Copyright © 2012 Tax Analysts
Tax Notes Today

JANUARY 18, 2012, WEDNESDAY

DEPARTMENT: News, Commentary, and Analysis; News Stories

CITE: *2012 TNT 11-1*

HEADLINE: #1 2012 TNT 11-1 THE RAMIFICATIONS OF THE EXPANDED NPC DEFINITION. (Section 1256 -- Futures Marked to Market) (Release Date: JANUARY 17, 2012) (Doc 2012-911)

CODE: *Section 1256* -- Futures Marked to Market;
Section 1001 -- Gain or Loss;
Section 446 -- Methods of Accounting

ABSTRACT: Karl Walli, senior counsel (financial products) in Treasury's Office of Tax Legislative Counsel, and Phoebe Mix, IRS special counsel and associate chief counsel (financial institutions and products), visited the Practising Law Institute seminar on financial products in New York on January 17 to discuss the proposed derivatives regulations.

AUTHOR: Sheppard, Lee A.
Tax Analysts

REFERENCES: Subject Area:
Financial instruments tax issues

TEXT:

Release Date: JANUARY 17, 2012

Published by Tax Analysts(R)

Karl Walli, senior counsel (financial products) in Treasury's Office of Tax Legislative Counsel, and Phoebe Mix, IRS special counsel and associate chief counsel (financial institutions and products), visited the Practising Law Institute seminar on financial products in New York on January 17 to discuss the proposed derivatives regulations.

The proposed regulations treat credit default swaps (CDSs) as notional principal contracts (NPCs; prop. reg. section 1.446-3(c)(1)(iii)). There is, however, no definition of CDS. The proposed rules limit the parameters of which CDSs can be considered NPCs. The IRS was moved to act by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA, P.L. 111-203), which removed swaps from *section 1256*. (For REG-111283-11, see *Doc 2011-19606* or *2011 TNT 180-13*. For tax-related excerpts of the conference report to the DFA, see *Doc 2010-14454* or *2010 TNT 125-28*.)

Many practitioners regard this as a logical, desirable result, because it clearly puts CDSs under the advantageous NPC source rule of *reg. section 1.863-7(b)*. But many others were treating cross-border CDSs as options, to avoid the gremlins that arise from the combination of claimed foreign residence and the NPC accounting rules.

What Embedded Loans?

© 2012, Tax Analysts, Tax Notes Today, JANUARY 18, 2012

Hedge funds and other pretend offshore investors are understandably nervous about being considered to be engaged in a U.S. trade or business, which would require their genuinely foreign investors to file U.S. tax returns.

They now fret that upfront payments on cleared swaps, required by the International Swaps and Derivatives Association, could be so significant that they could be considered loans under *reg. section 1.446-3(g)(4)*, which treats significant nonperiodic payments as loans. Spinning out the deemed loan fiction further, they worry that they could be in a U.S. trade or business of lending.

When a swap is cleared, the parties novate the contract to provide for an upfront payment by one party and the posting of collateral or variation margin by the other. The two payments cancel each other out initially, but the size of them can be substantial. (For prior analysis, see *Doc 2010-10959* or *2010 TNT 114-3*.)

The Managed Funds Association (MFA), which represents hedge funds, complained that significant upfront payments could unintentionally be considered loans for purposes of putting the funds in a U.S. trade or business of lending. Like other interested parties, the MFA was anxious to know when an upfront payment would be considered significant, fretting that even small upfront payments would be significant for some contracts. (For the MFA comments, see *Doc 2011-26814* or *2011 TNT 247-20*.)

The proposed regulations do not address the question whether a fund is in the U.S. trade or business of lending, Walli emphasized. Whether an activity rises to the level of a U.S. trade or business is a question of common law, he explained.

Mix noted that *section 1256* was historically enacted for futures contracts that provided for variation margin and daily marking. But, Mix argued, the legislative impetus for *section 1256(b)(2)(B)* was to prevent swaps from having 60/40 treatment, not to serve as a comment on the merits of the mark-to-market method for these contracts. The government retains the power to require mark-to-market accounting under *section 446(b)*.

KPMG LLP's Viva Hammer, who participated in the drafting of the deemed loan rule, argued that upfront payments are not disguised loans, but rather normal business practice and not necessarily abusive. So, given that the definition of NPC has been expanded to include CDSs, Hammer argued that the government should remove cleared NPCs from the ambit of the deemed loan rule.

Hammer would also exclude NPCs for which no deduction would be permitted for the upfront payment. The MFA likewise asked that any swap with on-market upfront pricing, for which collateral or variation margin is posted, be exempted from the deemed loan rules.

Walli countered that swap dealers use loan pricing models to determine the upfront payments. "Doesn't that give you pause?" he said. The government frets that if NPCs were excused from the deemed loan rule, loans would be disguised as NPCs. This is called structured finance, and heretofore it has been mainly a balance sheet abuse.

Hammer responded that the time value of money is accounted for in all financial contracts, but that does not mean that the underlying arrangement is a loan. Mix wondered whether the government was being asked to recognize the time value of money without calling the arrangement a debt.

The Payment Rule

Prop. reg. section 1.446-3(c)(1)(ii), the payment rule, provides that if the contract has some sort of payment that becomes fixed, it would be deemed to have two payments. The fixing of the amount of a later payment is deemed a payment.

CME Group (the old Chicago Mercantile Exchange and some others) wondered whether a variation margin payment could be considered a payment under the payment rule of prop. reg. section 1.446-3(c)(1)(ii). The CME was trying to defend *section 1256* treatment for Chicago players who had elected into it. (For the CME comments, see *Doc 2011-26811* or *2011 TNT 247-17*.)

© 2012, Tax Analysts, Tax Notes Today, JANUARY 18, 2012

Erika W. Nijenhuis of Cleary Gottlieb Steen & Hamilton LLP argued that variation margin should not be considered a payment under this rule. If variation margin is considered a payment, Mix responded, that would be tantamount to marking the contracts to market.

Swap dealers are required to mark their contracts to market, but Chicago is home to many swap participants who affirmatively elect *section 1256* for some contracts while refusing to elect to be treated as a mark-to-market trader under *section 475(f)*.

The practical problem here, Mix explained, was the practice of putting swaps in futures wrappers to obtain 60/40 treatment under *section 1256*. The IRS has been worried about this problem for a while, and the enactment of *section 1256(b)(2)(B)* gave the agency the impetus to act. Walli noted that the Commodity Exchange Act permits electivity with its self-certification system.

The proposed regulations provide that a regulated futures contract is a *section 1256* contract only if it is a futures contract that is not required to be reported to the Commodity Futures Trading Commission as a swap under the new DFA definition (prop. reg. section 1.1256(b)-1(b)). That means that reportable swaps would not be marked to market under *section 1256*. This would limit *section 1256* blended rates to futures contracts that are not included in the DFA definition.

Controversy rages over whether swaps based on indexes are deemed to have accruals that rise to the level of payments under the payment rule. Such contracts delineate a set of parameters at inception, then figure an amount to be accrued periodically and paid at the settlement date. At issue here are federal funds rate swaps, S&P 500 index swaps, and weather swaps, among others.

"A certain amount of paranoia has set in," Walli said, adding that people have been making "far-fetched" arguments. He promised that the government would refine the payment rule, hinting that swaps on composites that rely on fixed parameters would be excused. In every case, the contractual terms need to be analyzed.

Walli said that if an S&P 500 index contract has all the parameters known on day one except the amount to be paid on the settlement date, it should not be treated as a case for daily accruals. He argued that nothing has been accrued under such a contract, provided it was using day one dividend assumptions and not actual dividends. The government will study the federal funds rate contracts.

What type of accounting would apply to the accruals if the payment rule does not apply? The generally applicable matching rules of *reg. section 1.446-3(e)* and (f) require taxpayers to use accounting methods that achieve matching for both sides of an NPC. "It's not mysterious or difficult," Walli said. An accrual means that the party has effectively been paid, he added in response to practitioners' complaints that the party may never be paid.

Modifications

Most derivative contracts follow a universal template established by the ISDA. *Section 7* of the ISDA master prohibits transfer by either party without consent of the counterparty, unless there has been a default by the latter. Dealers are rearranging their businesses in response to the DFA, which anticipates that swaps will be cleared and strives to limit proprietary trading.

A proposed and temporary regulation issued in July would allow nonrecognition for dealer assignments of swaps under *section 1001* when a contract calls for consent by the counterparty, as swaps contracts commonly do. (For the proposed regulations (REG-109006-11), see *Doc 2011-15860* or *2011 TNT 141-7*. For the temporary regulations (T.D. 9538), see *Doc 2011-15858* or *2011 TNT 141-6*.)

This would seem straightforward, but there are lingering questions. Practitioners wanted to know what kind of modifications would fall out of the safe harbor provided by the new regulations.

© 2012, Tax Analysts, Tax Notes Today, JANUARY 18, 2012

Walli referred them to *reg. section 1.1001-3*, which interprets *section 1001* in light of *Cottage Savings.* He added that changes made according to contractual terms are unlikely to be modifications under *reg. section 1.1001-3*. (For *Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991),* see *Doc 91-3061* or *91 TNT 85-2*.)

Walli assured his audience that they could rely on the temporary regulations, and he could not say whether the final version would be identical. He explained that the regulations provide a safe harbor, not an interpretation of *section 1001*.

Nijenhuis wanted to know what would happen when consideration was paid for the assignment, but not to the non-assigning party, which would be excused from recognition. Surely the assigning party/payer made a loan to someone? Walli responded that the drafters did not want to give taxpayers an incentive to prefer termination over assignment. He promised to work out an explanation for the three-party situation.