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January 12, 2021

The Honorable David Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Re: Comments on the Final Regulations Under Treas. Reg. § 1.446-3(g) Relating to Notional Principal Contracts with Significant Nonperiodic Payments

Dear Mr. Kautter:

I am writing on behalf of the North American Tax Group ("NATG") of the International Swaps and Derivatives Association ("ISDA")[1] regarding the final regulations governing notional principal contracts ("NPCs") with significant nonperiodic payments published on September 14, 2020 (the "Final Regulations"). This letter supplements our letter to the Treasury Department dated March 11, 2016 (the "2016 Letter"), in which we provided detailed comments and recommendations regarding numerous important issues relating to the implementation of proposed regulations concerning NPCs with nonperiodic payments published on May 8, 2015 (the "Proposed Regulations"). The intent of this letter is to reiterate certain of our comments from the 2016 Letter that remain relevant and to provide additional recommendations with respect to the Final Regulations.

The NATG appreciates the significant helpful changes from the Proposed Regulations reflected in the Final Regulations. Those changes address many of the recommendations made in the 2016 Letter, particularly by reinstating a significance standard for embedded loan treatment and substantially expanding the margin exception contained in the Proposed Regulations to cover all cleared swaps, as well as non-cleared

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

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swaps that require the parties to meet the margin or collateral requirements of a federal regulator (a "regulated swap") or that provide for margin or collateral requirements that are substantially similar to a cleared swap or a regulated swap (the "Margin Exception"). The expansion of the Margin Exception in the Final Regulations was a welcome response to important concerns raised by industry groups regarding the complexity of implementing the more limited exception contained in the Proposed Regulations. While the Final Regulations will exempt a substantial majority of swaps with nonperiodic payments from embedded loan treatment, however, there remain areas of uncertainty regarding how the Final Regulations are applied to common market transactions that do not qualify for the Margin Exception.

NATG members remain concerned about the compliance burdens that will arise from implementation of the Final Regulations, which are very significant relative to the tax policy objectives advanced by the embedded loan rule. Even with the broadened Margin Exception included in the Final Regulations, there will remain numerous customary market transactions that fall beyond the ambit of that exception and for which we believe there are insufficient tax policy reasons to require onerous embedded loan treatment. In particular, given that a substantial number of swaps may be in scope for embedded loan treatment even with the changes implemented in the Final Regulations, swap dealers and other parties regularly entering into swaps will need to incur the cost and effort to build systems and processes for ensuring compliance with the Final Regulations. Such compliance will be particularly challenging given lingering uncertainties in the Final Regulations, particularly relating to when a nonperiodic payment will be considered significant.

To mitigate such burdens, and as described in greater detail below, we first recommend amending the Final Regulations to require embedded loan treatment for a NPC only where a principal purpose of including the nonperiodic payment in the terms of the NPC is to avoid the treatment of such item as a loan for federal income tax purposes. If such an anti-abuse approach is not adopted, and as set forth below, we recommend that the Final Regulations be amended to:

- Create an objective standard for determining whether a nonperiodic payment is "significant," to provide certainty with respect to when the exemption from embedded loan treatment for insignificant nonperiodic payments applies;

- Exempt nonperiodic payments that are in the nature of option premium from embedded loan treatment (including option premium deemed paid in connection with the physical exercise of a swaption);

- Exempt from embedded loan treatment NPCs that have a term of one year or less;

- Provide guidance on the information reporting requirements (if any) that apply to the interest component of an embedded loan; and

- Exempt from embedded loan treatment any one-time payment that is made in connection with a modification of a NPC to replace an interbank offered rate with an alternative rate.

In either case, we recommend that the Final Regulations be amended to delay the effective date of the Final Regulations so that they will apply only to NPCs entered into no earlier than April 1, 2022.

1. <u>Limit the Embedded Loan Rule to Cases of Abuse</u>

We urge the government to reconsider the Final Regulations' approach to significant nonperiodic payments in light of the tax policy rationale for embedded loan treatment. We believe that the appropriate role for a rule that bifurcates a swap with a significant nonperiodic payment into a loan and an on-market swap is to prevent taxpayers from disguising loans within swaps in order to avoid the application of certain rules whose application may depend on whether a transaction is a loan or other obligation for tax purposes (*e.g.*, section 163(j), section 514 and section 956). Except in circumstances where treatment as indebtedness is meaningfully different than treatment as a non-debt obligation, the difference between the characterization of a payment as a loan or as an amortizable item from a tax accounting perspective should not be sufficiently important to justify the significant cost and complexity involved in requiring taxpayers to identify which nonperiodic payments must be recharacterized. The tax consequences of respecting a nonperiodic payment as a payment on the swap or instead characterizing the payment as a loan generally do not differ meaningfully in terms of the timing, character and amount of income and deductions taken into account with respect to the swap. In our view, absent cases of abuse, the incremental benefit to the government of requiring embedded loan treatment is not sufficiently great as to require compliance with the burdensome regime reflected in the Final Regulations.

The fact that an upfront payment might, from a pure economic perspective, function in a manner similar to that of a loan does not, by itself, mean that the upfront payment should be separated from the transaction in which it resides and treated as a separate transaction. Upfront payments that occur within the context of many other types of transactions (*e.g.*, prepaid forward contracts) are not characterized as loans for tax purposes. In determining whether to require bifurcation of what would otherwise be a single inseparable instrument, we believe that the relevant question should be whether the benefits from a tax policy perspective from separating out the embedded loan outweigh the administrative complexity of doing so. In weighing the costs of compliance against the limited benefit to the government from requiring bifurcation other than in cases of abuse, we believe that the embedded loan treatment for swaps should apply only to transactions that are specifically structured in a manner to disguise a loan as a nonperiodic payment on a swap in order to garner a federal income tax benefit.

Although the Final Regulations reduce the number of swaps potentially subject to embedded loan treatment, the costs and effort needed to implement the Final Regulations remain high because swap dealers and other similar parties will need to build and implement systems that distinguish between swaps that are subject to embedded loan treatment under the Final Regulations and those that are not. Because there remain significant categories of market transactions that do not fall under the broadened Margin Exception, compliance with the Final Regulations will be complex, costly, and onerous if such rules apply regardless of whether a principal purpose of avoiding debt treatment is present. We note that Treas. Reg. § 1.446-3(i) currently includes a general anti-abuse rule that provides that "[i]f a taxpayer enters into a transaction with a principal purpose of applying the rules of this section to produce a material distortion of income, the Commissioner may depart from the rules of this section as necessary to reflect the appropriate timing of income and deductions from the transaction."[2] This rule, which has been in effect for decades, may itself be sufficient to ensure that taxpayers apply embedded loan treatment to NPCs that contain disguised loans where a taxpayer attempts to disguise an economic loan with the terms of a NPC in order to garner a tax benefit. But if the government believes such anti-abuse rule is insufficient to address the potential for abuse, we recommend that the Final Regulations be amended so that embedded loan treatment apply only to swaps where a principal purpose of including the nonperiodic payment in the terms of the swap is to avoid the treatment of such item as a loan for federal income tax purposes. If this anti-abuse approach is adopted, deemed loan treatment should apply only to the party that had a principal purpose to avoid loan treatment, unless its counterparty had actual knowledge that the anti-abuse rule applies, because it would be impractical for a party to monitor whether its counterparty had a tax avoidance purpose for structuring a swap to include a nonperiodic payment.

Whether or not the Final Regulations are amended to provide a targeted anti-abuse rule for disguised loans, we recommend delaying the effective date of the Final Regulations to provide sufficient time for taxpayers to build systems to comply with the Final Regulations. In addition, if the Final Regulations are not amended to provide a targeted anti-abuse rule for disguised loans, we provide below specific comments and recommendations with respect to the Final Regulations.

2. General Comments

a. Delay Effective Date of the Final Regulations

The Final Regulations are scheduled to be effective for NPCs entered into on or after September 14, 2021. As described below, there are significant remaining technical uncertainties with respect to the Final Regulations. If the Final Regulations are not revised to address these uncertainties, complying with the Final Regulations will require affected taxpayers to make numerous interpretive decisions regarding their application and such decisions will then need to be incorporated into the relevant systems for tracking embedded loans and their tax consequences. Such interpretive decisions and updating of systems will take significant time.

[2] In addition, an anti-avoidance rule in section 163(j) provides that any expense or loss economically equivalent to interest is treated as interest expense if a principal purpose of structuring the transaction is to reduce an amount that otherwise would have been treated as interest expense for purposes of section 163(j). Treas. Reg. § 1.163(j)-1(b)(22)(iv)(A)(1).

Moreover, given the enormous volume of swap transactions in the marketplace, taxpayers will require significant time to update systems whether or not such uncertainties are resolved. Consequently, the NATG recommends that the effective date of the Final Regulations be delayed so that they will apply to NPCs entered into no earlier than April 1, 2022. The adoption of such a delayed effective date would provide affected taxpayers with slightly more than 18 months from the date the Final Regulations were published, a period the NATG believes is the minimum period of time necessary to build systems to comply with the Final Regulations in a comprehensive manner. We think it would be reasonable, however, for the government not to apply such a delayed effective date for NPCs entered into with a principal purpose of disguising a loan as a nonperiodic payment on a NPC.[3]

b. <u>Guidance Regarding the Meaning of the Term "Significant"</u>

The Final Regulations helpfully depart from the Proposed Regulations by finding an embedded loan only where a nonperiodic payment is significant (the "Significance Standard"). The reinstatement of the Significance Standard[4] is a critical improvement from the Proposed Regulations. As a result, taxpayers should be able to avoid onerous compliance burdens where the amount at stake is relatively small. Nevertheless, implementation of the embedded loan rule in the Final Regulations by swap dealers and other taxpayers will be challenging given the lack of clarity regarding when a nonperiodic payment is considered "significant." Although the Original Regulations did not define or otherwise provide a standard for when a nonperiodic payment is "significant," they did provide two examples (not included in the Final Regulations) that provided some guidance regarding when a nonperiodic payment would be considered significant. Those examples indicated that a nonperiodic payment representing no more than 10 percent of the present value of the total amount of fixed payments due to the party making the upfront payment under the swap was not significant, but a nonperiodic payment representing at least 40 percent of the present value of the total amount of fixed payments (including the upfront payment) due to the party receiving the upfront payment under the swap was significant.[5] There remains considerable disagreement among tax advisors regarding the relevant thresholds and how to apply the relevant tests provided in the examples. Nevertheless, while those examples did not provide taxpayers with a precise method for determining whether a nonperiodic payment was significant (particularly where none of the payments under a swap were fixed), they provided at least some insight into how the government approached the significance determination.

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[3] By analogy, the treatment of interest on an embedded loan as interest for purposes of section 163(j) is generally delayed for one year, but such delay does not apply for purposes of the anti-avoidance rule in Treas. Reg. § 1.163(j)-1(b)(22)(iv).

[4] The Significance Standard was included in the original Treasury Regulations governing NPCs (the "Original Regulations") finalized in 1993 (T.D. 8491).

[5] *See* Original Regulations, Treas. Reg. § 1.446-3(g)(6), Examples 2 and 3.

In the 2016 Letter, the NATG described the critical need for the reinstatement of a standard limiting embedded loan treatment to significant payments. Further, recognizing the challenges faced by taxpayers where such a standard does not provide clarity, the NATG recommended that such standard provide that, if no other exception applies (i) a nonperiodic payment of more than $5 million would be subject to embedded loan treatment, (ii) a nonperiodic payment of $1 million or less would not be subject to embedded loan treatment and (iii) a nonperiodic payment of more than $1 million but not more than $5 million would be subject to embedded loan treatment only if the amount of such payment is more than 10 percent of the NPC's notional principal amount.[6] The benefit of this approach would be its simplicity, making it clear exactly when embedded loan treatment would apply.

The Final Regulations did adopt the NATG's recommendation to reinstate the Significance Standard. However, the Final Regulations reinstated the Significance Standard as it existed in the Original Regulations (as modified by the Margin Exception), but without the benefit of the guidance provided by the examples in the Original Regulations or further clarification on the Significance Standard. This lack of guidance presents challenges to taxpayers in complying with the Final Regulations. Of principal concern is that taxpayers may not fully comply with the Final Regulations because of their ambiguity, or similarly situated taxpayers may apply the Significance Standard in meaningfully different manners. In particular, some taxpayers may use the ambiguity to avoid treating large nonperiodic payments as embedded loans. For swap dealers and similar taxpayers, compliance with the Final Regulations will require the building of systems that must be programmed in a formulaic manner to distinguish between swaps eligible for the Significance Standard and those that are not so eligible. Although such systems will be immensely complex and costly even if there is perfect clarity regarding the "significance" threshold, building such systems will be particularly daunting without the benefit of any guidance regarding what nonperiodic payments are considered significant.

The NATG strongly recommends that the Significance Standard be revised to include an easy-to-apply, objective standard to determine significance so that both taxpayers and the government can apply the Significance Standard with certainty. While the NATG reiterates its recommendation from the 2016 Letter, an alternative approach (which the NATG would support) would be for the embedded loan treatment apply to a nonperiodic payment on a swap only if such payment is more than 25 percent of the present value of the total amount of the fixed payments due under the swap. Where neither leg of the swap provides for fixed amounts (a situation not addressed in the examples in the Original Regulations), we recommend that embedded loan treatment apply only if the nonperiodic payment is more than 25 percent of the present value of the expected amount of floating rate payments (using their value at the time of the swap's

[6] We note that an embedded loan of $5 million would, at an interest rate of 5 percent (a rate that exceeds the 10-year Treasury rate over most of the past 15 years), produce no more than $250,000 of interest annually, an amount that we believe is sufficiently small that the cost and complexity of performing the relevant computations for embedded loan treatment should not be required.

execution) to be received by the party making the nonperiodic payment.[7] The use of a 25 percent standard would be consistent with the examples provided in the Original Regulations by making the standard for significance the midpoint between the facts in those examples. Regardless of what standard is used, we continue to feel strongly that specifying when the Significance Standard applies is necessary to balance the government's stated rationale for requiring embedded loan treatment with the burden that the regulations impose on affected parties.

c. Exempt from Embedded Loan Treatment any Nonperiodic Payment That Is in the Nature of Option Premium

The 2016 Letter recommended that nonperiodic payments that are in the nature of option premium (such as amounts paid for swaptions, interest-rate caps and interest-rate floors) be exempted from embedded loan treatment. As described in more detail in the 2016 Letter, such nonperiodic payments economically represent a payment for an option right rather than a payment to reflect off-market terms of the NPC (and thus should not be treated as an embedded loan). It seems clear under the Final Regulations that upfront payments made on interest-rate caps and floors were not intended to be subject to embedded loan treatment because the regulations continue to reserve on the treatment of caps and floors that are significantly-in-the-money (which could potentially raise embedded loan concerns).[8] Notwithstanding the fact that payments made on interest-rate caps and floors appear to be excluded from the embedded loan rule, no such exclusion is provided for swaption premiums and other upfront amounts that are in the nature of option premiums. Consequently, we reiterate our recommendation that such amounts be exempted from embedded loan treatment.

d. Exempt from Embedded Loan Treatment Nonperiodic Payments Made with Respect to NPCs With a Term of One Year or Less

The Proposed Regulations would have added an exception to embedded loan treatment for NPCs with a term of one year or less (the "Short-Term Exception"). Specifically, the Short-Term Exception provided that, except for purposes of sections 514 and 956, embedded loan treatment did not apply to a NPC if the stated term of the NPC, inclusive of any extensions (optional or otherwise), was one year or less. The Short-Term Exception included an anti-abuse rule that allowed the government to treat two or more contracts as a single contract if a principal purpose of entering into separate contracts was to qualify for the Short-Term Exception. The Final Regulations removed the Short-Term Exception.

The NATG recommends reinstating the Short-Term Exception. We believe that the Short-Term Exception was a sensible carve-out from embedded loan

[7] We recommend that, if this approach is adopted, the regulations clarify whether the nonperiodic payment being tested should be taken into account as one of the payments included in the denominator of the fraction used to determine whether the 25 percent standard is satisfied.

[8] In addition, the embedded loan rule applies to "swaps" with nonperiodic payments (which appears not to include caps and floors, notwithstanding their treatment as NPCs).

treatment, as the administrative and tax compliance burden associated with embedded loan treatment for both taxpayers and the government should outweigh any government interest in requiring embedded loan treatment for such a short period of time.

e. Provide Guidance on Information Reporting Requirements Relating to Embedded Loan Treatment

The 2016 Letter recommended that the regulations governing information reporting for NPCs and interest clarify that no information reporting is required for interest accrued with respect to an embedded loan. As described in more detail in the 2016 Letter, certain aspects of information reporting for interest on embedded loans are unclear. In addition, the information reporting rules as written appear to provide for certain results that are difficult to justify from an administrative perspective, such as interest deemed paid to a foreign person on an embedded loan being subject to information reporting when (i) information reporting appears not to be required with respect to embedded loan interest deemed paid to a U.S. person and (ii) no information reporting is required with respect to other NPC payments made to a foreign person. We continue to believe that information reporting on embedded loan interest would be an enormous and costly undertaking to generate unnecessary paperwork that would have virtually no benefit for the government. As a result, we reiterate our recommendation that the information reporting regulations be amended to provide that no information reporting is required for interest deemed paid to a foreign person on an embedded loan with respect to a NPC other than in circumstances where U.S. tax is withheld with respect to the interest deemed paid.

Further, as noted in the 2016 Letter, the instructions to Form 1099-INT conflict with the regulations governing information reporting for interest by providing that "interest attributable to certain notional principal contracts with nonperiodic payments" is to be reported. In contrast, the Treasury regulations under sections 6041 and 6049 make clear that embedded loan interest is not treated as interest for information reporting purposes.[9] As a result, we recommend that the Form 1099-INT instructions be revised to conform to the regulations.

f. Exempt from Embedded Loan Treatment One-Time Payments Made in Connection with the Modification of NPCs to Replace an Interbank Offered Rate

Proposed regulations under Treas. Reg. § 1.1001-6 (the "IBOR Regulations") were issued on October 9, 2019, providing that if certain requirements are satisfied, a modification of the terms of a non-debt contract (including a NPC) to replace

[9] Treas. Reg. § 1.6041-1(d)(5); Treas. Reg. § 1.6049-5(b)(16).

an IBOR with a “qualified rate” or a “fallback rate” and any associated modification is not treated as a taxable event. For this purpose, an “associated modification” may include the addition of an obligation of a party to make a one-time payment in connection with replacement of an IBOR-referencing rate with a qualified rate to offset the change in value of the non-debt contract that results from the replacement (a “one-time payment”).

The IBOR Regulations were proposed before the Final Regulations were promulgated and do not address whether an obligation to make a one-time payment is subject to embedded loan treatment. As noted in the letters from the Alternative Reference Rates Committee (“ARRC”) to the Treasury Department and the Internal Revenue Service dated April 8, 2019 and March 12, 2020, the purpose of the IBOR Regulations and other guidance addressing significant tax barriers is to ensure an orderly market transition away from IBORs, and any requirement that taxpayers determine whether their NPCs are subject to embedded loan treatment adds significant administrative burdens to such a transition. Requiring such a one-time payment to be tested for embedded loan treatment would be inconsistent with the flexible approach sought by ARRC and would create unnecessary uncertainty in the IBOR transition process. As a result, we recommend that the final IBOR Regulations include a rule that exempts from embedded loan treatment any one-time payment made in connection with the replacement of an IBOR in a manner contemplated by the IBOR Regulations.

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I would be happy to discuss this matter further with you or to provide any assistance that you may require.

Yours truly,

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