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Credit Default Swaps Treated as NPCs Under Proposed Regs

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Summary by taxanalysts

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The proposed regs (REG-111283-11) provide guidance on the definition of swaps and similar agreements within the meaning of section 1256(b)(2)(B), along with the revised definition of NPCs.

"This is the most significant financial products guidance that's come out since the publication of the NPC regs," said Viva Hammer, a principal at KPMG LLP. "The IRS and Treasury are to be congratulated for putting it out in good time." (For REG-111283-11, see *Doc 2011-19606*. For prior coverage of the planned release, see *Doc 2011-11387* or *2011 TNT 102-5*.)

What Is in Section 1256 and What Is Out

Section 1256(b)(2)(B) was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA, P.L. 111-203) and was intended to carve out financial instruments that are not required or eligible to be marked to market. Under the provision, section 1256 contracts do not include "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." (For tax-related excerpts of the conference report to the DFA, see *Doc 2010-14454* or *2010 TNT 125-28*.)

That list of instruments that are excluded from mark-to-market treatment created significant uncertainty because although the list appeared to reference existing Treasury regulations on NPCs, the DFA itself included a swap definition that was much broader.

The proposed regulations tackle the problematic list. In the preamble, Treasury explained that it deduced that Congress meant to harmonize the category of swaps excluded under section 1256(b)(2)(B) with swaps that qualify as notional principal contracts under reg. section 1.446-3(c).

"The IRS had an impossible task of trying to provide rules for what is in and what is outside of section 1256," said Erika W. Nijenhuis, a partner at Cleary Gottlieb Steen & Hamilton LLP. "I think they did about as good a job as anyone could do." She said that although the approach that the rules took -- defining what is excluded from section 1256 by reference to tax law and what is included by reference to commodities law -- could leave some areas of overlap or exclusion, the regs ultimately set a pretty clear rule.

A consequence of the proposed regulations is that tax lawyers will have to consult their regulatory colleagues regarding what constitutes a swap under the Commodity Exchange Act.

Definition of NPC

Prior rules in reg. section 1.446-3(c) defined an NPC as an 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.

The preamble to the proposed regulations says that if a financial instrument has a single payment at maturity, but the payments are fixed during the payment period, the instrument is an NPC. "That is quite a significant statement, if it is supposed to be an interpretation of current law," said David H. Shapiro of PricewaterhouseCoopers LLP. He said the issue is likely to generate a number of comments to the IRS.

Nijenhuis said that change and the example in the proposed regulations that illustrate it are not consistent with other regulations regarding NPCs, which say that a payment made at maturity by reference to interest or dividends paid over a period of time is a non-periodic payment.

The new interpretation requires taxpayers to look beyond the timing of payments -- whether they are actually paid on a periodic or one-time basis -- and examine the way the payments are calculated. "There are certain very common transactions that call for a single payment that in financial theory are calculated by reference to offsetting amounts, but they aren't discussed in these terms" used in the preamble, said Shapiro. "There is a concern that somehow these regs might make you deem something a NPC that most people don't think is."

CDS Questions

A crucial piece of the proposed regulations is the determination that CDS are NPCs. Before the release of the proposed regulations, there was "significant uncertainty in the field and people are taking all kinds of positions, mostly whether CDS are options or NPCs," said Hammer.

Shapiro said it was not surprising that the government chose to treat CDS as NPCs. "In my view, it was the right thing to do, and although it may come as no surprise, it's very important that they did this," he said.

The appropriate treatment of CDS has been under consideration for years, explained Nijenhuis. The IRS published Notice 2004-52 seven years ago, requesting comments from taxpayers regarding how CDS should be handled for tax purposes. (For Notice 2004-52, 2004-2 C.B. 168, see *Doc 2004-14751* or *2004 TNT 139-8*.)

"These regulations say that CDS are derivatives, which is a great answer," she said. However, Nijenhuis explained that whether the regulation's conclusion that CDS are NPCs is a positive development depends on the taxpayer.

Shapiro added, "It's interesting that credit default swaps requiring physical delivery are being treated as NPCs, rather than as put options."

The decision to include CDS in reg. section 1.446-3 leaves open several important questions, however. Hammer, who was a Treasury attorney responsible for the original contingent NPC regulations, explained that the rules also need to address how to account for the final contingent payment on a CDS. "The problem with CDS is that you don't know whether there is going to be a final contingent payment," she said. Most CDS mature without any payment at all. "How do you tax account for a payment that will never be made in the overwhelming majority of cases?" she asked.

Another area that needs clarification and comment is the appropriate accounting methods for existing CDS. "What are we meant to do with our existing CDS that are not accounted for as NPC? They need to give taxpayers guidance as to how to transition a CDS portfolio to the NPC method if they are not already there," said Hammer.

Effective Date and Public Hearing

The proposed regulations are expected to apply to contracts entered into on or after the date final regulations are published. This effective date is intended to give taxpayers an opportunity to comment on the various issues in the proposed regs, said Hammer.

Also, taxpayers will have the opportunity to comment at a hearing before the IRS. The hearing is scheduled for January 19, 2012, and outlines of topics to be considered at the hearing must be received by the IRS by December 14, 2011.

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