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Treasury Issues Proposed Regulations Treating CDS as NPCs

On September 15, the Treasury Department issued proposed regulations that would add credit default swaps (CDS) to the definition of a notional principal contract (NPC) under Treasury regulation section 1.446-3 (NPC Rules). The proposed regulations provide guidance on the definition of swaps and similar agreements within the meaning of Internal Revenue Code (IRC) section 1256(b)(2)(B), along with the revised definition of NPCs.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) added IRC section 1256(b)(2)(B), which excludes certain financial instruments from the definition of IRC section 1256 contracts so that they are not required or eligible to be marked-to-market. Instead, those financial instruments generally follow an acceptable accounting method under the NPC accounting rules, which may or may not be preferential depending on the taxpayer. Under IRC section 1256 as amended by Dodd-Frank, IRC 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."

The post-Dodd-Frank list of financial instruments that are excluded from mark-to-market treatment created significant uncertainty because the list appeared to reference the existing NPC Rules while Dodd-Frank itself included a swap definition that was much broader than the definition of NPCs in the NPC Rules. Treasury addresses this apparent conflict in the proposed regulations, explaining in the preamble to the proposed regulations that it believes Congress intended to harmonize the category of swaps excluded under IRC section 1256(b)(2)(B) with swaps that qualify as NPCs under the NPC Rules.

NPC Definition. The preamble to the proposed regulations states that the proposed regulations provide that an NPC requires one party to make two or more payments to a counterparty, but that the fixing of an amount is treated as a payment for this purpose even if the actual payment is to be made at a later date. It is unclear whether this statement is intended to be an interpretation of current law. The proposed regulations would require taxpayers to look beyond the timing of payments—whether they are actually paid on a periodic or one-time basis—and examine the manner in which payments are determined. Prior to the application of the proposed regulations, the NPC Rules define 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.

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CDS as NPCs. Under the proposed regulations, CDS, even those requiring physical delivery, would be treated as NPCs rather than options. Under the NPC Rules currently it is unclear whether CDS, including CDS that require physical delivery, are to be treated as options or NPCs.

Outstanding Issues. The proposed regulations do not address how to account for the final contingent payment on a CDS. In addition, the proposed regulations do not address the appropriate methods of accounting for existing CDS that are not being accounted for as NPCs.

Effective Date and Public Hearing. The proposed regulations would apply to contracts entered into on or after the date final regulations are published. The IRS will hold a hearing on the proposed regulations on January 19, 2012. The IRS must receive any outlines of topics to be considered at the hearing by December 14, 2011.

Click here for a copy of the proposed Treasury regulations.

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