

# Current Federal Tax Developments

By *William R. Pomierski*

## Swap Assignments Safe Harbor Extended in Anticipation of Dodd-Frank Implementation

When fully implemented,<sup>1</sup> the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) will require that standardized swaps (as defined therein) be cleared by a derivatives clearing organization (DCO) if (1) the appropriate regulatory agency (the CFTC for non-security-based swaps and the SEC for security-based swaps) approves them for clearing, and (2) a DCO will accept them for clearing. An exception will be available for so-called “end users.”<sup>2</sup> Even if a swap is not required to be cleared, an end user that enters into a swap with a swaps dealer may have the right to require that the swap be cleared at a DCO (if one will accept it).<sup>3</sup>

Clearing an over-the-counter (or bi-lateral) swap through a DCO results in the end user being exposed to the credit risk of the DCO rather than to the credit risk of a swap dealer. This shifting of credit exposure to a centralized clearing organization was one of the main goals of the Dodd-Frank Act. To the extent an outstanding swap transaction is required (or permitted) to be cleared under the Dodd-Frank Act, the process is likely to involve a novation pursuant to which a DCO is substituted as the counterparty to each of the swap dealer and the end user.

In addition to the clearing requirements, other aspects of the Dodd-Frank Act may require derivatives dealers to transfer open derivatives positions from one affiliate to another.<sup>4</sup> This process will likely involve a simple assignment by a current counterparty to a derivative to an affiliated entity, resulting in the end user having a new counterparty.

A critical tax question that arises in anticipation of the Dodd-Frank Act requirements is the impact, if any, resulting from an assignment of an existing swap transaction by a swaps dealer to a DCO or to an affiliated entity, as the case may be. The specific question is whether, from an end user’s perspec-




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tive, the substitution of a new counterparty results in a taxable exchange of property under Code Sec. 1001 even if all of the remaining terms of the swap remain unchanged.<sup>5</sup>

In anticipation of the eventual implementation of the Dodd-Frank Act clearing and other requirements, temporary and proposed regulations under Code Sec. 1001 were issued on July 22, 2011 (and corrected on August 19, 2011). These regulations provide an expanded safe harbor to the nonassigning counterparty to a derivative instrument that is assigned by either a dealer or a DCO. Unfortunately, these regulations fail to address other types of modifications of derivative instruments, a question that has been lingering for more than 20 years.

## Contract Modifications Under Code Sec. 1001

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Code Sec. 1001(c) generally provides for gain or loss to be recognized on the sale or exchange of property. Under Reg. §1.1001-1(a), “[e]xcept as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.” The determination of whether a taxable exchange has occurred for federal income tax purposes is not obvious, however, because definitive rules for determining whether a sale or exchange of property has occurred are not set out in Code Sec. 1001 or elsewhere.

In considering whether a change in the counterparty to a swap results in a taxable exchange by the nonassigning party, and the implications of the safe harbor provided by the 2011 temporary regulations, it is useful to first review the historical tax rules relating to assignments of notional principal contracts, beginning with a series of Treasury Regulations issued in the 1990s.<sup>6</sup>

## NPC Regulations

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Pursuant to Reg. §1.446-3, a payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of a party to a notional principal contract (NPC) is defined as a “termination payment.” A termination payment includes a payment made between the original parties to the contract (an extinguishment), a payment made between one party to the contract and a third

party (an assignment), and any gain or loss realized on the exchange of one NPC for another.<sup>7</sup>

Proposed NPC regulations issued in 1991 initially provided that where one party to an NPC assigned its remaining rights and obligations to a third party, the nonassigning party would be deemed to have engaged in a taxable exchange of the NPC, potentially resulting in the realization of gain or loss.<sup>8</sup> The theory behind the proposed regulations presumably was that a change in counterparty is a significant event and, therefore, should automatically be treated as an exchange within the meaning of Code Sec. 1001(a) and Reg. §1.1001-1(a).<sup>9</sup> The proposed NPC regulations treated the nonassigning party as if it had received (or paid) a termination payment from (or to) the assigning party, and then having paid (or received) the identical amount to (or from) the new counterparty in the form of a deemed up-front (nonperiodic) payment to enter into a new, off-market transaction. This deemed nonperiodic payment would then be deducted (or taken into income) over the remaining life of the deemed new NPC under the amortization rules for nonperiodic payments, thereby resulting in an artificial timing (and potentially tax character) whipsaw for the nonassigning party.

This automatic exchange approach for the nonassigning party was criticized at the time.<sup>10</sup> Among other criticisms, the approach taken by the Proposed NPC regulations would have established a definitive modification rule for NPCs that did not apply to other forms of derivatives, such as options and forwards. The Treasury Department backed off its original position when the NPC regulations were finalized in 1994. Instead of providing for an automatic taxable exchange, the final NPC regulations simply provided that where one party to an NPC assigns its remaining rights and obligations to a third party, the nonassigning party will realize gain or loss only if the assignment results in a deemed exchange and a realization event under Code Sec. 1001.<sup>11</sup>

## NPC Dealer Assignment Safe Harbor

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Between the time the NPC regulations were proposed and issued in final form, proposed regulations (the “Proposed Cottage Savings Regulations”) were issued addressing whether and when the modification of a debt instrument gives rise to a deemed exchange of the original debt instrument for the modified instrument.<sup>12</sup> The Proposed Cottage Sav-

ings Regulations did not address modifications of NPCs or other derivatives. Instead, the preamble to these regulations simply invited comment as to whether they should be expanded to include financial instruments.<sup>13</sup>

When the Cottage Savings Regulations were finalized in 1996, the Treasury took a limited step toward addressing modifications of non-debt financial instruments by issuing Temporary Reg. §1.1001-4T, which provided a safe harbor for assignments of NPCs by dealers.<sup>14</sup> Under Temporary Reg. §1.1001-4T, the substitution of a new counterparty to an NPC is not treated as a deemed exchange by the nonassigning party under Code Sec. 1001 if two requirements are met. First, the party assigning its rights and obligations under the contract and the party to which the rights and obligations are assigned must both be dealers in NPCs, as defined in Reg. §1.446-3(c)(4)(iii).<sup>15</sup> Second, the terms of the contract must permit the substitution of parties.

While this NPC assignment safe harbor was beneficial to derivative end users, it was limited in application. First, it applied only to NPCs. Accordingly, dealer assignments of other forms of nondebt financial instruments, such as options, bullet swaps and forward contracts, were not under the umbrella of this safe harbor. Second, it was not clear from the regulations what was required in order for an assignment to be considered permitted under the terms of the derivative contract. Many practitioners were concerned that this requirement might be satisfied only where the NPC was assignable by the dealer without the consent of the nonassigning party, which frequently is not the case.<sup>16</sup>

The preamble accompanying Temporary Reg. §1.1001-4T (1996) also made it clear that no inference was intended “with respect to whether an assignment of rights by one party to other types of bilateral contracts results in an exchange or other disposition under section 1001 by the nonassigning party.”<sup>17</sup> In other words, Temporary Reg. §1.1001-4T did not cause assignments of nondebt financial instruments that did not otherwise meet the safe harbor to result in an exchange for purposes of Code Sec. 1001. Accordingly, in the case of an assignment that did not satisfy the requirements of this safe harbor, uncertainty remained as to whether or not the nonassigning counterparty would be required to recognize a taxable exchange under the general rules of Code Sec. 1001 and Reg. §1.1001-1(a). These Regulations were issued as

final regulations (Reg. §1.1001-4) without modification in January, 1998.<sup>18</sup>

## **Dealer Assignment Safe Harbor Extended for Dodd-Frank Act**

Recognizing the limited and uncertain application of Reg. §1.1001-4, and the increased importance of a safe harbor in light of the clearing and other requirements expected to be imposed by the Dodd-Frank Act, temporary regulations were issued on July 22, 2011, replacing prior Reg. §1.1001-4.<sup>19</sup> These temporary regulations were corrected on August 19, 2011, to add commodities dealers and commodities derivatives financial instruments. The corrected version is effective as of July 22, 2011. These regulations are collectively referred to herein as the “Temporary Regulations.” The Temporary Regulations also serve as proposed regulations.<sup>20</sup> It should be noted that while the Dodd-Frank Act was the impetus for the Temporary Regulations, there is nothing in the regulations themselves that requires that an assignment be precipitated by the Dodd-Frank Act.

The Temporary Regulations are similar to the 1998 version of Reg. §1.1001-4, but change or relax certain requirements. Under the Temporary Regulations, a nonassigning counterparty does not recognize an exchange of a derivative contract for purposes of Code Sec. 1001 solely because a dealer or a clearinghouse transfers or assigns the derivative contract to another dealer or clearinghouse, provided that the transfer or assignment is permitted by the terms of the contract and the terms are not otherwise modified in a manner that results in a taxable exchange under Code Sec. 1001.

The Temporary Regulations apply to assignments of derivative contracts, whereas the prior version of the safe harbor only applied to NPCs. A derivative contract is defined for these purposes as a contract that (1) meets the definition of a security under Code Secs. 475(c)(2)(D), 475(c)(2)(E), or 475(c)(2)(F) (without regard to the exclusion of Code Sec. 1256 contracts), (2) meets the definition of a commodity under Code Secs. 475(e)(2)(B), 475(e)(2)(C), or 475(e)(2)(D) or (3) meets the definition of an NPC under Reg. §1.446-3(c)(1).

The Temporary Regulations redefine—and expand—the definition of a qualified assigning party and qualified assignee party. Under the 1998 version of Reg. §1.1001-4, both the party assign-

ing the NPC and the party to which the NPC was assigned had to be dealers in NPCs as defined in Reg. §1.446-3(c)(4)(iii). The Temporary Regulations now provide that the party assigning the derivative and the party accepting the derivative assignment must be a dealer or a clearinghouse. A dealer is defined as a taxpayer who meets the definition of a dealer in securities in Code Sec. 475(c)(1) or is a dealer in commodities derivative contracts.<sup>21</sup> A clearinghouse is defined as a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or a clearing agency (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))) that is registered, or exempt from registration, under each respective Act.

The Temporary Regulations continue the requirement that a transfer or assignment must be permitted by the terms of the contract to qualify for the safe harbor. However, the Temporary Regulations address this requirement and states that transfers or assignments will be considered permitted by the terms of the contract whether or not consent of the nonassigning counterparty is required.

Finally, the Temporary Regulations provide that if consideration passes between the assignor and assignee in connection with the transfer or assignment, the consideration will not affect the availability of the safe harbor for the nonassigning party. However, if any consideration is paid to or received by the nonassigning party, that payment or receipt is to be analyzed under the general principles of Code Sec. 1001 to determine whether a taxable exchange occurred. In addition, the preamble to the Temporary Regulations cautions that any other changes to the terms of the derivative contract must be analyzed under the general principles of Code Sec. 1001 to determine whether there has been a deemed sale or disposition of the derivative.

## Observations

The Temporary Regulations provide welcome assurances to end users whose derivative instruments may be assigned by a counterparty as a result of the implementation of the Dodd-Frank Act or otherwise. The extension of the dealer assignment safe harbor beyond NPCs was a positive step, as was the inclusion of clearinghouses as potential assignors or assignees. Also, the fact that the Temporary Regulations relaxed the consent question in relation to the requirement that an assignment be permitted alleviates one of the concerns under the prior regulations.

Unfortunately, there are still some gaps in the Temporary Regulations. For example, it is likely there may be hard to classify derivatives that do not fall cleanly within the definition of a derivative contract set out in the Temporary Regulations, such as a weather derivative that may not meet the definition of a security or a commodity under Code Sec. 475 or the definition of an NPC under Reg. §1.446-3.

Finally, it is worth noting that the preamble to the Temporary Regulations failed to repeat the no inference provision from the 1996 temporary regulations relating to assignments that do not meet the requirements of the safe harbor. Instead, citing Cottage Savings, the preamble to the Temporary Regulations state that “As a general matter, the assignment of a notional principal contract is treated as a taxable disposition to a nonassigning counterparty if the resulting contract differs materially either in kind or in extent.” This is in stark contrast to the no inference language included in the preamble to Temporary Reg. §1.1001-4, when issued in 1996. It is unclear whether this signals a potential change in view relating to assignments outside of the safe harbor.<sup>22</sup> Further guidance on assignments not meeting the requirements of the dealer safe harbor, as well as on other forms of modifications of nondebt financial instruments, is much needed.<sup>23</sup>

## ENDNOTES

<sup>1</sup> Many of the provisions of the Dodd-Frank Act were scheduled to take effect on July 16, 2011. However, implementation was delayed for six months. See CFTC Final Order re Effective Date for Swap Regulations, 76 FR 42508 (July 19, 2011).

<sup>2</sup> An end user is any entity that is not a “swaps dealer” or a “major swap participant” (as those terms are defined under the Dodd-Frank Act).

<sup>3</sup> The definition of a “swap” is set out in § 721 of the Dodd-Frank Act.

<sup>4</sup> For a discussion of the Dodd-Frank Act provisions potentially requiring assignments of open positions by derivatives dealers to affiliated entities, see SIFMA comment letter dated February 28, 2011, “Dodd-Frank Implementation and Tax Treatment of Derivative Positions Assumed by Affiliated Entities,” (the “SIFMA Letter”), at [www.sifma.org/WorkArea/DownloadAsset.aspx?id=23589](http://www.sifma.org/WorkArea/DownloadAsset.aspx?id=23589).

<sup>5</sup> Unless otherwise indicated, all references to “Code Sec.” and “§” are to the Internal

Revenue Code of 1986, as amended (the “Code”), or the Treasury Regulations promulgated thereunder.

<sup>6</sup> Notional principal contracts are a subset of derivative financial instruments and are defined in Reg. §1.446-3. The definition of a swap under the Dodd-Frank Act is broader than the tax definition of a notional principal contract.

<sup>7</sup> Reg. §1.446-3(h)(1).

<sup>8</sup> Proposed Reg. §1.446-3(e)(6) defined a “termination payment” as follows:

## ENDNOTES

- (6) TERMINATION PAYMENTS -- (i) DEFINITION. A payment, whether made or received, that extinguishes or assigns all or a proportionate part of the rights and obligations of any party under a notional principal contract is a termination payment for all parties to the contract. A termination payment includes a payment made between the original parties to the contract (an extinguishment), and a payment made between one party to the contract and a third party (an assignment).
- <sup>9</sup> Because Proposed Reg. §1.446-3(e)(6) was issued shortly after the Supreme Court's decision in *Cottage Savings*, S Ct, 91-1 USTC ¶15,018, 499 US 554, 111 S Ct 1503, the approach taken by the Treasury in the Proposed NPC Regulations may have reflected the uncertain application of Reg. §1.1001-1(a) immediately following *Cottage Savings*.
- <sup>10</sup> See TNT 139-25, ABA Members Offer Detailed Comments On Notional Principal Contract Regs. (Section 446 -- Methods of Accounting) (Doc. 92-5836), July 8, 1992.
- <sup>11</sup> Reg. §1.446-3(h)(1) ("A payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract is a termination payment to the party making the termination payment and the party receiving the payment. A termination payment includes a payment made between the original parties to the contract (an extinguishment), a payment made between one party to the contract and a third party (an assignment), and any gain or loss realized on the exchange of one notional principal contract for another. Where one party assigns its remaining rights and obligations to a third party, the original nonassigning counterparty realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event under section 1001.")
- <sup>12</sup> See Proposed Reg. §1.1001-3 published in the Federal Register on December 2, 1992.
- <sup>13</sup> For a thorough discussion of the issues relating to the application of Code Sec. 1001 and Reg. §1.1001-1(a) to derivatives, see James M. Peaslee, *Modifications of Non-Debt Financial Instruments as Deemed Exchanges*, 95 TAX NOTES 737 (Apr. 29, 2002).
- <sup>14</sup> In the preamble to the Final Cottage Savings Regulations (T.D. 8675), the Treasury says those regulations do not apply to nondebt instruments as follows:
- In the preamble to the proposed regulations, the IRS invites comments with respect to whether the regulations should be expanded to address modifications of financial instruments other than debt instruments. In response, several commentators argued that a dealer's assignment of its position in an interest rate swap contract or other notional principal contract should not result in an exchange under section 1001 for the nonassigning counterparty. In response to these comments, the IRS and Treasury are issuing proposed and temporary regulations that provide a special rule for dealer assignments of notional principal contracts. However, those temporary and proposed regulations and these final regulations do not address whether particular instruments are debt instruments for Federal income tax purposes. With the exception of those temporary and proposed regulations, the final regulations have not been expanded to cover the modification of financial instruments other than debt instruments. The modification of other instruments is less common than the modification of debt instruments, and the rules for modifications of debt instruments would not necessarily work well or be appropriate in determining whether modifications of other instruments result in exchanges under section 1001.
- <sup>15</sup> Reg. §1.446-3(c)(4)(iii) defines a dealer in notional principal contracts as a person who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in notional principal contracts with customers in the ordinary course of a trade or business.
- <sup>16</sup> For a detailed discussion of the consent issues relating to this safe harbor, see the SIFMA Letter.
- <sup>17</sup> T.D. 8676 (June 25, 1996).
- <sup>18</sup> T.D. 8763 (Jan. 28, 1998).
- <sup>19</sup> See Reg. §1.1001-4T(d) (2011). According to the preamble to the Temporary Regulations (T.D. 9538):
- The need to amend § 1.1001-4 has been increased by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 (124 Stat 1376 (2010)) (Dodd-Frank), which in some cases will necessitate the movement of entire books of derivative contracts. In particular, there is a concern that the assignment of derivative contracts may create a taxable event for the nonassigning counterparties to the assigned contracts. The IRS and the Treasury Department agree that § 1.1001-4 should be amended and expanded to include derivative contracts other than notional principal contracts. These temporary regulations replace the current, final regulations of § 1.1001-4."
- <sup>20</sup> By their terms, the Temporary Regulations expire on or before July 21, 2014.
- <sup>21</sup> It is not clear whether the reference to a dealer in commodities derivatives contracts is meant to track the definition of a dealer in commodities under Code 475(e), the definition of a commodities derivatives dealer under Code Sec. 1221(a)(6), or perhaps either definition. While not identical, these alternative definitions of a commodities dealer are similar, so it would appear that there is no slippage.
- <sup>22</sup> Note that for an end user, to the extent a swap assignment or other modification results in a deemed taxable exchange under Code Sec. 1001 and Reg. §1.1001-1(a), the potential character and/or timing mismatch may be mitigated in the case of derivative transactions that qualify as hedging transactions under Code Sec. 1221(a)(7) and Reg. §1.446-4.
- <sup>23</sup> Beyond counterparty assignments, there are other unanswered questions relating to the application of Code Sec. 1001 and Reg. §1.1001-1 to nondebt financial instruments. One recent example can be

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ENDNOTES

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found in Advice Memorandum 2010-005 (the "Advice Memorandum"). The Advice Memorandum, which was publicly released on November 12, 2010, is a letter prepared by the Office of Chief Counsel of the IRS. It is intended to provide written advice or instructions from Chief Counsel to field examiners and/or service center employees. See Code Sec. 6110(i); see also Dale S. Collinson, *Generic Legal Advice, a New Form of Nonprecedential*

*Legal Advice*, J. TAX'N FIN'L PRODS., Volume 6, Issue 3. Pursuant to Code Sec. 6110(k) (3), these determination letters cannot be used or cited as precedent. The Advice Memorandum sets out the IRS's position on whether the purchased call option described therein should be respected as an option, treated as another form of a derivative transaction, or should be recast as resulting in tax ownership of the reference securities. As a side note

to its option analysis, the IRS suggested in a footnote that a taxable event might occur under Code Sec. 1001 and Reg. §1.1001-1(a) each time the components of a derivative basket changed. For a detailed discussion of the Advice Memorandum, see William R. Pomierski, *Advice Memorandum 2010-005: Further Blurring of the Lines Between Tax Ownership and Derivative Transactions*, J. TAX'N FIN'L PRODS., Volume 9, Issue 2 (2010).

