

Client Alert.

September 21, 2011

IRS Publishes Proposed Regulations on Swaps and Notional Principal Contracts

By Thomas Humphreys, Remmelt Reigersman, and Jared Goldberger

In response to the financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) to, among other things, increase regulation of the capital markets. In Congress’s attempt to increase regulation, Dodd-Frank requires the Commodity Futures Trading Commission (“CFTC”) to establish a comprehensive regulatory framework for swaps,¹ which includes the trading of swaps on registered exchanges. With the advent of swaps trading on registered exchanges, however, Congress feared such swaps would now qualify as “section 1256 contracts,” resulting in specific character and timing (e.g., mark-to-market) treatment for tax purposes. As a result, Congress included section 1256(b)(2)(B)² in Dodd-Frank, which carves out swaps and other similar agreements, even if traded on or subject to the rules of an exchange, from the definition of a “section 1256 contract.” On September 16, 2011, the Internal Revenue Service (“IRS”) and Treasury Department (“Treasury”) published proposed regulations providing guidance on the category of swaps and similar agreements that are included in the carve-out from a “section 1256 contract” and on the scope of the notional principal contract definition.

Section 1256 provides that “section 1256 contracts” are marked-to-market at the end of each year and that any gain or loss is generally treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. A “section 1256 contract” is defined as a regulated futures contract, foreign currency contract, nonequity option, dealer equity option, or dealer securities futures contract which, with the exception of a foreign currency contract, must be traded on or subject to the rules of a “qualified board or exchange.”

A primary focus of the proposed regulations is to clarify the scope of swaps excluded from section 1256 treatment (i.e., swaps excluded from the definition of a “section 1256 contract”). As enacted under Dodd-Frank, swaps included in the section 1256 carve-out were modeled after the Treasury Regulation definition of a notional principal contract with the addition of credit default swaps, as opposed to the Dodd-Frank definition of “swaps.” Following this principle, the proposed regulations provide that a section 1256 contract does not include a contract that qualifies as a notional principal contract.³ Also, according to the preamble to the proposed regulations, the IRS and Treasury believe that an option on a notional principal contract should be treated as an agreement similar to a notional principal contract; therefore, the proposed regulations carve out options on notional principal contracts from section 1256 treatment as well. The proposed regulations provide that any contract that is both a section 1256 contract and a notional principal contract is treated as a notional principal contract, with the result that such contract does not qualify for section 1256 treatment.

¹ Dodd-Frank defines a “swap” as including specified derivatives across various asset classes, but excludes, among other things, nonfinancial or security forwards that are intended to be physically settled, futures contracts, listed FX options, debt securities, securities options and forwards that are subject to the Securities Act of 1933 and the Securities Exchange Act of 1934, and security-based swaps.

² Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

³ As the proposed regulations provide an updated definition of “notional principal contracts,” references in this memorandum to “notional principal contracts” incorporate such updated definition.

Client Alert.

The proposed regulations also provide an updated definition for the term “notional principal contract.” As the scope of the current definition of a notional principal contract⁴ has been questioned by many, especially post-Dodd-Frank, the proposed regulations refine the scope by providing that a notional principal contract requires one party to make two or more payments to a counterparty. For this purpose, the fixing of an amount is treated as a payment, even if the actual payment reflecting that amount is to be made at a later date. With respect to this definition, the preamble to the proposed regulations provides the following example: a contract that provides for a settlement payment referenced to the appreciation or depreciation on a specified number of shares of common stock, adjusted for actual dividends paid during the term of the contract, is treated as a contract with more than one payment with respect to that leg of the contract.⁵

The definition of a notional principal contract is expanded under the proposed regulations by expressly providing that credit default swaps are included in such definition.⁶ This includes credit default swaps that permit or require physical settlement in satisfaction of one leg of the swap. This proposed definition of a notional principal contract is intended to be the operative definition for all federal income tax purposes, except where a different or more limited definition is specifically provided.

The proposed regulations also expand those “specified indices” which notional principal contracts can reference. According to the preamble, the IRS and Treasury felt that a swap on a non-financial index should be treated as a notional principal contract. The proposed regulations expand a “specified index” to include those non-financial indices that comprise any objectively determinable 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, and that cannot be reasonably expected to front-load or back-load payments accruing under the contract. For example, a “weather swap” would be treated as a notional principal contract under the proposed regulation.

In addition to addressing notional principal contracts, the proposed regulations provide guidance on the definition of a regulated futures contract and what constitutes a “qualified board or exchange.” The IRS and Treasury had to limit those section 1256 futures contracts that trade on designated contract markets to avoid mass confusion as, under Dodd-Frank, a “designated contract market” may trade both futures contracts and swap contracts, although there will be specified reporting rules for swap contracts. Therefore, the proposed regulations provide that a regulated futures contract qualifies for section 1256 treatment only if the contract is a futures contract that is not required to be reported as a swap for CFTC purposes. The proposed regulations also explain the IRS’s updated process to qualify as a “qualified board or exchange” for purposes of section 1256. As Dodd-Frank provides the CFTC with authority to adopt rules and regulations that require registration of a foreign board of trade that provides U.S. participants direct access to the foreign board of trade’s electronic trading system, the IRS has conditioned a foreign exchange’s “qualified board or exchange” status on the exchange continuing to satisfy certain CFTC conditions.

If adopted, the proposed regulations would be effective for all contracts entered into on or after the date such regulations are finalized.

⁴ Current Treasury Regulations define a notional principal contract 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.

⁵ If adopted, this rule would treat certain “bullet swaps” as notional principal contracts.

⁶ In Notice 2004-52 the IRS and Treasury requested comments from the public for specific guidance on the tax treatment of credit default swaps.

Client Alert.

Contact:

Thomas A. Humphreys

(212) 468-8006

thumphreys@mofo.com

Remmelt A. Reigersman

(212) 336-4259

rreigersman@mofo.com

Jared B. Goldberger

(212) 336-4441

jgoldberger@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.