New York State Bar Association

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March 15, 2004

Mr. Gregory F. Jenner
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Regulations Relating to Notional Principal Contracts with Nonperiodic Payments (REG-166012-02)

Dear Acting Assistant Secretary Jenner and Commissioner Everson:

I am writing to suggest that Treasury and the Internal Revenue Service issue interim guidance on certain issues raised by the recently proposed regulations under Section 446.[1]

The proposed regulations, which were published in the Federal Register on February 26th, 2004 (the "Proposed Regulations"), prescribe, among other things, a regime of tax accounting for a

[1] This letter has not been considered or approved by the New York State Bar Association Tax Section's Executive Committee, although in preparing it I have consulted informally with, and been assisted by, members of the Executive Committee.

Section references are to sections of the Internal Revenue Code of 1986, as amended.

contingent nonperiodic payment(a "CNP") provided for under a notional principal contract (a "CNP Swap"). The Tax Section intends to submit a full report on the Proposed Regulations in the near future. In preparing that report, we will be considering concerns that a number of members of the Tax Section have voiced regarding the appropriateness and complexity of the proposed method and the proliferation of regimes governing economically comparable instruments, which some view as a source of undesirable electivity. We will also be considering in detail whether, if a method like that of the Proposed Regulations is ultimately adopted in final regulations, it would be appropriate to continue to allow a different treatment (including, for example, the "wait-and-see" approach described in the Preamble to the Proposed Regulations) to be applied to some or all CNP Swaps entered into prior to the date the regulations are finalized.[2]

I write now because I believe that, given the positions taken in the Proposed Regulations, immediate guidance, in the form of an interim Announcement, is needed to address certain questions regarding accounting for CNP Swaps pending the publication of final regulations (which may, of course, take a different approach from that set out in the Proposed Regulations). The source of the questions on which I believe guidance is needed is the following language in the preamble to the Proposed Regulations (the "Preamble"):

> With respect to NPCs that provide for contingent nonperiodic payments and that are in effect or entered into on or after 30 days after the date of publication of these proposed regulations in the Federal Register, if a taxpayer has not adopted a method of accounting for these NPCs, the taxpayer must adopt a method that takes contingent nonperiodic payments into account over the life of the contract under a reasonable amortization method, which may be, but need not be, [a method described in the Proposed Regulations]. If a taxpayer has adopted a method of accounting for these NPCs, the Commissioner generally will not require a change in the accounting method earlier than the first

[2] The Proposed Regulations by their terms clearly would apply only to transactions entered into on or after 30 days after the date final regulations are published.

year ending on or after [30 days after finalization]. This language raises several questions as to which guidance is necessary.

One ambiguity in this language relates to whether taxpayers must have established a method of accounting for CNP Swaps as of February 26, 2004 (the date of publication of the Proposed Regulations), or whether taxpayers have until March 27, 2004, the 30th day thereafter, to do so. The phrasing "if a taxpayer has not adopted . . ." might refer back to "30 days after the date of publication . . ." in the prior clause, or might equally be a reference to the date the Proposed Regulations were issued (i.e., February 26, 2004). Under the former reading, taxpayers would have until March 26, 2004 to establish a method of accounting by filing a return reflecting CNP Swap positions (perhaps even by filing prior to the required due date for the return), whereas under the latter reading, taxpayers would need to determine whether they have a method of accounting without regard to post-publication filings. I question whether the former interpretation was intended; in any event, clarification on the point is needed.

Another uncertainty created by the above-quoted language is whether the wait-and-see method of accounting described in the Preamble will be considered "permissible" for purposes of determining whether a taxpayer has established a method of accounting for CNP Swaps entered into on or before February 26, 2004 ("Existing CNP Swaps"). Generally, a taxpayer is considered to have a method of accounting for a material item if that item is reflected on at least one return, has been reflected consistently, and is considered permissible. Otherwise, the taxpayer must have reflected the item consistently on at least two returns. Thus, it is important for some taxpayers to understand prior to their next return filing whether they have established a method of accounting for Existing CNP Swaps by filing only one return (in which event they must continue to use that method, absent the consent of the IRS) or whether they have established a method only if they have filed at least two consistent returns (in which case, taxpayers that have filed only one such return must use a "reasonable amortization method" on their next-filed return).

The Preamble describes the wait-and-see method as inconsistent with "the existing specific timing rules for periodic and nonperiodic payments and with the general rule . . . respecting

recognition of nonperiodic payments over the term of the contract," and "the timing regime that sec. 1.1275-4(b) provides for contingent debt instruments." This language could be read to suggest that Treasury and the IRS view the wait-and-see method as an "impermissible" one with respect to Existing CNP Swaps, or might instead be read merely as an explanation of Treasury's and the IRS's rationale for prospectively rejecting the wait-and-see method in favor of the regimes set forth in the Proposed Regulations. Indeed, in light of the long and well-acknowledged history of uncertainty as to the appropriate treatment of CNP Swaps, including a "reservation" on the issue in the preamble to the final NPC regulations in 1993 and the implicit assumption in Revenue Ruling 2002-30 that the wait-and-see method is appropriate to the extent that a nonperiodic swap payment is in fact contingent, the better answer would appear to be that, even in the Government's eyes, wait-and-see was a permissible method of accounting for CNP Swaps prior to the publication of the Proposed Regulations. In all events, it is critical that Treasury and the IRS provide guidance on when a taxpayer will be considered to have established a method of accounting for Existing CNP Swaps.

A third uncertainty is the suggestion in the Preamble that Treasury and the IRS do not intend to challenge taxpayers' accounting for CNP Swaps (other than those described in Revenue Ruling 2002-30 and other guidance) terminated prior to March 27, 2004. If that is the case, many taxpayers may consider terminating their Existing CNP Swaps prior to March 27, 2004,[3] which may entail considerable restructuring costs and other potential market impacts. More generally, I believe that further guidance on when and how Treasury and the IRS will require or permit taxpayers who have a method of accounting for Existing CNP Swaps to change that method

[3] Otherwise, taxpayers would bear the risk that the Proposed Regulations could be finalized in 2004 and they could be subject to an involuntary change in accounting method. The concern, for a taxpayer who would be taxed at a higher rate on ordinary income than capital gain, is that the IRS might impose a 481 adjustment in connection with a required change of accounting, resulting in ordinary income that would otherwise have been treated as capital gain if the swap were terminated. While it might appear at first blush that this issue will have led any taxpayer with this concern to act on or before March 27th, so that no need for guidance will remain thereafter, I do not believe this to be the case. It is by no means clear that final regulations will be published by the end of this year, and taxpayers with a calendar year tax year may well decide not to act now but to re-evaluate the question towards the end of this year.

would be helpful.[4] A reasonable approach to this issue would be to allow taxpayers an adequate, specified period of time (beyond March 26, 2004) in which to unwind their Existing CNP Swaps before requiring a change in accounting method for CNP Swaps. For example, the interim Announcement might state that if, in the future, a change in accounting is required with respect to Existing CNP Swaps that are currently subject to a wait and see method of accounting, such change will be imposed only with respect to such CNP Swaps that remain in existence on a specified date following any notice of required change is published (*e.g.*, one to two months after final regulations are issued).

Please feel free to contact the undersigned if you wish to discuss these issues.

Respectfully submitted,

Lewis R. Steinberg
Chair

cc: Eric Solomon, Deputy Assistant Secretary, Regulatory Affairs, Department of Treasury
Helen M. Hubbard, Tax Legislative Counsel, Department of The Treasury
Michael S. Novey, Associate Tax Legislative Counsel
Emily A Parker, Acting Chief Counsel, Internal Revenue Service
Nicholas J. DeNovio, Deputy Chief Counsel (Technical), Internal Revenue Service
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[4] Although not explicitly stated, it follows from the language in the Preamble that taxpayers who have established a wait-and-see method of accounting for Existing CNP Swaps will not be challenged with respect to such method on audits prior to the year of finalization, other than for "transactions described in Revenue Ruling 2002-30 . . . or other published guidance."

Again, whether requiring a change in method of accounting for Existing CNP Swaps is ever appropriate is an issue that will be discussed in the Tax Section's subsequent report.

Matthew Stevens, Special Counsel to the Chief Counsel, Office of Deputy Chief Counsel

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