ISDA Safe, Efficient Markets

June 18, 2015

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

Re: Request for Delay in the Effective Date of Temp. Treas. Reg. § 1.446-3T (g) (4)

Dear Mr. Mazur:

I am writing on behalf of the North American Tax Committee ("NATC") of the International Swaps and Derivatives Association ("ISDA")[1] regarding the temporary regulations concerning notional principal contracts ("NPCs") with nonperiodic payments published on May 8, 2015 in Treasury Decision 9719 (the "Temporary Regulations"). The Temporary Regulations substantially alter the circumstances in which a nonperiodic payment under an NPC will result in an embedded loan for federal income tax purposes.

The NATC appreciates the effort the government put into drafting the Temporary Regulations, and in particular the exception provided therein for certain NPCs subject to margin or collateral requirements (the "Margin Exception"). The Margin Exception is a welcome response to important concerns raised by industry groups regarding potential embedded loan treatment where the party receiving a nonperiodic payment is not receiving any net financing and reflects an intention to provide much-

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 67 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, 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 web site: www.isda.org.

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needed relief from the administrative burden of tracking embedded loan treatment for many market transactions and potential adverse consequences to some taxpayers. The Margin Exception demonstrates that not every NPC with a nonperiodic payment should be in scope for embedded loan treatment, which we believe is good tax policy and consistent with the approach taken in the prior regulations under Treas. Reg. § 1.446-3(g)(4) (the "Prior Regulations").[2]

The Temporary Regulations, however, materially change the standard for finding an embedded loan contained in the Prior Regulations in a manner that will take affected parties a substantial amount of time to process and systematize in order to ensure full compliance. The Temporary Regulations eliminate the exception from embedded loan treatment contained in the Prior Regulations where the nonperiodic NPC payment is insignificant (the "Insignificant Payment Exception"). Thus, for NPCs entered into on or after November 5, 2015, the Temporary Regulations will require embedded loan treatment whenever an NPC has a nonperiodic payment (no matter how small) unless the Margin Exception or the exception for certain short-term transactions (collectively, the "Exceptions") applies.

Certain types of swaps trade under standardized terms and as a result will often trade with an upfront payment in order to cause the economics of such standardized trade to reflect the current market price of such instrument. For example, an increasing number of over-the-counter interest-rate swaps and credit default swaps executed on ISDA documentation that trade on standardized terms have such nonperiodic, upfront payments although they are not cleared. Even where daily variation margin or collateral is required to be posted, such posted amounts often will not comply with the technical requirements of the Margin Exception, as noted below.

While an Exception may be available in many cases to prevent embedded loan treatment, there will be a multitude of situations (particularly in the non-cleared context) where no Exception will apply. Even in those cases where an Exception is applicable, as a practical matter, market participants do not have systems in place to track whether NPCs they engage in (or otherwise have withholding or information reporting responsibility for) qualify for either Exception and will not have the operational ability to

[2] In this regard, we note that when NPC regulations were proposed in 1991, the preamble stated that the bifurcation of swaps with significant nonperiodic payments was "not intended to disrupt typical market transactions." In particular, the Service stated that it was "aware of the withholding tax consequences that may arise from interest recharacterization." The preamble thus strongly suggested that the rule for bifurcating swaps with significant nonperiodic payments was intended to act, effectively, as an anti-abuse rule that would require recharacterization only of materially off-market transactions without affecting regular market transactions, including those with insignificant nonperiodic payments.

comply with the Temporary Regulations if the Temporary Regulations become fully effective on November 5, 2015 as currently scheduled.[3]

Moreover, there are a number of uncertainties and ambiguities regarding the Temporary Regulations that should be addressed, and changes that should be considered, in order to make the rules work in the manner that was apparently intended. In light of these issues and the need for such clarifications (as well as the potential for changes to reflect the specific manner that NPCs are typically structured in the market), it would be wasteful and unnecessary for such parties to build systems to attempt to reflect the rules contained in the Temporary Regulations (including the lack of an exception for even relatively minor nonperiodic payments), rather than waiting until final regulations are issued. This is particularly true, in our experience, given the absence of potentially abusive behavior in the market (thus suggesting that there should be no rush to implement the Temporary Regulations before these issues are resolved).

The NATC respectfully requests, for the reasons described below, that the effective date of the Temporary Regulations be delayed until the date that is one year after the date that final regulations are published in the Federal Register, but no earlier than January 1, 2017. Prior to that date, the NATC recommends that taxpayers be permitted to rely on the Exceptions where applicable.

We note that the NATC will be providing a more detailed letter addressing the most important issues raised by the Temporary Regulations, but is submitting this letter in advance of that more comprehensive letter because of the importance of getting effective date relief soon so that affected parties may work toward compliance with the Temporary Regulations in a more reasonable timeframe.

1. <u>Embedded Loan Treatment Results in Far-Reaching Consequences for the Parties to Ordinary Market Transactions</u>

There are certain products that generally trade, whether cleared or not, with standardized terms, such as market agreed coupon ("MAC") swaps.[4] These

[3] One of the complex aspects of complying with the Temporary Regulations is the requirement that daily mark-to-market margin/collateral be posted in cash. In this regard, we note that temporary regulations under section 956 that were withdrawn in connection with the promulgation of the Temporary Regulations (Temp. Treas. Reg. § 1.956-2T(b)(1)(xi)) permitted a controlled foreign corporation to disregard its receipt of an upfront payment in determining the amount of its investment in United States property where such payment was made under a clear contract and satisfied certain requirements. It is noteworthy that while those regulations required that a payment in the nature of initial variation equal to the upfront payment be posed as margin, they did not require that daily mark-to-market margin be posted in cash.

[4] ISDA press release, dated April 24, 2013, announcing the publication of MAC Confirmation for Interest Rate Swaps, intended "to further improve transparency and promote liquidity in the [OTC] IRS market", with link to MAC form of confirmation. https://www2.isda.org/news/isda-publishes-market-agreed-coupon-confirmation-for-interest-rate-swaps

contracts will trade with an upfront market adjustment payment, although the amounts of these payments may be relatively small in comparison with the notional amounts of the related swaps. Other examples of common marketplace transactions with nonperiodic payments that will need to be addressed include, without limitation:

- swaptions that may be physically settled;
- credit default swaps with standardized fixed rates;
- caps and floors;
- deliverable swap futures; and
- interest rate swaps with standardized terms.

Because there is no exception for smaller payments under the Temporary Regulations, swap dealers will need to build systems to identify (i) any large or small nonperiodic payments and (ii) whether any exceptions apply, which will involve identifying any non-qualifying collateral that is posted each day during the term of the transaction, and then allocating any such non-qualifying collateral to any trades with nonperiodic payments. These new systems will then need to be linked to swap dealers' current withholding and reporting systems, as further discussed below.

The federal income tax consequences of embedded loan treatment are sweeping, and compliance with such treatment will be extremely burdensome and time-consuming. These consequences include:

- changing the source of income recognized with respect to the swap;
- altering of information reporting for payments made under the swap;
- potential imposition of withholding tax on interest deemed paid to a foreign person (in contrast to swap payments, which generally are not subject to withholding tax);
- affecting the apportionment of interest expense under section 861; and
- numerous other ancillary effects.

The Prior Regulations do not require embedded loan treatment for NPCs with insignificant nonperiodic payments, at least in part, in order to avoid subjecting market NPCs to these consequences and the compliance burdens associated with such treatment. As noted below, we believe that there should be relief for insubstantial nonperiodic payments so that the administrative burden for accounting for a deemed loan is commensurate with the policy objectives of the rule.

2. <u>The Building of Systems to Implement the Temporary Regulations Will be Complex and Time-Consuming</u>

Broker-dealers and other industry participants will need to spend significant resources to modify withholding and information reporting systems in order to fulfill the obligations created by the Temporary Regulations. These systems will need to (i) be able to determine which NPCs will be treated as having embedded loans (including determining whether an Exception is available), (ii) use such determinations in fulfilling each party's withholding and information reporting obligations and (iii) where an NPC has an embedded loan, take into account such embedded loan treatment in calculating the relevant party's tax liability (*e.g.*, for purposes of determining the source of income and deductions and the allocation of interest expense). Such systems will also need to identify when an NPC has been modified in a manner that is treated as a taxable exchange under section 1001 and whether any deemed nonperiodic payment on the modified NPC will result in an embedded loan.

Simply determining which NPCs will be treated as having embedded loans is an enormous task. For instance, in tracking whether an NPC qualifies for the margin exception, a withholding and information reporting system will need to evaluate:

- the term of the NPC;
- whether a nonperiodic payment has been made on the NPC;
- whether the NPC (or relevant clearinghouse or other rules) requires the posting of daily variation margin/collateral and whether such daily variation margin/collateral is in dollars (or cash in the functional currency of the NPC) throughout the life of the contract; and
- for every day of the term of an NPC:[5]
    - o whether margin/collateral was posted;
    - o to what extent such margin/collateral was in cash and whether such cash was in dollars or the functional currency of the NPC or in excess of the mark to market exposure on the NPC;
    - o whether the posted margin/collateral was at least equal to the amount of any nonperiodic payment; and

[5] Cleared derivatives generally require daily variation margin to be posted in cash and initial margin that often include securities in addition to cash; however, eligible collateral under an ISDA Credit Support Annex covers both initial margin and variation margin and typically includes securities, in addition to cash.

- to the extent that some non-qualifying collateral is posted on a net basis to a portfolio of trades, allocate such collateral to one or more contracts that have nonperiodic payments.

New systems will need to be constructed to implement these rules essentially from scratch. In addition, market participants should be allowed adequate time to analyze all of the collateral consequences of the Temporary Regulations in order to build the systems needed to ensure appropriate compliance with embedded loan treatment.

3. Clarification of the Temporary Regulations is Needed as the Exceptions May Not Apply to Many Typical Market Transactions

The foregoing issues with respect to complying with the Temporary Regulations are exacerbated by the fact that the Exceptions as currently drafted are too narrow to cover many typical market transactions. While these issues will be addressed more comprehensively in a separate letter that the NATC expects to submit, they include the following:

- clarification is needed regarding the availability of the Margin Exception when margin/collateral between the parties is netted across multiple transactions, where cash may not actually be transferred in the manner required by the Temporary Regulations;

- whether non-cleared swaps may qualify for the Margin Exception when executed pursuant to contracts that contain certain standard terms (such as minimum transfer requirements, thresholds for posting collateral and rounding of collateral amounts);

- how the Margin Exception is intended to apply to initial margin and more generally when both cash and non-cash margin/collateral are posted during the life of a trade;

- clarification that embedded loan treatment does not apply to contingent nonperiodic payments;

- whether fees paid to enter into an NPC are considered nonperiodic payments for this purpose; and

- the treatment of payments on certain types of NPCs, such as swaptions, caps and floors.

These issues, and others that will be identified, will ideally be the subject of clarifying changes in the final regulations in order to ensure that the Exceptions apply to the full range of transactions they were intended to cover or should cover. It would be inefficient for industry participants to be required to build systems to implement the Temporary Regulations until these issues have been resolved.

4. An Alternative to the Insignificant Payment Exception for Smaller Payments Should Be Adopted

We understand that one of the reasons for the deletion of the Insignificant Payment Exception was the difficulty in determining when the exception applies and the concern that some taxpayers might use such ambiguity to avoid treating large nonperiodic payments as embedded loans. We agree that the application of the Insignificant Payment Exception is not sufficiently clear and, as a result, would support replacing the Insignificant Payment Exception with a different, easier-to-apply exception that similarly would be intended to exclude from embedded loan treatment NPCs with nonperiodic payments that are insufficiently large to justify the complexity of embedded loan treatment.

Specifically, the NATC proposes that in place of the Insignificant Payment Exception, an exception from embedded loan treatment be provided for nonperiodic payments that are less than the greater of: (a) 10 percent of the NPC's notional principal amount and (ii) $1 million. Such an exception would be straight-forward to apply and would avoid the unnecessary complexity created by needing to identify NPCs with relatively minor nonperiodic payments and the associated tax compliance burdens once such NPCs are identified.[6] To the extent the government is concerned that such a rule could be avoided (*e.g.*, by artificially inflating the NPC's notional amount or by entering into a series of NPCs with nonperiodic payments of less than $1 million in order to avoid embedded loan treatment), an anti-abuse rule could be incorporated into the final regulations to curtail any potential abuses. We feel strongly that such an exception should be provided and that it would make little sense for industry participants to build systems to identify NPCs with immaterial embedded loans, particularly if the final regulations will ultimately provide an exemption from such treatment as suggested above.

5. Summary

As described above, substantial updates to reporting and withholding systems and controls are required in order to fulfill the withholding and reporting obligations created by the Temporary Regulations. NATC members believe that it is not in the interests of good tax policy or good tax administration for the full consequences of the Temporary Regulations to go into effect before those consequences have been more thoroughly analyzed and understood and appropriate changes and clarifications to the

[6] We are evaluating the inclusion of a separate exception from embedded loan treatment be provided for NPCs with nonperiodic payments required solely by virtue of such NPCs having standardized terms that are prescribed by clearing organization rules, applicable agency regulations or by an industry standard or model, such as the ISDA CDS Standard Model.

regulations are made. NATC members are unaware of any statutory amendment, instances of abuse or other unusual circumstances involving nonperiodic payments on NPCs that would justify the implementation of this important policy change prior to the publication of final regulations.

Consequently, we urge that the effective date of the Temporary Regulations be delayed until the later of one year after the date that the Temporary Regulations are published as final regulations and January 1, 2017. (We believe, however, that taxpayers should be allowed to rely on the Exceptions, where applicable, prior to final regulations becoming effective.) Further, whether a rule excluding smaller nonperiodic payments is adopted (as recommended above) will dramatically affect how systems are built, and thus such a delay in the effective date would allow affected parties to design their systems accordingly.

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

Yours truly,

Thomas Prevost

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