June 12, 2014

Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: <u>Request for Guidance Relating to Upfront Payments on Swaps</u>

Gentlemen:

CME Group, Inc. ("CME Group"), the Securities Industry and Financial Markets Association ("SIFMA"), the North American Tax Committee of the International Swaps and Derivatives Association ("ISDA"), and the Futures Industry Association ("FIA") request that the Treasury Department and the Internal Revenue Service (the "Service") issue guidance providing relief from the application of existing rules treating as loans for federal income tax purposes swap upfront payments constituting "significant" nonperiodic payments. The Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (the "Dodd-Frank Act" or "Dodd-Frank") mandates central clearing for certain swaps and imposes margin requirements for certain non-cleared swaps. Dodd-Frank has led, and will continue to lead, to significant changes in market practices for the execution of both cleared and uncleared swaps, including increasing the prevalence of swaps requiring an upfront payment of some sort.

Unlike in a loan where the issuer may have discretion as to the use of the payment, in the context of cleared (and current market practice for many uncleared) swaps, a party receiving an upfront payment is not entitled to retain the payment, but rather must remit the

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

payment as variation margin back to the payor of the upfront payment. Such upfront payments therefore lack the debt-like attributes that were of concern when existing guidance was issued.

Limited guidance carving out upfront payments on certain swaps from the application of certain tax rules has already been issued in the context of section 956 (relating to controlled foreign corporations) and section 1001 (relating to the recognition of gain or loss on certain transfers) of the Code. Although this guidance is very helpful, it does not address other potential issues, such as the application of potentially burdensome tax information and withholding rules, the unrelated business taxable income ("UBTI") rules or the application of section 956 outside the specific situations addressed in the existing section 956 guidance. In order to avoid unnecessary tax impediments to the implementation of Dodd-Frank, guidance is needed exempting from the "significant" nonperiodic payment rules certain swaps with respect to which initial variation margin is posted by the party receiving the upfront payment.

Introduction

In Notice 2014-18,[2] the Treasury Department and the Service encouraged taxpayers and practitioners to provide comments and recommendations with respect to items that should be included on the 2014–2015 Priority Guidance Plan. CME Group, SIFMA, ISDA, and FIA request that the Service issue guidance with respect to the treatment of upfront payments on "swaps" cleared through regulated swap clearinghouses and other similar swaps.[3]

CME Group consists of four separate exchanges in the United States: the Chicago Mercantile Exchange, Inc. ("CME"); the Board of Trade of the City of Chicago, Inc. ("CBOT"); the New York Mercantile Exchange, Inc.; and the Commodity Exchange, Inc., as well as one U.S. based clearinghouse operated as a division of the CME ("CME Clearing"). The exchanges offer a wide range of futures and options based on interest rates, equity indexes, foreign exchange, and various commodities. In addition, CME Clearing provides clearing and settlement for exchange-traded contracts and, more recently, certain over-the-counter ("OTC") transactions submitted for clearing by the parties. For more information, visit http://www.cmegroup.com.

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

Since 1985, ISDA has worked to make the global OTC derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These

---

[2] 2014-15 I.R.B. 926 (March 21, 2014).

[3] For convenience, in these comments we have used market parlance in referring to the "swaps" at issue. These swaps would generally be classified for tax purposes as "notional principal contracts," as defined in Treas. Reg. § 1.446-3(c)(1).

members include a broad range of OTC 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 including exchanges, clearinghouses 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: http://www.isda.org.

FIA is the leading trade organization for the futures, options and cleared swaps markets worldwide. FIA's membership includes clearing firms, exchanges, clearinghouses and trading firms from more than 25 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's member firms play a critical role in the reduction of systemic risk in the global financial markets. FIA along with its affiliated associations, FIA Europe and FIA Asia, make up the global alliance, FIA Global, which seeks to address the common issues facing their collective memberships. For more information, visit http://www.futuresindustry.org.

<u>Growth of Centrally Cleared Swaps</u>

The Dodd-Frank Act grants the Commodity Futures Trading Commission ("CFTC") the authority to mandate central clearing of "swaps."[4] In addition to the clearing requirements, swap execution requirements fundamentally change the way many common swaps—including interest rate swaps and credit default swaps ("CDS")—will be traded.

Under the Commodity Exchange Act ("CEA"),[5] as amended by Dodd-Frank, certain swap transactions that are subject to the CEA and that have been made subject to mandatory clearing by the CFTC **must** be submitted for clearing to a registered derivatives clearing organization ("DCO") or a DCO exempt from registration.[6] A subset of such cleared swaps are subject to trade execution requirements whereby such swaps must be executed through a designated contract market ("DCM") or on a new type of trading platform called a swap execution facility ("SEF"), unless there is no DCM or SEF that makes the swap "available to trade," or the swap transaction is subject to a mandatory clearing exception under the CEA.[7] Once an "available to trade" determination has been made and becomes effective with respect to

4 For purposes of the Dodd-Frank clearing mandate, the definition of "swap" is broad and includes currency swaps, interest rate swaps, credit default and total return swaps on broad-based security indices, total return swaps on indexes of more than one loan, and swaps on other commodities. 7 U.S.C. § 1a(47).

5 7 U.S.C. § 2.

6 7 U.S.C. § 2(h)(1). CME is one of several DCOs clearing swaps in the United States. The issues described herein with respect to CME-cleared swaps also apply to swaps cleared by other DCOs.

7 7 U.S.C. § 2(h)(8).

a swap that is subject to the mandatory clearing requirement,[8] **all** transactions in that swap must be executed on a DCM or SEF and submitted for clearing to a DCO. Subject to limited exemptions and exceptions, no OTC trading in that swap will be permitted.

On November 29, 2012,[9] the CFTC issued its first clearing mandate, requiring that four types of interest rate swaps and two types of index CDS must be cleared.[10] It is anticipated that additional clearing mandates may be proposed and implemented by the CFTC for other classes of swaps in the future.

Although the CFTC has excepted some swaps market "end-users" from mandatory clearing,[11] "financial entities" are not exempt. The swap market-users subject to mandatory clearing account for most of the trading volume in the swaps marketplace, including not only swaps between dealers but also swaps involving pension funds, endowments, funds in which such taxpayers invest, and any other person qualifying as a financial entity. The following entities are "financial entities":

- Swap dealers and security-based swap dealers;
- Major swap participants and major security-based swap participants;
- Commodity pools and private funds;
- Employee benefit plans, as defined under sections 3(3) or 3(32) of ERISA; and
- Persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act.[12]

---

8 The CFTC allows a DCM or SEF to determine that a swap is "available to trade" by submitting its determination (a "MAT determination") to the CFTC either for approval (pursuant to the CFTC's regulations, 17 C.F.R. § 40.5) or for self-certification (pursuant to the CFTC's regulations, 17 C.F.R. § 40.6). In either case, the CFTC may object to and effectively deny a MAT determination or may stay the effectiveness of the determination and publish the MAT determination for public comment (17 C.F.R. § 40.6(c)).

9 Commodity Futures Trading Commission, Clearing Requirement Determination under Section 2(h) of the CEA; Final Rule, 77 Fed. Reg. 74,284 (Dec. 13, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR- 2012-12-13/pdf/2012-29211.pdf.

10 The parameters of swaps that are subject to this first CFTC clearing mandate are included in **Appendix A**.

11 Commodity Futures Trading Commission, Clearing Requirement Determination under Section 2(h) of the CEA; Final Rule, 77 Fed. Reg. 74,284 (Dec. 13, 2012) Subpart C – Exceptions and Exemptions to Clearing Requirement §50.50, *available at* http://www.gpo.gov/fdsys/pkg/FR- 2012-12-13/pdf/2012-29211.pdf.

12 12 U.S.C. § 1843(k).

An exception from mandatory clearing is available for risk management swaps entered into by certain commercial end-users that are not "financial entities."[13] Pursuant to the end-user exception, a clearing mandate or exchange-trading mandate will not apply to any swap in which *one* of the counterparties to the swap (1) is not a financial entity; (2) is using the swap to hedge or mitigate commercial risk; and (3) notifies the CFTC how it generally meets its financial obligations associated with entering into non-cleared swaps.[14] Reliance on the end-user exception is elective at the option of the end-user party.

At present, the volume of cleared swaps is already quite large. CME cleared interest rate swaps open interest was over $12.3 trillion on March 24, 2014.[15] For the first quarter of 2014, CME has averaged daily cleared interest rate swap notional volume of $126.5 billion on average daily transactions of more than 1,500.

Regulatory Rules for Uncleared Swaps

Dodd-Frank has also led to significant changes in the way that swap dealers transact with customers and how swap dealers hedge those transactions. Under current CFTC rules and new rules applicable to banks and their affiliates, and in anticipation of similar rules in other countries, regulators are driving the market towards localization of customer relationships. That is, U.S. swap dealers increasingly are dealing with U.S. customers, and foreign swap dealers—including affiliates of U.S. swap dealers—increasingly are dealing with foreign customers. This localization of trading is necessary because non-U.S. customers do not wish to become subject to U.S. requirements and U.S. customers do not wish to become subject to non-U.S. requirements.[16] In many cases, however, the market risk of a particular transaction may be best hedged in a country that is not the one where the customer is based. For example, if a foreign swap dealer enters into a U.S. dollar interest rate swap with a foreign customer, the swap dealer is likely to transfer the U.S. dollar interest rate risk of that transaction to a U.S. affiliate, through an intercompany swap that hedges the foreign swap dealer's market risk.[17]

As a result, U.S. swap dealers have and expect to continue to have billions of U.S. dollars of notional principal amount of intercompany swap transactions between U.S. and foreign affiliates. For commercial and regulatory reasons, it is strongly preferable and may be necessary for intercompany swaps to mirror or closely track the terms of the customer swaps that they hedge. For example, in the interest rate swap example below, a foreign affiliate may not have

[13] 7 U.S.C. § 2(h)(7)(C)(i).

[14] 7 U.S.C. § 2(h)(7)(A).

[15] http://www.cmegroup.com/education/cme-volume-oi-records.html.

[16] In addition to the mandatory clearing and trading requirements described above, the other rules that are driving such localization include, among other things, CFTC registration requirements (CFTC Regulations § 23.21), external business conduct standards (CFTC Regulations § 23.400-451), and real-time public reporting requirements (CFTC Regulations Part 43).

[17] The localization process and the consequent need for intercompany hedging transactions is described in more detail in SIFMA's letter dated January 23, 2013, which is attached to this letter as **Appendix C**.

the commercial expertise to manage U.S. dollar interest rate risk, or the regulatory rules to which it is subject may provide an incentive for it to fully hedge its U.S. dollar interest rate market risk. Because customers have *bona fide* business reasons for entering into swaps that have coupons that are off-market—for example, to hedge another transaction, or to better manage their overall position with respect to a particular type of risk—as a commercial and regulatory matter swap dealers must be able to enter into transactions with the same off-market terms with their affiliates.

Intercompany swaps between U.S. and non-U.S. affiliates of a type that are subject to mandatory clearing currently typically rely on a temporary CFTC rule (the "inter-affiliate clearing exemption") that requires that the parties "pay[] and collect[] full variation margin daily on all of the eligible affiliate counterparties' swaps with other eligible affiliate counterparties."[18] This rule was scheduled to expire on March 11, 2014, but this expiration was subsequently extended by the staff of the CFTC's Division of Clearing and Risk until 11:59 p.m. ET on December 31, 2014.[19] If they do not or cannot comply with this rule (for example, once it expires), U.S. swap dealers and their affiliates must comply with general CFTC rules that require either that (i) the foreign affiliate satisfy the CFTC's mandatory clearing requirement for its swaps with non-U.S. counterparties—that is, that the foreign affiliate clear those swaps, or (ii) the intercompany hedging transaction be cleared. Compliance with these rules would be more costly than providing full variation margin on an uncleared swap, and therefore would put U.S. swap dealer groups at a competitive disadvantage to foreign swap dealers with no U.S. connections. Consequently, under current law, intercompany interest rate swaps and CDS between U.S. and non-U.S. affiliates generally are entered into with the expectation that the affiliates will pay full variation margin, in a manner similar to that described below for cleared swaps.

In addition, Dodd-Frank requires the CFTC and other U.S. regulators to adopt margin requirements for non-cleared swaps.[20] Based on an international framework published in September 2013, it is contemplated that these rules will require a two-way exchange of initial and variation margin between all financial entities and systemically important non-financial entities.[21] Under this framework, initial margin requirements would be set at levels intended to promote central clearing, even for swaps not subject to mandatory clearing.[22] The framework's variation margin requirements would come into effect in December 2015, and initial margin

---

18 17 C.F.R. § 50.52 (exemption for swaps between affiliates), paragraph (b)(4)(ii)(A)(2).

19 CFTC Letter No. 14-25 (March 6, 2014), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-25.pdf.

20 7 U.S.C. § 6s(e)(2).

21 *See* Basel Committee on Banking Supervision and International Organization of Securities Commissions, Margin Requirements for Non-Centrally Cleared Derivatives (Sept. 2013), *available at* http://www.bis.org/publ/bcbs261.pdf.

22 *See id.* at p. 2.

requirements would be phased in over 2015-2019.[23] It is not certain how these requirements would apply to intercompany transactions.

<u>Traditional Upfront Payments</u>

In the swaps market, upfront payments are necessary when one party is receiving an above-market rate payment under the terms of the swap. Thus, the counterparty requires a payment to compensate it for entering into a swap for which the rate is off-market.

> **<u>Example 1</u>**. Prior to Dodd-Frank, counterparties F and L entered into a $100 million 10-year interest rate swap. F agreed to pay a fixed rate of 1.75% when the current market rate for the party paying the fixed interest rate on such a swap is 2.75%; L will pay 3-month BBA (British Bankers Association) Libor. Since F agreed to pay L a below-market rate, L insisted on receiving an upfront payment of $8.64 million as part of the transaction, which F paid L in cash.[24]
>
> Over the next ten years, on a periodic basis, L will pay 3-month Libor to F in exchange for receiving a fixed payment which was, at the time the swap was entered into, approximately 100 basis points below market. In present value terms, the $8.64 million upfront payment L received at the inception of the swap should approximately offset the difference between 2.75% and the below-market periodic payments L will receive from F over the term of the swap.

Regulations section 1.446-3(g)(4) provides for the treatment of "significant" nonperiodic payments with respect to swaps as loans. Under the Regulations, the time value component associated with the loan is to be treated as interest for purposes of the Code.[25] The Regulations do not provide a bright-line test for determining whether a payment is "significant." However, there are two examples in the Regulations, one illustrating a payment which is "significant" and one which is not.[26] The examples do not indicate that any collateral is paid by the parties to the swaps.

---

[23] *Id.* at p. 23-24.

[24] For the reasons discussed in *infra* note 26, such a payment, which would amount to approximately 36.3% of the fixed payments due under the swap, would appear to be a "significant" nonperiodic payment. The matter is not free from doubt, however, because 36.3% is between the percentages in the two examples described in *infra* note 26.

[25] Except as otherwise indicated, all sections citations, and references to the "Code" or "I.R.C.," are to the Internal Revenue Code of 1986, as amended. Citations to the "Regulations" are to the Treasury Regulations promulgated under the Code.

[26] Treas. Reg. § 1.446-3(g)(6), Examples (2) and (3). The example in which a payment was not "significant" involved a payment on a five-year contract of approximately 10% of the total value of all fixed payments under the contract (including the upfront payment). The example in which the payment was "significant" involved a payment on a five-year contract of approximately 40% of the total value of all fixed payments under the contract (including the upfront payment).

The above Regulations were promulgated before the advent of cleared swaps and when upfront payments and off-market swaps were highly out of the ordinary. If an upfront payment was received, the party receiving the payment was free to use the payment for its own business purposes (except to the extent that the terms of the swap required that party to provide corresponding collateral to the payor, which historically might or might not be the case for various commercial reasons), rather than depositing it with a centralized depository. In addition, the parties to the swap remained the same throughout its term—unless by mutual agreement they terminated the swap. Thus, any tax information reporting and withholding could be consistent throughout the life of the swap.

Cleared Swap Upfront Payments

With swaps cleared pursuant to the rules of a DCO, a party "receiving" an upfront payment does not have the use of the payment. Instead, to guarantee performance under the terms of the swap, the upfront "payment" is collected from the recipient of the upfront payment by the DCO as variation margin.[27] As illustrated in more detail by the examples set forth in Appendix B, although a party may in theory have "received" an upfront payment at the inception of the swap, the payment is immediately collected by the DCO as variation margin, with the DCO in turn remitting this variation margin to the original payor of the upfront "payment." As a result, the party entitled to receive the upfront "payment" does not have discretion as to its use.[28]

Moreover, as illustrated by Appendix B, because the upfront payment and associated variation margin pays and collects are netted, it is possible that little or no cash will actually change hands upon the clearing of a swap, even though the terms of the swap may call for an upfront payment. The amount initially credited to a party's margin account is also subject to subsequent adjustments to account for day-to-day changes in net present value of the parties' swap exposures.

Cleared swap upfront payments (as well as other swaps requiring the payment of variation margin) are thus fundamentally different than traditional swap upfront "payments" where no variation margin is required to be paid. An upfront "payment" on a cleared swap is thus a somewhat strange "loan" given that there is no extension of credit by the payor of the upfront "payment" to the recipient.

Example 2. The facts are the same as described in Example 1, except that the swap is entered into after Dodd-Frank and is subject to a CFTC-issued clearing

---

[27] Such margin payments have long been treated as amounts paid to guarantee future performance, rather than partial payment for the underlying instrument or a form of acquisition indebtedness. *See* GCM 39620 (April 14, 1987) (margin payments on regulated commodity futures contracts held not to give rise to acquisition indebtedness under section 514(c) of the Code; margin payments determined to be in the nature of deposits to guarantee performance on the futures contract, not partial payment for underlying commodity).

[28] However, as illustrated by the examples in Appendix B, a party required to pay variation margin on a cleared interest rate swap would also be entitled to payment of an amount, termed "Price Alignment Interest" ("PAI"), on the cumulative amount of such variation margin. PAI is generally calculated using an overnight risk free rate based on the swap's underlying currency. The amount of PAI, along with information relating to other cash flows with respect to the swap, is reported daily by CME Clearing to its clearing members.

mandate, and is thus a cleared swap.[29] Upon clearing, L, the party receiving a below-market fixed rate and paying floating, will be entitled to an upfront payment equal to the net present value of the difference between a market rate fixed payment and the fixed-rate payment provided by the swap. However, L will be required to pay variation margin (the difference between the current day's net present value and the prior day's net present value, which for a new swap is always zero) to the DCO. Thus, although L would be entitled to an upfront payment of $8.64 million, L would also have to make a variation margin payment to the DCO of $8.64 million, thereby leaving L with zero cash from entering into the cleared swap transaction. Similarly, F will be entitled to a variation margin payment from DCO of $8.64 million. Because F's right to collect variation margin will be netted against F's obligation to make the upfront payment, no actual cash will change hands upon clearing. (For a more detailed example showing the netting of cash flows in the context of cleared swaps, see Appendix B.)

Perhaps more importantly, as explained in the following section, the cleared swaps market does not as a practical matter provide a mechanism for parties to avoid the complexity of upfront payments. Once a swap is submitted and accepted for clearing, the counterparty in all cases is the DCO. After that point, neither counterparty knows whether the original counterparty still has the same swap position or has closed out its position by entering into an offsetting transaction and submitting it for clearing.

<u>Mandatory Clearing Will Vastly Increase the Prevalence of Upfront Payments</u>

In a marketplace where more interest rate swaps and other swaps are cleared through a DCO, swaps requiring an upfront payment of some sort will become more prevalent. Once a swap is cleared, a party wishing to exit the swap position must do so by entering into an offsetting trade. Because it is highly unlikely that the interest rate swap market will be unchanged if the swap was held for any significant period of time, creation of such an offsetting position will usually entail creation of a new position with an upfront payment. That is, from the perspective of the counterparty to an offsetting trade, it has entered into a new swap with an upfront payment, regardless of whether the original party books the new swap as a new trade or as closing out the original trade.

<u>Example 3</u>. P, a pension fund, customarily deals with two banks, A and B, for interest rate swaps. On Thursday, April 11, 2013, P and A agreed to a standard $100 million 5-year interest rate swap, with P to receive and A to pay a fixed rate of 0.75% per annum (the then prevailing rate for such swaps), and P to pay and A to receive 3-month BBA Libor. The swap is effective Monday, April 15, 2013, and terminates on Monday, April 16, 2018. The swap is submitted to CME

[29] As illustrated in Example 3 below, once a swap is cleared, even if the swap initially had no upfront payment (as is common in the interest rate swap market), subsequent transactions with respect to that swap will likely result in an upfront payment for participants in those transactions because market rates are unlikely to remain the same throughout the entire term of the swap.

Clearing and cleared so that CME Clearing becomes the counterparty to both P and A.

Three months later, on July 11, 2013, due to changes in its needs, P decides to extinguish its interest rate swap exposure, which now has a remaining term of 4 years and 9 months, by closing out its original swap. If the swap had not been subject to mandatory clearing, P might contact A to obtain terms to "tear-up" the swap. However, because CME Clearing is now the counterparty to both P and A, respectively, P instead must enter into an offsetting swap which is then submitted for clearing.

Unfortunately for P, however, market interest rates have risen to 1.52% for fixed-rate payments for an interest rate swap of that tenor, so, as the party receiving only a fixed-rate of 0.75%, P's position has depreciated in value. After seeking the best prices from swap dealers with which it deals, P agrees to an interest rate swap with B mirroring the terms of P's existing swap position. However, because B will be receiving a below-market fixed rate, P will be required to make an upfront payment of $3.521 million to B.[30]

When the interest rate swap is submitted to CME Clearing on the swap effective date of Monday, July 15, 2013, both P and B post the initial performance bond margin with CME Clearing (through their respective clearing members). In addition, P pays CME Clearing the required upfront payment (representing the present value of the deviation of the specified fixed rate from the current market rate) of $3.521 million. P will have closed out its interest rate swap positions as of the end of the day. Although B will receive the upfront payment, it will have to include it in the variation margin it must pay to CME Clearing. All of the cash flows relating to the termination of the original swap, including the return to P of the initial performance bond margin on both the original and the new swaps, will take place on the next business day.

Upfront payments are also more likely to occur with respect to swaps which trade with predetermined coupons, such as the Market Agreed Coupon ("MAC") interest rate swaps, as well as CDS. In the MAC interest rate swap and cleared CDS markets, every trade is done with a predetermined coupon. Because it is unlikely to be the case that the marketplace will ever precisely match the specified coupon rates as of the effective date of the swap, cleared MAC and CDS transactions present an even greater likelihood of an upfront payment which might be deemed to be significant.

In addition to MAC interest rate swaps, another interest rate swap trading vehicle—deliverable interest rate swap futures contracts ("DSF")—has been developed with the advent of Dodd-Frank swap regulation. Each product, and an illustration of the likelihood of an upfront payment in connection with such product, is described below.

---

[30] An upfront payment of $3.521 million would amount to approximately 49.6% of the total value of all fixed payments under the contract and would appear to be a "significant" nonperiodic payment. *See supra* note 26.

MAC Interest Rate Swaps. Standards for MAC interest rate swaps have been promulgated by the Asset Management Group of SIFMA ("SIFMA AMG") and the International Swaps and Derivatives Association ("ISDA"). MAC interest rate swaps all involve standard forms of confirmation which entail forward starting swaps that use IMM (International Monetary Market) dates (the third Wednesday of the month, or "IMM Wednesday") as their forward start (effective) dates, using standard swap conventions.[31]

SIFMA AMG plans to announce recommended MAC interest rate swap fixed rate levels around 6 months and 2 weeks prior to the MAC interest rate swap forward start date. The coupons are set close to par, based on the three- or six-month forward curve, and rounded to the nearest 25 basis point increment.[32] For instance, on Thursday, August 29, 2013, SIFMA AMG published MAC interest rate swap fixed rate recommendations for MAC interest rate swaps for forward start on March 19, 2014 (IMM Wednesday) for March 2014. Even though SIFMA AMG attempts to establish coupons that are consistent with market rates at the time of determination, because the coupon rates are set periodically, and market interest rates change more frequently, upfront payments will often arise.

The likelihood of upfront payments (significant or not)[33] may be illustrated by the following example involving a MAC interest rate swap.

> **Example 4**. On April 30, 2013, J and K agree to a 10-year MAC interest rate swap for forward settlement in June 2013. In accord with recommended standards for US dollar denominated ("USD") MAC interest rate swaps,[34] the terms are as follows:
>
> The effective date for the MAC interest rate swap shall be Wednesday, June 19, 2013 (the third Wednesday of the month), which is the recommended industry-standard effective date for all MAC interest rate swaps for June 2013 settlement. The MAC interest rate swap terminates 10 years later on Monday, June 19, 2023.
>
> J receives, and K pays, semiannual fixed interest at the rate of 2% per annum, the recommended industry-standard fixed interest rate for a USD 10-year MAC interest rate swap for June 2013 settlement.[35] J pays, and K receives, quarterly floating interest equal to 3-month BBA Libor, the recommended floating rate reference for USD MAC interest rate swaps.

---

31 http://www.sifma.org/Services/Standard-Forms-and-Documentation/Swaps/Swaps_Mac-Terms.

32 *See* http://www.sifma.org/services/standard-forms-and-documentation/swaps.

33 *See supra* note 26.

34 SIFMA AMG, "Market Agreed Coupon Contract for Interest Rate Swaps", 23 April 2013, *available at* http://www.sifma.org/Services/Standard-Forms-and-Documentation/Swaps/Swaps_Mac-Terms.

35 SIFMA AMG, "Historical Market Agreed Coupons, (MACs)", 23 April 2013, *available at* http://www.sifma.org/services/standard-forms-and-documentation/swaps-archive.

The fixed rate of 2% per annum is recommended by SIFMA AMG and ISDA as the standard for June 2013 10-year MAC interest rate swaps, on the basis that it signifies a *par, or nearly par, fixed rate* for a 10-year plain-vanilla interest rate swap, for forward start on IMM Wednesday in June 2013, in the context of market conditions and interest rate levels when such recommendation is made (in this example, on April 23, 2013).[36] As was generally the case in the interest rate swap market prior to mandatory clearing, J and K have agreed to the terms of this MAC interest rate swap with the straightforward intent of establishing a par (or nearly par) forward-starting 10-year interest rate swap exposure, not with the intent to create a synthetic extension of credit (or "deemed loan").

Notwithstanding J and K's desire to create an interest rate swap at par, interest rates have changed between the date SIFMA AMG established the recommended coupon rates (April 23) and April 30, when the parties agree to the swap based on the coupon rates. On April 30, 2013, the prevailing rate quoted in the OTC market for USD interest rate swaps for forward start on June 19, 2013 is approximately 1.883% per annum. Any such forward-starting plain-vanilla interest rate swap is understood to exchange semiannual fixed interest at the rate of 1.883% per annum for quarterly floating interest equal to 3-month BBA Libor, with an interest rate swap effective date of Wednesday, June 19, 2013, and with a termination date of Monday, June 19, 2023.

In the context of market conditions and interest rate levels as of April 30, it is clear that J, the fixed-rate receiver in the MAC interest rate swap, will receive fixed interest payments over the ensuing 10 years at a rate that is 11.7 basis points per annum above the par rate for forward settlement (i.e., 2% versus 1.883%) in an otherwise identical interest rate swap. Accordingly, J, the fixed-rate payer, makes an upfront payment to K, to compensate for the difference between the fixed rate on the MAC interest rate swap versus the par fixed rate for forward start of the otherwise identical interest rate swap for forward settlement.[37] Such upfront amount is set as the present value (for t+2 settlement on Thursday, May 2, 2013) of the difference between the fixed amounts for the MAC interest rate swap and the par forward-starting interest rate swap. Accordingly, if the notional amount of the MAC interest rate swap agreed by J and K on 30 April were $100 million, then the upfront payment that J would be recommended under MAC interest rate swap terms to make to K would be approximately $1.091 million.[38]

---

[36] SIFMA AMG, "Rationale for Market Agreed Coupon Contract for Interest Rate Swaps", 23 April 2013, *available at* http://www.sifma.org/Services/Standard-Forms-and-Documentation/Swaps/Swaps_Mac-Rationale.

[37] ISDA, "Form of Confirmation for Market Agreed Coupon Swap", 2013, *available at* http://assets.isda.org/media/277c5548/0d342961.pdf/?n=35052.

[38] The upfront payment of approximately $1.091 million amounts to approximately 5.69% of the total value of all fixed payments under the MAC interest rate swap. Thus, the upfront payment would not appear to be "significant" under the examples discussed in *supra* note 26.

Example 5. The facts are the same as in Example 4, except that J and K agree to the terms of the MAC interest rate swap on May 30, 2013, instead of April 30, 2013. Market conditions have changed, such that the "par" fixed interest rate is now 2.292% for a forward-starting interest rate swap that is identical to the MAC interest rate swap agreed by J and K (with the exception of the swap fixed rate) on May 30. That is, J, the fixed-rate receiver in the MAC interest rate swap, will receive fixed interest payments over the ensuing 10 years at a rate that is now judged to be 29.2 basis points per annum below the par rate for forward settlement (i.e., 2% versus 2.292%) in an otherwise identical interest rate swap. Accordingly, J, the fixed-rate payer, will receive an upfront payment from K, to compensate for the difference between the fixed rate on the MAC interest rate swap versus the par fixed rate for forward start of the otherwise identical interest rate swap for forward settlement.[39] Such upfront amount would be set as the present value (for t+2 settlement on Monday, June 3, 2013) of the difference between the fixed amounts for the MAC interest rate swap and the par forward-starting interest rate swap.

If, as before, the agreed notional amount of the MAC interest rate swap is $100 million, then the upfront payment that K would be recommended under MAC interest rate swap terms to make to J would be approximately $2.682 million.[40]

Deliverable Interest Rate Swap Futures. Other new forms of interest rate swap trading also may dramatically increase the incidence of upfront payments. The CME now offers for trading DSFs which, if held to delivery, result in delivery of a cleared interest rate swap. It can never be predicted with certainty how many, if any, of such contracts will be held to delivery. Although the percentage of futures contracts held to delivery in other non-cash-settled futures contracts varies, it generally does not exceed between 1 and 2% of the outstanding open interest held immediately prior to the delivery date. However, in the first four delivery months for these contracts (March 2013, June 2013, September 2013, and December 2013), a significantly greater number of deliveries occurred.[41]

---

[39] ISDA, "Form of Confirmation for market Agreed Coupon Swap", 2013, *available at* http://assets.isda.org/media/277c5548/0d342961.pdf/?n=35052.

[40] This upfront payment of approximately $2.682 million amounts to approximately 13.16% of the total value of all fixed payments under the MAC interest rate swap. Thus, the proportionate size of this upfront payment exceeds that of the payment deemed not to be "significant," but is smaller than the payment deemed to be "significant," under the examples discussed *supra* note 26, making it unclear whether the upfront payment should be treated as "significant."

[41] DSFs are listed on the CBOT, and end-of-month open interest data for contracts listed on CME Group DCMs, including CBOT, are published at http://www.cmegroup.com/market-data/volume-open-interest. In March 2013, 5,081 DSF contracts went to delivery (25.3% of DSF open interest at end of February). In June 2013, 9,733 DSF contracts went to delivery (18.4% DSF open interest at the end of May). In September 2013, 29,695 DSF contracts went to delivery (34.3% of DSF open interest at the end of August). In December 2013, 29,434 DSF contracts went to delivery (32.2% of DSF open interest at the end of November).

At DSF contract inception for any delivery month, the CME sets the fixed coupon rates for DSF as close as possible to market swap rates. However, by the time the delivery month arrives, market interest rates for swaps are unlikely to be precisely identical to the previously determined fixed coupon rates because of customary interest rate volatility. Thus, upon delivery, it is likely that the delivered swaps will result in an upfront payment in an amount not determinable until the delivery date. Whether that payment will or will not be "significant" cannot be determined with certainty because it depends upon the degree of interest rate swap market interest rate movements between the time the various contracts are entered into and prevailing rates at the delivery date.

Dealing with potential tax consequences of upfront payments is particularly challenging with respect to swaps delivered pursuant to a DSF. For purposes of determining appropriate tax information reporting and withholding obligations, the only thing that the party to delivery on an expiring futures contract knows is that CME Clearing will be the counterparty in the swap exposure created in delivery. However, treating CME Clearing as the "taxpayer" for purposes of determining reporting obligations creates a novel compliance regime since CME Clearing is simply interposed between swap interest payers and swap interest receivers, and is neither net long nor short at any time.

The use of upfront payments, and the challenge of dealing with potential tax obligations with respect thereto in the context of a DSF, are illustrated by the following examples:

> **Example 6**. X makes an upfront payment to CME Clearing in connection with a CME cleared interest rate swap ("delivered swap"), where such delivered swap is tendered and accepted for delivery in fulfillment of an expiring USD interest rate swap futures contract ("expiring futures"). The upfront payment represents the financial benefit to X of being able to make below-market fixed-rate payments or to receive above-market fixed-rate payments for the term of the delivered swap. Upon receiving the upfront payment, CME Clearing remits it to the other party to the delivered swap, Y.
>
> Y is required, at the same time, to make a payment of initial variation margin to CME Clearing. This initial variation margin payment, which is equal in amount to the upfront payment, represents contract performance bond, to ensure that Y will fulfill the terms of the delivered swap despite the disadvantage of being a receiver of below-market fixed-rate payments or a payer of above-market fixed-rate payments for the term of the delivered swap. After receiving Y's initial variation margin payment, CME Clearing remits it to X.
>
> Both the upfront payment paid by X and the variation margin monies paid by Y are due on the morning of the expiring futures contract delivery day.[42] In each

[42] In some instances, it is possible that the total amount of variation margin to be posted by Y on the expiring futures contract's delivery day may not be absolutely equal to the amount of X's upfront payment, due to changes in the value of the delivered swap that have occurred between termination of trading in the expiring futures (when the futures contract final settlement price is determined) and the expiring futures delivery day (when the required margin is paid). To the extent that changes in value of the delivered swap occur during this interval—typically two business days in length—daily variation margin may be added to or subtracted from Y's initial variation margin

case, unless X and Y are CME interest rate swap clearing members, payments will be made to or through each party's CME interest rate swap clearing member, which may be an affiliate of that party.

In addition to the upfront payment and variation margin payment described above, upon delivery of the CME cleared interest rate swap, both X and Y would be required to post initial performance bond to CME Clearing, via their respective CME interest rate swap clearing members. Such initial performance bond postings would be equal as between X and Y, and would be set by CME Clearing on the basis of risk exposure reflected in the prevailing level of interest rate volatility.

Example 7. Assume that D (a dealer, under section 475, who is not a CME interest rate swap clearing member) takes delivery on, and C (a customer) makes delivery on, an expiring futures contract, for which:

> (a) the final settlement price of such expiring futures contract is 75 price points (on a price basis of par equal to 100 points, with each point worth $1,000);
>
> (b) the CME cleared interest rate swap that is delivered and accepted for delivery in fulfillment of the expiring futures has been accepted for clearing by CME Clearing; and
>
> (c) the terms of such CME cleared interest rate swap, combined with the final settlement price of the expiring futures, require D to make below-market periodic payments to C.

Because D is taking delivery on the long open interest in the expiring futures contract, D will become the fixed rate receiver and floating rate payor in the delivered swap. As such, D is required—under both the terms of the futures contract and the variation margin requirements that apply to CME cleared interest rate swaps—to make an upfront payment of $25,000[43] (equal to (100 points minus 75 points) × ($1,000 per point)), to compensate C for the below-market fixed-rate payments that C will receive.

D makes this upfront payment to its CME interest rate swap clearing member, who then pays to CME Clearing an identical amount. CME Clearing, in turn, remits the same amount to Customer C's CME interest rate swap clearing member, who then makes the upfront payment to C.

---

payment, as the case may be. On a transaction-by-transaction basis, however, the payment of variation margin by Y should equal X's upfront payment, when any daily variation margin is viewed as separate from the initial variation margin posted on that day.

[43] This hypothetical example is intended to illustrate the potential for upfront payments in connection with a DSF; whether the $25,000 payment would be "significant" would depend upon the terms of the CME cleared interest rate swap that is delivered in fulfillment of the expiring futures contract. *See generally supra* note 26.

On the same business day, C is required to make an initial variation margin payment of $25,000 to its CME interest rate swap Clearing Member, who then pays that amount to CME Clearing. In turn, CME Clearing pays to D's CME interest rate swap clearing member the variation margin payment, which D's CME interest rate swap clearing member credits to D's account. Thus, the upfront payment, paid by D in respect of the delivered CME cleared interest rate swap, is immediately offset by a variation margin payment in the same amount from C.

In the above examples, the cash flows are essentially circular. In Example 7, although D was required to make an upfront payment to CME Clearing, which in turn made an equal payment to C, C must immediately remit the same payment to CME Clearing. This is a necessary feature of cleared swaps, since CME Clearing is unwilling to accept the risk of nonperformance by the party entitled to receive the upfront payment.

With a cleared swap, whether an upfront payment is required, and its potential treatment as "significant," is dictated by market prices.[44] Moreover, if the cleared swap results from delivery under a DSF, the counterparties will not even know the identity of the party taking the opposite position. The party required to pay the upfront payment would pay CME Clearing (through the CME clearing member with which it transacted the swap), which in turn would pay the payment receiving party (again through that party's CME clearing member), which in turn would be required to remit the payment back to CME Clearing as variation margin, which in turn would be required pay the original payor of the upfront payment a corresponding amount of variation margin (in each case, through such parties' CME clearing members). Moreover, as illustrated in Appendix B, due to the manner in which cash flows are netted in the context of a cleared swap, little or no cash may actually change hands.

Closing cleared swaps through offset also multiplies the number of cleared swaps that may produce an upfront payment. For example, if, in the example above, D wishes to close out its position, D may do so by entering into a swap which is the mirror image of the cleared swap it holds with a third party, E. If the new swap is submitted and accepted for clearing by CME Clearing, D will have closed out its position by offset, and E will now hold a swap with an upfront payment, presenting the same issues as addressed by the original example.

The dynamics of uncleared swaps are very similar to those of cleared swaps. In an uncleared swap with full variation margin, if the parties enter into a transaction with a significant upfront payment (for example, to achieve matching with existing obligations of one of the counterparties), the cash flows paid between the parties are the same as those described in the examples above. If one party is required to make an upfront payment to the other, the second party must pay the same amount back to the first party on a contemporaneous basis as variation margin. There is, therefore, the same essentially circular flow of cash as in the examples described above, albeit directly between the two parties to the swap rather than through the DCO.

---

[44] The cleared swap situation is thus unlike the question addressed by the Service initially in Notice 89-21, 1989-1 C.B. 651, where lump-sum payments in connection with notional principal contracts were being created by taxpayers attempting to accelerate or defer income.

Moreover, with intercompany swaps, whether an upfront payment is required, and its potential treatment as "significant" is also largely dictated by market prices. That is because, as explained above, intercompany swaps often hedge customer positions, and customers have a variety of reasons for entering into swaps with coupons that are not at market levels and therefore with upfront payments. In other cases, customer transactions may be entered into at market, but for regulatory reasons may be transferred from one swap dealer affiliate to another at a time when the customer's portfolio is off-market. The swap dealer that receives the portfolio may need to enter into an intercompany swap on the same terms with the original swap dealer to hedge its position. Both swap dealers and their customers thus must deal with the withholding and reporting issues arising from upfront payments on swaps. While the parties to uncleared swaps do not have the information gap described above for parties to cleared swaps, these taxpayers, including tax-exempt customers, have other very significant tax compliance concerns arising from upfront payments. These concerns are described below.

The Section 956 and Section 1001 Regulations

Temporary Regulations were promulgated in 2012 dealing with this issue under section 956 of the Code.[45] The Treasury Decision states that the "IRS and the Treasury Department do not believe that an obligation of a U.S. person created by an upfront payment resulting from a cleared contract that satisfies the requirements listed in this regulation is the type of transaction intended to be covered by section 956, whether or not the payment is treated as a loan under the NPC [notional principal contract] rules under section 446."[46] The Treasury Decision solicited comments as to whether the exception created by the Regulations[47] should apply more broadly.

---

[45] T.D. 9589, 2012-23 I.R.B. 971.

[46] *Id*. at 973.

[47] The following conditions for the exception are provided in Treas. Reg. § 1.956-2T(b)(2)(xi):

> (xi) An obligation of a United States person arising from an upfront payment by a controlled foreign corporation (within the meaning of section 957(a)) with respect to a notional principal contract (within the meaning of § 1.446- 3(c)(1)) where the following conditions are satisfied—
>
> (A) The controlled foreign corporation that makes the upfront payment is a dealer in securities or commodities (within the meaning of section 475(c)(1) or (e)(1));
>
> (B) The upfront payment is required under a contract that is cleared by 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, respectively;
>
> (C) The controlled foreign corporation makes the upfront payment: (1) To or through a United States person that is a clearing member of a derivatives clearing organization or clearing agency, or (2) Directly to the derivatives clearing organization or clearing agency if the controlled foreign corporation is a clearing member of such derivatives clearing organization or clearing agency;

Regulations dealing with payments under swaps submitted for clearing were also recently promulgated under section 1001 of the Code.[48] These Regulations, which were motivated in part by Dodd-Frank,[49] provide that, among other things, certain payments by a dealer or clearinghouse made in connection with the transfer of its rights and obligations under a swap to another dealer or clearinghouse are exempted from the deemed loan rules.[50]

The guidance provided by the Regulations is very helpful. However, the Regulations do not apply directly to resolve other issues that may be encountered by DCOs such as CME Clearing or by CME clearing members. In particular, whether some portion of an upfront payment is to be characterized as "interest" is important for purposes of compliance with the provisions of the Code and Regulations that potentially require information reporting and withholding on such payments in certain circumstances. As described below, the characterization of a swap as including a "loan" or "interest" payments also is important for other purposes of the Code and Regulations.

The Federal Income Consequences of Deemed Loans

Requiring upfront payments to be treated as loans implicates a number of federal income tax issues that are not addressed by the section 956 and section 1001 Regulations. For example, the creation of a deemed loan implicates information reporting and withholding requirements, as deemed interest payments resulting from upfront payments being treated as a loan could be subject to withholding and information reporting by CME Clearing or CME clearing members.[51] Although payments made pursuant to a notional principal contract are generally sourced to the residence of the payee and thus generally do not give rise to section

---

> (D) The upfront payment is made by the derivatives clearing organization or clearing agency, directly or indirectly, to the original counterparty to the contract;
>
> (E) The original counterparty to the contract that receives the upfront payment, as described in paragraph (b)(1)(xi)(D) of this section, is required by the derivatives clearing organization or clearing agency to make, by the end of the business day on which the upfront payment is made by the controlled foreign corporation, a payment in the nature of initial variation margin that is equal (before taking into account any change in the value of the contract between the time the contract is entered into and the time at which the payment is made) to the amount of the upfront payment and such payment is made, directly or indirectly, to the derivatives clearing organization or clearing agency; and
>
> (F) The payment in the nature of initial variation margin is paid by the derivatives clearing organization or clearing agency, directly or indirectly, to the controlled foreign corporation.

48 Treas. Reg. § 1.1001-4.

49 T.D. 9538, 2011-37 I.R.B. 229 (Sep. 12, 2011).

50 Treas. Reg. § 1.1001-4(c).

51 *See* I.R.C. §§ 1441(b) (section 1441 withholding), 3406(b)(3)(B) (backup withholding); Treas. Reg. §§ 1.1461-1(c)(2)(i)(B) (Form 1042-S information reporting), 1.6041-1(d)(5) (Form 1099 information reporting).

1441 withholding,[52] this general sourcing rule does not apply to deemed interest payments resulting from the treatment of a "significant" nonperiodic payment as a loan.[53]

Similarly, although payments attributable to notional principal contracts are generally not subject to information reporting when paid to a foreign payee (unless the amounts are required to be treated as effectively connected income)[54] this general exemption from information reporting does not apply to deemed interest payments resulting from upfront payments being treated as a loan.[55] Thus, the deemed interest could be subject to withholding by the person with primary withholding responsibility (including CME Clearing or CME clearing members)[56] unless a withholding exemption is available (e.g., because the interest constitutes portfolio interest or is subject to reduced withholding under an applicable tax treaty), and could be subject to information reporting even if no withholding is required.[57] The treatment of upfront payments with respect to cleared swaps as deemed loans thus imposes potentially burdensome information reporting and withholding requirements that would not apply in the absence of an upfront payment.

These concerns will be amplified by the implementation of sections 1471–1474 ("FATCA"). FATCA withholding may apply both to interest payments under a deemed loan[58] and to the gross proceeds from the retirement or redemption of a deemed loan.[59] Amounts

---

[52] *See generally* Treas. Reg. §§ 1.863-7(a)(1); 1.863-7(b)(1); 1.1441-4(a)(3)(i).

[53] *See* Treas. Reg. § 1.1441-4(a)(3)(i).

[54] *See id.*

[55] *See id.* Thus, for instance, CME Clearing could be required to report such amounts when dealing with a foreign clearing member, even if the foreign clearing member is a U.S. branch that is treated as a U.S. person or a qualified intermediary that has assumed primary withholding responsibility with respect to such payments. *See* Treas. Reg. § 1.1461-1T(c)(4)(i)(B)–(C). The deemed interest could also be subject to reporting on Form 1099 to the extent such payments are attributable to U.S. non-exempt recipients. *See, e.g.,* Treas. Reg. § 1.1461-1T(c)(4)(i)(B) (requiring certain payments by a U.S. withholding agent to a qualified intermediary to be reported on Form 1099); § 1.6041-1(d)(5) (requiring information reporting on deemed interest resulting from significant non-periodic payments).

[56] *See generally* Treas. Reg. §§ 1.1441-1(b)(2)(iv)–(v) (payments to U.S. branches, foreign intermediaries); 1.1441-1T(b)(2)(iv)(C) (requiring certain U.S. branches to act as withholding agents); 1.1441-1T(b)(6) (requiring certain foreign intermediaries and U.S. branches to act as withholding agents); 1.1441-1T(e)(5)(iv) (permitting assignment of primary withholding responsibility to certain qualified intermediaries).

[57] *See* Treas. Reg. § 1.1461-1T(b)(1).

[58] The "portfolio interest" exception to section 1441 withholding does not apply for purposes of FATCA withholding. *See* I.R.C. § 1473(1)(A)(i); Treas. Reg. § 1.1473-1(a)(2)(i)(C).

[59] *See* I.R.C. § 1473(1)(A)(ii); Treas. Reg. § 1.1473-1(a)(1)(ii).

subject to FATCA withholding are also generally required to be reported.[60] FATCA withholding is not reduced by any treaty.[61]

For taxpayers other than CME, the deemed loan/deemed interest rules raise additional concerns. For example, the temporary section 956 Regulations do not specifically address uncleared intercompany swaps. As the Regulations implicitly acknowledge, transactions in which a controlled foreign corporation makes a payment to a U.S. affiliate and contemporaneously receives that payment back as variation margin do not implicate the concerns to which section 956 is addressed, because there has been no net transfer of funds or assets from the controlled foreign corporation to the U.S. affiliate.[62]

Another example is that a tax-exempt organization that receives an upfront payment under a cleared or uncleared swap, or a fund in which such a tax-exempt organization invests, may be concerned that the upfront payment will be treated as giving rise to debt-financed income under section 514, even though the tax-exempt organization or fund has received no net funds. There is no indication that Congress intended routine transactions by tax-exempt organizations of this kind to become subject to UBTI as a result of the enactment of Dodd-Frank.[63]

Deeming interest income and interest expense to exist also has collateral consequences for other purposes of the Code and Regulations.

<u>Conclusion</u>

As implementation of the Dodd-Frank mandates progresses, cleared swaps with upfront payments are likely to arise more frequently over time. Whatever the basis for treating an upfront payment as a "loan" in the situations that were prevalent when the existing guidance was issued, such treatment seems inappropriate when the recipient of the upfront payment does

---

60 *See* Treas. Reg. § 1.1474-1T(d)(2)(i)(A).

61 A refund or credit may be available if the beneficial owner of a withholdable payment is entitled to a reduced rate of tax on the income under an applicable treaty. *See* I.R.C. § 1474(b); Treas. Reg. § 1.1474-5(a).

62 *See* Treas. Reg. § 1.956-2T(b)(1)(xi)(G), *Example 2* (cleared swap transaction pursuant to which CFC makes an upfront payment through a DCO to a U.S. affiliate, and U.S. affiliate pays a corresponding initial variation margin payment through the DCO to CFC, does not give rise to United States property for purposes of section 956).

63 The last time Congress considered questions of this kind, it clarified section 514 to ensure that routine securities lending transactions do not give rise to UBTI. *See* Section 514(c)(8) (obligation to return collateral received pursuant to a securities loan is not treated as "acquisition indebtedness"). The government has similarly interpreted or adopted rules in order to ensure that other types of routine financial transactions are not treated as giving rise to UBTI. *See* Treas. Reg. § 1.512(b)-1(a)(1) (notional principal contract income treated as excluded from UBTI); Rev. Rul. 95-8, 1995-1 C.B. 107 (short sales do not give rise to debt-financed income). The regulations also specifically grant the Commissioner the authority to exclude from UBTI "other substantially similar income from ordinary and routine investment" (with "ordinary" and "routine' intended to mean "investments which are ordinarily and routinely engaged in by investors in capital, commodity, and similar financial markets"). *See* Treas. Reg. § 1.512(b)-1(a)(1); T.D. 8423, 1992-2 C.B. 108 (July 28, 1992). We believe that today a cleared or uncleared swap with an upfront payment and offsetting variation margin is an ordinary and routine investment of this kind.

not have the use of the funds because they must be returned to the DCO as part of the payment flows associated with a cleared swaps environment. In addition, the clearing process raises practical issues that make compliance with tax information reporting and withholding on upfront payments challenging, if not impossible. Moreover, interest payments on any deemed loan embedded in a swap would generally be eligible for exemption from withholding tax. Similarly, uncleared swaps with upfront payments also are likely to increase in the future, but no tax compliance purpose appears to be served by treating upfront payments on cleared or uncleared swaps with full variation margin payments as deemed loans.

Thus, in the absence of particular situations which might be abusive with respect to withholding and information reporting rules or other rules, we urge Treasury and the Service to issue guidance that exempts upfront payments on swaps cleared through a DCO (either as part of a DSF delivery or otherwise) from the application of the rules that treat "significant" nonperiodic payments with respect to swaps as loans, and to treat such upfront payments as non-significant payments under Regulations section 1.446-3. We also urge that such treatment be extended to uncleared swaps with respect to which initial variation margin is posted by the party receiving the upfront payment.

Alternatively, we urge Treasury and the Service to expand the approach of T.D. 9549 to apply to information reporting and withholding rules as well where the swaps in question are cleared through a DCO. There does not appear to be any readily ascertainable reason for treating cleared swaps differently under section 956 and other provisions of the Code. Relieving the DCO and other parties to such swaps from applicable withholding and related information reporting requirements would assist in alleviating the practical challenges outlined in these comments. Similarly, we request that the approach of T.D. 9549 be extended to uncleared swaps for purposes of the information reporting and withholding rules and section 956, and for purposes of the UBTI rules for both cleared and uncleared swaps. We consider this piece-meal approach to be less efficient and effective for both taxpayers and the government, however, and accordingly urge adoption of the comprehensive approach described in the prior paragraph.

Granting the requested relief would eliminate or assist in eliminating the tax uncertainty with respect to upfront payments on swaps cleared through a DCO, thereby encouraging the continued development of transparent and effective swap clearing mechanisms, as envisioned by Dodd-Frank. It also would enable swap participants to carry out uncleared transactions in accordance with commercial and regulatory imperatives without bearing unnecessary tax risk. We urge the Service and Treasury to provide additional guidance to that effect as soon as practicable.

* * * * *

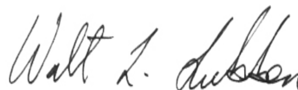
We would be pleased to meet with you to discuss the subject of these comments at your convenience. If such a meeting would be helpful, please contact Michael A. Clark of Sidley Austin LLP at (312) 853-2173 or Erika W. Nijenhuis of Cleary Gottlieb Steen & Hamilton LLP at (212) 225-2980.

Sincerely,

Kathleen M. Cronin
Senior Managing Director, General Counsel and Corporate Secretary
CME Group Inc.

Payson Peabody
Managing Director & Tax Counsel
Securities Industry and Financial Markets Association

Thomas Prevost
Chair
North American Tax Committee of the International Swaps and Derivatives Association, Inc.



Walt Lukken
President & Chief Executive Officer
Futures Industry Association

cc: Kristine Crabtree, Attorney-Advisor, Associate Chief Counsel (International), Branch 2, Internal Revenue Service
Helen Hubbard, Associate Chief Counsel (Financial Institutions & Products), Internal Revenue Service
Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Jeffery Mitchell, Branch Chief, Associate Chief Counsel (International), Branch 2, Internal Revenue Service
Michael Novey, Associate Tax Legislative Counsel, Department of the Treasury
Karl Walli, Senior Counsel--Financial Products, Department of the Treasury
Lisa Zarlenga, Tax Legislative Counsel, Department of the Treasury

Appendix A: Swaps Subject to CFTC Clearing Mandate

Specification	**Fixed-to-Floating Swap Class**			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)	Yen (JPY)
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	28 days to 50 years	28 days to 50 years	28 days to 50 years	28 days to 30 years
4. Optionality	No	No	No	No
5. Dual Currencies	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No

Specification	**Basis Swap Class**			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)	Yen (JPY)
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	28 days to 50 years	28 days to 50 years	28 days to 50 years	28 days to 30 years
4. Optionality	No	No	No	No
5. Dual Currencies	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No

Specification	**Forward Rate Agreement Class**			
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)	Yen (JPY)
2. Floating Rate Indexes	LIBOR	EURIBOR	LIBOR	LIBOR
3. Stated Termination Date Range	3 days to 3 years	3 days to 3 years	3 days to 3 years	3 days to 3 years
4. Optionality	No	No	No	No
5. Dual Currencies	No	No	No	No
6. Conditional Notional Amounts	No	No	No	No

Specification	**Overnight Index Swap Class**		
1. Currency	U.S. Dollar (USD)	Euro (EUR)	Sterling (GBP)
2. Floating Rate Indexes	FedFunds	EONIA	SONIA
3. Stated Termination Date Range	7 days to 2 years	7 days to 2 years	7 days to 2 years
4. Optionality	No	No	No
5. Dual Currencies	No	No	No
6. Conditional Notional Amounts	No	No	No

Specification	**North American Untranched CDS Indices Class**
1. Reference Entities	Corporate
2. Region	North America
3. Indices	CDX.NA.IG CDX.NA.HY
4. Tenor	CDX.NA.IG: 3Y, 5Y, 7Y, 10Y CDX.NA.HY: 5Y
5. Applicable Series	CDX.NA.IG 3Y: Series 15 and all subsequent Series, up to and including the current Series CDX.NA.IG 5Y: Series 11 and all subsequent Series, up to and including the current Series CDX.NA.IG 7Y: Series 8 and all subsequent Series, up to and including the current Series CDX.NA.IG 10Y: Series 8 and all subsequent Series, up to and including the current Series CDX.NA.HY 5Y: Series 11 and all subsequent Series, up to and including the current Series
6. Tranched	No

Specification	**European Untranched CDS Indices Class**
1. Reference Entities	Corporate
2. Region	Europe
3. Indices	iTraxx Europe iTraxx Europe Crossover iTraxx Europe HiVol
4. Tenor	iTraxx Europe: 5Y, 10Y iTraxx Europe Crossover: 5Y iTraxx Europe HiVol: 5Y
5. Applicable Series	iTraxx Europe 5Y: Series 10 and all subsequent Series, up to and including the current Series iTraxx Europe 10Y: Series 7 and all subsequent Series, up to and including the current Series iTraxx Europe Crossover 5Y: Series 10 and all subsequent Series, up to and including the current Series iTraxx Europe HiVol 5Y: Series 10 and all subsequent Series, up to and including the current Series
6. Tranched	No

Appendix B

Cash Flows Associated with Centrally Cleared Interest Rate Swaps

The following examples illustrate cash flows made and received by two market participants in connection with hypothetical conventional USD interest rate swap transactions accepted for clearing and guarantee by CME Clearing. They demonstrate that, in a regime of central clearing, guarantee, and margining of interest rate swap exposures, it would either be impractical or infeasible for one swap counterparty to extend credit to another in the guise of an upfront payment on an off-market interest rate swap.[64]

Example A. On Thursday, May 9, 2013, Party A and Party B enter a forward-starting 10-year interest rate swap, in which Party A pays fixed-rate interest to, and receives floating-rate interest from, Party B. The interest rate swap is submitted to CME Clearing the same day for centralized clearing and guarantee.

Exhibit 1: Trade Entry

Product	**10-Year USD Fixed/Floating Interest Rate Swap for Forward Start**	
Start Date	16 June 2013	
End Date	16 June 2023	
Notional Principal Amount	$1,000,000	
Fixed Rate	4%	(Party A pays fixed)
Floating Rate Reference	3-Month USD BBA Libor	(Party B pays floating)
Transaction Date	9 May 2013	
Cleared Date	9 May 2013	

Assume this interest rate swap is off-market, *i.e.*, that the fixed rate of 4% per annum that Party A agrees to pay to Party B is higher than the prevailing par fixed rate for an otherwise identical swap structure.

The divergence of the swap's fixed rate from the par swap rate of the moment necessitates an "upfront payment" to equilibrate the values of the fixed-rate and floating-rate sides of the swap. For this purpose, in the context of a purely bilateral interest rate swap, Party B would remit an upfront payment of $30,300—or approximately 8.4% percent of the of the fixed payments due under the swap—to Party A.

For precisely the same reason, the centrally cleared swap transaction also entails an upfront payment. As Exhibit 2 illustrates, however, Party B remits the upfront payment not to Party A, but to CME Clearing. CME Clearing in turn remits an equal sum to Party A. However, the recipient of the upfront payment in the centrally cleared swap must post the proceeds as variation margin in its account with the central counterparty. That is, Party A must post to its margin account with CME Clearing the upfront payment it has received from CME Clearing as performance bond against its fulfillment of the swap contract's obligations. (As Exhibit 2 illustrates, Party B would be entitled to payment of a corresponding amount of variation margin from CME Clearing.)

---

[64] For convenience, cash flows relating to initial margin (as distinguished from daily variation margin) and coupon payments have been omitted from the examples.

Indeed, Party A's initial net cash flow versus CME Clearing is a payment of $84.18 rather than a receipt of $30,300 (equal to the upfront payment). The incremental $84.18, which Party A must post to its margin account, is variation margin reflecting change in the net present value of the swap, arising from shifts in market conditions between the time at which the swap is transacted and the close of business for that day.

Each day thereafter, CME Clearing marks the interest rate swap to market. The resultant daily marks-to-market require collections from those who hold positions that have lost value, and convey payments to those who hold positions that have gained value. These payments and collections are comprised of four components: (i) initial contractually agreed upfront payments (as described above); (ii) periodic payments of contractually agreed fixed rate interest and floating rate interest; (iii) day-to-day changes in net present value of swap exposures (excluding the contractual cash flows identified in (i) and (ii)); and (iv) price alignment interest (PAI). For any given valuation date or cash payment date, all such pays and collects are moved by the Clearing House on the "banking date," i.e., the morning of the business day next following the value date's margin cycle. The mark-to-market process thus ensures that position gains and losses are daily recognized and margined, so that losses do not accumulate for any period greater than one business day. See Exhibits 2 and 3, which show hypothetical net payment amounts on the next two business days, May 13 and May 14.

Exhibit 2: Cash Flows for Cleared Interest Rate Swap on Cleared Date and Cleared Date + 1

Banking Date	Friday, May 10, 2013		Monday, May 13, 2013	
	Party A		**Party A**	
	Interest Rate Swap #1		**Interest Rate Swap #1**	
	Debit	Credit	Debit	Credit
Variation Margin	$30,384.18			$185.62
Upfront Cash		$30,300.00		
PAI	$0.00			$0.51
Net Cash Flow	**$84.18**			**$186.13**
(betw Party A and CME CH)				
	CME Clearing		CME Clearing	
	Party B		**Party B**	
	Interest Rate Swap #1		**Interest Rate Swap #1**	
	Debit	Credit	Debit	Credit
Variation Margin		$30,384.18	$185.62	
Upfront Cash	$30,300.00			
PAI			$0.51	
Net Cash Flow		$84.18	**$186.13**	
(betw Party B and CME CH)				

Exhibit 3: Cash Flows for Cleared Interest Rate Swap on Cleared Date + 2

Banking Date	**Tuesday, May 14, 2013**	
	Party A	
	Interest Rate Swap #1	
	Debit	Credit
Variation Margin	$2,476.23	
Upfront Cash		
PAI		$0.17
Net Cash Flow	**$2,476.06**	
(betw Party A and CME CH)		
	CME Clearing	
	Party B	
	Interest Rate Swap #1	
	Debit	Credit
Variation Margin		$2,476.23
Upfront Cash		
PAI	$0.17	
Net Cash Flow		**$2,476.06**
(betw Party B and CME CH)		

Example B. Assume that on May 14, 2013, Party A decides to extinguish the interest rate swap exposure described in Example A by transacting an offsetting trade with Party B that closes out the original swap transaction.[65] Assume moreover that the offsetting transaction is submitted for clearing on the day it is transacted (May 14, 2013). Finally, assume that the offsetting transaction is off-market, similar to the extant swap exposure established earlier, such that the contractually agreed fixed interest rate of 4% per annum is higher than the prevailing par fixed rate for an otherwise identical interest rate swap. Thus, the offsetting swap transaction also requires an upfront payment to equalize the net present values of its fixed-rate and floating-rate legs. In this instance, Party B — as payer of an above-market fixed interest rate — receives an upfront payment of $32,500 to its margin account from CME Clearing. Simultaneously, CME Clearing debits Party A's margin account for $32,500. Those payments will take place on the next banking day, May 15.

---

[65] Note that the counterparties to this offsetting swap transaction need not be the counterparties to the original swap transaction. Because the contractual counterparty to Party A is ultimately CME Clearing, Party A could have chosen to transact the offsetting interest rate swap with any eligible counterparty instead of Party B.

Exhibit 4: Termination of Existing Interest Rate Swap Exposure via Offsetting Transaction

Product	**10-Year USD Fixed/Floating Interest Rate Swap for Forward Start**	
Start Date	16 June 2013	
End Date	16 June 2023	
Notional Amount	$1,000,000	
Fixed Rate	4%	(Party B pays fixed)
Floating Rate Reference	3-Month USD BBA Libor	(Party A pays floating)
Transaction Date	14 May 2013	
Cleared Date	14 May 2013	

As Exhibit 5 details, the net effect of the offsetting trade is to extinguish both itself and the initial swap exposure.

Exhibit 5:Cash Flows for Initial and Offsetting Cleared Interest Rate Swap Transactions

	Banking Date	**Wednesday, May 15, 2013**				
Breakout of Net Payments						
	Party A				Party B	
	Interest Rate Swap #1	Banking Date			Interest Rate Swap #1	
	Debit	Credit			Debit	Credit
Variation Margin		$32,674.79		Variation Margin	$32,674.79	
Upfront Cash				Upfront Cash		
PAI		$0.18		PAI	$0.18	
Net		$32,674.97		Net	$32,674.97	
	Party A				Party B	
	Interest Rate Swap #2 (of	Banking Date			Interest Rate Swap #2 (offsetting)	
	Debit	Credit			Debit	Credit
Variation Margin				Variation Margin		
Upfront Cash	$32,500.00			Upfront Cash		$32,500.00
PAI				PAI		
Net	$32,500.00			Net		$32,500.00

On the next business day, May 15, 2013, a residual net payment of $174.97 moves from Party B to CME Clearing, and from CME Clearing to Party A. See Exhibit 6.

Exhibit 6: Net Cash Flows, Initial and Offsetting Trades

		Wednesday, May 15, 2013	
	TOTAL NET CASH MOVEMENTS		
	Party A		
		from Interest Rate Swap#1 + Interest Rate Swap#2	
		Debit	Credit
	Variation Margin		$32,674.79
	Upfront Cash	$32,500.00	
	PAI		$0.18
	Net Cash Flow		**$174.97**
(betw Party A and CME CH)			
		CME Clearing	
	TOTAL NET CASH MOVEMENTS		
	Party B		
		from Interest Rate Swap#1 + Interest Rate Swap#2	
		Debit	Credit
	Variation Margin	$32,674.79	
	Upfront Cash		$32,500.00
	PAI	$0.18	
	Net Cash Flow	**$174.97**	
(betw Party B and CME CH)			

Finally, Exhibit 7 summarizes daily net cash flows made during the week between Party A and Party B, via their margin accounts with CME Clearing. The net effect is a payment of $2,199.14 from Party A to Party B, which in this example includes the three daily variation margin cash flows, on May 10, 13 and 14, reflecting payments determined at the close of the prior business day, and the final payment under the first swap on May 15 in the amount determined at the close of May 14. Importantly, although both of the interest rate swaps in this scenario were off-market, and although the ensuing upfront payments were considerable when viewed in isolation, the resultant margin pays and collects were incidental and *de minimis*.

Exhibit 7: Summary of Daily Net Cash Flows for Initial and Offsetting Swap Transactions — 10-15 May 2013

	Party A			Party B	
	from Interest Rate Swap#1 + Interest Rate Swap#2			from Interest Rate Swap#1 + Interest R	
	Debit	Credit		Debit	Credit
5/10/13	**$84.18**		CME Clearing		**$84.18**
5/13/13		**$186.13**		**$186.13**	
5/14/13	**$2,476.06**				**$2,476.06**
5/15/13		**$174.97**		**$174.97**	

Appendix C: SIFMA letter dated January 23, 2013

January 23, 2013

Danielle Rolfes
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220
danielle.rolfes@treasury.gov

Karl Walli
Senior Counsel – Financial Products
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220
Karl.Walli@treasury.gov

Steven Musher
Associate Chief Counsel (International)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224
steven.a.musher@irscounsel.treas.gov

Michael H. Plowgian
Office of International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220
michael.plowgian@treasury.gov

Ronald Dabrowski
Deputy Associate Chief Counsel (Int'l)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224
Ronald.Dabrowski@irscounsel.treas.gov

Jeffrey G. Mitchell
Branch Chief, Branch 2 (CC:INTL)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224
Jeffrey.G.Mitchell@irscounsel.treas.gov

Re: Request for Guidance under Section 956 Relating to Cross-Border Cash-Collateralized Derivatives Transactions

Ladies and Gentlemen,

On behalf of the Securities Industry and Financial Markets Association ("SIFMA"),[1] we wish to express our appreciation of the guidance that the Internal Revenue Service (the "Service") and U.S. Treasury Department have issued in response to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act and related regulatory and market developments. Our members are devoting enormous resources to complying with many new Dodd-Frank rules, and in

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

the course of doing so have identified a number of new tax compliance concerns. We commend the Service and Treasury for their work in assisting taxpayers to reorganize their business operations in response to these new developments by alleviating these concerns.

In this letter we respond to a request for comments made in the preamble to Temporary Treasury regulation section 1.956-2T(b)(1)(xi), relating to the definition of "United States property" in connection with certain swaps that are cleared by a U.S.-registered clearing organization.[2] In particular, we are submitting comments on the question of whether and under what circumstances it is appropriate to extend the exception provided by the regulation to contracts that are not cleared by U.S.-registered clearing organizations. As described in more detail below, we request that regulations be issued confirming that an "upfront payment" on a swap or other derivative financial instrument made by a controlled foreign corporation ("CFC") to a U.S. affiliate in the ordinary course of a swaps dealer business is not treated as an investment in United States property to the extent that the U.S. affiliate provides cash or readily marketable securities to the CFC as collateral for the swap.

Overview

Dodd-Frank has transformed and is continuing to transform the U.S. derivatives markets in fundamental ways. Similar initiatives are under way in Europe and elsewhere. As a result, the terms under which market transactions are entered into, and the manner in which credit and market risks of those transactions are managed, are also changing in fundamental ways. In particular, as described in more detail below:

- It is increasingly common for swap transactions to be entered into with standardized payment terms that give rise to upfront payments from one party to another, with offsetting cash collateral payments;

- It is increasingly common for U.S. customers to enter into swaps with a U.S. swap dealer, and for non-U.S. customers of the same financial institution to enter into swaps with a non-U.S. swap dealer affiliate (customer-facing affiliate). That is true even if the market risk of the non-U.S. customer transaction is managed by the U.S. affiliate (risk-management affiliate); and

[2] T.D. 9589, 2012-23 I.R.B. 971, 973. While the temporary regulations do not address these transactions, similar concerns can arise if a swap is cleared through a foreign clearing organization.

All citations are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

- It is consequently increasingly common for there to be intercompany hedges of such transactions, meaning that there are more transactions in which the customer-facing (non-U.S.) affiliate enters into an intercompany swap in order to transfer the market risk of the transaction to the risk-management (U.S.) affiliate. For regulatory and commercial reasons those hedges generally mirror or closely track the customer transaction entered into by the customer-facing (non-U.S.) affiliate. Since the customer transaction provides for an upfront payment, the hedge also results in an upfront payment between the U.S. and non-U.S. affiliates. As a result, it is increasingly common for a controlled foreign corporation ("CFC") to make an *upfront payment on an intercompany swap* with a U.S. affiliate. It is payments of this kind that are the subject of this request for guidance.

There are also other fact patterns under which, for regulatory and commercial reasons, a CFC may make, or may be deemed to make, an upfront payment on a swap or other derivative financial instrument to a U.S. affiliate. These fact patterns reflect sweeping changes in the derivatives markets.

Historically, common swaps like interest rate swaps were virtually always entered into on "at-market" terms. For example, if the market rate for the fixed leg of the swap was 6 percent today and 7 percent tomorrow, a swap entered into today would provide for 6 percent periodic payments and a swap entered into tomorrow would provide for 7 percent periodic payments. That pattern has increasing changed to a different one.

The new fact pattern is a swap (a) that provides for one party to make periodic payments at a standardized rate that is below- or above-market, and (b) that consequently provides for an upfront payment on the swap to compensate for the below- or above-market periodic payments. A swap of this kind typically will be entered into subject to rules or contractual provisions that require the party that receives the upfront payment to make a contemporaneous offsetting cash payment of collateral (sometimes referred to as "margin") to the party that made the upfront payment.

For example, assume that the parties enter into a three-year swap at a time when the market rate for the fixed leg is 6 percent. For commercial or regulatory reasons, the parties agree that the fixed periodic payments will be 5 percent rather than 6 percent. The party that will receive the 5 percent periodic payments will receive 1 less per year than it could have received on an at-market swap. Consequently, it will require the other party to compensate it by making an upfront payment equal to the present value of the "missing" 1 of payment for 3 years, which for simplicity's sake we

Washington | New York

1101 New York Avenue, 8th Floor | Washington, DC 20005-4269 | P: 202.962.7466 | F: 202.962.7305

www.sifma.org | www.investedinamerica.org

assume is an upfront payment equal to 2.50. For the reasons described below, the party that receives the 2.50 of upfront payment generally will be required contemporaneously to provide 2.50 of collateral to the other party. Thus, there has been no net exchange of value on day 1.[3]

Under the timing regulations for swaps, the 2.50 upfront payment may be treated as a deemed loan.[4] A loan from a CFC to a U.S. affiliate ordinarily can give rise to an investment in United States property for section 956 purposes. The temporary section 956 regulations provide that, in the case of swaps that are cleared by a U.S.-registered clearing organization, an upfront payment made by a CFC directly or indirectly to a U.S. affiliate in the ordinary course of a swaps dealer business does not give rise to an investment in United States property provided that the U.S. affiliate is required to make an equal and offsetting payment of variation margin to the non-U.S. affiliate.[5] The temporary regulations thus alleviate concerns that very large, and completely random, deemed dividend inclusions could arise under section 956 as a result of transactions that swap dealers are required by law to carry out.

SIFMA believes that the same result should apply to any derivatives transaction in which (i) a CFC makes, or is deemed to make, a payment to a counterparty that is a U.S. affiliate pursuant to the terms of a derivatives transaction entered into in the ordinary course of a swaps dealer business, and (ii) the counterparty makes a contemporaneous payment of cash in the same amount to the dealer as collateral for the transaction. Under these circumstances there is no net advance of cash or assets from the CFC to a U.S. affiliate, and therefore there is no economic

---

[3] Another example of a transaction that would give rise to an upfront payment is one in which the periodic payments are made at an above-market rate. For example, if the market rate for coupons is 6 percent, but the parties agree that coupon payments will be made at an 8 percent rate, the party entitled to receive the 8 percent periodic payments will be required to make an upfront payment to the counterparty in order to compensate the latter for its obligation to make the "extra" 2 of payments during the term of the swap.

A swap is said to be "out of the money" to the party receiving the below-market periodic payments (or required to make above-market periodic payments), and "in the money" to the other party. Since the market rate for periodic payments changes daily, a swap that is "at the money" on day 1 typically will become in the money to one party and out of the money to the other thereafter.

[4] Treasury regulation section 1.446-3(g)(4). These regulations apply to "notional principal contracts." For ease of exposition, we refer to such transactions as "swaps" in this letter.

[5] The regulations apply only if a number of conditions are satisfied. It is our understanding that swaps cleared by all of the existing U.S.-registered clearing organizations satisfy those conditions.

"investment" by the CFC in an obligation of the affiliate. Consequently, we believe that these transactions do not raise the kind of concerns about surreptitious repatriations of earnings and profits to U.S. affiliates that section 956 is intended to address. In view of the enormous size of the potential exposure to swap dealers should the Service take the position that upfront payments on swaps that are not covered by the temporary section 956 regulations could be treated as investments in United States property, we request guidance confirming that no investment in United States property arises to the extent that an upfront payment of this kind is collateralized with cash.

More specifically, SIFMA requests that guidance be issued that clarifies that section 956(c)(2)(J) excludes from the definition of "United States property" any obligation of a United States person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities or cash received as collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities or commodities. We have attached diagrams illustrating a number of specific fact patterns for which such guidance would be relevant. The diagrams are intended to be illustrative, not exclusive.

We describe below in more detail the changes to the law and in the market that give rise to this request for guidance. We would be happy to provide further details in this regard.

Growing number of swaps with upfront payments

Dodd-Frank will require U.S. swap dealers and other major participants in the derivatives market to clear certain interest rate swaps ("IRS") and credit default swaps ("CDS"), starting in March 2013.[6] In anticipation of this requirement, billions of dollars (notional amount) of IRS and CDS are already being cleared.[7]

---

[6] Commodity Futures Trading Commission, Clearing Requirement Determination under Section 2(h) of the CEA; Final Rule, 77 Fed. Reg. 74,284 (Dec. 13, 2012), http://www.gpo.gov/fdsys/pkg/FR-2012-12-13/pdf/2012-29211.pdf. Mandatory clearing requirements will be expanded to additional categories of participants in the market over time.

[7] Based on publicly available information, as of the end of 2012, total open interest in interest rate swaps cleared on U.S.-registered clearing organizations was over $600 billion and total open interest in cleared credit default swaps was over $775 billion. See http://www.cmegroup.com/trading/interest-rates/cleared-otc/#data (open interest in CME USD IRS of about $492 billion with over $100 billion more in other currencies), visited Jan. 11, 2013; https://www.theice.com/clear_credit.jhtml (open interest in ICE Clear Credit CDS over $725 billion), visited Jan. 11, 2013; http://www.cmegroup.com/trading/cds/?tabs=21#data (open interest in CME CDS of about $50 billion), visited Jan. 11, 2013. LCH.Clearnet also clears interest rate swaps in the United

Washington | New York

1101 New York Avenue, 8th Floor | Washington, DC 20005-4269 | P: 202.962.7466 | F: 202.962.7305

www.sifma.org | www.investedinamerica.org

As described in the preamble to the temporary section 956 regulations, the terms of CDS cleared in the United States provide for standardized coupons of either 100 or 500 basis points (that is, 1 percent or 5 percent), under the rules of the clearinghouses. Except for the random case where the market-clearing level for a particular CDS is 100 or 500 basis points, all U.S.-cleared CDS are entered into with coupons that are below or above the market level. Consequently, the party that benefits from the below- or above-market periodic payments must make an upfront payment to its counterparty to compensate the latter. The party making the upfront payment then has credit risk to its counterparty, because the swap could terminate early if the counterparty defaults, in which case the first party would not realize the full anticipated benefits of the below- or above-market periodic payments. The counterparty therefore is required by the rules of a clearing organization to make a contemporaneous payment of cash collateral (referred to in that context as "margin") to the first party. This payment of margin is essential to the overall transaction.

Similarly, in the over-the-counter ("OTC") markets, CDS contracts with terms like those of cleared swaps trade with the same standardized coupons and upfront payments. Because of the credit risk created by the upfront payment, OTC CDS generally also require a contemporaneous payment of cash collateral by the party receiving the upfront payment to the party making the upfront payment.

IRSs historically have traded in both the OTC and cleared swap markets without upfront payments. Recently, however, one U.S. clearing organization has developed a futures contract that at maturity delivers a cleared IRS.[8] The IRS will, except for random cases, provide for fixed leg payments that are less than or greater than the then-market rate for fixed leg payments, because the economic terms of the IRS will be set when the futures contract is launched rather than when it matures. Consequently, for the same reasons described above, under the legal terms of the contracts, one party will be required to make an upfront payment on the IRS when entered into, and the other party will be required to make a contemporaneous payment of cash collateral (margin) in the same amount.

It is possible that, as with CDS, IRS will start to trade in the OTC market with upfront payments as a result of the development of cleared IRS with

---

States, but does not break out its U.S. and non-U.S. operations so we have not included any estimate for swaps cleared by LCH.Clearnet. The total notional amounts cleared to date by U.S.-registered clearing organizations are in the trillions of dollars.

8 See http://www.cmegroup.com/trading/interest-rates/deliverable-interest-rate-swap-futures.html.

Washington | New York

1101 New York Avenue, 8th Floor | Washington, DC 20005-4269 | P: 202.962.7466 | F: 202.962.7305

www.sifma.org | www.investedinamerica.org

upfront payments. More generally, it is anticipated that there will be other developments in the IRS market that will lead to IRS with upfront payments, although there are no specific initiatives that we are aware of.

As a result of these developments, billions of dollars (notional amount) of uncleared swaps are now being entered into by U.S. swap dealers with upfront payments and offsetting cash collateral. IRS, CDS and other swaps with upfront payments may also be entered into as a result of a transfer of a swap from one affiliate to another, as described in more detail below.

Movement of customers from U.S. affiliates to non-U.S. affiliates

The CFTC has adopted rules requiring U.S. swap dealers to register with the CFTC.[9] Registered swap dealers are subject to a broad range of regulatory rules affecting the manner in which they do business with customers, including requirements for capital and margin, reporting and recordkeeping, internal and external business conduct standards, documentation standards, and segregation of initial margin for uncleared swaps. Some of these requirements, for example requirements relating to the manner in which swaps are documented and obligations to provide certain representations and information to dealers, directly affect customers and are perceived by customers as burdensome. These rules apply to transactions entered into by customer of non-U.S. swap dealers as well. In the case of non-U.S. swaps dealers, however, these rules apply only with respect to swaps with U.S. customers.[10]

In response to this development, some non-U.S. customers of U.S. swap dealers have been moving their positions to non-U.S. affiliates of those dealers, which will mean that swaps entered into by those customers will be subject to local regulatory rules but not the burdensome new U.S. regulatory rules. We expect that this migration will continue for some time.

[9] Commodity Futures Trading Commission, *Performance of Registration Functions by National Futures Association with respect to Swap Dealers and Major Swap Participants*, 77 Fed. Reg. 2708 (Jan. 19, 2012), http://www.gpo.gov/fdsys/pkg/FR-2012-01-19/pdf/2012-791.pdf. The first deadline for registration was at the end of 2012. The Securities & Exchange Commission also requires U.S. swaps dealers in products regulated by the SEC to register with the SEC.

[10] *See* Commodity Futures Trading Commission, *Further Proposed Guidance Regarding Compliance With Certain Swap Regulations,* 78 Fed. Reg. 909 (Jan. 7, 2013), http://www.gpo.gov/fdsys/pkg/FR-2013-01-07/pdf/2012-31734.pdf.

Washington | New York

1101 New York Avenue, 8th Floor | Washington, DC 20005-4269 | P: 202.962.7466 | F: 202.962.7305

www.sifma.org | www.investedinamerica.org

While limited grandfathering may limit the applicability of some of the new CFTC rules for certain pre-existing swaps, customers typically move the entire portfolio of derivatives positions in a particular account to the non-U.S. affiliate. This allows the customer to more efficiently manage its collateral obligations under all of its swaps with the dealer, on a net basis, and mitigates credit risk to the customer in the event that the dealer goes bankrupt. As a result, existing swaps and other derivatives that were entered into at-market but whose coupons have become below- or above-market are being transferred from U.S. swap dealers to their non-U.S. swap dealer affiliates.

In exchange for entering into these swaps, a non-U.S. affiliate may make a payment to, or receive a payment from, a U.S. affiliate, usually a U.S. broker-dealer or bank.[11] Alternatively, if the underlying market risk is one that the dealer risk-manages in the United States, the U.S. and non-U.S. affiliate generally will enter into an intercompany swap that shifts the market risk of the transaction from the non-U.S. affiliate back to the U.S. affiliate.[12]

Resulting increase in intercompany transactions with upfront payments

Historically, intercompany swaps typically were entered into on at-market terms. One result of the developments described above is a substantial increase in intercompany swaps that are entered into with upfront payments because they are related to customer transactions with an upfront payment. The customer transaction may be a new cleared transaction that has standardized coupons that are below- or

---

[11] For example, if a customer entered into a swap with a 6 percent coupon when that was the market rate, and the market rate is 6.50% when the swap is transferred from the non-U.S. to U.S. affiliate, the non-U.S. affiliate will pay to a U.S. affiliate, or receive from a U.S. affiliate, a termination payment equal to the present value of the 0.50% difference between the contractual rate and the market rate.

[12] It is also possible that the market risk would be managed outside the United States by a non-U.S. branch of a U.S. bank. An intercompany swap between a CFC and that foreign branch would raise the same concerns as the transaction described in the text above.

Another transaction flow raising these concerns would be a transaction in which a U.S. swaps dealer (including a foreign branch of a U.S. bank) enters into a swap as to which the underlying risk is risk-managed in whole or part outside the United States by a related CFC. In that case, if the customer wishes to enter into a swap that provide for above-market payments to the U.S. affiliate, the U.S. affiliate would make an upfront payment to the customer . As described in the text below, the U.S. affiliate would receive a corresponding upfront payment on the intercompany hedge with the CFC hedging the market risk of the transaction.

above-market rate, or a new OTC transaction that has such terms because the customer has commercial reasons for doing so. Alternatively, for the reasons described above, the intercompany swap may hedge existing customer transactions that were entered into with at-market coupons but pay below- or above-market coupons at the time when they are moved from one dealer affiliate to another.

For regulatory and commercial reasons, it is common for the terms of the intercompany swaps to match precisely those of the customer transaction. A "back-to-back" transaction of this kind is an efficient structure, because the affiliate with the customer relationship bears (only) the credit risk of dealing with the customer, and the affiliate that risk-manages the underlying risk bears all of the market risk. As in the case of swaps with third parties, this generally means that the affiliate that benefits from the below- or above-market periodic payments is required under the terms of the swap to make an upfront payment to the other affiliate. Furthermore, for the reasons described above, these intercompany transactions are increasingly cross-border transactions. Consequently, swap upfront payments made by a CFC to a U.S. affiliate pursuant to the terms of a intercompany swap transaction have become common, and their number and size are expected to grow.

A possible alternative to the back-to-back hedge described above is a global, or "macro," hedge between the affiliates. In this case, the affiliates enter into a single net hedge reflecting all of their customer transactions with respect to a specific market risk. The macro swap is modified on a daily basis to reflect any additions, subtractions or other changes to the customer transactions. Macro hedges are used because they allow the financial institution to utilize its regulatory capital in a more efficient manner[13] and are easier to administer than potentially thousands of separate intercompany transactions. For the same reasons as described in the prior paragraph, these hedges transfer risk from the customer-facing affiliate to the risk-managing affiliate, on terms very similar to the customer transactions. As a result, one affiliate may make or receive an upfront payment to the other in order to reflect a new customer transaction. In addition, because the macro hedge is modified and rebalanced daily,

[13] For example, under proposed banking regulations, the amount of regulatory capital required to be allocated to a swap is determined based on the notional amount multiplied by a conversion factor that takes into account the underlying risk and the tenor of the transaction. See Department of the Treasury, Office of the Comptroller of the Currency, Federal Reserve System, and Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule*, 77 Fed. Reg. 52,978, at p. 53,014 (Aug. 30, 2012), http://www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-16761.pdf. We understand that a single net swap, with a lower notional amount as a result of offsetting positions, does not require as much capital under these rules as the sum of the capital that would be required for individual "gross" swaps.

and market rates move daily, if the modification is treated as a deemed termination of yesterday's macro hedge and a deemed entering into of today's macro hedge, the "new" macro hedge is likely to be in-the-money to one affiliate and out-of-the-money to the other. Consequently, it is possible that one party may be deemed to make or receive an upfront payment when the macro swap is modified and rebalanced.

For regulatory and other reasons, the intercompany transaction typically requires that collateral be provided on a daily basis, from the affiliate that would be required to make a payment if the transaction were terminated on that day to the affiliate that would be entitled to the payment. This collateral serves the same function for uncleared intercompany swaps that daily variation margin serves in the case of cleared swaps. That is, it protects the party that makes the upfront payment from the risk that the other party will default, in which case the first party will lose the benefit that it paid for. If a CFC is required to make an upfront payment on a swap to a U.S. affiliate, therefore, the U.S. affiliate generally will provide collateral in the same amount or value to the CFC.[14]

Because collateral on an uncleared swap entered into between affiliates is provided for the same reasons as daily variation margin on a cleared swap, SIFMA believes that the rationale that underlies the temporary section 956 regulations on cleared swaps applies with the same force to uncleared swaps and other derivatives.[15] As described above, swap dealers make upfront payments on these swaps for legal and practical reasons, as a result of changes to the law and related changes to the manner in which the derivatives markets operate. SIFMA respectfully requests that the Service and Treasury therefore extend the temporary section 956 regulations to provide that an upfront payment on any intercompany swap or other derivative financial instrument will not be treated as an investment in United States property to the extent of any readily marketable securities or cash collateral provided by recipient of the upfront payment to the payor.

[14] The CFTC has proposed rules that generally would exempt intercompany swaps from the clearing requirements described above, but that would require the parties to such swaps to provide daily variation margin. Commodity Futures Trading Commission, *Clearing Exemption for Swaps Between Certain Related Entities*, 77 Fed. Reg. 50,425 (Aug. 21, 2012), http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-20508a.pdf; Commodity Futures Trading Commission, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* 76 Fed. Reg. 23,732 (April 28, 2011).

[15] Other derivatives that raise similar concerns include transactions frequently characterized as prepaid variable forward contracts, because such transactions may be treated as having embedded loans for U.S. federal income tax purposes.

Please feel free to call me, at (202) 962-7333, or our outside counsel, Erika W. Nijenhuis, at (212) 225-2980, if we can answer any questions or assist you further in any way.

Very truly yours,

Payson R. Peabody
Managing Director & Tax Counsel

Attachments

cc: Kristine Crabtree, Internal Revenue Service (CC:INTL:B02)
Anthony Marra, Internal Revenue Service (CC:INTL:B05)

Washington | New York

1101 New York Avenue, 8th Floor | Washington, DC 20005-4269 | P: 202.962.7466 | F: 202.962.7305

www.sifma.org | www.investedinamerica.org