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Regulations - Notional principal contract swaps with nonperiodic payments

May 7: The Treasury Department and IRS today released for publication in the *Federal Register* temporary regulations (T.D. 9719) and by cross-reference, a notice of withdrawal of proposed regulations (REG-107548-11) from May 2012 and a release of new proposed regulations (REG-102656-15) concerning the treatment of nonperiodic payments made or received under certain notional principal contracts.

Today's regulations:

- Amend the regulations issued under section 446 relating to the treatment of nonperiodic payments made or received under certain notional principal contracts
- Generally provide that, with certain exceptions, a notional principal contract with a nonperiodic payment—whether the payment is determined to be significant or not—must be treated as two separate transactions consisting of one or more loans and an on-market, level payment swap
- Amend the definition of "United States property" under section 956 by providing an exception

Read text of the **temporary regulations** [PDF 217 KB] and the **proposed regulations** [PDF 219 KB].

The text of the temporary regulations also serves as the text of the proposed regulations. Comments and requests for a public hearing must be received by the date that is 90 days after May 8, 2015 (which is the scheduled publication date of the regulations in the *Federal Register).*

Background

Regulations under section 446 currently require taxpayers to account for nonperiodic payments made on a notional principal contract (NPC) over the life of the contract. Further, if the nonperiodic payment is determined to be "significant," the NPC must be treated as two separate transactions consisting of an on-market, level-payment swap and a loan (the "embedded loan rule"). The time value component of the loan is not included in the net income or deduction on the swap, but is instead treated as interest for all purposes of the Code. The regulations do

not provide a definition of what constitutes a “significant” nonperiodic payment, but instead only provide examples that illustrate what is (or is not) a significant nonperiodic payment.

The section 446 regulations further provide that for section 956 purposes, the Commissioner is entitled to treat any nonperiodic payment on a NPC as one or more loans.

Proposed regulations (and by cross-reference temporary regulations) under section 956—released in May 2012—provided an exception from the definition of “United States property” under section 956 for certain obligations arising from upfront payments on cleared contracts with respect to which full initial variation margin is posted.

In part, because of the growing number of upfront payments on cleared and uncleared contracts, the IRS and Treasury received comment letters noting the potentially burdensome tax consequences associated with treating an upfront payment as one or more loans. Also, comment letters asserted that receiving an upfront payment and posting cash margin back to the payor of the upfront payment lacked the most important attribute of indebtedness because the recipient lacks discretion as to the use of the underlying funds, and there were concerns expressed about the increased compliance burdens arising from withholding and information reporting resulting from the increasing number of upfront payments treated as loans.

New regulations

The regulations issued today:

- Under section 446, simplify and expand the embedded loan rule, and provide two exceptions to the newly expanded rule
- Under section 956, provide an exception to the definition of “United States property” for purposes of certain NPCs subject to margin or collateral requirements if the counterparty is a controlled foreign corporation that is either a dealer in securities under section 475(c)(1) or a dealer in commodities

Simplified embedded loan rule

As simplified by these regulations, the embedded loan rule provides that, unless an exception applies, the economic loan that is inherent in a nonperiodic payment is to be taxed as one or more loans—regardless of the relative size of such payment.

Exceptions

The two exceptions to the embedded loan rule are:

- First, a short-term exception—that is, except for purposes of sections 514 and 956, an exception for a nonperiodic payment made under an NPC with a term of one year or less (inclusive of any extension options)
- Second, an exception for certain notional principal contracts with nonperiodic payments that are subject to prescribed margin or collateral requirements

As explained in the preamble, the IRS and Treasury have concluded that when a party pays or receives an upfront payment and must immediately collect or post an equivalent amount of cash margin or collateral, the embedded loan rule should not apply to the upfront payment.

To qualify for the exception, both the margin or collateral posted and collected must be paid in cash and the parties to the contract must be required to post and collect margin or collateral in an amount that fully collateralizes 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 (i.e., initial and variation margin). This exception applies to both cleared and over-the-counter contracts.

The IRS and Treasury have requested comments as to whether there are other circumstances when the embedded loan rule should not apply, including whether it is necessary to apply the embedded loan rule to NPCs that are subject to market-to-market accounting. Comments are also requested on all other aspects of the regulations including any anticipated effects on market participants' behavior, the applicability of the full margin exception only in instances when cash margin is posted, and the possible effects of the goal of the Dodd-Frank Act to encourage centralized clearance of swaps.

Exception to "United States property" definition

Today's regulations under section 956 replace the current exception for certain nonperiodic payments, and provide an exception to the definition of "United States property" for certain obligations of United States persons arising from upfront payments made with respect to NPCs that qualify for the full margin exception to the embedded loan rule.

To qualify for the “United States property” exception, the upfront payment must be made by a controlled foreign corporation that is either a dealer in securities under section 475(c)(1) or a dealer in commodities.

Effective dates

The new regulations have varying effective dates.

The new embedded loan rule generally applies on a delayed basis to NPCs entered into on or after 180 days following publication of the regulations in the *Federal Register* (scheduled to be May 8, 2015). Taxpayers, however, are permitted to apply the rules to NPCs entered into before such date.

The two exceptions to the new embedded loan rule apply to NPCs entered into on or after the date of publication of the regulations in the *Federal Register*. Taxpayers are permitted to apply the rules to NPCs entered into before that date.

Finally, the section 956 exception applies to payments made on or after the date of publication of the regulations in the *Federal Register.* Taxpayers are permitted to apply the rules to payments made before that date.

Direct comments, including requests for subscriptions, to mailto:US-KPMGWNT@kpmg.com. For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street NW, Washington, DC 20006-1301.