

Tax Avoidance Using Notional Principal Contracts

Notice 2002-35

The Internal Revenue Service and the Treasury Department have become aware of a type of transaction, described below, that is used by taxpayers to generate tax losses. This Notice alerts taxpayers and their representatives that the tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. This Notice also alerts taxpayers, their representatives, and promoters of these transactions of certain responsibilities that may arise from participating in these transactions.

FACTS

In general, the transaction involves the use of a notional principal contract (“NPC”) to claim current deductions for periodic payments made by a taxpayer (“T”) while disregarding the accrual of a right to receive offsetting payments in the future. The NPC has a term of more than

one year. Under the NPC, *T* is required to make periodic payments to *CP* at regular intervals of one year or less based on a fixed or floating rate index. In return, *CP* is required to make a single payment at the end of the term of the NPC that consists of a noncontingent component and a contingent component. The noncontingent component, which is relatively large in comparison to the contingent component, may be based upon a fixed or floating interest rate. The contingent component may reflect changes in the value of a stock index or currency.

T may fund its obligation to make periodic payments in whole or in part by borrowing funds from a lender, who may be *CP*. In addition, *T* may engage in other transactions, such as interest rate collars, for purposes of limiting risk with respect to the NPC transaction. *T* may engage in short-term trading activity in securities with a view to establishing a trade or business. *T* may also engage in the transaction through a partnership, in which case instead of *T*, the partnership may engage in some or all of the activities described above. *T* will likely enter into an agreement with *CP* to terminate the

NPC prior to the scheduled payment date of *CP*'s payment.

T deducts the ratable daily portion of each periodic payment for the taxable year to which that portion relates. However, *T* does not accrue income with respect to the nonperiodic payment until the year the payment is received. *T* intends to report as capital any gain it realizes upon the termination of the NPC.

ANALYSIS

The requirement of § 1.446-3(f)(2)(i) that a nonperiodic payment must be recognized over the term of a NPC in a manner that reflects the economic substance of the contract must be applied separately to the noncontingent component of the contract, whether that component is based on a fixed or a floating interest rate.

For a discussion of the proper treatment of the periodic and nonperiodic payments made pursuant to the interest rate swap if the noncontingent component is based on a fixed interest rate, *see* Rev. Rul. 2002-30 (2002-21 I.R.B. 971), May 28, 2002 (holding that the nonperiodic payment must be accrued ratably over the

term of the NPC). In addition, depending on the facts of the particular case, the Service may challenge the purported tax results of these transactions on other grounds, including by: (i) recharacterizing one or more of the transactions under §§ 1.446-3(g)(2) or 1.446-3(i); (ii) determining that the swap expense, if any, was not incurred in the course of a trade or business and was therefore subject to the 2-percent floor limitation in section 67 of the Internal Revenue Code; (iii) disregarding the combination of the loans and the periodic payments as circular flows of cash; or (iv) applying other variations of the doctrine of substance-over-form.

The Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under section 6662, the return preparer penalty under section 6694, the promoter penalty under section 6700, and the aiding and abetting penalty under section 6701.

Transactions that are the same as, or substantially similar to, the transaction described in this Notice 2002-35 are identified as “listed transactions” for purposes of § 1.6011-4T(b)(2) of the Temporary Income Tax Regulations and § 301.6111-2T(b)(2) of the Temporary Procedure and Administrative Regulations. *See also* § 301.6112-1T, A-4. It should be noted that, independent of their classification as “listed transactions” for purposes of §§ 1.6011-4T(b)(2) and 301.6111-2T(b)(2), such transactions may already be subject to the tax shelter registration and list maintenance requirements of §§ 6111 and 6112 under the regulations issued in February 2000 (§§ 301.6111-2T and 301.6112-1T, A-4), as well as the regulations issued in 1984 and amended in 1986 (§§ 301.6111-1T and 301.6112-1T, A-3). Persons required to register these tax shelters who have failed to register the shelters may be subject to the penalty under section 6707(a), and to the penalty under section 6708(a) if the requirements of section 6112 are not satisfied.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this