

**Notional Principal Contract.** This ruling provides that where a nonperiodic payment made pursuant to a notional principal contract is comprised of noncontingent and contingent components, the parties must recognize the noncontingent component of the nonperiodic payment over the term of the notional principal contract.

## Rev. Rul. 2002-30

### ISSUE

What is the appropriate method for the inclusion into income or deduction of a nonperiodic payment made pursuant to a notional principal contract where the payment is comprised of noncontingent and contingent components?

### FACTS

*T* enters into a notional principal contract (“NPC”) with *CP* on October 1, 2002, for a term of 18 months. Pursuant to the terms of the NPC, *T* agrees to make quarterly payments to *CP* based on three-month LIBOR multiplied by a notional principal amount of \$100,000,000. In exchange, *CP* agrees that upon expiration

of the NPC on March 31, 2004, *CP* will pay *T* 6 percent per year multiplied by a notional principal amount of \$92,000,000 (the fixed payment amount). In addition, *CP* or *T* will make a payment upon expiration equal to the percentage change in the value of the S&P 500 stock index multiplied by a notional principal amount of \$8,000,000. If the change is positive (an appreciation amount), *CP* will make a payment to *T*; if the change is negative (a depreciation amount), *T* will make a payment to *CP*. Any depreciation amount payable by *T* will be netted against the fixed payment amount payable by *CP*.

### LAW

Section 1.446-3 of the Income Tax Regulations provides rules on the timing of inclusion of income and deductions for amounts paid or received pursuant to NPCs.

Section 1.446-3(c)(1)(i) defines a NPC 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. Payments made pursuant to NPCs are divided into three categories (periodic, nonperiodic, and termination payments), and the regulations provide separate timing regimes for each.

Section 1.446-3(e)(1) defines periodic payments as payments made or received pursuant to a NPC that are payable at intervals of one year or less during the entire term of the contract, that are based on a specified index, and that are based on a notional principal amount. Section 1.446-3(e)(2) provides that all taxpayers, regardless of their methods of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.

Section 1.446-3(h)(1) defines 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 NPC.

Section 1.446-3(f)(1) provides that a nonperiodic payment is any payment

made or received with respect to a NPC that is not a periodic payment or a termination payment. The recognition rules for nonperiodic payments are set forth in § 1.446-3(f)(2). Section 1.446-3(f)(2)(i) provides that all taxpayers, regardless of their methods of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a NPC in a manner that reflects the economic substance of the contract.

Section 1.446-3(f)(2)(ii) provides generally that a nonperiodic payment must be recognized over the term of the contract by allocating it in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.

Section 1.446-3(f)(2)(iii)(A) provides that an upfront payment may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level payment method).

Section 1.446-3(f)(2)(iii)(B) provides that nonperiodic payments other than an upfront payment may be amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties. The single upfront payment is then amortized under the level payment method described in § 1.446-3(f)(2)(iii)(A). The time value component of the loan is not treated as interest, but together with the amortized amount of the deemed upfront payment, is recognized as a periodic payment. See § 1.446-3(f)(4), Example 6, for an illustration of these rules.

Section 1.446-3(g)(4) provides that a swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is not included in the net income or net deduction from the swap under § 1.446-3(d) of this section, but is recognized as

interest for all purposes of the Internal Revenue Code.

Section 1.446-3(d) provides that for all purposes of the Code, the net income or net deduction from a NPC for a taxable year is included in, or deducted from, gross income for that taxable year. The net income or net deduction from a NPC for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year under § 1.446-3(e), and all of the nonperiodic payments that are recognized from that contract for the taxable year under § 1.446-3(f). Each party to the NPC determines its payments and receipts attributable to the taxable year and takes into account, as net income or net deduction, the result of those payments and receipts. See § 1.446-3(e)(3), Example 1; and § 1.446-3(g)(6), Example 3.

## ANALYSIS

The agreement between *T* and *CP* is a NPC as defined in § 1.446-3(c)(1)(i). Pursuant to the terms of the contract, *T* will pay to *CP* amounts based on LIBOR quarterly, in exchange for *CP*'s promise to pay specified consideration at expiration.

The amounts that *T* pays to *CP* are periodic payments as defined in § 1.446-3(e)(1). These LIBOR-based payments are payable at intervals of less than one year and are calculated by reference to a specified index upon a notional principal amount of \$100,000,000. Pursuant to § 1.446-3(e)(2), *T* and *CP* must recognize the ratable daily portion of each periodic payment for the taxable year to which that portion relates.

The amount payable on March 31, 2004, is a nonperiodic payment, which *T* and *CP* are required to recognize over the term of the NPC in a manner that reflects the economic substance of the NPC. In substance, the nonperiodic payment that *CP* must pay *T* on expiration equals the sum of two independent components, one noncontingent and the other contingent. The noncontingent component (the fixed payment amount) equals \$8,280,000, that is the product of 6 percent per year, or 9 percent for 18 months, and the notional principal amount of \$92,000,000. The contingent component (the appreciation

or depreciation amount) equals the product of the percentage appreciation or depreciation in the value of the S&P 500 stock index and the notional principal amount of \$8,000,000. In order to reflect the economic substance of the NPC, each component must be treated separately for purposes of applying the NPC rules in § 1.446-3. As a result, pursuant to § 1.446-3(f)(2)(i), the fixed payment amount due on March 31, 2004, must be recognized over the term of the NPC in a manner consistent with § 1.446-3(f)(2)(ii) or (iii). This treatment of the fixed payment amount payable by *CP* is not affected by the possibility that *T* may be required to pay a depreciation amount to *CP* that, under the terms of the NPC, will be netted against *CP*'s obligation to pay the fixed payment amount. Pursuant to § 1.446-3(g)(4), *T* must accrue interest income and *CP* may accrue interest deductions.

## HOLDING

*T* and *CP* must recognize the noncontingent component of the nonperiodic payment over the term of the NPC, and must also account for interest, in a manner consistent with §§ 1.446-3(f)(2)(ii) or (iii), and 1.446-3(g)(4).

## DRAFTING INFORMATION

The principal author of this revenue ruling is Elizabeth Handler of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Handler at (202) 622-3930 (not a toll-free call).