



## Proposed IRS Regulations Clarify Tax Treatment of CDS and Other Derivatives

The U.S. Internal Revenue Service (“IRS”) has released proposed regulations that would treat credit default swaps (“CDS”) as notional principal contracts (“NPCs”) and would also generally allow over-the-counter derivative contracts that are based on objective non-financial information (such as weather derivatives) to qualify as NPCs. The proposed regulations would also exclude NPCs from the mark-to-market system of Section 1256 of the U.S. Internal Revenue Code (the “Code”). The proposed regulations were set forth in a Notice of Proposed Rulemaking and Notice of Public Hearing issued on September 16, 2011.<sup>1</sup>

### Background

There has been substantial uncertainty regarding the proper U.S. federal income tax treatment of certain derivative transactions since final NPC regulations were published in 1993.<sup>2</sup> In particular, it has not been clear:

- How to characterize CDS (for example, as NPCs, options, guarantees, insurance or other instruments);
- How to characterize derivative contracts that are not based on financial information (including weather derivatives); and
- Which derivatives that are traded on an exchange or centrally cleared should be treated as contracts subject to the mark-to-market recognition system under Section 1256 of the Code (“Section 1256 Contracts”).

### CDS and Other Contracts Would be Treated as NPCs

The proposed regulations would treat CDS as NPCs; however, the proposed regulations do not provide a definition of CDS. A CDS would be treated as an NPC even if it provides for physical delivery of an identifiable deliverable obligation. Prior to the proposed regulations, many tax practitioners did not believe that a CDS that provided for physical delivery, versus payment of a pre-agreed price (typically par), of a deliverable obligation (as opposed to providing for cash settlement based on a market-priced snapshot or other metric) should be treated as a CDS.

<sup>1</sup> Notice of Proposed Rulemaking, 76 Fed. Reg. 57684 (Sep. 16, 2011). A copy of the proposed regulations is available at <http://frwebgate2.access.gpo.gov/cgi-bin/PDFgate.cgi?WAISdocID=ND8E0g/1/2/0&WAISection=retrieve>.

<sup>2</sup> Treas. Reg. § 1.446-3 (1993).

The proposed regulations do not specifically address how to account for a protection seller's contingent payment obligations and do not provide transitional guidance for persons currently accounting for CDS under a different method.

In addition, the proposed regulations would expand the definition of NPCs to include contracts that are based on objective non-financial information that is not within the control of the parties and that cannot be reasonably expected to back-load or front-load payments under the contract. The only specific example of such contracts provided by the proposed regulations is weather derivatives, but arguably catastrophic risk and longevity derivatives would fall within this rubric.

## **Uniform Definition of NPC for Many Purposes Under the Code**

The proposed regulations would provide a uniform definition of NPC for many purposes under the Code (e.g., unrelated business taxable income,<sup>3</sup> sourcing of income,<sup>4</sup> subpart F income<sup>5</sup> and foreign currency transactions<sup>6</sup>). As a result, payments on a contract such as a CDS that qualifies as an NPC would be sourced to their recipient and therefore would generally not be subject to U.S. federal withholding tax.

## **Clarification Regarding Section 1256 Contracts**

The proposed regulations further clarify that an NPC would not be treated as a Section 1256 Contract, even if an NPC otherwise met the definition of a Section 1256 Contract under the Code. An option on an NPC also would not be treated as a Section 1256 Contract. In addition, a regulated futures contract that is required to be reported as a swap under the Commodity Exchange Act would not be treated as a Section 1256 Contract.<sup>7</sup>

## **Requirement for More than One Payment**

The proposed regulations modify the definition of an NPC to require that one party make more than one payment that meets the other requirements of the NPC regulations. For these purposes, a payment includes the fixing of an amount even if that fixed amount is paid on a later date.<sup>8</sup> Thus, a swap that provides for a single payment at maturity that is based on payments that became fixed on multiple dates during the term of the swap (e.g., LIBOR as of more than one date, or dividends declared on more than one date) will be treated as providing for more than one payment. However, the proposed regulations do not specify how to account for such a payment as to timing (if more than one taxable period is involved in the fixing) or character.<sup>9</sup>

## **No Update to 2004 Proposed Regulations**

Readers may recall that in 2004, the IRS released proposed regulations<sup>10</sup> addressing the timing for taking into account contingent payments on NPCs and the character of payments on NPCs. The 2004 proposed regulations stated that any payment on an NPC other than a termination payment would constitute ordinary income or expense rather than capital gain or loss. This proposed characterization gave rise to considerable controversy and, together with other elements of the 2004 proposed regulations, were the subject of discussion and disagreement among various industry groups and tax professionals. The new proposed regulations are not by their terms intended to work in tandem with

<sup>3</sup> Prop. Treas. Reg. § 1.512(b)-1(a), 76 Fed. Reg. 57684, 57689 (Sep. 16, 2011).

<sup>4</sup> Prop. Treas. Reg. § 1.863-7(a), 76 Fed. Reg. 57684, 57689 (Sep. 16, 2011).

<sup>5</sup> Prop. Treas. Reg. § 1.954-2(h)(3), 76 Fed. Reg. 57684, 57689 (Sep. 16, 2011).

<sup>6</sup> Prop. Treas. Reg. § 1.988-1 (a)(2)(iii), 76 Fed. Reg. 57684, 57689 (Sep. 16, 2011).

<sup>7</sup> See Prop. Treas. Reg. § 1.1256(b)-1(b), 76 Fed. Reg. 57684, 57689 (Sep. 16, 2011). The IRS may revise this section if the swap reporting rules under the Commodity Exchange Act are not finalized prior to this section.

<sup>8</sup> Prop. Treas. Reg. § 1.446-3(c)(1)(ii), 76 Fed. Reg. 57684, 57687 (Sep. 16, 2011).

<sup>9</sup> For example, it is not clear whether such a payment should be accounted for as a nonperiodic payment, a termination payment or as a series of periodic payments.

<sup>10</sup> Notice of Proposed Rulemaking, 69 Fed. Reg. 8886 (Feb. 26, 2004).

the 2004 proposed regulations and do not address the timing of contingent payments on NPCs or the character of payments on NPCs.

## Effective Date and Public Hearing

The proposed regulations will not be effective until finalized. Although the proposed regulations reflect the current view of the U.S. Treasury Department and the IRS on the treatment of NPCs, they do not necessarily affect the treatment of prior transactions. The IRS is accepting comments from the public and will hold a public hearing regarding the proposed regulations on January 19, 2012.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

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