

Hearing Date and Time: July 19, 2011 at 10:00 a.m. (prevailing Eastern Time)
Response Deadline: July 5, 2011 at 4:00 p.m. (prevailing Eastern Time)

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Attorneys for the Debtor and Debtor in Possession

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

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<i>In re</i>	:	
	:	Chapter 11
AMBAC FINANCIAL GROUP, INC.,	:	
	:	Case No. 10-15973 (SCC)
Debtor.	:	
	:	
-----X	:	

**NOTICE OF DEBTOR’S OBJECTION TO PROOF OF CLAIM
NUMBERS 3694 AND 3699 FILED BY THE DEPARTMENT
OF THE TREASURY – INTERNAL REVENUE SERVICE**

PLEASE TAKE NOTICE that on June 14, 2011, Ambac Financial Group, Inc., as debtor and debtor in possession in the above-captioned chapter 11 case (the “Debtor”) filed the attached *Debtor’s Objection to Proof of Claim Numbers 3694 and 3699 Filed by the Department of the Treasury – Internal Revenue Service* (the “Objection”) with the United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”). A hearing to consider the Objection is scheduled for **July 19, 2011 at 10:00 a.m. (prevailing Eastern Time)** before the



Honorable Shelley C. Chapman, United States Bankruptcy Judge, in Courtroom 610 at the Bankruptcy Court, One Bowling Green, New York, New York 10004.

PLEASE TAKE FURTHER NOTICE that any response to the Objection must be in writing, conform to the Federal Rules of Bankruptcy Procedure, the Local Bankruptcy Rules for the Southern District of New York, the *Amended Notice, Case Management, and Administrative Procedures* approved by the Bankruptcy Court [Docket No. 75], and the *Order Pursuant to Section 105(a) of the Bankruptcy Code and Bankruptcy Rule 3007 Granting Relief From Certain Limitations of Bankruptcy Rule 3007 and Establishing Procedures for Objecting to Claims* [Docket No. 225], be filed electronically by registered users of the Bankruptcy Court's electronic case filing system, and be served, so as to be received no later than **July 5, 2011 at 4:00 p.m. (prevailing Eastern Time)**, by (i) the chambers of the Honorable Shelley C. Chapman, United States Bankruptcy Judge, One Bowling Green, Courtroom 610, New York, New York 10004; (ii) counsel for the Debtor, Dewey & LeBoeuf LLP, Attn: Jeffrey Chubak, 1301 Avenue of the Americas, New York, New York 10019; (iii) counsel for the statutory committee of creditors, Morrison & Foerster LLP, Attn: Anthony Princi, 1290 Avenue of the Americas, New York, New York 10104; (iv) counsel for the Office of the Commissioner of Insurance of the State of Wisconsin, Foley & Lardner LLP, Attn: Frank W. DiCatri, 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202; (v) the Office of the United States Trustee for the Southern District of New York, Attn: Brian S. Masumoto, 33 Whitehall Street, 21st Floor, New York, New York, 10004; and (vi) all entities which have filed a written request for notice with the Bankruptcy Court.

PLEASE TAKE FURTHER NOTICE that if no response to the Objection is timely filed and served, the Bankruptcy Court may enter an order sustaining the Objection without further notice or hearing.

Dated: June 14, 2011
New York, New York

Respectfully Submitted,

/s/ Allison H. Weiss
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**UNITED STATES BANKRUPTCY COURT
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In re :
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 : **Chapter 11**
 AMBAC FINANCIAL GROUP, INC., :
 : **Case No. 10-15973 (SCC)**
 Debtor. :
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**DEBTOR'S OBJECTION TO PROOF OF CLAIM NUMBERS
3694 AND 3699 FILED BY THE DEPARTMENT OF THE
TREASURY – INTERNAL REVENUE SERVICE**

TO THE HONORABLE SHELLEY C. CHAPMAN,
UNITED STATES BANKRUPTCY JUDGE:

Ambac Financial Group, Inc., as debtor and debtor in possession in the above-captioned chapter 11 case (the "Debtor"), by and through its undersigned counsel, hereby submits this objection (the "Objection") to proof of claim numbers 3694 and 3699 (the "IRS Claims"), filed

by the Department of the Treasury – Internal Revenue Service (the “IRS”) on May 5, 2011, and respectfully represents:

Preliminary Statement

The IRS Claims, which are substantially duplicative of one another, assert a priority claim against the Debtor of \$807,242,021.91. The Debtor believes that the IRS Claims are premised on the erroneous assumption that \$708,115,837 in tax refunds paid to the Debtor between December 2008 and February 2010 (the “Tax Refunds”) on account of carrying back losses that resulted from its credit default swap contracts (the “CDS Contracts”) were erroneously paid to the Debtor. However, as described below, the Tax Refunds were not erroneously paid to the Debtor.

Up until 2007, Ambac Assurance Corp. (“AAC”), the Debtor’s principal operating subsidiary, treated its CDS Contracts as put options subject to the “wait and see” method of accounting for federal income tax purposes. In preparing its 2007 federal income tax return, the Debtor, in consultation with its accounting firm, KPMG, determined that its Post-2004 CDS Contracts (as defined below) should have been treated as “notional principal contracts” within the meaning of Treas. Reg. § 1.446-3(c)(1)(i) (“NPCs”), rather than as put options subject to the “wait and see” method of accounting.

As described below, proposed regulations promulgated in 2004 by the Department of the Treasury (the “Treasury”) concerning NPCs (i) require that a taxpayer use either of two methods to account for “contingent nonperiodic payments,” such as payments made to credit protection buyers in respect of CDS Contracts upon the occurrence of a credit event—the “noncontingent swap” method or the “mark-to-market” method; and (ii) specify that these two methods apply to NPCs entered into on or after 30 days after the proposed regulations are finalized. *See* Prop. Treas. Reg. § 1.446-3 (the “2004 Proposed Regulations”).

In addition, the Preamble to the 2004 Proposed Regulations (the “Preamble”) provides that (i) the “wait and see” method of accounting for contingent nonperiodic payments is “inconsistent” with existing rules and regulations; and (ii) taxpayers that have not adopted an accounting method for NPCs providing for contingent nonperiodic payments must adopt a method that takes such payments into account over the life of the contract under a “reasonable amortization method.”

Because the 2004 Proposed Regulations had not been finalized in 2007 (and to date, have never been finalized), the Debtor adopted the “impairment” method of accounting as a reasonable accounting method with respect to the contingent nonperiodic payments under the Post-2004 CDS Contracts. The Debtor filed with the IRS its Accounting Method Application (as defined below) in April 2008 and supplemented that application in a September 2008 letter, specifying that AAC had not adopted an accounting method with respect to losses incurred for the first time in 2007 in respect of the Post-2004 CDS Contracts, and that AAC was adopting the impairment method as an initial accounting method with respect to those losses. The IRS has never formally ruled on the Accounting Method Application. As a result of the application of the impairment method, the Debtor reported significant losses in respect of the Post-2004 CDS Contracts and filed claims for tentative carryback adjustments between September 2008 and December 2009. Based on these claims, the IRS refunded the Tax Refunds to the Debtor between December 2008 and February 2010.

The Debtor is entitled to the Tax Refunds, and the IRS should not be entitled to assert claims in respect of such refunds, because AAC’s use of the impairment method beginning in 2007 with respect to the contingent nonperiodic payments under the Post-2004 CDS Contracts was the initial adoption of a proper method of accounting. Even if AAC’s use of the impairment

method could somehow be considered an impermissible change in accounting method, the IRS's withholding of consent from AAC to use the impairment method should be deemed an abuse of discretion, given that the Preamble expressly disavowed the "wait and see" method of accounting for NPCs with contingent nonperiodic payments, which AAC had been utilizing up until 2007, and the impairment method conforms with the Preamble and the IRS's prior guidance.

Alternatively, even if AAC's use of the impairment method could somehow be considered improper, the IRS should be equitably estopped from challenging AAC's use of such method in light of the fact that the IRS never formally ruled on the Debtor's Accounting Method Application and the Debtor's 2007 consolidated federal income tax return put the IRS on notice of AAC's use of the impairment method.

Jurisdiction

1. This court (the "Bankruptcy Court") has jurisdiction to determine this matter under 28 U.S.C. § 1334 and section 505(a) of title 11 of the United States Code (the "Bankruptcy Code"). This is a core proceeding pursuant to 28 U.S.C. § 157(b). Venue is proper before the Bankruptcy Court pursuant to 28 U.S.C. §§ 1408 and 1409.

General Background

2. The Debtor is a holding company and a Delaware corporation. AAC is a Wisconsin-domiciled financial guarantee insurance company whose business includes the issuance of financial guarantee insurance policies to support public finance, structured finance, and international finance transactions.

3. In 2008 and 2009, the Debtor filed with the IRS applications for tentative refunds entitling it to receive refunds for the tax years ending 2003 through 2008. Pursuant to these applications, the Debtor received Tax Refunds totaling approximately \$708,115,837 from carrying back losses that resulted from its CDS Contracts.

4. On March 24, 2010, the Office of the Commissioner of Insurance of the State of Wisconsin (“OCI”) commenced a rehabilitation proceeding, Dane County, Wisconsin Case No. 10-cv-1576, with respect to a segregated account of AAC established pursuant to Wisc. Stat. § 611.24(2) (the “Segregated Account”). The rehabilitation proceeding remains underway in the Circuit Court of Dane County, Wisconsin (the “State Court”). A specifically described list of policies and liabilities were allocated to the Segregated Account. All policies and liabilities of AAC not specifically allocated to the Segregated Account remain in the general account of AAC (the “General Account”).

5. In connection with the Segregated Account rehabilitation proceeding, the State Court entered an order enjoining actions against the Segregated Account by policyholders, counterparties, or other parties (the “Segregated Account Injunction”).

6. On October 28, 2010, the IRS issued an information document request seeking detailed information regarding the basis for the Debtor’s entitlement to the Tax Refunds. In addition, the Debtor was informed that the IRS was examining the propriety of the Tax Refunds and may seek to recoup payment of the Tax Refunds from the Debtor or nondebtor affiliates in the Debtor’s consolidated tax group.

7. Effective November 7, 2010, any and all liabilities (including contingent liabilities) AAC has or may have, now or in the future, to the IRS and/or the Treasury in regard to, or in respect of, the Tax Refunds were allocated to the Segregated Account.

8. On November 8, 2010 (the “Commencement Date”), the Debtor commenced a voluntary case under chapter 11 of the Bankruptcy Code. The Debtor continues to operate its businesses and manage its properties as debtor in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

9. On the Commencement Date, the State Court granted an expansion of the Segregated Account Injunction to prevent the IRS from asserting liens against and levying upon the assets of AAC and its subsidiaries and to prevent the Debtor or parties related to the Debtor from pursuing certain claims against the Segregated Account, the General Account, or AAC's subsidiaries.

10. On November 9, 2010, the Debtor commenced an adversary proceeding, Adv. Pro. Case No. 10-4210 (SCC) (the "Adversary Proceeding"), against the IRS by filing a complaint with the Bankruptcy Court [Adv. Pro. Docket No. 1] (the "Complaint"). Count I of the Complaint requests a determination that the Debtor and the members of its consolidated group have no tax liability for tax years 2003 through 2008 and are entitled to retain the full amount of the Tax Refunds.

11. On November 17, 2010, the Office of the United States Trustee for the Southern District of New York (the "U.S. Trustee") appointed a statutory committee of unsecured creditors [Bankr. Ct. Docket No. 27] (the "Committee"). No trustee or examiner has been appointed in this chapter 11 case.

12. On January 13, 2011, the IRS filed a motion with the United States District Court for the Southern District of New York (the "District Court") to withdraw its reference of the Adversary Proceeding to the Bankruptcy Court pursuant to 28 U.S.C. § 157(d), Case No. 11-cv-00270 (PGG). The Debtor has opposed, and the District Court has not yet ruled on, the IRS's motion.

Background with Respect to the IRS Claims

13. From 1999 through 2008, Ambac Credit Products LLC ("ACP"), a wholly-owned subsidiary of AAC, sold credit protection to buyers of the same in the form of CDS Contracts. Pursuant to each CDS Contract, ACP agreed to pay credit protection buyers specified amounts

upon the occurrence of a “credit event” with respect to one or more “reference obligations.”

ACP received consideration in the form of periodic payments. AAC insured ACP’s performance under the CDS Contracts. Because ACP is disregarded for federal income tax purposes, AAC was treated as the party to the CDS Contracts.

14. Substantially all of the CDS Contracts that ACP entered into from 1999 through 2004 (the “Pre-2005 CDS Contracts”) were substantially similar. Likewise, substantially all of the CDS Contracts that ACP entered into from 2005 through 2008 (the “Post-2004 CDS Contracts”) were substantially similar. The following are the key differences between the Pre-2005 CDS Contracts and the Post-2004 CDS Contracts:

- (i) Loss Provisions: Certain Pre-2005 CDS Contracts provided for “physical settlement,” that is, the credit protection buyer had the right to sell the underlying reference obligation to ACP if a credit event occurred with respect to the reference obligation. In addition, certain Pre-2005 CDS Contracts provided for “cash settlement,” that is, ACP was required to pay the counterparty the difference between the fair market value of the reference obligation and the price specified in the Pre-2005 CDS Contracts upon the occurrence of a credit event. In contrast, the Post-2004 CDS Contracts generally were “pay as you go” contracts, that is, such contracts provided that ACP could not be compelled to buy the reference obligation and was merely required to make payments to the credit protection buyer where the issuer of the reference obligation failed to make scheduled principal or interest payments.
- (ii) Definition of “Credit Event”: In the Pre-2005 CDS Contracts, the definition of “credit event” included nonpayment of principal or interest or the bankruptcy of the issuer of the reference obligation. In the Post-2004 CDS Contracts, “credit event” was defined as a default by the issuer of a reference obligation in the payment of principal or interest when due.
- (iii) Reimbursement: The Post-2004 CDS Contracts included a provision requiring a credit protection buyer to reimburse ACP if the issuer of a reference obligation subsequently made payments on account of a previous shortfall in the payment of principal or interest that triggered a credit event. In contrast, the Pre-2005 CDS Contracts did not include any such reimbursement provision.

15. Based on the nature of the Pre-2005 CDS Contracts, AAC treated such contracts as put options subject to the “wait and see” method of accounting for federal income tax purposes. Under this method, a taxpayer does not realize income or expense until a recognition event occurs. Thus, AAC did not realize income or expense until, for example, AAC disposed of a bond received from the exercise of a credit protection buyer’s physical settlement right or the contract expired unexercised. The IRS examined the Debtor’s 1999 through 2004 consolidated federal income tax returns and proposed no adjustments related to this treatment.

16. Despite the significant differences in the loss payment provisions of the Pre-2005 CDS Contracts and the Post-2004 CDS Contracts, AAC continued applying the “wait and see” method of accounting with respect to its income from the payments it received in respect of the Post-2004 CDS Contracts and therefore did not recognize income in either 2005 or 2006 because the contracts neither expired nor terminated. This treatment was fully disclosed on the Debtor’s consolidated federal income tax returns for 2005 and 2006.

17. As a result of adverse developments in the credit markets beginning in 2007, AAC suffered significant losses in its CDS Contract portfolio for both financial and statutory accounting purposes beginning in 2007.

18. In preparing its 2007 consolidated federal income tax return, the Debtor, in consultation with its accounting firm, KPMG, determined that based upon the differences between the Pre-2005 CDS Contracts and the Post-2004 CDS Contracts, the Post-2004 CDS Contract should have been treated as NPCs rather than as put options subject to the “wait and see” method of accounting.

19. As the 2004 Proposed Regulations concerning contingent nonperiodic payments on NPCs, such as payments made by ACP to credit protection buyers upon the occurrence of a

credit event in respect of the Post-2004 CDS Contracts, had not been finalized, the Debtor applied the “impairment” method of accounting to these losses. Under this method, changes in impairment were taken into account as taxable income or loss on a quarterly basis. Notably, as described below, the Preamble provides that taxpayers that have not adopted an accounting method for NPCs providing for contingent nonperiodic payments must adopt a method that takes such payments into account over the life of the contract under a “reasonable amortization method.”

20. In April 2008, the Debtor filed with the IRS an IRS Form 3115, Application for Change in Accounting Method (the “Accounting Method Application”). This application was supplemented by a letter dated September 2, 2008 that clarified that AAC had not adopted an accounting method with respect to losses incurred in respect of the Post-2004 CDS Contracts, as AAC had not incurred any losses with respect to such contracts until 2007, and that AAC would adopt the impairment method of accounting with respect to any such losses, consistent with the 2004 Proposed Regulations. The IRS has yet to formally rule on the Accounting Method Application.

21. As a result of the application of the impairment method of accounting with respect to the losses incurred under the Post-2004 CDS Contracts, the Debtor reported an approximately \$33 million taxable loss for 2007 and \$3.2 billion taxable loss for 2008. Section 6411(a) of title 26 of the United States Code (as amended, the “IRC”) allows a taxpayer to apply for a tax refund based on the carryback of net operating losses to prior taxable years based on a tentative claim arising from the transactions in the carryback year and provides for an accelerated process for IRS review of such refund claim. IRC § 6411(a).

22. Accordingly, on September 23, 2008, August 11, 2009, and December 21, 2009, the Debtor filed claims for tentative carryback adjustments on IRS Form 1139, Corporate Application for Tentative Refund, as a result of the carryback to prior taxable years of the net operating losses reflected on its 2007 and 2008 consolidated federal income tax returns. Based on these claims, in December 2008, September 2009, and February 2010, the IRS refunded to the Debtor approximately \$11,470,930, \$252,704,185, and \$443,940,722 in Tax Refunds, respectively, totaling approximately \$708,115,837.

23. Pursuant to a tax sharing agreement dated as of July 19, 1991 among the Debtor and its subsidiaries in its consolidated tax group, as amended, the Debtor distributed the Tax Refunds to AAC.

24. On May 5, 2011, the IRS filed the IRS Claims, both of which are attached hereto as Exhibit A. The IRS Claims list taxes allegedly due and interest and penalties thereon but do not explain the basis for the claims. Both IRS Claims assert a priority claim under section 507(a)(8) of the Bankruptcy Code of \$807,242,021.91 and a general unsecured claim of \$1,800.00. The Debtor believes that the IRS Claims are premised on the incorrect assumption that the Tax Refunds were erroneously paid to the Debtor.

Relief Requested

25. By this Motion, the Debtor requests entry of an order, substantially in the form attached hereto as Exhibit B, disallowing and expunging the IRS Claims on the grounds that the Tax Refunds were not erroneously paid to the Debtor.

Basis for Relief Requested

26. A filed proof of claim is deemed allowed unless a party in interest objects thereto. 11 U.S.C. § 502(a). If an objection refuting at least one of the claim's essential allegations is asserted, the claimant has the burden of demonstrating the validity of the claim. *See, e.g.,*

Sherman v. Novack (In re Reilly), 245 B.R. 768, 773 (2d Cir. B.A.P. 2000), *aff'd*, 242 F.3d 367 (2d Cir. 2000); *In re Oneida, Ltd.*, 400 B.R. 384, 389 (Bankr. S.D.N.Y. 2009); *In re DJK Residential LLC*, 416 B.R. 100, 105 (Bankr. S.D.N.Y. 2009).

27. Section 502(b)(1) of the Bankruptcy Code provides that the Bankruptcy Court shall allow a claim except to the extent that it “is unenforceable against the debtor and property of the debtor under any agreement or applicable law.” 11 U.S.C. § 502(b)(1). The IRS Claims are premised on the assumption that the Tax Refunds were erroneously paid to the Debtor under applicable tax law. As described below, this underlying premise is incorrect, and therefore, the IRS Claims should be disallowed and expunged in their entirety pursuant to section 502(b)(1) of the Bankruptcy Code.

The Tax Refunds Were Not Erroneously Paid to the Debtor

I. The Post-2004 CDS Contracts Are NPCs

28. As described above, in preparing its 2007 consolidated federal income tax return, the Debtor, in consultation with KPMG, determined that the Post-2004 CDS Contracts should have been treated as NPCs under Treas. Reg. § 1.446-3, which would impact the timing and character of income or loss under these contracts.

29. 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.” Treas. Reg. § 1.446-3(c)(1)(i). NPCs “include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements.” *Id.*

30. The Post-2004 CDS Contracts satisfy all elements required to be considered an NPC:

- (i) “Payment of amounts by one party to another at specified intervals”: The Post-2004 CDS Contracts provide for payment by the credit protection buyer to ACP at fixed quarterly payment dates.
- (ii) “Calculated by reference to a specified index”: Treas. Reg. § 1.446-3(c)(1) defines a “specified index” as, *inter alia*, “[a] fixed rate, price, or amount.” Under the Post-2004 CDS Contracts, payments are calculated by reference to a specified index because the credit protection buyer is required to pay a fixed amount based on a single fixed rate that does not vary over the term of the contract, a notional amount of reference obligations, and a period of time.
- (iii) “Upon a notional principal amount”: Treas. Reg. § 1.446-3(c)(3) defines a “notional principal amount” as “any specified amount of money or property that, when multiplied by a specified index, measures a party’s rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract.” “The notional principal amount may vary over the term of the contract, provided that it is set in advance or varies based on objective financial information.” Treas. Reg. § 1.446-3(c)(3). Treas. Reg. § 1.446-3(c)(4)(ii), in turn, defines “objective financial information” as “any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties’ circumstances (such as one party’s dividends, profits, or the value of its stock).” Under the Post-2004 CDS Contracts, the notional amount is a specified amount of money or property that, when multiplied by the applicable fixed rate and time factor, measures the credit protection buyer’s fixed amount. Although the notional amount may vary over the term of a Post-2004 CDS Contract, it varies based on objective financial information, that is, the performance of the reference obligation, and this information is not within the control of ACP or the credit protection buyer and is not unique to either party. Moreover, ACP and the credit protection buyer do not loan or borrow the notional amount from each other.
- (iv) “In exchange for specified consideration or a promise to pay similar amounts”: Under the Post-2004 CDS Contracts, the credit protection buyer pays fixed amounts to ACP in exchange for ACP’s promise to make payments upon the occurrence of specified credit events.

31. Pursuant to Treas. Reg. § 1.446-3(c)(1)(ii), contracts described in IRC § 1256(b), futures contracts, forward contracts, options, and instruments or contracts that constitute indebtedness are *not* NPCs. The Post-2004 CDS Contracts are clearly not IRC § 1256(b) contracts, futures contracts, forward contracts, or debt.

32. Moreover, the Post-2004 CDS Contracts are not properly characterized as options. “A contract is an option contract when it provides (A) the option to buy or sell, (B) certain property, (C) at a stipulated price, (D) on or before a specific future date or within a specified time period, (E) for consideration.” *Fed. Home Loan Mortg. Corp. v. Comm’r*, 125 T.C. 248, 261 (2005) (citing, *inter alia*, *W. Union Tel. Co. v. Brown*, 253 U.S. 101, 110 (1920)); *see also Dunn v. Commodity Futures Trading Comm’n*, 519 U.S. 465, 469 (1997) (defining an option contract as “a transaction in which the buyer purchases from the seller for consideration the right, but not the obligation, to buy or sell an agreed amount of [property] at a set rate at any time prior to the option’s expiration”). The Post-2004 CDS Contracts are not options because they do not concern the sale of property or the cash equivalent of property. Under the contracts, ACP is required to make payments to credit protection buyers upon the occurrence of a credit event on a “pay as you go” basis—there is no physical or cash settlement required of ACP.

33. In addition, “[o]ptions have been characterized as unilateral contracts because one party to the contract is obligated to perform, while the other party may decide whether or not to exercise his rights under the contract.” *Fed. Home Loan Mortg. Corp.*, 125 T.C. at 259 (citing *U.S. Freight Co. v. United States*, 422 F.2d 887, 894 (Ct. Cl. 1970)). Thus, the Post-2004 CDS Contracts are not options because both parties bear obligations throughout the terms of the contracts. Specifically, (i) ACP could be required to make multiple payments upon the occurrence of one or more credit events; (ii) credit protection buyers have no right to require ACP to purchase the reference obligation (or to pay the cash equivalent thereof); and (iii) credit protection buyers are required to make periodic payments and reimbursement payments to ACP in the event that specified payments are made with respect to the reference obligations.

II. The 2004 Proposed Regulations Required the Debtor to Adopt a “Reasonable Amortization Method” with Respect to Contingent Nonperiodic Payments Received Under NPCs

34. Treasury regulations promulgated in 1993 divide payments made pursuant to NPCs into the following three categories: (i) Periodic Payments: Periodic payments are payments made or received under an NPC that are payable at fixed intervals of one year or less during the entire contract term, that are based on a specified index, and that are based on either a single notional amount or a notional principal amount that varies over the contract terms in the same proportion as the notional principal amount that measures the other party’s payments, Treas. Reg. § 1.446-3(e)(1); (ii) Nonperiodic Payments: Nonperiodic payments are payments made or received under an NPC that are not periodic payments or termination payments, Treas. Reg. § 1.446-3(f)(1); and (iii) Termination Payments: Termination payments are any payments made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under an NPC. Treas. Reg. § 1.446-3(h)(1).

35. Pursuant to these regulations, taxpayers must recognize the ratable daily portion of periodic payments—those paid at least annually—and nonperiodic payments—all other payments which are not termination payments—for the taxable year to which those portions relate. Generally, a nonperiodic payment must be recognized over the term of an NPC in a manner that reflects the economic substance of the contract. *See* Treas. Reg. § 1.446-3(e)(2)(i); Treas. Reg. § 1.446-3(f)(2)(i).

36. The 1993 regulations do not distinguish between noncontingent and contingent nonperiodic payments, but the specific rules and examples provided address only noncontingent nonperiodic payments. The 2004 Proposed Regulations distinguish between two categories of nonperiodic payments made pursuant to NPCs: (i) Contingent Nonperiodic Payments: The 2004 Proposed Regulations define these payments as “any nonperiodic payment other than a

noncontingent nonperiodic payment;” and (ii) Noncontingent Nonperiodic Payments: The 2004 Proposed Regulations define these payments as “a nonperiodic payment that is either 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).”

37. Pursuant to the 2004 Proposed Regulations, a taxpayer may use either of two methods to account for contingent nonperiodic payments: (i) the “noncontingent swap” method, which generally requires taxpayers to project the reasonably expected amount of a contingent nonperiodic payment and account for the projected payment over the term of the NPC as if it were a noncontingent nonperiodic payment, or (ii) the “mark-to-market” method, which requires taxpayers to recognize gains or losses that would be realized if the NPC were sold for its fair market value on the last business day of the taxable year.

38. The Preamble states that the “wait and see” method of accounting for contingent nonperiodic payments is “inconsistent” with the existing specific timing rules and with the general rule in Treas. Reg. § 1.446-3(f)(2)(i) respecting recognition of nonperiodic payments over the term of the contract.¹ Instead, “the parties must use a reasonable estimate of the payment for determining taxable income in the year before the payment is fixed.” In addition, the Preamble states that the proposed two accounting methods—the noncontingent swap method and the mark-to-market method—provide a timing regime that “clearly reflects the economics of the underlying contracts.”

¹ Treas. Reg. § 1.446-3(f)(2)(i) provides that “[a]ll 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.”

39. The 2004 Proposed Regulations provide that the two proposed accounting methods apply to NPCs entered into on or after 30 days after the proposed regulations are finalized, and that until such regulations are finalized, a taxpayer is *not* required to adopt either the noncontingent swap method or the mark-to-market method. The Preamble provides that a taxpayer that has not yet adopted a method of accounting for NPCs providing for contingent nonperiodic payments that are in effect or entered into on or after 30 days after publication of the proposed regulations must adopt any “reasonable amortization method” to amortize contingent nonperiodic payments and that such “reasonable amortization method” may be, but need not be, a method that satisfies the proposed regulations.

40. The 2004 Proposed Regulations were *never finalized*, and consequently, a taxpayer that had not yet adopted an accounting method for NPCs providing for contingent nonperiodic payments was required only to adopt a “reasonable amortization method” with respect to such payments.

III. The Impairment Method of Accounting Adopted by AAC Is a “Reasonable Amortization Method” Within the Meaning of the Preamble to the 2004 Proposed Regulations

41. IRC § 446(a) provides that taxable income “shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” IRC § 446(a). Treas. Reg. § 1.446-1(a) provides that no uniform method of accounting applies to all taxpayers, and taxpayers are free to choose any method of accounting that clearly reflects income so long as the method chosen is not inconsistent with a method specifically prescribed by the IRC, Treasury regulations, or IRC pronouncements. Thus, if a taxpayer’s method of accounting clearly reflects income, the IRS may not require the taxpayer to change to a method that, in the IRS’s view, more clearly reflects income. Further, a taxpayer generally must treat a single “item” of income or expense consistently. *See* Treas. Reg. § 1.446-1(a)(2).

42. The term “method of accounting” includes both the overall method of accounting of a taxpayer as well as the accounting treatment of “any item.” Treas. Reg. § 1.446-1(a)(1). A taxpayer “adopts” a method of accounting on the first return on which an “item” is present when the taxpayer uses a proper method. Treas. Reg. § 1.446-1(e)(1). In situations where a taxpayer selects an improper method of accounting, the method is considered “adopted” only after the taxpayer has used such method on two consecutive tax returns. *See* Rev. Rul. 90-38, 1990-1 C.B. 57; *Diebold v. United States*, 891 F.2d 1579 (Fed. Cir. 1989).

43. For tax accounting purposes, AAC applied the impairment method of accounting to account for ACP’s Post-2004 CDS Contracts. Adoption of the impairment method of accounting was proper because, as stated above, the Post-2004 CDS Contracts were properly characterized as NPCs rather than as put options subject to the “wait and see” method of accounting. Once the Post-2004 CDS Contracts, which required ACP to make contingent nonperiodic payments to credit protection buyers,² were properly characterized as NPCs, AAC was permitted under the 2004 Proposed Regulations to adopt any “reasonable amortization method” to amortize the contingent nonperiodic payments. AAC adopted the impairment method for tax purposes, which mirrored statutory accounting principles applicable to AAC as a regulated insurance company.³ Indeed, OCI reviewed and approved AAC’s adoption of the

² Such payments were not termination payments within the meaning of the 2004 Proposed Regulations because such payments would not extinguish or assign all or a proportionate part of a credit protection buyer’s remaining rights and obligations.

³ In general, insurance companies must use statutory accounting principles as the basis for tax accounting, and in particular, use the underwriting and investment exhibits of the annual statement filed with state regulators. *See, e.g., Home Group, Inc. v. Comm’r*, 875 F.2d 377, 382 (2d Cir. 1989) (holding that statutory accounting should be used as the starting point for tax accounting); *State Farm Mut. Automobile Ins. Co. v. Comm’r*, 135 T.C. 543, 553 (2010) (“State insurance commissioners’ preferences about reserves ... are not some intrusion on federal tax policy; using their annual statement is federal tax law”) (quoting *Sears, Roebuck & Co. v. Comm’r*, 972 F.2d 858, 865–66 (7th Cir. 1992)). Notwithstanding the foregoing, courts have held that tax accounting principles override statutory accounting (i) when there is an explicit rule in the IRC for the treatment of an item of income or loss or (ii) when the

impairment method for statutory accounting purposes as a reasonable method to properly account for the contingent liability that may arise from future credit event payments on the Post-2004 CDS Contracts.

44. The impairment method adopted for tax accounting purposes is a “reasonable” accounting method insofar as it applied to AAC because (i) it is a valid alternative to the “wait and see” accounting method, which, as set forth above, the IRS explicitly rejected in the Preamble; (ii) it properly matches income by netting the present value of future expected losses against the present value of projected future premiums; (iii) AAC based its Post-2004 CDS Contract performance assumptions on the characteristics of the pool of securities supporting the reference obligation, as provided by objective third-parties; (iv) the impairment accounting principles and impairment calculations were audited and accepted by AAC’s outside auditor, KPMG; (v) it is similar to, but more conservative than, the GAAP mark-to-market method applicable to financial statement accounting, insofar as the mark-to-market method calculated larger losses on the Post-2004 CDS Contracts and would have created an even larger tax loss than the tax accounting loss upon which the Tax Refunds are based; (vi) it measured the change in value of the Post-2004 CDS Contracts based upon the expected value of the future nonperiodic payments, consistent with the 2004 Proposed Regulations; and (vii) its application is consistent with the statutory accounting method applied by AAC and reported to OCI.

use of statutory accounting results in a mismatch between income and expenses. *Home Group*, 875 F.2d at 381–82. In addition, courts have held that the primacy of statutory accounting principles does not prevent the IRS from examining the precise numbers used by the taxpayer in its annual statement. *See Physicians Ins. Co. of Wis. v. Comm’r*, T.C. Memo. 2001-304. These exceptions to the general rule, however, do not apply to AAC’s accounting treatment of the Post-2004 CDS Contracts. First, there is no general tax accounting rule regarding the treatment of CDS Contracts. Second, the impairment method does not create a mismatch between income and expenses, as courts have objected to in the past regarding certain statutory accounting practices. AAC’s reliance on statutory accounting principles in reporting losses on its Post-2004 CDS Contracts was therefore proper.

IV. AAC's Use, Beginning in 2007, of the Impairment Method with Respect to Credit Event Payments Under the Post-2004 CDS Contracts Was Not an Unauthorized Change in Method of Accounting

A. Regulations Governing Changes in Methods of Accounting

45. Treas. Reg. § 1.446-1(e)(2)(i) provides “[e]xcept as otherwise expressly provided ... a taxpayer who changes the method of accounting employed ... shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted.”

46. Treas. Reg. § 1.446-1(e)(2)(ii)(a), in turn, provides that “a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan.” “Material item” is defined as “any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.” Treas. Reg. § 1.446-1(e)(2)(ii)(a). Treas. Reg. § 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does *not* include the correction of computational or posting errors, a change that does not involve the timing of an item, or a change in treatment resulting from a change in underlying facts.

47. Although the IRS generally has discretion over whether to consent to a taxpayer request to change a method of accounting, it is an abuse of discretion for the IRS to deny a request to change from an improper method to a proper method of accounting or to put the taxpayer on a method which itself does not clearly reflect income. *See, e.g., Exxon Mobil Corp. v. Comm’r*, 114 T.C. 293, 322 (2000); *Sierracin Corp. v. Comm’r*, 90 T.C. 341, 368 (1988); *Wright Contracting Co. v. Comm’r*, 36 T.C. 620, 633 (1961).

B. Arguments

(1) AAC's Use of the Impairment Method Beginning in 2007 Was the Initial Adoption of a Proper Method of Accounting and Thus Not an Improper Change in Method of Accounting

48. As noted above, the term “method of accounting” includes not only the taxpayer’s overall method of accounting, but also the accounting treatment of any particular item. Treas. Reg. § 1.446-1(a). The term “item” is used to indicate any recurring incidence of income or expense. The determination of whether a taxpayer has adopted a method of accounting is heavily dependent on the definition of “item,” because a taxpayer may adopt a new and different method for a new item. Consequently, a taxpayer’s reporting of a new and different item of income or expense for the first time does not necessarily involve a “change” of accounting method requiring prior IRS consent; prior IRS consent is required where there is a change in the treatment of “any material item.” The method of accounting for an item should not be confused with the characterization of a financial instrument for federal income tax purposes. Even if AAC adopted an option-like “wait and see” method of accounting for income on an NPC in the 2005 and 2006 taxable years does not mean that the post-2004 NPCs are options for federal income tax purposes. Instead, at worst AAC may have used an improper method for one payment stream under such contracts; it did not, however, adopt a method in 2005 and 2006 for deductions on such contracts.

49. Recently, the U.S. Tax Court in *Capital One Financial Corp. & Subs. v. Commissioner*, 130 T.C. 147 (2008) (“*Capital One*”), addressed the meaning of the term “item” for accounting method purposes. The Tax Court concluded that whether a particular type of income (or expense) constitutes an “item” depends upon a consideration of all relevant facts and circumstances concerning that item. The court pointed out that an “item” for purposes of the adoption or change in accounting method rules may be narrower than the broad items of income

listed under IRC § 61; to define an item too broadly could undermine the reasons for and objectives of IRC § 446(e). 130 T.C. at 160–61. Accordingly, because the taxpayers’ late fee income was merely one of several types of interest income earned on a pool of credit card receivables, but was earned for reasons independent of the reasons that other types of income were earned on the pool, the court held that the late fee income, rather than interest, was the item for which IRS consent to an accounting method change was required. The taxpayers’ retroactive recharacterization of the late fee income thus was an impermissible accounting method change under IRC § 446(e). *Id.* at 161, 170.

50. In the context of NPCs, the IRS would seem in fact to share the Tax Court’s view in *Capital One* of “item” for accounting method purposes. In Revenue Ruling 2002-30, a situation is described where a taxpayer enters into an NPC with another party, which NPC requires a nonperiodic payment to be made that is comprised of noncontingent and contingent components. Rev. Rul. 2002-30, 2002-1 C.B. At issue was the appropriate method for the inclusion into income or the deduction of the nonperiodic payment. Of note, the IRS ruled that the taxpayer and the other party were required to recognize the nonperiodic payment over the term of the NPC in a manner that reflected the economic substance of the NPC because “each component must be treated separately for purposes of applying the NPC rules in [Treas. Reg.] § 1.446-3.”

51. Following the principles enunciated in *Capital One* and Revenue Ruling 2002-30, AAC’s credit event payments properly characterized as contingent nonperiodic payments are items that are separate and distinct from the other streams of revenue (such as the periodic credit protection payments received) and expense under the Post-2004 CDS Contracts. As such and because ACP did not incur any losses with respect to the Post-2004 CDS Contracts prior to 2007,

AAC had not yet established a method of accounting with respect to this item. Accordingly, AAC was free to adopt the impairment method as an initial accounting method in 2007 with respect to this item as a result of determining that the Post-2004 CDS Contracts properly are characterized as NPCs.

(2) Alternatively, the IRS's Withholding of Consent from AAC to Use the Impairment Method Constitutes an Abuse of Discretion

52. The IRS has been found to have abused its discretion in cases where (i) the IRS purported to deny a taxpayer the opportunity to change from an incorrect method to a correct method, (ii) the court found that the taxpayer's method did clearly reflect income, and (iii) the IRS sought to deny the taxpayer's use of a method that is expressly sanctioned by the IRC or applicable regulations. *See, e.g., Sierracin Corp.*, 90 T.C. at 341 (holding that the Commissioner of the IRS abused his discretion in rejecting the taxpayer's application of the completed contract method); *see also Wright Contracting*, 36 T.C. at 636 (abuse of discretion might be found if the IRS withheld consent to allow the taxpayer to change from an improper to a proper method of accounting); *Nat'l Bank of Fort Benning v. United States*, 79-2 USTC ¶ 9627 (M.D. Ga. 1979) (same); *Benefit Life Ins. Co. v. United States*, 517 F. Supp. 740, 773 (D. Kan. 1980), *aff'd*, 726 F.2d 1491 (10th Cir. 1984) (same); *SoRelle v. Comm'r*, 22 T.C. 459, 469 (1954) (in the context of other questions, court made it clear that the IRS could not compel a taxpayer to remain on an improper accounting method).

53. Additionally, courts have held that the IRS abuses its discretion when it seeks to put the taxpayer on a method which itself does not clearly reflect income. *See, e.g., Dayton Hudson Corp. & Subs. v. Comm'r*, 153 F.3d 660 (8th Cir. 1998), *rev'g* 73 T.C.M. (CCH) 2978, 2993 (1997) (although finding there was no error in the Tax Court's conclusion that the taxpayer's method of accounting for shrinkage did not reflect income clearly, the court of

appeals reversed the judgment of the Tax Court because the IRS had acted arbitrarily in prescribing a different method that did not reflect income clearly).

54. As noted above, the Preamble expressly disavowed the “wait and see” method of accounting for NPCs with contingent nonperiodic payments. The impairment method, however, conforms with the Preamble and the IRS’s prior guidance. Moreover, in 2008, the Debtor put the IRS on notice of AAC’s desire to use the impairment method when it timely filed its Accounting Method Application. (As noted above, the IRS has failed to formally rule on such application.) Further, the Debtor fully disclosed its tax position with respect to the Post-2004 CDS Contracts on its 2007 and 2008 federal income tax returns.

(3) Alternatively, the IRS Should Be Equitably Estopped from Challenging AAC’s Use of the Impairment Method

55. “Equitable estoppel is grounded on notions of fair dealing and conscience and is designed to aid the law in the administration of justice where injustice would otherwise result.” *In re Vebeliunas*, 332 F.3d 85, 93 (2d Cir. 2003) (quoting *In re Ionosphere Clubs, Inc.*, 85 F.3d 992, 999 (2d Cir. 1996)).

56. Courts have estopped the IRS from asserting that it had not consented to an accounting method change where the IRS implicitly approved a change to a correct method (or a waiver in effect resulted) by accepting a taxpayer’s return giving notice that the method originally adopted had been changed. *See, e.g., Fowler Bros. & Cox v. Comm’r*, 138 F.2d 774, 775 (5th Cir. 1943) (sustaining the IRS’s position that by its acceptance of the taxpayer’s returns, it had impliedly consented to the taxpayer’s change in accounting method from the accrual basis of accounting to the cash basis of accounting); *Tampa Tribune Bldg. Co. v. Tomlinson*, 52 AFTR 1799 (S.D. Fla. 1957) (holding that the filing of returns by a taxpayer on a cash basis from 1932 to the time of trial, where in prior years returns had been filed on an accrual basis, *ipso facto*

gave the IRS notice of the accounting method change, and therefore, acceptance of the cash basis returns was tantamount to approval of such change and the IRS was estopped from questioning the change for the first time fifteen years later); *Linen Thread Co., Ltd. v. Comm'r*, 14 T.C. 725, 732 (1950) (change in the taxpayer's books, together with a change in the basis of the returns accepted by the IRS, was held tantamount to a request for permission to change the applicable accounting method and the approval of such change).

57. The IRS should be equitably estopped from now challenging AAC's use of the impairment method because the Accounting Method Application has been pending with the IRS since April 2008 and Debtor filed its 2007 consolidated federal income tax return reflecting the same treatment with respect to the credit event payments indicated in its Accounting Method Application, which return put the IRS on notice of AAC's use of the impairment method.

Conclusion

WHEREFORE, for the reasons set forth herein, the Debtor respectfully requests that the Bankruptcy Court enter an order, substantially in the form attached hereto as Exhibit B, disallowing and expunging the IRS Claims in their entirety and granting such other and further relief as is appropriate.

Dated: June 14, 2011
New York, New York

Respectfully Submitted,

/s/ Allison H. Weiss
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Lawrence M. Hill
Allison H. Weiss
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- and -

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Attorneys for the Debtor and Debtor in Possession

EXHIBIT A

(IRS Claims)

UNITED STATES BANKRUPTCY COURT <u>SOUTHERN</u> DISTRICT OF <u>NEW YORK</u>		PROOF OF CLAIM
Name of Debtor: AMBAC FINANCIAL GROUP, INC.		Case Number: 10-15973-SCC
NOTE: This form should not be used to make a claim for an administrative expense arising after the commencement of the case. A request of payment of an administrative expense may be filed pursuant to 11 U.S.C. § 503.		
Name of Creditor (The person or other entity to whom the debtor owes money or property): Department of the Treasury - Internal Revenue Service		<input type="checkbox"/> Check this box to indicate that this claim amends a previously filed claim.
Name and address where notices should be sent: Internal Revenue Service P.O. Box 7346 Philadelphia, PA 19101-7346		Court Claim Number: _____ (If known)
Telephone number: 1-800-913-9358 Creditor Number: 5527944		Filed on: _____
Name and address where payments should be sent (if different from above): Internal Revenue Service 130 South Elmwood Ave Buffalo, NY 14202		<input type="checkbox"/> Check this box if you are aware that anyone else has filed a proof of claim relating to your claim. Attach copy of statement giving particulars. <input type="checkbox"/> Check this box if you are the debtor or trustee in this case.
Telephone Number: (716) 961-5259		
1. Amount of Claim as of Date Case Filed: \$ 807,243,827.91 If all or part of your claim is secured, complete item 4 below; however, if all of your claim is unsecured, do not complete item 4. If all or part of your claim is entitled to priority, complete item 5. <input checked="" type="checkbox"/> Check this box if claim includes interest or other charges in addition to the principal amount of claim. Attach itemized statement of interest or charges.		5. Amount of Claim Entitled to Priority under 11 U.S.C. §507(a). If any portion of your claim falls in one of the following categories, check the box and state the amount. Specify the priority of the claim. <input type="checkbox"/> Domestic support obligations under 11 U.S.C. §507(a)(1)(A) or (a)(1)(B). <input type="checkbox"/> Wages, salaries, or commissions (up to \$11,725*) earned within 180 days before filing of the bankruptcy petition or cessation of the debtor's business, whichever is earlier - 11 U.S.C. §507 (a)(4). <input type="checkbox"/> Contributions to an employee benefit plan -11 U.S.C. §507 (a)(5). <input type="checkbox"/> Up to \$2,600* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use - 11 U.S.C. §507 (a)(7). <input checked="" type="checkbox"/> Taxes or penalties owed to governmental units - 11 U.S.C. §507 (a)(8). <input type="checkbox"/> Other - Specify applicable paragraph of 11 U.S.C. §507 (a)(__). Amount entitled to priority: \$ 807,242,027.91
2. Basis for Claim: Taxes (See instruction #2 on reverse side.)		
3. Last four digits of any number by which creditor identifies debtor: See Attachment 3a. Debtor may have scheduled account as: _____ (See instruction #3a on reverse side.)		
4. Secured Claim (See instruction #4 on reverse side.) Check the appropriate box if your claim is secured by a lien on property or a right of setoff and provide the requested information. Nature of property or right of setoff: <input type="checkbox"/> Real Estate <input type="checkbox"/> Motor Vehicle <input type="checkbox"/> Other Describe: Value of Property: \$ _____ Annual Interest Rate ____% Amount of arrearage and other charges as of time case filed included in secured claim, if any: \$ _____ Basis for perfection: _____ Amount of Secured Claim: \$ _____ Amount Unsecured: \$ _____		
6. Credits: The amount of all payments on this claim has been credited for the purpose of making this proof of claim. 7. Documents: Attach redacted copies of any documents that support the claim, such as promissory notes, purchase orders, invoices, itemized statements or running accounts, contracts, judgments, mortgages, and security agreements. You may also attach a summary. Attach redacted copies of documents providing evidence of perfection of a security interest. You may also attach a summary. (See instruction 7 and definition of "redacted" on reverse side.) DO NOT SEND ORIGINAL DOCUMENTS. ATTACHED DOCUMENTS MAY BE DESTROYED AFTER SCANNING. If the documents are not available, please explain:		*Amounts are subject to adjustment on 4/1/13 and every 3 years thereafter with respect to cases commenced on or after the date of adjustment.
Date: 05/04/2011	Signature: The person filing this claim must sign it. Sign and print name and title, if any, of the creditor or other person authorized to file this claim and state address and telephone number if different from the notice address above. Attach copy of power of attorney, if any.	
/s/ JIANPING HUANG, Bankruptcy Specialist (716) 961-5259		FOR COURT USE ONLY Internal Revenue Service 130 South Elmwood Ave Buffalo, NY 14202

Penalty for presenting fraudulent claim: Fine of up to \$500,000 or imprisonment for up to 5 years, or both. 18 U.S.C §§ 152 and 3571.



101597311050500000000007

Proof of Claim for Internal Revenue Taxes

Department of the Treasury/Internal Revenue Service



Form 10
Attachment

In the Matter of: AMBAC FINANCIAL GROUP, INC.
ONE STATE ST PLAZA
NEW YORK, NY 10004

Case Number	10-15973-SCC
Type of Bankruptcy Case	CHAPTER 11
Date of Petition	11/08/2010

The United States has not identified a right of setoff or counterclaim. However, this determination is based on available data and is not intended to waive any right to setoff against this claim debts owed to this debtor by this or any other federal agency. All rights of setoff are preserved and will be asserted to the extent lawful.

Unsecured Priority Claims under section 507(a)(8) of the Bankruptcy Code

<i>Taxpayer ID Number</i>	<i>Kind of Tax</i>	<i>Tax Period</i>	<i>Date Tax Assessed</i>	<i>Tax Due</i>	<i>Interest to Petition Date</i>
XX-XXX1676	CORP-INC	12/31/2003	I Unassessed	\$77,713,584.00	\$2,053,495.77
XX-XXX1676	CORP-INC	12/31/2004	I Unassessed	\$144,929,795.00	\$3,829,438.04
XX-XXX1676	CORP-INC	12/31/2005	I Unassessed	\$210,799,742.00	\$5,570,140.54
XX-XXX1676	CORP-INC	12/31/2006	I Unassessed	\$191,018,375.00	\$10,341,992.25
XX-XXX1676	CORP-INC	12/31/2007	I Unassessed	\$94,824,558.00	\$20,448,498.92
XX-XXX1676	CORP-INC	12/31/2008	I Unassessed	\$41,463,532.00	\$4,248,876.39
XX-XXX1676	MISC PEN	12/31/2008	04/18/2011	\$0.00	\$0.00
				\$760,749,586.00	\$46,492,441.91

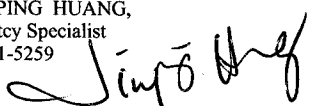
Total Amount of Unsecured Priority Claims: \$807,242,027.91

Unsecured General Claims

Penalty to date of petition on unsecured priority claims (including interest thereon) \$1,800.00

Total Amount of Unsecured General Claims: \$1,800.00

B10 (Official Form 10) (04/10)

UNITED STATES BANKRUPTCY COURT SOUTHERN DISTRICT OF NEW YORK		PROOF OF CLAIM
Name of Debtor: AMBAC FINANCIAL GROUP, INC.		Case Number: 10-15973-SCC
NOTE: This form should not be used to make a claim for an administrative expense arising after the commencement of the case. A request of payment of an administrative expense may be filed pursuant to 11 U.S.C. § 503.		
Name of Creditor (The person or other entity to whom the debtor owes money or property): Department of the Treasury - Internal Revenue Service		<input type="checkbox"/> Check this box to indicate that this claim amends a previously filed claim. Court Claim Number: _____ (If known) Filed on: _____
Name and address where notices should be sent: Internal Revenue Service P.O. Box 7346 Philadelphia, PA 19101-7346 Telephone number: 1-800-913-9358 Creditor Number: 5527944		
Name and address where payments should be sent (if different from above): Internal Revenue Service 130 South Elmwood Ave Buffalo, NY 14202 Telephone Number: (716) 961-5259		<input type="checkbox"/> Check this box if you are aware that anyone else has filed a proof of claim relating to your claim. Attach copy of statement giving particulars. <input type="checkbox"/> Check this box if you are the debtor or trustee in this case.
1. Amount of Claim as of Date Case Filed: \$ 807,243,827.91 If all or part of your claim is secured, complete item 4 below; however, if all of your claim is unsecured, do not complete item 4. If all or part of your claim is entitled to priority, complete item 5. <input checked="" type="checkbox"/> Check this box if claim includes interest or other charges in addition to the principal amount of claim. Attach itemized statement of interest or charges.		5. Amount of Claim Entitled to Priority under 11 U.S.C. §507(a). If any portion of your claim falls in one of the following categories, check the box and state the amount. Specify the priority of the claim. <input type="checkbox"/> Domestic support obligations under 11 U.S.C. §507(a)(1)(A) or (a)(1)(B). <input type="checkbox"/> Wages, salaries, or commissions (up to \$11,725*) earned within 180 days before filing of the bankruptcy petition or cessation of the debtor's business, whichever is earlier - 11 U.S.C. §507 (a)(4). <input type="checkbox"/> Contributions to an employee benefit plan - 11 U.S.C. §507 (a)(5). <input type="checkbox"/> Up to \$2,600* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use - 11 U.S.C. §507 (a)(7). <input checked="" type="checkbox"/> Taxes or penalties owed to governmental units - 11 U.S.C. §507 (a)(8). <input type="checkbox"/> Other - Specify applicable paragraph of 11 U.S.C. §507 (a)(____). Amount entitled to priority: \$ 807,242,027.91 <i>*Amounts are subject to adjustment on 4/1/13 and every 3 years thereafter with respect to cases commenced on or after the date of adjustment.</i>
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Date: 05/04/2011	Signature: The person filing this claim must sign it. Sign and print name and title, if any, of the creditor or other person authorized to file this claim and state address and telephone number if different from the notice address above. Attach copy of power of attorney, if any.	
/s/ JIANPING HUANG, Bankruptcy Specialist (716) 961-5259 		Internal Revenue Service 130 South Elmwood Ave Buffalo, NY 14202
		FOR COURT USE ONLY RECEIVED MAY 05 2011 KURTZMAN CARSON CONSULTANTS

Penalty for presenting fraudulent claim: Fine of up to \$500,000 or imprisonment for up to 5 years, or both. 18 U.S.C §§ 152 and 3571.

- Date Stamped Copy Returned
- No self addressed stamped envelope
- No copy to return



1015973110505000000000005

Proof of Claim for Internal Revenue Taxes

Department of the Treasury/Internal Revenue Service



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ONE STATE ST PLAZA
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Total Amount of Unsecured Priority Claims:

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Unsecured General Claims

Penalty to date of petition on unsecured priority claims (including interest thereon) \$1,800.00

Total Amount of Unsecured General Claims:

\$1,800.00

EXHIBIT B

(Proposed Order)

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

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In re :
:
:
AMBAC FINANCIAL GROUP, INC., : **Chapter 11**
:
:
Debtor. : **Case No. 10-15973 (SCC)**
:
:
-----X

**ORDER GRANTING DEBTOR’S OBJECTION TO PROOF OF
CLAIM NUMBERS 3694 AND 3699 FILED BY THE DEPARTMENT
OF THE TREASURY – INTERNAL REVENUE SERVICE**

Upon the objection (the “Objection”)¹ of Ambac Financial Group, Inc. (the “Debtor”), as debtor and debtor in possession in this chapter 11 case, pursuant to section 502(b)(1) of the Bankruptcy Code, seeking entry of an order (this “Order”) disallowing proof of claim numbers 3694 and 3699 filed by the Department of the Treasury – Internal Revenue Service (the “IRS”); and the Bankruptcy Court having reviewed the Objection and the pleadings filed in the Adversary Proceeding; and the Bankruptcy Court having jurisdiction to consider the Objection and the relief requested therein in accordance with 28 U.S.C. § 1334, section 505(a) of the Bankruptcy Code, and Standing Order M-61 Referring to Bankruptcy Judges for the Southern District of New York Any and All Proceedings Under Title 11, dated July 10, 1984 (Ward, Acting C.J.); and consideration of the Objection and the relief requested therein being a core proceeding pursuant to 28 U.S.C. § 157(b); and venue being proper before the Bankruptcy Court pursuant to 28 U.S.C. §§ 1408 and 1409; and due and proper notice of the Objection having been provided; and a hearing having been held to consider the relief requested in the Objection (the “Hearing”); and upon the record of the Hearing and all of the proceedings had before the

¹ Capitalized terms used but not defined herein shall have the meanings set forth in the Objection.

Bankruptcy Court; and the Bankruptcy Court having determined that the relief sought in the Objection is in the best interests of the Debtor, its estate, its creditors, and all parties in interest, and that the legal and factual bases set forth in the Objection establish just cause for the relief granted herein; and after due deliberation and sufficient cause appearing therefor, it is hereby:

ORDERED that the Objection is granted; and it is further

ORDERED that proof of claim numbers 3694 and 3699 filed by the IRS against the Debtor are hereby disallowed in their entirety and expunged pursuant to section 502(b)(1) of the Bankruptcy Code; and it is further

ORDERED that the terms of this Order shall be immediately effective upon its entry; and it is further

ORDERED that this Court shall retain jurisdiction with respect to all matters related to the implementation of this Order.

Dated: _____, 2011
New York, New York

THE HONORABLE SHELLEY C. CHAPMAN
UNITED STATES BANKRUPTCY JUDGE