MEMO# 13770

July 26, 2001

CONFERENCE CALL TO DISCUSS INSTITUTE COMMENTS ON TAXATION OF NOTIONAL PRINCIPAL CONTRACTS

[13770] July 26, 2001 TO: TAX COMMITTEE No. 21-01 RE: CONFERENCE CALL TO DISCUSS INSTITUTE COMMENTS ON TAXATION OF NOTIONAL PRINCIPAL CONTRACTS As described in the attached Notice 2001-44, the Internal Revenue Service (IRS) and the Treasury Department (Treasury) are seeking comments by November 19, 2001 on the taxation of notional principal contracts (NPCs), commonly referred to as "swaps."1 For this purpose, a NPC is defined as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts."2 Payments under a NPC may occur at specified intervals of one year or less (periodic payments), at termination (termination payments) or at any other time (nonperiodic payments). In particular, the IRS and Treasury request comments on the following four potential methods for including contingent nonperiodic payments made under a NPC in income: • "Noncontingent swap" method,3 • "Full allocation" method,4 • "Modified full allocation" method,5 and 1 Typical types of NPCs include interest rate swaps, currency swaps and equity swaps. 2 Treas. Reg. 1.446-3(c)(1)(i). 3 Under this method, a contingent nonperiodic payment would be converted into a noncontingent periodic amount using the cost of hedging the exposure to the NPC payment as a proxy for the contingent payment. A payment schedule would then be created to spread the recognition of income or deduction of the noncontingent periodic amount over the life of the NPC on a constant yield basis. 4 Under this method, taxpayers would not include or deduct any payment that is required to made under the NPC (periodic, nonperiodic, contingent and noncontingent) until the taxable year in which all contingencies are resolved. When the final contingency was resolved, the parties would treat all payments as made or received in the year of the resolution of the contingency. 2• "Mark-to-market" method.6 Further, the IRS and Treasury seek comments on (1) authority in support of any or each of these methods, (2) taxpayer recordkeeping and information reporting requirements for any or each of these methods, and (3) the extent to which current rules for NPCs and other related instruments would require modification if new rules for contingent NPCs were adopted. With respect to NPCs more generally, the IRS and Treasury also invite comments on (1) the appropriateness of special, simplified rules for short-term or standardized contracts, (2) appropriate policy considerations for making character designations (i.e., capital or ordinary) for NPC payments, (3) ways in which the tax accounting methods described in Notice 2001-44, or other methods, could be made applicable to a broader group of contracts that serve purposes similar to NPCs, and (4) the appropriate character of payments made pursuant to contracts similar to NPCs. ACTION REQUESTED: A conference call will be held on Tuesday,

September 11 at 1:00 pm (EST) to discuss the attached IRS notice, identify issues on which the Institute may submit comments and develop preliminary positions, as appropriate. Based upon the comments received, additional calls and/or a meeting may be scheduled. If you would like to participate in the September 11th call, please complete the attached response form and return it to Ezella Wynn electronically (to ewynn@ici.org) or by facsimile (to 202/326-5841). An agenda will be circulated in advance of the call to those that RSVP. Please contact the undersigned (dflores@ici.org or 202/371-5436) regarding the taxation of NPCs and issues to be addressed by the Institute under Notice 2001-44. Deanna J. Flores Associate Counsel Attachments Attachment no. 1 (in .pdf format) 5 Under this method, each party to a NPC would offset any noncontingent payments made by that party in a taxable year against any payments received in that year with respect to the NPC, but any net deductions would be deferred until all contingencies were resolved. 6 Under this method, taxpayers would mark their NPCs to market and recognize gain or loss at year end, or when the contract is terminated or assigned.
