

*Internal Revenue Service  
Proposed Regulation §1.446-3 -  
Taxation of Contingent Payment  
Swaps*

*June 23, 2004*

***Summary of the Proposed Regulations Regarding the Taxation of Contingent  
Payment Swaps***

**Overview**

On February 26, 2004, the Internal Revenue Service (the “IRS”) and Treasury Department issued proposed regulations (the “Proposed Regulations”) regarding the timing and character of contingent payments on notional principal contracts (“NPCs”). NPC<sup>1</sup> is the tax classification of a variety of swaps.

Prior to the issuance of the Proposed Regulations, the tax rules were silent as to when a taxpayer accrued contingent payments on swaps.

***SFG Observation:*** *The Proposed Regulations provide guidance in this area, however, the rules are quite complex, leaving additional questions unanswered and, if finalized, would radically change the manner in which many taxpayers calculate their income and deductions relating to such swaps. The area most affected in the structured finance industry would be the use of credit default swaps (“CDSs”) and total return swaps (“TRSs”)<sup>2</sup>.*

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<sup>1</sup> Although not all swaps are characterized as NPCs, this summary will use the terms NPC and swap interchangeably.

<sup>2</sup> This summary assumes that TRS and CDSs are structured so that they qualify as NPCs. Although the IRS has been asked to provide guidance on whether CDSs can be structured as NPCs, the Proposed Regulations do not address this issue. It should be noted that, in many transactions, the credit protection seller in CDSs may not make a payment over the life of the swap, while in TRSs both sides generally will make at least one payment.

The most noteworthy provisions of the Proposed Regulations relate to the timing of back-end contingent payments, such as credit event payments under CDSs and appreciation or depreciation payments under TRSs.

Under the proposed rules, the expected contingent payment will need to be recognized over the life of the swap even though at the beginning of the swap the amount of the contingent payment is not known. Alternatively, some taxpayers will be able to use a mark-to-market method. In addition, the Proposed Regulations impute an interest charge if the expected contingent payment is deemed significant.

### **Background**

Treasury Regulation §1.446-3 addresses the manner in which NPCs are subject to tax. These rules generally provided that a swap consists of three types of payments:

- (1) periodic payments,
- (2) nonperiodic payments (upfront or backend), and
- (3) termination payments.

Credit event payments under CDSs and appreciation or depreciation payments under TRSs typically are treated as nonperiodic payments.

Under Treasury Regulation §1.1446-3(f), taxpayers are required to recognize nonperiodic payments over the life of the swap in a manner that reflects the economic substance of the contract. This is relatively easy to implement when the nonperiodic payment is fixed at the beginning of the swap since the amount is known. It is more difficult to achieve allocation if the amount of the future payment is subject to a contingency. Adding to the uncertainty of the treatment of contingent payments is the fact that Treasury Regulation §1.446-3(f) provides no guidance on this matter.

***SFG Observation:*** *As a result, most taxpayers have taken the position that contingent payments do not need to be amortized over the life of the swap. In essence, the taxpayer waits to see what the payment is and then recognizes the payment as income or expense, as the case may be. This is done under the open transaction doctrine, which generally provides that a payment is not recognized until it becomes fixed and determinable. This approach is often called the open transaction or wait-and-see method.*

In 2001, the IRS published Notice 2001-44 (2001-2 C.B. 77), in which it requested comments on appropriate methods for the accrual of contingent nonperiodic payments. The intent of the Notice was to explore the different methods by which contingent payments could be subject to taxation.

***SFG Observation:*** *The IRS indicated that the existing uncertainty may cause taxpayers to pick and choose methods that might “whipsaw” the government. As a result, the IRS set forth four possible methods, two derivatives of which are used in the Proposed Regulations, the noncontingent swap method and the mark-to-market method.*

### **The Proposed Regulations**

In the Preamble to the Proposed Regulations, the IRS acknowledges that taxpayers currently use the wait-and-see method. They also note, however, that the back-loading of income afforded by the wait-and-see method is inconsistent with:

- (a) the requirement of Treasury Regulation §1.446-3(f) that nonperiodic payments be recognized over the term of the swap, and
- (b) the required current accrual of contingent payments on contingent debt obligations under Treasury Regulation §1.1275-4(b).

The Proposed Regulations attempt to reconcile these inconsistencies by requiring contingent payments to be recognized over the term of a swap in a similar manner to noncontingent nonperiodic payments. The Proposed Regulations aim to accomplish this by adopting variations of the noncontingent swap and the mark-to-market methods discussed in Notice 2001-44. The IRS believes that by doing so, symmetry between fixed payment and contingent payment swaps will be achieved.

***SFG Observation:*** *The Proposed Regulations will provide tax benefits to some taxpayers and tax detriments to others.*

*For example, potential recipients of appreciation payments under TRSs or credit event payments under CDSs will have phantom income (current accrual of the contingent payment). Conversely, their counterparties will receive phantom deductions (current accrual of the contingent payment).*

### **Method 1: Proposed Noncontingent Swap Method**

Under the noncontingent swap method, taxpayers are required to:

- (a) project the expected amount of the future contingent payment or payments,
- (b) amortize such amount over the term of the swap under a **level** payment methodology,
- (c) re-project the contingent amount annually, and

- (d) reflect the differences between the projected amounts and re-projected amounts through adjustments to income.

The Proposed Regulations provide **three** potential methods for projecting the expected amount of the future contingent payments.

**SFG Observation:** *The noncontingent swap method is effectively a hybrid of the noncontingent swap method discussed in Notice 2001-44 and a modified mark-to-market methodology. This is a complex method and even the IRS has acknowledged that it is burdensome. Nevertheless, the IRS has further acknowledged that though the method is burdensome, it is essential to achieve a “clear reflection of income.”*

### **Method 2: Proposed Mark-to-Market Method**

In addition to the noncontingent swap method, the Proposed Regulations provide a mark-to-market method for certain taxpayers. This method of accounting generally is available only:

- (a) if the swap is actively traded,
- (b) if the swap is marked to market by the taxpayer for financial accounting purposes (subject to certain other requirements),
- (c) if the taxpayer is subject to an agreement with a party to the swap to receive swap valuations and the swap counter party is treated as a dealer for tax purposes, or
- (d) if, in certain instances, the taxpayer is characterized as a regulated investment company for tax purposes.

**SFG Observation:** *The market-to-market method of accounting may relieve some of the complexities of the noncontingent swap method, however, the actual application of the market-to-market method could be complex.*

*For example, the Proposed Regulations require market-to-market taxpayers to use the noncontingent swap method to determine interest accruals on imputed loans, as discussed in the next section.*

### **Imputed Loans**

If a contingent payment is significant when compared to the present value of all of the total payments to be made by the payor, the swap must be bifurcated into a swap and a loan.

The potential recipient of the contingent payment (“protection buyer”) is deemed to loan the payor the expected contingent payment. The potential payor of the contingent payment is then deemed to receive interest payments. The deemed interest is treated as interest for all US federal income tax purposes and can potentially be subject to withholding taxes.

In transactions where the contingent payment payor is expected to make only one payment, such as credit event payments on CDSs, the contingent payment will always be considered significant. The imputed loan provisions apply to **both** the noncontingent swap and mark-to-market methods.

CDSs are frequently used in synthetic offshore securitizations. In these transactions, the credit protection seller is generally offshore and the credit protection buyer is domestic.

The imputed loan provision likely will cause a loan to be bifurcated from the credit event payment.

***SFG Observation:*** *In such instance, the domestic credit protection buyer (credit payment recipient) would be deemed to make interest payments to the credit protection seller (credit payment payor). Consequently, such interest payments could be subject to U.S. withholding taxes unless the swap can be structured so that the portfolio debt exception applies.*

### **Character Of Swap Payments**

Taxpayers that hold swaps as capital assets typically have taken the position that appreciation and depreciation payments on TRSs and credit event payments on CDSs are capital gains or losses.

The Proposed Regulations will change the characterization of the payments to ordinary income or expense. However, termination payments continue to be treated as capital gains or loss.

***SFG Observation:*** *If the Proposed Regulations are finalized, a taxpayer will be able to choose its desired characterization by either holding a swap to maturity or terminating the swap. In addition, payments on bullet swaps, if held as capital assets, will be considered capital gains or losses.*

### **Effective Dates**

In general, the Proposed Regulations will apply to NPCs entered into on or after 30 days after the final regulations are published. However, the Preamble to the Proposed Regulations provide some confusing rules for taxpayers with and without current methods of accounting for contingent payment swaps.

**SFG Observation:** *It should be noted that since the effective date provisions are not entirely clear, there have been several interpretations. Because of this uncertainty, the IRS has been asked to clarify the rules several times, but as of the date hereof, there has been no formal response from the IRS.*

The Preamble appears to provide that with respect to taxpayers that have not adopted a method of accounting for contingent swaps 30 days after the Proposed Regulations were published (March 27, 2004), such taxpayers need to accrue the contingent payment over the life of the swap.

**SFG Observation:** *The net effect of this appears to be that such taxpayers are precluded from currently using the wait-and-see method.*

*It also appears that if a taxpayer has adopted the wait-and-see method of accounting or another method by March 27, 2004, it may continue to use the method for up to one tax year after the final regulations are published.*

Taxpayers generally are considered to have adopted a method of accounting when the item is properly reflected in the first tax return that includes such item. If the item is improperly reflected, the taxpayer is **not** considered to have adopted a method until it has been consistently reported for two consecutive years.

**SFG Observation:** *It is uncertain whether the IRS will consider the wait-and-see method a proper method for this purpose. Therefore, it is unclear if taxpayers that use the wait-and-see method are considered to have adopted this method if they have filed a single tax return reflecting the method.*

Since the effective date provisions are unclear and subject to a great deal of interpretation, it is important that contingent swap participants consult with their tax advisors to determine their applicability.

## **Questions**

Please contact Frank Serravalli at (646) 471-2669, Debbie Rappoport-Bigman at (646) 471-2876, or Trent Johnson at (202) 414-1484, for more information concerning either contingent payment swaps or other structured finance strategies.

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