

INTERNAL REVENUE SERVICE PROPOSES REGULATIONS DEFINING SCOPE OF EXCLUSION OF SWAPS FROM SECTION 1256 AND REVISING DEFINITION OF NOTIONAL PRINCIPAL CONTRACTS

On September 16, 2011, the Internal Revenue Service issued proposed regulations providing guidance as to the swaps and similar agreements that are described in section 1256(b)(2)(B) of the Internal Revenue Code and revising the definition of notional principal contracts under section 1.446-3 of the Income Tax Regulations.¹

Swaps Excluded from Definition of Section 1256 Contracts

Section 1256(b)(2)(B) was added to the Internal Revenue Code as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which was signed into law on July 21, 2010, and provides that “any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement” is not considered a “section 1256 contract.” Section 1256 contracts, defined as any regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts, must be marked to market each year; forty percent of any gain or loss from the marking to market must be treated as short-term capital gain or loss and sixty percent of any gain or loss from the marking to market must be treated as long-term capital gain or loss.

The proposed regulations provide that any contract, or option on such contract, that would be a notional principal contract under section 1.446-3(c) will not be treated as a section 1256 contract.² According to the Preamble to the proposed regulations, it was Congress’s intent in adding the list of swaps in section 1256(b)(2)(B) “that parallels the list of swaps included under the definition of a notional principal contract in section 1.446-3(c) . . . to harmonize the category of swaps excluded under section 1256(b)(2)(B) with swaps that qualify as notional principal contracts under section 1.446(c), rather than with the contracts defined as ‘swaps’ under section 721 of the Dodd-Frank Act.”³ This proposed regulation also reflects the view of the IRS and the Treasury Department that an option on a contract that would be treated as a notional principal contract is “closely connected with the underlying contract” and therefore should fall under the category of “similar agreement” in section 1256(b)(2)(B).⁴

¹ Notice of Proposed Rulemaking, Swap Exclusion for Section 1256 Contracts, 76 Fed. Reg. 57,684 (Sept. 16, 2011) (“NPRM”).

² Prop. Treas. Reg. § 1.1256(b)-1(a), NPRM at 57,689.

³ NPRM at 57,685.

⁴ *Id.*

Under the proposed regulations, a contract that fits both the definition of a notional principal contract and a section 1256 contract will be treated as a notional principal contract and not as a section 1256 contract.⁵ This language addresses contracts traded as futures contracts and therefore regulated by the Commodity Futures Trading Commission (the “CFTC”) that also satisfy the definition of a notional principal contract; such contracts are not within the category of contracts that Congress intended to be covered by section 1256, according to the Preamble.⁶

The proposed regulations also provide a definition of regulated futures contracts, one of the enumerated categories of section 1256 contracts set forth in the statute itself. Under the proposed regulations, a regulated futures contract will qualify as a section 1256 contract only if it is “a futures contract — (1) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market; (2) that is traded on or subject to the rules of a qualified board or exchange; and (3) that is not required to be reported as a swap under the Commodity Exchange Act.”⁷ This last requirement is intended “to properly limit section 1256 to futures contracts that trade on designated contract markets,” according to the Preamble.⁸ The Preamble acknowledges that the reporting provisions for swaps are not finalized and states that if the proposed regulations are to be finalized before the swap reporting rules are effective, then the Treasury Department and the IRS will determine whether this regulation needs to be amended.⁹ This definition also evidences the determination by the Treasury Department and the IRS that a regulated futures contract can include certain “off-exchange transactions.”¹⁰

Credit Default Swaps as Notional Principal Contracts

The definition of notional principal contracts has been revised to explicitly provide that credit default swaps will be considered notional principal contracts.¹¹ The proposed regulations provide that a credit default swap “that permits or requires the delivery of specified debt instruments in satisfaction of one leg of the contract is a notional principal contract if it otherwise satisfies the [definition of notional principal contracts provided in section 1.446-3(c)(1)(i)].”¹² However, the proposed regulations further provide, without explanation, that options and guarantees, which credit default swaps often closely resemble, are not considered notional principal contracts.¹³

⁵ Prop. Treas. Reg. § 1.1256(b)-1(a), NPRM at 57,689.

⁶ NPRM at 57,685.

⁷ Prop. Treas. Reg. § 1.1256(b)-1(b), NPRM at 57,689.

⁸ NPRM at 57,685.

⁹ *Id.*

¹⁰ *Id.*

¹¹ Prop. Treas. Reg. § 1.446-3(c)(1)(iii), NPRM at 57,688.

¹² Prop. Treas. Reg. § 1.446-3(c)(1)(iii)(A), NPRM at 57,688.

¹³ Prop. Treas. Reg. § 1.446-3(c)(1)(iv), NPRM at 57,688.

Two or More Payments Required: Effect on Bullet Swaps

The proposed regulations change the definition of notional principal contracts to clarify that such a contract “is a financial instrument that requires one party to make two or more payments to the counterparty 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.”¹⁴ For purposes of this definition, “a payment includes an amount that is fixed on one date and paid or otherwise taken into account on a later date.”¹⁵ These proposed rules may conflict with earlier proposed regulations under section 1234A of the Internal Revenue Code which exempt from notional principal contract treatment certain bullet swaps whose payments all settle at or close to maturity regardless of when amounts of the payments become fixed.¹⁶ Bullet swaps usually generate capital gain or loss at maturity, but notional principal contracts, under more complex rules, generate ordinary income or loss, unless terminated or transferred prior to maturity. The newly proposed regulations exclude forward contracts from the definition of a notional principal contract.¹⁷

Weather and Other Non-Financial Derivatives

For these purposes, the proposed regulations expand the definition of a specified index to include specified financial indices and specified non-financial indices.¹⁸ A specified non-financial index “is any objectively determinable information that — (A) is not within the control of any of the parties to the contract and is not unique to one of the parties’ circumstances; (B) is not financial information; and (C) cannot be reasonably expected to front-load or back-load payments accruing under the contract.”¹⁹ The Preamble cites swaps based on weather-related indices, such as temperature, precipitation, snowfall and frost as types of non-financial indices that may qualify under this definition.²⁰

Qualified Boards and Exchanges

The Preamble also discusses the impact of the CFTC’s proposed registration system for foreign exchanges on the definition of a qualified board or exchange for purposes of section 1256. To date, the Treasury Department and the IRS have determined that six foreign futures exchanges are qualified boards or exchanges under the statutory provision providing that a qualified board or exchange includes “any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of [section 1256].”²¹ The Preamble

¹⁴ Prop. Treas. Reg. § 1.446-3(c)(1)(i), NPRM at 57,687.

¹⁵ Prop. Treas. Reg. § 1.446-3(c)(1)(ii), NPRM at 57,687.

¹⁶ Prop. Treas. Reg. § 1.1234A-1(c)(2).

¹⁷ Prop. Treas. Reg. § 1.446-3(c)(1)(iv), NPRM at 57,688.

¹⁸ Prop. Treas. Reg. § 1.446-3(c)(2), NPRM at 57,688.

¹⁹ Prop. Treas. Reg. § 1.446-3(c)(2)(ii), NPRM at 57,688.

²⁰ NPRM at 57,686–57,687.

²¹ Section 1256(g)(7)(C).

acknowledges that in the past, this determination has been made based on whether the CFTC has issued a “direct access” no-action relief letter, a practice that would be replaced by the proposed registration system; therefore, the IRS “will continue to evaluate” these rules to determine whether it needs to change its process for deciding whether a foreign exchange should qualify as a qualified board or exchange.²²

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²² NPRM at 57,686.