ISDA® Safe, Efficient Markets

March 11, 2016

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

Re: Comments on the Embedded Loan Rules in Prop. Treas. Reg. § 1.446-3(g)

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 proposed regulations concerning notional principal contracts ("NPCs") with nonperiodic payments published on May 8, 2015 (the "Proposed Regulations"). This letter supplements our letter dated June 18, 2015 (the "Effective Date Letter"), in which we requested (i) a delay in the effective date of the temporary regulations issued concurrently with the Proposed Regulations (the "Temporary Regulations") and (ii) the re-insertion of an exception from embedded loan treatment for smaller nonperiodic payments. The intent of this letter is to provide more detailed comments and recommendations on numerous important issues relating to the implementation of the Proposed Regulations.

As noted in the Effective Date Letter, the NATC appreciates the effort the government put into drafting the Proposed Regulations, and in particular the inclusion of an exception for certain NPCs subject to margin or collateral requirements (the "Margin Exception"). We believe that it is good tax policy not to require embedded loan treatment where the recipient of a nonperiodic payment does not receive any use of cash. There are, however,

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 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, 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.

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 **F** 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

numerous areas of uncertainty regarding how the Margin Exception applies to common market transactions, and in particular NPCs that are not cleared.

In addition, NATC members are particularly concerned about the compliance burdens that will arise from the Proposed Regulations. It will be difficult for financial institutions and investment funds to apply the Proposed Regulations, and in particular the Margin Exception. Such taxpayers do not have systems in place to track and monitor their NPC transactions and related collateral as required to determine whether the Margin Exception applies. The Proposed Regulations will require improvements to a number of non-tax systems that would then feed into their tax reporting systems. Building and updating such systems will be time-consuming and complex. For instance, to decide whether an NPC qualifies for the Margin Exception, affected taxpayers 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 daily posting of variation margin and whether such variation margin is in dollars (or cash in the functional currency of the NPC) throughout the life of the contract;
- how to allocate collateral posted between parties with respect to multiple derivatives transactions entered into between them using a single collateral arrangement that requires the netting of collateral; and
- whether the posted collateral was at least equal to the amount of any nonperiodic payment.

These requirements mean that, for every day of the term of each NPC, affected taxpayers will have to be able to observe:

  - whether collateral[2] was posted;
  - to what extent such collateral was in cash and whether such cash was in dollars or the functional currency of the NPC;
  - to what extent posted collateral exceeded the mark-to-market exposure on the NPC; and
  - to the extent that some non-qualifying collateral is posted on a net basis to a portfolio of trades, how such collateral should be allocated to one or more contracts that have nonperiodic payments.

[2] The Proposed Regulations generally refer to the posting of "margin" or "collateral." Except where the context requires otherwise, this letter will use the terms "margin" and "collateral" interchangeably.

We believe that the complexity of implementing the Proposed Regulations will be disproportionately burdensome relative to the tax policies that the Proposed Regulations are intended to uphold. This is particularly troubling to financial institutions and other taxpayers that are working diligently to prepare for the effectiveness of the section 871(m) regulations as well as to comply with the Common Reporting Standard and FATCA. NATC members have limited resources to implement such complicated tax compliance projects. We also note that it is expected that substantial work will need to be undertaken to update tax reporting systems to reflect the anticipated revised regulations on swaps with contingent nonperiodic payments. The NATC feels strongly that it would be duplicative and wasteful to develop systems to reflect the provisions of the Temporary Regulations and then to need to re-design such systems to deal with the contingent swap regulations. As a result, we ask that the effective date of the Proposed Regulations be sufficiently delayed so that industry has sufficient time to build systems and processes for these regulations after the initial implementation period for the section 871(m) regulations has ended. Specifically, we request that the final regulations apply only to transactions entered into on or after the later of January 1, 2018 and January 1 of the first calendar year that begins more than one year after the date that the contingent swap regulations are issued as final regulations. Although this date is later than the date that we requested in the Effective Date Letter, we have come to believe that a later effective date is extremely important in light of the daunting task of bringing to completion the various compliance projects currently underway. Furthermore, as discussed below, the non-tax regulatory rules for the posting of collateral are undergoing change at this time, and it would be difficult for institutions to manage the application of these rules if the scope of the Margin Exception were not to conform with the regulatory rules.

Because of the substantial complexity and administrative and technological burdens that the Proposed Regulations will impose on market participants in their current form, this letter includes a number of recommendations that are intended to make the provisions of the Proposed Regulations easier to implement. This letter also makes several recommendations that are intended to clarify areas of uncertainty, simplify how the Proposed Regulations apply to common transactions and promote the consistent application of the Proposed Regulations. The NATC believes these recommendations will simplify compliance with the Proposed Regulations while preserving the tax policy goals of the Proposed Regulations.

Under the Proposed Regulations, market participants would need to alter the collateral arrangements relating to many NPCs (particularly those relating to non-cleared NPCs) in order to comply with the Margin Exception. Thus, this letter also makes several recommendations that are intended to conform the scope of the Margin Exception to customary market practice. As described in Part 1 below, we believe that applying the Margin Exception to exempt customary market transactions is consistent with the tax policy behind the Proposed Regulations and that there are no compelling reasons to use a more restrictive Margin Exception to force taxpayers to change current market practice in order to qualify for the exception.

The NATC's recommendations on the Proposed Regulations, which are discussed in more detail below, include substantial recommendations on the application of the Margin Exception and on the Proposed Regulations more generally. With respect to the Margin Exception, it is recommended that final regulations on embedded loan treatment (the "Final Regulations"), when issued:

- Expand the types of collateral that are taken into account for purposes of the Margin Exception to include all currencies and readily marketable securities;

- Clarify that the exposure under NPCs will be deemed fully collateralized for purposes of the Margin Exception even when the actual amount of collateral transferred between the parties is determined on a net basis;

- Clarify how the Margin Exception applies when a combination of cash and other property is posted as variation margin, and when the relative amounts of cash and other collateral change over the term of an NPC;

- Permit the Margin Exception to apply to the extent that qualifying collateral has been posted as margin in respect of a nonperiodic payment regardless of whether the remainder of the nonperiodic payment is collateralized;

- Revise the Margin Exception to permit the use of the minimum transfer amount, rounding and threshold terms typically used in non-cleared swap transactions;

- Permit the Margin Exception to apply when collateral is posted to a third-party custodian rather than the NPC counterparty;

- Expand the Margin Exception to apply to collateral that is required to be posted under the rules or requirements of a non-U.S. clearinghouse or non-U.S. regulator; and

- Modify the treatment of excess collateral so that it is not treated as an embedded loan.

With respect to other aspects of the Proposed Regulations, the NATC recommends that the Final Regulations:

- Provide an exemption from embedded loan treatment for smaller nonperiodic payments;

- Exempt nonperiodic payments on NPCs subject to mark-to-market accounting from embedded loan treatment;

- Clarify that fees paid in connection with entering into an NPC are not treated as nonperiodic payments;

- Exempt nonperiodic payments that are in the nature of option premium from embedded loan treatment;

- Exempt nonperiodic payments that are reasonably expected to be economically offset with periodic payments within one year from embedded loan treatment;

- Exempt nonperiodic payments on NPCs with standardized terms from embedded loan treatment;

- Apply the section 956 exception from embedded loan treatment to CFCs that are not dealers in securities or commodities;

- Clarify that deemed interest payments on embedded loans will be eligible for the portfolio interest exemption and will not result in a lending business for non-U.S. payors of nonperiodic payments;

- Exempt nonperiodic payments that result from a deemed exchange of an NPC under section 1001 from embedded loan treatment; and

- Provide guidance on the information reporting requirements that result from embedded loan treatment.

1. <u>General Comments Regarding the Rationale for Embedded Loan Treatment</u>

We urge the government to consider the comments provided below in light of the tax policy rationale for characterizing nonperiodic payments of certain NPCs as deemed loans. The tax consequences of respecting a nonperiodic payment as a payment on the NPC or instead characterizing the payment as a loan generally do not differ significantly in terms of the timing of income and deductions with respect to the NPC. That is, the timing of income should not be materially different whether a nonperiodic payment is amortized over the term of the NPC or the NPC is bifurcated into a loan and an on-market NPC.

Consequently, we believe that the proper role for a rule that bifurcates an NPC with a nonperiodic payment into a loan and an on-market NPC is to prevent taxpayers from disguising loans within NPCs in order to avoid the application of certain rules whose application depends on whether a transaction is a loan or other obligation for tax purposes (*e.g.*, section 514 and section 956). Otherwise, from a tax accounting perspective, the difference between the characterization of a payment as a loan or as an amortizable item should not be sufficiently important to justify the complexity involved in requiring taxpayers to identify which payments must be recharacterized. 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 stripped out of the transaction in which it resides and treated as a separate transaction. Upfront payments that occur within the confines of many other types of transactions (*e.g.*, prepaid forward contracts) are not characterized as loans for tax purposes. It should instead be a question of weighing the benefits of stripping out the embedded loan versus the complexity of doing so. When the timing and character of a taxpayer's inclusions of income and deductions with respect to an NPC comport with its economic substance, it ordinarily should be acceptable to avoid the complexity of separating out an embedded loan. In our view, the appropriate reach of embedded loan treatment for NPCs is to transactions that are structured in a manner that presents significant potential for abuse by disguising a loan as a nonperiodic payment on an NPC.

For example, as discussed in more detail below, when a taxpayer enters into a standardized NPC that requires an upfront payment (due to its standardized terms and not due to the negotiation of the parties), the upfront payment is not being paid in order to disguise a loan as an NPC payment, and thus should not be recharacterized as an embedded loan.

2. Overview of Market Practice in Posting Collateral for NPCs

a. Types of NPCs Most Likely to Provide for Nonperiodic Payments

While nonperiodic payments can arise in a number of settings, they occur most frequently when the present value of the payments to be received under the NPC by one party is expected to be greater than the present value of the payments to be made by such party. In such a case, an upfront payment is typically made in order to equalize the economic consequences between the parties. This occurs most frequently in the context of credit default swaps ("CDSs"). We interpret the Temporary Regulations as not providing for embedded loan treatment in the case of NPCs that provide for contingent payments, such as CDSs (if they are considered NPCs), equity swaps and other types of total return swaps, and that the rules which will address the tax accounting for contingent NPCs will address how noncontingent nonperiodic payments in those transactions should be treated.

For non-contingent NPCs, nonperiodic payments may arise where the NPC utilizes standardized terms. For example, in 2013, ISDA released the "market agreed coupon" or "MAC" confirmation for interest-rate swaps in order to standardize interest-rate swap terms. The MAC confirmation contains a menu of fixed terms that can be selected by the parties to the swap. To the extent the current market pricing differs from the standardized MAC terms, a nonperiodic payment will be made at the inception of the swap. Using standard ISDA terms for non-cleared interest-rate swaps allows the parties to trade their swap positions more efficiently. Standardization of NPCs increases liquidity in the OTC markets. It also gives market participants opportunities to engage in "portfolio compression," thereby reducing the notional amounts of swaps outstanding.[3]

In portfolio compression, participating dealers are able to eliminate derivative trades among themselves where the risks of those trades offset one another according to the parameters agreed by each participant. At the end of the portfolio compression process, a large percentage of the derivative trades that were submitted for compression by the participant dealers are typically eliminated altogether, while the terms of the remaining trades that were submitted for compression are modified (*e.g.*, their notional amount could increase/decrease, the maturity date of the trade could be extended, etc.).

At the end of the portfolio compression, each participant either receives or pays a "compression fee" depending, among other things, on the value of the trades that were submitted to compression in the hands of each such participant as well as the terms of the modified trades

[3] Portfolio compression is widely used in practice among derivative dealers. For example, ISDA Year-End 2012 Market Analysis (available at http://www2.isda.org/news/isda-publishes-year-end-2012-market-analysisportfolio-compression-and-central-clearing-continue-to-impact-size-of-otc-derivatives-market) observes that during 2012, $48.7 trillion in notional amount of OTC derivatives were eliminated via portfolio compression, including $44.6 trillion of interest rate derivatives. A total of $214.3 trillion of OTC derivatives has been eliminated in the past five years via portfolio compression. Moreover, compression has been incorporated into the new regulatory landscape. For example, CFTC rule § 23.503 provides that "swap dealers" and "major swap participants" must have policies and procedures for portfolio compression (the logic being that reducing gross notional exposure is a critical goal in reducing operational risk and cost).

that resulted from the compression. At least with respect to portfolio compression among non-affiliates, we understand that the recipient of compression fees cannot, as a practical matter, determine what portion of the compression fees received represents fees for termination of existing trades that were included in the portfolio compression (fees that would represent "termination payments") and what portion of the fees represents payments for modification of the terms of existing trades (fees that would represent "non-periodic payments").

Another circumstance in which a non-contingent NPC may provide for a nonperiodic payment is where one party is entering into the NPC to hedge another position (*e.g.*, a debt instrument) and structures the NPC so that one of its payment legs matches the payment terms of the hedged position. In such a case, the terms of the NPC may be off-market, requiring one of the parties to make an upfront payment. Nonperiodic payments on NPCs also arise in the context of deliverable swap futures (which are interest rate swaps that are settled on a forward basis). Other circumstances in which nonperiodic payments arise are discussed below.

Finally, as described below, it is unclear whether certain amounts (*e.g.*, payments in the nature of fees) paid in connection with the execution of an NPC are considered nonperiodic payments for this purpose.

b. Types of Collateral Posted

In the case of cleared NPCs, variation margin is typically posted in cash, but not necessarily U.S. dollars or the currency the transaction is denominated in, while initial margin (often called the "independent amount") typically consists of both collateral consisting of U.S. dollars (or the currency in which payment obligations under the NPC are denominated) (in either case, "Qualifying Collateral") and other types of collateral ("Non-Qualifying Collateral"). In the case of non-cleared NPCs, under an ISDA Credit Support Annex (the "CSA") to the ISDA Master Agreement, the definition of "eligible collateral" applies to both initial margin and variation margin with these amounts generally commingled by the secured party, and parties often post non-cash property (such as Treasury securities and other marketable securities) and non-U.S. currencies other than the currency in which NPC payments are denominated. Under a CSA outside of the United States, parties generally will agree to a base currency other than the U.S. dollar, such as the euro, sterling, yen or Swiss franc.

Non-Qualifying Collateral is pledged for a variety of reasons, but often because it is economically less costly to post. In the most recent "Margin Survey" conducted by ISDA,[4] survey respondents reported that only 75.3% of the variation margin delivered as of December 31, 2014 for non-cleared derivatives was in the form of cash. The remaining 24.7% of the variation margin delivered was in securities. Respondents reported that variation margin delivered consisted of 21.4% government securities and 3.3% other securities (such as securities issued by government agencies, government-sponsored entities, municipalities, supranational bodies and corporations, as well as letters of credit and equities). Furthermore, the survey found that independent amount or initial margin was more frequently delivered in securities. As of December 31, 2014, only 64.7% of independent amount delivered was in cash while 11.1% was

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[4] *See* http://www2.isda.org/functional-areas/research/surveys/margin-surveys/.

in government securities and 24.1% was in other securities. Many firms reported commingled independent amount and variation margin. For those respondents, cash represented only 76.4% of commingled independent amount and variation margin delivered. Government securities were 20.9% of commingled collateral delivered, while other securities were 2.8% of commingled collateral delivered by those respondents.[5]

Approximately 48% of cash collateral delivered by reporting firms for non-cleared derivatives consisted of U.S. dollars.[6] While non-U.S. dollar collateral may be posted under most New York-law CSAs, non-U.S. dollar collateral is typically the base currency for non-U.S. collateral arrangements (such as the English law CSA).

For cleared derivatives, survey respondents reported that 100% of the collateral they received and delivered to meet variation margin for client clearing derivatives was in cash. Respondents reported delivering U.S. dollar cash to meet 65.6% of variation margin and other currencies to meet 34.4% of variation margin.[7]

c. Use of Collateral Arrangements Involving Rounding, Minimum Transfer Amounts and/or Thresholds

Parties to an NPC often employ a collateral arrangement (such as pursuant to a CSA) that generally requires full collateralization of the parties' obligations thereunder, but may not technically comply with the Margin Exception due to provisions such as "rounding," "minimum transfer requirements" and "thresholds."

The parties to a CSA typically establish a rounding convention to avoid the obligation to deliver collateral in an amount that is uneven. The amount of collateral that is required to be posted under the CSA is rounded up or rounded down to the nearest integral multiple specified by the parties. For example, if the amount of collateral that would otherwise be posted with respect to a party's mark-to-market exposure is $503,246.97, the rounding convention may require the posting of $500,000 of collateral.

The parties to a CSA often also specify a dollar amount as the "minimum transfer amount" for either or both parties. The use of minimum transfer amounts is employed so that a party will not be obligated to transfer a "nuisance" amount of collateral. In other words, the minimum transfer amount is intended to prevent the parties from being required to post relatively small amounts of collateral and permits them to wait until the mark-to-market exposure exceeds

[5] The amounts for variation margin received by survey respondents generally were similar to the amounts for variation margin delivered. Cash was 77.2%, and securities were 22.8%, of the variation margin received. Variation margin received included 16.3% government securities and 6.4% other securities. Only 55.4% of independent amount received by survey respondents was in cash while 24.2% was in government securities and 20.3% was in other securities. Of commingled independent amount and variation margin received, 71.7% was in cash, 12.0% was in government securities and 16.3% was in other securities.

[6] U.S. dollars represented approximately 46% of cash collateral received in such transactions.

[7] Of the cash received by respondents to meet variation margin for client clearing derivatives, 42.9% was in U.S. dollars and 57.1% was in other currencies.

a certain amount before collateral is required to be posted. Once the minimum transfer amount is reached, however, the full amount of collateral needed to cover the exposure must be transferred.

Finally, the parties to a CSA often agree to a "threshold" that applies across all of the transactions subject to the CSA. Like rounding and minimum transfer amounts, thresholds are used for administrative convenience to avoid collateral transfers that are deemed to be commercially unnecessary. Under a CSA with a threshold, no collateral is required to be posted until the aggregate net exposure for all transactions exceeds the threshold. Once the exposure exceeds the threshold, an amount of collateral equal to the excess must be posted in order to limit the exposure to the threshold amount. In addition, if a CSA has both a minimum transfer amount and a threshold, no collateral will be required to be posted until the amount of exposure exceeds the threshold by at least the minimum transfer amount. The amount of a threshold depends on the creditworthiness of the counterparty and is bilaterally negotiated. A CSA generally will provide for the minimum transfer amount and threshold to decrease to zero in the case of an event of default or if certain specified triggers are hit (*e.g.*, a decrease in credit rating or drop in net asset value below a certain amount).

d. Forthcoming Regulatory Changes

In the government's process for deciding how to revise the Temporary Regulations, we urge it to consider the forthcoming changes in the regulatory landscape relating to collateral for non-cleared swaps. Specifically, regulators in the United States, the European Union and Japan have all proposed or adopted rules regarding margin requirements for non-cleared derivatives. In certain jurisdictions, such as the United States, the rules regarding variation margin will begin to apply in late 2016 or early 2017, depending on the type of entity.

In the case of the United States, banking regulators—principally, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation—adopted in October 2015 joint final rules establishing minimum margin requirements for the non-cleared swap and security-based swap activity of registered dealers (such entities, "swap registrants") under their supervision.[8] In December 2015, the Commodity Futures Trading Commission ("CFTC") followed suit and issued final rules, largely identical to the U.S. banking agency final rules, for entities that are swap registrants registered with the CFTC that are not subject to supervision by a U.S. bank regulator.[9]

Under the U.S. rules, in a transaction between two swap registrants or between a swap registrant and a financial end-user, variation margin generally would be required to be posted at least daily. While this basic requirement is broadly in line with the requirements of the

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

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

The Securities and Exchange Commission has not at this time adopted parallel margin requirements for the non-cleared security-based swap activity of swap registrants registered with the SEC that are not under the supervision of a U.S. bank regulator.

Margin Exception, certain practices that are permitted under the U.S. rules may be inconsistent with the Margin Exception.[10] As a result, the Margin Exception may not be available for certain transactions that are fully in compliance with the U.S. regulatory margin regime for non-cleared swaps.

Of particular note is that under the final U.S. rules, the scope of assets constituting eligible collateral for the exchange of variation margin between a swap registrant and a financial end-user is not limited to cash but may include a broader range of collateral eligible to satisfy initial margin requirements, including government securities, certain other debt and equity securities and gold. Exchanges of variation margin between swap registrants still must be made in immediately available cash funds; however, U.S. bank regulators and the CFTC revised each final rule to allow counterparties to satisfy obligations in respect of variation margin in a major currency (*i.e.*, not necessarily the currency of settlement of the contract).

The U.S. rules also permit counterparties to use a minimum transfer amount of up to $500,000 in the aggregate for initial margin and variation margin (which is comparable to the €500,000 permitted minimum transfer amount under the proposed international framework).

In addition, to implement a statutory directive added by a recent amendment to the Dodd-Frank Act, the U.S. final rules explicitly provide that the requirements relating to both initial margin and variation margin do not apply to non-cleared swaps entered into by commercial end-user counterparties to hedge or mitigate commercial risk, along with a few other narrow transaction categories.[11] As a result, there will be a range of transactions that are not subject to mandatory posting of variation margin under the U.S. rules. It is expected that rules substantially similar to those in the United States will be finalized in Europe and Japan and that such rules will take effect at approximately the same time as the U.S. rules.

We believe that the Proposed Regulations should be revised to take into account the final U.S. rules implementing regulatory margin requirements (as well as the broadly similar approach expected to be taken by regulators in other jurisdictions). In particular, the U.S. tax characterization of a non-cleared swap transaction (and the character of swap payments that a party receives, including the applicability of U.S. withholding tax) should not depend on which one of the types of collateral permitted by regulators the taxpayer's counterparty decides to post as variation margin. Rather, the U.S. tax characterization of a swap should be consistent among all swaps permitted under the applicable margin regulations. Consequently, the Proposed Regulations should include in the definition of Qualifying Collateral currencies, government securities and other marketable securities or assets that regulators permit to be used as collateral. In addition, as discussed below, the Margin Exception should not be unavailable because a

[10] The final rules reflect a number of comments from industry groups that were designed to align the U.S. rules with the proposals of regulators in Europe and other jurisdictions.

[11] At the same time, the final rule of the U.S. bank agencies affirms the authority and obligation of swap registrants supervised by a U.S. bank regulator to collect from counterparties initial or variation margin pursuant to their counterparty credit risk management policies unless the relevant transaction is subject to the minimum margin requirements of the final rule (in which case such regulatory minimum applies) or exempted by the statutory directive.

counterparty takes advantage of a minimum transfer amount that is permitted under applicable regulations.[12]

3. Comments Relating to the Margin Exception

a. Expansion of the Exception to Treat All Currency and Certain Non-Cash Property as Qualifying Collateral

Under the Proposed Regulations, the Margin Exception applies to exempt a nonperiodic payment from embedded loan treatment only where the NPC is fully collateralized and only to the extent the collateral consists of Qualifying Collateral. As described above, in the case of non-cleared NPCs, a substantial amount of the collateral currently posted consists of non-cash property or non-U.S. dollar currency (which generally would constitute Non-Qualifying Collateral under the Proposed Regulations). We stress that under most existing ISDA documentation, each party typically has the right to post (in addition to U.S. dollars) certain types of non-cash collateral and currencies other than the U.S. dollar. Thus, absent a remediation of most ISDA documentation that is currently in place, when a nonperiodic payment is made on an NPC, a party to an ISDA would not be able to prevent the other party from causing a deemed loan to occur by posting Non-Qualifying Collateral as permitted under the ISDA agreement.

Applying the exception only to the extent of Qualifying Collateral would either (i) make the exception largely inapplicable to many non-cleared swaps (particularly without detailed guidance on how to allocate Qualifying Collateral and Non-Qualifying Collateral with respect to various transactions, as discussed further below in Part 3.c) or (ii) require parties to change the course of their behavior to post Qualifying Collateral even where it would be more efficient or otherwise preferable to post Non-Qualifying Collateral.

We recommend that the Margin Exception be revised to treat as Qualifying Collateral all readily marketable securities and currencies[13] regardless of whether payments on the NPC are denominated in such currency. A party that pledges as collateral readily marketable securities or currencies that are not Qualifying Collateral could simply have sold such securities or currencies for U.S. dollars and instead pledged such U.S. dollars as collateral.[14] We see no

[12] We also note that clearinghouses have been considering amending or clarifying their terms, rules and procedures to provide that the payment of variation margin with respect to OTC derivatives they clear constitutes settlement (rather than collateralization) of the exposure on such derivatives. Similarly, some financial institutions are exploring amending their documentation relating to non-cleared swaps to treat variation margin as settlement.

[13] We think all (or nearly all) currencies are sufficiently liquid that they should qualify as Qualifying Collateral. If the government is concerned about the pledging of illiquid currencies as collateral, we believe it would be reasonable to limit currencies that are considered Qualifying Collateral to those in which positions are traded through regulated futures contracts (*i.e.*, those currencies with respect to which foreign currency contracts (within the meaning of section 1256(g)(2)) could be traded).

[14] We note that in cleared transactions, while U.S. clearing organization rules generally require clearing members to post margin in U.S. dollars, a clearing member may accept collateral consisting of marketable securities or currency other than the U.S. dollar from the client on behalf of which it is clearing a trade. In these cases, the clearing member is acting as an agent of the client from a legal and accounting perspective. If the Final Regulations permit

significant tax policy reason why such pledgor should need to dispose of such securities or currencies and pledge the U.S. dollar proceeds of such sale in order to qualify for the Margin Exception.

In this regard, we note that under section 956(c)(2)(J), U.S. property does not include any obligation to the extent that the principal amount of the obligation does not exceed the fair market value of readily marketable securities posted or received as collateral for the obligation in the ordinary course of a dealer business. This suggests that, at least in that context, Congress has concluded that an amount of cash advanced against readily marketable securities does not have the same effect as a normal cash loan, and thus the rule generally applicable to a cash loan in such context should not apply. While section 956(c)(2)(J) by its terms applies only to collateral posted or received by dealers in securities or commodities, the principle it reflects (*i.e.*, that no impermissible financing is received when cash is advanced against securities) should have broader applicability.[15]

Consequently, we believe that the Margin Exception should be expanded to permit readily marketable securities and currencies other than the U.S. dollar that are pledged as collateral to be treated as Qualifying Collateral for this purpose.

b. Clarification That the Exception Applies Where Collateral Is Netted Across Multiple Trades

In order for the Margin Exception to apply, the parties to the NPC must be required to fully collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the NPC and the parties must post Qualifying Collateral in satisfaction of that requirement. This standard may be reasonably straightforward to apply in the unusual case where a collateral arrangement relates to a single NPC. Most NPCs (whether cleared or non-cleared), however, are executed pursuant to contracts or other arrangements that require the collateral for more than one contract to be calculated and netted on a daily basis, as illustrated by the examples below.

In all of the examples herein, A and B are parties to an ISDA Master Agreement that governs all derivatives transactions entered into between A and B. The collateral arrangements relating to the ISDA Master Agreement are governed by the CSA. The transactions described in the relevant examples are the only transactions that A and B have entered into under the ISDA Master Agreement.

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the broad use of marketable securities and currencies as Qualifying Collateral, the fact that the clearing member accepts collateral other than U.S. dollars from its clients would not prevent the Margin Exception from applying.

[15] We recognize that one might view the recipient of an upfront payment of cash on an NPC and the pledge of non-cash property as being economically similar to a repo of such non-cash property. Nevertheless, unlike a repo transaction, where the economic substance of the overall arrangement is that of a loan, in the context of an NPC with an upfront payment and the posting of collateral, the economic substance of the arrangement, in its totality, is merely that of a collateralized derivative contract, and not that of a loan.

Example 1: Single NPC with Full Cash Collateralization

On day 1, A makes an upfront payment of 100 to B on NPC1. Because the terms of the CSA require B to post 100 of variation margin to A, B posts 100 U.S. dollars directly to A on day 1.

Example 2: Two NPCs with Netted Cash Collateral

A and B enter into NPC1, as described in Example 1. In addition, on day 1, A and B enter into NPC2, and B makes an upfront payment of 50 to A on NPC2. The two upfront payments (which reflect partially offsetting market values of the two swaps) are netted and B is required to post 50 of variation margin to A under the CSA. B posts 50 U.S. dollars directly to A on day 1.

The situation in Example 1 is directly addressed by the Margin Exception as the amount of the upfront nonperiodic payment made by A to B equals the amount of U.S. dollar collateral posted by B as variation margin. In Example 2, the actual amount posted by B to A under the CSA at the time B receives the upfront payment of 100 on NPC1 is less than the upfront payment amount due to an offsetting transaction exposure of A to B. Similarly, A has not posted any collateral with respect to the upfront payment it received from B. In such a case, we believe that each of A and B should be treated for tax purposes as posting the gross amount of collateral required to collateralize its obligation to the other with respect to each transaction subject to the CSA, even though the actual transfer of cash is determined on the basis of net exposures.

In this regard, footnote 1 of the preamble to the Proposed Regulations states that the "total amount of initial variation margin posted by B may not equal the amount of A's upfront payment due to . . . the netting of B's notional exposure to A, or to the U.S.-registered clearinghouse, as a result of other transactions . . . . However, on a transaction-by-transaction basis, the payment of initial variation margin by B should equal (or closely approximate) A's upfront payment when any daily variation margin is treated as separate from the initial variation margin posted on that day."[16] While not entirely clear, this language suggests that the Proposed Regulations already contemplate that the netting of collateral should not prevent the Margin Exception from applying. Nevertheless, it is important for the Final Regulations to provide clearly that the exposure under NPCs will be deemed fully collateralized even when the actual amount of collateral transferred between the parties is determined on a net basis.

[16] We note that the preamble and the Proposed Regulations both refer in several places to the posting of "initial variation margin." The use of the term "initial variation margin" may cause confusion because "initial margin" is an amount that is required to be posted at the beginning of a transaction, regardless of mark-to-market exposure, to protect the pledgee from counterparty credit risk in case of future exposure (*e.g.*, due to a time delay in receiving mark-to-market collateral). In contrast, "variation margin" is an amount that is required to be posted to cover the mark-to-market exposure under a contract. *See, e.g.*, prop. reg. section 23.151, 79 Fed. Reg. 59,926 (Commodity Futures Trading Commission proposed regulations defining "Initial Margin" and "Variation Margin"). We suggest that in place of the term "initial variation margin," the Proposed Regulations instead refer to "variation margin" to make clear that such term relates solely to amounts posted to collateralize mark-to-market exposure under the NPC.

c. Clarification of How the Exception Applies Where Non-Qualifying Collateral Is Posted

The Proposed Regulations specifically contemplate that in some cases part but not all of a nonperiodic payment made on an NPC will be treated as an embedded loan. For example, while the rules contemplate that the mark-to-market exposure on an NPC may be collateralized with a combination of cash and non-cash property, they make clear that the excess of the nonperiodic payment over the amount of Qualifying Collateral posted is subject to embedded loan treatment under the Proposed Regulations. It is unclear how this partial application of the exception is meant to apply, particularly where the relative amount of Qualifying Collateral and Non-Qualifying Collateral varies over the term of the NPC. The following examples illustrate these issues.

Example 3: Single Swap with Qualifying and Non-Qualifying Collateral

> A and B enter into NPC1, as described in Example 1. However, instead of posting 100 of Qualifying Collateral as variation margin, B posts 50 of Qualifying Collateral and 50 of Non-Qualifying Collateral (*e.g.*, Treasury securities).

As written, the Proposed Regulations would likely be read to provide that A has made an embedded loan of 50 to B (*i.e.*, the amount of the Non-Qualifying Collateral). In such case, what would be the terms of the hypothetical "on-market" NPC? Would the NPC be bifurcated into two separate NPCs, each with a notional principal amount equal to half of the total notional principal amount of NPC1 (such that one of the NPCs has an embedded loan of 50 and the other qualifies for the Margin Exception)? Or would NPC1 be treated as having both a nonperiodic payment of 50 that is not an embedded loan and an embedded loan of 50, such that the terms of the NPC after bifurcation of the embedded loan would still include a nonperiodic payment and "off-market" periodic payments? While this creates significant complexity, a much more substantial complication arises if the relative value of Qualifying Collateral increases or decreases with respect to NPC1 (which often occurs in a typical collateral arrangement as the fair market value of collateral and positions change and the mix of collateral is modified).

Example 4: Single Swap with Changing Amount of Qualifying and Non-Qualifying Collateral

> A and B enter into NPC1, and B posts 50 of Qualifying Collateral and 50 of Non-Qualifying Collateral as variation margin, as described in Example 3. One week after entering into NPC1 and posting collateral, B withdraws 10 of the posted Non-Qualifying Collateral and substitutes 10 of Qualifying Collateral.

Such a change to the amount of Qualifying Collateral that is pledged raises a number of complex issues. For instance, does the amount of the embedded loan increase or decrease with each decrease or increase of Qualifying Collateral over the term of the NPC? If the amount of the embedded loan increases or decreases, do the terms of the NPC change as well and, if so, how should the change in terms be determined?

Example 5: Basic Netting

A and B enter into NPC1 and NPC2, as described in Example 2. That is, A makes an upfront payment of 100 to B under NPC1, and on the same day B makes an upfront payment of 50 to A under NPC2. However, instead of posting 50 of Qualifying Collateral as variation margin, B posts 30 of Qualifying Collateral and 20 of Non-Qualifying Collateral.

As to NPC2, the same issue described in Example 2 is presented here (*i.e.*, whether A is considered to have posted any variation margin at all with respect to the upfront payment by B). There is also a question as to whether, if A is treated as posting variation margin, such margin is deemed to consist of Qualifying Collateral. As to NPC1, how much Qualifying Collateral is B considered to have posted to A in respect of the 100 upfront payment by A to B? The answer should be 80 because there is no reason to deem B to have posted the netted collateral in any property other than Qualifying Collateral. However, it is not entirely clear whether it could be 60 (*i.e.*, whether B's netted collateral could be deemed to consist of the same mix of Qualifying Collateral and Non-Qualifying Collateral as the posted collateral).

Example 6: Complex Netting

A and B enter into NPC1 and NPC2, as described in Example 2. That is, A makes an upfront payment of 100 to B under NPC1, and on the same day B makes an upfront payment of 50 to A under NPC2. In addition, also on day 1, A makes an upfront payment of 30 to B under NPC3. Thus, A has a net payment obligation to B of 80, and B posts 80 as variation margin, but that margin consists of 60 of Qualifying Collateral and 20 of Non-Qualifying Collateral.

In this example, there are again questions as to whether A is considered to have posted any variation margin at all and, if so, whether such margin is deemed to consist of Qualifying Collateral. How would the Margin Exception be applied to the collateral posted by B with respect to A's nonperiodic payments? While one might conclude that 25% of each nonperiodic payment by A to B would be treated as an embedded loan (*i.e.*, the percentage of the overall collateral posted by B that consists of non-cash collateral), it is not clear that this is the correct way to apply the rule. Alternatively, the 20 of non-cash collateral might be allocated entirely to NPC1 or NPC3, or some other allocation might be viewed as appropriate.

In reality, collateral arrangements will regularly cover a variety of NPCs with and without upfront payments as well as other derivatives. As a result, the posted collateral generally will need to be deemed to cover various positions on a gross basis (before it is netted down to the amount that is actually posted) and allocated among those positions in some manner. When there is both Qualifying Collateral and Non-Qualifying Collateral posted, the gross collateral should be deemed to consist of Qualifying Collateral except to the extent that there is actually

Non-Qualifying Collateral posted. To make the rules more administrable, taxpayers should be permitted to allocate Qualifying Collateral to NPCs with nonperiodic payments to the extent possible on the date of the nonperiodic payment.

Example 7: Complex Netting Over Time

> A and B enter into NPC1, NPC2 and NPC3, and B posts variation margin consisting of 60 of Qualifying Collateral and 20 of Non-Qualifying Collateral, as described in Example 6. One week later, based on daily mark-to-market movements for the three NPCs, B is entitled to withdraw 10 of posted collateral. B withdraws 10 of Non-Qualifying Collateral.

In this example, will the portion of A's nonperiodic payments that are treated as embedded loans change? May the parties redetermine how much of the remaining posted Non-Qualifying Collateral relates to each NPC?

Importantly, the daily variation margin requirement in the Proposed Regulations effectively requires U.S. taxpayers and withholding agents to monitor the types of collateral posted every day throughout the life of the NPC for purposes of their own tax reporting as well as reporting and withholding on payments to foreign recipients. Furthermore, it must be determined how changes in the types of collateral affect the deemed loan. These complex issues arise solely because of the need to track the type of collateral posted throughout the life of the contract in order to determine whether a nonperiodic payment is treated as a loan. Due to the extreme complexity of monitoring the Qualifying Collateral and Non-Qualifying Collateral posted with respect to NPCs with nonperiodic payments and other derivatives as the fair market values of the collateral and positions change over time, the types of collateral that constitute Qualifying Collateral must be expanded. In addition, to alleviate this complexity and make the Margin Exception more administrable, we recommend that the amount of the embedded loan be determined by the amount of Qualifying Collateral that is posted when the nonperiodic payment is made. Under such a rule, changes in the types of collateral posted over time would not affect the amount of the embedded loan (or whether there is an embedded loan) unless there is a substitution or other change made in the relative amounts of Non-Qualifying Collateral and Qualifying Collateral associated with the NPC at a later date with a principal purpose of avoiding embedded loan treatment. This proposed change would make the Margin Exception significantly more administrable for market participants and the Service. Modification of the Margin Exception in this way would not affect the requirement for daily variation margin to be posted; rather, it would simply relieve market participants from having to track the type of collateral (rather than only the amount) posted on a daily basis and connect such collateral tracking with withholding and tax reporting systems.

If this suggestion is not adopted, there are several ways that the Final Regulations might address situations in which a portion of the posted collateral is Non-Qualifying Collateral. While the regulations could provide detailed technical rules explaining how to apply the embedded loan rule to deal with these complexities, it would be extremely complex to implement such rules in a systematic way. A more flexible approach would be to allow taxpayers to determine the application of the Margin Exception in circumstances where Non-

Qualifying Collateral is posted using any reasonable method that is consistently applied. More importantly, adoption of a number of the recommendations below (and in particular those relating to treatment of certain non-cash assets and currencies as Qualifying Collateral (in Part 3.a above) and the use of rounding, minimum transfer amounts and thresholds (in Part 3.e below)) would minimize the circumstances in which Non-Qualifying Collateral is posted by conforming the Margin Exception to market practice.

d. Permit the Margin Exception to Apply to the Extent Qualifying Property Is Posted Even If the NPC Is Not Fully Collateralized

The Margin Exception to the embedded loan rule applies when the posting and collection of margin in the amount of the nonperiodic payment precludes the recipient of the nonperiodic payment from receiving any financing. We believe that the same logic should apply when some, but less than all, of a nonperiodic payment is required to be posted and collected as margin, to the extent of the amount that is posted. The Proposed Regulations' rule that a swap must be required to be fully collateralized in order to benefit from the Margin Exception will result in unjustifiable differences in the tax treatment of transactions that are substantially similar economically. These differences could take on great importance depending on whether the Proposed Regulations are ultimately revised to account for customary exceptions to the posting of collateral, such as rounding, minimum transfer amounts and thresholds, which are discussed further below. The following examples are illustrative:

Example 8: Less Than Full Collateralization

A and B enter into NPC1, as described in Example 1. However, while A makes an upfront payment of 100 to B pursuant to NPC1, B is required to post variation margin consisting of only 90 of Qualifying Collateral.

In Example 8, the Margin Exception does not apply under the Proposed Regulations as currently drafted, and the entire 100 nonperiodic payment is characterized as a loan from A to B even though B receives only 10 of financing as an economic matter.

Example 9: Series of NPCs with Varying Collateralization

A and B enter into NPC4 and A makes an upfront payment of 50 to B. B posts 50 of Qualifying Collateral to A. The next day, A and B enter into NPC5 under which A makes an upfront payment of 50 to B. NPC5 has the same terms as NPC4 but is executed and settles one day later. B does not post any additional collateral for NPC5.

In Example 9, NPC4 is fully collateralized and the Margin Exception applies. When A and B enter into NPC5 the next day without any additional collateral, NPC4 may be viewed as continuing to be fully collateralized. If that view is correct, there is an embedded loan of only 50. On the other hand, if on day two NPC4 were cancelled and NPC5 were entered into with respect to the full combined notional amount of NPC4 and NPC5 with a 100 upfront payment, there would be a 100 embedded loan under the Proposed Regulations because NPC5 would not be fully collateralized.

We see no reason why the application of the Margin Exception should be limited to situations where the parties' obligations are fully collateralized. Rather, consistent with the policy behind the embedded loan rule, we recommend that the Final Regulations provide that embedded loan treatment will apply only to the extent that an NPC is not collateralized with Qualifying Collateral, even where the parties' obligations under such NPC are not required to be fully collateralized.

e. Revise the Margin Exception to Address Typical Provisions for Non-Cleared Swaps (Rounding, Minimum Transfer Amounts and Thresholds)

As described above, parties to an NPC often employ a collateral arrangement (such as pursuant to a CSA) that generally requires full collateralization of the parties' obligations thereunder, but may not technically comply with the Margin Exception due to provisions such as "rounding," "minimum transfer requirements" and "thresholds." The NATC believes that such provisions, which are widely used for non-tax reasons, should not, if commercially reasonable, prevent the Margin Exception from applying to an otherwise compliant collateral arrangement.

While the use of rounding may cause a contract not to be fully collateralized down to the penny, the amount of collateral posted should be sufficiently close to the mark-to-market exposure that the arrangement should be considered compliant with the Margin Exception. This is particularly true because a rounding convention usually applies bilaterally (*i.e.*, it may cause slight overcollateralization or slight undercollateralization).

The use of minimum transfer amounts is employed so that a party will not be obligated to transfer a "nuisance" amount of collateral. Like the use of rounding, the use of minimum transfer amounts provides for a more efficient operation of the collateral arrangement and avoids the need to make collateral transfers that are unnecessarily small. Minimum transfer amounts are contractual rules that the parties negotiate at arm's length for administrative convenience, not for tax avoidance. Minimum transfer amounts exist because swap counterparties conclude that it is commercially unnecessary for collateral to be transferred when the minimum transfer amount has not been reached. Furthermore, as mentioned above, regulators in the United States, Europe and Japan have proposed rules on margin requirements for uncleared swaps and uncleared security-based swaps that would permit the use of minimum transfer amounts for total margin (including both initial margin and variation margin). U.S. prudential regulators and the CFTC do not require the posting or collection of margin (both initial margin and variation margin) unless the total amount of exposure exceeds $500,000. European regulators have proposed to permit minimum transfer amounts that do not exceed €500,000 for the sum of variation margin, initial margin and any other collateral. Accordingly, we believe it would be inappropriate for the Final Regulations to adopt rules that compel swap parties to choose between eliminating the minimum transfer amount provisions from their CSAs and losing the administrative convenience of those provisions or subjecting themselves to the burdens and complexity of (i) determining which (if any) of the non-cleared contracts subject to the CSA are eligible for the Margin Exception and which are not and (ii) bifurcating ineligible swaps.

Like rounding and minimum transfer amounts, thresholds are contractual rules that parties negotiate at arm's length for administrative convenience rather than to disguise loans for tax avoidance purposes, and thus should not prevent an otherwise qualifying collateral arrangement from benefiting from the Margin Exception.

In sum, because nearly all CSAs currently provide for rounding, minimum transfer amounts and/or thresholds, the practical effect of not providing an exception for these features would be to make the Margin Exception unavailable to most non-cleared swaps. There are many regulatory changes being considered with respect to collateral arrangements for non-cleared swaps, and there should be flexibility for market participants to use commercially reasonable collateral arrangements that are permitted by regulators. The existence (or absence) of rounding, minimum transfer amount and/or threshold provisions in a CSA that may govern numerous swaps as well as other derivative transactions between two counterparties does not provide a strong basis to recharacterize a swap into a modified swap and an embedded loan transaction where a loan would not otherwise exist.

f. Amend Exception to Apply Where Collateral Is Posted to a Third Party Custodian or Similar Party

In order for the Margin Exception to apply, the parties to the NPC must "post and collect" collateral covering the mark-to-market exposure on the NPC. By requiring that the collateral not only be "posted," but also "collected," the exception appears to require the recipient of the nonperiodic payment to pledge collateral to the party making the payment. While that is typically what happens in the context of cleared NPCs, many non-cleared NPCs require collateral to be posted to a third party (such as a custodian or a party acting in a similar capacity). Third party collateral arrangements generally are intended to protect the pledgor from the credit risk of its counterparty.

We believe a third party collateral arrangement should qualify for the Margin Exception. The party receiving the nonperiodic payment will have received no use of cash because it will have pledged the same amount of cash or property to the third party collateral agent. While in such case the party making the nonperiodic payment will not have received the pledged amounts, the embedded loan rule should be focused on whether the party receiving the nonperiodic payment has received financing. Consequently, we believe that a collateral arrangement otherwise qualifying for the Margin Exception should be eligible for the exception regardless of whether the collateral is posted to a third party or to the party making the nonperiodic payment.

g. Expansion of the Exception to Cover Collateral Required to Be Posted Under the Rules or Requirements of a Non-U.S. Clearinghouse or Non-U.S. Regulator

Under the Proposed Regulations, a collateral arrangement will benefit from the Margin Exception only if the parties are required to fully collateralize their mark-to-market exposure on the contract on a daily basis and such requirement is imposed by (i) a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or a clearing agency (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)) 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 (a "Qualified Clearinghouse") or (ii) the terms of the contract or the requirements of a federal regulator. While certain non-U.S. clearinghouses are treated as Qualified Clearinghouses, many non-U.S. clearinghouses are not. It is unclear what policy objective is served by not permitting margin arrangements imposed by clearinghouses other than Qualified Clearinghouses to qualify for the Margin Exception. Similarly, it is unclear why an otherwise qualifying collateral arrangement that is required by a non-U.S. regulator should not be eligible for the Margin Exception. Therefore, we recommend modifying the Margin Exception to permit collateral arrangements to benefit from the exception even where such arrangements are required by a clearinghouse other than a Qualified Clearinghouse or by a non-U.S. regulator.

h. Modify the Treatment of Excess Collateral

The Proposed Regulations provide that if the amount of cash collateral that is posted and collected is in excess of the amount necessary to fully collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract, any excess is treated as a nonperiodic payment and subject to the rule providing embedded loan treatment for nonperiodic payments. This rule appears inconsistent with the policy behind the embedded loan rule and the general treatment of collateral for tax purposes. We believe it is clear that all amounts transferred under a collateral arrangement (such as a CSA) in respect of an NPC are not treated as payments under the NPC. Rather, such cash amounts are considered to be loaned or deposited by the pledgor to the pledgee, and there is interest payable on those amounts to the pledgor. An upfront payment under an NPC reduces one or more of the other payments made under the NPC whereas an amount transferred as collateral does not. Initial margin is primarily related to the credit risk of the counterparty with respect to the transactions entered into, and is routinely posted with respect to both cleared and non-cleared swaps in an amount that exceeds variation margin pledged to collateralize the mark-to-market exposure on a particular swap contract. When collateral in excess of the pledgor's mark-to-market margin obligations under the NPC is pledged in the form of cash, such excess cash should be treated for tax purposes in the same manner as any other cash collateral that is pledged (and the actual interest paid on such collateral should be respected as interest).

4. Other Comments

a. Exempt Smaller Nonperiodic Payments from Embedded Loan Treatment

In the Effective Date Letter, the NATC proposed that an exception from embedded loan treatment be provided for nonperiodic payments that are less than the greater of: (i) 10 percent of the NPC's notional principal amount and (ii) $1 million (the "Smaller Payment Exception"). NATC members continue to believe that the Smaller Payment Exception would be an appropriate replacement for the rule in the prior regulations that exempted a nonperiodic payment under an NPC from embedded loan treatment if such payment was not "significant." An exemption for smaller payments is critical to effective administration of the deemed loan rule by avoiding onerous compliance burdens where the amount at stake is relatively small. We understand, however, that there may be a concern that the Smaller Payment Exception (as proposed by the NATC) could allow for a substantial nonperiodic payment to escape embedded loan treatment when the notional principal amount of the NPC is very large. Accordingly, we reiterate our recommendation that the Smaller Payment Exception be adopted, but with the modification that the Small Payment Exception would not apply to any NPC with a nonperiodic payment of more than $5 million.[17] Thus, as modified, the Small Payment Exception would 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. If adopted, this recommendation would provide appropriate relief against the compliance burdens associated with determining whether the Margin Exception applies, and with accounting for an embedded loan, to those NPCs that will not produce a meaningful amount of embedded-loan interest. We continue to feel strongly that a Smaller Payment Exception is necessary to balance the government's stated rationale for requiring embedded loan treatment with the burden that the regulations impose on the affected parties.

b. <u>Exempt NPCs Subject to Mark-to-Market Accounting from Embedded Loan Treatment</u>

In the preamble to the Temporary Regulations, the government requested "comments on whether it is necessary to require taxpayers to apply the embedded loan rule to NPCs with nonperiodic payments that are subject to mark-to-market accounting." As an initial matter, we note that under the existing regulations, the mark-to-market timing rules of section 475 already take precedence over the timing rules for periodic and nonperiodic payments. *See* Treas. Reg. § 1.446-3(c)(1)(iii) (providing that "[t]o the extent that the rules provided in paragraphs (e) and (f) of [Treas. Reg. § 1.446-3] are inconsistent with the rules that apply to any notional principal contract that is governed by section 475 and regulations thereunder, the rules of section 475 and the regulations thereunder govern"). It is not clear, however, whether that rule applies to prevent embedded loan treatment (which is set forth in -3(g), rather than -3(f)). As a result, we recommend that the Final Regulations clarify that NPCs that are subject to mark-to-market treatment are exempt from embedded loan treatment.

A taxpayer that marks to market its NPC positions generally should be unaffected by embedded loan treatment because all income or loss (including any deemed interest deductions or inclusions) with respect to such NPCs will be ordinary in character. In addition, the timing of income and deductions with respect to the NPCs should be unaffected by deemed loan treatment where mark-to-market accounting applies. While treatment of certain items as interest income or deduction could have ancillary consequences, the use of embedded loan

[17] In this regard, we would 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 embedded loan treatment should not be required.

treatment in the case of a mark-to-market taxpayer should be viewed as unnecessarily complex to impose in such a case.

Consequently, we recommend that the Final Regulations provide an exception from embedded loan treatment in the case of any taxpayer that accounts for the relevant NPC under the mark-to-market method of accounting (including any NPC marked-to-market pursuant to a trader election under section 475(f)).

c. Clarify That Fees Paid in Connection with Entering into an NPC Are Not Treated as Nonperiodic Payments

When a swap dealer and its customer enter into an NPC, the customer sometimes will pay a fee to the dealer for entering into the transaction. Such a fee represents consideration paid to the dealer for entering into the transaction with the customer and does not otherwise affect the terms of the NPC (*i.e.*, the customer's periodic payments to the dealer are not reduced by the amount of the fees). This type of fee is to be distinguished from a "yield adjustment" payment or similar amount (whether or not denominated as a fee) that is intended to compensate for the fact that the present value of the payments expected to be received by the payment's recipient is less than the present value of the payments expected to be made by the payment's recipient (which amount should be considered a nonperiodic payment).

As an economic matter, payments in the nature of a fee do not constitute a financing from the customer to the dealer that will be repaid. Nevertheless, it might be argued that a fee paid in connection with entering into an NPC is a payment under the NPC as the fee generally will be reflected in the terms of the confirmation for the swap, in which case the fee might be considered a nonperiodic payment, and thus could give rise to an embedded loan. Because such fees are not in substance loans, we recommend that the Final Regulations clarify that fees paid to enter into an NPC do not constitute nonperiodic payments for purposes of the NPC rules.

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

With respect to many NPCs, a payment that is treated as a nonperiodic payment is, economically, a payment for an option right rather than a payment to reflect off-market terms of the NPC. For example, the premium paid for a swaption is treated as a nonperiodic payment on the resulting NPC if the swaption is exercised. However, the swaption premium is paid by the exercising party to the party issuing the swaption for the swaption right, not as a prepayment of future payments under the NPC. Thus, the treatment of the swaption premium as a loan under the Proposed Regulations is inconsistent with the economic substance of the payment.

Similarly, when an interest-rate cap or interest-rate floor is purchased, the purchaser may make a nonperiodic payment to the seller. The seller agrees to make payments to the purchaser on future dates if the applicable floating interest rate exceeds (in the case of a cap) or falls below (in the case of a floor) a specified amount. The nonperiodic payment by the purchaser to the seller does not necessarily reflect off-market terms of the cap or floor. Rather, such payment is in the nature of an option premium for the right to receive a payment if the applicable rate exceeds the cap or falls below the floor on a future date. That treatment is reflected in the final regulations under section 446, which specifically provide for the "premium" paid upfront for a cap or floor to be amortized. The final regulations reserve on the treatment of caps and floors that are significantly-in-the-money, and the Proposed Regulations do not propose to change that. Consequently, it is unclear whether it was intended that the Proposed Regulations would cover nonperiodic payments made to acquire a cap or floor rather than a swap. The Final Regulations should clarify that payments made to acquire a cap or floor are not recharacterized as loans.

In some cases, a nonperiodic payment may be in part an option premium and in part a payment to reflect that the contract is off-market. Requiring taxpayers to divide the nonperiodic payment into an option payment and a loan (reflecting the off-market component) would be overly complex. Rather, we recommend that all of such payment be excluded from embedded loan treatment unless, under an anti-abuse rule, the parties structure the transaction to have off-market terms in order to embed a loan into the option.

e. Exempt from Embedded Loan Treatment Nonperiodic Payments That Are Reasonably Expected to Be Economically Offset with Periodic Payments Within One Year

In the case of some NPCs, an upfront payment is made by a party not because such party expects to receive above-market payments under the NPC over the full term of the NPC, but because such party expects to receive a single larger payment during the initial period of the NPC.

Example 10: Upfront Payment with Expected Offsetting Payment Within One Year

> A and B enter into an NPC with a term of 3 years pursuant to which B will make an annual payment to A equal to the annual interest payment made by an unrelated issuer on a particular bond. The interest payment on the bond and first corresponding payment on the swap will occur in 1 month. A is required to make an upfront payment roughly equal to the 11 months of accrued interest on the bond.

In this example, A is effectively prepaying the accrued interest amount. If one were to view A as making a loan to B in the amount of the accrued interest, such loan would be repaid (as an economic matter) when B makes its first periodic payment to A under the NPC (which reflects the first interest payment on the bond after execution of the NPC). The Proposed Regulations generally provide an exception from embedded loan treatment for NPCs with a term of one year or less, presumably on the basis that it is not worth the administrative and tax compliance burden associated with embedded loan treatment to find an embedded loan to exist for such a short period of time. The same principle should apply where the NPC has a term (or is deemed to have a term) that is greater than one year, but where the nonperiodic payment is reasonably expected to be economically offset with periodic payments within one year of the commencement of the NPC. Accordingly, we recommend that an exception be provided to address this circumstance so that the Proposed Regulations do not cause the non-economic result of requiring an upfront payment that is economically repaid within one year to be amortized over the term of the NPC.

f. Exempt NPCs with Nonperiodic Payments Required Under Contracts with Standardized Terms

One common reason for NPCs to provide for the making of nonperiodic payments is that many types of NPCs have standardized terms prescribed by clearing organization rules, applicable agency regulations or an industry standard or model. For example, ISDA interest-rate swaps and credit default swaps typically have terms determined by an ISDA standard model. In order for the parties to fit their desired swap terms into the standard model, it is often necessary for one of the parties to make a nonperiodic payment to the other party upon entering into the contract. When a nonperiodic payment is made as a result of standardized terms, such terms typically are not selected with the tax consequences of the transaction in mind.

Notwithstanding that NPCs with standardized terms are used for creating more efficient and transparent swaps markets, rather than for disguising loan transactions, the preamble to the Proposed Regulations states that such NPCs contain an "economic loan" that "should be taxed as one or more loans" unless one of two limited exceptions applies. We recommend that the government reconsider this approach with respect to NPCs having standardized terms. Standardized swap contracts should be respected as swap contracts, and should not be recharacterized as a pair of other instruments, even when the requirements of the Margin Exception are not met.

The evolution of NPCs from contracts with bespoke terms to contracts with standardized terms warrants a different approach to standardized NPCs from the approach taken in the Proposed Regulations. While standardized NPCs have become more common market NPC transactions, when the NPC regulations in Treas. Reg. § 1.446-3 were first proposed and finalized more than 20 years ago, most, if not all, NPCs were bilateral contracts without standardized terms. There may have been few economic or non-tax reasons for entering into NPCs with upfront payments. Further, upfront payments had the potential to be used by taxpayers to obtain non-economic timing for items of income or deduction on the NPC and to disguise loan transactions.

The NPC market has changed significantly since that time, with many NPCs being cleared (which generally requires standardized terms) and a substantial portion of non-cleared NPCs using standardized terms as well. Thus, there now are compelling commercial reasons why taxpayers enter into NPCs with upfront payments. Standardized NPCs are particularly prevalent in the CDS market. While CDS are currently not addressed in these Proposed Regulations, the number of standardized NPCs potentially subject to embedded loan treatment will significantly increase if future NPC regulations apply embedded loan treatment to NPCs with contingent nonperiodic payments. The general trend toward standardization has included interest-rate swaps. Standardized NPCs, which normally require upfront payments, do not offer the potential for abuse if the upfront payments depend entirely on market terms and conditions, not on the parties' desire for financing. To the contrary, without nonperiodic payments, the standardization of non-cleared swap contracts would not be feasible. Thus, in contracts with standardized terms, nonperiodic payments are integral to the NPC.

For the reasons described above, standardized NPCs should not create the potential for the embedded loan abuse that the government was concerned about when Treas. Reg. § 1.446-3 was issued. The NATC therefore believes that the compliance burdens associated with the Proposed Regulations could be significantly lightened, without any loss of the policy effectiveness of the Proposed Regulations, by exempting standardized contracts from embedded loan treatment and by expanding the Margin Exception to include transactions that include posted margin consistent with normal market practice. Consequently, we recommend that an exception from "embedded loan" treatment be provided for transactions that have nonperiodic payments solely as a result of their use of standardized terms. For this purpose, a contract should be considered to have standardized terms if it (i) is documented on a standard form confirmation, (ii) uses a standardized date (*e.g.*, the third Wednesday of the month, or "International Monetary Market Wednesday") as its effective date and (iii) has a tenor and coupon rate set by reference to publicly available terms established by ISDA, SIFMA or any similar organization.

g. <u>Expand the Exception Under Section 956 So That It Does Not Require the Controlled Foreign Corporation to Be a Dealer</u>

The Proposed Regulations provide that, for purposes of section 956, the term "United States property" does not include an obligation of a U.S. person arising from an upfront payment by a controlled foreign corporation ("CFC") where (i) the CFC that makes the nonperiodic payment is a dealer in securities or commodities and (ii) all of the conditions for the Margin Exception are satisfied.[18] Thus, as drafted, an upfront NPC payment made by a CFC in cash that satisfies all of the requirements for the Margin Exception may still be considered an investment in United States property by the CFC if the CFC is not a dealer in securities or commodities. We see no policy reason, however, why the exception from section 956 should be limited by including the additional requirement that the CFC be a dealer.

The policy underlying section 956 looks to tax a U.S. shareholder when the CFC's assets are made, directly or indirectly, available to the U.S. shareholder. Such use of the CFC's assets simply cannot occur when a CFC makes an upfront payment to a person who is required to post such amount as collateral. An upfront payment made by a CFC that qualifies for the Margin Exception lacks the hallmark of an investment in United States property – the use by a U.S. shareholder of such funds. The fact that the CFC making the upfront payment is a dealer does not make the argument for an exemption any stronger. Thus, while the exemption from United States property treatment under section 956 will most commonly be relevant in the case of an upfront payment made by a CFC that is a dealer, the requirement that the CFC be a dealer is simply unnecessary to ensure that the exception operates in a manner consistent with the tax policy behind section 956. Thus, we recommend that the section 956 exception be amended to remove the requirement that the CFC that makes the upfront payment be a dealer in securities or commodities.

[18] Temporary regulations under section 956 that were in effect prior to the issuance of the Proposed Regulations provided a similar exception for an NPC that met certain requirements, including that the CFC that makes the upfront payment be a dealer in securities or commodities.

h. <u>Clarify Certain Potential Consequences of Embedded Loans Deemed Made by a Non-U.S. Person</u>

In the event that an NPC with a nonperiodic payment is bifurcated into a loan and an NPC, treatment of the payment as a loan can have ancillary consequences, particularly for non-U.S. persons. For example, it is critical for the efficient operation of swaps markets that non-U.S. persons that pay or receive nonperiodic payments not be considered to have derived such interest in the active conduct of a banking, financing or similar business in the United States or to have received interest that does not qualify for the portfolio interest exemption.

It should be clear that embedded loans under the Proposed Regulations are tax fictions that are not entered into in the course of a lending or banking business, and therefore cannot result in the deemed lender being engaged in a U.S. trade or business or deprived of the benefits of the portfolio interest exemption. Given the importance of this question in determining whether income is subject to U.S. tax when recognized by a foreign swap party, however, it is important for the Final Regulations to clarify this explicitly.

For example, under Treas. Reg. § 1.864-4(c)(5)(i), a nonresident alien individual or foreign corporation is considered for purposes of Treas. Reg. §§ 1.864-4 and 1.864-5(b)(2) to be engaged in the active conduct of a banking, financing or similar business in the United States if at some time during the taxable year the taxpayer is engaged in business in the United States and the activities of such business consist of receiving deposits of funds from the public or making loans to the public, in whole or in part, in the United States. A swap party that enters into one or more NPCs that are deemed to include embedded loans should not be considered to be making loans to or receiving deposits from the public. In commercial terms, there is no loan or deposit being made; there is only a tax fiction deeming a prepayment to be a loan because the prepayment, plus the expectation of reduced payments to be made in the future as a result, is economically similar to a loan.

As another example, the portfolio interest exemption provided in section 881(c) does not apply to a foreign corporation that is a "bank receiving interest on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business." Section 881(c)(3)(A). An embedded loan in a swap is, once again, a tax fiction that is not made pursuant to any loan agreement. It is a prepayment under a swap agreement that is recharacterized solely for tax purposes. Accordingly, it should be clear that the "bank" exception to the portfolio interest exemption should not apply to interest received on an embedded loan in a swap.

We recommend that the Final Regulations explicitly provide that embedded loan treatment for NPCs cannot result in a non-U.S. person deemed to make a loan being treated as engaged in a U.S. trade or business or, if it is a bank, failing to qualify for the portfolio interest exemption.

i. Exempt from Embedded Loan Treatment Nonperiodic Payments Deemed Paid Solely as a Result of a Deemed Exchange of an NPC Under Section 1001

When the terms of an NPC are modified in such a manner that the existing NPC is treated as exchanged for a new NPC under section 1001, the party that holds the NPC position with a positive value is treated as (i) having received a termination payment equal to such value with respect to the existing NPC and (ii) having made a nonperiodic payment of an equal amount with respect to the new NPC. *See* Treas. Reg. § 1.446-3(h)(1), (3). As a result, in the absence of an exception, the new NPC would likely be treated as having an embedded loan equal to the amount of the nonperiodic payment. It should be clear, however, that a nonperiodic payment resulting from a deemed exchange of an NPC under section 1001 does not provide the party who is treated as having received the payment with any financing. That is, the deemed recipient of the nonperiodic payment has received no cash, and thus is in a similar position to a party to an NPC that receives a nonperiodic payment and posts an equal amount of cash as collateral. Accordingly, we recommend that the Final Regulations provide an exemption from embedded loan treatment where the relevant nonperiodic payment is treated as received due to a deemed exchange of an NPC under section 1001.

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

As described above, there are very significant administrative and logistical obstacles that will need to be overcome in order for market participants to implement the Proposed Regulations. In addition, unless relief is provided, withholding and information reporting systems will need to be built to track information regarding NPCs and the collateral that is posted and collected with respect to those NPCs.

Under Treas. Reg. § 1.6041-1(d)(5), the regulation governing information reporting for NPCs, the amount required to be included in information reporting with respect to an NPC is limited to the amount of cash paid.[19] Such regulation further provides that interest on an embedded loan is not reportable as interest under section 6049. The regulations under section 6049 similarly provide that for information reporting purposes, the term interest does not include "interest as determined under the provisions of § 1.446-3(g)(4) (dealing with interest in the case of a significant nonperiodic payment with respect to a notional principal contract). Such amounts are governed by the provisions of section 6041."[20] Under these rules, while not entirely clear, we believe that interest deemed paid on an embedded loan should not be required to be separately reflected for information reporting purposes and that the changes in the Proposed Regulations should not require any alteration to how information reporting with respect to NPCs with nonperiodic payments is made to U.S. counterparties.

[19] We note in this regard that the preamble to the Treasury Decision promulgating the Information Reporting Regulation stated that "the amount of a notional principal contract payment reported on Form 1099 is the amount of cash paid on the contract for the calendar year." T.D. 8881 (May 16, 2000).

[20] Treas. Reg. § 1.6049-5(b)(16). These rules, however, appear to conflict with language in the instructions to the Form 1099-INT.

With respect to NPC payments to foreign persons, Treas. Reg. § 1.6041-4(a)(4) provides that information returns are not required for NPC payments if the payee represents in ISDA documentation that the payee is a foreign person but refers to Treas. Reg. § 1.1461-1(c)(2)(i) for "applicable reporting requirements." Treas. Reg. § 1.1461-1(c)(1) requires a withholding agent to make an information return on Form 1042-S to report amounts subject to reporting within the meaning of Treas. Reg. § 1.1461-1(c)(2). Included among the items listed in Treas. Reg. § 1.1461-1(c)(2)(i) is "[i]nterest, including the portion of a [NPC] payment that is characterized as interest." Thus, it appears that reporting of interest deemed paid on an NPC with an embedded loan must be reported to foreign recipients on a Form 1042-S, while other NPC payments are not so reportable unless they are effectively connected with a U.S. trade or business.

It is not clear why interest deemed paid to a foreign person on an embedded NPC loan would be subject to information reporting (where no U.S. tax is withheld) when information reporting appears not to be required with respect to embedded loan interest deemed paid to a U.S. person. Information reporting on embedded loan interest would be a Herculean and costly exercise to generate unnecessary paperwork that would have virtually no benefit for the Government. The taxpayers that have embedded loans will be sophisticated parties that can make their own determinations regarding embedded loans and do not need to be told how to report them by financial institutions. As a result, we recommend that the 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 an NPC other than in circumstances where U.S. tax is withheld with respect to the interest deemed paid.

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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,

Thomas Prevost

Thomas Prevost

cc: Thomas West, Tax Legislative Counsel
Karl Walli, Senior Counsel—Financial Products, U.S. Treasury
Helen Hubbard, Associate Chief Counsel (Fin. Inst. & Products), IRS Chief Counsel
David Silber, Deputy Associate Chief Counsel (Fin. Inst. & Products), IRS Chief Counsel
Christina Morrison, Branch Chief, Fin. Inst. & Products Branch 6, IRS Chief Counsel
Alexa Dubert, Attorney, Fin. Inst. & Products Branch 3, IRS Chief Counsel

Anna Kim, Attorney, Fin. Inst. & Products Branch 6, IRS Chief Counsel
Danielle Rolfes, International Tax Counsel
Marjorie Rollinson, Associate Chief Counsel (International) (Eff. Mar. 31, 2016), IRS Chief Counsel
John Sweeney, Branch Chief, International Branch 8, IRS Chief Counsel
Kristine Crabtree, Attorney, International Branch 2, IRS Chief Counsel