

Clients & Friends Memo

Proposed Treasury Regulations Regarding Swaps and Other Notional Principal Contracts

September 21, 2011

On Thursday, September 15, the Treasury Department and the Internal Revenue Service issued [proposed regulations](#) that affect swaps and other notional principal contracts. The proposed regulations are proposed to be effective for contracts entered into on or after the date the final regulations are published in the Federal Register.

I. Summary of the Proposed Regulations

Credit Default Swaps Treated as Notional Principal Contracts. The proposed regulations treat credit default swaps as notional principal contracts for federal income tax purposes, even if they permit or require physical delivery of the underlying debt instrument. This aspect of the proposed regulations, while helpful in eliminating some uncertainty regarding the taxation of credit default swaps, raises a number of questions, which are discussed below in Part II.B.

Significant Limitation on the Scope of “Bullet Swaps.” Proposed regulations issued in 2004 provide that a “bullet swap” that provides for (i) the computation of an amount or amounts due from one party to another by reference to a specified index upon a notional principal amount and (ii) settlement of all of the parties’ obligations at or close to maturity of the contract is not subject to the notional principal contract rules; instead recognition of all payments is deferred until maturity and may produce long-term capital gain.

The proposed regulations issued on Thursday treat bullet swaps with payments that are fixed prior to settlement as notional principal contracts. Thus, under these proposed regulations, an equity swap under which all payments (including substitute dividend payments) are deferred until maturity is treated as a notional principal contract because the substitute dividend payments are periodic payments that are fixed prior to maturity.

While this is a sensible result, it highlights the significant differences in taxation between economically similar financial instruments. These differences are discussed below in Part II.C.

Weather-Related Swaps and Other Swaps Based on “Non-Financial Information” May Qualify as Notional Principal Contracts. The proposed regulations provide that weather-related swaps and other swaps with specified indices based on non-financial information (such as catastrophe swaps) are treated as notional principal contracts for federal income tax purposes so long as the information is (i) objectively determinable, (ii) not within the control of either of the parties and not unique to one of the parties’ circumstances, and (iii) cannot be reasonably expected to front-load or back-load payments accruing under the contract.

This aspect of the proposed regulations is helpful because it confirms that many weather swaps, and earthquake, windstorm, hurricane and other catastrophe swaps qualify as notional principal contracts, and therefore are not subject to U.S. withholding tax. However, the provision also raises several questions, which are discussed below in Part II.D.

Conformity of the Definition of Notional Principal Contract in Regulations Sections 1.863-7 and 1.512(b)-1 with Section 1.446-3. The definition of notional principal contract in regulations section 1.863-7 (which addresses the source of payments, and therefore determines whether U.S. withholding tax applies to payments under a swap) and section 1.512(b)-1 (which provides that payments on a notional principal contract are not generally “unrelated business taxable income” and therefore are not taxable to a tax-exempt organization) are conformed to the definition in regulations section 1.446-3. This helpful rule eliminates some uncertainty as to whether different definitions of notional principal contract applied for purposes of each section.

Notional Principal Contracts Are Not Subject to Mark-to-Market Treatment Under Section 1256. The proposed regulations provide that notional principal contracts and options on notional principal contracts are not marked-to-market under section 1256, even if they would otherwise be subject to section 1256. This proposed regulation implements section 1601 of the Dodd-Frank Act, which added section 1256(b)(2)(B).

Regulated Futures Contracts That Are Required To Be Reported As Swaps Under the Commodity Exchange Act Are Not Treated as Section 1256 Contracts. The proposed regulations provide that if a regulated futures contract is in the future required to be reported as a swap under the Commodity Exchange Act, it is not treated as a regulated futures contract for purposes of section 1256 and is not marked-to-market.

“Off-Exchange” Transactions That Are Subject To the Rules of a Designated Contract Market Are Marked-to-Market Under Section 1256. Under the proposed regulations, “off-exchange” transactions, such as transfer trades or office trades, or an exchange of (i) futures contracts in connection with a cash commodity transaction, (ii) futures for cash commodities, or (iii) futures contracts for swaps that are carried out subject to the rules of a Commodities Futures

Trading Commission (“CFTC”) designated contract market are section 1256 contracts subject to mark-to-market treatment under section 1256.

II. Discussion

A. Background

1. Notional Principal Contracts with Contingent Nonperiodic Payments. Final regulations issued in 1993 define a “notional principal contract” as a financial instrument that provides for (i) the payment of amounts by one party to another, (ii) at specified intervals, (iii) calculated by reference to a “specified index,” (iv) upon a notional principal amount, (v) in exchange for specified consideration or a promise to pay similar amounts.¹ Notional principal contracts include interest rate swaps, currency swaps, caps, floors, and equity swaps, but do not include options and forwards.

The 1993 final regulations comprehensively address the treatment of notional principal contracts that provide for payments on an annual or more frequent basis, such as interest rate and currency swaps. However, these regulations do not expressly address the tax treatment of equity and similar swaps that provide for contingent “nonperiodic” payments (such as the payment at maturity of an equity swap equal to the appreciation or depreciation of the reference equity over the life of the swap).

In the absence of guidance, taxpayers took the position that the periodic payments on such a swap were recognized currently, but that gain or loss on the final contingent payment was deferred until it became fixed. Thus, a taxpayer that held a “long position” under an equity swap generally claimed current deductions for the LIBOR-based periodic payments it made, and reported currently any substitute dividend payments that it received, but deferred inclusion of any appreciation payment until maturity.

Regulations proposed in February 2004 would impose a modified mark-to-market method of accounting for these and other contingent swaps that provide for contingent nonperiodic payments. The 2004 proposed regulations generally require the parties to contingent swaps to estimate future

¹ Treasury regulations section 1.446-3(c).

A “specified index” is (i) a fixed rate, price, or amount, (ii) a fixed rate, price, or amount for one or more specified periods followed by one or more different fixed rates, prices, or amounts applicable in other periods, (iii) an index that is based on objective financial 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), or (iv) an interest rate index that is regularly used in normal lending transactions between a party to the contract and unrelated persons. Treasury regulations section 1.446-3(c)(2).

Except as otherwise indicated, all references to section numbers refer to the Internal Revenue Code, and the Treasury regulations issued or proposed thereunder.

contingent nonperiodic payments, and accrue the estimate over time, subject to annual re-estimates.² The preamble to the 2004 proposed regulations provides that, if a taxpayer has not adopted a method of accounting for contingent swaps that were in effect or entered into on or after 30 days after publication of the proposed regulations, the taxpayer is required to account for any contingent nonperiodic payments over the life of the contract under a reasonable method (even in the absence of final regulations). Thus, the 2004 preamble effectively held that taxpayers could not defer the maturity payment on an equity swap.

2. Bullet Swaps. On the other hand, the proposed regulations issued in 2004 provide that a “bullet swap” that provides for (i) the computation of an amount or amounts due from one party to another by reference to a specified index upon a notional principal amount and (ii) settlement of all of the parties’ obligations at or close to maturity of the contract is not subject to the notional principal contract rules; instead all payments are deferred until maturity and may produce long-term capital gain. Some taxpayers took the position that if an equity swap provided for all payments (including substitute dividend payments) to be deferred until maturity, then all gain or loss at maturity or upon an earlier termination of the contract gives rise to capital gain or loss, including the payments with respect to dividends.

3. Credit Default Swaps. The 2004 proposed contingent swap regulations did not indicate whether they were intended to apply to credit default swaps, but government officials publicly indicated that they were not intended to apply to credit default swaps.³

In 2004, the IRS issued Notice 2004-52, which expressed uncertainty as to the proper characterization and treatment of a credit default swap for federal income tax purposes, and requested comments. Among the possible characterizations suggested in the notice are “a contingent option or notional principal contract, a financial guarantee or standby letter of credit, and an insurance contract.”

B. Credit Default Swaps Under the Proposed Regulations

The proposed regulations issued on Thursday apparently resolve the uncertainty regarding credit default swaps and treat credit default swaps as notional principal contracts. This treatment is helpful because payments on a notional principal contract made to a foreign person are generally foreign-sourced and not subject to U.S. withholding tax. Accordingly, if the proposed regulations are finalized, cross-border payments on credit default swaps generally will not be subject to U.S.

² The proposed regulations also allow the parties to certain swaps to elect mark-to-market treatment.

³ See Lee A. Sheppard, IRS Inching Toward Answers on Financial Products, 2010 Tax Notes Today 184-1 (September 22, 2010) (reporting that “The IRS stands by its position that the proposed contingent payment swap regulations do not apply to credit default swaps . . .”).

withholding tax. However, the proposed regulations' treatment of credit default swaps raise several other questions.

First, because there are no final rules in effect for notional principal contracts with contingent nonperiodic payments (which arguably include credit default swaps), it remains unclear whether the existing proposed contingent swap regulations apply to credit default swaps and, in any event, it is expected that these proposed regulations will be substantially revised before being finalized. Therefore, it is entirely uncertain whether the contingent payment under a credit default swap is accrued or otherwise accounted for before maturity of the swap and, if so, how.

Second, the existing regulations do not contemplate notional principal contracts that provide for physical settlement (other than foreign currency swaps), and it is unclear how credit default swaps that provide for physical settlement will be taxed. For example, if a debt instrument is delivered under a credit default swap, the value of the debt instrument could be treated as a payment under the swap that is offset against the credit protection payment. In this case, the debt instrument would be treated as received with a fair market value basis, which would appear to be a sensible result. Alternatively, it is possible that the party receiving the debt instrument would not be permitted to deduct its credit protection payment and would instead receive the debt instrument with a basis equal to the payment.

Third, the proposed regulations issued on Thursday do not contain a definition of credit default swap and it is unclear whether financial instruments that are economically similar to credit default swaps, such as credit-linked notes, credit options, and financial guarantees, will be treated as credit default swaps and subject to the notional principal contract rules. Similarly, it is unclear whether a contract that satisfies both the definition of an insurance contract and a notional principal contract is treated as insurance or as a notional principal contract for federal income tax purposes.

C. Bullet Swaps Under the Proposed Regulations

The proposed regulations issued on Thursday narrow the scope of bullet swaps and provide that a payment amount that becomes fixed during the term of a swap is treated as a payment, even if the amount is not paid until a later date. Thus, under the proposed regulations issued on Thursday, an equity swap that provides for a single payment at maturity that reflects both appreciation or depreciation and dividend payments during the term of the swap is a notional principal contract and the recipient of the substitute dividend payment would be required to accrue the payment when it became fixed.

This change is sensible because it would prevent taxpayers from using equity swaps to defer inclusion of substitute dividend payments and prevent the use of swaps to convert ordinary income to capital gain. However, because there are no final regulations addressing the tax treatment of

contingent swaps, it is uncertain how the parties should account for the maturity payment. Moreover, this swap highlights how changes in terms of financial instruments that may be economically insignificant can dramatically affect the tax treatment of the instrument.

For example, under the proposed regulations, a five-year bullet swap that provides for the receipt of a positive amount (or payment of negative amount) at maturity equal to (i) the appreciation, if any, in a specified number of shares of Google or Berkshire Hathaway, plus (ii) any dividends paid on that number of shares over the term of the contract, less (iii) a fixed amount in the nature of a finance charge, and less (iv) any depreciation in the shares, is treated as a notional principal contract under the proposed regulations, and presumably will be subject to contingent swap rules that require the maturity payment to be accrued in some manner prior to maturity. However an identical contract that does not include dividends would be treated as a forward contract for federal income tax purposes and all gain or loss would be deferred until maturity (even though there is no meaningful economic difference between the contracts because neither Google nor Berkshire Hathaway pay dividends).

D. Weather and Catastrophe Swaps

Under the 1993 final notional principal contract regulations, a specified index includes any index that is based on any current, objectively determinable financial or economic information that is not within the control of either party and is not unique to one of the parties' circumstances.⁴ However, weather swaps that provide for payments based on the number of "degree days" during a specified period, and catastrophe swaps that provide for a payment upon the occurrence of a hurricane, windstorm, or earthquake, do not directly relate to financial or economic information (although the events all have economic consequences). Therefore, it was uncertain whether these swaps qualified as notional principal contracts.

The proposed regulations helpfully provide that weather-related swaps and other swaps with specified indices based on non-financial information are treated as notional principal contracts for federal income tax purposes so long the information is (i) objectively determinable, (ii) not within the control of either of the partners and not unique to one of the parties' circumstances, and (iii) cannot be reasonably expected to front-load or back-load payments accruing under the contract.⁵

Therefore, if the proposed regulations are finalized, typical weather and catastrophe swaps will qualify as notional principal contracts, and payments on them to a foreign person will generally be foreign-source income and not subject to withholding tax. However, the proposed regulations do raise several questions.

⁴ Treasury regulations section 1.446-3(c)(2)(iii)(4)(ii).

⁵ Proposed Treasury regulations section 1.446-3(c)(2)(ii)(C).

First, why are contracts based on non-financial information that front-load or back-load payments disqualified as notional principal contracts? While it may be appropriate to account for swaps with front-loaded or back-loaded payments differently than conventional swaps, it is entirely unclear how a front-loaded or back-loaded weather derivative would be treated if it is disqualified as a notional principal contract. Moreover, it is unclear why this condition applies only to swaps with non-financial indices.

Second, it is unclear whether a contract that satisfies both the definition of an insurance contract and a notional principal contract is treated as insurance or as a notional principal contract for federal income tax purposes.

Third, as with credit default swaps, how are these notional principal contracts (which provide for contingent nonperiodic payments) taxed?

Fourth, just how broad is this inclusive definition of a notional principal contract? The proposed regulations do not expressly exclude swaps that reference sporting events and other subjects of wager from the definition of notional principal contract. Can taxpayers create swaps that reference sporting events and take the position that the wagers are notional principal contracts because they satisfy the definition of a notional principal contract? We assume that the drafters did not intend to treat a swap that provides for periodic payments based on the number of games the Yankees win as a notional principal contract and we would expect the final regulations to clarify this point.

And finally, the preamble to the proposed regulations suggests that weather (and catastrophe) swaps may not qualify as notional principal contracts under current law. This suggestion creates uncertainty for the large number of swaps currently outstanding. By some estimates, the catastrophe swap market is in excess of \$10 billion notional and the weather swap market is approximately \$12 billion notional.

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If you have any questions about the foregoing, please contact David S. Miller, Mark Howe, Daniel J. Mulcahy, Shlomo Boehm, or any other member of our [Tax Department](#).