US FEDERAL INCOME TAXATION OF NOTIONAL PRINCIPAL CONTRACTS AND THE IMPLICATION OF NEW TREATY PROVISIONS

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The use of swap agreements, often called notional principal contracts, in the international financial community certainly is not new. In recent times, however, the use of such agreements has become increasingly common. While some swaps raise novel US federal income tax issues, swap payments generally receive favourable tax treatment in the United States.

**KEYWORDS: DERIVATIVES ■ FINANCIAL INSTRUMENTS ■ INTERNATIONAL TAXATION ■ NONRESIDENTS ■ SWAPS ■ TAX TREATIES**

**BACKGROUND**

A swap can be structured in many ways, and commonly appears to hedge or speculate on interest rates, commodities, and equities.1 As long as a swap satisfies the requirements described below, it will be treated as a notional principal contract (NPC) for US federal income tax purposes.2

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1 The International Swaps and Derivatives Association (ISDA) has a Web site (http://www.isda.org/) that contains commonly used forms for swaps.
2 Because all payments will be between the parties despite the performance of the index upon which the swap is based, it is important to evaluate the creditworthiness of a potential swap.