

Part III - Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Notional Principal Contracts

Notice 2006-16

SECTION 1. PURPOSE

This notice clarifies Notice 2002-35, 2002-1 C.B. 992, by illustrating certain transactions that are not the same as or substantially similar to the transaction described in Notice 2002-35, and thus are not “listed transactions” for purposes of §§ 6111 and 6112 of the Internal Revenue Code (Code) and § 1.6011-4(b)(2) of the Income Tax Regulations. This notice also modifies Notice 2002-35 by providing a safe harbor from the disclosure requirement otherwise imposed by § 1.6011-4 for taxpayers that have, solely as a result of their direct or indirect interest in a pass-through entity, participated in a transaction that is the same as or substantially similar to the transaction described in Notice 2002-35 (as clarified by section 3.01 of this notice).

This notice responds to concerns expressed by commentators that the difficulty in identifying transactions that are the same as or substantially similar to the transaction described in Notice 2002-35 has caused taxpayers to file large numbers of disclosure statements on Form 8886, Reportable Transaction Disclosure Statement, for common transactions, such as total return swaps, that are entered into for bona fide non-tax purposes. This notice is intended to narrow the scope of reportable transactions that might be perceived to be substantially similar to the transaction described in Notice 2002-35, and is intended to reduce the number of Form 8886 filings. This Notice should not be construed as expanding the scope or potential application of Notice 2002-35 in any way. Specifically, no inference is intended regarding whether transactions not described in Section 3.01 are or are not required to be reported under Notice 2002-35.

SECTION 2. BACKGROUND

Notice 2002-35 identifies as a listed transaction under § 1.6011-4(b)(2) a transaction that uses a notional principal contract (NPC) to claim current deductions for periodic payments made by a taxpayer while disregarding the accrual of a right to receive offsetting payments in the future. The specific facts of the listed transaction are set forth in Notice 2002-35.

On February 26, 2004, the Treasury Department and the IRS published in the Federal Register (69 FR 8886) proposed regulations (hereinafter the “Contingent NPC Proposed Regulations”) under § 446(b) of the Code. Section 1.446-3(g)(6) of the

Contingent NPC Proposed Regulations describes an accounting method for contingent nonperiodic payments under an NPC. That method requires that contingent nonperiodic payments be spread over the term of the NPC. Section 1.446-3(i) of the Contingent NPC Proposed Regulations also provides an elective mark-to-market regime for certain NPCs with nonperiodic payments.

The preamble to the Contingent NPC Proposed Regulations states; "With respect to NPCs that provide for contingent nonperiodic payments and that are in effect or entered into on or after 30 days after [February 26, 2004], 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."

Section 1.6011-4(c)(3)(i)(A) of the Income Tax Regulations provides that a taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in published guidance that lists the transaction under § 1.6011-4(b)(2). Section 1.6011-4(c)(3)(i)(A) also provides that a taxpayer has participated in a listed transaction if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy that is a listed transaction.

SECTION 3. DISCUSSION

.01 Transactions Excluded from the Scope of Notice 2002-35

An NPC that requires a counterparty to make a contingent nonperiodic payment, whether or not the nonperiodic payment consists of contingent and noncontingent components, is not a "listed transaction" for purposes of §§ 6111 and 6112, or for purposes of § 1.6011-4(b)(2), by reason of being the same as or substantially similar to the transaction described in Notice 2002-35 if:

- (a) The taxpayer uses a method of accounting for the NPC that takes the contingent nonperiodic payment into account over the life of the contract under a reasonable amortization method;
- (b) The taxpayer properly accounts for the NPC under § 475 of the Code;
- (c) The taxpayer properly accounts for the NPC under § 1.446-4;
- (d) The taxpayer properly accounts for the NPC as a § 1.988-5(a) hedge in connection with a qualified hedging transaction; or
- (e) The taxpayer properly accounts for the NPC under § 1.988-2(e) (including the application of § 1.446-3(g)(4) as appropriate).

.02 Disclosure Requirement Safe Harbor

- (1) A taxpayer that, solely by reason of that taxpayer's direct or indirect interest in a pass-through entity, participated (within the meaning of § 1.6011-4(c)(3)(i)(A)) in a transaction that is the same as or substantially similar to the transaction described in Notice 2002-35 (as clarified by section 3.01 this notice) is not required under § 1.6011-4 to file a disclosure statement with respect to that transaction if the taxpayer meets the requirements of section 3.02(2) of this notice.
- (2) This section 3.02 will apply if a taxpayer receives acknowledgement that the pass-through entity has or will comply with its separate disclosure obligation under § 1.6011-4 with respect to a transaction described in Notice 2002-35 (as clarified by section 3.01 of this notice), and if the taxpayer's only obligation under § 1.6011-4 to file a disclosure statement with respect to that transaction arises from the taxpayer's direct or indirect interest in that pass-through entity. The acknowledgment can be a copy of the Form 8886 filed (or to be filed) by the pass-through entity, and must be received by the taxpayer prior to the time set forth in § 1.6011-4(e) in which the taxpayer would otherwise be required to provide disclosure.

Taxpayers meeting the requirements of section 3.02 of this notice will not be treated as having participated in an undisclosed listed transaction for purposes of § 1.6664-2(c)(3)(ii).

.03 Continuing Disclosure Obligations

Transactions described in sections 3.01 or 3.02 of this notice may be described in § 1.6011-4(b)(3) through (b)(5) or (b)(7) and, notwithstanding this notice, may be subject to disclosure by taxpayers under § 1.6011-4(a), and subject to disclosure and list maintenance requirements by material advisors under §§ 6111 and 6112. For example, an NPC that results in a large loss for a taxpayer under § 165 may be subject to disclosure by the taxpayer under § 1.6011-4(b)(5), notwithstanding that under this Notice it is not subject to disclosure under § 1.6011-4(b)(2).

SECTION 4. EFFECTIVE DATE

Section 3.01 of this notice is effective as of May 6, 2002. Section 3.02 of this notice is effective for disclosure statements that would otherwise be due on or after February 13, 2006.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Notice 2002-35 is clarified and modified.

SECTION 6. CONTACT INFORMATION

For further information regarding this notice, contact Dale S. Collinson at (202) 622-3900 (not a toll-free number).