

Character of Income, Deduction, Gain, or Loss From Notional Principal Contracts, Bullet Swaps, and Forwards Is Addressed in Proposed Regulations

Linda E. Carlisle and Geoffrey B. Lanning*

On February 25, 2004, the Treasury Department and the IRS published proposed regulations addressing the timing of income, deductions, gains, and losses arising from notional principal contracts (“NPCs”) that contain “contingent nonperiodic payments” (the “Proposed Regulations”).¹ The primary focus of the Proposed Regulations is the timing of income and deductions attributable to contingent nonperiodic payments under NPCs. The Proposed Regulations, however, also address the character of income, deductions, gains, and losses from NPCs, “bullet swaps,” and forward contracts. This article focuses on the character issues addressed under the Proposed Regulations.

Background

The 1993 NPC Regulations

On October 14, 1993, the IRS published final regulations (the “1993 NPC Regulations”)² relating to the timing of income and deductions for amounts paid or received in connection with NPCs.³ Payments made or received

* Linda E. Carlisle is a partner and Geoffrey B. Lanning is an associate in the Washington, D.C. office of White & Case LLP. Ms. Carlisle is on the editorial advisory board of this Journal.

¹ REG-166012-02, 69 Fed. Reg. 8886 (February 26, 2004).

² TD 8491, 58 Fed. Reg. 53125 (October 14, 1993).

³ Reg. 1.446-3. Reg. 1.446-3(c)(1)(i) define a “notional principal contract” 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.” Reg. 1.446-3(c)(1)(i) provides that the term includes “interest rate swaps, currency swaps,

under NPCs are divided into three categories: periodic payments, nonperiodic payments, and termination payments. Periodic payments, which are payments made or received at periodic intervals throughout the term of the NPC based on a specified index and the notional principal amount of the NPC, are recognized ratably throughout the periods in which such payments accrue.⁴ Nonperiodic payments, which are all other payments made pursuant to the terms of an NPC, are recognized over the term of the NPC in a manner that reflects the economic substance of the NPC.⁵ Termination payments, which are payments made or received to assign or extinguish the rights and obligations of a party to an NPC, are recognized in the taxable year that the party's rights and obligations under the NPC are terminated.⁶ Termination payments include payments made between the parties to an NPC to extinguish the NPC and payments made between a party to an NPC and a third person to assign the rights and obligations under the NPC to such third person.⁷ The 1993 NPC Regulations did not address the treatment of contingent nonperiodic payments.

Character of NPC Payments

The 1993 NPC Regulations did not explicitly provide rules governing the character of the income, deduction, gain, or loss arising from payments made with respect to NPCs. The character of a payment made with respect to an NPC depends on whether the gain or loss attributable to the payment meets the definition of a capital gain or loss under Section 1222 or is treated as a capital gain or loss under Section 1234A(1), as described below.

Section 1222. Section 1222 defines a capital gain or loss as a gain or loss from the sale or exchange of a capital asset. The disposition of property in a transaction that is not a "sale or exchange" therefore does not give rise to a capital gain or loss under Section 1222. Courts and the IRS have interpreted the sale or exchange requirement in connection with transactions

basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar instruments." Reg. 1-446-3(c)(1)(ii) provides that futures, forwards, options, and debt instruments are not NPCs.

⁴ Reg. 1.446-3(3)(2).

⁵ Reg. 1.446-3(f)(2)(i).

⁶ Reg. 1.446-3(h)(2).

⁷ Reg. 1.446-3(h)(1). Any gain or loss realized from the sale or exchange of one NPC for another is also treated as a "termination payment" that is recognized in the taxable year that the NPC is sold or exchanged.

that cancel, terminate, or otherwise extinguish a taxpayer's rights under a contract to mean that there is no sale or exchange if the taxpayer's rights are extinguished in the transaction and do not pass to the other party.⁸

In years before the enactment of Section 1234A and the straddle rules under Section 1092, taxpayers engaged in commodity straddle transactions that exploited the ordinary loss treatment of contract terminations. In a series of cases that were finally decided after the enactment of the straddle rules and Section 1234A, commodities traders' losses resulting from amounts paid to cancel forward contracts with respect to currencies and securities were held to be ordinary because the cancelled contracts were extinguished.⁹ Thus, the taxpayers realized ordinary losses for amounts paid to cancel losing positions while realizing capital gain from the sale of offsetting valuable positions.

Section 1234A. In response to taxpayer's attempts to exploit the ordinary loss treatment of contract terminations in the commodity straddle transactions described above, Section 1234A was enacted as part of the Economic Recovery Tax Act of 1981¹⁰ to provide capital gain or loss treatment for certain contract terminations. In its present form, Section 1234A provides:

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

- (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
- (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,

shall be treated as gain or loss from the sale of a capital asset.

⁸ See, e.g., *Leh v. Commissioner*, 260 F.2d 489 (9th Cir. 1952) (capital gain treatment denied for payment received to terminate taxpayer's right to purchase gas); *Commissioner v. Starr Bros.*, 204 F.2d 673 (2d Cir. 1953) (capital gain treatment denied for payments received to terminate taxpayer's rights under exclusive distributorship); *Commissioner v. Pittston Co.*, 252 F.2d 344 (2d Cir. 1958) (capital gain treatment denied for payment received to surrender rights under exclusive contract to purchase coal); *Rev. Rul. 75-527*, 1975-2 CB 30 (capital gain treatment denied for payment received to terminate contract).

⁹ See, e.g., *Stoller v. Commissioner*, 994 F.2d 885 (DC Cir. 1993); *Wolff v. Commissioner*, 148 F.3d 186 (2d Cir. 1998); *Israel's Estate v. Commissioner*, 159 F.3d 593 (DC Cir. 1998).

¹⁰ PL 97-34.

The critical interpretative issue under Section 1234A(1) is whether capital gain or loss treatment is provided for the termination of a *contract* that is a capital asset or for the termination of a contract with respect to *property* that is a capital asset.

As originally enacted, Section 1234A read as follows:

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.

The committee report accompanying the bill reported by the Senate Finance Committee states that ordinary loss treatment from the termination of a contract is inappropriate if “the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the contract.”¹¹ This suggests that Congress believed that a taxpayer’s gain or loss from the disposition of a contract that was a capital asset in the hands of the taxpayer should give rise to a capital gain or loss regardless of whether the taxpayer disposes of the contract by sale, exchange, cancellation, or termination.

In the Technical Corrections Act of 1982,¹² Section 1234A was amended to read as follows:

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

- (1) a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
- (2) a regulated futures contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,

shall be treated as gain or loss from the sale of a capital asset.

The conference report accompanying the Technical Corrections Act of 1982 explains that under Section 1234A as originally enacted, the settlement or termination of a contract results in capital gain or loss notwithstanding the absence of a sale or exchange only if “the contract is with respect to personal property that would be a capital asset in the hands of the taxpayer.”¹³

¹¹ S. Rep. No. 97-144, 170-171 (1981).

¹² PL 97-448.

¹³ H. Rep. No. 97-986, 26-27 (1982).

The commencement of trading in regulated futures contracts that settled only in cash raised the problem that such contracts were not contracts with respect to personal property, since they could not be settled by the physical delivery of personal property. The conference report explained that Section 1234A(2) was added to provide that “capital gain or loss results from the termination of a contract which does not require the physical delivery of personal property ... if the contract itself is a capital asset in the hands of the taxpayer.”¹⁴ Accordingly, the 1982 amendment to Section 1234A clarifies that Section 1234A(1) only applies if the underlying property referenced by the contract is a capital asset.

The legislative history of Section 1234A makes it clear that capital gain or loss treatment under Section 1234A(1) applies to the termination of contracts with respect to *property* that is, or upon acquisition would be, a capital asset in the hands of the taxpayer. If Section 1234A(1) applies to the termination of *contracts* that are capital assets in the hands of the taxpayer, there is no need for Section 1234A(2). Moreover, if Section 1234A(1) applies to the termination of *contracts* that are capital assets in the hands of the taxpayer, the reference in Section 1234A(1) to property that *would be* a capital asset in the hands of the taxpayer would be nonsensical.

The application of Section 1234A to NPCs therefore is problematic on several grounds. The legislative history of amended Section 1234A and the words of the statute are inconsistent with applying 1234A(1) to the termination of a *contract* that is, or upon acquisition would be, a capital asset in the hands of the taxpayer. On the other hand, if Section 1234A(1) applies only to the termination of a contract with respect to *property* that is, or upon acquisition would be, a capital asset in the hands of the taxpayer, certain NPCs are not contracts “with respect to property.” For example, the payments under interest rate swaps, caps, floors, and collars are based on a notional amount of money and one or more fixed or variable interest rates. Money and interest rates are not “property.” Accordingly, such NPCs are not contracts “with respect to property.” A similar problem arises with respect to equity swaps that are based on a price index, such as the S&P 500 index, because a price index is not “property.”

Although equity swaps and commodity swaps that are based on the price of a specific security or physical commodity relate to “property,” the legislative history of Section 1234A(2) indicates that Section 1234A(1) does not apply to a contract that does not provide for the physical delivery of property that is, or upon acquisition would be, a capital asset in the hands of the taxpayer. NPCs, by definition, do not provide for the physical delivery of any property other than money. Nevertheless, Section 1234A(1) might be interpreted to apply to NPCs that are based on the price of a

¹⁴ Id.

specified security or commodity if such security or commodity would be a capital asset in the hands of the taxpayer since such NPCs reasonably could be characterized as conferring rights or obligations “with respect to” the security or commodity referenced in the NPC.

Character of NPC Payments Prior to the Proposed Regulations

The proper character treatment of periodic and nonperiodic payments under NPCs is clear. Periodic and nonperiodic payments under an NPC do not involve a sale or exchange of property and therefore do not constitute capital gains or losses as defined in Section 1222. Moreover, such payments do not arise from the “cancellation, lapse, expiration, or other termination” of a taxpayer’s right or obligation with respect to property and therefore should not be treated as capital gains or losses under Section 1234A(1).¹⁵ Accordingly, periodic and nonperiodic payments under NPCs should not give rise to capital gains or losses. It also is clear that any gain realized from the sale or exchange of an in-the-money NPC should be a capital gain under Section 1222 if the NPC is a capital asset in the hands of the taxpayer.

The areas of uncertainty regarding gains and losses from NPCs involve losses from the disposition of underwater NPCs to third parties and gains and losses from the termination or extinguishment of NPCs. A taxpayer assigning an underwater NPC position to a third party must make a payment to the assuming party in exchange for the assumption of the taxpayer’s position. It is not clear that an underwater position, which has a negative value, is “property.” Moreover, if the underwater NPC is “property” that is transferred to the assuming party, it is not clear that the assigning party has received anything in exchange, since the assigning party must make a payment for its release from the NPC.¹⁶

¹⁵ The preamble to the 1993 NPC Regulations stated that “nothing in the regulations supports characterizing either periodic or nonperiodic payments as attributable to the settlement, exercise, cancellation, lapse, expiration, or other termination of forward or option contracts.” In TAM 9730007, the IRS concluded that periodic payments on a commodity swap were ordinary because such payments are not gain or loss attributable to the sale or exchange of property and are not attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to property within the meaning of Section 1234A.

¹⁶ In 1993 FSA LEXIS 279 (March 22, 1993) and 1993 FSA LEXIS 256 (August 6, 1993), the IRS addressed the issue whether a payment made by the taxpayer to terminate its interest in an interest rate swap gives rise to an ordinary or capital loss. The IRS concluded that an interest rate swap is “property” and that there is “no rational basis” for distinguishing between a payment received by the taxpayer for the surrender or assignment of its contract rights and obligations and a payment made by the taxpayer for the cancellation or assumption of its contract rights and obligations. It could be argued that the fact that the taxpayer receives something for its surrender or assignment of contract

In the case of a disposition of an NPC in a transaction that is not a “sale or exchange,” the character of a payment made or received to terminate the taxpayer’s rights and obligations under the NPC depends on whether Section 1234A(1) applies. The position of the IRS has been that the termination of an NPC constitutes the termination of a right or obligation with respect to the NPC and therefore gives rise to a capital gain or loss if the NPC is a capital asset in the hands of the taxpayer.¹⁷ This position, however, is based on an interpretation of Section 1234A(1) that the termination of a *contract* that is a capital asset gives rise to a capital gain or loss regardless of whether the contract is with respect to *property* that is, or upon acquisition would be, a capital asset in the hands of the taxpayer. As noted above, this interpretation of Section 1234A is inconsistent with the legislative history of Section 1234A and the words of the statute.

2004 Proposed Regulations

On July 23, 2001, the IRS published Notice 2001-44¹⁸ soliciting comments on the proper timing of income and deductions attributable to contingent nonperiodic payments made under NPCs. The Notice also solicited comments on the proper character of payments made or received in connection with NPCs and certain other financial derivative instruments. The IRS and Treasury issued the Proposed Regulations after considering the comments received from the public.

The Proposed Regulations provide that the net periodic and nonperiodic payments under NPCs (including mark-to-market deductions under the elective mark-to-market election) are deductible by the payor under Section 162 as ordinary and necessary business expenses.¹⁹ A similar rule is provided for individuals in proposed amendments to the regulations under Section 212.²⁰ The Proposed Regulations provide that periodic and nonperiodic payments under an NPC constitute ordinary income and expense.²¹ These rules are consistent with the ordinary character of such payments.

rights but receives nothing when it pays for the cancellation or assumption of its contract rights and obligations is a “rational basis” for making a distinction between the cases.

¹⁷ See 1993 FSA LEXIS 279 and 1993 FSA LEXIS 279, *supra*, in which the IRS concluded that in addition to there being authority for treating the termination of an interest rate swap as a sale or exchange or property, Section 1234A(1) should apply to treat a payment made by the taxpayer to terminate its position in an interest rate swap as a capital loss.

¹⁸ 2001-2 CB 77.

¹⁹ Prop. Reg. 1.162-30.

²⁰ Prop. Reg. 1.212-1(q)(1).

²¹ Prop. Reg. 1.1234A-1(b).

The most significant character rule in the Proposed Regulations is that any gain or loss arising from an NPC “termination payment” (as defined in the 1993 NPC Regulations) is treated as a gain or loss from the termination of the NPC for purposes of Section 1234A.²² The 1993 NPC Regulations define a “termination payment” as a “payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract.”²³ The preamble to the Proposed Regulations states that the effect of this rule is that gain or loss arising from a termination payment with respect to an NPC is treated as capital gain or loss. As discussed below, it is not clear that the rule provided in the Proposed Regulations actually achieves this result even if it is assumed that there is statutory authority for such a regulation.

The Proposed Regulations also provide that any gain or loss arising from the settlement of a bullet swap or forward contract is treated as gain or loss from the termination of the bullet swap or forward contract for purposes of Section 1234A(1).²⁴ A payment “in settlement of” a bullet swap or forward contract includes a payment made between the parties to the bullet swap or forward contract pursuant to the terms of the bullet swap or forward contract and a payment made to assign or extinguish a party’s rights and obligations under the bullet swap or forward contract. For these purposes, a “bullet swap” is defined as a financial instrument that would be an NPC but for the fact that a single payment based on a specified index and notional principal amount is made, rather than periodic payments.²⁵

In a rule described by the preamble to the Proposed Regulations as a “clarification,” periodic payments, noncontingent nonperiodic payments, and contingent nonperiodic payments are not considered termination payments for purposes of Section 1234A.²⁶ Accordingly, such payments cannot be treated as capital gains or losses.

The character rules in the Proposed Regulations are proposed to be effective for NPCs, bullet swaps, and forward contracts entered into on or after 30 days after final regulations are issued.²⁷

²² Prop. Reg. 1.1234A-1(a).

²³ Reg. 1.446-3(h)(1). The 1993 NPC Regulations also provide that a termination payment includes any gain or loss realized on the exchange of one notional principal contract for another.

²⁴ Prop. Reg. 1.1234A-1(c)(1).

²⁵ Prop. Reg. 1.1234A-1(c)(2).

²⁶ Prop. Reg. 1.1234A-1(b).

²⁷ Prop. Reg. 1.1234A-1(d).

Character Issues Under the Proposed Regulations

Character of Periodic and Nonperiodic Payments Under NPCs

The Proposed Regulations provide that periodic and nonperiodic payments under an NPC are ordinary. Since there is a difference between the character of the payments made under an NPC and the character of gain or loss from the sale or exchange of an NPC, there is an opportunity for character arbitrage. This opportunity for character arbitrage is not unique to NPCs and exists in instruments such as dividend-paying stock and debt instruments, which generate ordinary income payments and capital gains or losses from the sale or exchange of the instruments.

Character of Gain or Loss From the Disposition of NPCs

If there are character differences between the gain or loss realized from a sale or exchange of an NPC and the gain or loss from the termination of an NPC, taxpayers also have the opportunity to manipulate the character of the gain or loss from an NPC based on the manner in which the taxpayer disposes of its interest in the NPC. Section 1234A(1) was enacted to address a similar problem in the case of contracts to buy or sell capital assets and reasonably could be interpreted to apply to other contractual rights or obligations “with respect to” capital assets. For example, Section 1234A(1) could be interpreted to apply to the termination of bullet swaps, forward contracts, and notional principal contracts that provide for settlement in cash based on the price of a referenced capital asset such as a commodity or currency.

The drafters of the Proposed Regulations, however, were not content to apply Section 1264A(1) to terminations of commodity swaps and equity swaps, which arguably confer rights or obligations “with respect to” the referenced commodity or security. Rather, the drafters of the Proposed Regulations seek to apply Section 1234A(1) to all NPCs and thereby prevent character arbitrage attributable to the disposition of any NPC that is a capital asset in the hands of the taxpayer. The authority of the IRS and Treasury to apply Section 1234A in this manner is based on an interpretation of Section 1234A that is subject to challenge.

The Proposed Regulations provide that any gain or loss arising from a termination payment with respect to an NPC, as defined in Reg. 1.446-3(h)(1), “is treated as gain or loss from the termination of the [NPC].” Although the preamble to the Proposed Regulations states that “any gain or loss arising from a termination payment . . . is treated as capital gain or loss pursuant to the proposed regulations under Section 1234A,” it is unclear how the Proposed Regulations actually achieve this objective. The

rule in the Proposed Regulations, that a gain or loss attributable to a payment made or received to terminate an NPC is a gain or loss from the termination of the NPC seems self-evident. The fact that a gain or loss is from the termination of an NPC, however, does not resolve the question whether the character of the gain or loss is determined by reference to the character of the NPC or by reference to the character of the property, if any, to which the NPC relates. In addition, although it is the clear intent of the Proposed Regulations that NPCs, including underwater NPCs, should be treated as “property” for purposes of Section 1234A, this intent is not made explicit in the Proposed Regulations.

It is difficult to understand why the drafters of the Proposed Regulations adopted such an ambiguous formulation for the rule they clearly intended. Perhaps the IRS and Treasury are reserving the option to interpret Section 1234A(1) to mean that, in some cases, the character of the property underlying the terminated contract should determine the character of gain or loss from the termination of the contract. For example, if a taxpayer is a dealer in commodities and enters into a physical-settlement commodities forward contract, the forward contract would be a capital asset unless it served as a hedge. If the taxpayer settles the forward contract by making or taking physical delivery, gain or loss from the sale of the commodity would be ordinary. Alternatively, a sale or exchange of the forward contract would produce capital gain or loss. In this case, it is not clear whether the IRS and Treasury would prefer that gain or loss from a termination of the contract be treated as capital or ordinary. Final regulations under Section 1234A should make clear how Section 1234A is being interpreted and make clear whether it is the capital character of the terminated contract, the capital character of property subject to the terminated contract, or some combination of the two that determines the character of gain or loss from the termination.

The Proposed Regulations also provide that a payment in settlement of obligations under a bullet swap or forward contract, including a payment pursuant to the terms of the bullet swap or forward contract, is treated as gain or loss from a termination of the bullet swap or forward contract for purposes of Section 1234A. The intent of this is to eliminate character differences between sales and terminations. This rule is also intended to prevent character arbitrage attributable to whether the contract is settled pursuant to its terms or is disposed of before settlement. In all cases, the intent of the rule is to determine the character of the gain or loss by reference to the character of the contract in the hands of the taxpayer. The rule for bullet swaps and forward contracts is, in this regard, different from the rules for NPCs, which treat all payments pursuant to the terms of the NPC as ordinary. Since bullet swaps and forward contracts do not have any periodic payments or nonperiodic payments that are recognized over the

term of the contract, it is possible to treat the single payment as capital under Section 1234A without raising the issue of whether other payments under the contract should be treated as capital under Section 1234A. As in the case of the rule for NPC termination payments, the application of Section 1234A to prevent character arbitrage with respect to terminations of all bullet swaps and forward contracts is based on an interpretation of Section 1234A that is subject to challenge.

The Proposed Regulations also clarify that periodic and nonperiodic payments under NPCs are not payments made or received to terminate the NPC. Periodic and nonperiodic payments are not “termination payments” as defined in Prop. Reg. 1.446-3(h)(1) and the Proposed Regulations provide that such payments are ordinary. Although it might be argued that a payment such as the final payment under an equity swap, reflecting changes in the value of the security over several years, should be treated as capital on the grounds that the payment is similar to payments made under other financial instruments that receive capital treatment (e.g., cash-settled options), there is no reasonable argument that such a payment cancels or terminates the equity swap.

Conclusions

The character rules in the Proposed Regulations attempt to resolve the issue of the character of the gain or loss from terminations of NPCs, bullet swaps, and forward contracts, based on the character of the NPC, bullet swap, or forward contract. This may be the correct answer to the problem of character arbitrage between sales and terminations of contracts that are capital assets. However, Section 1234A requires amendment to achieve this goal.