Assignment of the Times: New Tax Rules Respond to Concerns Regarding Assignment of Derivative Contracts Required by Dodd-Frank

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On July 21, 2011, the Internal Revenue Service (IRS) and Treasury issued temporary regulations (T.D. 9538) that modify Treas. Reg. § 1.1001-4 and generally provide that an assignment of a derivative contract by a dealer (or a clearinghouse) to a dealer or clearinghouse generally will not result in a taxable exchange to the non-assigning counterparty. The temporary regulations are significant because the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires the transfer of certain derivative contracts. Although the stated purpose of the temporary regulations is to expand the existing exception for transfers of notional principal contracts to include most other derivative contracts that permit assignment, the temporary regulations make a possibly inadvertent, but obviously important, change by excluding commodity-based notional principal contracts from the exception. The temporary regulations also clarify that a contract will be treated as permitting assignment even if the non-assigning counterparty is required to consent to the assignment.

The IRS and Treasury acknowledged a need to amend the regulations under section 1001 because of Dodd-Frank, which, under the “Volcker Rule” and the “Bank Push Out Provision,” requires the movement of entire books of derivative contracts. A bank is required under the Volcker Rule to limit its proprietary trading activities, including investments in any securities or derivatives, to no more than 3% of its Tier One capital. In addition, a bank will lose federal deposit insurance, access to the Federal Reserve credit facility, and other potential federal assistance if it is registered as a swap dealer under the Bank Push Out Provision. As a result of these new rules, a bank may need to “push out” its derivatives trading activities to a subsidiary or another entity. Before the issuance of the temporary regulations, there was some concern that the transfer of existing derivative contracts could create a taxable event for the non-assigning counterparty.

The temporary regulations are meant to be an expansion of the prior regulations under section 1001 that provide that the assignment of a notional principal contract between dealers in notional principal contracts is not treated as a taxable exchange of the notional principal contract by the non-assigning counterparty, provided that the assignment was permissible under the terms of the notional principal contract. The prior regulations did not apply to derivative contracts other than notional principal contracts. Furthermore, it was unclear whether the prior regulations were applicable if the contract permitted assignment, but only with the consent of the non-assigning counterparty.

As noted above, the temporary regulations apply to transfers of derivative contracts described in section 475(c)(2)(D), (E), and (F) between dealers and clearinghouses, and are no longer limited to transfers of notional principal contracts. However, on account of the cross-reference to the provisions of section 475, which concern security-based derivative contracts, the temporary regulations exclude commodity-based notional principal contracts from the exception. Although this exclusion appears to be inadvertent, amended guidance will need to be published by the IRS and Treasury in order to confirm that conclusion.

The temporary regulations continue to require that the contract permit assignment, but clarify that a derivative contract is considered to permit assignment even if the assignment requires the consent of the non-assigning counterparty. With regard to a contract that otherwise does not permit assignment, consideration should be given to whether an assignment of such a contract following an amendment to permit assignment falls within the exception provided by the temporary regulations. That situation is not materially different from the situation where a contract provides for assignment but only with consent of the non-assigning counterparty. Nevertheless, if the requirement that the contract permit assignment is read this broadly, it makes that requirement effectively meaningless. Accordingly, if the contract must be amended to permit assignment, a facts and circumstances analysis under section 1001 and the common law rules articulated in the Supreme Court's 1991 decision in *Cottage Savings Association v. Commissioner* may well be warranted.

Notable caveats are included in the temporary regulations. One such caveat to the exception provided by the temporary regulations is that the non-assigning counterparty cannot receive a payment in connection with the assignment. If the non-assigning counterparty receives a payment, the determination of whether there has been a sale or exchange by the non-assigning counterparty will be made under section 1001 and the common law rules articulated in *Cottage Savings*. A further caveat to the exception provided by the temporary regulations is that the terms of the derivative contract that is transferred or assigned cannot otherwise be modified in a manner that results in a taxable exchange under section 1001.

The temporary regulations provide much needed guidance with respect to transactions that will be required by the Volcker Rule and Bank Push Out Provision of Dodd-Frank. Unfortunately, the temporary regulations provide little guidance with respect to assignments of derivative contracts between non-dealer taxpayers. The preamble to the temporary regulations notes that assignments outside the scope of the temporary regulations are subject to the common law rules articulated in *Cottage Savings*, *i.e.*, the assignment of a derivative contract is treated as a taxable disposition to a non-assigning counterparty *if the resulting contract differs materially either in kind or in extent*. There is no clear guidance as to when a derivative contract that has been assigned is considered to differ materially in kind or in extent. For example, does it matter whether the assignee has the same credit rating as the assignor? Is it relevant whether the contract is "in the money" to the assigning party? Guidance addressing the application of these rules outside the dealer context would be welcomed by many non-dealer taxpayers.

The text of the temporary regulations also serves as the text of proposed regulations on which the IRS and Treasury are seeking public comment. In particular, the IRS and Treasury specifically requested comments on the clarity of the new regulations and how they "may be made easier to understand." Comments on the new regulations are due by October 20, 2011.

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