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Tax Section

Report on Temporary Regulations Addressing Notional Principal Contracts With Nonperiodic Payments

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I. INTRODUCTION

This report[1] comments on the temporary[2] and proposed regulations[3] published on May 8, 2015 relating to the treatment of nonperiodic payments made or received pursuant to notional principal contracts ("**NPCs**").[4] The text of the proposed regulations is identical to the temporary regulations. Accordingly, the proposed regulations and temporary regulations are referred to here as the "Temporary Regulations."

In very general terms, unless one of two fairly narrow exceptions applies,[5] the Temporary Regulations require an NPC with one or more nonperiodic payments to bifurcate the NPC into a loan component and an "on market" NPC. The loan component is treated as a loan (and the time value associated with the loan component as interest) for all purposes of the Code. Under prior guidance, an NPC with one or more nonperiodic payments was bifurcated only if one or more

[1] The principal author of this report is John T. Lutz, with assistance from Chelsea Hess. Significant comments were received from Erika W. Nijenhuis, Michael Farber, Michael Schler, W. Kirk Wallace, Peter J. Connors, Stephen B. Land, Edward Gonzalez and Peter Schuur. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] *Notional Principal Contracts; Swaps with Nonperiodic Payments*, 80 Fed. Reg. 26,437 (May 8, 2015), *as amended by* 80 Fed. Reg. 34,051 (June 15, 2015) and 80 Fed. Reg. 61,308 (Oct. 13, 2015). All "Section" references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and all "Treas. Reg. §" references are to the Treasury Regulations promulgated under the Code.

[3] REG-102656-15, 80 Fed. Reg. 26,500 (May 8, 2015).

[4] The Temporary Regulations generally apply to NPCs entered into on or after November 4, 2015; however, the date of the bifurcation rule for NPCs with nonperiodic payments is the later of January 1, 2017 or six months after the final regulations are published.

[5] As described in more detail herein, to qualify for one of the exceptions, either the upfront payment must be collateralized (in cash) or the term of the NPC must be less than one year.

nonperiodic payments were *significant*.[6] Bifurcation has significant consequences to the timing, character and source of payments made or received on an NPC with nonperiodic payments, and for this reason is difficult to implement and will impose significant withholding and reporting burdens on NPC counterparties.

The Temporary Regulations were issued, in part, to address recent regulatory and market developments in NPC clearing and execution. Since the mid-2000s, market participants have been working towards the centralized clearing and standardization of NPCs. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**") accelerated that process. The Commodities Futures Trading Commission ("**CFTC**") has mandated that certain swap contracts, including swaps that are NPCs under the Temporary Regulations, be cleared through U.S.-registered derivatives clearing organizations (so-called "cleared contracts"). Cleared contracts have standardized terms, such as fixed coupons, payment dates and start/end dates. In addition, the CFTC, the Securities and Exchange Commission ("**SEC**") and other Dodd-Frank regulators are required by Dodd-Frank to impose strict collateral requirements for certain "uncleared" contracts (*i.e.*, derivatives contracts that are not cleared through a U.S.-registered derivatives clearing organization) between regulated entities. We commend the Treasury and IRS for updating the regulations to reflect these changes to regulatory and market developments in NPC clearing and execution.

The standardization of many interest rate swaps and credit default swaps has resulted in more nonperiodic (generally, upfront) payments on NPCs. For cleared contracts and uncleared contracts that are fully collateralized, however, the recipient of the payment is required to post an amount equal (or substantially equal) to the upfront payment as margin (or collateral) to the clearing organization (counterparty). If the payment is posted as collateral, the recipient of the upfront payment does not have an increase in "available" assets, and for this reason it seems unreasonable to bifurcate a cleared or collateralized swap into a loan and an on-market NPC. We believe that the case law does not compel the bifurcation of NPCs with upfront payments, absent abusive transactions, and that the IRS and Treasury should more closely harmonize the tax rules dealing with NPCs with the Dodd-Frank regulatory rules. For this and the other reasons discussed below:

1. We agree with the Temporary Regulations that all cleared contracts should be exempt from bifurcation because they are fully collateralized with cash.

2. We agree with the concept that appropriately collateralized uncleared NPCs should be exempt from bifurcation. However, we believe that the determination of whether an NPC is "collateralized" should be closely linked to the requirements adopted by the Dodd-Frank regulators. Thus, if an NPC meets the swap margin

[6] Treas. Reg. §§ 1.446-3(f), (g)(4).

requirements of the CFTC, SEC or other Dodd-Frank regulator, it should be exempt from bifurcation.

3. We recommend that the final regulations reinstate and clarify the "significant" test for NPCs with nonperiodic payments. Ordinary course transactions with modest upfront payments should not be bifurcated even if they are not collateralized.

The remainder of this report makes a number of technical comments to the Temporary Regulations.

A. Background

Prior to Notice 89-21[7] and final Treasury Regulations under Section 446 issued in 1993 (the "**1993 Regulations**"),[8] taxpayers attempted to use nonperiodic payments on NPCs to accelerate income. In a common example, a taxpayer would enter into an off-market NPC the terms of which required the taxpayer to make periodic, above-market payments to the counterparty in exchange for receiving periodic, on-market payments. The counterparty would typically make an upfront payment at the outset of the NPC to compensate the taxpayer for the off-market arrangement. Relying on case law addressing prepayments for services,[9] the taxpayer would treat the entire payment as income in the year of receipt. This income could be used, for example, to offset expiring net operating losses.

1. Notice 89-21

Notice 89-21 required that a taxpayer receiving a lump-sum payment in connection with an NPC use a method of accounting that clearly reflects income:

> In the case of a payment received during one taxable year with respect to a [NPC] where such payment relates to the obligation to make a payment or payments in other taxable years under the contract, a method of accounting that properly recognizes such payment over the life of the contract clearly reflects income. Moreover, including the entire amount of such payment in income when it is received or deferring the entire amount of such payment to the termination of the contract does not clearly reflect income and is an impermissible method of accounting. [10]

[7] 1989-1 C.B. 651.

[8] T.D. 8491, 58 Fed. Reg. 53,125 (Oct. 14, 1993).

[9] *See, e.g.,* Schlude v. Comm'r, 372 U.S. 128 (1963).

[10] Notice 89-21, 1989-1 C.B. 651.

According to the Notice, only methods of accounting that take payments into account over the life of the contract are considered to clearly reflect income. The Notice intended to curtail NPC transactions that the IRS viewed as abusive, such as transactions described above, in which taxpayers characterized upfront payments on NPCs as income in the year of receipt.

The Notice further provided that "[n]o inference should be drawn from this notice as to the proper treatment of transactions that are not properly characterized as [NPCs], for instance, to the extent that such transactions are in substance properly characterized as loans." Accordingly, the Notice adopts a "substance over form" approach to NPCs with nonperiodic payments, rather than a bifurcation regime.[11]

2. 1993 Regulations

The 1993 Regulations set forth the rules for determining the timing of income and expense on NPCs. The 1993 Regulations treat payments made or received with respect to NPCs as one of the following: periodic payments, nonperiodic payments or termination payments. Periodic payments are payments made or received pursuant to an NPC that are payable at intervals of one year or less during the entire term of the contract and the amounts of which are based on a specified index.[12] A termination payment is made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under an NPC.[13] A nonperiodic payment means any payment made or received with respect to an NPC that is not a periodic payment or a termination payment.[14] A nonperiodic payment commonly arises when a party to an NPC makes below-market periodic payments or receives above-market periodic payments under the terms of the NPC. Frequently, the party receiving above-market periodic payments makes an upfront payment to its NPC counterparty. The upfront payment compensates the counterparty for the off-market NPC payments.

Taxpayers must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates, regardless of their method of accounting.[15] With respect to

[11] Treasury also adopted a "substance over form" approach in the Section 988 regulations. *See* Treas. Reg. § 1.988-2(f)(1).

[12] Treas. Reg. § 1.446-3(e)(1), special rules applying to dealers.

[13] Treas. Reg. § 1.446-3(h)(1).

[14] Treas. Reg. § 1.446-3(f)(1).

[15] Treas. Reg. §§ 1.446-3(f)(2), 1.446-3(e)(1). In general, a party to an NPC recognizes a termination payment in the year the contract is extinguished, assigned or exchanged. A payment made or received by an assignee, however, is treated as a nonperiodic payment and recognized under the rules applicable to nonperiodic payments. Treas. Reg. § 1.446-3(h)(2) and (3).

nonperiodic payments, all taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates.[16] This rule achieves the clear reflection of income standard established in Notice 89-21.

An NPC with "significant" nonperiodic payments, however, is subject to a special rule (the "**Embedded Loan Rule**"):[17]

> [An NPC] with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment [NPC] and a loan. The loan must be accounted for by the parties to the contract independently of the [NPC]. The time value component associated with the loan is not included in the net income or net deduction from the [NPC], but is recognized as interest for all purposes of the Code. For purposes of Section 956, the Commissioner may treat any nonperiodic swap payment, whether or not it is significant, as one or more loans.

There is no definition of "significant" under the 1993 Regulations. Instead, taxpayers and practitioners are required to interpret the meaning of "significant" based on two examples. Treasury Regulation § 1.446-3(g)(6), Example 2 describes an NPC with a nonperiodic payment that is not significant:

> (a) On January 1, 1995, *G* enters into an interest rate swap agreement with unrelated counterparty *H* under which, for a term of five years, *G* is obligated to make annual payments at 11% and *H* is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time *G* and *H* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 1995, *H* pays *G* a yield adjustment fee of $3,790,786. *G* provides *H* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10% compounded annually, of five annual payments of $1,000,000 (1% × $100,000,000). *G* and *H* are calendar year taxpayers.
>
> (b) In this situation, the yield adjustment fee of $3,790,786 is not a significant nonperiodic payment in light of the amount of the fee in proportion to the present value of the total amount of fixed payments due under the contract. Accordingly, no portion of the swap is recharacterized as a loan for purposes of this section.

[16] Certain taxpayers are required to utilize (or may elect) mark-to-market accounting.

[17] Treas. Reg. § 1.446-3(g)(4), prior to amendment by the Temporary Regulations.

Treasury Regulation § 1.446-3(g)(6), Example 3 describes an NPC with a significant nonperiodic payment:

> (a) On January 1, 1995, unrelated parties *M* and *N* enter into an interest rate swap contract. Under the terms of the contract, *N* agrees to make five annual payments to *M* equal to LIBOR times a notional principal amount of $100 million. In return, *M* agrees to pay *N* 6% of $100 million annually, plus $15,163,147 on January 1, 1995. At the time *M* and *N* enter into this swap agreement the rate for similar on- market swaps is LIBOR to 10%, and *N* provides *M* with information that the amount of the initial payment was determined as the present value, at 10% compounded annually, of five annual payments from *M* to *N* of $4,000,000 (4% of $100,000,000).
>
> (b) Although the parties have characterized this transaction as an interest rate swap, the $15,163,147 payment from *M* to *N* is significant when compared to the present value of the total fixed payments due under the contract. Accordingly, under paragraph (g)(4) of this Section, the transaction is recharacterized as consisting of both a $15,163,147 loan from *M* to *N* that *N* repays in installments over the term of the agreement, and an interest rate swap between *M* and *N* in which *M* immediately pays the installment payments on the loan back to *N* as part of its fixed payments on the swap in exchange for the LIBOR payments by *N*.

Thus, an upfront payment with a value equal to 10% of the present value of the on-market fixed payments was not "significant" but an upfront payment with a value of 40% was "significant." Aside from the above quoted examples, there is no guidance as to the meaning of "significant" with regard to nonperiodic NPC payments.[18]

While the definition of "significant" may be unclear and requires further guidance, the intent of the 1993 Regulations seems clear. NPCs with nonperiodic payments are not bifurcated except in very limited circumstances. Practitioners can debate the how to draw the significance line within the 10%–40% band created by the examples, but even the most conservative interpre-

[18] *See, e.g.,* David C. Garlock, *The Proposed Notional Principal Contract Regulations: What's Fixed? What's Still Broken?* 2004 TNT 56-26, at 1515 n. 11 (Mar. 22, 2004); Investment Company Institute, *Proposed Regulations on Notional Principal Contracts with Contingent Nonperiodic Payments*, 2004 TNT 147-14, at 6 (July 21, 2004); David H. Shapiro, *Taxation of Equity Derivatives*, B.N.A. Tax Mgmt. Portfolio 188-1st, at n. 252. Treasury recognized the concern when it issued the 1993 Regulations: "[a]lthough many commenters requested that the IRS define more explicitly what constitutes a "significant" nonperiodic swap payment, the final regulations retain the test set out in the proposed regulations. The IRS is working on a project dealing more generally with off-market and prepaid financial instruments, however, and may amend these regulations to accord with the decisions reached in that project." T.D. 8491, 56 Fed. Reg. 31,350 (Oct. 10, 1991).

tation (10%) permits NPC counterparties to make or receive small nonperiodic payments and avoid bifurcation.

B. Temporary Regulations

1. Treatment of NPCs with Nonperiodic Payments

The Temporary Regulations apply the Embedded Loan Rule to all nonperiodic NPC payments and add two exceptions to the Embedded Loan Rule:

> In general, an NPC with one or more nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and one or more loans. The loan(s) must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan(s) is not included in the net income or net deduction from the swap, but it is recognized as interest for all purposes of the Code.[19]

The two exceptions are discussed in Part I.B.3 below.

2. Significance of the Changes

The Temporary Regulations eliminate the rule set forth in the 1993 Regulations that only *significant* nonperiodic payment NPCs are subject to the Embedded Loan Rule. Thus, unless an exception applies, under the Temporary Regulations, *all* nonperiodic payments on NPCs are considered as including one or more loans:

> The Treasury Department and the IRS have determined that, unless an exception applies, the economic loan that is inherent in a nonperiodic payment should be taxed as one or more loans, and that it is reasonable to require taxpayers to separate the loan or loans from an NPC in the case of any nonperiodic payment, regardless of the relative size of such payment."[20]

The Preamble to the Temporary Regulations suggests that the general recognition rule under the 1993 Regulations was the exception and the Embedded Loan Rule was the appropriate accounting method: "[b]ecause excepting non-significant nonperiodic payments from the embedded loan rule is not functioning as a rule of administrative convenience as intended, these temporary regulations eliminate that exception." This sentence was unexpected because we are not aware of taxpayers abusing the 1993 Regulations and, other than determining what consti-

[19] Treas. Reg. § 1.446-3T(g)(4)(i).

[20] T.D. 9719, 80 Fed. Reg. 26,437, 26,439 (May 8, 2015).

tutes a "significant" nonperiodic payment, taxpayers are not experiencing difficulty applying the 1993 Regulations. We understand that, as the Preamble suggests, the elimination of the "significant" test was not the result of government concerns about abuse, but instead was driven by the government's desire to revisit the regulatory framework for nonperiodic NPC payments in a market environment where nonperiodic NPC payments have become more common.

The Temporary Regulations represent a reversal of prior guidance. The 1993 Regulations "treat a [NPC] as a single instrument"[21] and require bifurcation only for significant nonperiodic payments.[22] The mere existence of a time value of money component to a payment should not be sole driver of the bifurcation determination. The Temporary Regulations represent a significant change to the approach to the tax treatment of NPC nonperiodic payments.

The Temporary Regulations require bifurcation without regard to whether the nonperiodic payment possesses the common law attributes of debt, namely, the unconditional right of the payor to receive a return of the loan component of the nonperiodic payment.[23] Thus, assuming one of the two exceptions (discussed below) does not apply, counterparties to an NPC with one or more nonperiodic payments are required to create a loan (and address the source, information reporting, withholding and other tax consequences associated with a loan and the related interest) without inquiry (or expectation) as to whether the deemed loan will be repaid. Of course, if the deemed loan is not repaid, the deemed lender may recognize a loss and the deemed borrower may recognize cancellation of indebtedness income.

[21] T.D. 8491, 58 Fed. Reg. 53,125, 53,126 (Oct. 14, 1993).

[22] Treas. Reg. § 1.446-3(g).

[23] For example, assume that a market-rate transaction would provide for coupons at a 6% rate by one party and LIBOR payments by the other, in each case multiplied by a $100,000 notional principal amount. If the terms of an actual swap provide for the first party to pay 5% instead of 6%, that party will make an upfront nonperiodic payment to the second party to compensate the second party for not receiving coupons at the market rate of 6%. There is no assurance that the second party will repay that upfront payment to the first party during the term of the swap. Indeed, as long as LIBOR remains below 5%, the first party will be the only party making periodic payments on the swap, to the second party. It is quite possible that the second party will never make any payments under the swap. Even if the second party does make some payments to the first party under the swap (that is, if LIBOR rises above 5%), there is no promise (or economic assurance) by the second party to ensure that the first party receives the return of its upfront payment.

3. Exceptions to the Embedded Loan Rule.

The Temporary Regulations provide two exceptions to the Embedded Loan Rule: the Short Term Exception and the Margin Exception.

a. Short Term Exception

The first exception applies to contracts with a term of less than one year (the "**Short Term Exception**"):

> In general, the Embedded Loan rule does not apply to an NPC if the term of the contract is one year or less . . . the term of a [NPC] is the stated term of the contract, inclusive of any extensions (optional or otherwise) provided for in the terms of the contract, without regard to whether any extension is unilateral, is subject to approval by one or both parties to the contract, or is based on the occurrence or non-occurrence of a specified event.[24]

The Short Term Exception does not apply for purposes of Section 514 (the unrelated debt-financed income rules applicable to tax-exempt organizations) or Section 956 (rules regarding investments in United States property by controlled foreign corporations). Finally, the IRS may treat two or more contracts as a single contract for purposes of determining whether a contract comes within the Short Term Exception if a principal purpose of entering into separate contracts is to qualify for the Short Term Exception. A purpose may be a principal purpose even though it is outweighed by other purposes.

b. Margin Exception

The second exception applies to NPCs with nonperiodic payments that are subject to prescribed margin or collateral requirements (the "**Margin Exception**").

In general, the Embedded Loan Rule does not apply to an NPC with one or more nonperiodic payments if (1) the NPC is cleared by a derivatives clearing organization[25] or by a clearing agency,[26] and the parties are required to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract,[27] or (2) the parties are required, either pursuant to their contract or under the re-

[24] Treas. Reg. § 1.446-3T(g)(4)(ii)(A)(1).

[25] As that term is defined in § 1a of the Commodity Exchange Act (7 U.S.C. 1a).

[26] As that term is defined in § 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c).

[27] Treas. Reg. § 1.446-3T(g)(4)(ii)(B)(1).

quirements of a federal regulator, to post daily variation margin (or collateral) in an amount equal to the daily change in fair market value of the NPC.[28]

The mark-to-market exposure on a contract will be fully collateralized only if the contract is subject to both initial variation margin[29] (or collateral) in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin (or collateral) in an amount equal to the daily change in the fair market value of the contract.[30]

The Margin Exception only applies to an NPC if the parties post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) by paying and receiving the required margin or collateral in cash.[31] Additionally, with regard to the daily posting of margin or collateral, if the amount of cash margin or collateral posted and collected is in excess of the amount necessary to fully collateralize the mark-to-market exposure on the NPC (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract, any excess is subject to the Embedded Loan Rule (the "**Excess Margin Rule**").[32]

If an NPC with nonperiodic payments meets the requirements of the Margin Exception, the nonperiodic payment must be taken into account over the term of the NPC in a manner that reflects the economic substance of the contract.[33]

The Temporary Regulations provide an example:

> On January 1, 2016, unrelated parties *M* and *N* enter into an interest rate swap contract.
>
> Under the terms of the contract, *N* agrees to make five annual payments to *M* equal to LIBOR times a notional principal amount of $100 million. In return, *M* agrees to pay N 6% of $100 million annually, plus an upfront payment of $15,163,147 on January 1, 2016.

[28] Treas. Reg. § 1.446-3T(g)(4)(ii)(B)(2).

[29] As discussed in Part II below, NPCs are generally subject to two kinds of collateral: an upfront payment of initial margin, which is due regardless of whether there is an upfront payment under the NPC; and daily payments of variation margin, which account for changes in the value of the NPC over time. In the case of an NPC with an upfront payment, the first variation margin payment will be made at inception to account for the fact that the NPC is not on-the-money. This first payment is referred to here as "initial variation margin"; it is distinct from true initial margin, and simply represents the first payment of daily variation margin.

[30] Treas. Reg. § 1.446-3T(g)(4)(ii)(B)(1), (2).

[31] Treas. Reg. § 1.446-3T(g)(4)(ii)(C).

[32] Treas. Reg. § 1.446-3T(g)(4)(ii)(C)(2).

[33] Treas. Reg. § 1.446-3(f)(2).

At the time *M* and *N* enter into the contract, the rate for similar on-market swaps is LIBOR to 10%, and *N* provides *M* with information that the amount of the upfront payment was determined as the present value, at 10% compounded annually, of five annual payments from *M* to *N* of $4,000,000 (4% of $100,000,000). The contract does not require the parties to post and collect margin or collateral to collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract.

The Short Term and the Margin Exceptions do not apply. The transaction is recharacterized as consisting of both a $15,163,147 loan from *M* to *N* that *N* repays in installments over the term of the contract and an interest rate swap between *M* and *N* in which *M* immediately pays the installment payments on the loan back to *N* as part of its fixed payments on the swap in exchange for the LIBOR payments by *N*.

The upfront payment is recognized over the life of the contract by treating the $15,163,147 as a loan that will be repaid with level payments over five years. Assuming a constant yield to maturity and annual compounding at 10%, *M* and *N* account for the principal and interest on the loan as follows:

	Level Payment	*Interest Component*	*Principal Component*
2016	$ 4,000,000	$ 1,516,315	$ 2,483,685
2017	4,000,000	1,267,946	2,732,054
2018	4,000,000	994,741	3,005,259
2019	4,000,000	694,215	3,305,785
2020	4,000,000	363,636	3,636,364
	20,000,000	4,836,853	15,163,147

M recognizes interest income, and *N* claims an interest deduction, each taxable year equal to the interest component of the deemed installment payments on the loan. These interest amounts are not included in the parties' net income or net deduction from the swap contract under Treasury Regulation Section 1.446-3(d). The principal components are needed only to compute the interest component of the level payment for the following period and do not otherwise affect the parties' net income or net deduction from this contract.

N also makes swap payments to *M* based on LIBOR and receives swap payments from *M* at a fixed rate that is equal to the sum of the stated fixed rate

and the rate calculated by dividing the deemed level annual payments on the loan by the notional principal amount.

Thus, the fixed rate on this swap is 10%, which is the sum of the stated rate of 6% and the rate calculated by dividing the annual loan payment of $4,000,000 by the notional principal amount of $100,000,000, or 4%. The fixed swap payments from *M* to *N* of $10,000,000 (10% of $100,000,000) and the LIBOR swap payments from *N* to *M* are included in the parties' net income or net deduction from the contract for each taxable year.[34]

4. Section 956

In very general terms, pursuant to Section 956, a United States shareholder[35] of a controlled foreign corporation[36] is taxed on its pro rata share of the controlled foreign corporation's investment in "United States property." In general, a debt obligation of a controlled foreign corporation's United States shareholder (or a United States person of which more than 25% of the voting power is owned by the controlled foreign corporation's United States shareholders) is included in the term "United States property."[37] An NPC is not. Thus, in the absence of a bifurcation regime for NPCs with nonperiodic payments, a United States shareholder could avoid the application of Section 956 if its controlled foreign corporation made nonperiodic payments to an NPC counterparty that is a United States person.

The 1993 Regulations provide the IRS *may* treat any nonperiodic payment, significant or otherwise, as one or more loans. Thus, a United States shareholder of a controlled foreign corporation could not rely on the "significant" standard to avoid Section 956 if the controlled foreign corporation made a nonperiodic NPC payment to a United States person. If a controlled foreign corporation made a nonperiodic NPC payment to a United States person, that payment could be United States property for purposes of Section 956.

Section 956(c)(2)(J) eliminates this concern to a limited extent by providing that "United States property" does not include an obligation of a United States person if the United States person provides collateral in the form of readily marketable securities, and one of the parties is a dealer in securities or commodities acting in the ordinary course of its business. In 2012, temporary regulations under Section 956 established an exception to the definition of United States

[34] Treas. Reg. § 1.446-3(e)(2)

[35] Section 951(b).

[36] Section 957.

[37] Sections 956(c)(1)(C); 956(c)(2)(F); 956(c)(2)(L).

property for obligations of United States persons arising from upfront payments made with respect to certain cleared contracts that are classified as NPCs.[38]

The Temporary Regulations revised the exception set forth in the 2012 temporary Section 956 regulations, to provide that obligations of United States persons are not considered United States property if they arise from upfront payments made on NPCs that qualify for the Margin Exception, by a controlled foreign corporation that is a dealer in securities[39] or commodities.[40] As discussed above, the Margin Exception is limited to certain cleared or fully collateralized NPCs if the parties post and collect the required margin or collateral in cash. The Temporary Regulations do not attempt to harmonize the Margin Exception and Section 956(c)(2)(J).

5. Effective Date

The Temporary Regulations generally apply to NPCs entered into on or after November 4, 2015; however, the date of the bifurcation rule for NPCs with nonperiodic payments is the later of January 1, 2017 or six months after the final regulations are published.[41] We thank Treasury and the IRS for extending the effective date of the Temporary Regulations. The extension gives taxpayers and their advisors time to implement new systems to comply with the Temporary Regulations.

II. DISCUSSION AND PRINCIPAL RECOMMENDATIONS

The Temporary Regulations are intended address the impact of Dodd-Frank on the derivatives market.[42] As described in the Preamble to the Temporary Regulations, Dodd-Frank:

> (1) Provides for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposes clearing and trade execution requirements on many standardized swap contracts; (3) creates rigorous recordkeeping and real-time reporting regimes; and (4) enhances rulemaking and enforcement authority of various federal regulators with respect to entities and intermediaries within their jurisdiction. As part of implementing the Dodd-Frank Act, the Commodity Futures Trading Commission (CFTC) has mandated that certain swap contracts (cleared contracts), including swaps that are NPCs under Treas. Reg. § 1.446-3, be cleared through U.S.-registered derivatives clear-

[38] Prior Temp. Treas. Reg. § 1.956-2T(b)(1)(xi) (2012), T.D. 9589, 2012-1 C.B. 971 (June 4, 2012).

[39] Section 475(c)(1).

[40] Treas. Reg. § 1.956-2T(b)(1)(xi).

[41] 80 Fed. Reg. 61,308 (Oct. 13, 2015).

[42] *See* T.D. 9719, 80 Fed. Reg. 26,437, 26,438 (May 8, 2015).

> ing organizations. The Securities and Exchange Commission (SEC) has not yet mandated clearing of any security-based swaps through clearing agencies (which, together with derivatives clearing organizations, are referred to herein as U.S.-registered clearinghouses).
>
> To facilitate clearing and exchange trading, cleared contracts generally have standardized terms, which often give rise to upfront payments.

The Preamble to the Temporary Regulations provides examples of these standardized contracts, such as a Market Agreed Coupon interest rate swap ("**MAC**"), which has standardized terms, including a standardized fixed coupon rate. It is unlikely that the standardized fixed coupon will equal the market rate on the start date of the MAC. Consequently, a MAC with a standardized fixed coupon will almost always be off-market, and will require an upfront payment to equalize the present value of the payment obligations under the NPC.

Certain "uncleared" swap contracts have voluntarily adopted terms similar to the MAC, including pre-defined, market-agreed start and end dates, payment dates, and fixed coupons to achieve greater standardization of contract terms. Similar to cleared contracts, these uncleared contracts are resulting in an increasing number of upfront payments.

The standardization of NPCs is designed to improve trading efficiency, liquidity, and price transparency in the swaps markets. Market participants believe that greater liquidity will lead to lower initial margin requirements, improved hedging, and more efficient portfolio management. These benefits have the unintended consequence of increasing the number of NPCs with upfront payments and the associated tax complexity.

Unlike more traditional over-the-counter NPCs with nonperiodic payments, the counterparties do not set the terms of standardized interest rate swaps, credit default swaps and other standardized NPCs. The NPC parties do not control the terms. There is no independent decision by the payor of the nonperiodic payment to extend credit to the recipient. The nonperiodic payment typically "converts" an off-market NPC into an on-market one. Further, the nonperiodic payment recipient is not attempting to accelerate income by entering into a standardized swap. The Preamble to the Temporary Regulations acknowledges that in the context of cleared swaps, the recipient of the upfront payment is required to make a payment of initial variation margin to the U.S.-registered derivatives clearing organization generally no later than the end of the business day on which the upfront payment is made, in an amount equal to (or substantially equal) to the amount of the upfront payment. Consequently, the recipient of the upfront payment has no increase in available assets.[43]

[43] The Preamble to the Temporary Regulations acknowledges that the Embedded Loan Rule should not apply to an upfront payment "when a party pays or receives an upfront payment and must immediately collect or post an equivalent amount of cash margin or collateral."

U.S.-registered derivatives clearing organizations require that each party to a cleared NPC contract provide, in addition to the initial margin, daily variation margin in cash, in an amount equal to the change in the fair market value of the contract.

The CFTC[44] and the U.S. banking regulators (OCC, Federal Reserve, FDIC, FCA and FHFA)[45] have adopted, and the SEC has proposed,[46] initial margin and variation margin requirements for uncleared contracts executed by regulated entities. These requirements are similar to cleared contracts in that the credit risk posed by a regulated entity will be appropriately collateralized with cash (including certain major currencies), in the case of variation margin and with cash, securities, major currencies, and gold (subject to specific haircuts depending on the nature of the eligible collateral) in the case of initial margin. Non-cash collateral is only permitted for initial margin on uncleared swaps. Variation margin is always posted in cash.

We recommend that an NPC with a nonperiodic payment should not be subject to the Embedded Loan Rule if it is a cleared contract or an uncleared contract that meets (or would meet) the swap margin requirements of the CFTC, SEC or other Dodd Frank regulator.[47] As a result of the margin and collateral requirements, there has been no transfer of cash and collateral to the upfront payees that can be used for other purposes. As noted in the Preamble, the recipient lacks discretion as to the payment's use.[48]

We understand that the CFTC,[49] SEC[50] and other Dodd-Frank regulators[51] have or will adopt uncleared swap margin requirements that permit netting of swap exposures, initial margin

[44] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016).

[45] *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74,840 (Nov. 30, 2015).

[46] *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 Fed. Reg. 70,214 (Nov. 23, 2012).

[47] Alternatively, the Section 446 regulations could use the marketable securities definition in Section 956 to define the scope of eligible collateral.

[48] Our recommendations are intended to apply to tax-exempt organizations as well as U.S. taxpayers. Thus, if a significant nonperiodic payment would not be subject to the Embedded Loan Rule because the NPC met one of the three recommended exceptions, the unrelated debt-financed income rules would not apply to the nonperiodic payment. We believe that this recommendation is consistent with a tax-exempt organizations treatment of securities loans. *See* Section 512(a)(5).

[49] *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636, 697–98 (Jan. 6, 2016), amending 17 CFR Chapter I to include §23.152(c) (which governs netting with regard to collection and posting of initial margin) and §23.153(d) (which governs netting with regard to collection and posting of variation margin).

thresholds, daily variation thresholds, and exemptions. We believe that taxpayers should be permitted to provide collateral of a kind permitted under current law for transactions entered into prior to the effective date of the new regulatory rules, to avoid a situation where the tax rules effectively prohibit the use of collateral that the Dodd-Frank regulators permit. Our recommendation is intended to harmonize the tax treatment of cleared swaps and uncleared swaps with the Dodd-Frank regulatory regime. In doing so, we acknowledge that the final Section 446 regulations will need to address the effective dates, transition rules and other complications resulting from adopting the uncleared swap margin requirements of the Dodd Frank regulators.

The Temporary Regulations do not address the netting of margin between NPC counterparties. There is one footnote in the Preamble that seems to accept the market practice of netting, but the application of both the Embedded Loan Rule and the Margin Exception is unclear. For example, suppose Party A makes a $100 upfront payment to Party B pursuant to an NPC on day one. On day two, Party B makes a $100 upfront payment to Party A on a second NPC. Both contracts are treated as separate NPCs. If neither NPC counterparty posts the upfront payment as collateral, it is unclear whether the Temporary Regulations treat these transactions as two deemed loans or a single loan on a day one that is extinguished on day two. If both parties post initial variation margin equal to the upfront payment, and the parties net the exposures, the Temporary Regulations do not address whether both NPCs meet the Margin Exception. Also, if non-cash collateral is posted, it is virtually impossible to apply the Margin Exception to NPC counterparties that net exposure. Given this complexity, our recommendation that Treasury adopt the swap margin requirements of the Dodd-Frank regulators is intended to minimize the risk that NPC counterparties become subject to the Embedded Loan rule on a potentially daily basis.

We believe our recommendation would be easier to administer and more flexible than the Short Term Exception and the Margin Exception, which currently permit only cash collateral. The "all or nothing" approach to the Margin Exception makes it difficult to satisfy if taxpayers provide both cash and securities collateral, as permitted under current law, and there is a substantial risk that taxpayers could fall in and out of compliance, resulting in springing loans and deemed loan extinguishments. The Margin Exception adds to taxpayer complexity and administrative burdens. Our recommendation would permit changes in the CFTC, SEC and other Dodd-Frank regulators' margin rules and regulations without a corresponding amendment to the Sec-

[50] *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 Fed. Reg. 70,214, 70,348 (Nov. 23, 2012) (amending 17 CFR Chapter II to include § 240.18a-3(b)(4), (c)(5)).

[51] *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74,840, 74,903 (Nov. 30, 2015).

tion 446 regulations.[52] The principle of our core recommendation is the same, which is that the types of assets used as collateral – often Treasuries – are essentially cash equivalents, and therefore should be treated in a manner similar to actual cash.[53] Our recommendation is premised on the belief that current law does not require bifurcation of upfront payments, absent abusive transactions,[54] and therefore bifurcation should be required only when significant assets are transferred from one party to another and made available to the recipient.

If our recommendation is adopted, nonperiodic NPC payments made or received on (i) all cleared contracts, and (ii) on uncleared NPCs that meet the swap margin requirements of a Dodd-Frank regulator, would be recognized over the term of the NPC in a manner that reflects the economic substance of the contract. This standard is identical to the treatment of nonsignificant nonperiodic payments under the 1993 Regulations and the treatment of nonperiodic payments of NPCs that meet either the Short Term Exception or Margin Exception of the Temporary Regulations. The existing Section 446 regulations provide detailed examples illustrating the application of the recognition rules to nonperiodic NPC payments.

The Embedded Loan Rule imposes substantial burdens on both parties to the NPC. Bifurcation of an NPC with one or more nonperiodic NPC payments into its loan component and an "on-market NPC" has both direct and collateral consequences to NPC counterparties that are U.S. taxpayers (and United States shareholders of controlled foreign corporations).[55] As previously noted, characterization of a portion of an NPC as a loan could have unrelated trade or business income consequences to tax-exempt organizations and Subpart F income consequences to United States shareholders in controlled foreign corporations. The loan component has a direct impact on other tax interested parties depending on the tax status of the NPC counterparties. Banks will treat gain or loss on the deemed loan as ordinary. Dealers and electing Section 475 traders will be required to mark-to-market deemed loans *made* to NPC counterparties but may not be able to mark to market loans *received*.[56] Foreign taxpayers presumably must consider whether deemed loans made to U.S. persons will result in a U.S. trade or business.

[52] Alternatively, Treasury could utilize the marketable securities reference in Section 956 to define the scope of eligible collateral.

[53] All of the working group members agreed that collateral should include cash and Treasuries. The majority of the working group would extend non-cash collateral to any collateral that meets the requirements of a Dodd-Frank regulator.

[54] We discuss the reasons for this belief in Parts II.A and II.B below.

[55] For an additional discussion of the Temporary Regulations, see Erika W. Nijenhuis, *Observations on the Temporary Regulations on Swap Upfront Payments*, 13 J. TAX'N FIN. PRODUCTS 17 (2015).

[56] Section 475(b)(1)(B).

Further, the deemed interest associated with the loan component is subject to different sourcing rules,[57] withholding[58] and information reporting.[59] Interest income and expense can have collateral consequences to many taxpayers, including, but not limited to, foreign persons engaged in a United States trade or business,[60] United States taxpayers with net investment income,[61] United States taxpayers subject to limitations on the use of foreign tax credits[62] or the deductibility of interest expense.[63]

We are not suggesting that the Treasury lacks authority to require bifurcation, but we feel that the Treasury and IRS should use their authority to bifurcate sparingly. Bifurcation is not required by the current authorities addressing financial contracts with upfront payments. To require bifurcation of NPCs with nonperiodic payments also is inconsistent with published IRS guidance addressing other derivative contracts, such as structured notes and prepaid forward contracts, which are frequently similar to NPCs.

A. Bifurcation

A full discussion of the authorities addressing the bifurcation of a single instrument into its component parts is beyond the scope of this report.[64] In short, however, the case law and existing IRS guidance do not apply bifurcation to complex financial instruments, absent a statutory mandate. Outside of the financial products guidance, it is difficult to find support for bifurcation of commercial transactions.[65] Contingent payment debt instruments, options, prepaid forwards and prepaid derivatives, such as non-principal protected notes, are not bifurcated under current

[57] Under the Code, the source of interest is determined by the residence of the payor. Section 861(a)(1), 862(a)(1). Typically, the source of income earned on an NPC is determined by the residence of the recipient. Treas. Reg. § 1.863-7(b)(1).

[58] Sections 871, 881, 1441, and 1442 impose a 30% gross tax (collected through withholding) on all U.S.-source payments of "fixed or determinable, annual or periodical" income (FDAP) made to nonresidents, including interest payments. Section 1441(b).

[59] *See, e.g.,* Section 6049, governing returns regarding payment of interest.

[60] Section 864(b), (c).

[61] Section 1411(c).

[62] Section 904.

[63] Sections 264, 265, 163(e)(5) and 163(j).

[64] *See* Michael S. Farber, *Equity, Debt, Not—The Tax Treatment of Non-Debt Open Transactions*, 60 TAX LAW. 653–84 (2007).

[65] *See* Albertson's, Inc. v. Comm'r, 74 AFTR 2d 94-7072 (1994), the U.S. Court of Appeals for the Ninth Circuit held that a taxpayer could not bifurcate its nonqualified deferred compensation obligation between its compensatory component and its interest component, at least for purpose of obtaining an interest deduction prior to paying plan benefits to the eligible employees.

law. Even in the limited circumstances that the Code requires bifurcation, such as the treatment of prepaid rent pursuant to Section 467, bifurcation only applies in a limited set of circumstances.

Chock Full O'Nuts Corp. v. United States[66] addressed the issue of whether a transaction that is in form a single transaction can be treated as two transactions. The case involved an issuer of a convertible debenture who attempted to bifurcate the conversion feature from the debenture and claimed a deduction for the resulting original issue discount (OID). The debentures were issued at $100 par value, at 4.5% interest, due in 20 years. The parties stipulated that as of the date of the sale of the debentures, the same debentures without the conversion feature would have sold at $89.625 for each $100 par value. The taxpayer claimed a deduction for that year's amortization of the bond discount, and the IRS denied it.

The Second Circuit found in favor of the IRS and denied the taxpayer its OID deduction on the grounds that the taxpayer failed to satisfy its burden of showing that the amount of the issue price allocable to the conversion feature "represented a cost of borrowing money that must without qualification be paid,"[67] because the taxpayer had the option to exercise his right to convert the debenture into common stock, in which event the taxpayer would surrender the debenture and would not be redeemed or paid at maturity. "To permit deduction of the amount attributable to the conversion feature in the face of such a possibility would be to disregard established conditions precedent to the allowance of discount as a cost of borrowing money which must be repaid."[68]

The Second Circuit rejected the taxpayer's argument that the convertible debentures were analogous to bond-warrants, which consist of a bond obligation and an option for the purchase of stock (two separate instruments):

> The convertible debenture is an indivisible unit; the issuer has but one obligation to meet, either redemption *or* conversion. It can never be required to do both. With the bond-warrant investment unit, however, the holder receives and the issuer incurs two separate and independent obligations, and both may have to be fulfilled. Indeed, while the warrant and debt obligations are often issued as a package, since they are far more attractive to investors in unison than they would be separately, they are totally independent and separable obligations, and the warrant, unlike the conversion privilege, should be independently valued. Further evidence of this independence is the fact that the conversion feature of a bond is

[66] 453 F.2d 300 (2d Cir. 1971).

[67] *Id.* at 304.

[68] *Id.*

not assignable apart from the bond itself . . . whereas warrants "are customarily traded both on the [stock] exchanges and in the over-the-counter market."

Farley Realty Corp. v. Commissioner[69] is one of the few cases that bifurcated a single instrument into its component parts. *Farley Realty* involved a conventional fixed-rate mortgage loan under which the lender was entitled to a share of the future appreciation of the property securing the debt. The Second Circuit Court of Appeals determined that a payment made to the lender's estate by the borrower to settle the appreciation claim was not deductible interest on the mortgage, but consideration for the lender's separate equity interest in the property. Two features of the appreciation right particularly supported the equity characterization: lender's appreciation right had an indefinite term (and thus did not terminate when the debt was repaid), and the overall return was not subject to a cap.

We are aware of only one case that characterized an NPC payment as a loan. *Schering-Plough Corp. v. United States*[70] addresses the recharacterization of swaps as loans using a substance-over-form analysis. In *Schering-Plough Corp.*, a pharmaceutical company ("Schering-Plough") was the ultimate owner of two foreign subsidiaries, each of which conducted manufacturing activities and held significant cash reserves. The company wanted to make use of those cash reserves.[71]

Schering-Plough entered into an interest rate swap transaction with a bank. The taxpayer assigned the "receiver" leg of the swap to one of its controlled foreign corporations in exchange for cash. Stated differently, the taxpayer assigned its rights under the swap, but retained its obligation under the swap to make payments to the bank. Of course, receiving cash from its controlled foreign corporation pursuant to the assignment gave the taxpayer access to the controlled foreign corporation's cash reserves while avoiding the Section 956 income inclusion.

The district court concluded that the entire arrangement was tax-motivated and constituted, in substance, a loan between the subsidiaries and Schering Plough. The parties believed they were entering into a loan (there was evidence that the Schering-Plough financial director recorded in his notes "[w]e are really accounting for the net deferred income as a loan, but tax could

[69] 279 F.2d 701 (2d Cir. 1960).

[70] 651 F. Supp. 2d 219 (D.N .J. 2009), *aff'd sub nom.* Merck & Co. Inc. v. United States, 652 F.3d 475 (3d Cir. 2011).

[71] While income of a controlled foreign corporation engaged in manufacturing generally is not taxable to its U.S. shareholders when earned, the U.S. shareholder is taxed on its pro rata share of those earnings if the controlled foreign corporation invests in U.S. property (Section 956), including debt obligations of U.S. persons. Therefore, if the foreign subsidiaries loaned money to the United States parent directly, the United States parent would have taxable income.

not have us record it as a loan.")[72] The transactions were designed such that there was virtually no uncertainty as to the return the parties would receive.

Importantly, the court treated the assignment of the receiver leg of the swap by the taxpayer to its controlled foreign corporation as a loan despite the absence of traditional loan features – namely a fixed obligation to repay the "loaned" amount. Of course, the majority of transactions that will be captured by the Embedded Loan Rule will not involve facts like the ones in *Schering-Plough Corp*.

B. Treasury and IRS Guidance

Treasury Regulations and IRS guidance on contingent payment debt obligations, options, variable prepaid forward contracts, NPCs with contingent payments and prepaid rent indicate that a financial instrument or lease is not usually bifurcated into its various components for U.S. federal income tax purposes.

1. Contingent Payment Debt Instruments

Under the final contingent payment debt instrument regulations promulgated in 1996, contingent payment debt instruments that are issued for money or publicly traded property are not bifurcated. Under the noncontingent bond method for contingent payment debt instruments, interest accruals are computed by determining the comparable yield[73] for the debt instrument as of the issue date and determining a payment schedule to produce that yield.[74] The payment schedule consists of all fixed payments on the debt instrument and a projected amount for each contingent payment. The rules are designed to produce a yield similar to the yield the issuer would obtain on a fixed rate debt instrument.[75] For market-based contingencies (*i.e.*, contingencies for which price quotes are readily available), the projected amount is the forward price of the contingency. For other contingencies, the issuer first determines a reasonable yield for the debt instrument and then sets projected amounts equal to the relative expected payments on the contingencies so that the payment schedule produces the reasonable yield.

Nonpublicly traded contingent payment debt instruments issued in a sale or exchange of nonpublicly traded property are analyzed using a bifurcation approach but only for purposes of timing; not character or source. The instrument is separated into noncontingent and contingent

[72] *Id.* at 241.

[73] Treas. Reg. § 1.1275-4(b)(4)(i), the "comparable yield" is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to the contingent payment debt instrument.

[74] Treas. Reg. § 1.1275-4(b)(3).

[75] T.D. 8674, 61 Fed. Reg. 30,133 (1996).

components. The noncontingent payments are treated as a separate debt instrument, which is generally taxed under the rules for noncontingent debt instruments. The debt instrument's contingent payments are taken into account when made, in two ways. A portion of each contingent payment is treated as principal, based on the amount determined by discounting the payment at the applicable Federal rate from the payment date to the issue date, and the remainder is treated as interest.[76]

In 1991, Treasury issued Proposed Regulation § 1.1275-4(g), under which contingent payment debt instruments would be bifurcated into contingent and noncontingent components if the debt (1) is issued for cash or publicly traded property; (2) provides for noncontingent payments equal to or greater than the instrument's issue price; and (3) provides for one or more contingent payments.[77] On December 16, 1994, Treasury withdrew Proposed Regulation § 1.1275-4(g).[78] Treasury discussed commentary on the withdrawn proposed regulation as follows:

> Commentators criticized [S]ection 1.1275-4 of the 1986 proposed regulations because the regulations ignored the economics of many contingent payment debt instruments. In particular, commentators believed that the 1986 proposed regulations did not reflect the reasonable expectations of the parties because the regulations used a "wait and see" approach to the accrual of interest determined by reference to contingencies. The commentators noted that, with respect to certain contingent payment debt instruments, the 1986 proposed regulations resulted in a significant backloading of interest.
>
> Commentators also criticized the 1991 proposed amendment to [S]ection 1.1275-4. Commentators argued that there is rarely a unique set of components into which a contingent payment debt instrument can be bifurcated. In addition, commentators questioned whether it is appropriate to bifurcate a contingent payment debt instrument because it is often unclear how the contingent components should be taxed.
>
> Some commentators suggested that it is preferable to determine interest accruals on a contingent payment debt instrument by assuming that the issue price of the debt instrument will bear a return at the applicable Federal rate (AFR) or some other specified rate. Other commentators suggested that it is preferable to

[76] Thus, all amounts are treated as interest, even if these amounts do not represent the cost of funds.

[77] *Id.* at 8309.

[78] FI-59-91, 59 Fed. Reg. 64,884, 64,885 (1994).

determine interest accruals by constructing a projected payment schedule and accruing on the basis of the projections. [79]

2. Options

Options are not bifurcated for tax purposes. An option premium is not included in the income of the option writer (or deductible to the option holder) when the option is written.[80] Instead, it is not recognized or deducted until the option lapses, or is exercised. This rule applies regardless of the timing of the option premium.

An option premium includes an intrinsic value component and a time value component. The intrinsic value component is the "in-the-money" portion of the option's premium. For example, if the strike price of a call option is $10 and the value of the underlying stock is $15, the intrinsic value of the call option is $5. The portion of an option premium that exceeds the intrinsic value is its time value component. This value represents the amount a person will pay for the option in the expectation that its value will increase because of a favorable change in the price of the underlying asset prior to expiration of the option. Despite the fact that an option includes both intrinsic value and time value components, the IRS has never suggested that the time value component of an option should be taxed separately from the intrinsic value of an option.

3. Variable Prepaid Forward Contracts

Revenue Ruling 2003-7[81] involves a variable share delivery prepaid forward contract. An individual shareholder holds shares of common stock in a publicly traded corporation, with a basis of less than $20 per share. The shareholder enters into an arm's length agreement with an investment bank, at a time when a share of common stock in the corporation has a fair market value of $20. The shareholder receives a lump-sum payment of cash, in return for which shareholder is obligated to provide, on a date three years (the "Exchange Date") in the future, a number of shares of common stock of the corporation to be determined by a to the investment bank. Under the formula, if the market price of a share of the corporation common stock is less than $20 on the Exchange Date, the investment bank will receive 100 shares of common stock. If the market price of a share is at least $20 and no more than $25 on the Exchange Date, the investment bank will receive a number of shares having a total market value equal to $2,000. If the market price of a share exceeds $25 on the Exchange Date, the investment bank will receive 80 shares of common stock. The shareholder has the right to deliver to cash equal to the value of the common stock in place of the common stock.

[79] *Id.*

[80] Rev. Rul. 78-182, 1978-1 C.B. 265, *citing* Rev. Rul. 58-234, 1958-1 C.B. 279.

[81] 2003-1 C.B. 363.

The shareholder pledged the maximum number of shares that the shareholder could be required to deliver to the investment bank on the Execution Date in order to secure the obligation. Shareholder effected this pledge by transferring the shares in trust to a third-party trustee, but retained the right to vote the pledged shares and to receive dividends.

At issue in Revenue Ruling 2003-7 are whether the agreement is a forward contact, and whether the transaction constitutes a constructive sale. The IRS stated:

> Shareholder has neither sold stock currently nor caused a constructive sale of stock if Shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not economically compelled to deliver the pledged shares.

Revenue Ruling 2003-7 is of interest because at no point does it consider the possibility of treating the lump-sum payment as a loan. The unstated implication of the ruling is that no such loan was embedded in the contract. It is difficult to rationalize varying treatment of upfront payments under the Temporary Regulations and Revenue Ruling 2003-7.

Notice 2008-2[82] requests comments from taxpayers on the appropriate methodology of accruing income and expense on prepaid forward contracts, "if the transaction is not otherwise indebtedness for U.S. federal income tax purposes." The prepaid forward contracts at issue:

> resemble typical forward contracts (that is, bilateral, executory contracts in which one party agrees to purchase an asset on a future date for a specific forward purchase price, payable at that future time), but the purchase price is paid in advance of future delivery or cash settlement. Thus, these transactions typically involve an initial payment by one party in exchange for a promise of either (i) a future delivery of a particular asset or group of assets (for example, stocks or commodities), or (ii) a future payment determined exclusively by reference to the value of such assets.[83]

The prepaid forward contract includes an upfront lump-sum payment and is not dissimilar to the NPCs with nonperiodic payments addressed in the Temporary Regulations. Notice 2008-2 makes clear that the IRS does not believe that *all* prepaid forward contracts include a loan component, despite the existence of the upfront payments. The NPCs covered by the Embedded Loan Rule

[82] 2008-1 C.B. 252.

[83] *Id.*

and the prepaid forward contracts of Notice 2008-2 seem to be sufficiently similar that there should not be a significant difference in the baseline tax treatment of each instrument.

Revenue Ruling 2003-97[84] involves a purchase-contract/note unit. This unit consists of a five-year note (the "**Note**") and a three-year forward contract to buy common stock of the note's issuer (the "**Purchase Contract**"). The unit holder must make an initial payment to acquire the unit, and must pledge the Note received to secure the holder's obligation to pay on the Purchase Contract. The unit holder has the unrestricted right to separate the note from unit by pledging other collateral and transfer the note by itself. Additionally, it is "substantially certain" that the notes will be successfully remarketed and remain outstanding after the forward contract is settled. The question is whether the Note qualifies as debt, allowing for interest deduction, or as a part of a stock purchase contract.

The revenue ruling determines that the Note and Purchase Contract are considered separate instruments when issued. The IRS considered a wide array of possible characterizations of the instrument:

> An important initial inquiry bearing on whether the Note may be separately analyzed for federal income tax purposes is whether the Note is separable from the Purchase-Contract/Note unit. Even if the Note is separable, however, various features of the Note and Purchase Contract raise the possibility that, for federal income tax purposes, the Purchase-Contract/Note unit nevertheless is treated as some other combination of instruments. For example, a Purchase-Contract/Note unit could be treated as a prepaid forward contract to purchase a variable quantity of X's stock together with options (1) to acquire a Note by tendering a Strip to be combined into a Purchase-Contract/Strip unit or (2) to purchase a Note for cash by settling the forward contract early, together with a commitment by X to issue new Notes in the context of a "remarketing."

Critical factors leading to the IRS's conclusion that the Note and Purchase Contract should be treated separately include (1) the fact that the Note and the Purchase Contract are legally separable, (2) that there is no economic compulsion to keep the Note and the Purchase Contract together, (3) that it is substantially certain that a remarketing of the Notes will succeed (the Notes are required to be remarketed on specific dates, and a successful remarketing of the Notes generally will result in the sale of the Notes to new holders effective on the next quarterly interest payment date), (4) that the remarketing dates and the maturity date are such that the Notes will remain outstanding after the remarketing for a period that is significant both absolutely and relative to the total term of the Notes, and (5) that on the Maturity Date, the issuer corporation will have an obligation to pay the principal amount of the Notes. This is a rare example of published

[84] 2003-2 C.B. 380.

IRS guidance that does involve bifurcation, but in this case the investment formally comprised two separate instruments.

4. NPCs with Contingent Payments

Revenue Ruling 2002-30[85] also provides evidence that an "embedded loan" is not a feature of all nonperiodic payments made pursuant to an NPC. In Revenue Ruling 2002-30, the taxpayer enters into an NPC with a counterparty for a term of 18 months. Pursuant to the terms of the NPC, the taxpayer agrees to make quarterly payments to the counterparty based on three-month LIBOR multiplied by a notional principal amount of $100,000,000. In exchange, the counterparty, upon the expiration of the NPC, will pay taxpayer 6% per year multiplied by a notional principal amount of $92,000,000 (the fixed payment amount). In addition, one of the parties will make a payment upon expiration equal to the percentage change in the value of the S&P 500 stock index multiplied by a notional principal amount of $8,000,000. If the change is positive (an appreciation amount), taxpayer will receive the payment; if the change is negative (a depreciation amount), taxpayer will make a payment to the other person. Any depreciation amount payable by the taxpayer will be netted against the fixed payment amount payable by the counterparty.

Citing the 1993 Regulations, Revenue Ruling 2002-30 characterizes the agreement as an NPC, the quarterly payments made by the taxpayer as periodic swap payments, and the payment upon maturity as a nonperiodic payment that must be recognized over the term of the NPC in a manner that reflects the economic substance of the NPC. In substance, the payment that the counterparty must pay the taxpayer upon maturity of the NPC equals the sum of two components: one contingent and one noncontingent. The noncontingent component equals the product of 6% and the notional principal amount of $92,000,000 for 18 months. The contingent component equals the product of the S&P 500 stock index appreciation (or depreciation) and the notional principal amount of $8,000,000. The noncontingent component is subject to the nonperiodic payment rules, which require the noncontingent portion of the nonperiodic payment to be amortized or, if significant, bifurcated. The contingent portion of the nonperiodic payment must be accounted for pursuant to the general recognition rules.

[85] 2002-1 C.B. 971.

5. Section 467

Congress enacted Section 467 because it was concerned about the ability of taxpayers to manipulate the timing of their tax liability through the use of increasing or decreasing rents or prepaid or deferred rents.[86]

Section 467 attempts to limit potential abuses by requiring taxpayers to recognize rent on an accrual basis, and to treat prepaid or deferred rent that does not provide for adequate interest as a "Section 467 Loan." It applies to rental agreements for the use of tangible property under which total payments will exceed $250,000 if the payment of some rent is deferred beyond the close of the calendar year following the calendar year in which the use occurs, or there are increases in rent during the term.[87] This $250,000 floor is a bright line *de minimis* exception to the treatment of prepaid or deferred rent that does not state adequate interest as a Section 467 Loan. The Temporary Regulations do not contain a similar *de minimis* exception to the Embedded Loan Rule. If Treasury and IRS disagree with our recommendation that the "clear reflection standard" should apply to all nonperiodic NPC payments, except in potentially abusive arrangements, we suggest that Treasury follow the example set in the Section 467 regulations and provide a bright-line *de minimis* exception.[88]

III. ADDITIONAL RECOMMENDATIONS

A. Reinstate the "Significant" Test for Nonperiodic Payments

As previously discussed, we recommend that the final Section 446 regulations exempt cleared NPCs and certain collateralized NPCs from the Embedded Loan Rule. For uncleared NPCs that fail to meet the swap margin requirements of the Dodd-Frank regulators, we recommend a return to the 1993 Regulations with a more specific definition of the term "significant." While members of the working group believe that the 1993 Regulations worked well for both taxpayers and the Federal government, the Preamble to the Temporary Regulations indicates the Treasury and IRS have received several comment letters noting the potentially burdensome tax consequences associated with treating an upfront payment as one or more loans. The Preamble acknowledges that the 1993 Regulations do not define what constitutes a "significant" nonperiodic payment.

[86] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISION OF THE DEFICIT REDUCTION ACT OF 1984, at 283.

[87] Section 467(d).

[88] N.Y. ST. BA. ASS'N, TAX SEC., *Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts*, *reprinted at* 92 TNT 10-48 (Mar. 4, 1992).

Treasury recognized this issue when it issued the 1993 Regulations.[89] We continue to recommend that Treasury define more explicitly what constitutes "significant" for this purpose. An exception to the Embedded Loan Rule for nonperiodic payments that are not significant should ease taxpayer compliance and tax administration.

The working group members support the approach taken in the 1993 Regulations, that is, a percentage comparison between the size of the upfront (or nonperiodic) payment and the present value of the total amount of fixed payments due under the NPC. To be consistent with the example set forth in the 1993 Regulations, we recommend a fixed percentage of at least 10 percent. [90] Treasury and tax advisors agree that there is some ambiguity in applying the present value test in practice. It would be helpful if the final Section 446 regulations set forth additional details regarding the present value calculation.

We believe Treasury should also consider a *de minimis* exception to the Embedded Loan Rule. This could take the form of a fixed percentage of an NPC's weighted average notional amount (1 percent, for example) or a fixed dollar amount (the minimum threshold permitted by the Dodd-Frank regulators, for example). We acknowledge that any *de minimis* exception would be arbitrary but we believe it would benefit less sophisticated taxpayers. It should be easy to apply. Arbitrary *de minimis* rules, by their nature, are subject to abuse (multiple NPCs executed with the same parties with the same terms, for example). Thus, any *de minimis* rule should be subject to an anti-abuse rule.

B. Section 956

As previously noted, the Temporary Regulations provide a special rule for Section 956 purposes. The term "United States property" excludes an obligation of a United States person arising from a nonperiodic NPC payment by a controlled foreign corporation if (i) the foreign controlled corporation that makes the nonperiodic payment is either a dealer in securities (within the meaning of Section 475(c)(1)) or a dealer in commodities, and (ii) the Margin Exception is satisfied.

[89] See *supra* note 18.

[90] Of course, there are multiple sources for guidance regarding the meaning of "significant." *See* Treas. Reg. § 1.351-3(d) (defining a "significant" transferor as the owner of 5% of publicly traded stock); Treas. Reg. § 1.507-3(c)(2) (defining a "significant disposition" for private foundation purposes as "25% or more of the fair market value of the net assets of the foundation."); Treas. Reg. § 1,279-3(c)(1) (For Section 279 purposes, defining the term "substantial amount of unsecured indebtedness" as an amount of unsecured indebtedness equal to 5% or more of the face amount of the obligations…); Rev. Proc. 97-30, 1996-1 C.B. 696, Appendix A; § 2.05(3) (defining "significant shareholder" for Section 355 purposes as any person who directly or indirectly, or together with related persons, who owns 5% or more of any class of stock).

We have two comments on this portion of the Temporary Regulations. First, Treasury should confirm that the statutory rule set forth in Section 956(c)(2)(J) applies. If one of the NPC parties is a dealer in securities or commodities and the United States person provides collateral in the form of cash or readily marketable securities, any nonperiodic NPC should not be treated as United States property for Section 956 purposes.

Second, since the 1993 Regulations, the Section 956 treatment of nonperiodic NPC payments has not been clear. Treasury and the IRS can apply our recommendations to controlled foreign corporations for Section 956 purposes. This would permit controlled foreign corporations to make insignificant uncollateralized nonperiodic NPC payments to United States persons without the controlled foreign corporation's United States shareholders having to treat the nonperiod-nonperiodic payment as United States property. Alternatively, Treasury and the IRS can adopt a different view. For example, the final Section 956 regulations could treat all uncollateralized nonperiodic payments as United States property. Either way, we recommend clarity on the issue.

C. Mark-to-Market Accounting

The Preamble to the Temporary Regulations requests comments as to whether the Embedded Loan Rule should apply to taxpayers that are subject to mark-to-market accounting.

As a general matter, if Treasury and the IRS adopt our principal recommendation, the Embedded Loan Rule would not apply to (i) cleared NPCs, (ii) uncleared NPCs that meet (or would meet) the swap margin requirements of the CFTC, SEC or other Dodd-Frank regulator and (iii) uncleared NPCs that do not satisfy the "collateralized" standard with nonperiodic payments that are not significant. This segment of the NPC market represents an increasingly smaller percentage of the overall NPC market.

A mark-to-market exception to the Embedded Loan Rule could be helpful and administratively convenient to dealers. As a general matter, it would avoid the need for a dealer to carry out bifurcation of an NPC on its books in a situation where it has no effect on the amount of income or expense that the dealer reports.[91] Today, dealers mark their NPCs to market and they

[91] For example, assume that a dealer enters into an NPC with an upfront payment that would otherwise be treated as a loan on which the dealer would accrue $10 of interest income. If the dealer held an actual loan that accrued $10, and there were no other changes to the value of the loan (or the NPC), the dealer would (a) accrue $10, and (b) mark the loan to market under rules that determine gain or loss as if the dealer had sold the loan for its par amount plus $10. Since the sale of a loan under those circumstances would not give rise to income (because the $10 has already been taken into account as interest and therefore is not treated as part of the amount realized, under Treas. Reg. § 1.61-7(d)), the dealer would not recognize any gain or loss on the mark. The dealer's income for the year would be $10 of ordinary income. By contrast, if the NPC were not bifurcated, and $10 economically accrued on the NPC, the dealer's mark would give rise to $10 of ordinary income.

should continue to do so. A mark-to-market regime for Section 475 taxpayers should also help resolve a potential disconnect that may result from applying the Embedded Loan Rule. If a Section 475 taxpayer is viewed as the deemed borrower under the Embedded Loan Rule, the mark-to-market rules will not apply to the deemed loan, since Section 475(b)(1)(B) denies the taxpayer the ability to mark its own debt obligations to market. This could create significant mismatches in the timing and character of income, because virtually all Section 475 taxpayers hedge their position, and the offsetting hedge would not be subject to the Section 475(b)(1)(B) limitation. A mark-to market exception to the Embedded Loan Rule would avoid this result.

We note, however, that a mark-to-market exception to the Embedded Loan Rule may be complicated to administer and may not achieve symmetry between a Section 475 taxpayer and its NPC counterparties. The non mark-to-market NPC counterparty would presumably remain subject to the Embedded Loan Rule. As a result, an exception to the Embedded Loan Rule for mark-to-market taxpayers may have limited utility if NPC dealers are required to apply the Embedded Loan Rule in order to comply with the information reporting and withholding tax issues for its counterparty.

Finally, if Treasury adopts a mark-to-market exception to the Embedded Loan Rule, we recommend that it not apply to controlled foreign corporations that are dealers. The existing Section 956 guidance and, in particular, the Embedded Loan Rule better address the Section 956 consequences to non-U.S. dealer investments in obligations of their U.S. affiliates.

D. General Comments Regarding the Temporary Regulations

In addition to our principal recommendations, we offer the following general comments regarding the scope of the Temporary Regulations.

1. Clarify that the Temporary Regulations Do Not Apply to Caps and Floors

By their terms, the Temporary Regulations apply to "notional principal contracts," including swaps, interest rate caps, interest rate floors and similar agreements.[92] In addition, certain caps and floors that comprise a collar may be treated as a single NPC.[93] Caps, floors and collars are generally used by taxpayers to protect against changes in interest rates or otherwise

The characterization difference between interest and ordinary gain may be significant in some contexts, such as the subpart F rules in the case of a non-U.S. dealer that is a controlled foreign corporation. That difference should not drive what is fundamentally a method of accounting determination. Rather, those differences should follow from the determination of what method of accounting is appropriate.

[92] Treas. Reg. § 1.446-3(c)(1).

[93] *Id.*

hedge financial expenses. Given the absence of a "funding component" it would be difficult to apply the Embedded Loan Rule to caps, floor and collars.

The 1993 Regulations simply "reserve" on the treatment of caps and floors that are significantly in the money, although the proposed version of the 1993 Regulations provides as follows:[94]

> *Caps and floors that are significantly in-the-money.* If, on the date that a cap or floor is entered into, the current value of the specified index in a cap agreement exceeds the cap rate by a significant amount, or the floor rate exceeds the current value of the specified index in a floor agreement by a significant amount, then the cap or floor is treated as including one or more loans. The time value component of a cap or floor that is significantly in-the money is recognized as interest for all purposes of the Code. For any taxable year during the term of the agreement, this time value component is deemed to be the lesser of:
>
> > (A) The ratable daily portion of the cap or floor premium that is recognized for the taxable year under paragraph (e)(3)(ii)(C)[95] of this section, multiplied by the discount rate used by the parties to determine the amount paid for the cap or floor compounded from the date the premium is paid to the earlier of the date such option contracts expire or the end of the taxable year; or
> >
> > (B) The net income or deduction from the cap or floor for the taxable year under paragraph (e)(1)[96] of this section, computed without regard to this paragraph (e)(4)(iv). In the case of an interest rate cap or an interest

[94] Prop. Reg. § 1.446-3(e)(4)(iv).

[95] "*Caps and floors.* Any payment that relates to the purchase and sale of a cap or floor must be recognized over the term of the agreement by allocating it in accordance with the values of a series of cash-settled option contracts that reflect the specified index and the notional principal amount. For purposes of this allocation the option pricing used by the parties to determine the total amount paid for the cap or floor will be respected, if reasonable. Only the portion of the purchase price that is allocable to the option contract or contracts that expire during a particular period is recognized for that period. Accordingly, straight-line and accelerated amortization methods are not permissible." Prop. Reg. § 1.446-3(e)(ii)(C).

[96] "*Net income or deduction from a notional principal contract for the taxable year.* The net income or deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year. The net income or deduction from a notional principal contract for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year… and all of the nonperiodic payments that are recognized from that contract for the taxable year…. No portion of a payment by a party is recognized prior to the first year to which any portion of a payment by the counterparty relates." Prop. Reg. § 1.446-3(e)(1).

> rate floor, a significant amount for purposes of this paragraph is more than 25 basis points. Interest recognized under this paragraph is not included in the net income or deduction from the cap or floor under paragraph (e)(1) of this section.

This regulation remains in proposed form because "the IRS anticipates that the regulations governing off-market and prepaid financial instruments will address in-the-money caps, floors, forwards, and options in a comprehensive fashion."[97] Consistent with the 1993 Regulations, the proposed regulation requires bifurcation of caps and floors only if the terms of the cap or floor are significantly in the money. The Temporary Regulations did not alter the 1993 proposed regulations treatment of caps and floors that are significantly in the money.

One IRS official has publicly commented that the Embedded Loan Rule was not intended to apply to caps and floors.[98] If these comments are correct, we recommend that the final Section 446 regulations expressly exclude caps and floors that are not significantly in the money from the Embedded Loan Rule. Alternatively the final Section 446 Regulations should provide clear examples of how the Embedded Loan Rule is applied.

2. Clarify that the Temporary Regulations Do Not Apply to NPCs with Contingent Payments

Treasury and the IRS issued proposed regulations addressing NPCs with contingent periodic payments on February 26, 2004.[99] After more than a decade, these regulations remain in proposed form. The Treasury's 2015-2016 Priority Guidance Plan includes "[r]egulations under § 446 on [NPCs] relating to the inclusion in income or deduction of a contingent nonperiodic payment and guidance relating to the character of payments made pursuant to an NPC."[100] The 1993 Regulations did not address the timing of inclusion or deduction of NPC contingent nonperiodic payments.[101] Treasury should make clear that the Temporary Regulations do not apply to contingent payment NPCs.

This is consistent with Revenue Ruling 2002-3, in which an NPC included a nonperiodic payment which was composed of noncontingent and contingent components. The taxpayer was required to recognize the noncontingent component of the nonperiodic payment over the term of the NPC. However, no recognition was required on the contingent component until the conclu-

[97] T.D. 8491, at 53,127.

[98] William R. Davis, *Contingent Swap Not Covered by Embedded Loan Regs, Official Says*, 2015 TNT 190-1 (Oct. 1, 2015).

[99] REG-166012-02, 69 Fed. Reg. 8886 (Feb. 26, 2004).

[100] Dep't of Treasury and IRS, *2015–2016 Priority Guidance Plan* (Oct. 23, 2015).

[101] Notice 2001-44, 2001-2 C.B. 77.

sion of the contract, indicating that the contingent component was not subject to the general rule under the 1993 Regulations, requiring recognition of the ratable daily portion of a nonperiodic payment on an NPC for the taxable year to which that portion relates.

One IRS official has publicly commented that the Embedded Loan Rule was not intended to apply to contingent NPCs.[102] If this comment is correct, we recommend that the final Section 446 regulations expressly exclude contingent payment NPCs from the Embedded Loan Rule. Alternatively the final Section 446 Regulations should provide clear examples of how the Embed-Embedded Loan Rule is applied to contingent payments. For example, credit default swaps are contingent in nature and the final Section 446 regulations should clarify that credit default swaps are not subject to the Embedded Loan Rule.

3. Clarify that the Temporary Regulations Do Not Apply to Swaptions or Forward Starting NPCs

A "swaption" is an option to enter into an NPC. A "forward starting NPC" is a forward contract to enter into an NPC. The 1993 Regulations specifically excluded these instruments from the definition of NPC, unless and until the underlying NPC is entered into.[103] The 1993 Regulations provide as an example that the premium for an option to enter into an NPC constitutes a nonperiodic payment if and when the option is exercised.[104] The same treatment presumably applies to the upfront payment for a forward starting NPC.

The Temporary Regulations leave these rules in place, but do not specify that premium payments on swaptions and upfront payments on forward starting NPCs are excluded from the Embedded Loan Rule. As discussed above, option premiums are not generally bifurcated into their intrinsic value component and a time value component, and it would be inconsistent to subject them to bifurcation under the Embedded Loan Rule.

E. Specific Comments on the Margin Exception

If our principal recommendations are not accepted, we offer the following technical comments to the Margin Exception.

[102] William R. Davis, *Contingent Swap Not Covered by Embedded Loan Regs, Official Says*, 2015 TNT 190-1 (Oct. 1, 2015).

[103] Treas. Reg. § 1.446-3(g)(3).

[104] Treas. Reg. § 1.446-3(f)(1).

1. Expand the Margin Exception to Certain Non-Cash Collateral

The Margin Exception is only available "to the extent" the NPC parties fully collateralize the mark-to-market exposure on the NPC (including the nonperiodic payments) in cash.[105] If the NPC parties collateralize the mark-to-market exposure with cash and other property, the Embedded Loan Rule applies to the extent the nonperiodic payment exceeds the cash collateral.

This limitation imposes several important challenges to uncleared contracts (we understand that all cleared contracts must be collateralized by cash). First, NPC parties are typically permitted to post cash and securities as collateral. The Margin Exception should be extended to high quality, highly liquid securities such as Treasuries that effectively act as "cash equivalents." It seems unnecessary for NPC parties to borrow cash or sell assets to generate cash to meet this requirement.

Treasury and the IRS should look to the Dodd-Frank regulators, who have published detailed final and proposed criteria for eligible collateral for initial margin, or Section 956(c)(2)(J) to broaden the scope of eligible collateral.[106]

Second, it is difficult to apply the "to the extent" rule. The cash collateral must be allocated between the nonperiodic payment and the mark-to-market exposure related solely to the periodic payment. As the mark-to-market exposure changes, so too will the value of the non-cash collateral change. Additional collateral could take the form of cash or other property. This variation in non-cash collateral values and additional collateral creates allocation issues under the Temporary Regulations. Finally, the allocation of cash collateral becomes exceedingly complex in the case of multiple NPC transactions.[107] If the all cash collateral requirement is retained, we recommend that guidance be issued regarding the allocation with cash collateral to nonperiodic payments under a single NPC and among multiple NPCs with the same parties.

2. Clarify the Application of the Margin Exception to Multiple NPCs

The NPC regulations apply on a contract-by-contract basis. The 1993 Regulations provide that each confirmation under a master agreement to enter into NPCs is treated as a separate

[105] Temp. Reg. § 1.446-3T(g)(4)(ii)(C)(2).

[106] The Dodd-Frank regulators provide that for purposes of satisfying the margin requirements, non-cash collateral is subject to an "haircut" or "discount." *See, e.g. Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74,840, 74,845 (Nov. 30, 2015). Therefore, the Dodd-Frank regulators require parties to an NPC to post non-cash collateral that has a current value that is actually greater than the amount of cash that would be posted as collateral. If the cash collateral requirement is not retained, non-cash collateral posted in compliance with the Dodd-Frank regulators proposed and final regulations should not be subject to the Excess Margin Rule.

[107] See discussion in Part II above.

NPC.[108] The Temporary Regulations do not change this result. However, netting of collateral is common in NPCs documented under the same master agreement. The Preamble to the Temporary Regulations recognizes this practice.[109] As previously discussed, we respectfully ask for guidance regarding the application of the Margin Exception to multiple NPCs that permit netting under a master agreement, in particular in the case of NPCs under the master agreement are collateralized with different types of noncash collateral. As a practical matter, it will be virtually impossible for NPC counterparties to comply with the Margin Exception if one of the parties posts non-cash collateral. If the "all cash" rule is retained, the final Section 446 regulations should permit taxpayers to treat non-cash collateral as allocated to a specific NPC(s). In this regard, maybe an identification regime would be appropriate.

3. Variation Margin

The mark-to-market exposure on a cleared contract will be fully collateralized only if the contract is subject to both initial variation margin in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin in an amount equal to the daily change in the fair market value of the contract, and on an uncleared contract if it is subject to equivalent margin or collateral requirements (full margin exception).

Under the Margin Exception's strict definition of "fully collateralized NPC," the mark-to-market exposure on a cleared contract will be fully collateralized only if the contract is subject to both initial variation margin in an amount *equal* to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin in an amount *equal* to the daily change in the fair market value of the contract, and on an uncleared contract if it is subject to equivalent margin or collateral requirements (full margin exception). However, this rule fails to take into account market practice. Many NPCs permit the variation margin (or collateral) posted to vary somewhat from the nonperiodic payment or daily change in value.

One common mechanism for permitting these variances is the use of minimum transfer thresholds, under which no additional collateral is required to be posted, or outstanding collateral recalled, as a result of daily changes in value, unless and until the cumulative change in value reaches a particular threshold, known as the "minimum transfer amount." We recommend that the Margin Exception apply to NPCs that provide for a minimum transfer amount. The minimum transfer amount could be a fixed dollar amount, a fixed percentage of the daily variation margin or both.

[108] Taxpayers typically enter into master agreements to establish a framework of standard terms. A typical master agreement allows the NPC parties to net collateral and termination payments.

[109] *Notional Principal Contracts; Swaps with Nonperiodic Payments*, 80 Fed. Reg. 26,437, 26,438, at n. 1 (May 8, 2015).

4. Confirm that the Margin Exception Can Apply to Non-U.S. Clearing Organizations

The Temporary Regulations provide that the Margin Exception applies to NPCs that are "fully collateralized" either (1) as a result of being "cleared by a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act) or by a clearing agency (as such term in defined in section 3 of the Securities Exchange Act of 1934) that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively…,"[110] or (2) pursuant to the terms of the contract or the requirements of a federal regulator.[111]

If the terms of the NPC require the parties to post or collect margin or collateral to fully collateralize[112] the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract, the Margin Exception should apply, notwithstanding the contract is not cleared by a derivatives clearing organization or clearing agency or subject to federal regulation. It would be helpful if the final Section 446 regulations confirm this interpretation by example or otherwise.

5. Eliminate the Excess Margin Rule

The Margin Exception is only available "to the extent" the NPC parties fully collateralize the mark-to-market exposure on the NPC (including the nonperiodic payments) in cash.[113] However, the Excess Margin Rule provides that if the amount of cash margin or collateral posted and collected is in excess of the amount necessary to fully collateralize the mark-to-market exposure on the NPC (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract, any excess is subject to the Embedded Loan Rule.

Excess Margin is generally returned to the posting counterparty on the same day (or the following business day). In addition, the posting counterparty typically receives on any excess cash collateral.

Given current market practices, it is difficult to understand how treating excess margin as an embedded loan will improve taxpayer accounting or the administration. If the Margin Excep-

[110] Temp. Reg. § 1.446-3T(g)(4)(ii)(B)(1).

[111] Temp. Reg. § 1.446-3T(g)(4)(ii)(B)(2).

[112] The mark-to-market exposure will be "fully collateralized" only if the contract is subject to both initial variation margin or collateral in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin or collateral in an amount equal to the daily change in the fair market value of the contract.

[113] Temp. Reg. § 1.446-3T(g)(4)(ii)(c)(i).

tion is retained in the final Section 446 regulations, we recommend eliminating the Excess Margin Rule.