New York State Bar Association

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NYSBA

May 22, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section recommending certain changes in current rules for determining the character and timing of income from notional principal contracts. In our report, we recommend changes in current rules for determining the character of payments under commodity, equity, and similar swaps that provide for payments based on the value of capital assets. We also recommend changes in current rules for determining the timing of income from swaps that provide for contingent payments. Adoption of our recommendations for changes in current character rules may require legislation, but our recommended timing rules for contingent payment swaps could be implemented by regulation. We also recommend legislation exempting payments under notional principal contracts from the "two-percent floor" and other limitations on miscellaneous itemized deductions.

Character Issues.

Our report begins by discussing the uncertainty under current law as to the character of income from certain notional principal contracts. The character of income from swaps is unclear because of uncertainty as to the scope of section 1234A, which generally treats the gain or loss attributable to the termination of rights and obligations with respect to capital assets as capital gain or loss. We also note that under current law, economically equivalent transactions may result in different character consequences.

We recommend consideration of two alternative regimes for determining the character of income from notional principal contracts. Under one regime, all payments under a notional principal contract would be treated as capital gain or loss to the extent that they are determined by reference to changes in the value of property that is (or on acquisition would be) a capital asset. The remaining portion of the payments under a notional principal contract would be ordinary. The sale, assignment or unscheduled termination of a notional principal contract would give rise to ordinary income or expense only to the extent of fixed amounts that would be ordinary payments if made. All other gain or loss upon the sale, assignment, or unscheduled termination of a notional principal contract would be treated as capital gain or loss.

Under the second regime, all payments made or received pursuant to a notional principal contract would give rise to ordinary income or expense. In addition, any gain or loss on the sale, assignment or termination (whether scheduled or unscheduled) of a notional principal contract would be treated as ordinary gain or loss. We recognize that a set of rules that treats loss from the sale, assignment or unscheduled termination of a notional principal contract as ordinary loss may permit selective realization of losses ("cherrypicking"). Accordingly, we propose a loss limitation rule for losses from sale, assignment or unscheduled termination of notional principal contracts.

Treatment of Notional Principal Contract Expenses as Miscellaneous Itemized Deductions.

Our report also discusses the treatment under current law of payments by individuals under notional principal contracts as miscellaneous itemized deductions, which are subject to the "two-percent floor" and other limitations. We believe that the policy reasons that may support these limitations for certain kinds of expenses do not apply to

payments under notional principal contracts. Thus, we recommend legislation that would exempt such payments from these limitations.

Timing Issues.

The portion of our report addressing timing issues responds to a request in the preamble to final regulations on the timing of income from notional principal contracts (T.D. 8491, 1993-2 C.B. 215) for comments on the treatment of contingent payments. We recommend that the Treasury Department and the Internal Revenue Service adopt by regulation one of two alternative regimes. Under one regime, a taxpayer that enters into a contingent payment notional contract would be permitted fully to offset payments made against payments received, but would be required to defer deduction of the excess. This regime would be symmetric, and would also permit deferral of net amounts received. Under the second regime, the amount of contingent payments under a swap would be projected, and taxpayers would be required to accrue income and expense as though the swap provided for noncontingent payments equal in amount to the projected contingent payments. If the actual amount of a contingent payment differs from its projected amount, the taxpayer would take into account an adjustment at that time. In addition to these two alternatives, we recommend that the Treasury Department and the Internal Revenue Service consider permitting taxpayers to elect mark-to-market accounting for notional principal contracts.

If the Treasury Department and the Internal Revenue Service adopt neither of our proposed timing regimes, we recommend that section 163(d) be amended to treat any ordinary expense with respect to a contingent payment notional principal contract as investment interest solely for purpose of section 163(d).

Effective Date Issues.

We recommend that legislation and regulations changing or clarifying the treatment of notional principal contracts be prospective only and apply only to contracts entered into on or after its effective date.

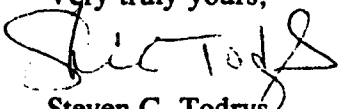
Comprehensive Timing and Character Rules for All Derivatives.

We recognize that certain of the policy arguments that support adoption of the character regimes we recommend also support changes to

current character rules for other derivatives. We also recognize that adoption of the regimes we recommend will not eliminate differences in the treatment among notional principal contracts and other economically equivalent derivatives, including forward contracts and options. Although our report does not consider specific reforms to the treatment of derivatives other than notional principal contracts, we believe that the timing and character rules for other derivatives should be reexamined. Accordingly, we recommend that the Treasury Department and the Internal Revenue Service consider opening a project to study the feasibility of a comprehensive taxing regime for all derivative instruments that would reduce divergent (or, at least, uncertain) tax rules for economically equivalent financial instruments. In the absence of such a regime, we believe that additional guidance would be helpful as to the proper treatment of certain financial instruments, described in the report, that cannot easily be classified under current law.

Please let me know if we can be of any further assistance to you in addressing these issues.

Very truly yours,



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May 22, 1998

New York State Bar Association (Tax Section)
Report on Notional Principal Contract Character and Timing Issues

I. Introduction.

This report, prepared by an ad hoc committee of the Tax Section of the New York State Bar Association,[1] provides comments on the proper character of payments made or received pursuant to a notional principal contract (an "NPC").[2] This report also responds to the Service's request for comments on the proper timing of payments made pursuant to an NPC that provides for one or more contingent nonperiodic payments (a "contingent payment swap").[3]

This report is divided into seven Parts. Part II summarizes our recommendations. Part III describes a variety of NPCs and the uncertainty existing under current law regarding the character of payments made or received under them. Part III also describes a variety of contingent swaps and the uncertain timing treatment of gain or loss in

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1 The ad hoc committee was chaired by David S. Miller, who was the principal drafter of the report, with substantial assistance from Samuel J. Dimon, Charles M. Morgan, III, Robert H. Scarborough, and David A. Soloshatz. The committee also included Eric Fox, Lucy Farr, John Harper, David P. Hariton, Richard O. Loengard, Jr., John Narducci, Erika W. Nijenhuis, Mark Perwien, Richard L. Reinhold, David M. Schizer, Po Y. Sit, and Andrew P. Solomon. Helpful comments were received from Linda E. Carlisle, Bruce Kayle, Michael L. Schler and Steven C. Todrys.

2 The Internal Revenue Service (the "Service") has thus far declined to address the character of payments made or received pursuant to an NPC. See Treasury Decision 8491, 1993-2 C.B. 215, 216 (characterizing economic substance of a swap as a series of forward payments for purposes of recognizing a nonperiodic payment but indicating that this treatment is not relevant for character purposes).

3 Treasury Decision 8491, 1993-2 C.B. 215, 216 ("The IRS expects to address contingent payments in future regulations, and welcomes comments on the treatment of those payments.").

respect of them. Part IV suggests a regime to address NPC character issues, Part V discusses timing issues, and Part VI makes certain effective date recommendations. Finally, Part VII raises some fundamental questions regarding the tax treatment of financial instruments generally and suggests that a comprehensive overhaul of the entire area may be appropriate.

The primary objectives underlying our recommendations are threefold. First, our recommendations are designed to increase certainty of result. Uncertainty of tax treatment discourages bona fide financial transactions and encourages taxpayers to claim the tax treatment that gives rise to the least amount of tax. Second, our recommendations are intended to more accurately measure economic gain or loss and to reduce the beneficial tax treatment that may be enjoyed by one particular financial instrument (such as an NPC) over other economically equivalent financial instruments or arrangements (or *vice versa*). Disparate tax treatment of economically similar financial instruments permits taxpayers to achieve more beneficial tax treatment simply by altering the form of their instrument and penalizes other taxpayers who for non-tax reasons are unable to avail themselves of the more favorable form. Finally, our recommendations aim to reduce complexity. Although some complexity is inevitable in a regime designed to more accurately tax sophisticated financial instruments, simplicity (to the extent it is consistent with our other objectives) improves compliance and administrability.

We have not, however, attempted to revisit basic assumptions regarding the distinction between capital gains and ordinary income, or the timing of income and loss of traditional financial instruments under established principles. Accordingly, we do not consider a mandatory mark-to market regime. We instead suggest in Part VII that some of these basic

assumptions lack a sound economic basis and are the source of significant complexity. We invite the Service to consider these issues in a broader context.

II. Summary of Recommendations.

1. We discuss two alternative regimes for addressing character issues with respect to NPCs. Under the first regime, the portion of any gain or loss in respect of an NPC that is determined by reference to changes in the value of property that is (or on acquisition would be) a capital asset would be treated as capital gain or loss. We refer to these payments as "value payments." Other gain or loss would be treated as ordinary income or expense ("ordinary payments"). In addition, the sale, exchange or unscheduled termination of an NPC would give rise to ordinary income or expense only to the extent of fixed amounts that would be ordinary payments if made. All other gain or loss upon the sale, exchange, or unscheduled termination of an NPC would be treated as capital gain or loss. We would require value payments to be reported on information returns separately from ordinary payments.

Under the second regime, all payments made or received pursuant to an NPC would give rise to ordinary income or expense. Moreover, any gain or loss on the sale, exchange, assignment, cancellation, lapse, expiration or termination of an NPC (or any other payment in respect of an NPC) would be treated as ordinary gain or loss. However, in order to prevent taxpayers from selling, exchanging or terminating NPCs that generate losses in order to offset ordinary income from other sources, any loss on the sale, exchange, or unscheduled termination of an NPC would be available only to offset income or gain in respect of all of the taxpayer's NPCs or capital gain from other sources, but any such excess "unscheduled losses" could be carried forward indefinitely. We also invite the Service to

consider allowing taxpayers to elect between the two regimes on or before the date an NPC is entered into, or alternatively to elect to adopt a consistent method for all of the taxpayer's NPCs.

In addition, regardless of the regime that is adopted, we would amend section 263(g) to require the capitalization of net ordinary expense on the combined positions in a straddle and we would provide authority for the Service to integrate for purposes of these rules two or more NPCs entered into with a principal purpose of avoiding the rules. We would also amend section 67(b) (the "two-percent floor"), section 56(b)(1) (relating to the individual alternative minimum tax) and section 68 (phase out of certain itemized deductions) to exempt net NPC expenses from the limitations imposed by these provisions. We believe that NPC expenses do not raise the policy concerns that justify these limitations. The implementation of these recommendations would require statutory amendments.

2. We discuss the merits and shortcomings of five alternative approaches for the recognition of gains and loss in respect of a contingent payment swap. We recommend that the Service adopt either an approach based on the method for accounting for NPCs that provide for noncontingent nonperiodic payments (the "noncontingent swap" method), or a method that would permit a full offset of gross payments made to the extent of payments made (and *vice versa*), but would defer taxpayers' deductions and inclusions for net payments made or received (the "full allocation" method). We also recommend an elective mark-to-market regime for NPCs. If neither of our recommended timing regimes for contingent payment swaps is adopted, and taxpayers are permitted to currently deduct periodic payments in respect of contingent nonperiodic payments, we recommend that section 163(d) be amended to treat

any ordinary expense in respect of a contingent payment swap as investment interest solely for purpose of section 163(d).

3. We recommend that the effective date of any future guidance on the character treatment of NPC payments or the timing of gain or loss on contingent payment swaps be prospective only (applying to contracts entered into after the effective date of the regulations).

4. We recommend that the Service consider opening a project to study the feasibility of a comprehensive taxing regime for all derivative instruments that would reduce divergent (or, at least, uncertain) tax treatment for economically equivalent financial instruments. In the absence of such a regime, we recommend that the Service provide additional guidance as to the proper characterization of financial instruments that do not neatly fit into a single "tax cubbyhole."

III. Background and Current Law Treatment.

A. The Character of Payments Made Pursuant to a Notional Principal Contract.

This Part III.A. describes six different types of NPCs and illustrates the disparity of views regarding the character of the gain or loss in respect of them under current law (and the rationales for the views).[4]

1. A "Plain Vanilla" Interest Rate Swap. Under a "plain vanilla" interest rate swap, one party ("A") makes periodic payments to the other party ("B") equal to

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[4] For ease of reference, descriptions of the NPCs discussed in this report are reprinted in Appendix A to this report.

an interest rate index (such as LIBOR) times a notional principal amount in exchange for periodic payments equal to a fixed rate times the same notional principal amount. The periodic payments are netted and one party makes a net payment to the other.

Plain vanilla interest rate swaps have been likened to a package of parallel cash settlement forward contracts on loans or certificates of deposit each with a principal amount equal to the notional amount (i.e., one forward contract from the date of inception to the end of the first period, a second forward contract from the date of inception to the end of the second period, etc.).[5] However, the analogy is not perfect if, on the date of inception, the current values are different for forward contracts on certificates of deposit coming due on each date a payment is required to be made on the swap. In this case, B (the fixed-rate payer) could not enter into a series of forward contracts with unrelated parties that provide for level payments in each period.[6]

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5 In other words, each contract would provide, for example, that in one year one party will pay the other a fixed amount set today (the forward price) in exchange for a payment in one year equal to the value of an identified certificate of deposit with a principal amount equal to the swap notional principal amount, that matures in one year and on which interest accrues (but is not paid until maturity) at a rate equal to the specified floating rate on the swap (e.g., LIBOR) over an interval equal to the interval at which payments are made on the swap (e.g., one year).

6 Stated differently, the fixed leg of a plain vanilla interest rate swap represents the average of the forward prices for separate contracts coming due at the end of each period. To illustrate in simplified terms, assume that a plain vanilla interest rate swap has a ten year term, provides for a single annual net payment and is based upon annual LIBOR v. 7 %. If the market price of a forward contract for a one-year LIBOR certificate of deposit coming due at the end of year one is less than that for a one-year LIBOR certificate of deposit coming due at the end of year ten, then a series of forward contracts between B and unrelated parties would require B to pay a different amount in year one than in year ten as the fixed leg, and B's cash flows would be different than the plain vanilla interest rate swap entered into between A and B. A is willing to accept

(continued . . .)

The Committee agrees that, under current law, the net payments made or received with respect to a plain vanilla interest rate swap are ordinary income or expense (or ordinary gain or loss), but the Committee is not in agreement as to the basis for this result.[7]

The Committee is in agreement that making or receiving a payment under an NPC does not constitute the "sale or exchange" of a capital asset within the meaning of section 1222, and therefore that section 1234A would provide the exclusive means to treat net

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level payments from B because A has determined that those level payments cause the interest rate swap to have the same value as a series of equivalent forward contracts on one-year LIBOR certificates of deposits priced at market.

Other economic differences exist between a plain vanilla interest rate swap and a package of parallel forward contracts on certificates of deposits entered into with unrelated parties. First, a package of parallel forward contracts is more liquid than a single interest rate swap (because each forward contract could be separately transferred) and therefore presumably more valuable. Second, a package of forward contracts presumably would diversify credit exposure and be more valuable. On the other hand, negotiating a package of forward contracts with separate counterparties is more expensive.

[7] Further, it is unclear as to whether these net payments give rise to income or expense, on the one hand, or gain or loss, on the other. (In fact, this dispute applies to all non-capital gain or loss in respect of NPCs.) A majority of the Committee believes that the net periodic payments on NPCs that are not capital in nature are more properly characterized as income or expense because they are made at intervals and are not made in connection with the creation, preservation, or disposition of property. Cf. Treasury Decision 8734 (Preamble to Withholding Regulations), 1997-44 I.R.B. 5 ("income from notional principal contracts is not gain from the disposition of property, nor is it the equivalent of gain"); Edward D. Kleinbard and Erika W. Nijenhuis, "Short Sales and Short Sale Principles in Contemporary Applications," in 53rd New York University Institute on Federal Taxation § 17.05[2][a] at 17-60 n. 109 (1995) (arguing that periodic swap payments constitute expenses rather than losses under this rationale; citing authority). Others disagree. This distinction has particular practical significance with respect to NPCs that are positions in a straddle. See Part III.A.2.

As a matter of convention, the balance of this report refers to recognized non-capital net payments on an NPC as ordinary income or expense without resolving the issue.

payments on an NPC as giving rise to capital gain or loss.[8] Section 1234A applies only to "gain or loss." Arguably, deductible payments made pursuant to the original terms of a contract are always treated as "income" or "expense" and are never treated as giving rise to gains or losses.[9] Some members of the Committee believe that deductible payments made pursuant to the original terms of an NPC may give rise to gain or loss within the meaning of the first two words of section 1234A. Others disagree.

Second, section 1234A applies only to gain or loss "attributable to the cancellation, lapse, expiration, or other termination of a right or obligation." Even if a deductible payment made pursuant to the original terms of an NPC can give rise to gain or loss, payments made pursuant to the original terms of a contract arguably are never treated as "canceling" or "terminating" rights or obligations. Some members of the Committee believe that a payment made pursuant to the original terms of an instrument may be treated as "terminating" a right or obligation with respect to property (other than the swap itself).[10] Other members of the Committee believe that a payment made pursuant to the original terms of an instrument never "terminates" any right or obligation.

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8 Section 1234A provides that "[g]ain or loss attributable to the cancellation, lapse expiration or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer," is treated as capital gain or loss.

9 See footnote 6.

10 Cf. Frane v. Commissioner, 998 F.2d 567, 570 (8th Cir. 1993) (considering the word "cancellation" in a different context: "While we agree with the [taxpayers] that there is a distinction to be made by act subsequent to the contract and cancellation upon a contingency pursuant to the contract's terms, the term 'cancellation' can be used to describe both situations.").

Third, the Committee is in disagreement as to whether the rights and obligations under a plain vanilla interest rate swap are "with respect to property." Some would say that because LIBOR is simply read off a Telerate screen, it is not with respect to property. Others would agree with this result but would argue that the rights and obligations under a plain vanilla interest rate swap are with respect to the U.S. dollar, which is not considered "property" for federal income tax purposes. Some members of the Committee would argue that LIBOR rates reflect the rates of interest on actual certificates of deposit, which are property and could be a capital asset in the hands of a party to an interest rate swap. Even these members agree that periodic payments on a plain vanilla interest rate swap give rise to ordinary income or expense under one or more other rationales.

Fourth, the NPC regulations (i) require that taxpayers recognize the ratable daily portion of a periodic payment for the taxable year to which the portion relates, (ii) make no distinction between the portion attributable to periodic and nonperiodic payments (other than with respect to "significant nonperiodic payments"), (iii) refer generally to "inclusions" and "deductions," (iv) in conjunction with the new withholding tax and information reporting regulations, generally net all payments for reporting and other purposes,[11] and (v) do not provide a mechanism for parties to break out the portion of each net payment attributable to ordinary income or expense from the portion possibly attributable to capital gains and losses. Consequently, as a matter of marketplace practice, parties to swaps do not generally break out

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[11] See Treasury regulations section 1.6041-1(d)(5) ("The amount required to be reported under this paragraph (d)(5) is limited to the net income from the notional principal contract as described in section 1.446-3(d).") (effective as of January 1, 2000).

net swap payments into gross amounts or allocate these gross amounts between ordinary income or expense and possible capital gain or loss. Some members of the Committee believe that these rules provide further support for the view that all periodic payments on all NPCs (including plain vanilla interest rate swaps) give rise to ordinary income and expense. Other members disagree with this reasoning (although not with the result) in the case of a plain vanilla interest rate swap, noting that the notional principal contract regulations do not address character and should not be viewed as authoritative in resolving those issues.

Nevertheless, the Committee agrees that regulations section 1.1092(d)-1(c)(2) clearly provides that a plain vanilla interest rate swap itself constitutes property in its own right and may be a capital asset.[12] Accordingly, if either A or B sells or exchanges (or assigns) its rights and obligations under it, capital gains or losses will generally result (unless the taxpayer is a dealer). By the same token, if A and B terminate the swap prior to its scheduled maturity and one party makes a termination or settlement payment to the other, A and B will generally recognize capital gain or loss attributable to the cancellation or termination of rights and obligations with respect to the swap (which is "property") under section 1234A.

2. The Commodities Swap Considered in TAM 9730007. In the commodities swap considered in private letter ruling 9730007,[13] one party ("C") made

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12 Treasury regulations section 1.1092(d)-1(c)(2) ("The rights and obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest in personal property.")

13 (April 10, 1997) (National Office Technical Advice Memorandum) ("TAM 9730007"). See MDU Resources Group, Inc. v. Commissioner, Tax Court Docket No. 23246-97 (filed December 2, 1997).

periodic payments to the other party ("D") equal to the monthly average of settlement prices for Light Sweet Crude Oil futures contracts on the New York Mercantile Exchange times a specified number of barrels in exchange for a fixed rate of payments times the same number of barrels. The periodic payments were netted and one party made a net periodic payment to the other.

The commodities swap considered in TAM 9730007 could be likened to a package of parallel cash settlement forward contracts with respect to Light Sweet Crude Oil futures contracts (i.e., one forward contract from the date of inception to the end of the first period, a second forward contract from the date of inception to the end of the second period, etc.), but for the same reasons described above for plain vanilla interest rate swaps, the economic analogy probably is inaccurate. It is unlikely that C would be able to enter into forward contracts with unrelated persons at settlement prices exactly equal to C's fixed rate leg on the swap because the payments on the swap reflect an average of the various forward rates.

The Committee is divided as to whether the net payments made or received with respect to the commodities swap considered in TAM 9730007 more properly give rise under current law to capital gain or loss, on the one hand, or ordinary income or loss, on the other.

First, as with the plain vanilla interest rate swap, some members of the Committee believe that payments made pursuant to the original terms of a contract may give rise to gain or loss within the meaning of the first two words of section 1234A. Others disagree.

Second, the Committee does agree that, in contrast to a plain vanilla interest rate swap, the periodic payments on the commodities swap described in TAM 9730007 do (or, for

a nondealer, could) give rise to gain or loss "attributable to . . . a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer" within the meaning of section 1234A, and further agrees that the relevant property is the Light Sweet Crude Oil futures contracts.

However, the Committee is not in agreement as to whether the phrase "cancellation, lapse, expiration, or other termination" describes each periodic payment under the swap. Some members of the Committee believe that each periodic payment on the swap should be treated as "terminating" the right to receive or the obligation to pay the changes in the value of the oil futures contract between the inception of the contract and the end of the period. [14] Other members believe that payments pursuant to the original terms of an instrument never give rise to gain or loss attributable to the termination of a right or obligation with respect to property. A third group of members believe that periodic payments pursuant to the original terms of a swap (including the final periodic payment) do not give rise to gain or loss attributable to a termination of a right or obligation with respect to property within the meaning of section 1234A and are not economically equivalent to a terminating payment. However, this group would distinguish a nonperiodic contingent maturity payment and believes that such a payment properly gives rise to gain or loss attributable to the termination of a right or obligation with respect to property within the meaning of section 1234A.

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[14] See S. Rep. 97-144, 97th Cong., lst Sess. at 170-171 (1981), 1981-2 C.B. 412, 480 (describing reasons for section 1234A: "The Committee considers this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the contract.")

Fourth, the Committee acknowledges that while taxpayers may not be able to perfectly replicate the economic effect of the commodities swap described in TAM 9730007 with other financial instruments, the economic value of the contract at any particular time will reflect to a significant extent changes in the value of oil futures. A rule that treats the periodic payments as ordinary income or expense would permit taxpayers to alternatively claim an ordinary loss by holding a depreciated contract to the end of the period (and making the scheduled payment), or a capital gain by selling, exchanging, assigning, or terminating an appreciated contract before the end of the period.[15] The recent amendments to section 1234A were animated by a desire to prevent taxpayers from achieving character manipulations of this general type.[16] On the other hand, this ability to convert the character of economic gain due to market changes by selling (rather than holding) the NPC clearly exists under current law with respect to fixed-rate debt instruments whose value increases as a result of decreases in market interest rates.

Fifth, the character treatment of periodic payments on the commodities swap described in TAM 9730007 also has collateral consequences if C holds the swap as a

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15 The Tax Court recently used similar economic equivalency arguments to find, on a super-statutory basis, capital gains or losses. See Estate of Israel v. Commissioner, 108 T.C. 208 (1997) (full court). The opinion was, however, accompanied by a vigorous dissent, see Estate of Israel, 108 T.C. at 232 (Halpern, J., dissenting), and is contrary to Stoller v. Commissioner, 994 F.2d 855 (D.C. Cir. 1993), which rejected a super-statutory basis for capital gain or loss treatment.

16 The daily accrual rule of regulations section 1.446-3(e)(2) does not clearly resolve the issue. Although it requires taxpayers to accrue the daily portion of periodic payments as of the end of each tax year, it does not indicate the character of the accrual. Regulations section 1.446-3 does not address character issues.

nonbusiness hedge or as a position in a straddle. The Committee agrees that these considerations also tend to support capital gains treatment under current law as a policy matter (but not necessarily as a legal matter). For instance, if C actually holds a series of forward contracts on Light Sweet Crude Oil as capital assets and enters into the swap to hedge its economic exposure, because forward contracts give rise to capital gain or loss on settlement, treating C's net payments as ordinary income or expense will create character mismatches. (Integration of the forward contracts and the commodities swap is not permitted in this situation.)

Alternatively, if the commodities swap is a position in a straddle and the net payments on the swap are treated as losses, section 1092 would defer those losses, which is consistent with the purpose behind section 1092.[17] In contrast, if the net payments do not give rise to "losses" and instead are characterized as "expenses," then section 1092 would not by its terms apply and C would apparently be able to claim those expenses as current deductions.[18]

In any event, the Committee agrees that the commodities swap considered in TAM 9730007 itself constitutes property in its own right and may be a capital asset. Accordingly, if either C or D sells or exchanges (or assigns) its rights and obligations under it,

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17 Section 1092 applies to defer "loss" with respect to a position in a straddle to the extent the loss exceeds the unrecognized gain in the offsetting positions in the straddle.

18 Some members of the Committee disagree with this statement and would argue that any distinction between losses and expenses is irrelevant for purposes of section 1092. It is unclear whether the periodic payments on the swap would be treated as interest or carrying charges that must be capitalized under section 263(g). The payments arise as part of a position, and are not paid or incurred to carry personal property. These issues are considered further in Part V.C.1.

capital gains or losses will generally result under current law unless the taxpayer is a dealer. By the same token, if C and D terminate the commodities swap prior to scheduled maturity and one party makes a payment to the other, C and D will generally recognize capital gain or loss under current law attributable to the cancellation or termination of rights and obligations with respect to the swap (which is "property") under section 1234A.

3. **A "Plain Vanilla" Equity Swap.** Under a plain vanilla equity swap, one party ("E") makes periodic payments to the other party ("F") equal to an interest rate index (such as LIBOR) times a notional principal amount (equal to the initial value of a specified number of shares of a publicly-traded equity security) plus the depreciation, if any, in those shares during the relevant period in exchange for periodic payments equal to the appreciation, if any, in the value of those shares over the relevant period plus the dividends paid on those shares during the relevant period. The periodic payments are netted and one party makes a net payment to the other.

For a taxpayer similarly situated to E, a plain vanilla equity swap is economically similar to a leveraged purchase of the underlying equity at the beginning of each period and a sale of the equity security and repayment of the loan at the end of the period, or a package of forward contracts with respect to the underlying equities (i.e., one forward contract from the date of inception to the end of the first period, a second forward contract from the beginning of the second period to the end of the second period, etc.).[19]

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[19] Comparing a plain vanilla equity swap to a package of serial forward contracts does not suffer the imprecisions of the analogy between the commodities swap considered in TAM 9730007 and a parallel series of forward contracts because E effectively bears the (continued . . .)

The Committee is divided as to the proper character treatment under current law of the periodic payments made or received under a plain vanilla equity swap for the same reasons discussed above with respect to the commodities swap described in TAM 9730007. Nevertheless, because the economics underlying a plain vanilla equity swap closely approximate a series of leveraged purchases and sales of the underlying equity securities or a package of forward contracts, the Committee agrees that the policy reasons under current law favoring capital gain or loss with respect to the portion of each periodic payment reflecting the change in value of the underlying equity ("value payments") are even more compelling for a plain vanilla equity swap than for the commodities swap considered in TAM 9730007.

However, even the members of the Committee who would treat these value payments as giving rise to capital gain or loss under current law agree that the law is unclear as to the method of measuring the amount of the gain or loss. To illustrate the uncertainty, assume that the plain vanilla equity swap has a ten-year term, provides for E to make annual payments equal to one-year LIBOR times $100 (the initial value of 10 shares of XYZ Co.) plus the depreciation, if any, on those 10 shares during the year in exchange for an annual payment equal to the appreciation in value of 10 shares of XYZ Co. over the year plus the dividends, if any, paid on the 10 shares during the year. Assume also that, at the inception of the contract, LIBOR is equal to 10% and remains at 10% at the end of the first year, XYZ Co. pays no dividends, but the value of 10 shares of XYZ Co. appreciates from $100 to $115. As a result, E will receive a net payment of $5 ($15 appreciation payment netted against a $10 LIBOR

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risk of interest rate changes in each period. The credit exposure is also significantly less.

payment). E could be treated as recognizing capital gains of $5 (the net payment) or E could be treated as recognizing capital gains of $15 offset by $10 of ordinary expense. If, instead, LIBOR drops to 5% at the end of the swap so that E receives a net payment of $10 ($15 appreciation payment netted against $5 LIBOR payment), E could be treated as recognizing capital gains of $10 (the net payment actually received) or $15 offset by $5 of ordinary expense.

A second unresolved issue under current law involves the holding period with respect to any such capital gains or losses. Section 1234A provides for capital gain or loss treatment with respect to the cancellation, lapse, expiration or other termination of "a right or obligation." Section 1223 generally determines holding period by reference to the "period for which the taxpayer has held property." Arguably, the equity swap — and not the right to receive a specific payment with respect to it — is the relevant property for this purpose. A literal reading of these two sections together could lead to the conclusion that any capital gain or loss realized with respect to a plain vanilla equity swap held by a taxpayer for a period in excess of 18 months benefits from the reduced 20% rate for extra long-term capital gains, even if the payment relates to appreciation over a shorter measuring period.[20]

The Committee agrees that when a plain vanilla equity swap is compared to a series of leveraged purchases and sales of the underlying securities, a rule treating economically similar transactions consistently would allow E (the LIBOR payer) to claim an

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20 If the purpose behind reduced capital gains rates is to encourage long-term investment, this result could be justified on the grounds that the taxpayer has entered into a long-term investment. On the other hand, this reading of section 1223 would increase the tension between the tax treatment of actual and derivative ownership.

ordinary deduction for the LIBOR-based payments it makes (which are equivalent to interest on the loan). However, when a plain vanilla equity swap is compared to a package of forward contracts with respect to the underlying equities in a period when no dividends are paid on the underlying equities, equivalent treatment would require E to treat the net amount paid or received as short-term capital gain or loss. Current law appears to adopt the first approach, at least to the extent of a net LIBOR-based payment.[21]

In a period in which dividends are paid on the underlying equity securities, which either reduce E's (the LIBOR payer's) net payment or cause E to receive a net payment, some members of the Committee believe that because the naked right to receive dividend income on an equity security is not property or is not property that can give rise to capital gains, the dividend substitute payments are not described in section 1234A and therefore would not give rise to capital gains.[22] Other members of the Committee would argue that the naked right to receive dividends (i.e., a usufruct) may constitute a property right and that the property right also could give rise to capital gain or loss upon a sale by its holder. These members would nevertheless treat the periodic payments on a plain vanilla equity swap in a

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21 The source of the inconsistency between the ordinary character of interest payments under a leverage purchase and the capital character of gain or loss under a forward contract arises because forward prices include a time value component which is not required to be separately stated and treated as interest for tax purposes.

22 Cf. Saviano v. Commissioner, 765 F.2d 643 (7th Cir. 1985) (a payment made for the right to receive future income is ordinary income to the recipient). In contrast, the sale of a coupon on a debt instrument is property that can give rise to capital gains. See section 1286.

period in which the value of the underlying equity remains static as giving rise to ordinary income or expense.

In any event, the Committee agrees that a plain vanilla equity swap itself constitutes property in its own right and may be a capital asset. Accordingly, if either E or F were to sell or exchange (or assign) its rights and obligations under it, capital gains or losses would generally result under current law unless the taxpayer is a dealer. By the same token, if E and F terminate the equity swap prior to scheduled maturity and one party makes a payment to the other, E and F will generally recognize capital gain or loss under current law attributable to the cancellation or termination of rights and obligations with respect to the swap (which is "property") under section 1234A.[23]

4. A "Dividend" Swap. Under a dividend swap, one party ("G") makes periodic payments to the other party ("H") equal to an interest rate index times a notional principal amount (equal to the initial value of a specified number of shares of a publicly-traded equity security) in exchange for periodic payments equal to the dividends paid on those shares during the relevant period. The periodic payments are netted and one party makes a net payment to the other.

The Committee is divided as to the proper character treatment under current law of the periodic payments made or received under a dividend swap. Some members of the

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[23] TAM 9730007 argues that no gain or loss would arise on the sale, exchange, assignment or termination of the swap because regulations section 1.446-3(e)(2) requires daily accrual of periodic payments. However, as mentioned above in Part III.A.1., regulations section 1.446-3(e)(2) addresses only the timing of income or gain in respect of periodic payments, and does not resolve character issues.

Committee believe that because the naked right to receive dividend income on an equity security is not property that can give rise to capital gains, the dividend substitute payments are not described in section 1234A and therefore would not give rise to capital gains, and all net payments made or received under a dividend swap should give rise to ordinary income or expense. Other members would argue that the naked right to receive dividends (i.e., a usufruct) may constitute a property right and that the property right also could give rise to capital gain or loss upon a sale by its holder, and therefore that capital gains or losses may be appropriate.

In any event, the Committee agrees that a dividend swap itself constitutes property in its own right and may be a capital asset. Accordingly, if either G or H were to sell or exchange (or assign) its rights and obligations under the dividend swap, capital gains or losses would generally result under current law unless the taxpayer is a dealer. By the same token, if G and H terminate the dividend swap prior to its scheduled maturity and one party makes a payment to the other, G and H will generally recognize capital gain or loss under current law attributable to the cancellation or termination of rights and obligations with respect to the swap (which is "property") under section 1234A.

5. A "Contingent Payment" Equity Swap. Under a contingent payment equity swap, one party ("I") makes periodic payments to the other party ("J") at an interest rate index (such as LIBOR) times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security and, at maturity, agrees to pay the depreciation, if any, in those shares during the entire term of the swap. In exchange, I receives periodic payments equal to the dividends paid on the underlying shares during the

relevant period and, at maturity, a payment equal to the appreciation, if any, in the value of those shares over the term of the swap. The periodic payments are netted in each period; at maturity one party makes a net payment to the other.

A contingent payment equity swap is economically similar to a leveraged purchase of the underlying equity at the beginning of the swap and a sale of the equity security and repayment of the loan at the end of the swap.

Some members of the Committee believe that the final maturity payment under a contingent payment equity swap gives rise to capital gain or loss under existing common law or section 1234A.[24] Others believe that a payment pursuant to the original terms of an agreement should never be regarded as a termination payment. Even these members agree that if the parties to the swap agreed to terminate the swap prior to its scheduled maturity, the payment would give rise to capital gain or loss under section 1234A.

The Committee agrees that the policy reasons under current law for treating the maturity payment on a contingent payment equity swap as giving rise to capital gain or loss are very strong. However, the Committee is divided as to the rationale for this result for the same reasons applicable to a plain vanilla equity swap.[25]

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24 See Estate of Israel v. Commissioner, 108 T.C. 208, 217 (1997) ("Although no delivery or physical exchange of the underlying commodity is contemplated, the monetary settlements that occur between the respective parties holding the contract positions in forward contracts have long been recognized to constitute 'sales or exchanges' under the tax laws.").

25 As noted above, some members of the Committee believe that the result would be the same whether or not the termination is pursuant to the original terms of the contract. Other members believe that section 1234A would apply to produce capital gain or loss only if the termination is not pursuant to the contract's original terms.

In any event, the Committee agrees that a contingent payment equity swap itself constitutes property in its own right and may be a capital asset. Accordingly, if either I or J were to sell or exchange (or assign) its rights and obligations under it, capital gains or losses would generally result under current law unless the taxpayer is a dealer. By the same token, if I and J terminate the contingent payment equity swap prior to its scheduled maturity and one party makes a payment to the other, I and J will generally recognize capital gain or loss under current law attributable to the cancellation or termination of rights and obligations with respect to the swap (which is "property") under section 1234A.

6. A "Carried Interest" Contingent Swap. Under a carried interest contingent swap, one party ("K") makes periodic payments to the other party ("L") at an interest rate index (such as LIBOR) times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security and, at maturity, agrees to pay the depreciation, if any, in those shares during the entire term of the swap in exchange for at maturity, a payment equal to the appreciation, if any, in the value of those shares over the term of the swap plus an amount reflecting the dividends that were paid on the underlying equity security over the term of the swap. The dividend-based payment may be adjusted to reflect the return that would be received if the dividends were reinvested in the equity security, or may be increased to reflect a time-value-of-money return. At maturity one party makes a net payment to the other.

Some members of the Committee believes that, although current law is unclear as to the proper treatment of the portion of the maturity payment reflecting carried dividends, the better view is that the entire maturity payment gives rise to a capital gain or loss and that

the payment is not deconstructed into the portion representing ordinary income and the portion representing capital gain or loss.[26] Nevertheless, these members agree that this result is unattractive as a policy matter because it permits taxpayers to use a derivative arrangement to convert what would otherwise be ordinary income on a direct ownership interest in the underlying property into capital gains. Other members of the Committee believe that the entire maturity payment does not give rise to capital gain or loss because a payment pursuant to the original terms of the agreement never constitutes gain or loss attributable to a termination of a right or obligation within the meaning of section 1234A. Even under this view, however, an unscheduled termination shortly before scheduled maturity would produce capital gain.

B. The Timing of Payments Made Pursuant to a "Contingent Swap."

The Committee believes that, under current law, gain or loss with respect to a contingent nonperiodic payment is deferred until it is fixed under the wait-and-see approach.[27]

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26 In general, financial instruments are not generally deconstructed into their component parts for federal income tax purposes unless a specific provision (such as regulations section 1.446-3(g)(4)) so requires. But cf. Farley Realty v. Commissioner, 279 F.2d 701, 704 (2d Cir. 1960) (treating debt instrument with equity kicker as debt plus "equity interest in the property"); Richmond, Fredericksburg & Potomac R.R. v. Commissioner, 33 B.T.A. 895, 899 (1936) (treating payments on certain "guaranteed stock" in part as interest and on part as dividends).

Section 1258 does not appear to apply to the maturity payment (or any portion of it) unless substantially all of the taxpayer's expected return in the carried interest contingent swap is attributable to the time value of the taxpayer's net investment. Stated another way, section 1258 does not contemplate a deconstruction of a single financial instrument into one or more time-value-of-money components.

27 See generally Erika W. Nijenhuis, "Taxation of Notional Principal Contracts," in Taxation of Financial Instruments § 3:45 at 3-87 — 3-88 (1997).

The treatment of periodic payments made by the prospective recipient of a contingent nonperiodic payment is less clear. Some members of the Committee believe that the better view under current law would permit current deductions for the periodic payments made on a contingent payment equity swap. First, the current regulations permit current deductions for periodic payments on all NPCs (and do not provide special rules for contingent payment swaps), although the Service is clearly aware of contingent payment swaps and has expressly declined to treat them differently.[28] Moreover, in the case of a contingent payment equity swap, current deductions for periodic payments is consistent with the treatment of a leveraged purchase of the underlying equity security (a carried interest contingent equity swap, in contrast, would be more consistent with the treatment of the leveraged purchase of a prepaid forward contract[29] in respect of the underlying equity security).[30]

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28 Treasury Decision 8491, 1993-2 C.B. 215, 216 ("The IRS expects to address contingent payments in future regulations.").

29 There is some division among the Committee members as to whether "prepaid forward contracts" constitute a separate recognizable category of financial instruments for federal income tax purposes. Some members would argue that these instruments are more properly characterized either as CPDIs or as giving rise to deemed interest income under section 7872. Accordingly, these members do not believe that comparisons to prepaid forward contracts are convincing. A majority of the Committee believes that prepaid forward contracts do constitute a recognizable category of financial instruments. These members argue that prepaid forward contracts do not provide for a "sum certain" (and therefore do not constitute indebtedness for federal income tax purposes), and are not otherwise described in section 7872 or the regulations promulgated or proposed thereunder. These members maintain that the treatment of prepaid forward contracts as a class of financial instruments distinct from debt, and the absence of interest imputation to their holders (and deduction by their issuers), represents the logical extension of the principles governing option premium.

30 Economically, a contingent payment equity swap is more consistent with a leveraged purchase of the underlying equity security followed by a sale than a leveraged purchase

(continued . . .)

Other members of the Committee disagree. These members argue that the tax consequences of a financial instrument should not necessarily be governed by the consequences of other "equivalent" instruments or combinations of instruments, and argue that permitting a taxpayer current deductions for periodic payments in respect of deferred income pursuant to a single financial instrument represents a material distortion of income.[31] These members maintain that section 446 provides no support for an approach that would apply "clear reflection of income" principles by analogy to other financial instruments or combinations of instruments, unless these other instruments clearly reflect income. Moreover, these members

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of a prepaid forward contract because a contingent payment equity swap provides for dividend substitute payments (which would not be received by the holder of a prepaid forward contract). Alternatively, a contingent payment swap could be compared to a leveraged purchase of a CPDI. In this case, the taxpayer's interest deductions on the borrowing would be largely or entirely offset by OID inclusions at the issuer's comparable yield on the CPDI. A carried interest contingent swap is more consistent with a leveraged purchase of a prepaid forward contract with an adjustment to the forward price on account of dividends paid (followed by a sale) because current dividend substitute payments are not received.

In any case, for an individual taxpayer, if the periodic payments on an NPC are treated as miscellaneous itemized deductions (as a majority of the Committee believes is the case under current law), the tax treatment of a contingent payment equity swap under current law may very likely be worse than an actual leveraged purchase of the underlying equity or even an actual purchase paid in installments. Itemized miscellaneous deductions are subject to the 2% floor under section 67 and other limitations under section 68. (In contrast, interest payments on an actual leveraged purchase could be entirely deductible to the extent of the individual's investment income. Section 163(d).) Moreover, miscellaneous itemized deductions are not deductible for purposes of the alternative minimum tax. Section 56(b)(1)(A)(i).

31 Treasury regulations section 1.446-3(i). Arguably, this authority would be more clearly applied where the taxpayer could not achieve equivalent treatment through an actual leveraged purchase (such as a leveraged purchase of PFIC stock) and less clearly applied where the cash flows on the swap match the cash flows on an actual leveraged purchase of the underlying asset and an actual leveraged purchase would permit current deductions and deferred capital gain.

assert that comparisons between an actual leveraged purchase and an equity swap are inappropriate in light of the special rules applicable to interest expense (such as section 163(d) and regulations section 1.861-8) that ultimately affect both the timing and amount of interest deductions.

Nevertheless, the Committee does acknowledge that, if taxpayers are permitted to deduct the periodic payments on a carried interest contingent equity swap, but to defer inclusion of the dividend equivalent payments until maturity, the tax treatment of a carried interest contingent swap would compare favorably to the leveraged purchase of the underlying equity. On the other hand, if the taxpayer is not permitted current deductions and full deferral, the tax treatment of a carried interest contingent swap would be worse than that of the leveraged purchase of a prepaid forward contract with a dividend adjustment formula or an option whose exercise or settlement price reflects a similar mechanism.[32]

IV. Alternative Character Regimes for NPCs.

A. Fundamental Threshold Issues.

The development of a regime to address the character treatment of NPCs requires preliminary consideration of the policies underlying the current distinction between

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[32] Certain legislation introduced by Representative Barbara B. Kennelly on February 5, 1998 (the "Kennelly Bill") would treat all or a portion of any gain on certain of these transactions as short-term capital gain and would impose an additional tax in the nature of an interest charge on such short-term capital gain. The Kennelly Bill will be the subject of a separate report by the Tax Section. This report assumes that a prepaid forward contract constitutes a recognizable category of financial instrument for federal income tax purposes. Some members of the Committee disagree with this conclusion. See note 26 and Part VII.

ordinary and capital treatment, and the comparative treatment of other financial instruments under current law.

There are two principal policy justifications for the distinction between ordinary and capital treatment. First, reduced rates of tax for individuals recognizing long-term capital gain are designed to encourage long-term "investment" in capital-formation enterprises and assets.[33] This policy justification applies most clearly where an individual invests after-tax income directly in equity or debt securities (or other real or tangible property), holds the asset for a long-term period and then sells the asset in a taxable transaction.

However, the benefit of reduced capital gains rates historically has been permitted under circumstances where the policy of encouraging long-term capital-formation investment is less clearly advanced. For example, reduced rates are permitted in respect of gains recognized by an individual taxpayer who borrows all or substantially all of his or her net investment and deducts interest on the borrowing. Second, the benefit is also permitted for derivative instruments such as options or forward contracts for which the taxpayer's "investment" is significantly less than that which would be necessary for a direct ownership

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[33] The Joint Committee on Taxation identified five reasons justifying preferential rates for capital gains: (i) preferential capital gains rates encourage investors to provide venture capital for new companies, thereby stimulating investment in productive business activities, (ii) preferential capital gains rates are designed to encourage household savings, (iii) lower rates impose a smaller cost on redirecting monies from older investments to projects with better prospects, allowing for more efficient allocation of capital, (iv) because the United States' major trading partners have preferential capital gains rates, U.S. individual taxpayers would be at a competitive disadvantage without them, and (v) preferential capital gains treatment on a disposition of corporate stock ameliorates the double taxation of retained corporate earnings. See Joint Committee on Taxation, Present Law and Background Relating to Taxation of Capital Gains (February 6, 1998).

interest. Third, current law permits the benefit of reduced capital gains rates even if the derivative is cash-settled and is never invested in the underlying securities.[34] Finally, in the case of options, the benefit of reduced rates is permitted for the individual taxpayer's entire amount of gain, even though option pricing typically reflects a time-value-of-money component for which our federal tax law does not permit favorable rates.[35]

Since an NPC represents at least as much of a cash outlay as a forward contract, and a contingent payment equity swap is economically similar to a leveraged purchase of the underlying stock, it would appear from the taxpayer's perspective that a sufficient investment has been made to justify capital gain treatment upon the sale or exchange of an NPC held as a capital asset, or for a net NPC payment received in respect of the appreciation in an underlying capital asset.

Nevertheless, when compared to a direct investment in debt or equity securities (or some other capital-formation investment such as real or personal property), the policies behind reduced rates for long-term capital gains are less clearly advanced with respect to NPCs. First, notwithstanding the similarities to leveraged purchases, options and forward contracts, the reduced outlay of capital required to invest in NPCs might be viewed as insufficient to justify the reduced rates. Second, NPC investment through a financial

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34 See, e.g., section 1234(c)(2).

35 Section 1256 is anomalous because it effectively permits individual taxpayers a reduced rate of tax for short-term gains on certain exchange-traded futures and options contracts (effectively at 27.84%, representing 60% long-term capital gains and 40% short-term capital gains), and denies these taxpayers the reduced 20% extra long-term capital gains rate for long-term investments.

institution might be regarded as less directly related to capital-formation than a direct investment in stocks, securities, or real or tangible personal property. Third, to the extent that reduced capital gains rates on the sale of corporate stock are justified as an amelioration of corporate level taxation of retained earnings, this policy is not advanced by allowing capital gains rates for nonownership equity derivatives. Finally, because the taxpayer's counterparty on an NPC is likely to be a securities dealer on a mark-to-market system that will not suffer capital losses to offset the taxpayer's capital gains, permitting reduced capital gains rates for NPCs might result in greater revenue loss for the fisc than that suffered by allowing reduced capital gains rates for direct investment in capital-formation enterprises or assets.

Thus, it would be reasonable to conclude that the policy reasons to permit reduced capital gains rates are less strong for NPCs than for direct investment in capital assets. Nevertheless, all of these objections apply equally to options and forward contracts, and selective denial of capital gains rates for NPCs would effectively penalize taxpayers that invest in them and would distort otherwise purely economic decisions. The contingent payment debt instrument ("CPDI") regulations, which deny individual holders reduced capital gains rates for CPDIs, have been criticized on this ground.

A second purpose served by character distinctions (in addition to encouraging long-term investment in capital assets) is to prevent taxpayers from "cherry-picking" capital losses (which are generally recognized at the taxpayer's discretion) to offset ordinary income (which is generally less subject to a taxpayer's manipulation while deferring realization of capital gains). Accordingly, capital losses are not generally available to offset ordinary

income.[36] Since the sale, exchange, assignment, or unscheduled termination of an NPC is also an event within a taxpayer's control, even if it is decided that NPCs (or certain classes of NPCs) should not benefit from reduced capital gains rates, and therefore should give rise to ordinary gains and losses, it would also be necessary to adopt a loss limitation rule to prevent taxpayers from selectively realizing losses on NPCs to offset ordinary income from other sources, while deferring realization of gains.[37]

With these policies and concerns in mind, we suggest two alternative character regimes for NPCs. The first regime would treat as capital any gain or loss recognized on an NPC to the extent it is attributable to changes in the value of an underlying capital asset. This regime would more closely align NPCs with the treatment of leveraged purchases of capital assets, options and forward contracts, and would therefore avoid the economic distortive effect of dramatically different tax treatment for economically similar financial instruments. If this regime is adopted, the Service might consider also amending the CPDI regulations to permit capital gains treatment, to the extent the aggregate contingent payments exceed projections.

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36 On the other hand, overzealous application of the capital loss limitation rule imposes a hardship on taxpayers that use "capital assets" to hedge their business income. Regulations under section 1221 address some, but not all, of these concerns.

37 Taken to its logical extreme, if the sale, exchange, assignment or unscheduled termination of an NPC gives rise to ordinary gain or loss, the absence of a loss limitation rule would permit taxpayers to maintain a balanced portfolio of "long" and "short" NPC positions that are not positions in a straddle, wait until one of the positions decreases in value, terminate it in a year the taxpayer has recognized ordinary income from other sources, claim the current ordinary loss to offset the ordinary income, and recognize the offsetting ordinary gain in a future year. If the loss had been a capital loss, it could not generally offset the ordinary income. (It is, however, unclear to us whether the additional costs of an NPC, as opposed to a direct investment, would justify the benefits of such a strategy.)

The second regime would deny individual taxpayers reduced capital gains rates for net gain in respect of an NPC (and generally simplify the taxation of NPCs) by treating all gain or loss in respect of an NPC as ordinary gain or loss, subject to a loss limitation rule. However, before this regime is adopted, we recommend a reevaluation of the character treatment of all derivatives, and leveraged assets, to determine whether the tax policies are sufficiently strong to allow reduced capital gains rates for these other financial instruments and assets. In Part VII, we encourage the Service to consider character and timing issues for financial instruments in a comprehensive manner, but discussion of the tax treatment of financial instruments (other than NPCs) is beyond the scope of this report.

Finally, both of the regimes could be adopted and each made elective, which would avoid character mismatch issues for taxpayers using NPCs as business hedges (and are not otherwise able to integrate) but otherwise would permit individuals reduced capital gains rates for the appreciation in underlying capital assets. In the event an elective regime is adopted, we would require the election to be made on or before the date an NPC is entered into, but we would allow the election to be made on an NPC by NPC basis.

B. Capital Treatment for Value Payments.

Under the first regime, taxpayers would treat the net amount of any payments received in a taxable year under the NPC as capital gain to the extent of any "value payments" received, and the net amount of any payments made in a taxable year under the NPC would constitute capital loss to the extent of value payments made. The remaining amount, if any,

paid or received ("ordinary payments") would be treated as ordinary expense or income.[38] We would, therefore, recommend that current law be changed so that such amounts are not treated as miscellaneous itemized deductions.[39]

The effect of this regime would be to allow a full offset of ordinary payments received on the NPC (such as dividend substitute payments) against ordinary payments made (such as LIBOR-based floating payments), which is consistent with the current law treatment of a taxpayer that borrows to purchase the underlying asset. However, in certain circumstances, taxpayers' treatment would be different than their treatment had they borrowed to actually purchase the underlying asset. These differences are illustrated in Appendix B.

A "value payment" for these purposes would be the portion of any gross payment made or received pursuant to an NPC to the extent that such portion is measured by reference to the value of property that is (or on acquisition would be) a capital asset in the hands of the taxpayer. Payments that represent dividend or interest payments on underlying securities would not qualify as value payments. However, if amounts representing dividends or interest are treated pursuant to the NPC as reinvested in assets that would qualify as capital assets, then the portion of any gross payment reflecting the change in value of the reinvested amount would be treated as a value payment.[40] We would also exclude from the definition of

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38 Sections 475 and 988 and Treasury regulations sections 1.1275-6 and 1.1221-2 would trump the regime we propose.

39 Our reasoning for this recommendation is described below in Part IV.E.2.

40 This treatment of the reinvested amount would be subject to any statutory amendment discussed below in Part V.D. that would treat all contingent nonperiodic payments as giving rise only to ordinary income, or the Kennelly Bill.

value payment any payment substantially all of the amount of which is attributable to the time value of money.[41] A payment that otherwise qualifies as a value payment would not be disqualified as a value payment because it provides for a floor, unless there is no reasonable likelihood that payments will exceed the floor.

Payments that would qualify as value payments but are fixed more than six months before being paid would be discounted at the payer's "comparable yield."[42] The discounted payment would qualify as a value payment but the balance would be treated as an ordinary payment.

We would require taxpayers and their counterparties, to a reasonable extent, to "deconstruct" NPCs into their relevant components in order to quantify the extent of value and ordinary payments. For this purpose, we would apply a look-through rule for NPCs that reference the value of equity interests in entities to the extent that the relevant information is reasonably available to either party to the contract. We would not, however, require inquiry into the assets held by an entity that is treated as a C corporation for federal tax purposes.

We would determine the holding period (for purposes of capital gains rates) of any net capital gain by reference to the period over which the value is measured (but not in excess of the period from the date the NPC is entered into until the date the payment is

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41 Accordingly, a payment based on the accreted value of a zero coupon bond would not be treated as a value payment. Moreover, no value payments would arise in respect of a plain vanilla interest rate swap (or its equivalent) even if payments are based on actual prices for certificates of deposit.

42 See Treasury regulations section 1.1275-4(b)(4) (defining comparable yield).

fixed).[43] We would exclude for this purpose any period during which the economic risk of changes in value is diminished (under a standard analogous to that under regulations section 1.246-5) in comparison to prior periods under the swap.[44]

In addition, under this regime, a sale, exchange or assignment, or any cancellation, lapse, expiration or termination of an NPC that is not made pursuant to the NPC's original terms (and any other similar payment in respect of the NPC) would give rise to capital gain or loss, on the one hand, and ordinary income or expense, on the other, to the same extent that capital or ordinary treatment would apply with respect to amounts that have been fixed under the NPC.[45] Otherwise, all gain or loss would be capital gain or loss.

If this regime is adopted, we would require (i) any information returns exchanged by the parties to consistently report the portion of each gross payment that represents a value payment (and the appropriate holding period) and the portion that represents

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43 For example, if a taxpayer enters into a two-year swap providing for a contingent nonperiodic payment based on the change in value of IBM over the first year and of AT&T over the second year, any capital gain or loss would be short-term capital gain or loss.

Holding periods would be subject to the straddle rules. See proposed Treasury regulations section 1.1092(d)-2 (treating stock and an offsetting NPC as positions in a straddle).

44 Accordingly, if a taxpayer enters into a two-year equity swap where a contingent nonperiodic payment is based on 100% of the change in value of IBM over the first year and 5% of the change in value of IBM over the second year, any capital gain or loss would be short-term capital gain or loss.

45 Thus, a taxpayer could not transfer an NPC immediately prior to maturity and achieve capital gains treatment in respect of accrued ordinary payments. However, we would not otherwise require taxpayers to separately allocate proceeds from the sale or exchange of an NPC between capital and ordinary treatment.

an ordinary payment, and (ii) consistent reporting of any other gain or loss in respect of the NPC (i.e., payments made to or received from third parties).

C. Ordinary Treatment For All NPC Payments.

Under this regime, all payments (whether periodic or nonperiodic) made or received pursuant to the original terms of an NPC would give rise to ordinary income or expense. In addition, all gain or loss on the sale, exchange, assignment, cancellation, lapse, expiration or termination of an NPC would give rise to ordinary gain or loss. All expense and loss incurred pursuant to the original terms of an NPC would be fully deductible without limitation.

However, any loss realized upon the sale or exchange or unscheduled termination of an NPC would be deductible only to the extent of the excess of (a) all gains and income from all NPCs for the year, including periodic payments received (whether or not value payments) and all gains from scheduled or unscheduled terminations, sales or assignments over (b) all losses and expenses from NPCs other than "unscheduled" losses, including periodic payments made and gains and losses from scheduled terminations. Any losses not deductible against other NPC gains or income (an "excess NPC loss") would be carried forward indefinitely, and could, at the taxpayer's election, be used to offset capital gains.[46]

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[46] We believe that the loss limitation rule described in text should be sufficient to protect against "cherry-picking" of losses to offset unrelated ordinary income. A more restrictive regime would permit unscheduled losses on NPCs to offset only "value payments" (generally as defined for the capital treatment regime) in respect of NPCs or capital gain from other sources.

(continued . . .)

Under either regime, we would retain the rule of regulations section 1.446-3(g)(4) that treats a swap with a significant noncontingent nonperiodic payment as an on-market, level payment swap and a loan, and we would continue to treat the interest payable on the deemed loan as interest for all federal tax purposes.

D. Application of the Alternative Regimes to Specific NPCs.

1. A Plain Vanilla Interest Rate Swap. Adoption of the capital treatment regime would have no effect with respect to payments between the parties pursuant to the original terms of a plain vanilla interest rate swap (because no portion would constitute a value payment). However, on the sale, exchange, assignment or unscheduled termination of the NPC, fixed amounts that if paid would constitute ordinary payments would be treated as deemed ordinary payments, but otherwise the taxpayer would recognize capital gain or loss.

Under the ordinary treatment regime, all net payments under a plain vanilla interest rate swap would give rise to ordinary income or expense. However, in a change from current law, any gain or loss on the sale, exchange or assignment of the NPC (or any other section 1234A transaction) would also give rise to ordinary gain or loss (but the loss would be subject to the loss limitation rule).

2. The Commodities Swap Considered in TAM 9730007. Under the capital treatment regime, the entire amount of the floating-rate payment made by C (the fixed

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We note that adoption of this ordinary treatment regime for NPCs but not for other financial instruments (such as options, forwards and futures contracts) would increase the tension between the tax treatment of economically similar financial instruments. In Part VII below, we recommend that the Service consider the tax treatment of financial instruments in a comprehensive manner. However, the treatment of these other financial instruments is beyond the scope of this report.

payer) would qualify as a value payment because it is determined by reference to the value of an asset that would be a capital asset in the hands of C. Accordingly, the entire net amount received or paid in each period would give rise to capital gain or loss. Any gain recognized in the first year would be short-term capital gain, any gain recognized in the second year would be long-term capital gain, and any gain recognized after 18 months would be extra long-term capital gain entitled to the reduced 20% rate.

Under the ordinary treatment regime, all payments under the commodities swap described in TAM 9730007 would give rise to ordinary income or expense and any gain or loss on the sale, exchange, or assignment of the swap (or any other section 1234A transaction) would also give rise to ordinary gain or loss (subject to the loss limitation rule).

3. **A Plain Vanilla Equity Swap.** Under the capital treatment regime, in any taxable year that E (the floating-rate payer) receives net payments, to the extent those payments reflect appreciation in the value of the underlying equity, E would report capital gain. If in a taxable year, E makes net payments to F, to the extent those payments reflect depreciation in the underlying equity, E would report capital loss. Because each value payment reflects a change in value of the underlying equity over a single year, all such capital gains or losses would be short-term gain or loss. Otherwise E would report ordinary income or expense. These consequences are illustrated in Appendix B.

E. Corresponding and Collateral Changes.

1. **Corresponding Changes to the Straddle Rules.** Regardless of the regime that is adopted, we would amend the straddle rules to provide that a taxpayer may deduct net ordinary expense on a NPC that is a position in a straddle only to the extent of

ordinary inclusions on other positions making up the straddle in the taxable year or a prior year that the straddle was in place.[47] Ordinary expense that is not utilized until the straddle is terminated would increase the taxpayer's basis for purposes of determining gain or loss with respect to the position that is last disposed of.[48] We recommend that this treatment be implemented by statutory amendment to section 263(g).

If the capital treatment regime is adopted, capital gain would be included under the rules discussed above, but capital loss would be deferred until all unrealized gain in the other straddle positions (including the NPC) is recognized. This rule could be implemented by regulations under section 1092.

2. Treatment of Ordinary Expense In Respect of an NPC. As mentioned above, regardless of the regime that is adopted, we would not treat net ordinary expense in respect of an NPC as an miscellaneous itemized deduction. If either of the two timing regimes we propose (i.e., the "full allocation method" or the "noncontingent swap method") is adopted, we would not subject the net ordinary expense in respect of an NPC to any limitation on deductibility. However, if the "deduction/deferral method" is adopted, we would treat any

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47 However, expenses otherwise allowable in connection with a short sale that is part of a straddle with an NPC could be used to offset the NPC income.

48 Accordingly, a taxpayer would not be permitted to purchase a derivative that provides a long position with respect to the S&P 500 and an NPC that provides a short position with respect to the S&P 500, make a capital treatment election with respect only to the long position, wait until the S&P 500 appreciates and at that time claim a capital gain on its long position and an ordinary expense or loss on the NPC.

net ordinary expense in respect of an NPC as if it were investment interest expense, but solely for purposes of applying the limitation on deductibility imposed by section 163(d).[49]

The deduction limitations imposed on miscellaneous itemized deductions are best understood as a "rough justice" response to certain expenses (such as safety deposit box fees, subscriptions to *The Wall Street Journal* and similar publications, and an employee's unreimbursed business-related meals and entertainment) that have elements of a business but also a personal nature, and serve as a rule of administrative convenience to avoid recordkeeping for small amounts.

Treatment of an expense as a miscellaneous itemized deduction may deny an individual taxpayer the benefit of deductions if the taxpayer's total miscellaneous itemized deductions do not exceed the 2% floor imposed by section 67. In addition, this treatment sometimes (depending on the relationship between adjusted gross income and total itemized deductions subject to the limitation) denies high-income individual taxpayers the benefit of a full deduction under the 3% limitation imposed by section 68. Miscellaneous itemized deductions also are not deductible for AMT purposes.[50]

In contrast to miscellaneous itemized deductions, an individual taxpayer's investment interest expense is fully deductible to the extent of the taxpayer's net investment

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[49] This section 163(d) expense limitation rule would apply only to net ordinary expense in respect of scheduled payments. If the ordinary treatment regime is adopted, loss would be subject to the loss limitation rule.

[50] Section 56(b)(1)(F).

income.[51] This limitation achieves a matching of a taxpayer's overall investment expense with the income generated from investments and prevents taxpayers from taking current ordinary deductions in respect of investments that generate deferred long-term capital gain.

Whether payments on an NPC should be subject to section 163(d) depends on the timing rules that apply to contingent payment swaps. In Part V.B. below, we suggest two alternative timing regimes (the "full allocation method" and the "noncontingent swap method") that would not permit current deductions in respect of unrealized gain. Accordingly, if the Service adopts one of these two alternative regimes, we believe that there is no policy reason to extend section 163(d) to apply to NPCs payments. If, however, our recommendations are not adopted, and taxpayers are permitted to deduct periodic payments on contingent swaps without accruing into income the projected amounts of contingent payments, we recommend that section 163(d) be amended to treat NPC payments as subject to the investment interest limitation. This treatment would be solely for purposes of section 163(d) and not for purposes of other special rules in the Internal Revenue Code dealing with interest.

3. **Integration Authority and Disaggregation Ability.** If the capital treatment regime is adopted, we would provide the Service with authority to integrate for purposes of applying these character rules to two or more NPCs, or an NPC and some other financial instrument, that are entered into with a principal purpose of avoiding these rules.[52] Until a consistent comprehensive regime is developed for the taxation of financial instruments

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[51] Section 163(d).

generally, we would not extend this authority to permit the Service to integrate for these purposes two or more financial instruments that qualify for federal income tax purposes as instruments or contracts that are not NPCs.[53] Accordingly, the Service would not have the authority to construct NPCs for purposes of these rules from options, forward contracts, or debt instruments or to recharacterize one of these other types of financial instruments for purposes of applying these rules to them.

F. Implementation of the Proposed Regime.

A number of members of the Committee believe that the treatment of all payments on an NPC as ordinary income or expense is inconsistent with the better view under current law, that the provision for a capital treatment election probably exceeds the Service's regulatory authority, and that ordinary income or expense treatment in respect of a third party payment, a negotiated termination payment, or a scheduled nonperiodic payment is contrary to current section 1234A. Accordingly, we believe that the regime we suggest should be implemented by Congress.

G. Alternative Regimes Considered and Rejected.

1. Ordinary Treatment In Respect of Payments Made to or Received Pursuant to the Original Terms of the NPC; Capital Gains or Losses Under Current Section 1234A or In Respect of Payments Made to or Received From Third Parties. We

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52 Broader authority was proposed by the Treasury Department on February 2, 1998. See General Explanations of the Administration's Revenue Proposals 53 (February 2, 1998) (hereinafter, the "February Proposals").

53 Thus, we would restrict the apparently unfettered authority proposed in the February Proposals at 194.

considered and rejected an approach that would treat as ordinary income or expense all net payments made or received pursuant to the original terms of the NPC (whether periodic or nonperiodic) but would treat the sale or exchange of an NPC (or some other section 1234A transaction) as giving rise entirely to capital gains or losses. Although this treatment has some support in the historic tradition of our tax law, it permits well-advised taxpayers to achieve the most favorable tax treatment based on post hoc decisions and presents a trap for unadvised taxpayers that receive a net maturity payment on an NPC without first assigning to a third party. We believe that the recent amendments to section 1234A reflect a Congressional decision to prevent taxpayers from benefiting from post hoc decisions and we agree that this decision represents prudent tax policy.

2. **Ordinary Treatment for Periodic Payments; Capital Treatment for Nonperiodic Payments.** We considered and rejected an approach that would treat all periodic payments as giving rise to ordinary income or expense but all nonperiodic payments as giving rise to capital gain or loss. Although this rule would be simple to apply, it would create an economically artificial distinction between a payment made at intervals of one year and payments made every year-and-a-day. Moreover, it would permit taxpayers to generate capital gains that would not otherwise arise for non-NPC financial instruments.

V. Proposed Timing Regime for Contingent Payment Swaps.

A. Fundamental Threshold Issues.

Our federal income tax law has developed a number of conflicting timing regimes for taxing different financial instruments, which makes it particularly difficult to develop a "correct" regime for taxing contingent payment swaps. For example, it is possible

to develop a regime for taxing contingent payment swaps by analogy to a taxpayer who borrows funds at a floating rate of interest to purchase an equity security, holds the equity security for the term of the loan, and then sells the equity and uses the proceeds to repay the loan. The cash flows for such a taxpayer might very well be identical to those for a taxpayer who enters into a contingent payment equity swap. Similar tax treatment for economically similar financial arrangements would suggest that the floating-rate payer on such a contingent payment equity swap should be entitled to current deductions for the excess of any floating rate payments made over dividend substitute payments received (subject, perhaps, to section 163(d) limitations) and deferral of any appreciation payment until maturity.

Alternatively, it is possible to develop a regime for taxing contingent payment swaps by analogy to a swap that provides for a noncontingent nonperiodic payment. Regulations section 1.446-3(f)(2)(iii)(B) provides a method for accruing a noncontingent nonperiodic payment, which could be applied to contingent nonperiodic payments by estimating the amount of any contingent payments, accruing the estimate based on the method described in regulations section 1.446-3(f)(2)(iii)(B) and then adjusting the inclusion based on the actual amount of the contingent payment. This method would tax contingent swaps identically to noncontingent swaps whenever the estimate is accurate.

Third, if the appropriate analogy for taxing contingent payment swaps is by reference to a taxpayer that borrows at a floating rate of interest to purchase a CPDI, the taxpayer's interest deductions on the floating-rate borrowing would be largely or entirely offset by OID inclusions at the issuer's comparable yield on the CPDI.

Fourth, it is possible to view a contingent payment equity swap as a series of "mini-CPDIs." If this is the appropriate comparison, not only would a floating-rate payer generally be denied a deduction for each net payment, but the payer would be required to accrue OID on each payment until the contingency is resolved,

Finally, one could reject reasoning by analogy to multiple financial instruments as the basis for developing a regime to tax a single financial instrument, and instead attempt to determine and apply "first principles" of clear reflection of income to contingent payment swaps. Based on the principle that denies taxpayers current deductions for option premium (including option premium paid in installments), one could conclude that no deduction should be permitted for net periodic payments made on a contingent payment swap until all contingencies are resolved. Moreover, based on the principle that deems the recipient of dividends as recognizing current income even though an ultimate loss on the investment might be suffered, one could conclude that any net periodic payments received should be included currently.

Although the Committee is divided over the relevant reference point for taxing contingent payment swaps, it agrees that the development of a taxing regime for contingent payment swaps should be informed by a comparison of the relative tax consequences of each possible approach. Part V.B. and Appendices C, D, and E attempt to further explain five plausible approaches to taxing contingent payment swaps and to quantify the relevant tax consequences to the parties.

We suggest that the Service consider the "noncontingent swap method," or the "full allocation method" (described in Part V.B.) as the basis for taxing contingent payment

swaps. We would also allow taxpayers to elect to mark any NPC to market. This elective regime is discussed in Part V.C. We cannot recommend the deduction/deferral method and strongly recommend against the nonallocation and mini-CPDI methods.

B. Alternative Approaches Available.

For purposes of illustration and comparison, assume that I and J enter into a two-year contingent payment equity swap under which I makes semi-annual payments to J at a rate equal to LIBOR + 2.00% times a notional amount of $975.04 (equal to the closing price of the S&P 500 Index on December 31, 1997) and, at the maturity of the swap, I agrees to pay to J the depreciation, if any, in the S&P 500 Index over the swap's two-year term. In exchange, J agrees to pay I semi-annually the dividend yield on the S&P 500 Index and, at maturity, to pay I the appreciation, if any, in the S&P 500 Index over the swap term.[54] This Part V.B. assumes that neither party is a securities dealer for federal income tax purposes and that each party makes a capital treatment election. Appendix C to this report illustrates the cash flows and tax consequences to the parties of such a swap under the first four approaches described below. (Appendix C does not describe the consequences of the fifth approach.)

1. The "Noncontingent Swap" Method. Under this approach, the parties to the swap would estimate the amount of any nonperiodic contingent payments under the swap, would treat the estimate as if it was a nonperiodic noncontingent payment, and would

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[54] LIBOR + 2.00% is assumed to be the rate at which J would loan $975.04 to I for a two year term; 1.60% is assumed to be an estimate of the dividend yield on the S&P 500 Index over the term of the swap (1.60% was the actual dividend yield on the S&P 500 Index in 1997).

amortize the estimate under the method described in regulations section 1.446-3(f)(2)(iii)(B) and (f)(4), Example (6).

More specifically, first the estimate would be present valued based on the rate used by the parties to price the swap. This present-valued estimate would be treated as an upfront payment on the swap that is amortized under the "level payment" method described in regulations section 1.446-3(f)(2)(iii)(B). Accordingly, the amount that represents the annual principal components of a level-payment installment obligation issued for the present-valued estimate and providing for interest at the rate used by the parties to price the swap would be included in income each year by the expected recipient of the contingent payment (e.g., I), and an equal amount would be deducted by the expected payer (e.g., J).

In addition, J would be treated, solely for timing purposes, as having issued to I a zero coupon bond with an issue price equal to the present-valued estimate, and a stated redemption price at maturity equal to the estimate of the contingent payment. Accordingly, I would also include in income each year the amount of OID that would accrue on such a zero coupon bond in that year. (The sum of the annual accrued "principal components" described in the preceding paragraph plus the sum of the annual accrued "OID accruals" described in this paragraph equal the total estimated contingent payment.) Under this method, net payments made or received by either party (after taking into account the accrual of the estimated contingent payment) would be entirely deductible, subject to the principles of section 163(d).

The "estimate" for purposes of the accrual could be determined under one of several methods. First, the parties could use market forward or futures rates for the subject index to estimate the contingent payment. For example, if on January 2, 1998, the parties

entered into a two-year contingent payment swap based on the S&P 500 Index with a notional principal amount of 975.04 (equal to the value of the S&P 500 Index on that day), the estimate under this method would be equal to 1061.70 (because that was the price of a two-year futures contract on the S&P 500 Index maturing on December 31, 1999).[55] (This method is referred to as Noncontingent Swap Method 1 in Appendix C.) Using actual market forward or futures rates would provide an objective measure of expected future values. However, because the implied internal rate of return reflected by market forward or futures prices is significantly less than the yield that I would expect to receive from the swap, the estimate derived under this method is likely to be less than I would expect to break even, and therefore could result in a perceived underaccrual.

Alternatively, the parties could estimate the contingent payment by projecting the final contingent payment under the swap to be equal to the sum of the future values of the net periodic payments that I expects to make.[56] (This method is referred to as Noncontingent

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55 These are the numbers used in the spreadsheet that is Appendix C to this Report.

56 In the spreadsheet that is Appendix C to this report, the gross periodic payments to be made by I are one-year LIBOR + 2.00% (which on January 2, 1998 was 7.94% on a simple interest basis or 7.654% on a compounded basis with semi-annual accrual) and the gross periodic payments are the expected dividend yield on the S&P 500 Index (which in 1997 was 1.60%). Accordingly, I would expect to make net periodic payments equal to 6.34% (7.94 - 1.60). The discount rate used is 7.654%.

A third method would estimate the contingent payment based on the forward pricing formula [futures price/$(1+r)^t$ = spot price - present value of foregone dividends, where r is the periodic interest rate and t is the number of periods until settlement]. See Brealey & Myers, Principles of Corporate Finance 638 (1995). This method is referred to as Noncontingent Swap Method 3 in the spreadsheet that is Appendix C to this Report.

Swap Method 2 in Appendix C.) This estimate would achieve a better matching of the parties' expectations with their tax consequences because, by the time the contingent payment is due, I will have accrued into income an amount that exactly equals the amount that would be required to be received by I to "break even" (and J will have deducted an equal amount), excluding dividend payments.[57] We would expect, even if using market values is preferable to future valuing I's expected net periodic payments, that this second method would apply in the absence of market benchmarks.

In the year a contingency is resolved, the estimated (and therefore accrued) amount would be treated as an ordinary payment made by I in that year.[58] Thus, if I receives a net payment in the year of the swap's maturity, and that maturity payment exceeds the estimated payment, I would recognize gain (which would be capital gain if the capital treatment regime is adopted) to the extent of the appreciation in the S&P 500 Index. (Conversely, J would recognize capital loss in an equal amount.) This approach would effectively treat the parties as if the swap provided for J to make a noncontingent nonperiodic payment to I in an amount equal to the estimate of such payment in the year the contingency is resolved.

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57 In the spreadsheet that is Appendix C to this Report, this amount is 130.85.

If the forward pricing formula was used, this amount would be 123.26 because $1098.61/(1+3.823\%)^4 = 975.04 - 29.52$ [where 29.52 is the present value of foregone dividends computed by using 7.645% as a discount rate, with semi-annual compounding], and 1098.61 - 975.04 is 123.57.

58 The same treatment would occur to the extent of the accrual for a party that assigns, disposes of or terminates a contingent payment swap prior to maturity.

Appendix C-1 explains in greater detail the mechanical application of this approach to the example.

This approach better matches I's deductions and inclusions than does the deduction/deferral approach (discussed below) if I actually receives a maturity payment from J. Moreover, this approach has the virtue of taking into account as increased or reduced income for the year differences between actual and expected floating rate and dividend payments. Thus, this approach more accurately measures actual economic income each year than the full allocation method, which does not permit such differences to be taken into account on a current basis. Because this approach permits the taxpayer to take deductions currently to the extent that floating rate payments made exceed those expected when the swap was entered into, it does not create an incentive for a taxpayer in this position to terminate the swap early to recognize that expense. An approach, such as the full allocation method, that requires deferral of floating rate payments that are higher than expected would created such an incentive.

However, the consequences of the noncontingent swap method are entirely dependent upon the accuracy of the contingent payment estimate. For example, as illustrated in Appendix C, if the contingent payment of a two-year swap on the S&P 500 Index is estimated using the market price of a two-year futures contract, the noncontingent swap method produces results that are always more favorable than the "full allocation method" described below.

In addition, this approach would also present some additional complexity to determine the estimate and to schedule the accrual.[59] If J is a securities dealer that marks-to-market the swap against an offsetting position, the parties' interest in correctly estimating the contingent payment would not be adverse and a low estimate would reduce I's effective tax rate without increasing J's. Accordingly, this approach might be expected to increase disputes between taxpayers and the Service.[60]

2. **The "Full Allocation Method."** Under the full allocation method, I would be entitled to fully offset any ordinary payments made by I in the taxable year against any ordinary payments received in such year, but I would not be permitted to claim a current deduction for any excess.[61] Conversely, J would not include net payments received in income, but would defer its gain or loss until the final contingency is resolved. When the final contingency is resolved, the parties would treat the deferred ordinary payments as ordinary

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59 The parties to a swap would be required to estimate the contingent payments to be made (a calculation which the parties would not necessarily make in order to price the swap). In addition, because futures contracts on the S&P 500 Index extend only for a two-year period, S&P 500 contingent payment swaps of longer maturity would necessarily involve estimates.

60 If the estimate is equal to the future values of the net periodic payments that I expects to make, a requirement that the net periodic payments not exceed the current price spread between I's gross periodic payments to J and the current rate of substitute dividend payments required to be made by J to I would provide some backstop against abuse.

61 Under a variation of this approach, I would be permitted to offset any deferred ordinary deductions from prior years against any net ordinary payments received in a current year.

payments made or received in the year the final contingency is resolved, and, if the capital treatment regime is adopted, would recognize capital gain or loss.[62]

This approach would match the parties' inclusions and deductions with respect to the contingent swap because it would prohibit I from receiving current deductions in respect of a future contingent payment that is not currently accrued and would not require J to accrue income in respect of a future contingent obligation. Accordingly, if the dividend substitute payments received by I are less than I's floating rate payments in each taxable year and I receives a net payment in respect of the contingency, economic gain or loss will correspond exactly to taxable gain or loss for I and J (as illustrated in Case Two in Appendix C).[63] This equivalence between economic income and taxable income will obtain only if the floating rate used in determining I's floating rate payments are exactly as expected when the swap was entered into. If this is not the case, and interest rates rise unexpectedly (and are not matched by increased substitute dividend payments under the swap), I will experience a real economic loss, which will not be taken into account for tax purposes until termination of the NPC.

This approach appears to present moderate results under a broad spectrum of outcomes. For example, it does not provide I with a net tax benefit where I recognizes economic gain on the transaction (e.g., Case Two), and does not result in net present value tax

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62 A similar approach would be applied to a party that terminates, assigns, or disposes of a swap prior to its maturity.

63 The alternative approach of permitting I to offset prior year's deferred expenses against current net ordinary payments would better match income and loss for a contingent payment swap in which the dividend substitute payments received by I in a taxable year exceed I's floating-rate payments during some taxable years.

liability where I suffers an economic loss (Case Five). However, this method may be less favorable to I (and less accurately time I's actual economic income and expense) than the noncontingent swap method if the floating rate payments it is required to make exceed expectations because I will be required to defer deductions to the extent it makes net periodic payments to its counterparty.

This approach of allowing J deferral of any income or gain until the contingency is resolved is subject to criticism on the ground that taxpayers could elect into this deferral regime by inserting an economically insignificant contingency into an otherwise noncontingent swap. However, we believe this concern could be addressed by an anti-abuse rule or de minimis exception.

3. **"Deduction/Deferral Method."** Under the deduction/deferral method, if I makes net periodic payments to J during a taxable year other than the year of the swap's maturity (i.e., I makes a net periodic payment in the first year), I would claim current ordinary deductions (and J would report current ordinary income) in an amount equal to the net payments made.[64] Alternatively, if I receives net periodic payments from J during a taxable year other than the year of the swap's maturity (i.e., the second year), I would report ordinary income (and J would report current an ordinary deduction) in an amount equal to the net payments received.

Pursuant to our recommendation in Part IV above, any net ordinary payments made by either party would be treated as investment interest expense solely for purposes of the

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[64] These payments would all be "ordinary payments" (as described in Part V).

limitation under section 163(d). If I receives net payments from J in the year of the swap's maturity (i.e., the second year), the net payment received would give rise to capital gain to I (and capital loss to J) to the extent of any appreciation in the S&P 500 Index (which would qualify as a value payment) and otherwise as ordinary income to I (and as an expense, subject to section 163(d) principles, for J). If I makes a net payment to J in the year of the swap's maturity (i.e., the second year), the net payment made would give rise to capital loss to I (and capital gain to J) to the extent of any depreciation in the S&P 500 Index and otherwise would be treated as an ordinary deduction by I (and as ordinary income to J).[65]

This approach is simple to apply, and would provide for tax treatment that conforms to I's treatment if I had borrowed funds at a rate equal to I's annual gross periodic payments and used the funds to purchase an actual ownership interest in the S&P 500 Index. However, this approach would provide taxpayers with current deductions in respect of an expected future payment whose inclusion is deferred. We believe that this treatment should be reserved for actual leveraged ownership, subject to the limitations that Congress has specifically imposed on the deduction of interest expense. Accordingly, we do not recommend it.

4. **The "Nonallocation Method."** Under this approach, I would be required to include in income the gross amount of any payments that would have been received if the swap did not provide for net settlement, but would not be entitled to any offset or

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[65] We would also defer inclusions and deductions of "carried dividends" in respect of carried interest contingent swaps. This portion of the contingent payment is analogous to an adjustment for dividends in the exercise or settlement price of an option or forward contract.

deduction in respect of a gross (or net) payment made if a contingency remains outstanding under the swap. Instead, the year in which the last contingency is resolved, all deferred payments would be treated as if they were actually made in that year. Accordingly, under this approach, I would report dividend substitute payments over the term of the swap, even if I makes net payments to J. Conversely, J would be entitled to deductions for the substitute payments made and would not including floating payments received.

This approach is roughly analogous to I's treatment if I had bought (and J had sold short) a cash-settled contract on the S&P 500 Index for a purchase price equal to the aggregate amount of I's gross payments, payable in installments, with an adjustment to the cash-settled value for dividends paid.[66] However, this approach results in a net tax liability where I recognizes no gain (Case Two) and generally is the least favorable of the four illustrated in Appendix C. We strongly recommend against it.

5. **"Mini-CPDI" Method.** Under this approach, not only would a taxpayer be denied a deduction for periodic payments made under a contingent equity swap (as under the nonallocable method), but the taxpayer would be required to accrue income (and corresponding tax basis) as if each payment under the swap was the issue price of a "mini CPDI." While this regime would bring the taxation of contingent payment swaps under the umbrella of the CPDI regime and might advance our ultimate hope for a comprehensive taxing regime for all financial instruments, we have rejected it for three reasons.

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[66] Under this view, I's payments would give rise to basis, but I's deductions would be limited to the time value component of each payment, computed at the applicable federal rate (or possibly J's comparable yield).

First, the complexity of this regime would be prohibitive. Second, the CPDI regime, which denies capital gain treatment for net gain, is inconsistent with the encouragement provided by our tax system for long-term investment. Finally, this method is the least favorable of the five for I and we believe that the likely effect of this a regime would be to effectively outlaw contingent payment swaps (because their taxation would be so unfavorable relative to a leveraged prepaid forward contract or an actual leveraged purchase of the underlying securities). We do not recommend adoption of this approach.

C. Elective Mark-to-Market Regime for NPCs.

Regardless of the timing regime that is adopted for contingent payment swaps, we also recommend that taxpayers be permitted to irrevocably elect to mark-to-market their NPCs on an NPC by NPC basis on or before the date the NPC is entered into, whether the NPC is contingent or noncontingent. We believe, in general, that a method that requires a taxpayer to annually mark-to-market a financial instrument "clearly reflects" income. However, an elective mark-to-market regime for NPCs should be accompanied by consideration of the following issues.

First, the character of gains or losses would have to be addressed. As one possibility, all gains or losses on a marked-to-market NPC could be treated as ordinary gain or loss. This treatment would be simple to apply and consistent with the section 475 regime, but may not provide sufficient incentive for long-term investment.

Alternatively, a mechanism could be developed to permit reduced capital gains rates for marked-to-market NPCs.[67] Although this regime would encourage longer-term investment in NPCs consistent with our capital gains system, it would be more complicated. We note that, because a mark-to-market regime does not permit selective realization of losses (i.e., "cherrypicking"), there does not appear to be a policy reason to limit their deductibility.

Second, regardless of the character of gains or losses on marked-to-market NPCs generally, their treatment would have to be coordinated with the straddle rules and section 1256. We recommend that if all of the positions that make up a straddle are subject to mark-to-market treatment (either by virtue of the elective mark-to-market regime for NPCs, section 475, section 1256, or otherwise), then the positions should not be subject to sections 263(g), 263A, and section 1091.[68] We also recommend that section 1092 not deny losses to the extent that the gains in offsetting positions are reported.

In addition, if on a single day a taxpayer enters into a straddle consisting of one or more section 1256 contracts and an NPC, and identifies the positions, we would recommend that (i) the positions be excluded from sections 1092 and 263(g), and (ii) all of the positions be

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67 For example, any gain or loss for the first year would be treated as short-term capital gain or loss or ordinary gain or loss; all gain or loss for the second and subsequent years would be treated as long-term capital gain or loss; and, all gain for the third and subsequent years would be treated as "extra long-term capital gain" entitled to the 20% maximum rate.

A final alternative would treat any marked-to-market NPC as a section 1256 contract. It more difficult to articulate a tax policy for expansion of the 60/40 character regime applicable to section 1256 contracts.

68 Cf. section 475(d)(1).

treated as section 1256 contracts. This rule would eliminate potential character mismatches in respect of these straddles.

D. Implementation of the Proposed Regime.

We believe that our timing proposal could be implemented by regulations issued under section 446. The character aspects would require statutory amendment.

VI. Effective Date Issues.

The Service has expressly declined to provide guidance on the character treatment of payments made pursuant to an NPC or on the timing treatment of contingent payment swaps.[69] Accordingly, we recommend that the effective date of any future guidance on the character treatment of NPC payments or the timing of gain or loss on contingent payment swaps be prospective only (applying to contracts entered into after the effective date of the regulations).

VII. The Characterization and Taxation of Financial Instruments Generally.

As the discussion in this report indicates, the tax treatment of financial instruments varies dramatically depending on their characterization for federal income tax purposes. For example, a taxpayer that holds a prepaid forward contract arguably is not required to accrue income in respect of the investment and arguably is entitled to long-term capital gains rates, but the holder of a CPDI must accrue income at a fixed rate and is denied

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[69] Treasury Decision 8491, 1933-2 C.B. 215, 216 ("the final regulations do not include any examples of how to treat nonperiodic payments that are not fixed an amount at the inception of the contract."); Treasury Decision 8491, 1993-2 C.B. 215, 216 (characterizing economic substance of a swap as a series of forward payments for purposes of recognizing a nonperiodic payment but indicating that this treatment is not relevant for character purposes).

favorable capital gains rates. These disparities of treatment, which are often of greater tax importance than economic significance, create tension in our tax system and place a tremendous premium on the correct characterization of a particular financial instrument.

We believe this disparity of treatment reflects two fundamental shortcomings of our federal system for taxing financial instruments. First, except for the regime applicable to debt instruments, the tax system fails to account for the time value of money or changes in the value of the instrument.[70] Thus, an investor in a debt instrument is required to accrue current income at a fixed rate but an investor in an option or prepaid forward contract is not required to accrue any income or loss until maturity.

Second, the tax law places great significance on the difference between capital gains and ordinary income but at times bases that distinction on economically meaningless tests. Thus, a taxpayer that holds an NPC to maturity may be treated as recognizing ordinary income or expense, but a sale or exchange or unscheduled termination gives rise to capital gain or loss.

A similar problem exists on the other side of the balance sheet (or income statement). The deduction of interest expense is subject to certain limitations (such as the investment expense limitations) but the deduction of ordinary expenses is subject to other limitations (such as those applicable to itemized miscellaneous deductions). Nevertheless, taxpayers often have the ability to leverage their investments through means other than indebtedness and so may elect to be subject to the indebtedness regime or avoid it.

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[70] The tax system also fails to account for the yield curve for all financial instruments (including debt instruments), but this is a lesser problem.

Ultimately, we believe that the problem of inconsistent tax treatment for economically similar instruments will be solved only if a comprehensive regime is developed for the taxation of all financial instruments that addresses these two shortcomings. We encourage the Service to study the possibility. Alternatively (or in the interim), we suggest some guidance as to the distinction among CPDIs, NPCs, options, and forward contracts and as to their characterization and treatment.[71] We illustrate the uncertainties existing under current law with the following examples relating to NPCs:

1. **A Synthetic Cash-Settled Forward Contract.** Under a synthetic cash-settled forward contract, one party ("O") makes periodic payments to the other party ("P") at a fixed rate times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security and, at maturity, agrees to pay the depreciation, if any, in those shares during the entire term of the contract in exchange for a maturity payment equal to the appreciation, if any, in the value of those shares over the term of the contract. At maturity, one party makes a net payment to the other. (Dividends are not accounted for.)

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[71] Guidance as to the proper characterization and treatment of pre paid forward contracts would be particularly helpful. A number of public transactions have disclosed to investors the view that prepaid forward contracts are separately recognizable financial instruments, and it could be expected that future issuers will take that position. However, there is division among the Committee as to their proper characterization and treatment. If the government does not believe that the tax law recognizes prepaid forward contracts as a category of financial instruments distinct from debt, or disagrees with their treatment as disclosed in the prospectuses for these financial instruments, we recommend guidance to that effect. In light of the reasonable difference of opinion on the issue, we urge that any such guidance not be retroactive and not affect the significant number of taxpayers currently issuing and holding such instruments. We would also recommend that any guidance be statutory (and not regulatory only).

It is unclear whether a synthetic cash-settled forward contract is properly characterized as an NPC (analogous to a contingent payment equity swap with fixed-rate periodic payments that excludes dividends), or a cash-settled forward contract partially prepaid in installments. O's character (and arguably timing) treatment depends on the proper characterization of the financial instrument.

2. **A Synthetic Cash-Settled Option.** Under a synthetic cash-settled option, one party ("Q") makes periodic payments to the other party ("R") at a fixed rate times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security in exchange for a maturity payment equal to a portion of the appreciation, if any, in the value of the shares over the term of the contract. At maturity, R makes a payment to Q if the value of the shares have appreciated (or no payment if they have not), but Q is not required to make a maturity payment to R if the value of the shares has depreciated. (Dividends are not accounted for.)

It is unclear whether a synthetic cash-settled option is properly characterized as an NPC (analogous to a contingent payment equity swap with fixed-rate periodic payments and a unilateral maturity payment (and that excludes dividends)), or a cash-settled option contract with premium paid in installments (equal to the fixed-rate periodic payments). Q's character (and arguably timing) treatment depends on the proper characterization of the financial instrument.

3. **A Synthetic CPDI.** Under a synthetic CPDI, one party ("S") makes periodic payments to the other party ("T") at a fixed rate times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security in

exchange for a maturity payment equal to a portion of the appreciation, if any, in the value of the shares over the term of the contract, subject to a minimum maturity payment representing 50% (or some other portion) of the sum of the periodic payments made by S.

It is unclear whether a synthetic CPDI is properly characterized as an NPC, as a CPDI (with the issue price paid in installments), or an option (with premium paid in installments). S's character and timing treatment depends on the proper characterization of the financial instrument.

1. **A "Plain Vanilla" Interest Rate Swap.** Under a "plain vanilla" interest rate swap, one party ("A") makes periodic payments to the other party ("B") equal to an interest rate index (such as LIBOR) times a notional principal amount in exchange for periodic payments equal to a fixed rate times the same notional principal amount. The periodic payments are netted and one party makes a net payment to the other.

2. **The Commodities Swap Considered in TAM 9730007.** In the commodities swap considered in TAM 9730007, one party ("C") made periodic payments to the other party ("D") equal to the monthly average of settlement prices for Light Sweet Crude Oil futures contracts on the New York Mercantile Exchange times a specified number of barrels in exchange for a fixed rate of payments times the same number of barrels. The periodic payments were netted and one party made a net periodic payment to the other.

3. **A "Plain Vanilla" Equity Swap.** Under a plain vanilla equity swap, one party ("E") makes periodic payments to the other party ("F") equal to an interest rate index (such as LIBOR) times a notional principal amount (equal to the initial value of a specified number of shares of a publicly-traded equity security) plus the depreciation, if any, in those shares during the relevant period in exchange for periodic payments equal to the appreciation, if any, in the value of those shares over the relevant period plus the dividends paid on those shares during the relevant period. The periodic payments are netted and one party makes a net payment to the other.

4. **A "Dividend" Swap.** Under a dividend swap, one party ("G") makes periodic payments to the other party ("H") equal to an interest rate index times a notional principal amount (equal to the initial value of a specified number of shares of a publicly-traded equity security) in exchange for periodic payments equal to the dividends paid on those shares during the relevant period. The periodic payments are netted and one party makes a net payment to the other.

5. **A "Contingent Payment" Equity Swap.** Under a contingent payment equity swap, one party ("I") makes periodic payments to the other party ("J") at an interest rate index (such as LIBOR) times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security and, at maturity, agrees to pay the depreciation, if any, in those shares during the entire term of the swap in exchange for periodic payments equal to the dividends paid on those shares during the relevant period and, at maturity, a payment equal to the appreciation, if any, in the value of those shares over the term of the swap. The periodic payments are netted in each period; at maturity one party makes a net payment to the other.

6. **A "Carried Interest" Contingent Swap.** Under a carried interest contingent swap, one party ("K") makes periodic payments to the other party ("L") at an interest rate index (such as LIBOR) times a notional principal amount equal to the initial value

of a specified number of shares of a publicly-traded equity security and, at maturity, agrees to pay the depreciation, if any, in those shares during the entire term of the swap in exchange for at maturity, a payment equal to the appreciation, if any, in the value of those shares over the term of the swap plus an amount reflecting the dividends that were paid on the underlying equity security over the term of the swap. The dividend-based payment may be adjusted to reflect the return that would be received if the dividends were reinvested in the equity security, or may be increased to reflect a time-value-of-money return. At maturity one party makes a net payment to the other.

7. **A Compound Contingent Payment Swap.** Under a "compound contingent payment swap," one party ("M") makes periodic payments to the other party ("N") at an interest rate index (such as LIBOR) times a notional principal amount and, at maturity, agrees to pay an amount equal to the percentage outperformance, if any, in the change in value of one publicly-traded equity security or index (such as the S&P 500) over the change in value of another (such as IBM) during the term of the swap times the notional principal amount in exchange for periodic payments equal to the dividends, if any, paid on the second equity security or index in the relevant period and, at maturity an amount equal to the percentage outperformance, if any, in the change in value of the second equity security or index over the change in value of the first during the term of the swap.

8. **A Synthetic Cash-Settled Forward Contract.** Under a synthetic cash-settled forward contract, one party ("O") makes periodic payments to the other party ("P") at a fixed rate times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security and, at maturity, agrees to pay the depreciation, if any, in those shares during the entire term of the contract in exchange for a maturity payment equal to the appreciation, if any, in the value of those shares over the term of the contract. At maturity, one party makes a net payment to the other. (Dividends are not accounted for.)

9. **A Synthetic Cash-Settled Option.** Under a synthetic cash-settled option, one party ("Q") makes periodic payments to the other party ("R") at a fixed rate times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security in exchange for a maturity payment equal to a portion of the appreciation, if any, in the value of the shares over the term of the contract. At maturity, R makes a payment to Q if the value of the shares have appreciated (or no payment if they have not), but Q is not required to make a payment to R if the value of the shares has depreciated. (Dividends are not accounted for.)

10. **A Synthetic CPDI.** Under a synthetic CPDI, one party ("S") makes periodic payments to the other party ("T") at a fixed rate times a notional principal amount equal to the initial value of a specified number of shares of a publicly-traded equity security in exchange for a maturity payment equal to a portion of the appreciation, if any, in the value of the shares over the term of the contract, subject to a minimum maturity payment representing 50% (or some other portion) of the sum of the periodic payments made by S.

Appendix B

A Comparison of the Proposed Capital Treatment Regime for Taxing Plain Vanilla Equity Swaps Against Actual Leveraged Ownership (For E) or a Loan and a Naked Short Sale of the Underlying Equity (For F)

E makes periodic payments to F equal to an interest rate index (such as LIBOR) times a notional principal amount (equal to the initial value of a specified number of shares of a publicly-traded equity security) plus the depreciation, if any, in those shares during the relevant period in exchange for periodic payments equal to the appreciation, if any, in the value of those shares over the relevant period plus the dividends paid on those shares during the relevant period. The periodic payments are netted and one party makes a net payment to the other.

Case One (Net Payment Made By E; Appreciation in Underlying).

E makes a floating rate payment of <10> to F.
F makes an appreciation payment of 3 to E.
F makes a dividend substitute payment of 5 to E.
(Thus, E makes a net payment of <2> to F [<10>+3+5].)

Treatment of E if E Had Maintained Actual Leveraged Ownership of the Underlying Equity for the Year and Then Sold the Underlying Equity to Repay the Loan.

E would recognize investment interest expense of <10>, which E would be permitted to offset fully against E's dividend substitute payment of 5. E could also use the remaining <5> of investment interest expense to offset investment income from other sources in the current taxable year or carry the investment interest expense forward to future years.

E would also recognize short-term capital gain of 3, which could be offset by the investment interest expense or used to offset short-term capital losses from other sources.

Proposed Approach for E.

E would recognize ordinary expense of <2> (because E makes a net payment of <2> and the value payment component is 0), which would be fully deductible. [E's treatment would be simpler but less favorable than had E actually bought and sold the underlying equity.]

Treatment of F if F Had Loaned E the Purchase Price of the Underlying Equity for a Year and Had Entered Into A Naked Short Sale of the Underlying Equity to E (Assuming that F Is Not A Securities Dealer).

F would recognize interest income of 10.

F would recognize a deduction of <5> (which under section 67(b)(8) would not be a miscellaneous itemized deduction).

F would recognize a short-term capital loss of <3> (which may not offset the interest income, except to a limited extent).

Proposed Approach for F.

F would recognize net ordinary income of 2 (F receives a net payment of 2 and the value payment component is 0). [F's treatment would be simpler and more favorable than had F loaned E funds and entered into a naked short sale of the underlying equity to E.]

Case Two (Net Payment Made by E; Depreciation in Underlying).

E makes a floating rate payment of <10> to F.
E makes a depreciation payment of <3> to F.
F makes a dividend substitute payment of 5 to E.
(Thus, E makes a net payment of <8> to F [<10> + <3> +5].)

Treatment of E if E Had Maintained Actual Leveraged Ownership of the Underlying Equity for the Year and Then Sold the Underlying Equity to Repay the Loan.

E would recognize investment interest expense of <10>, which E would be permitted to offset fully against E's dividend substitute payment of 5. E could also use the remaining <5> of investment interest expense to offset investment income from other sources in the current taxable year or carry the investment interest expense forward to future years.

E would recognize short-term capital loss of <3>, which could offset only E's capital gains from other sources (except to a very limited extent).

Proposed Approach for E.

E would recognize ordinary expense of <5>, which would be fully deductible, and a short-term capital loss of <3> (because E is making a net payment of <8> and the value payment component is <3>). [E's treatment would be simpler and substantively the same as if E actually bought and sold the underlying equity.]

Treatment of F if F Had Loaned E the Purchase Price of the Underlying Equity for a Year and Had Entered Into A Naked Short Sale of the Underlying Equity to E (Assuming that F Is Not A Securities Dealer).

F would recognize interest income of 10.

F would recognize a deduction of <5> (which would fully offset the interest income).

F would recognize a short-term capital gain of 3 which could offset short-term capital losses from other sources or could be offset by the interest income, but may not be fully offset by the interest income.

Proposed Approach for F.

F would recognize net ordinary income of 5 and a short-term capital gain of 3 (because F is receiving a net payment of 8 and the value payment component is 3). [F's treatment would be simpler than had F loaned E funds and entered into a naked short sale of the underlying equity to E.]

Case Three (Net Payment Received By E; Appreciation in Underlying).

E makes a floating rate payment of <10> to F.
F makes an appreciation payment of 8 to E.
F makes a dividend substitute payment of 5 to E.
(Thus, E receives a net payment of 3 [<10>+8+5].)

Treatment of E if E Had Maintained Actual Leveraged Ownership of the Underlying Equity for the Year and Then Sold the Underlying Equity to Repay the Loan.

E would recognize investment interest expense of <10>, which E would be permitted to offset fully against E's dividend substitute payment of 8. E could also use the remaining <2> of the investment interest expense to offset investment income from other sources in the current taxable year or carry the investment interest expense forward to future years.

E would recognize short-term capital gain of 5, which could be offset by the investment interest expense or used to offset short-term capital losses from other sources.

Proposed Approach for E.

E would recognize short-term capital gain of 3 (because E receives a net payment of 3, which does not exceed the value payment of 8). [E's treatment would be simpler but less favorable than had E actually bought and sold the underlying equity.]

Treatment of F if F Had Loaned E the Purchase Price of the Underlying Equity for a Year and Had Entered Into A Naked Short Sale of the Underlying Equity to E (Assuming that F Is Not A Securities Dealer).

F would recognize interest income of 10.

F would recognize a deduction of <5> (which, under section 67(b)(8), would not be a miscellaneous itemized deduction).

F would recognize a short-term capital loss of <8> (which may not offset the interest income, except to a limited extent).

Proposed Approach for F.

F would recognize a short-term capital loss of <3> (because F makes a net payment of <3>, which does not exceed the value payment of <3>. [F's treatment would be simpler, and more favorable than had F actually loaned funds to E and entered into a short position with E.]

Case Four (Net Payment Received by E; Depreciation in Underlying).

E makes a floating rate payment of <10> to F.
E makes a depreciation of <3> to F.
F makes a dividend substitute payment of 15 to E.
(Thus, E receives a net payment of 2 [<10> + <3> + 15].)

Treatment of E if E Had Maintained Actual Leveraged Ownership of the Underlying Equity for the Year and Then Sold the Underlying Equity to Repay the Loan.

E would recognize investment interest expense of <10>, which E would be permitted to offset fully against E's dividend substitute payment of 15.

E would recognize net ordinary income of 5 with respect to the excess of a 15 dividend substitute payment received over an interest expense payment of <10>.

E would also recognize a short-term capital loss of <3> (which may not offset the dividend substitute payment, except to a limited extent).

Proposed Approach for E.

E would recognize net ordinary income of 2 (because E receives a net payment of 2 and the value payment component is 0). [E's treatment would be simpler and more favorable than had E actually bought and sold the underlying equity.]

Treatment of F if F Had Loaned E the Purchase Price of the Underlying Equity for a Year and Had Entered Into A Naked Short Sale of the Underlying Equity to E (Assuming that F Is Not A Securities Dealer).

F would recognize interest income of 10.

F would recognize a deduction of <15> (which would fully offset the interest income).

F would also recognize a short-term capital gain of 3, which could offset short-term capital losses from other sources or would be offset by the interest income, but may not be fully offset by the interest income.

Proposed Approach for F.

F would recognize ordinary expense of <2> (because F makes a net payment of 2 and the value payment component is 0), which would be fully deductible. [F's treatment is simpler than had F loaned E funds and entered into a naked short sale of the underlying equity to E.]

Summary of Tax Consequences for E.

	Leveraged Ownership		Proposed Plain Vanilla Equity Swap Treatment	
Case One	ordinary	<5>	ordinary	<2>
	capital	3	capital	0
Case Two	ordinary	<5>	ordinary	<5>
	capital	<3>	capital	<3>
Case Three	ordinary	<2>	ordinary	0
	capital	5	capital	3
Case Four	ordinary	5	ordinary	2
	capital	<3>	capital	0

Appendix C

Contingent Payment Equity Swap									
1/2/98 closing price of underlying security					975.04				
price on 1/2/98 of forward price of underlying security maturing on 12/31/99					1,061.70				
dividend yield of underlying security as of 1/2/98					1.60%				
one-year Libor + 2.00% as of 1/2/98 (1)					7.94%				
periodic payments					7.94%				
short term applicable federal rate as of 1/2/98					5.00%				
implicit IRR reflected by forward rate					4.35%				
expected maturity payment					86.66				
corporate effective rate of tax					35.0%				
1. Table assuming final payment equals forward value payment								Corporate PV Tax Based	
		1/2/98	6/30/98	12/31/98	6/30/99	12/31/99	TOTAL	On AFR	
		(975.04)				1,061.70			
periodic payments made by I			(38.70)	(38.70)	(38.70)	(38.70)	(154.79)		
periodic payments made by J			7.80	7.80	7.80	7.80	31.20		
net periodic payments made by I			(30.90)	(30.90)	(30.90)	(30.90)	(123.59)		
nonperiodic payment made by J						86.66			
investor's cash flows			(30.90)	(30.90)	(30.90)	55.76	(36.93)		
investor's net inclusions based on deduction/deferral method			(30.90)	(30.90)	(30.90)	55.76	(36.93)	(13.20)	
investor's net inclusions based on noncontingent swap method 1 (2)			(10.44)	(9.65)	(8.84)	(8.00)	(36.93)	(12.20)	
investor's net inclusion based on full allocation method			-	-	-	(36.93)	(36.93)	(11.72)	
investor's net inclusions based on noncontingent swap method 2 (3)			(0.00)	(1.18)	2.41	(40.51)	(36.93)	(11.69)	
investor's net inclusions based on noncontingent swap method 3 (4)			(1.79)	(0.68)	0.47	(34.93)	(36.93)	(11.77)	
investor's net inclusions based on nonallocation method			7.80	7.80	7.80	(60.33)	(36.93)	(11.35)	
								Corporate	
2. Table assuming final payment equals initial value plus future value of expected net payments								PV Tax Based	
		1/2/98	6/30/98	12/31/98	6/30/99	12/31/99	TOTAL	On AFR	
		(975.04)				1,105.89			
periodic payments made by I			(38.70)	(38.70)	(38.70)	(38.70)	(154.79)		
periodic payments made by J			7.80	7.80	7.80	7.80	31.20		
net periodic payments made by I			(30.90)	(30.90)	(30.90)	(30.90)	(123.59)		
nonperiodic payment made by J						130.85			
investor's cash flows			(30.90)	(30.90)	(30.90)	99.96	7.27		
investor's net inclusions based on deduction/deferral method			(30.90)	(30.90)	(30.90)	99.96	7.27	0.83	
investor's net inclusions based on noncontingent swap method 1			(10.44)	(9.65)	(8.84)	36.20	7.27	1.83	
investor's net inclusions based on full allocation method			-	-	-	7.27	7.27	2.31	
investor's net inclusions based on noncontingent swap method 2			(0.00)	1.18	2.41	3.68	7.27	2.35	
investor's net inclusions based on noncontingent swap method 3			(1.79)	(0.68)	0.47	9.27	7.27	2.26	
investor's net inclusions based on nonallocation method			7.80	7.80	7.80	(16.13)	7.27	2.68	

								Corporate	
3. Table assuming final payment at three times the forward rate								PV Tax Based	
		1/2/98	6/30/98	12/31/98	6/30/99	12/31/99	TOTAL	On AFR	
		(975.04)				1,235.02			
periodic payments made by I			(38.70)	(38.70)	(38.70)	(38.70)	(154.79)		
periodic payments made by J			7.80	7.80	7.80	7.80	31.20		
net periodic payments made by I			(30.90)	(30.90)	(30.90)	(30.90)	(123.59)		
nonperiodic payment made by J						259.98			
investor's cash flows			(30.90)	(30.90)	(30.90)	229.08	136.39		
investor's net inclusions based on deduction/deferral method			(30.90)	(30.90)	(30.90)	229.08	136.39	41.82	
investor's net inclusions based on noncontingent swap method 1			(10.44)	(9.65)	(8.84)	165.32	136.39	42.83	
investor's net inclusion based on full allocation method			-	-	-	136.39	136.39	43.30	
investor's net inclusions based on noncontingent swap method 2			(0.00)	1.18	2.41	132.81	136.39	43.34	
investor's net inclusions based on noncontingent swap method 3			(1.79)	(0.68)	0.47	138.39	136.39	43.25	
investor's net inclusions based on nonallocation method			7.80	7.80	7.80	112.99	136.39	43.67	
								Corporate	
4. Table assuming final payment at three times the forward rate and an investment yield of 12%								PV Tax Based	
		1/2/98	6/30/98	12/31/98	6/30/99	12/31/99	TOTAL	On AFR	
		(975.04)				1,235.02			
periodic payments made by I			(38.70)	(38.70)	(38.70)	(38.70)	(154.79)		
periodic payments made by J			58.50	58.50	58.50	58.50	234.01		
net periodic payments made by I			19.81	19.81	19.81	19.81	79.22		
nonperiodic payment made by J						259.98			
investor's cash flows			19.81	19.81	19.81	279.79	339.20		
investor's net inclusions based on deduction/deferral method			19.81	19.81	19.81	279.79	339.20	108.63	
investor's net inclusions based on noncontingent swap method 1			40.27	41.05	41.86	216.02	339.20	109.63	
investor's net inclusion based on full allocation method			19.81	19.81	19.81	279.79	339.20	108.63	
investor's net inclusions based on noncontingent swap method 2			50.70	51.88	53.11	183.51	339.20	110.15	
investor's net inclusions based on noncontingent swap method 3			48.91	50.02	51.18	189.10	339.20	110.06	
investor's net inclusions based on nonallocation method			58.50	58.50	58.50	163.69	339.20	110.48	

								Corporate	
5. Table assuming final payment at 900 and an investment yield of 12%								PV Tax Based	
		1/2/98	6/30/98	12/31/98	6/30/99	12/31/99	TOTAL	On AFR	
		(975.04)				900.00			
periodic payments made by I			(38.70)	(38.70)	(38.70)	(38.70)	(154.79)		
periodic payments made by J			58.50	58.50	58.50	58.50	234.01		
net periodic payments made by I			19.81	19.81	19.81	19.81	79.22		
nonperiodic payment made by J						(75.04)			
investor's cash flows			19.81	19.81	19.81	(55.23)	4.18		
investor's net inclusions based on deduction/deferral method			19.81	19.81	19.81	(55.23)	4.18	2.27	
investor's net inclusions based on noncontingent swap method 1			40.27	41.05	41.86	(119.00)	4.18	3.28	
investor's net inclusion based on full allocation method			19.81	19.81	19.81	(55.23)	4.18	2.27	
investor's net inclusions based on noncontingent swap method 2			50.70	51.88	53.11	(151.51)	4.18	3.79	
investor's net inclusions based on noncontingent swap method 3			48.91	50.02	51.18	(145.92)	4.18	3.71	
investor's net inclusions based on nonallocation method			58.50	58.50	58.50	(171.33)	4.18	4.13	
NOTES:									
(1) A 7.94% rate on a simple interest basis is equivalent to a 7.645% rate with semi-annual compounding									
(2) Total accruals are based on the implicit forward rate (86.66)									
(3) Total accruals are based on the value of the expected net payments (130.85)									
(4) Total accruals are based on the forward price of the S&P 500 accounting for foregone dividends (123.57)									

Explanation of Noncontingent Swap Methods in Appendix C

Appendix C reflects two different noncontingent swap methods. This Appendix C-1 explains the methodology underlying each of those methods.

Terms of the Contingent Payment Swap. Appendix C contemplates a two-year contingent payment equity swap under which I makes semi-annual periodic LIBOR-based payments to J and J makes semi-annual dividend yield periodic payments to I, each on a notional principal amount equal to the value of the S&P 500 Index at the inception of the contract. At maturity, J pays to I any appreciation in the S&P 500 Index and I pays to J any depreciation in the S&P 500 Index, each over the term of the swap. More specifically:

> The term of the swap is two years.
>
> J expects to receive net periodic payments from I at 7.94% computed on a simple-interest basis, or 7.645% based on semi-annual compounding (7.94% is equal to LIBOR + 2.00% on January 2, 1998). In other words, 7.645% is J's expected annual yield on the transaction, and I's expected annual cost for the right to receive the contingent maturity payment.
>
> The expected annual dividend yield of the S&P 500 Index is 1.60% (equal to 1997 dividend yield on the S&P 500). For purposes of Appendix C, both LIBOR and the dividend yield are assumed to be static over the term of the swap.
>
> The notional principal amount of the swap is 975.04 (equal to the January 2, 1998 closing price of S&P 500 Index).

Noncontingent Swap Method One. "Noncontingent swap method one" estimates the contingent payment based on the trading value of an S&P 500 Index futures contract maturing at the maturity of the swap. On January 2, 1998, the trading price of an S&P 500 Index futures contract maturing on December 31, 1999 was 1061.70. Since the S&P

500 Index was 975.04 on January 2, 1998, the expected contingent nonperiodic payment under this method is 88.66 [1061.70 - 975.04].

Under the noncontingent swap method, I and J are taxed as though they had entered into a swap that provided for a single, noncontingent nonperiodic payment equal to the estimated contingent payment by J to I at maturity (88.66 under Method One). Any difference between the actual amount of the final payment and the assumed amount is taken into account by I and J as an adjustment in year 2.

Under regulations section 1.446-3(f)(2)(iii)(B), 88.68 would be discounted back from the end of year 2 to the beginning of year 1 at 7.645% (which is the stated periodic rate under the swap), producing a present value of 74.59.

J is treated a making an upfront payment on the swap of 74.59. In addition, solely for timing purposes, J is treated as borrowing 74.59 from I, and issuing to I a zero coupon bond with an issue price of 74.59 and a stated redemption price of maturity of 86.66.

Assuming semi-annual compounding at 3.827% (7.645%/2), the time value component of that deemed loan is computed as follows:

	Loan Balance	OID	Principal Component
6/30/98	74.59	**2.85**	— 0 —
12/31/98	77.43	**2.96**	— 0 —
6/30/99	80.40	**3.07**	— 0 —
12/31/99	83.47	**3.19**	86.66

The time value component of the deemed loan from I to J is increased by the amortization of the deemed upfront payment of 74.59, which is recognized over the term of the

swap by assuming that the deemed upfront payment is repaid in four level payments. Assuming a constant yield-to-maturity and semi-annual compounding at 3.827% (7.645%/2), the ratably daily portions are computed as follows:

	Level Payment	Time Value Component	Principal Component
6/30/98	20.46	2.85	**17.61**
12/31/98	20.46	2.18	**18.28**
6/30/99	20.46	1.48	**18.98**
12/31/99	20.46	0.75	**19.71**
	81.84	7.26	**74.58**

Accordingly, I's amortization of 86.66 is allocated to each year as follows by adding the OID on the deemed loan plus the principal component representing the amortization of the estimated contingent payment:

	OID	Amortization of Upfront Payment	Sum
6/30/98	2.85	17.61	**20.46**
12/31/98	2.96	18.28	**21.24**
6/30/99	3.07	18.98	**22.05**
12/31/99	3.19	19.71	**22.90**
	12.07	74.58	**86.65**

Assuming that LIBOR + 2.00% remains at 7.94% and the dividend yield remains at 1.60%, I would take into account the following amounts of income/(expense) in each year of the swap and J would account for the following amounts as expense/(income):

	LIBOR Payment	Dividend Payment	Amortization	Net
6/30/98	(38.70)	7.80	20.46	(10.44)
12/31/98	(38.70)	7.80	21.24	(9.65)
6/30/99	(38.70)	7.80	22.05	(8.84)
12/31/99	(38.70)	7.80	22.90	(8.00)
Adjustment				- 0 -
				(36.93)

If I receives more than the expected contingent payment of 86.66 on December 31, 1999, the excess will first reduce I's 1999 deduction of <16.84>(<8.00>+ <8.84>), and then give rise to gain. If the contingent payment received by I on December 31, 1999 is less than 86.66 or I makes a maturity payment, I would have a loss.

Noncontingent Swap Method Two. Noncontingent swap method two is identical to method one except that the contingent payment is estimated to be equal to the sum of the future values of the net periodic payments that I expects to make. Since LIBOR + 2.00% at inception is 7.94% and the dividend yield on the S&P 500 Index for 1997 was 1.60%, I expects to make annual net payments of 6.34% times the notional principal amount of 975.04. The sum of the future values of I's net periodic payments, calculated at a discount rate of 7.654%, is 130.85. The tables for method two are as follows:

	Level Payment	Time Value Component	Principal Component
6/30/98	112.62	**4.31**	— 0 —
12/31/98	116.93	**4.47**	— 0 —
6/30/99	121.40	**4.64**	— 0 —
12/31/99	126.04	**4.82**	130.85

	Level Payment	OID	Principal Component
6/30/98	30.90	4.31	**26.59**
12/31/98	30.90	3.29	**27.61**
6/30/99	30.90	2.23	**28.66**
12/31/99	30.90	1.14	**29.76**
	123.59	10.97	**112.62**

	OID	Amortization of Upfront Payment	Sum
6/30/98	4.31	26.59	**30.90**
12/31/98	4.47	26.71	**32.08**
6/30/99	4.64	28.66	**33.30**
12/31/98	4.82	29.76	**34.58**
	18.23	112.62	**130.85**

	LIBOR Payment	Dividend Payment	Amortization	Net
6/30/98	(38.70)	7.80	30.90	-0-
12/31/98	(38.70)	7.80	32.08	1.18
6/30/99	(38.70)	7.80	33.30	2.41
12/31/99	(38.70)	7.80	34.58	3.68
Adjustment				-0-
				7.27

Appendix D

Net Present Value Tax Consequences For I of Alternative Approaches Under Various Cases

	Case One	Case Two	Case Three	Case Four	Case Five
Cash Flow	<36.93> (net loss)	7.27 (net gain)	136.39 (net gain)	339.20 (net gain)	4.18 (net gain)
Deduction/Deferral Method (Equivalent to Leveraged Purchase of Underlying Equity)	<13.20> (tax benefit)	0.83	41.82	108.63	2.27
Noncontingent Swap Method One	<12.20> (tax benefit)	1.83	42.83	109.63	3.28
Noncontingent Swap Method Three	<11.77> (tax benefit)	2.26	43.25	110.06	3.71
Full Allocation Method	<11.72> (tax benefit)	2.31	43.30	108.63	2.27
Noncontingent Swap Method Two	<11.69> (tax benefit)	2.35	43.34	110.15	3.79
Nonallocation Method	<11.35> (tax benefit)	2.68	43.67	110.48	4.13

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