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November 14, 2001

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Ladies and Gentlemen:

I am pleased to enclose NYSBA Tax Section Report No. 1001, proposing a method for determining the timing of income inclusions and deductions from notional principal contracts ("swaps") that call for contingent payments ("contingent swaps"). This report responds to a request for comments set out in Notice 2001-44, I.R.B. 2001-30 (July 3, 2001) (the "Notice"). Our proposal extends and refines the rules set out in Treas. Reg. § 1.446-3.

For contingent swaps that provide only for current, "periodic" payments, we propose a relatively simple "periodic treatment" under which taxpayers include or deduct the amounts actually received or paid each year. For swaps with contingent *non*periodic payments, we generally recommend an approach, similar to the "Noncontingent Swap Method" described in the Notice, that would require taxpayers to (1) prepare a schedule, when the swap is entered into, reflecting the expected amount of each anticipated payment, and (2) include or deduct the difference between these anticipated amounts and the actual payments when made.

We recommend a simpler approach than the Notice does, however, for determining the expected amounts of anticipated payments. We do not, for example, determine expected payments by reference to the market price of rights to receive them. Rather, for swaps with terms of 3 years or less, the parties simply will assume that 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, the parties effectively accrue interest on earlier payments by constructing a "deemed debt obligation" and a "deemed matching-payment swap," in a manner consistent with current regulations governing the treatment of nonperiodic swap payments generally.

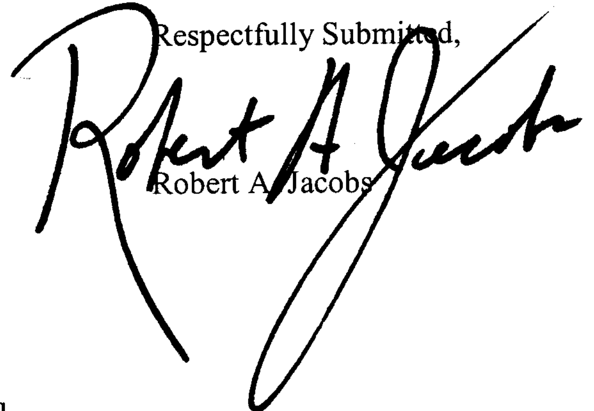
In forging our proposal, we have sought to follow the Notice directive that the method chosen reflect fundamental tax principles, including certainty of outcome, ease of administrability, consistency with the treatment of similar economic transactions, consistency in the treatment of different taxpayers, economic accuracy, clear reflection of income, and flexibility in the accommodation of new financial arrangements. Moreover, we have sought to follow, as closely as possible, the general methodology already set out in Treas. Reg. § 1.446-3, because we view that regulation as an excellent exercise of rulemaking authority. We believe our proposed approach is largely consistent with the regulations that govern the treatment of contingent debt instruments under Treas. Reg. § 1.1275-4.

In light of the above, we reject the "Full Allocation Method" mentioned in the Notice. That approach effectively would abandon the realization method of accounting and the approach of Treas. Reg. § 1.446-3 by directing taxpayers to defer the inclusion or deduction of gains and losses that they actually realize through the exchange of periodic payments until the swap is terminated. We also reject the Modified Full Allocation Method mentioned in the Notice, under which the amounts of expected payments that are determined at the outset of the swap periodically would be adjusted to reflect intervening changes in the value of referenced property, as well as the outright Mark-to-Market Approach mentioned in the Notice. We reject these approaches because the realization method of accounting would continue to govern the treatment of most other equivalent financial transactions entered into by taxpayers and we think its abandonment in this narrow context would produce inconsistent treatments 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 Swaps. Moreover, we do not think it clear that Treasury has authority to abandon the realization method without a Congressional directive. As the Notice points out, a mark-to-market method of accounting also raises serious valuation issues that would introduce considerable additional complexity into the accounting of income and deductions from swaps.

Part II of our report sets out in greater detail the reasons we recommend our proposed approach in light of the policy, administrative and other considerations set forth in the Notice. Part III-A sets out our proposed treatment of contingent swaps primarily providing for *current* periodic payments. Part III-C sets out our proposed simplified approach for contingent nonperiodic swaps with terms of 3 years or less and contains a series of examples. Part III-D sets out our general approach for contingent nonperiodic swaps with terms of more than 3 years and also contains a series of examples. Part III-E makes some specific recommendations for contingent swaps that hedge portfolios of debt instruments.

Respectfully Submitted,



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