hearing on the ordering of rules of section 664(b) for characterizing distributions from charitable remainder trusts.

DATES: The public hearing originally scheduled for March 9, 2004, at 10 a.m., is cancelled.

FOR FURTHER INFORMATION CONTACT: Robin R. Jones of the Publications and Regulations Branch, Legal Processing Division at (202) 622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION: A notice of proposed rulemaking and notice of public hearing that appeared in the **Federal Register** on Thursday, November 20, 2003 (68 FR 65419), announced that a public hearing was scheduled for March 9, 2004, at 10 a.m., in the auditorium. The subject of the public hearing is proposed regulations under section 664 of the Internal Revenue Code. The public comment period for these regulations expired on February 17, 2004.

The notice of proposed rulemaking and notice of public hearing, instructed those interested in testifying at the public hearing to submit an outline of the topics to be addressed. As of Wednesday, February 18, 2004, no one has requested to speak. Therefore, the public hearing scheduled for March 9, 2004, is cancelled.

Cynthia E. Grigsby,

Acting Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration).

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–166012–02]

RIN 1545–BB82

National Principal Contracts; Contingent Nonperiodic Payments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the inclusion into income or deduction of a contingent nonperiodic payment provided for under a notional principal contract (NPC). This document also provides guidance relating to the character of payments made pursuant to an NPC. These regulations will affect taxpayers that enter into NPCs. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronically transmitted comments and requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for May 25, 2004, at 10 a.m., must be received by May 4, 2004. Comments on the collection of information should be received by April 26, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–166012–02), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–166012–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at: *http://www.irs.gov/regs.* The public hearing will be held in the IRS Auditorium, Seventh Floor, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments, the hearing, or to be placed on the building access list to attend the hearing, Sonya Cruse, (202) 622–7180; concerning the regulations, Kate Sleeth, (202) 622–3920 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by April 26, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in these proposed regulations is in § 1.446–3(g)(6)(vii). This information is required by the IRS to verify compliance with section 446 and the method of accounting described in § 1.446–3(g)(6). This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required to properly determine the amount of income or deduction to be taken into account. The respondents are sophisticated investors that enter into notional principal contracts with contingent nonperiodic payments.

Estimated total annual recordkeeping burden: 25,500 hours.

Estimated average annual burden per recordkeeper: 6 hours.

Estimated number of recordkeepers: 4,250.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to 26 CFR Part 1 under section 446(b) of the Internal Revenue Code (Code). This document also contains proposed amendments under sections 162, 212 and 1234A of the Code.

In 1989, the IRS issued Notice 89–21 (1989–1 C.B. 651), to provide guidance with respect to the tax treatment of lump-sum payments received in connection with NPCs. The Notice stated that a method of accounting that properly recognizes a lump-sum payment over the life of the contract clearly reflects income and indicated that regulations would be issued to provide specific rules regarding the manner in which a taxpayer must take into account over the life of an NPC payments made or received with respect to the contract. The Notice further stated that ''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.'' (1989–1 C.B. 652).

On October 14, 1993, the IRS published in the **Federal Register** final regulations (TD 8491; 1993–2 C.B. 215 [58 FR 53125]) under section 446(b) relating to the timing of income and deductions for amounts paid or received pursuant to NPCs. § 1.446–3. In this preamble, the final regulations published in 1993 are referred to as the 1993 Treasury regulations.

The 1993 Treasury regulations define an 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.'' § 1.446–3(c)(1)(i). Payments made pursuant to NPCs are divided into three categories (periodic, nonperiodic, and termination payments), and the 1993 Treasury regulations provide timing regimes for each. The 1993 Treasury regulations require all taxpayers, regardless of their method of accounting, to recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Nonperiodic payments generally must be recognized over the term of an NPC in a manner that reflects the economic substance of the contract. § 1.446–3(f)(2)(i). Although § 1.446–3 does not distinguish between noncontingent and contingent nonperiodic payments, the specific rules and examples in the 1993 Treasury regulations address only noncontingent nonperiodic payments. The Preamble to the 1993 Treasury regulations states that ''the IRS expects to address contingent payments in future regulations, and welcomes comment on the treatment of those payments.'' (1993–2 C.B. 216). In addition, neither § 1.446–3 nor any other section provides specific rules governing the character of the various types of NPC payments.

On July 23, 2001, the IRS published Notice 2001–44 (2001–2 C.B. 77), soliciting comments on the appropriate method for the inclusion or deduction of contingent nonperiodic payments made pursuant to NPCs and the proper character treatment of payments made pursuant to an NPC. The Notice set forth four different methods under consideration by the IRS and Treasury and asked the public to comment on the extent to which each method reflects certain fundamental tax policy principles, including certainty, clarity, administrability, and neutrality. Several comments were received from the public, which expressed diverse views regarding the relative advantages and disadvantages of the different methods. Included in the four methods were the noncontingent swap method and a mark-to-market method, versions of which are adopted in the proposed regulations.

The Notice also solicited comments on the proper character of payments on NPCs and bullet swaps. The comments received on this issue also reflected differing views.

Explanation of Provisions

A. Overview

The IRS and Treasury understand that some taxpayers take into account contingent nonperiodic payments on an NPC only when the payment becomes fixed and determinable (the open transaction or wait-and-see method of accounting). The wait-and-see method, however, is inconsistent with the existing specific timing rules for periodic and nonperiodic payments and with the general rule in § 1.446–3(f)(2)(i) respecting recognition of nonperiodic payments over the term of the contract. For example, if the amount of a periodic payment is set in arrears at the end of an accrual period that spans taxable years, the parties cannot use a wait-and-see method for the portion of the accrual period in the first taxable year. Instead, the parties must use a reasonable estimate of the payment for determining taxable income in the year before the payment is fixed. § 1.446–3(e)(2)(ii). In addition, some NPCs are structured to provide for nonperiodic payments consisting of a noncontingent component and a contingent component, which the parties to the contract treat as a single contingent payment that they account for under the wait-and-see method. The attempted application of the wait-and-see method to these contracts highlights the potential for abuse present in the method. *See* Rev. Rul. 2002–30 (2002–1 C.B. 971).

The back-loaded timing of tax consequences that results from the wait-and-see method is also inconsistent with the timing regime that § 1.1275–4(b) provides for contingent debt instruments subject to the noncontingent bond method. Under the noncontingent bond method, the parties to a contingent payment debt instrument must determine the yield at which a comparable noncontingent debt instrument would be issued and then project a fixed amount for each contingent payment and each noncontingent payment. The projected amounts are accounted for over the term of the debt instrument. The difference, if any, between the projected amount of a contingent payment and the actual amount of the payment generally is accounted for when payment is made.

The proposed regulations adopt a variation on the noncontingent swap regime described in Notice 2001–44, as well as an elective mark-to-market regime. The 1993 Treasury regulations reflect an underlying principle that nonperiodic payments should be spread over the term of an NPC in a manner that properly reflects the economic substance of the contract. The proposed regulations build upon this principle. Furthermore, the IRS and Treasury believe that the proposed regulations provide a timing regime for contingent nonperiodic payments that clearly reflects the economics of the underlying contracts. The requirement that nonperiodic payments be spread over the term of an NPC results in substantially similar treatment for all NPCs without regard to whether payment obligations are settled on a current basis through periodic payments or are either pre-paid or deferred through nonperiodic payments. Adopting this approach for contingent payment NPCs achieves symmetry between fixed payment NPCs and contingent payment NPCs.

The proposed noncontingent swap method requires taxpayers to project the expected amount of contingent payments, to take into account annually the appropriate portions of the projected contingent amounts, to reproject the contingent amounts annually, and to reflect the differences between projected amounts and reprojected amounts through adjustments. The IRS and Treasury recognize that annual reprojections will require additional effort by taxpayers and the IRS. The IRS and Treasury believe, however, that the annual reprojection requirement is essential to ensure clear reflection of income with respect to NPCs with one or more contingent nonperiodic payments. Moreover, reprojections, and the resulting adjustments to current inclusion and deduction amounts, are especially important for the income and deductions generated by these types of contracts because otherwise taxpayers might be more likely to attempt to manipulate the character of the income or deductions from the contract.

In developing the proposed regulations, the IRS and Treasury have taken into account comments received in response to Notice 2001–44, as well as the following considerations. First, although many comments advocated the wait-and-see method of accounting for contingent nonperiodic payments, this method encourages the creation of NPCs that provide such payments. As a result of the adoption of guidelines for taking contingent nonperiodic payments into account over the term of an NPC, the tax treatment of payments with respect to an NPC should no longer provide an incentive for structuring payments in a particular manner. Second, taxpayers using swaps with contingent nonperiodic payments are sophisticated investors. Many of these taxpayers will be making similar projections and reprojections for their own purposes in evaluating the results of their derivative investments and taking actions to manage the risks created by their derivative investments. Third, the proposed regulations also provide an elective mark-to-market method as an alternative to the noncontingent swap method. Taxpayers who use a mark-to-market method for financial reporting purposes may adopt the elective mark-to-market method to reduce their tax and accounting administrative burden for NPCs.

The IRS and Treasury understand that similar timing issues exist for other types of derivative investments, like bullet swaps and prepaid forward contracts. Although the application of the proposed regulations to these types of transactions may achieve appropriate timing, the application of these rules to investments other than NPCs could present a number of issues not directly addressed by the rules contained in these proposed regulations. The expansion of the scope of these proposed regulations to contracts other than NPCs is not being proposed at this time so as not to delay the publication of the proposed regulations.

With respect to character, the proposed regulations under sections 162 and 212 provide that both periodic and nonperiodic payments with respect to NPCs are generally ordinary in character. This is because neither periodic nor nonperiodic payments (whenever made) involve a sale or exchange within the meaning of section 1222, and no other section of the Code provides otherwise. The proposed regulations issued under section 1234A provide capital treatment for termination payments. Under the proposed regulations, however, even nonperiodic payments made at the maturity of an NPC are not termination payments under section 1234A.

Because of their recurring nature, periodic payments should be treated as ordinary income items, whether or not the payments are made at the expiration of an NPC. The same rationale applies to nonperiodic payments, which are required to be spread over the term of an NPC. Even if a nonperiodic payment is made at the expiration or termination of an NPC, only the final portion is taken into account on the termination date for the contract, and that portion should be treated in the same way as a periodic payment.

B. Specific Provisions

Adjustments

Paragraph (d)(2) of the proposed regulations provides for adjustments to be made in the gain or loss realized on the sale, exchange, or termination of an NPC, to account for inclusions into income and deductions provided for in the 1993 Treasury regulations and the proposed regulations, as well as for any payments made or received on the NPC. These adjustments are expected to produce consequences similar to the consequences that would result if basis were increased or decreased for these items. Using adjustments for this purpose avoids the issue of negative basis.

Significant Nonperiodic Payments

Paragraph (g)(4) of the proposed regulations clarifies the rules for the treatment of an NPC with a significant upfront nonperiodic payment and provides additional rules for the treatment of a significant nonperiodic payment that is not paid upfront. The 1993 Treasury regulations provide that a significant nonperiodic payment on an NPC is treated as two separate transactions—an on-market level payment NPC and a loan. § 1.446–3(g)(4). The proposed regulations clarify that the parties to an NPC with one or more significant nonperiodic payments must treat the contract as two or more separate transactions consisting of an on-market NPC and one or more loans. In some cases, the on-market NPC payments for a party making a significant nonperiodic upfront payment will be level payments that may be constructed through a combination of the actual payments on the NPC and level payments computed under the level payment method described in § 1.446–3(f)(2)(iii)(A).

The proposed regulations also provide that an NPC with a significant nonperiodic payment that is not paid upfront is treated as if the party receiving the significant nonperiodic payment paid a series of annual level payment loan advances, equal to the present value of the nonperiodic payment, to the party owing the significant nonperiodic payment. The interest component of the level payments is treated as interest for all purposes of the Code and is not taken into account in determining the income and deductions on the NPC. The principal component of the level payments is calculated solely to determine the interest amount. The party owing the significant nonperiodic payment is then treated as using the level payment loan advances to make annual level payment NPC payments, which are included in income and deducted as provided in § 1.446–3(d).

Contingent Nonperiodic Payments

The 1993 Treasury regulations define both periodic and nonperiodic payments but do not distinguish between contingent and noncontingent nonperiodic payments. Paragraph (g)(6)(i)(B) of the proposed regulations defines a contingent nonperiodic payment as any nonperiodic payment other than a noncontingent nonperiodic payment. A noncontingent nonperiodic payment is defined in paragraph (g)(6)(i)(A) of the proposed regulations as a nonperiodic payment that either is fixed on or before the end of the taxable year in which a contract commences or is equal to the sum of amounts that would be periodic payments if they are paid when they become fixed, including amounts determined as interest accruals.

Paragraph (g)(6)(ii) of the proposed regulations sets forth the noncontingent swap method for the inclusion into income and deduction of contingent nonperiodic payments. The noncontingent swap method requires taxpayers to project the reasonably expected amount of the contingent nonperiodic payment and to apply the level payment method and, as appropriate, the rules for significant nonperiodic payments, to the projected amount as if it were a noncontingent nonperiodic payment. The risk-free rate of return, which is defined in the proposed regulations, is used in applying the level payment method.

Paragraphs (g)(6)(iii)(A) through (C) of the proposed regulations provide the methods for projecting the reasonably expected amount. If the contingent payment is determined by reference to the value of a specified index at a designated future date, the projected amount may be determined by reference to the future value of the specified index in actively traded futures or forward contracts providing for delivery or settlement on the designated future date. If no actively traded contract exists for the designated future date, the value may be derived from actively traded futures or forward contracts providing for delivery or settlement within three months of the designated future date.

The projected amount may also be determined based on the projected future value of the current market price of the specified index. The future value is determined using a constant yield method at the risk-free interest rate with appropriate compounding and making appropriate adjustments for expected cash payments on the property underlying the specified index. The proposed regulations use the applicable federal rate under section 1274(d)(1) as the risk-free rate for this purpose. Comments are requested on whether this rate is appropriate.

If neither of the two methods described above results in a reasonable estimate of the future value of the specified index, the taxpayer must use another method that does result in a reasonable estimate of the amount of the contingent payment and that is based on objective financial information, and must consistently use the method from year to year.

The proposed regulations require annual adjustments to the projected amounts of the contingent payment. Paragraphs (g)(6)(iv) through (vi) of the proposed regulations provide rules for the redetermination of the projected amount of the contingent payment and the subsequent adjustments to the recognition of income and deductions under a contract based on the reprojected amount.

Paragraph (g)(6)(iv) of the proposed regulations provides that the projected amount must be redetermined on each successive anniversary date (redetermination date) and on each special redetermination date as described below. On each redetermination date, the taxpayer must reproject the amount of the contingent payment using the same method used at the commencement of the NPC but applied to the new current value of the specified index. Once the contingent payment is reprojected, the level payment method (and the rules for significant nonperiodic payments, if applicable) are applied again using the new projected amount.

Comments are requested as to how the reprojection process should respond to changes in the availability of market data during the life of an NPC. Suppose, for example, that the initial projection is made when there are no actively traded futures or forward contracts in the specified index but that these contracts come into existence before the time of one of the reprojections. Should the reprojections be made using the newly available futures data rather than the method employed for the first projection?

Paragraph (g)(6)(v) of the proposed regulations provides rules for adjustments following the redetermination of the projected amount of the contingent payment. The amounts determined for the redetermined projected amount under the level payment method and, as applicable, the rules for significant nonperiodic payments, are recognized in the current and subsequent taxable years. In addition, any difference between the newly determined amounts for prior periods and the amounts determined and previously taken into account using the previously projected contingent payment are recognized ratably over the one-year period beginning with the redetermination date. Any difference in amounts that would have been treated as interest under the rules for significant nonperiodic payments is also treated as interest for all purposes of the Code.

Paragraph (g)(6)(iv)(B) of the proposed regulations provides a special rule for a contingent nonperiodic payment that is fixed more than six months before it is due. If the date on which the payment becomes fixed is in a different taxable year from the date it is due, the date on which the payment becomes fixed is a special redetermination date. In such a case, the fixed amount is treated as the reprojected amount, and the rules described above for redeterminations and adjustments apply.

In general, under paragraph (g)(6)(vi) of the proposed regulations, when a contingent payment is made, the parties must make appropriate adjustments to the amount of income or deduction attributable to the NPC for any differences between the projected amount of the contingent payment and the actual amount of the contingent payment.

Paragraph (g)(6)(vii) of the proposed regulations provides a recordkeeping requirement with respect to the noncontingent swap method. Taxpayers must maintain in their books and records a description of the method used to determine the projected amount of the contingent payment, the projected payment schedules, and the adjustments taken into account under the proposed regulations.

The IRS and Treasury are considering whether to provide an alternative to the noncontingent swap method that would permit a taxpayer to use a current inclusion method for certain NPCs that provide for periodic calculations of amounts due under the terms of the NPC, but provide for deferred payment of the amounts. The IRS and Treasury are considering permitting current inclusion of income and deduction for the amounts so calculated, provided the NPC also provides for accrual of interest at a qualified rate until the periodically determined amounts are paid or offset against other amounts due under the NPC. The purpose of providing a current inclusion method for the deferred payment NPC described above is to provide tax treatment for NPCs with contingent nonperiodic payments that is economically equivalent to the tax treatment of NPCs providing only for periodic payments while avoiding the necessity of using projected amounts for contingent payments. The IRS and Treasury request comments concerning whether an NPC like the deferred payment NPC described above would be a viable transaction for market participants, whether a current inclusion method would be an appropriate substitute for the noncontingent swap method for deferred payment NPCs, and whether that method should require separate computation of interest accruals.

Elective Mark-to-Market Methodology

Paragraph (i) of the proposed regulations provides an elective mark-to-market methodology for certain NPCs providing for nonperiodic payments. If an election is made, the specific accounting rules for nonperiodic payments in § 1.446–3(f)(2) (other than (f)(2)(i)) are not applicable. Instead, for any contract that is held at the close of the taxable year, the taxpayer determines income inclusions and deductions by reference to the gain or loss that would be realized if the contract were sold for its fair market value on the last business day of the taxable year. Because the determination of fair market value takes into account the expected value of future nonperiodic payments, the mark-to-market methodology constitutes a reasonable basis for amortizing the nonperiodic payments over the term of the contract as required by § 1.446–3(f)(2)(i).

Proper adjustments are made in the amount of gain or loss subsequently realized (or calculated) for income inclusions and deductions taken into account in marking the contract to fair market value. Furthermore, under paragraph (i)(5) of the proposed regulations, if an election is made for a contract providing for a significant non periodic payment, paragraph (g)(4) continues to apply and proper adjustments must be made to the income inclusions and deductions recognized under the mark-to-market methodology to take into account amounts recognized as interest and the payment or receipt of the significant nonperiodic payment, subject to the special rule set forth below.

The proposed regulations set forth a special rule for contracts providing for significant contingent nonperiodic payments that are subject to the mark-to-market election. If a contract provides for a significant contingent nonperiodic payment, the taxpayer must apply the noncontingent swap method to determine the amounts recognized as interest under paragraph (g)(4). However, the taxpayer is not required to reproject the amount of the contingent payment each year. The interest amounts for subsequent years are the interest amounts as determined using the initial projection of the contingent payment. Furthermore, an alternative deemed equivalent value method may be used to determine the projected amount of the contingent payment. The deemed equivalent value method may be applied when the contract fixes the timing and amount of all of the payments under the contract, except for the significant contingent nonperiodic payment. The amount of the significant contingent nonperiodic payment is deemed to be the amount that causes the present value of all the payments by the taxpayer to equal the present value of all of the payments of the counterparty to the contract.

The inclusion of an elective mark-to-market methodology is intended to provide taxpayers with an alternative to the provisions of paragraphs (f) of the 1993 Treasury regulations and (g)(6) of the proposed regulations respecting nonperiodic payments. With respect to significant nonperiodic payments, however, the proposed regulations preserve certain features of those provisions for purposes of computing an interest component of swap payments. Such a calculation is necessary to preserve the characterization of an accrual as interest. The IRS and Treasury request comments on the appropriateness of requiring taxpayers to compute an interest amount for significant nonperiodic payments under the elective mark-to-market methodology and, in particular, on any effect that requirement may have on the relative usefulness and administrability of the mark-to-market methodology.

Paragraph (i)(2) of the proposed regulations provides the scope of the election. The election is available to contracts that are: (1) Actively traded within the meaning of § 1.1092(d)–1(c) (determined without regard to the limitation in § 1.1092(d)–1(c)(2)); (2) marked to market for purposes of the taxpayer's financial statements provided the taxpayer satisfies the requirements in paragraph (i)(4) of the proposed regulations; (3) subject to an agreement by a party to the contract that is a person to whom section 475 applies to supply to the taxpayer the value that it uses in applying section 475(a)(2); or (4) marked to market by a regulated investment company (RIC) described in section 1296(e)(2). Paragraphs (i)(3) (i) through (iv) of the proposed regulations provide the acceptable methods for determining fair market value. If the contract is actively traded, the fair market value is determined based on the mean between the bid and asked prices quoted for the contract. If a contract is not actively traded, but is marked to market for financial statement purposes, and the valuations used for those purposes comply with the requirements of paragraph (i)(4), the fair market value is deemed to be the value used for the financial statements. For a contract that is subject to an agreement with a dealer in securities to provide a value, the value that is provided by the dealer is the fair market value. Finally, for a contract marked to market by a RIC, the fair market value is equal to the value used for purposes of determining the RIC's net asset value.

Paragraph (i)(6) of the proposed regulations provides that the mark-to-market election shall be made in the time and manner prescribed by the Commissioner and is effective for the taxable year in which it is made and all subsequent years unless revoked with the consent of the Commissioner.

The proposed regulations indicate that a taxpayer will be permitted to elect the mark-to-market method for NPCs that are marked to market for purposes of the taxpayer's financial statements and that the values used on the financial statements may be used as fair market value under the mark-to-market election. However, the proposed regulations also indicate that an election to use financial statement values will be subject to further requirements. On May 5, 2003, the IRS and Treasury published in the **Federal Register** an Advance Notice of Proposed Rule Making (REG–100420–03) requesting comments regarding appropriate rules for the use of financial statement values under the mark-to-market provisions of section 475 applicable to securities dealers and electing commodities dealers and securities and commodities traders. The IRS and Treasury will take into account the comments received in response to that Advance Notice in developing the rules to be established for use of financial statement values under the mark-to-market method set forth in paragraph (i) of the proposed regulations. In addition, unlike other mark-to-market regimes, the mark-to-market method proposed in paragraph (i) does not require a mark immediately before disposition in either a recognition or nonrecognition context. *Cf.* section 1256(c) and proposed regulations § 1.475(a)–2. The IRS and Treasury request comments regarding this aspect of the proposed regulations and whether taxpayers who are eligible to elect a mark-to-market method under section 475 but do not do so should be eligible to make the paragraph (i) election for NPCs.

Anti-abuse Rule

Paragraph (i) of the 1993 Treasury regulations provides that if a taxpayer "enters into a transaction with a principal purpose of applying the rules of [§ 1.446–3] to produce a material distortion of income," the IRS may depart from those rules "as necessary to reflect the appropriate timing of income and deductions from the transaction." In light of the comprehensive rules in the proposed regulations prescribing methods of accounting for NPCs, the IRS and Treasury have determined that a general anti-abuse rule is not necessary to prevent these methods being used in a manner that fails to clearly reflect income. Accordingly, the proposed regulations delete this rule.

Proposed Dates of Applicability

These proposed regulations contain both new substantive rules as well as clarifying changes to the 1993 Treasury regulations. The new substantive rules, which are contained in paragraph (g)(6) (the noncontingent swap method) (except (g)(6)(i)) and paragraph (i) (the mark-to-market election), are proposed to apply to NPCs entered into on or after 30 days after the date of publication of the final regulations in the **Federal Register.** Paragraphs (c) (definitions), (d) (taxable year of inclusion and deduction), (f) (nonperiodic payments), (g)(4) (significant nonperiodic payments), and (g)(6)(i) (definition of contingent and noncontingent nonperiodic payments) are proposed to be integrated into the 1993 Treasury regulations which apply to NPCs entered into on or after December 13,

1993. Because of their purely clarifying nature, these proposed changes will apply to the same transactions that are governed by the 1993 Treasury regulations.

With respect to NPCs that provide for contingent nonperiodic payments and that are in effect or entered into on or after 30 days after the date of publication of these proposed regulations in the **Federal Register,** 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. If a taxpayer has adopted a method of accounting for these NPCs, the Commissioner generally will not require a change in the accounting method earlier than the first year ending on or after 30 days after the date of publication of the final regulations in the **Federal Register.** The preceding sentence does not apply to transactions described in Rev. Rul. 2002–30 (2002–1 C.B. 971) or other published guidance.

The proposed regulations do not contain a specific consistency requirement. Nevertheless, under the general rules governing accounting methods, once a taxpayer adopts a method of accounting for an item, the taxpayer must use the same method from year to year unless the taxpayer obtains the Commissioner's consent to change to another method of accounting.

Character

The proposed regulations under § 1.162–30 provide that in general, the net periodic and nonperiodic payments (including mark-to-market deductions) are deductible by the payor under section 162 as ordinary and necessary business expenses. However, payments representing interest under the rules for significant nonperiodic payments as well as termination payments are not deductible under section 162. A similar rule is provided for individuals in the proposed regulations under § 1.212–1(q). These regulations under sections 162 and 212 are proposed to apply to NPCs entered into on or after 30 days after the date of publication of the final regulations in the **Federal Register.**

Any gain or loss arising from a termination payment, however, is treated as capital gain or loss pursuant to the proposed regulations under section 1234A. These proposed regulations clarify that periodic payments, noncontingent nonperiodic payments, and contingent nonperiodic payments are not termination payments.

The proposed regulations under section 1234A also apply to any gain or loss arising from the settlement of obligations under a bullet swap or forward contract. 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 these proposed regulations, a bullet swap is defined as a financial instrument that is not an excluded contract as defined in § 1.446–3(c)(1)(ii), that provides for the computation of an amount or amounts due from one party to another by reference to a specified index upon a notional principal amount, and that provides for settlement of all the parties' obligations at or close to maturity of the contract, rather than for the payment of the specified amounts at specific intervals. The definition of bullet swap is intended to cover a contract that obligates each party to make a payment at the end of the contract, although only one net payment will actually be paid. For example, party A is obligated to pay at the end of three years a fixed rate multiplied by the notional amount. Also at the end of three years, party B is obligated to pay a variable rate multiplied by the same notional amount. At the end of three years, only one party makes a net payment equal to the difference between the fixed rate multiplied by the notional amount and the variable rate multiplied by the notional amount.

These regulations under section 1234A are proposed to apply to NPCs entered into on or after 30 days after the date of publication of the final regulations in the **Federal Register.**

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that very few small businesses enter into NPCs with contingent nonperiodic payments because these contracts are costly and complex and because they require constant monitoring and a sophisticated understanding of the capital markets. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 25, 2004, beginning at 10 a.m., in the IRS Auditorium, Seventh Floor, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments or electronic comments and an outline of topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by May 4, 2004. A period of 10 minutes will be allotted to each person making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Kate Sleeth, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.162–30 is added to read as follows:

§ 1.162–30 Notional principal contract payments.

(a) *In general.* Amounts taken into account by a taxpayer pursuant to § 1.446–3(d)(1) (including mark-to-market deductions) with respect to a notional principal contract as defined in § 1.446–3(c)(1)(i), are deductible as ordinary and necessary business expenses. However, this section will not apply to any amount representing interest expense on the deemed loan component of a significant nonperiodic payment as described in § 1.446–3(g)(4). For any loss arising from a termination payment as defined in § 1.446–3(h)(1), see section 1234A and the regulations thereunder. For the timing of deductions with respect to notional principal contracts, *see* § 1.446–3.

(b) *Effective date.* Paragraph (a) of this section is applicable to notional principal contracts entered into on or after 30 days after the date a Treasury decision based on these proposed regulations is published in the **Federal Register**.

Par. 3. In § 1.212–1, paragraph (q) is added to read as follows:

§ 1.212–1 Nontrade or nonbusiness expenses.

* * * * *

(q) *Notional principal contract payments*—(1) Amounts taken into account by an individual pursuant to § 1.446–3(d)(1) (including mark-to-market deductions) with respect to a notional principal contract as defined in § 1.446–3(c)(1)(i), are ordinary and necessary, and are deductible to the extent these amounts are paid or incurred in connection with the production or collection of income. However, this section will not apply to any amount representing interest expense on the deemed loan component of a significant nonperiodic payment as described in § 1.446–3(g)(4). For any loss arising from a termination payment as defined in § 1.446–3(h)(1), see section 1234A and the regulations thereunder. For the timing of deductions with respect to notional principal contracts, *see* § 1.446–3.

(2) *Effective date.* Paragraph (q) of this section is applicable to notional principal contracts entered into on or after 30 days after the date a Treasury decision based on these proposed regulations is published in the **Federal Register**.

Par. 4. Section 1.446–3 is amended by:

1. Revising the introductory text of paragraph (a) and the table of contents in paragraph (a).
2. Adding paragraph (c)(5).
3. Revising paragraphs (d), (f)(2)(i), (f)(2)(iii)(A), and (g)(4).
4. Redesignating the text of paragraph (g)(6) as paragraph (g)(7).
5. Adding new paragraph (g)(6).
6. Amending the newly designated text of paragraph (g)(7) by:

(a) Revising the heading for *Example 3*.

(b) Adding *Example 5* through *Example 9.*

7. Revising paragraphs (i) and (j).

The revisions and additions read as follows:

§ 1.446–3 Notional principal contracts.

(a) *Table of contents.* This paragraph (a) lists captioned paragraphs contained in this section.

§ 1.446–3 Notional principal contracts.

(6) Election.
(j) Effective dates.
(1) General rule.
(2) Exception.

* * * * *

(c) * * *

(5) *Risk-free interest rate and determination date*—(i) *Risk-free interest rate.* The risk-free interest rate is the applicable Federal rate determined in accordance with section 1274(d)(1) for a determination date and the period remaining in the term of the contract on the determination date.

(ii) *Determination date.* A determination date is the commencement date of the swap, each redetermination date as defined in paragraph (g)(6)(ii) of this section, and each special redetermination date as defined in paragraph (g)(6)(iv)(B) of this section.

(d) *Taxable year of inclusion and deduction; adjustment of gain or loss*—(1) *Inclusion and deduction.* For all purposes of the Internal Revenue Code, the net income or net deduction from a notional principal contract for a taxable year is taken into account for that taxable year. The net income or net deduction from a notional principal contract for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year under paragraph (e) of this section, all of the nonperiodic payments that are recognized from that contract for the taxable year under paragraph (f) of this section, and the mark-to-market income inclusions and deductions recognized from that contract under paragraph (i) of this section.

(2) *Adjustment of gain or loss.* Proper adjustment shall be made in the amount of any gain or loss realized on a sale, exchange, or termination of a notional principal contract for inclusions or deductions pursuant to paragraphs (d)(1) and (g)(4) of this section and for payments or receipts with respect to the notional principal contract.

* * * * *

(f) * * *

(2) *Recognition rules*—(i) *In general.* All taxpayers, regardless of their method 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 notional principal contract in a manner that reflects the economic substance of the contract. *See* paragraph (g)(6) of this section for additional rules for contingent nonperiodic payments.

* * * * *

(iii) * * *

(A) *Prepaid swaps.* An upfront payment on a swap 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), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The discount rate used in this calculation must be the rate (or rates) used by the parties to determine the amount of the nonperiodic payment. If that rate is not readily ascertainable, the discount rate used must be a rate that is reasonable under the circumstances. Under this method, an upfront payment is allocated by dividing each equal payment into its principal recovery and time value components. The principal recovery components of the equal payments are treated as periodic payments that are deemed to be made on each of the dates that the swap contract provides for periodic payments by the payor of the nonperiodic payment or, if none, on each of the dates that the swap contract provides for periodic payments by the recipient of the nonperiodic payment. The sum of the principal recovery components equals the amount of the upfront payment. The time value component is used to compute the amortization of the nonperiodic payment but is otherwise disregarded. *See* paragraph (f)(4) *Example 5* of this section.

* * * * *

(g) * * *

(4) *Swaps with significant nonperiodic payments.* The parties to a swap with one or more significant nonperiodic payments must treat the contract as two or more separate transactions consisting of an on-market swap and one or more loans. The parties must account for the loans separately from the swap. The payments associated with the on-market swap are included in the net income or net deduction from the swap under paragraph (d) of this section. The time value components associated with the loans are not included in the net income or net deduction from the swap under paragraph (d) of this section but are recognized as interest for all purposes of the Internal Revenue Code. The on-market swap must result in recognition of the payments associated with the swap in a manner that complies with the principles set forth in paragraph (f)(2)(i) of this section. *See* paragraph (g)(7) *Example 3* of this section for a situation in which the on-market swap payments for a party making a significant nonperiodic upfront payment will be level payments that may be constructed through a combination of the actual payments on the swap and level payments computed under the level payment method provided by paragraph (f)(2)(iii)(A) of this section. In certain cases, a swap with significant nonperiodic payments other than an upfront payment may be treated as if the swap provided for a series of level payment loan advances having a present value equal to the present value of the nonperiodic payments, with the amount of each loan advance being immediately returned as a level payment on the swap. *See* paragraph (g)(7) *Example 5* of this section. For purposes of section 956, the Commissioner may treat any nonperiodic swap payment, whether or not it is significant, as one or more loans.

* * * * *

(6) *Notional principal contracts with contingent nonperiodic payments*—(i) *Definitions*—(A) *Noncontingent nonperiodic payments.* A noncontingent nonperiodic payment is a nonperiodic payment that either is fixed on or before the end of the taxable year in which a contract commences or is equal to the sum of amounts that would be periodic payments if they are paid when they become fixed (including amounts determined as interest accruals).

(B) *Contingent nonperiodic payments.* A contingent nonperiodic payment is any nonperiodic payment other than a noncontingent nonperiodic payment.

(ii) *Noncontingent swap method.* Under the noncontingent swap method, a taxpayer, regardless of its method of accounting, recognizes each contingent nonperiodic payment with respect to a notional principal contract by determining the projected amount of the payment and by applying to that projected amount the level payment method described in paragraphs (f)(2)(iii)(A) and (B) of this section. The projected amount of a contingent nonperiodic payment is the reasonably expected amount of the payment, which is determined by using one of the methods described in paragraph (g)(6)(iii) of this section and by using the risk-free interest rate in applying the level payment method. On each successive anniversary date for the notional principal contract (a redetermination date) and each special redetermination date (as defined in paragraph (g)(6)(iv)(B) of this section), the taxpayer must redetermine the projected amount of each contingent nonperiodic payment, reapply the level payment method as provided in paragraph (g)(6)(iv) of this section, and make the adjustments specified in paragraph (g)(6)(v) of this section. If paragraph (g)(4) of this section applies to the notional principal contract, redeterminations and adjustments must also be made to account for the time value components of the transaction as interest in accordance with that paragraph. Except for contingent nonperiodic payments governed by paragraph (g)(6)(iv)(B) of this section, in the taxable year in which a contingent payment is made or received, the parties must make appropriate adjustments to the amount of income or deductions attributable to the notional principal contract for any differences between projected and actual contingent nonperiodic payments as provided in paragraph (g)(6)(vi) of this section.

(iii) *Determining projected amount of contingent payment*—(A) *Payment based on actively traded futures or forward contracts.* If a contingent nonperiodic payment is determined under the contract by reference to the value of a specified index on a designated future date, the projected amount of the payment may be determined on the basis of the future value for the specified index in actively traded futures or forward contracts, if any, providing for delivery or settlement on the designated future date. If no actively traded contract exists for the designated future date, a determination from the future values for the specified index in actively traded futures or forward contracts, if any, providing for delivery or settlement on dates within three months of the designated future date may be used.

(B) *Payment based on extrapolation from current market prices.* If a contingent nonperiodic payment is determined under the contract by reference to the value of a specified index on a designated future date, the projected amount of the payment may be determined on the basis of the current value of the specified index as established by objective financial information adjusted to convert the current value to a future value for the specified index on the designated future date. The current value is converted to a future value by adding to the current value an amount equal to the accrual of interest on the current value under a constant yield method at the risk-free interest rate with appropriate compounding and by making appropriate adjustments for expected cash payments on the property underlying the specified index.

(C) *Payment based on reasonable estimate.* If the methods provided in paragraphs (g)(6)(iii)(A) and (B) of this section do not result in a reasonable estimate of the amount of the contingent payment, the taxpayer must use another method that does result in a reasonable estimate of the amount of the contingent payment and that is based on objective financial information.

(iv) *Redeterminations of projected payments and level payment amounts*—(A) *General rule.* On each redetermination date, the taxpayer must redetermine the projected amount using current values on the redetermination date and the same method that was used on the commencement date of the notional principal contract, and must reapply the level payment method as of the commencement date of the notional principal contract on the basis of the new projected payment amount and the risk-free interest rate in effect on the redetermination date.

(B) *Special rule for fixed but deferred contingent nonperiodic payments.* If a contingent nonperiodic payment is fixed more than six months before it is due, and if the date the payment is fixed is in a different taxable year from the date the payment is due, the date on which the payment is fixed is a special redetermination date. As of that date, the taxpayer must treat the fixed amount as the projected amount for that contingent nonperiodic payment and apply paragraphs (g)(6)(iv) and (v) of this section as if the special redetermination date were a redetermination date.

(v) *Adjustments following redeterminations.* Following each redetermination of projected payments and level payment amounts, the taxpayer must apply the new schedule of level payments for purposes of determining amounts to be recognized in the current and subsequent taxable years with respect to the contingent nonperiodic payments. Any difference between the amounts recognized in prior taxable years and the amounts that would have been recognized in those years had the new level payment schedule been in effect for those years is taken into account as additional payments or receipts with respect to the contract ratably over the one-year period beginning with the redetermination date and, to the extent attributable to a difference in the interest amounts calculated under paragraph (g)(4) of this section, is recognized as interest for all purposes of the Internal Revenue Code.

(vi) *Adjustments for differences between projected and actual payments.* Any difference between the amounts taken into account under paragraph (f) and this paragraph (g)(6) on the one hand and the amount of the actual payment under the contract on the other hand is taken into account as an adjustment to the net income or net deduction from the notional principal contract for the taxable year during which the payment occurs, and not as an adjustment to interest income or expense.

(vii) *Recordkeeping requirements.* The books and records maintained by a taxpayer must contain a description of the method used to determine the projected amount of a contingent payment, projected payment schedules, any adjustments following redeterminations, and any adjustments for differences between projected and actual contingent payments.

(7) * * *

Example 3. Upfront significant nonperiodic payment. * * *

* * * * *

Example 5. Backloaded significant nonperiodic payment. (i) On January 1, 2003, unrelated parties *P* and *Q* enter into an interest rate swap contract. Under the terms of the contract, *P* agrees to make five annual payments to *Q* equal to LIBOR times a notional principal amount of $100,000,000. In return, *Q* agrees to pay *P* 6% of $100,000,000 annually, plus $24,420,400 on December 31, 2007. At the time *P* and *Q* enter into this swap agreement the rate for similar on-market swaps is LIBOR to 10%. Assume that on January 1, 2003, the risk-free rate is 10%.

(ii) The $24,420,400 payment from *Q* to *P* is significant when compared to the present value of the total payments due from *Q* under the contract. Accordingly, pursuant to paragraph (g)(4) of this section, the transaction is recharacterized as two separate transactions. First, *P* is treated as paying to *Q* a series of $4,000,000 level payment loan advances. The present value of the level payment loan advances equals the present value of $24,420,400, the significant nonperiodic payment. Stated differently, the sum of the level payment loan advances and accrued interest on those advances equals the significant nonperiodic payment.

(iii) Next, *Q* is treated as using each loan advance to fund five annual level swap payments of $4,000,000. The level payment loan advances and accrued interest on the advances computed with annual compounding at 10% are as follows:

	Level payment	Accrued interest
2003	$4,000,000	$0
2004	4,000,000	400,000
2005	4,000,000	840,000
2006	4,000,000	1,324,000
2007	4,000,000	1,856,400
	$20,000,000	$4,420,400

(iv) *P* recognizes interest income, and *Q* accrues interest expense, each taxable year equal to the interest accruals on the deemed level payment loan advances. These interest amounts are not included in the parties' net income or net deduction from the swap contract under paragraph (d) of this section.

(v) The level payment amounts of $4,000,000 are taken into account in determining the parties' net income and deductions on the swap pursuant to paragraph (d) of this section.

Example 6. Contingent nonperiodic payment on an equity swap. (i) On January 1, 2005, unrelated parties V and *W* enter into an equity swap contract. Under the terms of the contract, V agrees to make three annual payments to *W* equal to 1-year LIBOR times a notional principal amount of $50,000,000. In return, *W* agrees to make a single payment on December 31, 2007, equal to the appreciation, if any, of a $50,000,000 investment in a basket of equity securities over the term of the swap. V is obligated to make a single payment on December 31, 2007, equal to the depreciation, if any, in the same $50,000,000 investment in the basket of equity securities. Assume that on January 1, 2005, 1-year LIBOR is 9.5%, and the risk-free rate is 10.0%.

(ii) This contract is a notional principal contract as defined in paragraph (c)(1) of this section. The annual LIBOR-based payments from *V* to *W* are periodic payments and the single payment on December 31, 2007, is a contingent nonperiodic payment.

(iii) Pursuant to the method described in (g)(6)(iii)(B) of this section, the parties determine that the projected amount of the contingent nonperiodic payment that *W* will pay *V* on December 31, 2007, is $16,550,000. The present value of this projected fixed payment is significant when compared to the present value of the total payments due from *W* under the contract. Accordingly, pursuant to paragraph (g)(4) of this section, the transaction is recharacterized as two separate transactions.

(iv) As a preliminary step, using the risk-free rate of 10.0% as the discount rate, the parties determine the level payment amounts that have a present value equal to the present value of $16,550,000, the projected significant nonperiodic payment. Stated differently, the sum of the level payment amounts and accrued interest at 10.0% on those amounts must equal the projected significant nonperiodic payment. The level payment amounts thus determined are $5,000,000.

(v) Next, *V* is treated as paying to *W* a series of $5,000,000 loan advances.

(vi) Then, *W* is treated as using each loan advance to fund one of the three annual level swap payments of $5,000,000. The level payment loan advances and accrued interest on the advances computed with annual compounding at 10.0% are as follows:

	Level payment	Accrued interest
2005	$5,000,000	$0
2006	5,000,000	500,000
2007	5,000,000	1,050,000
	$15,000,000	$1,550,000

(vii) No interest amount is taken into account for the contract year 2005.

(viii) The level payment amount of $5,000,000 is taken into account for the contract year 2005 in determining the parties' net income and deductions on the swap pursuant to paragraph (d) of this section.

(ix) For the contract year 2005, *V* makes a swap payment to *W* equal to 1-year LIBOR at 9.5% times $50,000,000, or $4,750,000, and *W* is deemed to make a swap payment to *V* equal to the annual level payment of $5,000,000. The net of the ratable daily portions of these payments determines the annual net income or deduction from the contract for both *V* and *W*.

Example 7. Initial Adjustment. (i) The terms of the equity swap agreement are the same as in *Example 6*. In addition, assume that on January 1, 2006, the first redetermination date, 1-year LIBOR is 10.0%, and the risk-free rate is 10.5%. On that date, the parties redetermine the projected amount of the contingent nonperiodic payment using current values in effect on that date. Under the method described in (g)(6)(iii)(B) of this section, the parties determine that the reprojected amount of the contingent nonperiodic payment that *W* will pay *V* on December 31, 2007, is $23,261,500. The present value as of January 1, 2005, of this projected fixed payment is significant when compared to the present value of the total payments due from *W* under the contract. Accordingly, pursuant to paragraph (g)(4) of this section, the transaction is recharacterized as two separate transactions.

(ii) The parties use the redetermined projected amount of $23,261,500, to reapply the method provided by paragraph (g)(4) of this section effective as of the commencement date of the swap. As a preliminary step, using the risk-free rate of 10.5% as the discount rate, the parties determine the level payment amounts that have a present value equal to the present value of $23,261,500, the reprojected significant nonperiodic payment. Stated differently, the sum of the level payment amounts and accrued interest at 10.5% on those amounts must equal the reprojected significant nonperiodic payment. The level payment amounts thus determined are $6,993,784.

(iii) Next, *V* is treated as paying to *W* a series of $6,993,784 loan advances.

(iv) Then, *W* is treated as using each loan advance to fund one of the three annual level swap payments of $6,993,784. The level payment loan advances and accrued interest on the advances computed with annual compounding at 10.5%, are as follows:

	Level payment	Accrued interest
2005	$6,993,784	$0
2006	6,993,784	734,347
2007	6,993,784	1,545,801
	$20,981,352	$2,280,148

(v) For the contract year 2006, *V* recognizes interest income, and *W* accrues interest expense equal to the accrued interest of $734,347 on the deemed level payment loan advance. These interest amounts are not included in the parties' net income or net deduction from the swap contract under paragraph (d) of this section.

(vi) The level payment amount of $6,993,784 is taken into account for the contract year 2006 in determining the parties' net income and deductions on the swap pursuant to paragraph (d) of this section.

(vii) The parties also take into account for the contract year 2006 the difference between the amount recognized for 2005 and the amount that would have been recognized in 2005 had the new level payment schedule in this *Example 7* been in effect in 2005. Thus, for purposes of paragraph (d) of this section, *W* is treated as making a swap payment, and *V* is treated as receiving a swap payment of $1,993,784 ($6,993,784 − $5,000,000) for purposes of paragraph (d) of this section.

(viii) For the contract year 2006, *V* makes a swap payment to *W* equal to 1-year LIBOR at 10.0% times $50,000,000, or $5,000,000, and *W* is deemed to make a swap payment to *V* equal to the annual level payment of $6,993,784 and the adjustment amount of $1,993,784. The net of the ratable daily portions of these payments determines the annual net income or deduction from the contract for both *V* and *W*.

Example 8. Subsequent Adjustment. (i) The terms of the equity swap agreement are the same as in *Example 7*. In addition, assume that on January 1, 2007, the second redetermination date, 1-year LIBOR is 11.0%, and the risk-free rate is also 11.0%. On that date, the parties redetermine the projected amount of the contingent nonperiodic payment using current values in effect on that date. The parties determine that the reprojected amount of the contingent nonperiodic payment that *W* will pay *V* on December 31, 2007, is $11,050,000. The present value as of January 1, 2005, of this projected fixed payment is significant when compared to the present value of the total payments due from *W* under the contract. Accordingly, pursuant to paragraph (g)(4) of this section, the transaction is recharacterized as two separate transactions.

(ii) The parties use the redetermined projected amount of $11,050,000, to reapply the method provided by paragraph (g)(4) effective as of the commencement date of the swap. As a preliminary step, using the risk-free rate of 11.0% as the discount rate, the parties determine the level payment amounts that have a present value equal to the present value of $11,050,000, the reprojected significant nonperiodic payment. Stated differently, the sum of the level payment amounts and accrued interest at 11.0% on those amounts must equal the reprojected significant nonperiodic payment. The level payment amounts thus determined are $3,306,304.

(iii) Next, *V* is treated as paying to *W* a series of $3,306,304 loan advances.

(iv) Then, *W* is treated as using each loan advance to fund one of the three annual level swap payments of $3,306,304. The level payment loan advances and accrued interest on the loan advances computed with annual compounding at 11.0% are as follows:

	Level payment	Accrued interest
2005	$3,306,304	$ 0
2006	3,306,304	363,693

	Level payment	Accrued interest
2007	3,306,304	767,393
	$9,918,912	$1,131,086

(v) For 2007, *V* recognizes interest income, and *W* accrues interest expense equal to the $767,393 accrued interest amount for 2007 on the deemed loan advances. In addition, *V* has a net interest expense item and *W* has a net interest income item equal to $370,654 ($734,347 − 363,693), the difference between the interest accrual taken into account for 2006 and the amount that would have been taken into account for 2006 had the new level payment schedule in this *Example 8* been in effect for 2006. As a result, *V* has net interest income and *W* has net interest expense in the amount of $396,739 for 2007. These interest amounts are not included in the parties' net income or net deduction from the swap contract under paragraph (d) of this section.

(vi) The level payment amount of $3,306,304 is taken into account for the contract year 2007 in determining the parties' net income and deductions on the swap pursuant to paragraph (d) of this section.

(vii) For 2007, the parties also take into account for 2007 the difference between the amounts previously recognized for 2005 and 2006 and the amounts that would have been recognized for those years had the new level payment schedule in this *Example 8* been in effect in 2005 and 2006. The amounts previously recognized were: a total of $6,993,784 for 2005, which is the sum of $5,000,000 (in 2005) and $1,993,784 (in 2006), and a total of $6,993,784 for 2006 (in 2006). The adjustment amount, therefore, equals two times $3,687,480 ($6,993,784 − $3,306,304), or $7,374,960. This amount is taken into account as a payment for purposes of paragraph (d) of this section.

(viii) For the contract year 2007, *V* makes a swap payment to *W* equal to 1-year LIBOR at 11.0% times $5,000,000, or $5,500,000. *W* is deemed to make a swap payment to *V* equal to the annual level payment for 2007 of $3,306,304, and *V* is deemed to make a swap payment to *W* equal to the adjustment amount of $7,374,960. The net of the ratable daily portions of these payments determines the annual net income or deduction from the contract for both *V* and *W*.

Example 9. Adjustment for actual payment. (i) The terms of the equity swap agreement are the same as in *Example 8.* In addition, on December 31, 2007, *W* makes a payment to *V* of $25,000,000, an amount equal to the appreciation of a $50,000,000 investment in the basket of equity securities.

(ii) For 2007, $13,950,000, the difference between $25,000,000 and $11,050,000, the projected amount of the contingent payment as of January 1, 2007, is taken into account as an adjustment to the parties' net income or deductions for each party's taxable year that contains December 31, 2007, pursuant to paragraph (d) of this section.

* * * * *

(i) *Election to mark to market.* A taxpayer may elect to mark to market notional principal contracts providing for nonperiodic payments. The rules of paragraphs (f) (other than (f)(2)(i)), (g)(6)(ii) through (vii), and (h) of this section do not apply to contracts to which this paragraph (i) applies. See paragraph (i)(5) of this section for rules respecting interest accruals under paragraph (g)(4) of this section for contracts providing for significant nonperiodic payments to which this paragraph (i) applies.

(1) *General rule.* In the case of any contract held at the close of the taxable year to which this paragraph (i) applies, the taxpayer shall determine income inclusions and deductions by reference to the gain or loss that would be realized if the contract were sold for its fair market value on the last business day of the taxable year. Proper adjustment shall be made in the amount of any gain or loss subsequently realized (or calculated) for the income inclusions and deductions taken into account by reason of this paragraph (i)(1) as provided in paragraph (d)(2) of this section.

(2) *Scope of election.* The election provided by this paragraph is available for notional principal contracts that are—

(i) Of a type that is actively traded within the meaning of § 1.1092(d)–1(c) (determined without regard to the limitation in § 1.1092(d)–1(c)(2));

(ii) Marked to market by the taxpayer for purposes of determining the taxpayer's financial income provided the taxpayer satisfies the requirements in paragraph (i)(4) of this section;

(iii) Subject to an agreement by a party to the contract that is subject to section 475 to supply to the taxpayer the value that it uses in applying section 475(a)(2); or

(iv) Marked to market by a regulated investment company described in section 1296(e)(2).

(3) *Determination of fair market value.* For purposes of paragraph (i)(1) of this section, fair market value is determined by applying the rules set forth in paragraphs (i)(3)(i) through (iv) of this section.

(i) *Determination based on readily ascertainable value.* For a contract described in paragraph (i)(2)(i) of this section, fair market value is determined based on the mean between the bid and asked prices quoted for the contract on an established financial market as defined in § 1.1092(d)–1(b)(1), or, if bid and asked prices are not available, comparable prices determined on the basis of recent price quotations described in § 1.1092(d)–1(b)(2).

(ii) *Determination based on value used for financial statements.* For a contract described in paragraph (i)(2)(ii) of this section that is not described in paragraph (i)(2)(i) of this section, fair market value is the value used by the taxpayer for purposes of preparing its financial statements under paragraph (i)(4) of this section.

(iii) *Determination based on counterparty's mark-to-market value.* For a contract described in paragraph (i)(2)(iii) of this section that is not described in paragraph (i)(2)(i) of this section, fair market value is the mark-to-market value provided by a counterparty as being the value the counterparty used for purposes of section 475(a)(2).

(iv) *Determination based on value used in determining net asset value.* Notwithstanding paragraphs (i)(3)(i) through (iii) of this section, for a contract described in paragraph (i)(2)(iv) of this section, fair market value is the value used by the taxpayer in determining its net asset value.

(4) *Requirements for use of financial statement values.* [Reserved].

(5) *Notional principal contracts accruing interest on significant nonperiodic payments*—(i) *General rule.* If a notional principal contract that is marked to market under this paragraph (i) provides for one or more significant nonperiodic payments, paragraph (g)(4) of this section applies to the contract (computed with regard to the rule in paragraph (i)(5)(ii) of this section). Proper adjustment shall be made in the amount of any income inclusions or deductions recognized under paragraph (i)(1) of this section to take into account amounts recognized as interest under paragraph (g)(4) of this section and the payment or receipt of the nonperiodic payment or payments.

(ii) *Special rules for significant contingent nonperiodic payments.* In the case of a contract providing for a significant contingent nonperiodic payment, the projected amount of the payment is determined by applying one of the methods described in paragraph (g)(6)(iii) of this section or by applying the deemed equivalent value method described in this paragraph (i)(5)(ii). The amount of the payment is not redetermined except as provided in paragraph (g)(6)(iv)(B) of this section. The deemed equivalent value method may be applied if the contract fixes the timing and amount of all of the payments under the contract, except for a sole significant contingent nonperiodic payment. Under the deemed equivalent value method, the amount of the significant contingent nonperiodic payment is the amount that, as of the date the terms of the contract are fixed, causes the present value of all of the payments by the taxpayer to equal the present value of all of the payments of the counterparty to the contract. The present value of each payment of the contract is determined by applying the risk-free interest rate.

(iii) *Nonapplicability to regulated investment companies.* Paragraphs (i)(5)(i) and (ii) of this section do not apply to a regulated investment company described in paragraph (i)(2)(iv) of this section that makes an election under paragraph (i) of this section.

(6) *Election.* An election to apply this paragraph (i) must be made with respect to all notional principal contracts described in paragraph (i)(2) of this section to which the taxpayer is a party. The election must be made in the time and manner prescribed by the Commissioner and is effective for the taxable year for which made and all subsequent taxable years, unless revoked with the consent of the Commissioner.

(j) *Effective dates*—(1) *General rule.* Except as provided in paragraph (j)(2) of this section, this section is applicable for notional principal contracts entered into on or after December 13, 1993.

(2) *Exception.* Paragraphs (g)(6) (other than (g)(6)(i)) and (i) of this section are applicable for notional principal contracts entered into on or after 30 days after the date a Treasury decision based on these proposed regulations is published in the **Federal Register**.

Par. 5. Section 1.1234A–1 is added to read as follows:

§ 1.1234A–1 Notional principal contracts, bullet swaps, and forward contracts.

(a) *General rule.* If a taxpayer has a position in a notional principal contract governed by the rules of § 1.446–3, any gain or loss arising from a termination payment as defined in § 1.446–3(h)(1) is treated as gain or loss from a termination of the notional principal contract.

(b) *Nonapplicability to payments other than termination payments.* For purposes of section 1234A, none of the following payments terminate or cancel a right or obligation: a periodic payment described in § 1.446–3(e), a nonperiodic payment described in § 1.446–3(f), a contingent nonperiodic payment described in § 1.446–3(g)(6) to which § 1.446–3(g)(6)(ii) applies, or mark-to-market income inclusions and deductions described in § 1.446–3(i)(1). Accordingly, section 1234A does not apply to any of these items, including any final scheduled payment. If a payment made or received pursuant to a notional principal contract is not a termination payment as defined in § 1.446–3(h)(1), the payment constitutes ordinary income or expense. See sections 162 and 212 and the regulations thereunder.

(c) *Bullets swaps and forward contracts*—(1) Any gain or loss arising from the settlement of obligations under a bullet swap or forward contract (including a payment pursuant to the terms of the obligations) is treated as gain or loss from a termination of the bullet swap or forward contract.

(2) *Definition of bullet swap.* A bullet swap is a financial instrument that is not an excluded contract as defined in § 1.446–3(c)(1)(ii), that provides for the computation of an amount or amounts due from one party to another by reference to a specified index upon a notional principal amount, and that provides for settlement of all the parties' obligations at or close to maturity of the contract.

(d) *Effective date.* Paragraphs (b)(1) and (c) of this section are applicable to notional principal contracts, bullet swaps, and forward contracts entered into on or after 30 days after the date a Treasury decision based on these proposed regulations is published in the **Federal Register**.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

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DEPARTMENT OF THE INTERIOR

Office of Surface Mining Reclamation and Enforcement

30 CFR Parts 701, 773, 774, 778, 843 and 847

RIN 1029–AC08

Ownership and Control Settlement Rule

AGENCY: Office of Surface Mining Reclamation and Enforcement, Interior.

ACTION: Proposed rule; extension of comment period.

SUMMARY: We, the Office of Surface Mining Reclamation and Enforcement (OSM), are extending the comment period on the proposed Ownership and Control Settlement Rule published on December 29, 2003. The comment period is being extended in response to a request for an extension from members of the public.

DATES: We will accept written comments on the proposed rule until 5 p.m., Eastern Time on March 29, 2004.

ADDRESSES: You may mail or hand-deliver comments to the Office of Surface Mining Reclamation and Enforcement, Administrative Record, Room 101, 1951 Constitution Avenue, NW., Washington, DC 20240. You may also submit comments electronically to OSM at the following Internet address: *osmrules@osmre.gov.*

FOR FURTHER INFORMATION CONTACT: Earl D. Bandy, Jr., Office of Surface Mining Reclamation and Enforcement, Appalachian Regional Coordinating Center, Applicant/Violator System Office, 2679 Regency Road, Lexington, Kentucky 40503. Telephone: (606) 260–8424 or (800) 643–9748. E-Mail: *ebandy@osmre.gov.*

SUPPLEMENTARY INFORMATION: On December 29, 2003 (68 FR 75036), we published a proposed rule for public comment. The proposed rule, referred to as the Ownership and Control Settlement Rule, would revise certain provisions adopted in our December 19, 2000, Ownership and Control final rule in order to effectuate a settlement agreement we entered into with the National Mining Association. Specifically, the proposed rule would revise the provisions in the 2000 final rule pertaining to the definitions of ownership and control; permit eligibility determinations eligibility for provisionally issued permits; improvidently issued permits; challenges to ownership or control listings or findings; post-permit issuance requirements for regulatory