

Derivatives Week

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Learning Curve®

Derivatives Taxation Under Dodd-Frank

The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in the summer of 2010 made an impact both in the U.S. and internationally. Dodd-Frank altered the landscape of the capital markets through an imposition of vast federal regulation. The U.S. Congress did not couple this new financial regulation with any related federal income tax rules. The Act dedicates a single page to taxation, addressing the federal income taxation of certain derivatives. This Learning Curve discusses the effect of Dodd-Frank on the taxation of derivatives, with a particular focus on section 1256 of the Internal Revenue Code and the swaps pushout rule.

Pre-Dodd-Frank & Section 1256

After the financial crisis, Congress reacted swiftly to address public outrage by enacting Dodd-Frank. Many suggested that over-the-counter derivatives contributed to the economic collapse. In response, Congress focused on increasing regulation of the OTC derivatives market and increasing transparency for the OTC derivatives market.

Prior to Dodd-Frank, most derivative contracts were privately negotiated between sophisticated parties in what is commonly referred to as the OTC derivatives market. OTC derivatives contracts were regulated bilaterally and tended to be highly customized and not exchange-traded. Historically, the market was not as heavily regulated as the exchange-traded market. Unlike the OTC derivatives market, which was regulated to an extent, there was a general lack of regulation in the tax realm. Although specific federal income tax provisions addressing the taxation of derivatives are sparse, one exception is section 1256. Section 1256 was enacted in the early 1980s as Congress's anti-abuse measure combating tax "straddle" shelters. The basic intent behind such shelters was the use of regulated futures contracts to create commodity straddles in an effort to defer capital gains and convert short-term capital gains into long-term capital gains (which are generally taxed at preferential

rates). Section 1256, in combination with other provisions, was the chosen weapon to eliminate such straddle shelters through the employment of a mark-to-market system, as well as a 60/40 character split between long-term and short-term capital gains and losses. More specifically, a taxpayer holding a regulated futures contract subject to section 1256 is required to mark the contract to market at the end of the taxable year and to treat 60% of any gain or loss as long-term capital gain or loss, and 40% as short-term capital gain or loss for federal income tax purposes. A regulated futures contract is defined as a contract "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, and which is traded on or subject to the rules of a qualified board or exchange." Since the enactment of section 1256 and its initial target of regulated futures contracts, its coverage has been expanded to include additional types of derivative contracts, including certain foreign currency contracts, non-equity contracts, dealer equity contracts, and dealer securities futures contracts, each as defined in section 1256.



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Dodd-Frank Impact

Dodd-Frank requires regulators, including the U.S. **Commodity Futures Trading Commission** and U.S. **Securities and Exchange Commission**, to establish a comprehensive regulatory framework for swaps and security-based swaps. Dodd-Frank creates parallel regulatory regimes for the CFTC and SEC, and divides jurisdiction between the two regulators based on whether a swap or a security-based swap is involved, with the CFTC having jurisdiction over the former and the SEC having jurisdiction over the latter. Not all derivatives are swaps under Dodd-Frank; a swap is defined to include specified

derivatives across various asset classes, but excludes, among other things, nonfinancial or security forwards that are intended to be physically settled, futures contracts, listed fx options, debt securities, securities options and forwards that are subject to the Securities Act of 1933 and the Securities Exchange Act of 1934, and security-based swaps. A security-based swap is a swap on a single security, loan, or certain type of index. A market participant must evaluate whether its swaps activities require that it register as a swap dealer or a major swap participant, as separate registrations are established by the CFTC and SEC depending upon the market participant's activities. If a market participant must register as a swap dealer or a major swap participant, it will become subject to substantial and significant new regulatory requirements. As far as clearing and trading requirements, standardized swaps must be cleared if the applicable regulator so determines and a clearing organization accepts the swaps for clearing. There are also specific rules governing a commercial end user exception, which eliminates the mandatory clearing requirement in certain cases.

The relevant question for federal income tax purposes is what the impact of the Dodd-Frank regulation of derivatives is on the tax treatment of such derivatives and in particular with respect to the application of section 1256. A regulated futures contract is defined as a contract "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, and which is traded on or subject to the rules of a qualified board or exchange." A qualified board or exchange is defined as "(i) a national securities

QUICK FACT:

U.S. Treasury regulation section 1.446-3 addresses the federal income tax treatment of instruments treated as "notional principal contracts." With the exception of the reference to credit default swaps, the Dodd-Frank exclusion from the definition of section 1256 contracts appears to be based on the current definition of a notional principal contract in these Treasury regulations.

exchange which is registered with the SEC; (ii) a domestic board of trade designated as a contract market by the CFTC; or (iii) any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section."

Since Dodd-Frank will cause increased exchange trading of derivatives through obligatory clearing of the instruments in many cases, it would seem that many more derivatives would be

caught up in the net of section 1256 by meeting the definition of

a "regulated futures contract" for federal income tax purposes. However, Congress amended section 1256 as part of Dodd-Frank to narrow the definition of what constitutes a section 1256 contract, thereby also narrowing the definition of a regulated futures contract. This amended definition now excludes "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." Presumably, this

exclusion was aimed at avoiding section 1256's

net from being cast too wide. However, it is not clear why there is a disconnect between the definition of swaps under Dodd-Frank and those swaps excluded from section 1256. While Congress could have linked the CFTC, SEC and tax definitions, the section 1256 carve-out appears to be based on the definition of a notional principal contract as defined in the U.S. Treasury Department regulations, with the addition of credit default swaps. As a result of this disconnect there was some uncertainty as to the application of section 1256 for federal income tax purposes with respect to derivatives that would be treated as swaps for Dodd-Frank purposes but not for section 1256.

In September, however, the U.S. **Internal Revenue Service** and Treasury issued proposed regulations providing guidance on the category of swaps and similar agreements that are excluded from the definition of a section 1256 contract and on the scope of the notional principal contract definition. Similar to the section 1256 amendment provided in Dodd-Frank, the proposed regulations also follow the definition of a notional principal contract, providing that a section 1256 contract does not include a contract that qualifies as a notional principal contract. The definition of a notional principal contract is expanded under the proposed regulations by expressly providing that credit default swaps are included in such definition. In addition, according to the preamble to the proposed regulations, the Internal Revenue Service and Treasury believe that an option on a notional principal contract should be treated as an agreement similar to a notional principal contract; therefore, the proposed regulations carve out options on notional principal contracts from section 1256 treatment as well. The proposed regulations provide that any contract that is both a section 1256 contract and a notional principal contract is treated as a notional principal contract, with

QUICK FACT:

FX swaps and FX forwards qualify as swaps unless the Secretary of the Treasury determines otherwise; however, notwithstanding any such determination, all FX swaps and FX forwards must satisfy certain reporting requirements.

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the result that such contract does not qualify for section 1256 treatment.

The proposed regulations also provide guidance on the definition of a regulated futures contract and what constitutes a “qualified board or exchange.” The Internal Revenue Service and Treasury had to limit those section 1256 futures contracts that trade on designated contract markets to avoid mass confusion as, under Dodd-Frank, a designated contract market may trade both futures contracts and swap contracts, although there will be specified reporting rules for swap contracts. Therefore, the proposed regulations provide that a regulated futures contract qualifies for section 1256 treatment only if the contract is a futures contract that is not required to be reported as a swap for CFTC purposes. The proposed regulations also explain the Internal Revenue Service’s updated process to qualify as a qualified board or exchange for purposes of section 1256. As Dodd-Frank provides the CFTC with authority to adopt rules and regulations that require registration of a foreign board of trade that provides U.S. participants direct access to the foreign board of trade’s electronic trading system, the Internal Revenue Service has conditioned a foreign exchange’s qualified board or exchange status on the exchange continuing to satisfy certain CFTC conditions.

The Swaps Pushout Rule

Section 716 of Dodd-Frank, known as the swaps pushout rule or the Lincoln Provision, essentially prohibits most banks from being dealers in many derivative instruments, by providing no “Federal assistance” to any swaps entity. The prohibition does not apply to insured depository institutions that limit their swap activities to (i) hedging and other similar risk mitigating activities directly related to their activities, and (ii) engaging in swaps involving rates or reference assets that are permissible for investment by national banks. For purposes of the exception in clause (ii), credit default swaps are permissible only if cleared. This prohibition only applies to swaps entered into after the end of the transition period of Dodd-Frank, which could be up to five years after enactment. A bank must either terminate prohibited activities or move such activities to a non-bank affiliate of the bank holding company. There are many unanswered questions with respect to the reach of this “swaps pushout” rule, including whether it applies to U.S. branches of foreign banks and whether it applies to foreign corporations owned by a federally incorporated bank subsidiary that acts as a holding corporation for said foreign corporations.

As Dodd-Frank did not enact an accompanying federal

MAJOR SWAP PARTICIPANT:

A major swap participant is any person who is not a swap dealer and:

- ▲ Maintains a “substantial position” in swaps for any major swap category, excluding positions held for hedging or mitigation of commercial risk;
- ▲ Outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets;
- ▲ Is a financial entity that is highly leveraged relative to the amount of capital that it holds, is not subject to any Federal banking agency’s capital requirements, and maintains a “substantial position” in outstanding swaps in any major swap category.

income tax provision to the swaps pushout rule, the tax implications will largely depend on how a bank chooses to comply. It is commonplace for a bank to book its swaps in one entity. However, in the post-Dodd-Frank world, banks will be forced either to book all swaps in a non-bank affiliate or split the swap activity among various related entities. Not only will the swaps pushout rule affect banks for federal income tax purposes, but it will have an impact on swap counterparties as well. If banks decide to comply by transferring existing swaps to a non-bank affiliate by means of an assignment, such an assignment may result in a recognition event to the counterparty for federal income tax purposes under the general principles of section 1001. For federal income tax purposes, gain or loss is recognized upon the exchange of property for other property differing materially either in kind or extent. Therefore, the nonassigning counterparty to any swap subject to a transfer may be treated as recognizing gain or loss. Since Treasury regulations

only addressed the transfer and assignment of derivatives that qualify as notional principal contracts for federal income tax purposes, public comments indicated these regulations were too narrowly drawn, especially for the post-Dodd-Frank world, since not all derivatives subject to the swaps pushout are necessarily treated as notional principal contracts for federal income tax purposes. In response to these comments, in July the Internal Revenue Service and Treasury expanded the regulations by issuing temporary and proposed regulations addressing the transfer and assignment of a broader set of derivative contracts.

The temporary and proposed Treasury regulations expanded the existing regulations by providing that there is no exchange to the nonassigning counterparty for federal income tax purposes, provided (i) both the transferring or assigning party and the party to which the rights and obligations are transferred or assigned are either a dealer, for federal income tax purposes, or a clearinghouse, (ii) the terms of the derivative contract permit the transfer or assignment of the contract (whether or not the consent of the nonassigning counterparty is required for the transfer or assignment to be effective), and (iii) the terms of the derivative contract are not otherwise modified in a manner that results in a taxable exchange. The definition of derivative contract has been expanded to not only include notional principal contracts but also an interest in, or a derivative financial instrument in, stock, a

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partnership, note, bond, other evidence of debt or certain hedges. In addition, if any consideration passes between the assignor and assignee in connection with the transfer or assignment, this will not affect the federal income tax treatment of the nonassigning counterparty.

Conclusion

While Dodd-Frank barely scratched the surface on tax regulation,

the implementation of any financial reform will inevitably have tax consequences. The void left in the taxation of derivatives by Dodd-Frank will create significant amounts of guidance to be issued by the Treasury, or will lead to mass confusion for tax practitioners.

This week's Learning Curve was written by **Remmelt Reigersman**, partner, and **Jared Goldberger**, associate, at **Morrison and Foerster** in New York.

*Derivatives Week is now accepting submissions from industry professionals for the Learning Curve® section. For details and guidelines on writing a Learning Curve®, please call **Rob McGlinchey** at (44-20) 7303-1789.*