Contingent Payment NPCs—A Long Guidance Journey

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Panelists

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- Alan Munro—EY
- Michael Novey—Treasury

Agenda

- Intros
- Brief History of Contingent Nonperiodic Payment Guidance
- What Taxpayers Do Today
- Pros and Cons of Current Guidance v. Final Regs

Brief History

- Early guidance addressed source/withholding
- Timing guidance initially addressed perceived abuses
- Details on timing were left to a later day
- Comments solicited, resulting in 2004 proposed regs
  - Projected payment method default (limited MTM)
  - Preamble rejected "wait and see"
- Changes to what is an NPC subject to these rules
  - CDSs
  - Bullet swaps—payment dates v. measurement dates
- What's next?

What Do Taxpayers Do?

- Projection/modified projection methods
- MTM/modified MTM
- Wait and see (“grandfathered” or not)
- Modified full allocation
- Other?

Positions possibly not NPCs:

- Bullet swaps
- CDSs
- Other options/forwards/APCs/ownership of the underlying

Current Guidance v. Final Regs

- How elective is the current law and is that good or bad?
- Can timing choices be evaluated without looking at the complete picture (including character, sourcing, guidance for non-NPCs, and interaction with other positions)?
- Should there be a number of choices to accommodate different profiles (e.g., section 212 or capital loss concerns)?
- Is some definitive guidance better than none?
- Should guidance avoid or include an anti-abuse provision?

Appendix – Selected History

For information only

Initial Steps – Withholding & Source (Notice 87-4)

- Early swaps were exchanges of currency or interest rate cash flows measured by a notional amount.
- In a cross-border scenario, the foreign counterparty might receive payments in one period and make payments in another. This did not seem like the prototype case for which gross payment withholding was designed.
- But it was not clear what source analogy to apply: interest, futures, gambling contracts, services, something new?
- Solution: Notice 87-4 (swap income that is not business income is sourced to residence of recipient).

Initial Steps - Timing

- A key feature of notional principal contracts is that the timing of actual payments is controllable by the parties.
- A TP with an expiring NOL was advised that it could enter into an NPC and receive an immediately includible large up front payment that would be offset by the NOL. To compensate the counterparty, the TP would be obligated to make larger deductible payments over the life of the NPC, which would effectively refresh the NOL.
- Solution: Notice 89-21 (describing rules to be included in regulations)
  - Applies to "lump sum payments received in connection with interest rate and currency swap contracts, interest rate cap contracts, and similar financial products ('notional principal contracts')".
  - "In the case of a payment received during one taxable year with respect to a notional principal contract where such payment relates to the obligation to make a payment or payments in other taxable years under the contract, a method of accounting that properly recognizes such payment over the life of the contract clearly reflects income. Moreover, including the entire amount of such payment in income when it is received or deferring the entire amount of such payment to the termination of the contract does not clearly reflect income and is an impermissible method of accounting."
  - "For contracts entered into prior to the effective date of the regulations, the Commissioner will generally treat a method of accounting as clearly reflecting income if it takes such payments into account over the life of the contract under a reasonable amortization method, whether or not the method satisfies the specific rules in the forthcoming regulations."

Initial Steps – NPC Definition

- T.D. 8258 (Aug. 1, 1989)(Treas. Reg. §1.863-7T(a)):
  - Generally, a notional principal contract is an interest rate swap, cap, floor, collar, or similar financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to an interest rate index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. For this purpose, an agreement shall not be considered a notional principal contract unless the notional principal amount and each of the payments under the agreement are denominated in terms of and are determined by reference to the taxpayer's functional currency. In addition, an agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer shall not be considered a notional principal contract.
- T.D. 8330 (Jan. 14, 1991)(Treas. Reg. §1.863-7(a)):
  - notional principal contract is 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. An agreement between a taxpayer and a qualified business unit (as defined in section 989 (a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract, because a taxpayer cannot enter into a contract with itself.
    - No definition of “specified index” provided but preamble indicates the definition includes commodity swaps.

Initial Steps – NPC Definition Continued

- Proposed NPC Regulations (July 10, 1991)(Treas. Reg. §1.446-3):
  - "A notional principal contract is 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. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer can not enter into a contract with itself."
  - "Notional principal contracts governed by this section include interest rate swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, total return swaps, equity index swaps, and similar agreements."
  - Also contained definition of "specified index."

Early Steps – Contingent Nonperiodic Payments

- T.D. 8491 (Oct. 14, 1993)(Treas. Reg. §1.446-3):
  - Preamble: “The final regulations do not include any examples of how to treat nonperiodic payments that are not fixed in amount at the inception of the contract. The IRS expects to address contingent payments in future regulations, and welcomes comments on the treatment of those payments.”
  - Text: “*Nonperiodic payments*-(1) *Definition.* A nonperiodic payment is any payment made or received with respect to a notional principal contract that is not a periodic payment (as defined in paragraph (e)(1) of this section) or a termination payment (as defined in paragraph (h) of this section). Examples of nonperiodic payments are the premium for a cap or floor agreement (even if it is paid in installments), the payment for an off-market swap agreement, the prepayment of part or all of one leg of a swap, and the premium for an option to enter into a swap if and when the option is exercised.

    (2) *Recognition rules*-(i) *In general.* All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a non-periodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.

Early Steps – Contingent Nonperiodic Payments Continued

- NEW YORK STATE BAR ASSOCIATION (TAX SECTION), REPORT ON NOTIONAL PRINCIPAL CONTRACT CHARACTER AND TIMING ISSUES (May 22, 1998), 98 TNT 104-78 (June 1, 1998):
  - "The portion of our report addressing timing issues responds to a request in the preamble to final regulations on the timing of income from notional principal contracts (T.D. 8491, 1993-2 C.B. 215) for comments on the treatment of contingent payments. We recommend that the Treasury Department and the Internal Revenue Service adopt by regulation one of two alternative regimes. Under one regime, a taxpayer that enters into a contingent payment notional contract would be permitted fully to offset payments made against payments received, but would be required to defer deduction of the excess. This regime would be symmetric, and would also permit deferral of net amounts received. Under the second regime, the amount of contingent payments under a swap would be projected, and taxpayers would be required to accrue income and expense as though the swap provided for noncontingent payments equal in amount to the projected contingent payments. If the actual amount of a contingent payment differs from its projected amount, the taxpayer would take into account an adjustment at that time. In addition to these two alternatives, we recommend that the Treasury Department and the Internal Revenue Service consider permitting taxpayers to elect mark-to-market accounting for notional principal contracts." From transmittal letter.

Early Steps – Contingent Nonperiodic Payments Continued

•Notice 2001-44 (July 3, 2001):

- "However, no guidance is provided in the regulations for the timing of inclusion or deduction of contingent nonperiodic payments made under NPCs."
- "The methods the IRS and Treasury are considering for the inclusion into income or deduction of contingent nonperiodic payments made pursuant to NPCs are described below under the following headings: the Noncontingent Swap Method; the Full Allocation Method; the Modified Full Allocation Method; and the Mark-to-Market Method. The IRS and Treasury are seeking comments on the relative merits of each of these methods, as well as suggestions as to other methods that may be superior to these methods with respect to the fundamental tax policy principles listed above. The IRS and Treasury are interested in what authority taxpayers believe exists for mandating any and each of these methods."

Defining Contingent Nonperiodic Payments

- Rev. Rul. 2002-30 & Notice 2002-35 (both May 28, 2002):
  - Facts: 18-month NPC with quarterly LIBOR payments by T based on $100 million. Upon expiration, CP will pay T 6 percent per year on $92 million (the fixed payment amount). In addition, CP or T will make a payment equal to the percentage change in the value of the S&P 500 stock index based on $8 million.
  - Holding: NPC treated as having a noncontingent component and a contingent component. The noncontingent component must be taken into account over the term of the contract. (Silent on tax accounting for contingent component.)
  - Transaction was "listed" under the reportable transaction regime.

Defining Contingent Nonperiodic Payments

•Proposed regs (Feb 26, 2004)(Treas. Reg. §§1.446-3 & 1.1234A-1):

- Proposed a projection method as the default method of accounting for NPCs with contingent nonperiodic payments
- Allowed elective MTM in certain circumstances
- Bullet swaps are forwards, not NPCs

Preamble stated:

With respect to NPCs that provide for contingent nonperiodic payments and that are in effect or entered into on or after 30 days after [February 26, 2004], 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 that satisfies the specific rules in these proposed regulations."

Defining Contingent Nonperiodic Payments

•Notice 2004-52 (Aug. 9, 2004)(requesting comments on characterization of Credit Default Swaps)

- Possible categories for CDS were:
  - Contingent put option
  - NPC with contingent nonperiodic payments
  - Guarantee
  - Insurance
  - Other
- At stake was sourcing, timing, and character

Defining Contingent Nonperiodic Payments

•Notice 2006-16 (Feb. 27, 2006)(exceptions to listed transaction reporting):

- The taxpayer uses a method of accounting for the NPC that takes the contingent nonperiodic payment into account over the life of the contract under a reasonable amortization method;
- The taxpayer properly accounts for the NPC under section 475 (MTM);
- The taxpayer properly accounts for the NPC under Treas. Reg. §1.446-4 (hedge timing);
- The taxpayer properly accounts for the NPC as a Treas. Reg. §1.988-5(a) hedge in connection with a qualified hedging transaction;
- The taxpayer properly accounts for the NPC under Treas. Reg. §1.988-2(e) (including the application of Treas. Reg. §1.446-3(g)(4)—swaps with significant nonperiodic payments treated as part debt, as appropriate); or
- The reporting was done lower down the ownership chain.

Defining Contingent Nonperiodic Payments

- Proposed Regs (Sept. 16, 2011)(Treas. Reg. §§1.446-3, 1.1256(b)-1)
  - Certain swaps that might otherwise be section 1256 contracts are NPCs
  - Bullet swaps are NPCs (multiple measurement dates versus multiple payment dates)
  - CDSs are NPCs

Result—there are more instruments that are NPCs with contingent nonperiodic payments, for which the guidance is not yet final

Defining Contingent Nonperiodic Payments

•TD 9572 (Jan. 23, 2012); modified (Aug. 31, 2012)—Temporary and Proposed Regs (Temp. Reg. §1.871-16T; Prop. Reg. §§1.871-15 and -16)

- Decoupled NPC characterization and scope of dividend equivalent amounts potentially subject to section 871(m) withholding
- Provision would apply to both NPCs and Equity Linked Instruments
- Statutory interim specified NPCs (four filters) applies through 2013
- Proposed seven-filter regime (including ELIs) would start for payments made in 2014