

**NYSBA Tax Section Report No. 1001**

**Report Responding to Notice 2001-44**

**on the Timing of Income and Loss**

**from Swaps Providing for Contingent Payments**

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## I. Introduction

This report responds to Notice 2001-44, I.R.B. 2001-30 (July 3, 2001) (the “Notice”), soliciting comments on the appropriate method of including or deducting contingent nonperiodic payments made pursuant to a notional principal contract (a “swap”) and the treatment of those inclusions and deductions.<sup>1</sup> Our comments also address the treatment of periodic payments on swaps that provide for contingent nonperiodic payments because we believe (as discussed below) that the presence of the latter alters the appropriate treatment of the former.

The current swap regulations under Code Section 446 (the “Current Swap Regulations”) prescribe a method of accounting for income and deduction from swaps and therefore deal only with the timing of inclusions and deductions arising from swaps and do not address concerns arising from the source and character of the inclusions or deductions.<sup>2</sup> Guidance on the source and character of these inclusions and deductions presumably will be forthcoming in regulations or other pronouncements governing Code Sections 1221, 1234A and 863. Our comments deal with the regulations under Section 446 and are therefore limited to the appropriate timing of inclusions and deductions.<sup>3</sup>

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This report was prepared by an ad hoc committee of the New York State Bar Association’s Tax Section consisting of Dickson Brown, Mike Farber, David Hariton, David Miller, Charles Morgan, Erica Nijenhuis, David Nirenberg, David Schizer, and Mike Schler. David Hariton drafted the committee’s report. Helpful comments were received from Robert Jacobs, Sam Dimon and Lewis Steinberg.

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See Treas. Reg. § 1.446-3(b), the associated Preamble, T.D. 8491, 58 FR 53125 (October 14, 1993) and the prior notice of proposed rulemaking, 56 FR 31350 (July 10, 2001).

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We dealt extensively with the source and character of inclusions and deductions in our Report on Notional Principal Contract Character and Timing Issues dated May 22, 1998, and we refer you to it for the conclusions that we reached on that subject. We agree with the Notice, however, that the lack of comprehensive guidance concerning accounting for contingent nonperiodic payments under Section 446 has created significant uncertainty for taxpayers and exposed the government to a risk of whipsaw. We have therefore designed, and agreed upon, an appropriate methodology for

For swaps providing for “periodic” contingent payments, we generally recommend a more expansive definition of “periodic payments,” to extend the relatively simple treatment of periodic payments (*i.e.*, inclusion or deduction when paid) to the maximum reasonable number of cases. For swaps with contingent nonperiodic payments, we generally recommend an approach, similar to the “noncontingent swaps approach” described in the Notice, that would require taxpayers to (a) prepare a schedule, when the swap is entered into, reflecting the “average expected amount” of their anticipated payments, and (b) include and deduct the difference between those anticipated payments and the actual payments when made. We recommend a simpler approach than the one set out in the Notice. For swaps with terms of 3 years or less, we think the parties should simply assume the contingent payments will equal the fixed (or floating) payments that are made in exchange for them. For swaps with terms of more than 3 years, we think the parties should also effectively accrue interest on earlier payments by constructing a “deemed debt obligation” and a “deemed matching-payment swap,” but our recommended approach is nevertheless relatively simple. Our recommended approaches are illustrated below in a series of examples.

We, in any case, think appropriate accounting for the timing of income and deduction from contingent swaps is very important, given that gains and losses from payments on contingent swaps can be arbitrarily large and are not limited by the requirement that there be any investment in them. They differ in this regard from debt instruments, where there *is* an investment in the right to receive future payments. It is possible, for example, to ignore as insignificant relatively small variations in the amounts of interest paid on a debt instrument. In a swap that is economically equivalent to two debt instruments offsetting each other, however, these insignificant variations may give rise to the only net payments that are made under the swap, and these net payments may

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the timing of inclusions and deductions on contingent payment swaps, and we urge you to adopt it. As suggested in our Prior Report, it is more difficult to achieve consensus concerning the appropriate source and character of inclusions and deductions, and we therefore have not addressed these topics again in this report.

be very large, because the parties need not make any actual investment to create them. We therefore commend Treasury and the IRS for devoting special attention to this issue.

## II. Basis for General Approach

The Notice sets out several methods for including and deducting payments on a swap providing for contingent nonperiodic payments (a “Contingent Nonperiodic Swap”). The Notice instructs that the method chosen should reflect certain fundamental tax principles, including certainty of outcome, ease of administrability, consistency with the treatment of similar economic transactions, consistency in the treatment of different taxpayers, economic accuracy, clear reflection of income, and flexibility in the accommodation of new financial arrangements. We agree and have taken all these into account in the discussions giving rise to the recommendations we make below.

In general, and consistent with all of the methods set out in the Notice, we do not believe taxpayers should be permitted to deduct, as expenses or losses, payments that do not reflect economic expenses or losses but rather represent investments in rights to receive payments in later periods of the swap. Neither do we believe counterparties receiving such payments should be required to include them in income. This view is consistent with the methodology already set out in the Current Swap Regulations governing nonperiodic payments on noncontingent swaps.<sup>4</sup> In the case of noncontingent swaps, however, a nonperiodic payment can readily be matched to the periodic payments that constitute investments in it. This cannot be done in the case of a contingent swap, however, because the amount of the contingent payment is not known. The matching must therefore occur the other way round -- *i.e.*, the periodic payments that constitute investments must be matched to the appropriate nonperiodic contingent payment. It follows that periodic payments on a Contingent Nonperiodic Swap should not be treated

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<sup>4</sup>

See Treas. Reg. §§ 1.446-3(f) and (g).

as “periodic payments” and included and deducted in full when they are made.<sup>5</sup> We think this is the most fundamental point for any methodology dealing with Contingent Nonperiodic Swaps.

We do not think it follows, however, that none of the payments on a Contingent Nonperiodic Swap should be included or deducted prior to maturity. A swap, unlike other financial instruments, generally results in partial, or periodic, recognition of gains and losses from changes in the value of property through the exchange of periodic payments prior to the actual disposition of the swap. If, for example, A agrees to make payments based on periodic changes in the value of a commodity and actually makes a large periodic payment because the value of the commodity has increased, A has, in fact, realized the change in value of the commodity through the periodic payment of more than was originally anticipated. A complete deferral approach would effectively abandon the realization method of accounting by not permitting or requiring taxpayers to include or deduct gains and losses that they actually realize through the exchange of periodic payments. We do not think that abandonment would be appropriate. The realization method of accounting would continue to govern the treatment of most other equivalent financial transactions entered into by taxpayers, and its abandonment here would produce inconsistent treatment of economically similar financial transactions, thereby violating several of the principles set out in the Notice for determining an appropriate methodology for dealing with Contingent Nonperiodic Swaps. Moreover, we do not think it evident that Treasury has authority to abandon the realization method without a Congressional directive.

In other words, we think the appropriate method of accounting for Contingent Nonperiodic Swaps generally should result in the inclusion and deduction of that portion of gain or loss that has, in fact, been realized through the exchange of periodic payments, as opposed to more or less of such gain or loss (*i.e.*, as opposed to all

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See Treas. Reg. § 1.446-3(e) for the treatment of Periodic Payments under the Current Swap Regulations.

of the gain or loss, whether realized or not; or none of the gain or loss until the swap is disposed of; or the entire amount of a periodic payment, whatever that amount may be). Such treatment would be broadly consistent with the treatment of noncontingent swaps, including interest-rate swaps, under the Current Swap Regulations. If A agrees to pay B fixed, while B agrees to pay A floating, and shortly thereafter interest rates rise, A does not take a large deduction based on the resulting change in the value of the swap as a whole. Neither does A take no deduction at all until the swap is disposed of. Rather, A deducts the changes in value that it actually realizes through net payments over the remaining life of the swap, or by paying to terminate or dispose of its swap position. This treatment is also consistent with the treatment of debt instruments under current law. If A issues a fixed-rate debt obligation, and interest rates fall, A effectively deducts the resulting change in value of its obligation as it actually pays interest over the life of the obligation, or by redeeming the debt at a premium.

We note that our approach for dealing with Contingent Nonperiodic Swaps, while generally consistent with the treatment of other swaps and debt instruments under current law, is not consistent with the treatment of leveraged ownership of the property referenced in the swap. Where, for example, A takes the “long position” in an equity swap -- *i.e.*, A agrees to pay LIBOR plus amounts equal to any periodic decreases in the value of Stock X in exchange for amounts equal to any dividends paid on Stock X plus periodic increases in the value of Stock X -- A is in a position that is economically equivalent to borrowing (at LIBOR) to purchase Stock X. If A had, in fact, borrowed to purchase Stock X, A would be entitled to deduct the interest periodically paid or accrued on the borrowing in full (subject to applicable limitations) while deferring gain attributable to the anticipated appreciation in the value of Stock X. We do not think it follows, however, that A should be entitled to deduct in full A’s periodic LIBOR payments under the swap. The tax benefit of deferral that is associated with the ownership of so-called “growth stock” reasonably can be limited to taxpayers who actually own stock, and indeed, there is presumably a real owner of the stock who already is claiming the tax benefit. The tax law does not, for example, treat corporate recipients

of “in lieu of” dividend payments as entitled to the dividends received deduction, or recipients of “in lieu of” interest payments arising from loans of tax-exempt securities as entitled to tax exemption.<sup>6</sup> In general, we do not think the Secretary should seek to replicate limited tax benefits by conferring them on derivative transactions.<sup>7</sup>

Given the methods that are set out in the Notice, and consistent with our Prior Report, we think the Noncontingent Swap Approach described in the Notice comes closest to meeting the principles described in the Notice for determining a proper method of accounting. We believe that unlike the other posited approaches, this approach generally follows the realization approach and method of accounting described above. As discussed above, we also believe this approach is largely consistent with (a) the regulations that already govern the treatment of contingent debt instruments under Treas. Reg. § 1.1275-4 and (b) the treatment of swaps other than Contingent Nonperiodic Swaps under the Current Swap Regulations. We believe that consistency is beneficial, both in terms of providing for the consistent treatment of equivalent financial transactions and in providing a coherent and comprehensive framework from which to devise the reasonable treatment of new financial instruments.

As explained below, however, we believe that the application of the Noncontingent Swap Approach described in the Notice is somewhat more complex than it needs to be to achieve its stated objectives. We do not think, for example, that it would prove easy or accurate to estimate anticipated contingent payments by reference to what

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See Rev. Ruls. 60-177, 1960-1 C.B. 9 and 80-135, 1980-1 C.B. 18.

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For similar reasons, we do not think that the tax “detriment” associated with a collateralized short position in growth equities should be replicated by a derivative short swap position. Thus, we note that under our proposed rules there will likewise be a difference in tax treatment between actual and derivative transactions on the “short side” of a swap. For example, a taxpayer who borrows growth stock, sells it short and invests the short sale proceeds in an interest-bearing account will recognize current income without any offsetting deduction for a systematic increase in the “negative” value of the taxpayer’s short liability, whereas under our proposed rules, a taxpayer’s analogous current receipts from a short position in an economically equivalent contingent nonperiodic swap would not be included in income.



it would cost to hedge the obligation to pay them. We also do not think it necessary to amortize those estimates over the life of the swap using relatively complex methodologies, and we think the resulting additional precision in the timing of inclusions and deductions would be small and largely illusory, given the uncertain nature of the estimates on which the amortizations would be based. Thus, where A makes fixed or floating payments to B in exchange for contingent payments, we think the anticipated amount of B's contingent payments are better determined by reference to the amount of A's scheduled payments than by reference to the price for which B could purchase equivalent rights in the marketplace.<sup>8</sup>

We also do not believe the amounts of expected payments that are determined at the outset of the swap should be periodically adjusted to reflect intervening changes in the value of referenced property. As the Notice points out, to the extent that changes in value are not realized through actual payments, the methodology effectively would constitute a modified "mark-to-market system," which would diverge from the realization method of accounting. As in the case of the "full deferral approach" discussed above, we view divergence as undesirable, given that equivalent financial transactions are dealt with under the realization method of accounting, nor are we certain there is authority for instituting realization divergence in this context. If A agrees to make a payment at maturity of a swap based on the change in the value of commodity, we see no reason why A should be permitted or required to recognize gain or loss long before it is established that a payment will ever be made or how much that payment will be. Moreover, as the Notice points out, a mark-to-market method of accounting raises serious

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Where A and B both make contingent payments, however, the anticipated amounts of scheduled payments must necessarily be determined by reference to all of the relevant facts and circumstances, and these facts and circumstances presumably will include the price for which equivalent rights could be purchased in the marketplace. They may also include such facts as what the current dividend rate is on underlying stock, as discussed in the examples below.

valuation issues that introduce considerable additional complexity into the accounting of income and deductions from swaps.<sup>9</sup>

### III. Recommended Approach

We set out below the approach we think best reflects and implements the principles discussed above:

#### A. Periodic Treatment

We note first that the rules we propose for Contingent Nonperiodic Swaps (the “Proposed Rules”) will not apply to a broad range of swaps providing for contingent periodic payments but not providing for any nonperiodic payments (a “Contingent Periodic Swap”). The timing of periodic payments, whether fixed or contingent, is already set out in the Current Swap Regulations and, in general, those payments simply are included or deducted in the year in which they are paid or received.<sup>10</sup> Consider, for example, a swap where A promises to pay B \$7x each year, and B promises to pay A an amount each year equal to the increase, if any, in the value of a specified commodity. A and B will include in their respective incomes and deduct from their respective incomes the net amount received or paid each year (hereafter, “Periodic Treatment”), and we think this treatment is both logical and consistent with general tax accounting principles.

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We recognize that the counterparties for many swaps are U.S. securities dealers that are on a mark-to-market method of accounting. We are informed, however, that these dealers do not value their swaps on an individual basis but rather as part of a large, integrated market portfolio. Taxpayers would therefore not be able to use dealer valuations to establish the values of their swaps on a periodic basis. We also recognize that given that U.S. dealers use a mark-to-market method of accounting, the timing of income or loss from swaps often will not be consistent with the timing of the counterparty. This is equally true, however, of options, forwards, equities, commodities and other financial positions held by taxpayers. It is also true of swaps between U.S. persons and foreign persons not subject to U.S. tax at all. We therefore think it more important to maintain consistency of treatment among a variety of economically equivalent transactions entered into by a given taxpayer than to maintain consistency between counterparties.

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Treas. Reg. § 1.446-3(e).

Likewise, consider the typical “periodic” equity swap in which A agrees to make annual payments to B equal to \$5x plus an amount equal to the decrease, if any, in the value of X stock over the course of the year in exchange for amounts equal to the increase in value, if any, of X stock over the course of the year plus any dividends paid on X stock. We think that all of the payments on this swap should be treated as Periodic Payments and should receive Periodic Treatment, even though payments under the swap are based on two objective formulas, rather than one. Thus, A and B should simply include and deduct the net amounts received or paid each year.

We recognize that in most cases, Periodic Treatment will overlook a modest amount of front or backloading of payments, because the price of most stocks and commodities are expected to increase (*e.g.*, with inflation) over time. Thus, in the example above, the payments that A receives from B would be somewhat larger, on average, in the later years of the swap than in the earlier ones. (This may be contrasted, for example, with a swap where B promises to pay A amounts based on the percentage increase, rather than the absolute increase, in the value of a specified commodity, in which case the payments would not be expected to increase over time.) We do not think it necessary, however, to adjust for this sort of backloading of contingent payments, because we believe the potential for backloading abuse is limited and the risk of abuse therefore does not justify implementing a complex adjustment methodology. Moreover, because backloading generally is attributable to inflation, the net present value of the anticipated payments under the swap generally may be equal, notwithstanding the modest backloading. Put differently, the fixed-rate payments under a long-term swap might themselves be viewed as “frontloaded,” in the sense that earlier payments have a greater net present value than later payments.

We also note that it is possible, under the definition of periodic payments in the Current Swap Regulations, to construct a Contingent Periodic Swap with a much more substantial backloading of payments. Suppose, for example, that the currency of Country X is currently pegged to the U.S. dollar but will float freely after Date 1. B promises to make payments to A based on changes in the U.S. dollar value of

Currency X. These payments will be \$0 prior to Date 1 and quite substantial thereafter. Alternatively, suppose B promises to make payments to A based on the increase, if any, in the value of a specified commodity above \$300x, but the commodity is trading at \$100x today.

Were Periodic Treatment to apply to these swaps, substantial income distortions would ensue. As noted in Part II above, where A is making fixed payments to B during the earlier periods of a swap and B is not making corresponding payments to A, we do not think A should be entitled to deduct, as a current expense, what amounts to A's "investment" in A's right to receive future contingent payments from B. One might argue that some swaps of this sort can be excluded from the definition of "notional principal contract," and therefore denied Periodic Treatment under the Current Swap Regulations, on the grounds that they are really "caps," "options," "forwards" or other financial instruments.<sup>11</sup> We do not think this is an adequate response to the problem, however, for two reasons: first, we do not think objective rules can serve to properly distinguish between swaps on the one hand and other financial instruments on the other; second, we in any case do not think that the tax treatment of swaps should diverge from other financial instruments so that important tax consequences turn on classification. Such "cliffs" in the tax treatment of financial instruments give rise to both traps for the unwary and undesirable planning opportunities, and while they are in some cases unavoidable, one of the objectives of this report is to help the Treasury limit them.

We therefore recommend instead that the definition of Periodic Payments in the Current Swap Regulations be revised to exclude payments that produce "substantial" front or backloading by reason of caps, floors or other limitations on the amounts of payments, idiosyncrasies in the nature of the referenced property or similar factors.<sup>12</sup> Payments thus excluded would then be dealt with in the manner we propose

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See Treas. Reg. § 1.446-3(c)(1)(ii), dealing with "excluded contracts."

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We intend this rule to be more lenient than the rule of Treas. Reg. § 1.1275-5(c)(4) (defining an

below for contingent nonperiodic payments, which treatment is designed to make appropriate adjustments for anticipated variations in the timing of payments. We think the line between substantial and insubstantial front or backloading can best be fleshed out with a number of examples, and practitioners can then use their judgment in dealing with specific cases.

We also note that there may be some contingent payments that would be Periodic Payments but for the presence of a contingency that likely would be viewed as “remote” or “incidental” (as these terms have been defined in the regulations under Code § 1275) when considered in relation to the amount or frequency of the payments under the swap. For example, B might promise to make periodic payments to A equal to the dividends paid on a specified stock, but not in the case of an unanticipated “extraordinary dividend;” or B might promise to make payments to A equal to the decline in value, if any, of a specified stock, but not equal to a decline in value arising from an extraordinary dividend.

Given the relative simplicity of Periodic Treatment, we think the Periodic Payments definition should be flexible enough to permit the broadest possible range of periodic swaps to qualify for Periodic Treatment. We therefore recommend that the definition of Periodic Payments in Treas. Reg. § 1.446-3 contain language similar to the language of Treas. Reg. § 1.1275-2(h)<sup>13</sup> that permits taxpayers to ignore certain remote or

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“objective rate of interest” on a variable rate debt instrument), which effectively defines a substantial front or backloading of interest to include any case where the average value of the rate during the first half of the instrument’s term is reasonably expected to be significantly less or greater than the average value of the rate during the last half of the instrument’s term. As noted above, this value variance is true of almost any swap providing for contingent payments based on the value of property.

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“(2) *Remote contingencies.* A contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur.

(3) *Incidental contingencies* – (i) *Contingency relating to amount.* A contingency relating to the amount of a payment is incidental if, under all reasonably expected market

incidental contingencies. (These contingencies would be ignored solely for purposes of determining whether swap payments were Periodic Payments.) We note that unlike debt instruments, swaps do not also provide for relatively large payments of principal and interest. The relevant language must make it clear, therefore, that the contingency in question must be remote or incidental when considered in relation to the other payments that are promised by the same payor under the terms of the swap. For example, suppose that A makes fixed payments to B in exchange for B's promise to make a large payment to A at maturity of the swap if the price of a specified stock is more than 10 times at maturity what it was on the date that the swap was entered into. B's payment is not "remote" merely because it is unlikely to occur -- to the contrary, it is the only payment B can make under the swap.

#### B. Exclusion of Periodic Swaps with Contingent Nonperiodic Payments from Periodic Treatment

For the reasons set out in Part II above, we do not think that any of the payments on a swap should be accorded Periodic Treatment (*i.e.*, included or deducted in full) if the swap provides for a contingent nonperiodic payment. Unlike the noncontingent nonperiodic payments described in B above, contingent nonperiodic payments cannot be matched to the remaining Periodic Payments on the swap. It follows

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conditions, the potential amount of the payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(i), the payment is ignored until the payment is made. However, see paragraph (h)(6)(i)(B) of this section for the treatment of the debt instrument if a change in circumstances occurs prior to the date the payment is made.

(ii) *Contingency relating to time.* A contingency relating to the timing of a payment is incidental if, under all reasonably expected market conditions, the potential difference in the timing of the payment (from the earliest date to the latest date) is insignificant. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(ii), the payment is treated as made on the earliest date that the payment could be made pursuant to the contingency. If the payment is not made on this date, a taxpayer makes appropriate adjustments to take into account the delay in payment. However, see paragraph (h)(6)(i)(C) of this section for the treatment of the debt instrument if the delay is not insignificant."

that the Periodic Payments must be matched to the contingent nonperiodic payments and therefore cannot simply be included or deducted from income.

As discussed in A above, however, there may be noncontingent nonperiodic payments that are remote or incidental when considered in relation to the Periodic Payments made by the *same* payor under the swap. We think it appropriate, in such a case, to allow Periodic Treatment of all of the remaining Periodic Payments under the swap.

We also note that in certain cases, A may agree to make Periodic Payments in exchange for one or more contingent nonperiodic payments that may be made at any time. For example, B may agree, in exchange for A's Periodic Payments, to make a large payment to A if and when an earthquake occurs in a given community. In such a case, the "average amount" that B is expected to pay A in any given year presumably equals the average amounts that A is expected to pay B. If B makes no payment in a given year, therefore, we think that A should be able to deduct from income, and B should be required to include in income, the payment that A makes to B. In other words, we think that A's payments *should* be accorded Periodic Treatment. We think the regulations should make it clear that this treatment is available only if neither the likelihood that B will make a payment nor the likely amount of B's payment, if made, is expected to vary significantly over the life of the swap.

#### C. Simplified Non-Interest-Accrual Approach for Certain Contingent Swaps with Terms of 3 Years or Less

Set out in section D below is a general methodology for matching the timing of payments on Contingent Nonperiodic Swaps. We believe it to be reasonably simple and consistent with the current methodology set out in the Current Swap Regulations for dealing with noncontingent swaps. The methodology does, however, generally require the accrual of interest on earlier payments that are treated as loans; and to this end it generally requires that a Contingent Nonperiodic Swap be effectively

“disaggregated” into a deemed loan and a deemed matching-payment swap. We do not believe the complexity associated with disaggregation is justified in the case of certain relatively common swaps that (a) have terms of 3 years or less, and (b) require one party (“A”) to make noncontingent (*i.e.*, fixed or floating) Periodic Payments (or increasing payments) in exchange for one or more nonperiodic contingent payments. We think that in such a case, the resulting interest accrual would be *de minimis* and would not justify the associated administrative complexity, even where the contingent payments are made solely at swap maturity.<sup>14</sup>

We are therefore proposing a simplified approach for swaps with the characteristics described above. Like the more complex approach set out in Section D below, this approach requires the parties to prepare a schedule reflecting both the number of anticipated fixed or floating payments and the “average” anticipated amounts of each contingent payment, and to include and deduct the difference between the anticipated payments and the actual payments. The approach is easier to administer than the general approach, however, because the differences in the timing of the payments on the swap are not accounted for through interest accruals. The contingent payments on the swap can therefore simply be deemed to equal the non-contingent payments, and the swap can be accounted for accordingly. Except as noted below, we would not expect the parties to file anticipated payment schedules with the IRS. We would expect the IRS to require,

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The decision is one of judgment, balancing technical precision (and any concerns regarding abuse) against administrative convenience. We recognize, moreover, that this proposed nonaccrual of interest diverges from the treatment of noncontingent swaps with terms of 3 years or less. We do not think, however, you should revise the general rules governing nonperiodic swap payments to eliminate interest accrual on noncontingent swaps with terms of three years or less, because time value is a much more dominant component of non-contingent swap. While it may be reasonable to ignore interest accrual where A pays B \$100x today in exchange for a wholly contingent payment in three years, for example, we do not think it would be appropriate to ignore interest accrual where A pays B \$100x today in exchange for \$120x in three years. We recognize, however, that taxpayers have the ability to cast payments as contingent even though their variability is limited (*e.g.*, a payment determined by the value of a short-term Treasury security). We therefore think you might consider an anti-abuse rule designed to ensure that taxpayers do not characterize otherwise noncontingent swaps as including contingent payments merely to avoid interest accrual.



however, that the parties' schedules be consistent with each other and that they be agreed upon when the swap is entered into.

As noted in Section B above, we do not think any of the payments on a Contingent Nonperiodic Swap should be entitled to Periodic Treatment. Rather, consistent with the more complex approach set out in Section D below, A and B should be required to include and deduct only the variations of actual payments made under the swap from the amounts that were expected to be paid at the time the swap was entered into. Where appropriate, the inclusion and deduction of those variations should continue to be governed by the rules that apply to Periodic Payments generally. For example, where A deducts \$2x because a periodic LIBOR payment that is set in arrears turns out to be \$9x rather than \$7x (*i.e.*, because interest rates have risen), the allocation of that deduction between two relevant taxable years would be governed by the rules of Treas. Reg. § 1.446-3(e).

Our simplified approach can best be understood through the application of a number of examples:

#### Example C-1

First, suppose A agrees to pay B \$7x in years one, two and three of a swap in exchange for the receipt, at the end of year 3, of a wholly contingent payment. The taxpayers should assume that A will pay B \$7x in each of years 1 and 2, and that B will pay A \$14x in year 3 (*i.e.*, an amount equal to the aggregate of the two \$7x payments that A will pay B in years 1 and 2). Any difference between \$14x and the net amount A actually receives from B in year 3 will be treated in year 3 as gain or loss.

#### Example C-2

Second, suppose in Example C-1 that A agrees to pay LIBOR plus 200 basis points, rather than \$7x, per annum (but LIBOR plus 200 basis points equals \$7x when the swap is entered into). The taxpayers should make the same assumptions and

include or deduct, in years 1 and 2, any difference between \$7x and the amount A actually pays to B in that year. In other words, the taxpayers should make the simplifying initial assumption that LIBOR will not change throughout the life of the swap.

#### Example C-3

Third, suppose in Example C-1 (where A pays \$7x per annum) that B agrees to pay A, in addition to a contingent payment at the end of year 3, a “floating amount” at the end of year 2 (*i.e.*, based on interest rates) that will be \$5x if interest rates do not change after the swap is entered into. The taxpayers should assume that A will pay B \$7x in year 1, and \$2x ( $\$7x - \$5x$ ) in year 2, and that B will pay A \$9x ( $\$7x + \$2x$ ) in year 3. They should include or deduct, in the appropriate years, any differences between these expected payments and the actual payments.

#### Example C-4

Fourth, suppose that B will make two *wholly* contingent payments to A -- one at the end of year 2, and one at the end of year 3. The aggregate amount of B’s payments, which are assumed to equal the aggregate amount of A’s scheduled payments (*i.e.*, \$21x), should be divided between the two scheduled payments based on all facts and circumstances. We think, moreover, that if B’s contingent payments would be Periodic Payments if the swap were entered into at the start of year 2, then A and B should be permitted to make the simplifying assumption that B’s contingent payments will be equal (*i.e.*, in this case, \$10.5x each).<sup>15</sup> Thus, A should be expected to pay B \$7x in year 1, and B should be expected to pay A \$3.5x ( $\$10.5x - \$7x$ ) in each of years 2 and 3. The parties

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<sup>15</sup>

The simplifying assumption would appear to be consistent with Treas. Reg. § 1.446-3(f)(2)(iii)(A), which permits a taxpayer to amortize an upfront payment on a swap by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap. The parties could also be permitted to devise a more complex allocation, based on all relevant facts and circumstances. Allowing the latter approach would give more precise answers in some cases but also would permit some “electivity” and cause different similarly situated taxpayers to be treated somewhat differently.

should include and deduct, in the appropriate years, any differences between these scheduled payments and the actual payments.

#### Example C-5

Fifth, suppose B will make contingent payments to A at the end of years 1, 2 and 3, but the contingent payments at the end of years 1 and 2 will equal the dividends paid on an identified amount of a specified stock, while the payment at the end of year 3 also will include an amount equal to the increase, if any, in the value of the identified stock. We think that if the issuer of the identified stock is not controlled by A or B, the parties should be required to make the simplifying assumption that B's "dividend equivalent payments" will equal the dividends actually being paid on the stock on the date the swap is entered into. Thus, if the stock is not paying any dividends when the swap is entered into, A will be expected to pay B \$7x in years 1 and 2, and B will still be expected to pay A \$14x in year 3. If, however, the stock is paying a dividend of \$1x per annum when the swap is entered into, A will be expected to pay B \$6x in each of years 1 and 2, and B will be expected to pay A \$12x in year 3.

#### Example C-6

Sixth, assume that in exchange for a wholly contingent payment from B at the end of year 3, A agrees to pay B per annum, rather than \$7x, \$5x plus an amount equal to any decrease in the value of a specified stock over the course of the year. We think, in this case, the parties should be required to estimate the "average anticipated amounts" of A's contingent payments to B, based on all relevant facts and circumstances. We further think A and B should be required to make the simplifying assumption that all contingent payments will be equal if they are Periodic Payments as defined in the Current Swap Regulations (*i.e.*, if they are based on the same formula and involve periods of equal length).<sup>16</sup> Assuming, for example, that A estimates an average additional payment

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<sup>16</sup>

*Id.*

to B of \$2x, A would be expected to pay B \$7x (\$5x+\$2x) in years 1 and 2, and B would be expected to pay A \$14x in year 3. We think it might be helpful in this case to require a taxpayer that is not on a mark-to-market method of accounting to file a schedule of expected payments with its federal income tax return for the year in which the swap is entered into.<sup>17</sup>

#### Example C-7

Seventh, assume A agrees to make increasing payments to B of \$5x, \$7x and \$9x (or LIBOR, LIBOR plus 200 basis points, and LIBOR plus 400 basis points) over the life of the swap in exchange for a wholly contingent payment from B at maturity. The accounting would be similar: A would be expected to pay B \$5x in year 1 and \$7x in year 2, and B would be expected to pay A \$12x in year 3. The parties would include or deduct any differences between the expected payments and the actual payments in each of the three years the swap remained in existence.

#### Example C-8

Eighth, assume A agrees to pay B, in years 1, 2 and 3, \$5x plus amounts equal to the decrease in value of a specified amount of an identified stock, and B agrees to pay A, in years 1, 2 and 3, amounts equal to the dividends paid on that stock, and, at maturity, an amount equal to the increase in value of the stock over the life of the swap.<sup>18</sup> A and B should make the simplifying assumption that A's value payments will equal each other and that B's dividend equivalent payments will equal the dividends paid on the stock when the swap is entered into. The taxpayers should determine the difference between the former and the latter based on all relevant facts and circumstances.

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<sup>17</sup>

We note that in a different context, regulations under Code § 1060 require the parties to a sale of assets to file forms showing the allocation of purchase price among various asset classes.

<sup>18</sup>

If B's value payments are to be made periodically, the arrangement simply would be treated as a Periodic Swap, as discussed in A above.

Assuming, for example, they agree the average amount of A's periodic value decrease payments will exceed B's periodic "dividend equivalent payments" by \$1x per annum, A will be expected to pay B \$6x per annum in years 1 and 2, and B will be expected to pay A \$12x in year 3.

#### Example C-9

Finally, assume A agrees to pay B \$18x in year 1, and B agrees to make periodic payments to A at the end of years 1, 2 and 3 based on the increase in value, if any, of a specified stock. If B's contingent payments are Periodic Payments, the parties should be required to assume that these payments will be equal (*i.e.*, \$6x each). A should therefore expect to pay B \$12x (\$18x-\$6x) in year 1 and to receive \$6x from B in each of years 2 and 3. If B's periodic payments are not Periodic Payments, then the parties should be required to allocate the \$18x of total payments A expects to receive from B among the 3 anticipated payments based on all of the relevant facts and circumstances.<sup>19</sup>

#### D. The Accrual Approach for All Other Contingent Nonperiodic Swaps

Our Proposed Rules for dealing with contingent nonperiodic payments generally follow the methodology the Current Swap Regulations already provide for dealing with other nonperiodic payments. As discussed in Part II above, they start with the assumption that the timing of payments under a swap must be matched so that taxpayers are not including or deducting, as income or expense, payments that are in fact matched by offsetting payments in later periods and therefore represent "prepayments" or "investments," rather than items of income or expense. They further assume, however, that income (in the nature of interest income, although it may not be so characterized if the amounts involved are not "significant") should accrue on earlier payments that are

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<sup>19</sup>

We note that this final example would be a change from the Current Swap Regulations, which effectively requires that interest accrue on the upfront periodic payment, even though the swap term is only 3 years. See Treas. Reg. § 1.446-3(g)(6), ex. 3 and the discussion in Part D below.

offset by subsequent payments.<sup>20</sup> Thus, where an earlier payment effectively is offset by a later payment, our Proposed Rules effectively replace the earlier payment with a larger later payment of equivalent present value and accrue interest income over the intervening period in an amount equal to the excess of the latter over the former.

For the reasons set out in Part II above, we approve of the methodology set out in the Current Swap Regulations for dealing with nonperiodic payments and seek to do no more than adapt it adequately to account for contingent nonperiodic payments. However, as noted in Part II above, because the amount of a contingent nonperiodic payment is not known, the amount of the “matching” noncontingent payment must be determined by reference to the earlier (or later) actual noncontingent payment, rather than by reference to the amount of the contingent nonperiodic payment. This matching requires reversing the steps set out in the Current Swap Regulations for creating a deemed debt obligation and a deemed matching-payment swap. We do not think adapting the Current Swap Regulations to deal with contingent nonperiodic payments involves any additional complexity, however. Our thinking in this regard is best illustrated by a series of examples.

#### 1. Basic Methodology: Fixed Upfront Payment in Exchange for a Deferred Contingent Payment

Let us consider first the simple case in which A pays B \$25x today in exchange for B’s promise to make a fixed payment to A of \$45x at the end of 5 years. Let us assume, for purposes of analysis, that this is a notional principal contract governed

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<sup>20</sup>

Under Current Swap Regulations, where an upfront nonperiodic payment is “significant,” interest income received by the deemed lender is offset by an additional payment made by the deemed lender under the swap terms. Where the nonperiodic payment is “insignificant,” however, these two offsetting payments are effectively ignored, and the deemed lender is permitted to amortize and deduct the “principal” portion of the deemed loan (*i.e.*, the amount of the upfront payment) over the life of the swap. Compare Treas. Reg. § 1.446-3(g)(6), ex. 3 with Treas. Reg. § 1.446-3(f)(4), ex. 5.

by the Current Swap Regulations,<sup>21</sup> rather than simply a zero-coupon loan. Under the Current Swap Regulations, the parties would be treated as if (a) A had lent B \$25x in exchange for B's promise to repay \$45x at the end of 5 years (the "Deemed Debt Obligation"), and (b) A had separately agreed to pay B, at the end of 5 years, \$45x in exchange for \$45x (the "Deemed Matching-Payment Swap").<sup>22</sup> This result would be reached through the following methodology: the amount of A's Deemed Payment to B under the Deemed Matching-Payment Swap (*i.e.*, \$45x) would be determined first and would be derived by assuming that it is equal to the amount of B's promised \$45x payment to A. A's deemed \$45x payment to B under the Deemed Matching-Payment Swap would then determine the amount of A's deemed receipt from B at maturity of the Deemed Debt Obligation (*i.e.*, likewise \$45x).

With this in mind, let us consider the case where B promises to pay A a completely contingent amount at the end of 5 years. Let us assume, for purposes of analysis, that this is a notional principal contract governed by the Current Swap Regulations, rather than just a prepaid forward or option contract. In this case, A and B do not know, when the swap is entered into, how much B will pay A at maturity of the swap. Thus, while the same general approach may be employed to arrive at a similar treatment, the method for determining the amount of the payments involved must be reversed. First, A's deemed receipt from B under the Deemed Debt Obligation must be determined by reference to the amount of A's actual \$25x payment to B at the beginning of the swap. The amount of A's deemed receipt from B under the Deemed Debt Obligation must then determine the amount of A's deemed payment to B under the Deemed Matching-Payment Swap.

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<sup>21</sup>

As a technical matter, the Current Swap Regulations might not apply in the manner here described to these particular payments, because the regulations were not designed for instruments with no periodic payments.

<sup>22</sup>

See Treas. Reg. § 1.443-3(g)(6), ex. 3.

Thus, A's known \$25x payment to B at the beginning of the swap should accrue interest over the 5-year life of the swap at B's true borrowing rate (presumably determined under the rules set out in Treas. Reg. § 1.1275-4). Assuming that A will, as a result, include \$20x of interest in income over the life of the Deemed Debt Obligation, A will be deemed to receive \$45x from B at maturity of the Deemed Debt Obligation. This deemed \$45x receipt will, in turn, cause A to be treated as making a \$45x payment to B at maturity of the Deemed Matching-Payment Swap in exchange for the Contingent Amount. At swap maturity, applying the general rules for Periodic Payments to the Deemed Matching-Payment Swap, A will include any excess of the amount it receives from B over \$45x in income, and A will deduct any excess of \$45x over the amount it receives from B.

Likewise, A's basis in the Deemed Debt Obligation, and therefore in the swap, will increase from \$25x to \$45x over the life of the swap. If the swap is terminated or disposed of prior to maturity, A will include or deduct any difference between the amount received and A's basis in the swap at that time.

Of course, the Deemed Matching-Payment Swap is, in this case, nothing but a forward contract, and the swap as a whole is nothing but a prepaid forward contract. The application of these rules is not consistent with the treatment of prepaid forward contracts, which do not accrue interest under current law. The application of these rules is wholly consistent, however, with the recommendations in our report of March, 2001, on the timing and character rules for prepaid forwards and options (the "Options and Forward Report").<sup>23</sup> It is also wholly consistent with the treatment of swaps other than Contingent Nonperiodic Swaps under the Current Swap Regulations, which accrue interest on "significant" upfront investments at the lender's true borrowing rate,<sup>24</sup> and

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<sup>23</sup>

Tax Section Report No. 990 (March 26, 2001) entitled "Timing and Character Rules for Prepaid Forwards and Options."

<sup>24</sup>

Treas. Reg. §§ 1.446-3(f) and (g)(4).



with the current regulations under Treas. Reg. § 1.1275-4 dealing with contingent debt instruments. If, therefore, Treasury and the IRS adopt the recommendations of our Options and Forwards Report, it will not matter (at least insofar as timing is concerned) whether the swap described above is characterized for U.S. tax purposes as a contingent debt instrument, an option, a forward contract or a notional principal contract. Its treatment will, in all of these cases, generally be the same.

If these rules are adopted apart from our other recent recommendations, however, we think it would be important to provide guidance regarding the distinction between swaps governed by the accrual regime of Treas. Reg. § 1.446-3 and forwards, options and other instruments that do not receive accrual treatment. We are especially concerned about the opportunities for whipsaw or abuse and the economic inefficiencies associated with a “cliff” in the treatment of equivalent financial instruments.

## 2. Typical Exchange of Current Noncontingent (Fixed or Floating) Payments for a Deferred Contingent Payment

### Example D-1

Having set out the basic approach, let us turn to the more typical case in which A pays B \$7x per annum for 5 years in exchange for the receipt of the Contingent Amount at swap maturity. Once again, A’s periodic payments to B should not be deducted currently because they represent investments, not expenses. The technical reason they cannot be deducted as Periodic Payments under the Proposed Rules is that they are replaced by a single deemed payment at maturity under the Deemed Matched-Payment Swap. More specifically, the Deemed Debt Obligation is deemed to consist of a series of \$7x loans from A to B at the end of years 1, 2, 3 and 4, respectively, in exchange for notes with terms of 4, 3, 2 and 1 years, respectively, that are issued by B for \$7x each. Interest accrues on B’s Deemed Debt Obligations to A at B’s true borrowing rate, and let us assume that the resulting deemed receipt by A from B at the end of 5 years is \$45x. Under the Deemed Matching-Payment Swap (which once again is really nothing but a

forward contract), A is therefore deemed to pay B \$45x at maturity, rather than \$7x per annum, and the Deemed Matching-Payment Swap is taxed in the manner set out in 1 above. A's basis in the Deemed Debt Obligations, and therefore in the swap, likewise increases from \$0x to \$45x over the life of the swap. In the event of termination or disposition of the swap prior to maturity, A recognizes any difference between its basis and the amount actually received.<sup>25</sup>

### Example D-2

Taking this one step further, suppose A promises to pay B LIBOR plus 200 basis points, rather than \$7x, per annum (but LIBOR plus 200 basis points happens to equal \$7x on the date the swap is entered into). Consistent with both the Current Swap Regulations and the rules of Treas. Reg. §§ 1.1275-4 and 5,<sup>26</sup> the swap accounting should

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<sup>25</sup>

This approach is consistent with the approach that applies, on an elective basis, to other nonperiodic swaps under Treas. Reg. §§ 1.446-3(f)(2)(v)(B) and (f)(2)(iii)(A). The latter approach appears, however, to take two steps, rather than one, to accomplish a substantially similar result. Under the latter approach, B's anticipated \$45x payment at maturity of the swap would first be converted to a \$25x upfront payment. A would be deemed to lend B the \$25x B needed to make this upfront payment in exchange for B's promise to pay A \$45x at maturity, and A would include, and B would deduct, \$20x of interest over the life of this first deemed debt obligation. Next, B would be deemed to lend A \$25x in exchange for A's promise to pay B \$7x per annum over the life of the swap under an installment obligation. B would include, and A would deduct, \$10x of interest over the life of this second deemed debt obligation. A's deemed receipt of \$20x of interest over the life of the first debt obligation would be offset by A's deemed payment of \$10x of interest over the life of the second debt obligation, leaving A in substantially the same position as if A were simply deemed, as in the example in the text above, to be lending B \$7x per annum in exchange for the receipt of \$45x per annum at maturity and including \$10x per annum of interest in income over the life of the deemed debt obligation.

As noted above, however, where B's payment at maturity is a contingent payment, it is not possible to perform this two-offsetting-debt-obligations analysis, because it is not possible to know, ahead of time, that B's payment at maturity is expected to be \$45x. Moreover, we do not see any reason to accomplish in two steps what can be accomplished more simply and directly in one. We think the two-step approach will prove needlessly complex and confusing. We therefore think the regulations governing noncontingent nonperiodic swap payments should be revised and clarified to provide that a taxpayer making periodic payments in exchange for a later nonperiodic payment is deemed to be lending to, rather than borrowing from, its counterparty, consistent with the example set out above.

<sup>26</sup>

Treas. Reg. §§ 1.1275-4(b) and 5(e).

be based on the LIBOR value at the time the swap is entered into and should therefore be the same as the treatment described above. The only difference is that A and B should include and deduct each year any difference between \$7x and the amount that A actually pays B based on floating interest rates. In other words, A and B should effectively be deemed to have added an at-the-money fixed-to-floating interest rate swap to their transaction.

#### Example D-3

Next, suppose A promises to pay B per annum, rather than \$7x, \$5x plus an amount equal to any decrease in the value of a specified commodity. The parties must estimate the “average anticipated amount” of A’s contingent payments to B, based on all relevant facts and circumstances. Consistent with the approach set out for Periodic Payments in A above, if A’s contingent payments are Periodic Payments (*i.e.*, based on the same objective formula throughout the life of the swap and involving payment periods of equal length), then the parties should be required for this purpose to make the simplifying assumption that all of A’s contingent payments will be equal. Assuming, for example, A estimates an average contingent payment to B of \$2x, A would be presumed to pay B \$7x (\$5x+\$2x) per annum, and the accounting for the swap would be the same as above. We think it might be helpful, however, to require both parties, if they are not on a mark-to-market method of accounting, to file a schedule of payments with the IRS with the return for the year in which the swap is entered into.

#### Example D-4

Suppose A promises to make wholly contingent periodic payments to B, based on the annual changes in value of a specified commodity, in exchange for B’s promise to make a wholly contingent payment to A at swap maturity. The taxpayers must, in this case, estimate the “average anticipated amount” of all of their future payments and receipts, based on all relevant facts and circumstances. The resulting schedule of payments would be subject to general schedule constraints (*e.g.*, interest

would have to accrue on the resulting Deemed Debt Obligation at B's true borrowing rate, and scheduled payments would have to match actual payments in number and timing). We once again think it might be helpful to require each party to file a schedule of anticipated payments with the IRS if the party is not on mark-to-market accounting. If A files a schedule showing anticipated payments of \$7x per annum and an anticipated receipt of \$45x at maturity, the swap would be accounted for in the manner described above.

### 3. Typical Exchange of a Fixed Upfront Payment for Periodic Contingent Payments

#### Example D-5

Consider the case in which A pays B \$25x upfront in exchange for B's promise to make annual payments to A based on the increase, if any, in the value of a designated commodity. A must construct a schedule of deemed Periodic Payments that match, in number and timing, the potential receipts A is scheduled to receive from B. We believe the rules of Treas. Reg. § 1.1275-4 should prove suitable guidance for A in constructing this schedule, and under both those rules and the Current Swap Regulations, the aggregate amount of the resulting Deemed Receipts must be such that interest accrues on the resulting Deemed Debt Obligation at a rate that equals B's true borrowing rate, and the relative amounts of the estimated Deemed Receipts should be based on all relevant facts and circumstances.

If B's payments are Periodic Payments, however, the parties should be required to assume that all of B's payments will be equal.<sup>27</sup> A might therefore expect to receive \$7x per annum on the resulting Deemed Installment Obligation, in which case A would include \$10x of interest (\$35x-\$25x) in income over the 5-year life of the Deemed

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<sup>27</sup>

Alternatively, the parties could simply be permitted to make this assumption but also be permitted to devise a more complex allocation. This approach likely would provide more precise answers but also would permit some undesirable "electivity" and cause similarly situated taxpayers to be treated somewhat differently.

Installment Obligation. Likewise, A would be deemed to pay B \$7x per annum under the Deemed Matching-Payment Swap. A would therefore include in income any excess of the amount actually received from B each year over \$7x, and A would deduct any excess of \$7x over the amount actually received from B.<sup>28</sup>

A's basis in the Deemed Installment Obligation, and therefore in the swap, would decrease from \$25x to \$0x over its 5-year life. If A terminated or disposed of its position in the swap prior to maturity, A would include or deduct any difference between its then basis and the amount A actually received.

#### Example D-6

Next, consider the case where A pays B \$25x upfront in exchange for B's promise to make annual payments to A equal to the dividends paid on a specified amount of a designated stock, and also, at maturity of the swap, an amount equal to the increase in value, if any, of the stock over the life of the swap. A must construct a table of expected receipts with relative values based on all relevant facts and circumstances. The table must provide for payments that are equal in timing and amount to the contingent payments A is scheduled to receive from B, and it must reflect the accrual of interest on the Deemed Debt Obligation at a rate equal to B's true borrowing rate. If the issuer of the designated stock is not controlled by either A or B, the expected amount of B's "dividend equivalent payments" should equal the amount of the annual dividends actually being paid on the stock on the day the swap is entered into.<sup>29</sup>

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<sup>28</sup>

We note that, under the Current Swap Regulations, if A's upfront \$25x payment were deemed to be "not significant," A would ignore its inclusions of interest income and its offsetting deductions of payments of additional amounts under the swap equal to that interest received, and A would therefore simply deduct its \$25x upfront payment over the life of the swap, under yield to maturity principles, as an offset to the Periodic Payments received from B. See Treas. Reg. § 1.446-3(f)(4), ex. 5. We here assume that all nonperiodic contingent payments on these swaps would be "significant."

<sup>29</sup>

Once again, we note the alternative that the parties could be permitted to make this assumption.

Thus, if the stock in question has not been paying any dividends on the day the swap is entered into, A can simply assume that B will pay A \$45x at the end of 5 years and account for the swap as described in 1 above. If the stock has been paying dividends of \$1x per annum, A should construct a table of anticipated receipts from B equal to \$1x per annum in years one through four and, let us assume, \$40x in year 5. A would include, and B would deduct, the resulting \$19x of interest paid on the resulting Deemed Installment Obligation ratably over the life of the Obligation. A would likewise be deemed to pay B \$1x per annum under the Deemed Matching-Payment Swap. Thus, if A, in fact, received nothing from B in year 1, A would deduct \$1x, and B would include \$1x in income. But, if A, in fact, received \$2x from B in year 1, A would include \$1x in income, and B would deduct \$1x.

#### 4. Exchange of Contingent Periodic Payments for a Deferred Noncontingent (Fixed or Floating) Payment

##### Example D-7

A agrees to pay B \$45x at the end of year 5 in exchange for B's agreement to make annual payments to A based on the periodic increases, if any, in the value of a commodity. As noted above, A's fixed payment must be matched to B's contingent payments, rather than the other way round, and A's payment at maturity must therefore be accelerated. A is therefore deemed to *borrow* from B amounts sufficient to permit A to repay \$45x to B under a Deemed Debt Obligation. A constructs a schedule of deemed loan receipts under the methodology set out above (*e.g.*, that results in the accrual of interest on the Deemed Debt Obligation at A's true borrowing rate) and is therefore deemed to receive \$7x per annum of loan proceeds from B. A deducts, and B includes in income, \$10x of interest (\$45x-\$35x) over the life of the Deemed Debt Obligation. B's basis in the Deemed Debt Obligation, and therefore in the swap, increases from \$0x to \$45x over the life of the swap. In the event of early termination or disposition, B includes or deducts any difference between B's adjusted basis and the amount B actually

receives. Similarly, A includes or deducts any difference between A's adjusted basis and the amount A pays to have the swap terminated or assumed.

Note, however, that A is still deemed to pay B \$7x per annum under the Deemed Matching-Payment Swap. Thus, A includes each year, and B deducts, the excess, if any, of the amount B pays to A over \$7x, and A deducts, and B includes, any excess of \$7x over the amount that A actually receives from B. The only difference between cases 3 and 4, therefore, is that in case 3, A is deemed to have loaned money to B, while in case 4, B is deemed to have loaned money to A.

#### E. Swaps that Hedge Debt Portfolios

While we believe the accounting method set out above serves to clearly reflect income from a contingent swap considered in isolation, the prescribed accounting might not clearly reflect income when a contingent swap is considered together with a portfolio of debt instruments the swap hedges. For example, assume A holds a subordinated "junk bond" paying 12% per annum and hedges that position by entering into a contingent swap under which A pays B 4% per annum and B pays A an amount equal to any loss A experiences on account of issuer default (which default is likely to occur, if at all, towards the latter part of the swap). Taking the two positions together, A is in the same economic position as a taxpayer who purchases a bond of superior credit paying 8% per annum, and we think it would clearly reflect A's income to permit A to treat the swap as a Periodic Swap, and currently deduct 4% per annum, so that A's net income from the combined positions is 8% per annum.<sup>30</sup> While this result might, in some cases, be reached under the approach set out above (*e.g.*, where default, if any, is expected to occur at any time), in other cases (*e.g.*, where default, if any, is expected to occur near swap maturity), the approach set out above would produce substantial deferral of deductions for the periodic swap payments.

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<sup>30</sup>

We do not here consider the possible application of the straddle rules.

We recognize there are limits to taxation by reference to economic equivalence. For example, if A purchases Stock X that pays dividends at a rate of 4% per annum and enters into a swap under which A pays 4% per annum and, at maturity, exchanges an amount of cash equal to the then value of Stock X for an amount of cash equal to the then value of Growth Stock Y, we do not think it would clearly reflect A's income to permit A to "integrate" the two positions and effectively defer current income from the dividends received on Stock X (*e.g.*, by currently deducting the full amount of its 4% periodic payments on the swap) merely because A would be in that position if A actually owned Growth Stock Y, rather than Stock X. Presumably the actual owner of Growth Stock Y already is claiming the tax benefit of deferral associated with its ownership. As noted in Part II above, for similar reasons, tax law does not permit the corporate recipient of an "in lieu of" dividend payment to take a dividends received deduction or the recipient of an "in lieu of" interest payment from the loan of a tax-exempt bond to exclude the payment from income.<sup>31</sup> We note, moreover, that the issuer of the junk bond described above presumably will be deducting interest at a rate of 12% per annum, notwithstanding that A effectively includes interest in income at a rate of only 8% per annum, and that the swap counterparty likely will be on a mark-to-market method of accounting.

Nevertheless, where a contingent swap hedges one or more debt obligations, we think the benefits of integrated tax accounting outweigh their potential costs. The health and fluidity of debt capital markets is important to the economy as a whole, and we think the development of credit swaps as a management tool has facilitated a more efficient allocation of capital. Treasury should encourage, rather than discourage, this development. In this case, for example, integrated treatment will encourage investors to direct capital to riskier growth corporations and use derivative instruments to efficiently allocate the associated risks.

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<sup>31</sup>

See fn. [6], *supra*.



As a technical matter, integration is sometimes available under current law under Treas. Reg. § 1.1275-6. Integration is permitted only if the combined positions permit the calculation of a single fixed or floating yield to maturity on the resulting integrated instrument.<sup>32</sup> This may not always be possible, and indeed, is not possible in the most typical case where B promises to pay A amounts equal to A's loss from the disposition of the referenced bond following default.<sup>33</sup> Moreover, it is not clear how the rules of Treas. Reg. § 1.1275-6 would accommodate an integrated hedging transaction that did not result in a single fixed or floating yield to maturity.

We further note that the “matching rules” of Treas. Reg. § 1.446-4 are not available to resolve this problem because they do not deal with investment hedging but rather with hedging in the ordinary course of business.<sup>34</sup> Moreover, it is not clear how the timing of gain or loss from the hedge would be matched, under those rules, to the timing of income or loss from the underlying bond.

In light of the above, we think the Periodic Payments definition should be broadened to include payments that otherwise would be Periodic Payments but for the fact that the counterparty is making contingent nonperiodic payments that serve primarily to hedge the risk of loss on specific debt obligations or loans held by the taxpayer. This treatment would permit A to deduct currently the payments described in the swap above while deferring any associated inclusions until they were received. We think this

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<sup>32</sup>

See Treas. Reg. § 1.1275-6(b)(2), defining a qualifying hedge for purposes of integration.

<sup>33</sup>

Moreover, the integration rules do not apply to debt instruments “to which section 1272(a)(6) applies,” which includes most asset-backed securities and, in light of the recent addition of Code § 1272(a)(6)(C)(iii) (pools of debt instruments where yields may be affected by prepayments), arguably might not apply to any portfolio of debt instruments that are callable (whether or not part of a securitization).

<sup>34</sup>

In general, the swap cannot be a qualifying hedge of the bonds, because the bonds produce capital gain or loss, and the bonds cannot be a qualifying hedge of the swap, because the bonds are excluded from the definition of a qualifying hedge by reason of being a financial investment. See Treas. Reg. § 1.1221-2(c)(3) and (5).

treatment would be consistent with other rules that effectively permit a taxpayer to integrate the cost of hedging risk from the ownership of debt with the debt itself, such that the taxpayer is in the same tax position as if it had acquired less risky debt. For example, Treas. Reg. § 1.446-3(f)(2)(v) permits a taxpayer to amortize the cost of purchasing an interest rate “floor” over the life of a floating-rate debt instrument that it hedges, even though the purchase of the floor effectively preserves the taxpayer’s “upside” from increases in interest rates while eliminating some of the taxpayer’s “downside” from decreases in interest rates.

We assume these periodic payments would not be treated as Periodic Payments in the hands of the swap counterparty, who would therefore not be required to include their full amount in income. Because most swap counterparties are either swap dealers on mark-to-market accounting or foreign persons, however, we do not think this recommended treatment would result in a significant revenue loss for the fisc.