To be published in the next issue of *The Journal Of Taxation Of Investments*

780 Third Avenue
New York, NY 10017

TWENTY-FIRST SECURITIES CORPORATION

Phone: 212-418-6000
Fax: 212-418-6038
www.twenty-first.com

The New Tax Whipsaw for Swaps

Mark Fichtenbaum and Robert Gordon*

Profits Are Taxable But Losses Aren't Deductible

Under the recently enacted Tax Cuts and Jobs Act of 2017, expenses that were deductible under Section 212, but subject to the 2 percent of adjusted gross income limitation of Section 67, are no longer deductible at all. In the case of an investor, Section 212 used to allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income. A major expense that falls under this rule would be payments made under a notional principal contract ("swap").

While Treasury Regulation Section 1.446-3 allowed for the accounting of payments and receipts related to swaps, the regulation did not grant the authority for a taxpayer to actually deduct such amounts. Section 61 imposes the burden on the taxpayer to recognize the receipts as income, and either Section 162 or Section 212 gave the taxpayer the authority to deduct the expenses from the swap.

Treasury Regulation Section 1.162-1(a) states that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. This issue could become very important for partnerships that take the position that they are traders for income tax purposes. As traders, the net swap payments would be treated as an expense incurred in a trade or business and deductible under Section 162 and Treasury Regulation Section 1.162-1(b)(8). The expense would flow through to the partners and, in effect, would be deductible by the partners. However, if it is determined that the partnership is really an investor and not a trader, the net payments made under the swaps would flow through to the partners as investment expenses and would not be deductible at all.

* Mark Fichtenbaum is the president of MF Consulting, a Vice President at Twenty-first Securities, and a professor at the Lubin School of Business at Pace University. Robert Gordon is the founder and CEO of Twenty-First Securities and an adjunct professor at the Stern School of Business at NYU. They can be reached at mark@twenty-first.com and bob@twenty-first.com, respectively.

Is There Any Relief by Netting Swap Payments?

Pursuant to Treasury Regulation Section 1.446-3, it is the net amount of expense or income that is recognized on the swap that should be included in or deducted from income. Therefore, it appears that if there are payments and receipts that are netted under the swap, then only the net amounts should be taken into account in determining the amount of taxable income from the swap. In effect, the payments made would still be able to be used by the taxpayer to reduce the amount of income that had to be included in income from the swap, even though a net payment on the swap would no longer be deductible at all. Since taxes are computed on an annual basis, however, investors can be subject to a whipsaw even on the same swap. For example, if a swap continued over two years, an investor's net receipts in one year might equal the net payments in the subsequent year. In such a case, the unhappy result would be that the net receipt in Year 1 would be subject to tax and the net payment in Year 2 would be non-deductible. Even though the taxpayer broke even economically, there still would have been a net tax expense.

If a fund were to enter into multiple swaps, each relating to a different reference security (or index), and if some of these swaps were profitable and others had net losses, it appears that investors would not be able to net the losses across the fund's various swaps to offset the gains.

Can Swap Payments Be Turned Into Capital Losses?

A bullet swap that defers all payments until the conclusion of the swap is not treated as a swap for tax purposes at all. Instead, it is treated as a forward contract, and all payments or receipts will be treated as capital to investors. Therefore, both payments and receipts under such swaps are treated as either capital gains or capital losses. Capital losses are deductible under Section 165, so they could still be fully deductible.

In a standard non-bullet swap, if an investor is scheduled to make a swap payment and instead terminates the swap early, the termination payment that the investor would make could be a capital loss instead of a non-deductible swap payment. Under Treasury Regulation Section 1.446-3(h)(1), termination payments or receipts should be treated as made or received with respect to the disposition of an asset, resulting in either gain or loss. So, if the swap would be treated as a capital asset in the hands of the investor, then any gain or loss on the termination also should be capital. To the extent the right to receive or make a payment under the swap for terminating exists, however, an issue arises whether that amount should have been accrued under the swap. If so, the amount accrued under the swap would be treated as ordinary income or a non-deductible expense.

Normally, changes in the value of property are not accrued into income. Rather they are recognized when the underlying property is disposed of. If the amount due under the swap is based on the increase or decrease of the value of the underlying property, that amount is not typically accrued. If the amount is not accrued, then the receipt of the payment should be treated as capital gain and any payment should be treated as a capital loss. To the extent that payments are being made periodically under the swap, it is only the amount due since the last payment that would be subject to this rule.

Conclusion

Going forward, investors should be very wary of making their investments through swaps. Profitable investments will be subject to tax and unprofitable transactions will not give rise to deductions. Investors may be advised to structure economically equivalent transactions using other financial instruments that give rise to gains and losses as opposed to income and expenses. Typically options, forward contracts, and futures contracts are derivatives that could be utilized in a way to produce substantially identical economic results, while not being subject to these oppressive tax rules.