

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9538]

RIN 1545-BK14

Modifications of Certain Derivative Contracts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that address when a transfer or assignment of certain derivative contracts does not result in an exchange to the nonassigning counterparty for purposes of §1.1001-1(a). The text of these temporary regulations also serves as the text of the proposed regulations (REG-109006-11) set forth in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Applicability Date: For the date of applicability, see §1.1001-4T(d).

FOR FURTHER INFORMATION CONTACT: Andrea M. Hoffenson, (202) 622-3920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

**Background**

Section 1001 of the Internal Revenue Code (Code) provides rules for the computation and recognition of gain or loss from a sale or other disposition of property. For purposes of section 1001, §1.1001-1(a) of the Income Tax Regulations generally provides that gain or loss is realized upon an exchange of property for other property differing materially either in kind or in extent. 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. See Cottage Savings Association v. Commissioner, 499 U.S. 554, 566 (1991) [1991-2 CB 34, 38] (“Under [the Court’s] interpretation of [section] 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are ‘materially different’-- that is, so long as they embody legally distinct entitlements.”). Section 1.1001-4(a) provides, however, that the substitution of a new party on a notional principal contract is not treated as a deemed exchange of the contract by the nonassigning party for purposes of §1.1001-1(a) if two conditions are satisfied: the assignment is between dealers in notional principal contracts and the terms of the contract permit the substitution.

Many notional principal contracts permit assignment of the contract only with the consent of the nonassigning counterparty. There has been some uncertainty as to whether a contract that requires the consent of the nonassigning counterparty as a condition to assignment will satisfy the second

requirement of §1.1001-4(a) as described in the previous paragraph. In addition, commenters have suggested that the scope of §1.1001-4 is too narrow because it only applies to notional principal contracts. 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.

### **Explanation of Provisions**

These temporary regulations provide that there is no exchange to the nonassigning counterparty for purposes of §1.1001-1(a) solely because a dealer in securities or a clearinghouse transfers or assigns a derivative contract to another dealer in securities or clearinghouse, provided that the transfer or assignment is permitted by the terms of the contract. The derivative contracts to which these regulations apply are those described in section 475(c)(2)(D), 475(c)(2)(E), or 475(c)(2)(F). In addition, these temporary regulations provide that transfers or assignments are permitted by the terms of the contract when

consent of the nonassigning counterparty is required as well as those transfers or assignments that do not require consent. If consideration passes between the assignor and assignee in connection with the transfer or assignment, the consideration will not affect the treatment of the nonassigning counterparty for purposes of §1.1001-4. If any consideration is paid to or received by the nonassigning counterparty, however, the payment or receipt of the consideration is analyzed under the general principles of section 1001 to determine its effect on the nonassigning counterparty. In addition, any changes to the terms of the contract are analyzed under the general principles of section 1001 to determine whether there has been a sale or disposition of the contract by the parties.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### **Drafting Information**

The principal author of these regulations is Andrea M. Hoffenson, Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1--INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.1001-4 is revised to read as follows:

#### §1.1001-4 Modifications of certain derivative contracts.

(a) through (d) [Reserved]. For further guidance, see §1.1001-4T(a) through (d).

Par. 3. Section 1.1001-4T is added to read as follows:

#### §1.1001-4T Modifications of certain derivative contracts (temporary).

(a) Certain assignments. For purposes of §1.1001-1(a), the transfer or assignment of a derivative contract is not treated by the nonassigning counterparty as a deemed exchange of the original contract for a modified contract that differs materially either in kind or in extent if--

(1) Both the party transferring or assigning its rights and obligations under the derivative contract and the party to which the rights and obligations are transferred or assigned are either a dealer in securities or a clearinghouse;

(2) 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

(3) The terms of the derivative contract are not otherwise modified in a manner that results in a taxable exchange under section 1001.

(b) Definitions. (1) Dealer in securities. For purposes of this section, a dealer in securities is a taxpayer who meets the definition of a dealer in securities in section 475(c)(1).

(2) Clearinghouse. For purposes of this section, a clearinghouse is 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.

(3) Derivative contract. For purposes of this section, a derivative contract is a contract described in section 475(c)(2)(D), 475(c)(2)(E), or 475(c)(2)(F) without regard to the last sentence of section 475(c)(2) referencing section 1256.

(c) Consideration for the assignment. Any consideration for the transfer or assignment that passes between the party transferring or assigning its rights and obligations under the contract and the party to which the rights and obligations

are transferred or assigned will not affect the treatment of the nonassigning counterparty for purposes of this section.

(d) Effective/applicability date. This section applies to transfers or assignments of derivative contracts on or after **INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER**.

(e) Expiration date. The applicability of this section expires on or before July 21, 2014.

Steven T. Miller  
Deputy Commissioner for Services and Enforcement.

Approved: July 15, 2011

Emily S. McMahon  
Assistant Secretary of the Treasury (Tax Policy).

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