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Delivered Electronically

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United States Department of the Treasury
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Internal Revenue Service
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RE: Dodd-Frank Implementation and Tax Treatment of Derivative Positions Assumed by Affiliated Entities

Dear Assistant Secretary Mundaca and Chief Counsel Wilkins:

The Securities Industry and Financial Markets Association ("SIFMA")[1] and its members are writing to request Internal Revenue Service guidance that we believe is necessary to allow certain derivatives dealers to properly implement key provisions of The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). More specifically, for the reasons set out below, the implementation of Dodd-Frank will in some cases necessitate the wholesale movement of books of over-the-counter derivative positions (e.g., notional principal contracts, forward contracts, over-the-counter options, etc.) between affiliates of derivatives dealers. As noted below, pursuant to standard and customary ISDA documentation these transfers will likely require counterparty consent. Under current law, for the reasons set out below, we do not think the resulting assumption of derivative positions by related affiliates should cause the counterparties (i.e., the customers) of the relevant derivatives dealers to be deemed, for tax purposes, to have terminated their derivative contracts and entered into new ones. Nevertheless, for the reasons set out below, it is important to have certainty on this point if counterparties are to consent to these transfers and the implementation of Dodd-Frank is to move forward in the manner that Congress has envisioned. As a result, we are seeking express confirmation (in the form of a notice or otherwise) that the assumption of a derivative position by a related derivatives dealer does not cause the assignor's counterparty to be deemed, for tax purposes, to have terminated its position and entered into a new one.

[1] SIFMA brings together the shared interests of securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

I. What Dodd-Frank Requires.

Dodd-Frank contains a number of provisions that will, as a practical matter, require derivatives dealers to move certain books of derivative transactions to different affiliates. Preparations and strategies for these movements are currently being discussed by such dealers, and tax uncertainty has been an impediment to the discussions.

More specifically, first, Sections 731 and 764 of Title VII of Dodd-Frank require the CFTC and the SEC, by July 10th of this year, to enact regulations that will require registration of, and will significantly regulate the conduct of business by, certain entities (hereafter "Regulated Derivatives Entities") that enter into "swaps" or "security-based swaps" as defined under Dodd-Frank and its implementing regulations.[2] (These terms include not only notional principal contracts but also a broad range of derivative transactions, such as certain over-the-counter option and forward contracts, that are not normally thought of as swaps per se.) While regulations have not yet been finalized, the CFTC has proposed regulations that would begin provisional registration of Regulated Derivatives Entities as early as April of this year and could require registration as early as July of this year. Regulated Derivatives Entities will be subject to extensive regulation, including business conduct standards, a reporting and recordkeeping regime, and capital and margin requirements. The CFTC and the SEC will monitor and change their regulatory requirements on an ongoing basis. In light of the detail, complexity and fluidity of the relevant regulatory requirements and the resulting compliance cost, an affiliated group will need to limit the number of Regulated Derivatives Entities that are required to register with the CFTC and SEC. By contrast, at present, numerous affiliates—both domestic and foreign—within the same affiliated group may enter into derivative positions with U.S. counterparties. Derivative positions of an affiliated group will therefore need to be consolidated into a limited number (e.g., one or two) of Regulated Derivatives Entities that can register and comply with the resulting regulatory requirements. Depending on each institution's decision as to the structure of its derivatives business, the resulting transfers may include cross-border assignments – i.e., from derivatives dealers outside the United States to Registered Derivatives Entities within the United States and vice versa.

Second, Section 716 of Title VII (the so-called "Lincoln Push-Out Rule") will (over the course of a series of rolling effective dates beginning in the summer of 2013) provide a significant limitation on the availability of "federal assistance" (including FDIC insurance and use of the Fed discount window) such that, effectively, U.S. banks can no longer be counterparties to certain derivative transactions. At present, however, many banks enter into these kinds of derivative transactions with customers in the ordinary course of business. Because the availability of federal assistance is essential for the conduct of a banking business in the United States, most market participants expect that these kinds of derivative positions will have to be moved to non-bank affiliates, presumably likewise to one or more Regulated Derivatives Entities. Regulated Derivatives Entities may in some cases benefit from a parent holding company guarantee, but for regulatory reasons they may not be able to benefit from a guarantee of the bank itself. There may therefore be some change in the credit of the derivatives dealer from the perspective of relevant counterparties. Regulated Derivatives

[2] As a general matter, "swaps" will be regulated primarily by, and will require the registration of the relevant Regulated Derivatives Entities with, the CFTC; and "security-based swaps" will be regulated by, and will require registration of the relevant Regulated Derivatives Entities with, the SEC.

Entities will in all cases be capitalized as required by the regulations of the SEC and CFTC, however, and the relevant counterparties would not consent to the assumption of derivative positions by the Regulated Derivatives Entities if they were not comfortable that the Regulated Derivatives Entities would in all scenarios be able to meet their payment obligations.

Although Dodd-Frank does not itself require any transfers of derivative positions entered into prior to the effective date of its relevant provisions, derivatives dealers may not, as a practical matter, be in a position to "leave old positions behind" in entities that are not able to comply with requirements that would be applicable to Regulated Derivatives Entities or that are otherwise not permitted to enter into new derivative transactions of a similar kind. For one thing, most customers enter into more than one position with a derivatives dealer, and the positions of any given customer are cross-collateralized and netted against each other to limit margin and collateralization requirements. Complex regulatory rules, including Section 23A of the Federal Reserve Act, and various record-keeping and other practical constraints prevent affiliated derivatives dealers from entering into "split" collateralization arrangements with customers across bank and non-bank entities. Moreover, even if an affiliate might be legally entitled to continue to hold legacy derivative positions, it might be imprudent as a practical matter to allow this to happen in cases where the affiliate no longer retains the necessary personnel, regulatory know-how and compliance infrastructure needed to monitor and deal with that kind of derivative.

Thus, in order to properly implement Dodd-Frank, derivatives dealers anticipate transferring entire books of existing positions to affiliated Regulated Derivatives Entities. As would normally be the case in arm's length dealing between affiliates, it is anticipated that there may be a payment to or from a transferee Regulated Derivatives Entity to reflect the net value of the relevant transferred books of derivative positions. Given that positions within a book tend to offset each other, however, the amount of any such payment would likely be small in relation to the notional amount of the transferred derivative transactions. (Alternatively, assignee Regulated Derivatives Entities may acquire the hedging positions of the assignor from other affiliates and then cancel these hedging positions in consideration of assuming and acquiring the relevant books of derivatives.)

Master Agreements published by the International Swaps and Derivatives Association (both the 1992 version and the 2002 version), under which the majority of current swaps and security-based swaps are documented, provide that a derivative position may only be transferred with the prior written consent of a counterparty, except in narrow cases.[3]

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[3] The 2002 version of the ISDA Master Agreement provides in § 7 that: "Subject to Section 6(b)(ii) and to the extent permitted by applicable law, neither this Agreement nor any interest or obligation in or under this Agreement may be transferred (whether by way of security or otherwise) by either party without the prior written consent of the other party, except that:—(a) a party may make such a transfer of this Agreement pursuant to a consolidation or amalgamation with, or merger with or into, or transfer of all or substantially all its assets to, another entity (but without prejudice to any other right or remedy under this Agreement); and (b) a party may make such a transfer of all or any part of its interest in any Early Termination Amount payable to it by a Defaulting Party, together with any amounts payable on or with respect to that interest and any other rights associated with that interest pursuant to Sections 8, 9(h) and 11. Any purported transfer that is not in compliance with this Section 7 will be void."

Section 6(b)(ii) reads as follows: "(ii) Transfer to Avoid Termination Event. If a Tax Event occurs and there is only one Affected Party, or if a Tax Event Upon Merger occurs and the Burdened Party is the Affected Party, the Affected Party will, as a condition to its right to designate an Early Termination Date under Section 6(b)(iv), use all reasonable efforts (which will not require such party to incur a loss, other than immaterial, incidental

Therefore, we believe most derivative dealers intend to solicit consent from their counterparties to make such transfers, rather than risk that the transfers would be void. As part of this solicitation process, it is possible that some transactions that were documented under ISDA Agreements antedating the current industry-standard 2002 ISDA Agreement may be updated to use the 2002 ISDA Agreement, as amended or supplemented by Protocols, though in no case will any substantive economic changes be made to the relevant derivative positions in connection with the updating of the ISDA Agreement.

II. Current Tax Treatment of the Assumption of a Derivative Position.

Under current law, a taxpayer realizes gain or loss from an exchange of property for other property that "differs materially either in kind or extent".[4] While a considerable amount of Treasury and IRS authority speaks to when this occurs in the case of a debt obligation,[5] relatively little authority currently speaks to when this occurs in the case of a notional principal or other derivative contract. Authority governing the former does not, however, govern the latter.

More specifically, a debt obligation normally promises a fixed return of principal plus interest, and so from an investment perspective, the most important factor that serves to distinguish among different kinds of debt instruments is the credit of the issuer—i.e., the likelihood that the otherwise fixed amounts will ultimately be paid. Indeed, the risk of borrower default is the only business risk that the typical lender is expecting to bear. Likewise, because the primary purpose of a borrowing is to allow the borrower to obtain useable funds from the lender, the borrowing is not normally collateralized. By contrast, a derivative contract normally provides for payments that vary directly or inversely with interest rates, currency values, and equity or commodity prices. The specific terms that govern the amount of these payments are by far the most important ones in determining the value of the position. The credit of the counterparty is comparatively insignificant, so long as the credit of the counterparty is adequate. Indeed, derivative positions are generally collateralized (either by the posting of separate collateral, and/or pursuant to cross-collateralization arrangements) in any case where the credit of the counterparty is questionable. Partly for the above reasons, the IRS has consistently looked to the issuers of the assets underlying an option, rather than to the issuer of the option itself, in determining whether investments in options meet investment

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expenses) to transfer within 20 days after it gives notice under Section 6(b)(i) all its rights and obligations under this Agreement in respect of the Affected Transactions to another of its Offices or Affiliates so that such Termination Event ceases to exist. If the Affected Party is not able to make such a transfer it will give notice to the other party to that effect within such 20 day period, whereupon the other party may effect such a transfer within 30 days after the notice is given under Section 6(b)(i). Any such transfer by a party under this Section 6(b)(ii) will be subject to and conditional upon the prior written consent of the other party, which consent will not be withheld if such other party's policies in effect at such time would permit it to enter into transactions with the transferee on the terms proposed."

The 1992 ISDA Agreement similarly restricts transfers without counterparty consent.

[4] Treas. Reg. Sec. 1.1001-1(a).

[5] Most of this authority is now set out in Treas. Reg. Sec. 1.1001-3. Prior to the adoption of that regulation, however, a considerable number of published and private rulings also spoke to this question.

diversification requirements for various purposes of the Internal Revenue Code of 1986, as amended (the "Code").[6]

Moreover, while a debt obligation generally reflects only unilateral obligations of the borrower to the lender, a derivative contract generally reflects both rights and obligations on the part of each party and therefore generally has no net value at the time the contract is entered into. Given this fact, the credit quality of either counterparty is far less significant as an investment factor, and indeed, the contract cannot be viewed by either party as an "investment" in the other the character of which turns on the credit quality of the "issuer".[7] Indeed, bilateral derivative contracts are difficult to distinguish from other bilateral contracts such as leases, licenses, service agreements, take-or-pay contracts, etc., that are entered into as a routine matter by businesses and individuals alike. There is no authority suggesting that parties to such agreements recognize gain or loss when their counterparties assign their rights and obligations to related parties, or even to unrelated parties in the course of, for example, a merger or acquisition.

Consistent with and reflecting the distinctions described above, relevant authorities under Section 1001 of the Code generally treat the assumption of a debt obligation by a new obligor as a modification sufficiently material in kind to cause the lender to be treated as having exchanged the old obligation of the old obligor for a new obligation of the new obligor. Private letter rulings antedating the promulgation of Treas. Reg. Sec. 1.1001-3 generally carved out an exception for cases of assumptions of debt obligations by related parties where there was no meaningful change in the credit behind the obligation.[8] In a reversal that has been criticized by some,[9] Treas. Reg. 1.1001-3 appears to treat the assumption of a debt

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[6] See e.g. Rev. Rul. 83-69, 1983-1 C.B. 126, dealing with options on stock for purposes of RIC diversification, and associated Priv. Let. Rul. 8834046:

"Revenue Ruling 83-69 by focusing on the corporation whose stock or securities underlie an option as the issuer of the option under section 851(b)(3) of the Code, in essence is stating that for purposes of section 851(b)(3), the risk in respect of options on stock or securities lies in the fact that the value of the stock or securities underlying the option may or may not go in a particular direction. In other words, the success or failure of the option depends on the economic fortunes of the entity whose stock or securities underlie the option. In the case of option contracts on stock indexes, the success of the option depends on the fortunes of the corporations whose stocks are on the index. It depends on the business fortunes of these corporations in proportion to their representation on the index. . . . We therefore conclude that the issuers of an option on a stock index, long and short positions on stock index futures contracts and options on stock index futures are the issuers of the stocks underlying the index (i.e. the corporations whose stocks are on the index) in proportion to the weighting of the stocks in the computation of the index."

[7] While an option does have some positive value in the hands of the option holder, this value is generally small in relationship to the strike price of the option, and variations in the value of the assets underlying the option dwarf the significance of changes in the credit quality of the issuer of the option. As noted above, primarily for this reason, the IRS has consistently looked to the issuers of the assets underlying the option, rather than to the issuer of the option itself, in determining whether investments in options meet investment diversification requirements for various purposes of the Code.

[8] See e.g., PLR 8813035 (December 31, 1987), PLR 8734042 (May 27, 1987), PLR 8731045 (May 8, 1987), and after the issuance of Treas. Reg. Sec. 1.1001-3, see PLR 199904017 (January 29, 1999).

[9] See e.g., comment letter by Marc D. Levy and Bryan P. Collins, Arthur Andersen & Co., to the IRS (March 5, 1993) (The "Change of Obligor Realization Event" in Prop. Treas. Reg. 1.1001-3 allows taxpayers to vary tax consequences at will, especially "in situations involving intra-group transactions, particularly where the creditor is another member of the consolidated group (or the parent corporation has guaranteed the debt).")

obligation by a related party as a taxable event regardless of whether there is a meaningful change in the credit behind the obligation,[10] but it does not treat significant credit enhancements (e.g., addition or deletion of a co-obligor, change in priority, change in security, credit enhancement, etc.) as resulting in a taxable event unless there is a meaningful change in payment expectations, and this (as discussed further below) it defines fairly liberally.[11]

By contrast, practitioners appear to have generally assumed that the assignment of a derivative contract to even an unrelated party does not result in a taxable event for the non-assigning counterparty absent a meaningful change in payment expectations. A 1992 New York State Bar Association Report, for example, includes the following language:

> "In the experience of committee members, normal commercial practice to date has assumed that a non-assigning party does not recognize gain or loss on the assignment of a notional principal contract, regardless of whether the non-assigning party's consent is required. Consents to assignments have been routinely given without concern over the impact of such assignments on the tax position of the consenting party. This should be contrasted, for example, with the elaborate procedures regularly employed to assure that the legal defeasance of an obligation pursuant to its terms does not generate adverse tax consequences to the holders.
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> The practice of assuming that assignments have no tax consequences for the non-assigning party has developed over the roughly 10 years in which the notional principal contract marketplace has existed. Although tax results are not dictated by commercial practice, the committee does not see any clear statutory or tax policy reason for treating an assignment of a notional principal contract as a taxable event for non-assigning parties."

There is, however, relatively little express authority dealing with this question. In regulations proposed in July of 1991, Treasury initially proposed to treat an assignment of a notional principal contract as a taxable event for the non-assigning counterparty if a payment was made between the assignor and the assignee in respect of the assignment.[12] Derivatives dealers and commentators disagreed with that proposal, however,[13] and Treasury effectively

[10] Treas. Reg. Sec. 1.1001-3(e)(4)(i).

[11] Treas. Reg. Sec. 1.1001-3(e)(4)(ii).

[12] Prop. Treas. Reg. Sec. 1.446-3(e)(6), 56 FR 31350 (July 10, 1991).

[13] See comment letter from Peter F. Hiltz, General Motors Corp., to the IRS (August 15, 1991) ("Although we understand the theory underlying the intent to treat assignments as a termination event for the assigning party, the economic reality for the non-assigning party is that its position is unchanged and it should therefore not recognize any gain or loss on the assignment."), comment letter from E. Noel Harwerth, Citibank Inc., to the IRS (Sept. 20, 1991) ("Dealers in notional principal contracts regularly assign contracts to other dealers in order to balance their credit or liquidity positions. The [deemed termination] rule, if adopted, could lead to counter parties declining consent to an assignment solely to avoid adverse tax consequences (i.e., income or loss recognition) even where there would be no material economic consequence or shift in credit risk."), comment letter from Edward I. O'Brien, President, Securities Industry Association, to the IRS (September 20, 1991) ("Because in the case of a notional principal contract the terms of the agreement will as a commercial matter define precisely the conditions under which assignment will be permitted and, among other requirements,

withdrew it. Current Treas. Reg. Sec. 1.446-3(h) now merely asserts that the answer turns on the application of Section 1001.[14] The preamble to the final regulations, promulgated in October, 1993, contains the following explanation:

> "Many commenters objected to the rule in the proposed regulations that a termination payment is recognized by all of the parties to the contract. Of particular concern was the effect of this rule where one party to a swap assigns its rights and obligations and the counterparty is deemed to have made or received a termination payment. This rule has been revised to reflect that whether an assignment by one party results in a deemed exchange of contracts by the counterparty (and, therefore, realization of gain or loss by the counterparty) is determined under section 1001 of the Code and the regulations thereunder."[15]

Treas. Reg. Sec. 1.1001-4 sets out a limited rule to deal with the case where rights and obligations under a notional principal contract are assumed by one derivatives dealer from another and conditions a conclusion that the assignment does not result in a deemed exchange for the non-assigning party on the twin requirements that (a) both the assignor and the assignee are dealers in notional principal contracts, and (b) the terms of the contract permitted the substitution. There is nothing to suggest, however, that the opposite conclusion need be reached where one of these requirements has not been met. To the contrary, it seems reasonable to assume that this is a limited "safe harbor" granted in response to the requests of derivatives dealers.[16] It cannot reflect any broader view as to what constitutes a material modification of a derivative contract, since it deals only with transfers from one securities

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ensure that the assignee will not be materially less creditworthy than the assigning party, under prior authority the mere assignment of the contract should not cause a deemed exchange for the non-assigning holder even if the debt analogy is applied."), comment letter from Joanne Ames, American Bankers Association, to the IRS (Sept. 23, 1991) ("The ABA believes that the assignment of one party's rights and obligations under a NPC should not be considered a termination for the non-assigning party."), comment letter from Stephen L. Gordon, Cravath, Swaine & Moore, New York, on behalf of the International Swap Dealers Association, to the IRS (September 27, 1991). "The proposed treatment would disrupt the market for no clear policy reason…. The [deemed termination] rule should be eliminated."), comment letter from Reginald W. Kowalchuk, International President, Tax Executives Institute, Inc., to the IRS (November 4, 1991) ("TEI questions the propriety of requiring the non-assigning party to recognize current income when it experiences no change in its economic position."), comment letter from Saul M. Rosen, Managing Director, Salomon Brothers, Inc., to the IRS (December 6, 1991) ("[W]e believe that a rule that requires current recognition of gain or loss by a taxpayer that has not changed its economic position under a notional principal contract does not represent the correct policy choice."), comment letter from Peter L. Faber, Chair, American Bar Association Tax Section, to the IRS (July 1, 1992) ("The final regulations should provide that an assignment of a notional principal contract does not in itself trigger gain or loss to the non-assigning party."), comment letter from Denise O. Strain, Citibank Inc., to the IRS (July 20, 1992) ("Citicorp is one of the largest dealers in the global swap market, and in our view, the deemed termination rule will significantly disrupt the normal course of business in that market.").

[14] "Where one party assigned 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."

[15] T.D. 8491 58 FR 53125 (October 14, 1993).

[16] The preamble to the enactment of Treas Reg. Sec. 1.1001-4, TD 8676, sheds little light on the matter, but rather merely repeats the words of the regulation itself.

dealer to another. It would, for example, be counterintuitive to suppose that there is something about assignments from one derivatives dealer to another that makes them less or more significant (for purposes of applying section 1001) than similar assignments from, say, one insurance company to another. Likewise, if the second requirement is interpreted as requiring a right of substitution without counterparty consent, it seems out of step with other related authorities. As noted above, for example, Treas. Reg. Sec. 1.1001-3 dealing with debt instruments treats an assignment as a taxable event regardless of whether there is counterparty consent;[17] and numerous private letter rulings antedating the promulgation of Treas. Reg. Sec. 1.1001-3 (that did not treat an assignment as resulting in a deemed exchange if it did not meaningfully change the credit behind the debt instrument) did not turn on counterparty consent.[18] Moreover, given the active debate regarding this issue that accompanied the promulgation of Proposed Treas. Reg. Sec. 1.446-3(e)(6), it seems unlikely that Treasury intended to settle the matter without further discussion and by drawing so arbitrary a line. Commentators appear to have taken the same view.[19] In light of the above, and as a matter of practical administration, it might be more reasonable to interpret the second requirement as requiring only that the relevant documentation allow the parties to the contract to agree to an assignment by mutual consent (as we understand is generally the case). This would serve to make it generally clear that assignments of derivative contracts between dealers do not give rise to taxable events for their counterparties.

However, it is not necessary for our current purposes to address the question of what happens to the counterparty outside of Treas. Reg. Sec. 1.1001-4 when a derivatives dealer assigns its position in an over-the-counter derivative to an unrelated derivatives dealer. Rather, we here address only the case where the assignment is to a *related* derivatives dealer. It seems to us that, absent other material changes in the terms of the contract (or unless the ability of the related assignee to meet its obligations under the transaction is speculative), such an assignment does not rise to the level of a material difference in kind or extent that should cause the counterparty to be treated as having entered into a new transaction within the meaning of Section 1001 of the Code. This conclusion would seem generally consistent not only with common business practice but also with whatever IRS authority has been promulgated to date pursuant to various private letter rulings, most of which has been directed towards allowing assumptions of debt obligations by related parties to accommodate routine business transactions.[20] It is also consistent with the thrust of the regulations that have been promulgated under Treas. Reg. Sec. 1.1001-3. For example, even in the case of debt

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[17] Such an assignment is a per se modification under Treas. Reg. Sec. 1.1001-3(c)(2), and it therefore does not cease to be a modification merely because it occurs pursuant to the terms of the original instrument, as provided in Treas. Reg. Sec. 1.1001-3(c)(1).

[18] See fn 8 supra.

[19] "While Treas. Reg. §1.1001-4 and the accompanying preamble are not as clear as they might otherwise be, it appears that the IRS and the Treasury intended to provide a limited safe harbor without creating any inference with respect to assignments of NPCs that did not satisfy the safe harbor. Accordingly, until future regulations are issued, the assignment of an NPC—including assignments by one dealer to another that fall outside the protection of Treas. Reg. §1.1001-4—should not give rise to any federal income tax consequences to the non-assigning party." **Financial Products: Taxation, Regulation and Design by Andrea Kramer, §78.05, TERMINATION PAYMENTS.**

[20] See fn. 8 supra.

instruments--where credit is paramount--these regulations do not treat a credit-related change in terms as giving rise to a "change in payment expectations" unless "There is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification" (or vice versa).[21] In other words, whatever thinking lies behind the rule of Treas. Reg. Sec. 1.1001-3 that automatically treats a change in the obligor of a debt instrument as a deemed exchange, it should not—for all of the reasons set out above--be applied to the assignment of a derivative transaction, let alone to the assignment of a derivative transaction to a related party occurring in the context of a legitimate reorganization of business operations undertaken in connection with the implementation of regulatory reform legislation.

III. Consequences of a Deemed Exchange.

While the discussion above would appear to suggest that the assignments required as a practical matter to implement Dodd-Frank should not give rise to deemed exchanges for non-assigning counterparties, the analysis is not completely clear under current law. The tax consequences of a subsequent adverse conclusion by the IRS, moreover, would be serious. Not only would counterparties recognize gain or loss based on the value of their contracts at the time of the assignment, but the timing of the recognition could be asymmetric—i.e., gains might be immediately recognized while losses were deferred under the wash sale or straddle rules.

Such a treatment might also give rise to serious character mismatches. A counterparty might, for example, have a capital loss from a deemed exchange of an old for a new position that is offset by additional ordinary income arising from payments on the deemed new position (or from payments on hedging positions). For example, suppose that (a) a counterparty receives fixed and pays floating in a typical interest rate swap on a notional amount of $1 million, (b) interest rates were 5% per annum when she entered into the swap, and she is therefore entitled to receive 5% fixed against floating payments, and (c) interest rates have since risen from 5% to 8% per annum, such that she would have to pay $300,000 to cancel the rest of the swap. If she was required to treat her derivatives dealer's assignment of its position to a related dealer as a deemed exchange, she would recognize a $300,000 capital loss in respect of the deemed termination of the old swap, and she would be deemed to receive this $300,000 back as a "prepayment" to induce her to enter into the same swap with the related dealer. This latter prepayment would not be accounted for as gain but rather would be accounted for in a manner that generated additional income over time to offset the net deductions to which her net payments under the "new" swap would otherwise give rise.[22] Unlike the replaced net deductions, the capital loss would be subject to the capital loss limitation and could not be offset against ordinary income. In particular, if the counterparty had hedged her position with another position that generated ordinary income over time, the counterparty would be exposed to a serious mismatch.

A different problem would arise in connection with reporting obligations. Imagine in the example above that interest rates had fallen from 5% to 2%, and the counterparty was therefore deemed to receive, rather than make, a $300,000 payment to terminate the swap with

[21] Treas. Reg. Sec. 1.1001-3(e)(4)(vi).

[22] See generally Treas. Reg. Sec. 1.446-3(f).

the original derivatives dealer, and then to make a $300,000 payment to the new related derivatives dealer to enter into the same above-market swap. This deemed upfront payment would be treated as a "significant" upfront payment and therefore as a loan under current regulations,[23] and deemed interest payments on this loan would be reportable to the IRS and to counterparties on Forms 1099 and 1042. At present, however, derivatives dealers do not have systems to withhold, deposit and report on such payments on the automated scale that could be required if each novation is a taxable event, and the effort to develop the necessary systems would be time consuming and costly.

We believe that concerns about these kinds of issues would likely discourage counterparties from consenting to assignments by derivatives dealers to related dealers and would impede the implementation of Dodd-Frank. SIMFA is therefore seeking express confirmation, in the form of a notice or other official pronouncement, that the assumption of a position in a derivative transaction by a related derivatives dealer does not cause the derivatives dealer's non-assigning counterparty to be deemed to have terminated its derivative transaction and entered into a new one for tax purposes. Please feel free to contact me at (202) 962-7400 or kbentsen@sifma.org or Ellen McCarthy at (202) 962-7333 or emccarthy@sifma.org if you have any questions or if we can be of further assistance.

Sincerely,

Kenneth E. Bentsen, Jr.
Executive Vice President, Public Policy and Advocacy
Securities Industry and Financial Markets Association

Cc: Emily McMahon
Jeffrey Van Hove
Karl Walli
Steve Larson

[23] Treas. Reg. Sec. 1.446-3(g)(4).