table 5: Forward Contract Nominal Values ($100 Notional)

Because 5.70% is the par swap rate, the present value of this sequence of values (making use of the swap zero prices in Table 2) must be zero. This is confirmed as follows:

6 Months	12 Months	18 Months
.70 X .97895 = .69	.58 X .95721 = .56	.18 X .9323 = .17
24 Months	30 Months	36 Months
-.14 X .90528 = -.13	-.56 X .8754 = -.49	-.94 X .84346 = -.79

Table 6: Forward Contract Present Values ($100 Notional)

The sum of .69, .56, .17, -.13, -.49 and -.79 is .01 (attributable to founding).

If a swap were off market (i.e., provided fixed payments based on a rate other than 5.7%), then the values of the forward contracts comprising such swap would equal the present values of, the nominal values set forth in Table 5 increased or decreased by the difference between the fixed payments based on 5.7% and the swap rate. Under the Proposed Regulations, these relative values would be used in allocating swap premium. We propose instead to ignore the forward prices and base the allocation solely on the difference between level payments at a 5.7% rate and at the actual swap rate.