

## Part III - Administrative, Procedural and Miscellaneous

### Notional Principal Contracts

Notice 2001- 44

#### **I. PURPOSE**

The IRS and the Treasury Department are soliciting comments on the appropriate method for the inclusion into income or deduction of contingent nonperiodic payments made pursuant to a notional principal contract and the treatment of such inclusions or deductions.

#### **II. BACKGROUND**

##### **I. In General**

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 notional principal contracts. T.D. 8491, 1993-2 C.B. 215. The regulations define a notional principal contract ("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." Section 1.446-3(c)(1)(i). Payments made pursuant to NPCs are divided into three categories (periodic, nonperiodic, and termination payments), and the regulations provide separate timing regimes for each. However, no guidance is provided in the regulations for the timing of inclusion or deduction of contingent nonperiodic payments made under NPCs. In addition, neither

§ 1.446-3 nor any other section provides specific rules governing the character of the various types of payments that could be made pursuant to a NPC.

The lack of comprehensive guidance in this area of the law has created significant uncertainty for taxpayers. For some, this uncertainty adds a considerable burden to the tax compliance process, and may discourage certain taxpayers from entering into NPCs. Other taxpayers welcome the ability to pick and choose among various tax law theories as to the character and timing of NPC payments, but this can lead to a whipsaw of the government. Both result in lack of confidence in the tax system, and inefficiencies in the capital markets.

The IRS and Treasury have reviewed several methods for including into income or deducting contingent nonperiodic payments made pursuant to NPCs. In evaluating each method, the IRS and Treasury have considered the extent to which it reflects certain fundamental tax policy principles. These policy principles include: whether the method provides sufficient certainty as to the amount and timing of inclusions or deductions (certainty/clarity); whether the method is complex, and the compliance and administrability burden created by that complexity (administrability); whether the method creates or increases inconsistencies in the tax treatment of financial instruments with similar economic characteristics (neutrality); whether the method creates or increases inconsistencies in the tax treatment of different taxpayers entering into the same instruments (symmetry); whether the method accurately reflects the accretion or reduction in economic wealth in the period in which the taxpayer is measuring the tax consequence of being a party to the NPC (economic accuracy); and whether the method is flexible enough to readily accommodate new financial arrangements

(flexibility). It is clear that these principles are frequently in conflict, and there is no method of accounting that would satisfy all the criteria. However, the examination of an accounting method in the light of these principles can highlight the strengths and weaknesses of the method and inform the rulemaking process.

The methods the IRS and Treasury are considering for the inclusion into income or deduction of contingent nonperiodic payments made pursuant to NPCs are described below under the following headings: the Noncontingent Swap Method; the Full Allocation Method; the Modified Full Allocation Method; and the Mark-to-Market Method. The IRS and Treasury are seeking comments on the relative merits of each of these methods, as well as suggestions as to other methods that may be superior to these methods with respect to the fundamental tax policy principles listed above. The IRS and Treasury are interested in what authority taxpayers believe exists for mandating any and each of these methods.

Although this Notice is addressing the timing issues regarding NPCs with a contingent component, the IRS and Treasury are aware that there must be some coordination between the existing NPC rules and any new applicable rules. The IRS and Treasury are interested in comments on the need to revise the current rules for NPCs and related instruments if new rules for contingent NPCs are introduced. The IRS and Treasury are also interested in whether taxpayers believe it is necessary to develop rules on a much wider range of instruments before any kind of rule is issued with respect to contingent NPCs, which are only one specific type of instrument, i.e., whether the proliferation of individualized rules is more harmful than helpful in this area.

The IRS and Treasury are interested in comments from taxpayers as to the appropriateness of special, simplified rules for short-term or standardized contracts, and what form the simplified rules should take. If taxpayers suggest that a simplified rule should be provided for certain contracts, the IRS and Treasury are interested in what kind of test should be used to determine whether the simplified rule applies.

In addition to reviewing methods for the timing of income and expense with respect to contingent nonperiodic payments, the IRS and Treasury are considering what the character should be for all types of payments made pursuant to NPCs. In the current tax law, the distinction between capital gain and ordinary income is significant in two ways. First, taxpayers cannot offset capital losses against ordinary income (with a small exception for individuals). One policy reason for the rule against offsetting of capital losses against ordinary income is that taxpayers are able to choose the timing of their sales or exchanges of capital assets much more easily than the timing of their ordinary income or loss ("cherry picking"). They could, therefore, sell their loss assets at a time when they are expecting large amounts of ordinary income while deferring recognition on their gain assets. Second, for individuals, long-term capital gains are taxed at lower rates than ordinary income.

In determining whether particular payments made pursuant to a NPC should most appropriately be characterized as capital or as ordinary, attention should be given to the goals of minimizing cherry picking of character results and consistent application of the policy rationale for the current capital gains preference. In addition, in the financial products area, it is particularly important to pay attention to the neutrality principle, i.e., consistent treatment of different instruments with similar economic

characteristics. There is almost limitless flexibility in the design of derivatives, and tax rules that provide for differences in tax treatment that do not reflect economic differences may produce inappropriate tax consequences. For example, some taxpayers are permitted to treat certain payments received pursuant to forward and option contracts as capital. If these taxpayers entered into NPCs with the same economic characteristics as the options or forwards contracts, but did not receive the same tax character treatment, tax- advantaged products might develop to arbitrage the tax differences between the various instruments. The particular problem the IRS and Treasury face with regard to neutrality is that the existing rules for various financial instruments are so inconsistent with each other, that it is difficult to decide, when developing rules for new instruments that can mimic many types of instruments, which set of existing rules should be followed. The IRS and Treasury are interested in comments on how the neutrality principle can best be given consistent effect for complex financial instruments.

The IRS and Treasury invite comments on the appropriate policy considerations for making character designations for NPC payments, as well as the application of those principles illustrated by the examples in the Notice. The IRS and Treasury also seek comments on: the authority governing the character of NPC payments and whether and what legislative change may be necessary to rationalize the rules.

The IRS and Treasury are aware that the definition of NPC as provided in § 1.446-3 covers only one class of the possible notional principal contracts that are transacted in the marketplace. For example, a contract that provides for a single payment at maturity based on some notional amount and specified index may not be

covered by the definition because there are no "payments" made at "specified intervals." Such a contract is sometimes called a "bullet swap." There may be little difference in economics between a NPC as defined in § 1.446-3 and a series of bullet swaps, yet the payments made under one are covered by the regulation, whereas the payments under the other may not. The IRS and Treasury seek comments on how the tax accounting methods described in this Notice, or other methods, could be made applicable to a broader group of contracts that serve similar purposes as NPCs. The IRS and Treasury also seek comments on the appropriate character of payments made pursuant to contracts similar to NPCs.

A. **Methods for Determining the Timing of Payments under NPCs**

1. The Noncontingent Swap Method

a. Timing. The noncontingent swap ("NCS") method provides an approach to accruing contingent payments made pursuant to a NPC. The method provides techniques for taxpayers to convert the contingent nonperiodic payment provided for in the NPC into a noncontingent periodic amount. The method would provide rules for creating a payment schedule that spreads the recognition of income or deduction of this noncontingent amount over the life of the NPC on a constant yield basis.

b. Illustration. This method is illustrated using the following example of a simple equity swap contract, on a notional amount of 100 shares of XYZ stock, entered into on January 1, 2001, between A and B with the following terms:

A pays B:

Every six months until expiration – any dividend payments to the holder of one share of XYZ times 100

At expiration, December 31, 2002 – any appreciation in a share of XYZ since contract inception times 100

B pays A:

Every six months until expiration – 7.00% (annual rate) of notional amount at inception

At expiration, December 31, 2002 – any depreciation in a share of XYZ since contract inception times 100

The contingent payment is equal to the appreciation or depreciation in the value of a share during the period between the inception and expiration of the contract, multiplied by 100 shares. The payments are netted, and only the net amounts are transferred. The net payments can flow from either A to B or from B to A.

Under the NCS method, the cost of hedging the exposure to the contingent NPC payment is used as a proxy for the contingent payment itself. The cost of hedging the contingent payment under the NPC is the current price of a portfolio of financial assets that, if liquidated on December 31, 2002, will exactly cover the cost of the contingent payment. This approach has been chosen because if a party to a contingent NPC assumed the hedging cost, both counterparties would be in the same position as if the contingent future obligation were actually paid. This hedging cost is therefore deemed to be paid, for example, by A to B, in satisfaction of the contingent obligation (for purposes of making calculations under the NCS method). The NCS method then provides a mechanism for amortizing this deemed payment by A to B into B's income throughout the life of the swap. It should be noted that the hedge transaction need not be entered into by either A or B. The deemed hedge merely provides a computational mechanism for converting the contingent payment into a fixed payment. Further details regarding this illustration, with computations of the hedging cost and the amounts of deductions and income inclusions, are provided in the Appendix.

c. Policy Considerations. The NCS method has the policy advantage of being certain and clear in many cases. It depends, however, on the ability to establish the cost

of hedging the contingent payment exposures using forward pricing analysis. The methodology may be difficult to administer and apply in other cases because of the subjectivity in pricing forward contracts where there is no active market. This problem may be partially overcome by requiring appropriate record keeping and information reporting. The NCS method provides relative neutrality of tax treatment compared to contingent debt, but does not provide neutrality of tax treatment as compared to forwards and options, or as compared to ownership of the underlying equity (in the example of an equity NPC). Given that for many NPCs, at least one counterparty is on a mark-to-market method of accounting with respect to the NPC under § 475 of the Internal Revenue Code, in many cases there would be asymmetry of tax treatment between counterparties. The NCS method does not accurately reflect the change in economic position over time of either counterparty as a result of being a party to the NPC, because the schedule that determines inclusions and deductions is fixed at the outset and, in the simplest description of the method, does not change with market conditions. Finally, it is unclear how flexible the method is in accommodating variations in NPCs and related instruments.

d. Request for Comments.

(i) The IRS and Treasury request comments on a number of aspects of this method. The amount of inclusions and deductions under this method could significantly diverge from market prices as the swap runs its course. The ability of this method to meet the policy principles outlined above may be reduced unless the counterparties to the swap are required to revise their payment schedules with changes in market conditions. The IRS and Treasury invite comments on if and when it would be



appropriate to require taxpayers to make such revisions to the payment schedule (e.g., every three years), or if the underlying index changes a certain percentage from its level at the inception of the contract, or both. Comments are also solicited on the treatment of adjustments resulting from updated projections. For example, should adjustments from updated projections be taken into account in the year of the updated projections or should they be spread over the remaining term of the NPC?

The IRS and Treasury are aware that the more frequently payment schedules are required to be updated, the more the method begins to resemble a mark-to-market method. We are seeking comments on the relative effectiveness of the NCS method, given the inaccuracies that are possible when only one market observation is required at the inception of the contract, and the fact that as the number of adjustments to that initial observation is increased, the benefits of using this technique (e.g., certainty of tax result) decline.

(ii) The IRS and Treasury also request comments on the treatment of contingent payments that are made prior to their expected payment date, and how this should be coordinated with the treatment of revised payment schedules.

(iii) The character of payments generated by the NCS method is unclear under current law. The IRS and Treasury are seeking comments on what the character of payments under the NCS method would be under current law, both originally projected payments and any periodic revisions (see (i), above). In addition, comments are solicited on whether it would be appropriate to change or clarify the character rules, either statutorily or through regulations, so that the various policy goals can be achieved.

(iv) One commentator suggested an interpretation of § 1234A that would

conform the character treatment of NPCs with the character of the underlying position or positions. Comments would be welcome on the desirability of this approach, including the authority for its adoption under current law, and the feasibility of administration.

(v) More generally, comments are invited on the problem of mismatching of the character of payments and receipts and on methods of avoiding or minimizing such mismatches.

## 2. The Full Allocation Method

a. Timing. Under the full allocation method, taxpayers would not include or deduct any payment that is required to be made under the NPC (periodic, nonperiodic, contingent and noncontingent) until the taxable year in which all contingencies are resolved. When the final contingency is resolved, the parties would treat all payments as made or received in the year of the resolution of the contingency.

b. Policy Considerations. This method has the policy advantages of being certain, clear, and administrable. The method provides partial neutrality of tax treatment compared to options and forwards, and compared to ownership of the underlying equity, but does not provide neutrality of tax treatment compared to contingent debt. There would be asymmetry of tax treatment between the counterparties if only one party to the contingent NPC were on a mark-to-market method of accounting with respect to the NPC. The full allocation method does not reflect the change in economic position over time of either counterparty as a result of being a party to the NPC, because all tax consequences are postponed until the contract matures, is terminated, etc. This result is particularly open for manipulation to the extent taxpayers have the ability to terminate a contract if it has decreased in value but can retain the contract if it has increased in value.

Finally, it would appear that the method is flexible enough to accommodate many financial instruments, although it is unclear whether the method would be appropriate for all forms of NPCs and related contracts.

c. Request for Comments. The IRS and Treasury request comments on a number of aspects of this method:

(i) The IRS and Treasury are aware that this method permits complete deferral for taxpayers entering into NPCs with contingent elements, in contrast to the accrual method required for NPCs without such contingent elements. However, even though the full allocation method would create discontinuities between different types of NPCs, it is somewhat consistent with the treatment of both straight equity and certain other derivatives, such as options and forward contracts, as noted above. The IRS and Treasury are soliciting comments on whether the inconsistency between contingent and noncontingent NPCs could be mitigated through the use of an anti-abuse rule (and on what the nature and scope of such an anti-abuse rule might be), or whether a more global change in the treatment of derivatives would be necessary to overcome this problem.

(ii) It is unclear how current law would characterize the various payments made pursuant to a contingent NPC under the full allocation method. Based on one interpretation of § 1234A, it is possible that taxpayers could elect the character of their NPC payments by terminating their NPC early or holding it until maturity. Comments are solicited on how taxpayers could be prevented from manipulating the character of payments made pursuant to a NPC under current law if the full allocation method is required. Comments are also solicited on whether and how a modification of current law

could improve the character treatment of payments made pursuant to a contingent NPC under the full allocation method.

(iii) The IRS and Treasury seek comments on how the full allocation method should apply when contingencies under a NPC are resolved at a time other than at the maturity of the contract.

### 3. Modified Full Allocation Method

a. Timing. Under this method, each party to a NPC would offset any noncontingent payments made by that party in a taxable year against any payments received in that year with respect to the NPC, but would not be able to claim a deduction if the amount received were less than the amount paid out. Any net deductions with respect to the NPC would be deferred until all contingencies are resolved. In effect, this method accords with those tax principles that provide for income to be recognized when received and deductions to be deferred until all contingencies with respect to that deduction are resolved. However, this method modifies the effects of these principles by first determining income on an annual net basis.

b. Policy Considerations. This method has the advantages of being certain and clear, and being relatively easy to administer. However, the method does not provide for neutrality of tax treatment with respect to any financial instrument or combination of instruments that have economic characteristics similar to a contingent NPC. The method does not accurately reflect the change in economic position over time of a counterparty subject to the method because of the differing treatment of net receipts and payments under the NPC. In addition, there would be asymmetry of tax treatment of the counterparties to the NPC if one of the parties were subject to the mark-to-market

method of accounting with respect to the NPC. Finally, it is unclear how flexible the method would be in accommodating variations in NPCs and related instruments.

c. Request for Comments. The IRS and Treasury request comments on a number of aspects of this method:

(i) The IRS and Treasury are aware that the modified full allocation method may result in mismatching of income and deductions. This is because income from the NPC would be recognized when received while deductions would be deferred until all contingencies are resolved. The IRS and Treasury are seeking assistance in developing rules to ensure that the asymmetrical treatment of the income and deductions under this method does not lead to undesirable consequences for either taxpayers or the government.

(ii) It is unclear how the payments made pursuant to a NPC would be characterized under the modified full allocation method. It is possible that application of current law to the modified full allocation method could result in differences in character for current inclusions and for gains or losses on final settlement of the NPC. For example, a taxpayer may be taxable currently on net receipts as ordinary income but have an offsetting capital loss subject to loss limitations on the final settlement of the NPC. Mismatches of timing and character could be reduced if deductions were permitted in years before the resolution of all contingencies, in a manner similar to the treatment of unreversed inclusions under § 1296(a)(2). The IRS and Treasury request comments on ways to avoid this mismatching of character, and whether a regime similar to that used under § 1296(a)(2) would be administratively burdensome to implement.

(iii) The IRS and Treasury seek comments on how the modified full allocation method should apply when contingencies under a NPC are resolved at a time other than at the maturity of the contract.

4. Mark-to-Market Method

a. Timing. Under this method, taxpayers would mark their NPCs to market and recognize gain or loss at year end, or when the contract is terminated, assigned, etc.

b. Policy Considerations. The mark-to-market method has the advantages of being certain and clear with respect to timing and character. It would likely, however, be difficult to administer for non-exchange traded instruments to the extent that there is no consensus on the fair market value of the NPC. This problem may be partially overcome by requiring appropriate record keeping and information reporting. The mark-to-market method does not provide neutrality of tax treatment compared to almost any financial instrument or combination of instruments or compared to the underlying property. It would, however, provide equitable tax treatment between counterparties. The mark-to-market method accurately reflects the change in economic position over time of both counterparties as a result of being a party to the NPC, to the extent that the mark is accurate. Finally, the mark-to-market method is the most flexible of the methods, as it is constrained only by the ability to provide a consistent system for measuring the market value of instruments.

c. Request for Comments. The IRS and Treasury request comments on a number of aspects of this method:

(i) The IRS and Treasury are interested in comments generally on the benefits and burdens of imposing a mark-to-market regime.

(ii) The IRS and Treasury are interested in what the character of a gain or loss on a mark would be under current law, and how the law may be modified to ensure appropriate characterization of the mark, based on policy principles.

(iii) The IRS and Treasury are interested in comments on what authority taxpayers believe exists to mandate a mark-to-market regime for NPCs. We are also requesting comments on whether this regime should be made elective if another regime is used as the primary regime.

(iv) The IRS and Treasury seek comments on how to ensure that the values taxpayers use as market values are truly related to the market, and are not subject to consistently biased manipulation by taxpayers. It appears that substantial investment has been made by the financial community into technology that enables a regular mark-to-market of many types of derivatives.<sup>1</sup> The IRS and Treasury are requesting comments on how a valuation regime could be developed to ensure some consistency by a single taxpayer with different NPCs, and between taxpayers.

### **C. Recordkeeping and Information Reporting**

The IRS and Treasury are seeking comments on what kinds of record keeping and information reporting would be necessary for each and any of the methods of accounting for contingent NPCs that would enable the IRS to verify the inclusions and deductions of

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<sup>1</sup> Much of the impetus for this has come from the Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by Statement of Financial Accounting Standards No. 138, which requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. However, this is not the only source of interest in technology to enable a regular marking of derivatives. Treasury departments of many corporations require a tool to assess the impact of financial stress on their portfolios, and this requires a mechanism for marking their securities in various scenarios. In addition, in a different context entirely, mutual funds must have some mechanism for regularly assessing the value of their portfolios (including derivatives) as they have to report a daily net asset value.

counterparties to contingent NPCs and minimize the compliance burdens for taxpayers.

In particular, the IRS and Treasury are interested in the following:

1. Are there any special kinds of information necessary for the IRS to obtain from taxpayers in order to verify their tax return positions with respect to contingent NPCs?

2. If there are special kinds of information relating to tax return positions for contingent NPCs, how should that information be made available to the IRS? Is it sufficient for taxpayers to keep detailed books and records which an agent can request if necessary? Or should specific information be required to be reported with the tax return? If the information is reported with a tax return, what form should the reporting take?

3. Is there sufficient justification to require third party reporting with respect to any of the methods of accounting for NPCs, particularly for the NCS method and the mark-to-market method? Should counterparties who are dealers be required to report their marks to nondealer counterparties under the mark-to-market method?



4. If certain types of record keeping or information reporting are recommended in comments to the IRS and Treasury, what would be the appropriate penalties for failure to keep the required records or provide the information?

### **III. REQUEST FOR COMMENTS**

Written comments are requested to be submitted no later than **INSERT DATE 120 DAYS AFTER THIS DOCUMENT IS PUBLISHED IN THE INTERNAL REVENUE BULLETIN**], to CC:FIP (Notice 2001-44), room 4300, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:FIP (Notice 2001-44), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html). All comments will be available for public inspection and copying.

### **DRAFTING INFORMATION**

The principal authors of this notice are: Elizabeth Handler and Dale S. Collinson, Office of Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service; Viva Hammer, Office of the Tax Legislative Counsel, Office of Tax Policy, United States Department of the Treasury; and Matthew J. Eichner, Office of Tax Analysis, Office of Tax Policy, United States Department of the Treasury. However, other personnel from the IRS and Treasury Department participated in its development. For

further information regarding this notice contact Viva Hammer on (202) 622-0869 or Dale Collinson at (202) 622-3900 (not toll free calls).

## APPENDIX

The method described in Section II.B.1.b. is illustrated using the following example of a simple equity swap contract on a notional amount of 100 shares of XYZ stock, entered into on January 1, 2001 between A and B with the following terms:

A pays B:

Every six months until expiration – any dividend payments to the holder of one share of XYZ times 100

At expiration, December 31, 2002 – any appreciation in a share of XYZ since contract inception times 100

B pays A:

Every six months until expiration – 7.00% (annual rate) of notional amount at inception

At expiration, December 31, 2002 – any depreciation in a share of XYZ since contract inception times 100

Assume that the market price of a share of XYZ was \$975 at the inception of the contract, and the forward price for future delivery of a share of XYZ was \$1,062. For computational purposes only, A is deemed under the NCS method to have hedged itself by entering into a forward contract at the inception of the NPC for the purchase of 100 shares of XYZ, in exchange for \$106,200, on December 31, 2002. In order to make the \$106,200 payment, A would need to set aside at the inception of the contract an amount that equals the present value of \$106,200, i.e., \$92,547 (based on a 7% annual interest rate compounded semiannually).

With this forward contract in place, A would be able to make the required payment to party B.<sup>2</sup> However, the arrangement described thus far would involve A committing more funds to building the hedge than is absolutely necessary. A is required to pay B only the difference between the price of the shares on December 31, 2002 and the price of the shares on January 1, 2001, and not the entire value of the shares on December 31, 2002. For example, suppose that the price of the 100 XYZ shares has risen to \$110,000 by expiration of the NPC. If this happens, A would be obligated to pay B \$12,500. A would purchase the shares pursuant to the forward contract for \$106,200, sell them for \$110,000, and pay party B the \$12,500 required under the terms of the swap. The remaining \$97,500 in proceeds would belong to A. This \$97,500 (the market price of the shares on January 1, 2001) would always remain in A's possession at maturity no matter how the value of XYZ stock changes through the life of the NPC. Therefore, simply entering into a forward contract for the purchase of the XYZ stock is not an exact hedge for A's commitment under the swap contract. To further refine the hedge, A could borrow the present value of \$97,500, i.e., \$84,966 on January 1, 2001. Borrowing this amount would mean that the cost of assembling the hedge would be (\$92,547 - \$84,966), or \$7,582.

The net cash flow from these two transactions - purchasing the forward contract and borrowing the present value of the current price of the 100 shares - would always enable A to exactly make the payment due to B under the NPC on December 31, 2002, no less and no more. If the share price rises to \$1,000 by December 31, 2002, A would

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<sup>2</sup> The terms of the contract require B to make a payment to A if the XYZ stock decreases in value. Because forward pricing for investment property such as corporate stock always assumes an increase in price, the method would also assume at the outset that the contingent payment would be made by A to B.

sell the stock delivered in satisfaction of the forward contract for \$100,000, pay \$2,500 to B and repay the loan with the remaining \$97,500. If, instead, the price were to fall to \$935 by December 31, 2002, A would actually receive \$4,000 from B which, in combination with the proceeds from selling the stock delivered under the forward contract for \$93,500, would allow A to repay the loan balance of \$97,500.

Once the present value of A's deemed hedge for the contingent payment is determined, this amount must be amortized into B's income. This can be done by deeming A to provide to B a zero coupon bond with a present value of \$7,582. Such a bond has a face value, payable at maturity, of \$8,700 (assuming again an annual rate of 7.00% and compounded semiannually).

The original issue discount (OID) is found by multiplying the present value of the bond at the beginning of each six month period by the periodic rate,  $7.00\%/2$  or  $3.50\%$ :

Period ending	OID	Present Value of Bond (at end of period)
6/30/01	\$265 [= \$7,582 * 3.50%]	\$7,847 [= \$7,582 + \$265]
12/31/01	\$275 [= \$7,847 * 3.50%]	\$8,122 [= 7847 + \$275]
6/30/02	\$284	\$8,406
12/31/02	\$294	\$8,700

Note that the total OID sums to \$1,118, precisely the difference between the present value of the bond (\$7,582) and the face value of the bond (\$8,700).

This OID is the first component of income for each period; amortization of the principal of \$7,582 is the other piece. The following table summarizes the annuity calculation:

Period Ending	Payment	Interest	Principal	Balance (end of period)
6/30/01	\$2,064	\$265 [= \$7,582 x 3.5%]	\$1,799 [= \$2,064 - \$265]	\$5,783 [= \$7,582 - \$1,799]
12/31/01	\$2,064	\$202	\$1,862	\$3,921
6/30/02	\$2,064	\$137	\$1,927	\$1,994
12/31/02	\$2,064	\$120	\$1,994	\$0

The principal allocated to each period is then added to the OID to reach a total income allocation for the period. This would become the "payment schedule" which determines the tax inclusions required for B through the life of the contingent NPC.

Period Ending	OID	Principal	Income
6/30/01	\$265	\$1,799	\$2,064
12/31/01	\$275	\$1,862	\$2,137
6/30/02	\$284	\$1,927	\$2,211
12/31/02	\$294	\$1,994	\$2,288
Total			\$8,700