

This article originally appeared in slightly different form in the May 2006 Vol. 7 No. 9 issue of *Derivatives – Financial Products Report*.

Financial Products Report



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Notice 2006-16: IRS Clarifies Prior Guidance on Notional Principal Contracts with Contingent Nonperiodic Payments

Notice 2006-16 explains Notice 2002-35 by illustrating certain notional principal contract transactions that are not “Listed Transactions” for purposes of the tax shelter disclosure and list maintenance rules.

Notice 2002-35, 2002-1 CB 992 (“2002 Notice”), released by the IRS on May 6, 2002, identified certain transactions in notional principal contracts (NPCs) with contingent nonperiodic payments as “listed transactions” subject to the tax shelter disclosure and list maintenance rules under Sections 6111 and 6112 and Reg. 1.6011-4(b). Concurrent with the release of the 2002 Notice, the IRS issued Rev. Rul. 2002-30, 2002-1 CB 971, to provide the correct method of accounting for the “noncontingent component” of a contingent nonperiodic payment under an NPC. The 2002 Notice and Rev. Rul. 2002-30 left many taxpayers and practitioners confused about the type of transaction that the IRS would regard “the same as, or substantially similar to,” the transaction described in the 2002 Notice. Due to the penalties that could be imposed for failure to disclose a listed transaction, many taxpayers filed disclosure

statements for common swap transactions entered into for bona fide nontax purposes.

On February 13, 2006, the IRS issued Notice 2006-16, 2006-9 IRB 538 (“2006 Notice”), to provide examples of NPC transactions that are not “the same as, or substantially similar to,” the transactions described in the 2002 Notice and that accordingly are not “listed transactions” for purposes of the tax shelter disclosure and investor list maintenance rules. In the 2006 Notice, the IRS also offers a safe-harbor from the tax shelter disclosure requirements for taxpayers participating in transactions described in the 2002 Notice through a pass-through entity, such as a partnership.

This article describes the circumstances giving rise to the issuance of the 2002 Notice and the 2006 Notice—primarily the lack of comprehensive guidance on how to account for NPCs with contingent nonperiodic payments—and analyzes the extent to which the 2006 Notice has clarified the issues raised by the 2002 Notice.

Accounting for NPC Payments

The accounting methods that are generally used to account for payments made with respect to NPCs are in Reg. 1.446-3.

Special rules apply to NPCs that are subject to the mark-to-market method of accounting under Section 475, are foreign currency transactions, or are hedging transaction.¹

Under the general rules of Reg. 1.446-3, the parties to an NPC must account for “periodic payments”—*i.e.*, payments made at regular intervals of one year or less during the entire term of the NPC—by accruing each payment ratably over the period to which the payments relates.² For “non-periodic payments”—*i.e.*, NPC payments not made at regular intervals during the entire term of the NPC—the parties to the NPC must allocate the payment among the periods covered by the NPC and recognize the portion allocable to each period.³

There is no guidance in Reg. 1.446-3 for the timing of income and deductions with respect to contingent nonperiodic NPC payments, such as a payment to be made at the maturity of the NPC based on a commodity or stock price index. As discussed more fully below, in 2001, the IRS and Treasury solicited comments on how to account for NPCs with contingent nonperiodic payments, and in 2004, issued Proposed Regulations dealing with the timing of income and deductions for NPCs with contingent nonperiodic payments. Absent comprehensive guidance on the matter, it was not clear which methods of accounting were proper methods to use for NPCs with contingent nonperiodic payments.

Rev. Rul. 2002-30

In Rev. Rul. 2002-30, the IRS addressed the proper method of accounting for a nonperiodic payment under an NPC that has a “contingent component” and a “fixed noncontingent component.” The NPC, which had a term of 18 months, required the taxpayer to make quarterly payments to the counterparty based on three-month LIBOR multiplied by a notional amount of \$100 million. In exchange, the counterparty was required to make a payment at the end of the 18-month term of the NPC equal to 9% of a notional principal amount of \$92 million (\$8.280 million) plus or minus the percentage change in the value of the S&P 500 Index multiplied by a notional

principal amount of \$8 million. Since the S&P 500 Index could not lose more than 100% of its value, the minimum payment to be made by the counterparty would be \$280,000 (\$8,280,000 – \$8,000,000).

The IRS conclude that the nonperiodic payment was, “in substance,” the sum of two independent components: (1) a noncontingent component equal to \$8.280 million, and (2) a contingent component equal to the positive or negative percentage change in the value of the S&P 500 index multiplied by a notional principal amount of \$8 million. The IRS ruled that, to reflect the economic substance of the NPC, each component must be treated separately for purposes of applying Reg. 1.446-3. It also ruled that the parties must recognize the \$8.280 million noncontingent component over the 18-month term of the NPC. Not ruled on was the issue of how the parties should recognize the contingent component of the nonperiodic payment.

2002 Notice

In conjunction with its issuance of Rev. Rul. 2002-30, the IRS issued the 2002 Notice, designating as “listed transactions” certain transactions using NPCs to claim current deductions for periodic payments made by the taxpayer while disregarding the accrual of the taxpayer’s right to receive future contingent nonperiodic payments. The transaction described in the 2002 Notice involves an NPC that requires the taxpayer to make periodic payments based on a fixed or floating interest rate index and the counterparty to make a single payment at the scheduled termination of the NPC that consists of “a noncontingent and a contingent component.” The 2002 Notice describes the noncontingent component of the nonperiodic payment as “relatively large” compared with the contingent component. It further describes the noncontingent component as based on a fixed or floating interest rate and the contingent component as based on changes in the value of a stock index or a currency during the term of the NPC.

The essential characteristic of the transaction is that the taxpayer accrues deductions for the periodic payments that it must make, but does not accrue any

income attributable to the nonperiodic payment until the year in which it actually receives the payment. The transaction, however, may have additional features, such as the taxpayer borrowing the funds to make periodic payments from the counterparty, entering into transactions to hedge the taxpayer's risk of loss from the NPC, or engaging in the transaction through a partnership. The taxpayer may also engage in short-term securities trading to establish a trade or business and claim an ordinary loss from an early termination of the NPC. If the NPC is terminated at a gain before the scheduled payment date for the nonperiodic payment, the taxpayer would report the gain as capital gain.

The 2002 Notice states that the rules in Reg. 1.446-3 relating to the recognition of nonperiodic payments under NPCs must be applied separately to both the noncontingent and contingent component of the contract. It also refers to Rev. Rul. 2002-30 for a discussion of the proper treatment of the noncontingent component of a nonperiodic payment. Like Rev. Rul. 2002-30, the 2002 Notice does not provide any guidance on how the contingent component of the nonperiodic payment should be accounted for.

2004 Proposed Regulations

On February 25, 2004, the IRS released Proposed Regulations on the timing of income and deductions for NPCs with contingent nonperiodic payments ("2004 Proposed Regulations").⁴ Under the 2004 Proposed Regulations, the generally applicable method is a "noncontingent swap method" that requires the parties to the swap to determine the future value of the contingent nonperiodic payment and to accrue income and deductions as if that amount were noncontingent. For most NPCs, taxpayers had the option of electing to use a considerably simpler mark-to-market method of accounting for those NPCs.

The rules in the 2004 Proposed Regulations relating to the noncontingent swap method and the mark-to-market election are proposed to be effective for NPCs entered into after the issuance of final

Regulations. The Preamble to the 2004 Proposed Regulations provides, however, that for NPCs entered into on or after March 30, 2004, a taxpayer that has not adopted a method of accounting for NPCs with contingent nonperiodic payments must adopt a method that takes contingent nonperiodic payments into account over the life of the NPCs under a "reasonable amortization method, which may be, but need not be, a method that satisfies the specific rules in these proposed regulations."

2006 Notice

The IRS released the 2006 Notice to clarify the scope of the 2002 Notice and provide a safe harbor from tax shelter disclosure requirements for taxpayers that participated in transactions described in the 2002 Notice through a pass-through entity, such as a partnership. The 2006 Notice excludes from the scope of the 2002 Notice any NPC that requires the counterparty to make a contingent nonperiodic payment if the taxpayer meets any of the following conditions.

1. Uses a method of accounting that takes the contingent nonperiodic payment into account over the life of the contract under a reasonable amortization method.
2. Marks the NPC to market under Section 475.
3. Properly accounts for the NPC under Reg. 1.466-4, relating to accounting methods for hedging transactions as defined in Reg. 1.1221-2(b).
4. Properly accounts for the NPC as a Reg. 1.988-5(a) hedge in connection with a qualified hedging transaction.
5. Properly accounts for the NPC as a Reg. 1.988-2(e).

The 2006 Notice is not intended to expand the scope of the 2002 Notice, and no inference is intended as to whether transactions not specifically excluded from the 2002 Notice are or are not required to be disclosed as listed transactions under the 2002 Notice.

The 2006 Notice further provides a safe harbor from the tax shelter disclosure requirements for taxpayers that participated in transaction described in the 2002 Notice through a pass-through entity. Where a taxpayer has participated in a transaction the same as, or substantially similar to, the transaction described in the 2002 Notice, solely because of its interest in a pass-through entity that has participated in such a transaction, the taxpayer under Reg. 1.6011-4 and will not be treated as having participated in the transaction for purposes of Reg. 1.6664-2c(3)(ii).

To qualify for the safe harbor, the taxpayer must receive an acknowledgement from the pass-through entity that it has complied, or will comply, with its separate disclosure requirement under Reg. 1.6011-4. The taxpayer must receive the acknowledgement before it would otherwise be required to provide the disclosure.

What Does the 2006 Notice Clarify?

The 2002 Notice implied that the IRS's principal concern was that the noncontingent component of the nonperiodic component of the nonperiodic payment be amortized over the term of the NPC, regardless of whether it might be offset by the contingent component, and that recognition of the noncontingent component not be deferred until payment of the nonperiodic payment. The proper treatment of the contingent component of the nonperiodic payment was not addressed in either the 2002 Notice or Rev. Rul. 2002-30. In other words, although neither the 2002 Notice or Rev. Rul. 2002-30 stated that recognition of the contingent component could be deferred until the amount of the contingent component became fixed ("wait and see approach"), there was no guidance explicitly requiring a different method of accounting for the contingent component.

Thus, one source of uncertainty regarding the scope of the 2002 Notice was whether it applied if the taxpayer accrued into income the noncontingent component of the nonperiodic payment but deferred recognition of the contingent component.

Another source of uncertainty regarding the scope of the 2002 Notice was how to determine whether a contingent nonperiodic payment had a noncontingent component and the amount of the noncontingent component. In Rev. Rul. 2002-30, the NPC had a contingent nonperiodic payment that explicitly included contingent and noncontingent components. The stated noncontingent component was \$8.280 million, and the stated contingent component was the product of a notional \$8 million principal amount and the percentage increase or decrease in the S&P 500 stock index. Although the nonperiodic payment in Rev. Rul. 2002-30 could have been described as including a noncontingent component of \$280,000 plus the product of a notional \$1 million principal amount multiplied by the value of the S&P 500 stock index on the scheduled payment date of the nonperiodic payment, the Ruling concluded that the nonperiodic payment and a noncontingent component of \$8.280 million.

However, Rev. Rul. 2002-30 did not provide any guidance on how it determined that amount of the noncontingent component was \$8.280 million rather than \$280,000, or any guidance on how the taxpayer should account for the contingent component of the contingent nonperiodic payment. Thus, although the 2002 Notice refers to Rev. Rul. 2002-30 for guidance on how to account for NPCs with contingent nonperiodic payments, the guidance in Rev. Rul. 2002-30 is unclear.

The 2006 Notice does not clarify either of these areas of confusion or uncertainty regarding the 2002 Notice. For NPCs that are subject to the general rules in Reg. 1.446-3 (*i.e.*, NPCs that are not subject to the mark-to-market method of accounting under Section 475 or the special rules that apply to hedging transaction or foreign currency transactions), the 2006 Notice essentially supersedes the guidance in Rev. Rul. 2002-30. Under the 2006 Notice, the only way to ensure that such NPCs are excluded from the scope of the 2002 Notice is to amortize the entire contingent nonperiodic payment into income under a "reasonable" amortization method, such as the noncontingent swap method described in the 2004 Proposed Regulations.

Taxpayers adopting the bifurcation approach of Rev. Rul. 2002-30 to account for NPCs with contingent nonperiodic payments and deferring recognition of the contingent component of those contingent nonperiodic payments cannot be sure that their transactions are not within the scope of the 2002 Notice, even though the focus of the 2002 Notice was the deferral of recognition of the noncontingent component of such nonperiodic payments. Thus, the real “clarification” in the 2006 Notice could be that unless taxpayers adopt or change to a method of accounting for NPCs with contingent nonperiodic payments that complies with the guidelines in the preamble to the 2004 Proposed Regulations, the IRS may challenge the taxpayer’s accounting for such NPC transactions, which should be reported as listed transactions in accordance with the 2002 Notice.

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- 1 Regs. 1.446-3c(1)(iii) and (iv) and 1.446-4(e)(5).
- 2 Reg. 1.446-3(e)(2)(i).
- 3 Reg. 1.446-3(f)(2).
- 4 In Notice 2001-44, the 2001-2 CB 77, the IRS and Treasury solicited comments on the appropriate methods for including in income or deducting contingent nonperiodic NPC payments. The methods that they are considering include a “noncontingent swap method” based on the noncontingent bond method applicable to contingent payment debt instruments and a “mark-to-market” method.