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

Re: Comments on Temporary and Proposed Regulations Under Sections 446 and 956

Dear Commissioner Koskinen:

Enclosed please find comments on the temporary and proposed regulations providing embedded loan treatment for certain notional principal contracts under sections 446 and 956 (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III  
Chair, Section of Taxation

CCs: Hon. William Wilkins, Chief Counsel, Internal Revenue Service  
Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service  
Helen Hubbard, Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service  
Diana Imholtz, Special Counsel to the Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service  
Hon. Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury  
Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury  
Karl Walli, Senior Counsel (Financial Products), Department of the Treasury
These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Stefan Gottschalk of the Section’s Banking and Savings Institutions ("Banking") and Financial Transactions Committees, with substantive contributions from Stevie Conlon, Christopher DiJulia, Lucy W. Farr, Yoram Keinan, Eileen Marshall, and Erika Nijenhuis. The Comments were reviewed by Anthony Tuths, Chair of the Banking Committee and Eileen Marshall, Chair of the Financial Transactions Committee. The Comments were further reviewed by Daniel Mayo of the Section's Committee on Government Submissions, Lucy W. Farr, the Section’s Council Director for the Banking and Financial Transactions Committees, and Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: January 19, 2016
EXECUTIVE SUMMARY

On May 8, 2015, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") issued temporary and proposed regulations (the "Temporary Regulations" and the "Proposed Regulations" respectively, and together the "2015 Embedded Loan Regulations") that address nonperiodic payments under notional principal contracts ("NPCs"). These regulations would require the bifurcation of certain NPCs into loan and NPC components for federal income tax purposes.

The loan component (the "Embedded Loan") would be treated as a loan for federal income tax purposes ("Embedded Loan Treatment"). The time value component of an Embedded Loan (the "Embedded Loan Interest") would be treated as interest.

We commend Treasury and the Service for issuing the 2015 Embedded Loan Regulations; the principle of bright-line guidance that these regulations embrace will help taxpayers and the government determine where Embedded Loan Treatment applies. The 2015 Embedded Loan Regulations also give rise to ambiguity and practical concerns. These should be addressed in order to improve the regulations' administrability and effectiveness. These Comments set forth recommendations regarding certain matters addressed by the 2015 Embedded Loan Regulations for the consideration of Treasury and the Service when finalizing the Proposed Regulations, publishing revised Temporary Regulations, or issuing other related guidance.

In summary, our recommendations are:

1. Provide a de minimis exception to Embedded Loan Treatment to eliminate unnecessary complexity and to provide administrative convenience for both taxpayers and the Service. We recommend adding a de minimis exception to Embedded Loan Treatment for nonperiodic payments that do not exceed the greater of: (a) a fixed percentage of the NPC's notional principal amount and (b) a higher fixed percentage of the net present value of the fixed payments scheduled

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2 Temp. Reg. § 1.446-3T(g)(4)(i).

3 Temp. Reg. § 1.446-3T(g)(4)(i).

4 Alternatively, for NPCs with a variable notional principal amount, the NPC's weighted average notional principal amount, computed in any reasonable manner, could be used.
under the NPC. This approach provides two alternatives for an NPC to qualify for the *de minimis* exception. The notional principal amount-based computation provides simplicity, and the net present value alternative uses an approach similar to that employed by section 1.446-3(g)(6), Examples 2 and 3, with certain revisions to improve clarity.

2. Expand the scope of and remove rigidity from the margin exception of Temporary Regulation section 1.446-3T(g)(4)(ii)(B) (the "Margin Exception") by:
   a. Expressly providing that netting of margin (or collateral) balances is equivalent to cash margin (or collateral) transfer.
   b. Permitting minor margin variances within an objectively-defined range (*i.e.*, up to a fixed threshold), and specifying the permitted variances in a manner that allows taxpayers and the Service to test for qualification on the date the NPC is entered into, with no retesting permitted or required.
   c. Permitting the use of certain non-cash margin (or collateral) payments.
   d. Rewording the full collateralization requirement to clearly allow NPCs entered into through options or forward contracts to qualify for the Margin Exception.
   e. Acknowledging (in a preamble or in one or more examples) that NPCs cleared through non-United States-registered clearing organizations may qualify for the Margin Exception.
   f. Eliminating the excess margin (or collateral) rule.

3. Provide an exception from Embedded Loan Treatment for payments in the nature of option premium, because an option premium generally represents a payment for an option rather than an extension of credit, a loan, or a repayment of funds.

4. Expand the scope of the anti-abuse rule to cover all exceptions to Embedded Loan Treatment (not just the short term NPC exception). The scope expansion would allow the anti-abuse rule to safeguard against inappropriate application of any of the exceptions to Embedded Loan Treatment, including, for example, the *de minimis* and option premium exceptions we recommend in these Comments.

5. Facilitate consistent and accurate information reporting (*i.e.*, Form 1099 reporting) with respect to Embedded Loan Interest and Embedded Loans by adopting a consistent approach that either "turns off" or "turns on" interest, proceeds, and tax basis information reporting with respect to Embedded Loan Interest and Embedded Loans across the board -- either by:

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5 For example, a *de minimis* exception to Embedded Loan Treatment could be provided for nonperiodic payments that do not exceed the greater of: (a) two percent (2%) of the NPC's notional principal amount and (b) ten percent (10%) of the net present value of the fixed payments scheduled under the NPC.

6 All references in this letter to "section" or "§" refer to the Internal Revenue Code of 1986, as amended (the "Code"), unless the context requires otherwise. All references to "regulation section" or "Reg. §" or "regulations" refer to regulations promulgated under the Code, unless the context requires otherwise.
a. Expressly excepting both the Embedded Loan Interest and the Embedded Loans from interest, proceeds, and tax basis information reporting under sections 6049 and 6045 (i.e., retaining the rule provided in regulation section 1.6041-1(d)(5) excepting Embedded Loan Interest from section 6049 (i.e., from Form 1099-INT/OID reporting) and expressly extending its approach to section 6045 (i.e., to Form 1099-B reporting); or

b. Expressly requiring information reporting with respect to Embedded Loan Interest (under section 6049) and proceeds and tax basis of Embedded Loans (under section 6045) (i.e., eliminating the rule provided in regulation 1.6041-1(d)(5) that excepts Embedded Loan Interest from Form 1099-INT and Form 1099-OID reporting and providing new rules that expressly require information reporting (on Forms 1099-INT/OID and Forms 1099-B).

The former approach provides administrative convenience. The latter approach better facilitates accurate self-reporting of income by certain recipients of Embedded Loan Interest. We request that Treasury and the Service weigh the relevant considerations, including those mentioned in these Comments, and adopt one of the two approaches. We lack sufficient information to weigh these considerations, so we are not providing a specific recommendation at this time.

6. Further amend the 2015 Embedded Loan Regulations’ general effective date. Treasury and the Service have already amended the regulations in this regard, postponing the Embedded Loan rule’s general effective date to the later of (a) January 1, 2017, or (b) 180 days after publication of final regulations.7 We commend Treasury and the Service for making this important and helpful amendment. Taxpayers will likely need to establish new systems, procedures and controls to facilitate reporting of Embedded Loan Interest and Embedded Loans. We understand that the time required to properly do so may be approximately one year. We therefore request that the Embedded Loan rule’s general effective date be changed to the later of (a) January 1, 2017, or (b) one year after the publication of final regulations.

7. Provide an exception for contingent nonperiodic payments.

We discuss each of these recommendations below.

In response to the request made by Treasury and the Service,8 we also briefly discuss certain considerations relevant to the question of whether regulations should provide an exception to the Embedded Loan rule for taxpayers who mark NPCs to market under section 475. These Comments do not provide any specific recommendation with respect to that question, however, because no consensus could be reached.

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DISCUSSION

I. Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") mandates central clearing for certain swaps and imposes margin requirements for certain noncleared swaps. Dodd-Frank, regulatory actions, and other factors have resulted in significant changes to the swap markets and are likely to result in further changes.

A consequence of these changes is an increased prevalence of swap transactions involving a one-time payment from one swap counterparty to the other at or near the inception of the swap contract (an "Upfront Payment"). The 2015 Embedded Loan Regulations address Upfront Payments, which generally meet the regulations' definition of a "nonperiodic payment" on an NPC. 10

Regulations issued in 1993 contain rules that generally govern Upfront Payments (and other nonperiodic payments). 11 They provide that an NPC with a nonperiodic payment receives Embedded Loan Treatment if the nonperiodic payment is significant. 12 The regulations do not define "significant" for this purpose, but instead give two examples:


10 Most swap contracts meet the regulations' definition of NPCs (compare, e.g., Reg. § 1.446-3(c)(1) (defining NPCs for tax purposes) with 7 U.S.C. § 1a(47) (defining "swap" for the purpose of swap clearing requirements under Dodd-Frank)), and NPCs' federal income tax treatment generally is governed by Reg. § 1.446-3. The NPC regulations define "nonperiodic payments" as payments provided for under an NPC that meet neither (a) the definition of "periodic payments" in Reg. § 1.446-3(e)(1) (generally, payments payable at intervals of one year or less based on a specified index and a notional principal amount) nor (b) the definition of "termination payments" in Reg. § 1.446-3(h)(1) (generally, payments made to extinguish or assign all or a proportionate part of a party's rights and obligations under an NPC). Reg. § 1.446-3(f)(1). Under these rules, Upfront Payments generally are nonperiodic payments on an NPC (payments that are not Upfront Payments also may be nonperiodic payments).

11 Reg. §§ 1.446-3(f) and (g)(4). See also Reg. §§ 1.446-3(g)(6), Ex. 2 and -3(g)(6), Ex. 3.

12 Reg. §§ 1.446-3(f) and (g)(4). As a general matter, NPCs generally are not treated as loans for federal income tax purposes. See Reg. § 1.446-3 (governing NPCs in general). See also Reg. § 1.988-2(e) (governing certain currency swaps). Principles of tax law do not compel issuance of regulations that treat an Upfront Payment as a loan for tax purposes. See, e.g., Notice 89-21, 1989-1 C.B. 651 (upfront payments on swaps generally must be amortized over the life of a swap, under method of accounting principles); Revenue Ruling 2003-7, 2003-1 C.B. 363 (prepaid forward contract is treated as a forward contract, not a loan and a post-paid forward contract); Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011), aff'g Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219 (D.N.J. 2009) (lump-sum payment equal to present value of 100% of one leg of a swap treated as a loan under substance over form principles). On the other hand, the economics of an Upfront Payment on a swap may be similar to those of a loan. That is, the party making the Upfront Payment is compensated for that payment by payments that it will receive later (or reductions to payments it will make later) under the contract.
one illustrating a nonperiodic payment that is not significant; and another illustrating one that is significant.\textsuperscript{13} The economic value of the nonperiodic payment in the first example is much less than the value of the nonperiodic payment in the second example, in each case as a portion of the total fixed payments under the NPC.\textsuperscript{14} For nonperiodic payments that fall between these examples, the regulations do not provide clear guidance regarding whether a nonperiodic payment is large enough to be "significant."\textsuperscript{15}

The 2015 Embedded Loan Regulations address the Embedded Loan issue in a different manner. They treat all nonperiodic payments as giving rise to Embedded Loans, unless an exception applies.\textsuperscript{16} They provide two exceptions: (1) the margin exception,\textsuperscript{17} and (2) the short term NPC exception.\textsuperscript{18} The 2015 Embedded Loan Regulations are generally effective for NPCs entered into on or after the later of (a) January 1, 2017, or (b) 180 days after publication of final regulations.\textsuperscript{19} **

The bright-line approach of the 2015 Embedded Loan Regulations provides some welcome clarity to the NPC regulations. Our recommendations are intended to supplement and to clarify the 2015 Embedded Loan Regulations in a manner consistent

\textsuperscript{13} Reg. §§ 1.446-3(g)(6), Ex. 2 and -3(g)(6), Ex. 3.

\textsuperscript{14} Reg. §§ 1.446-3(g)(6), Ex. 2 and -3(g)(6), Ex. 3.

\textsuperscript{15} See Reg. §§ 1.446-3(g)(4), -3(g)(6), Ex. 2 and -3(g)(6), Ex. 3. The regulations reference a comparison of two present values: (a) that of the nonperiodic payment, and (b) that of all of the fixed payments due under the NPC. See Reg. §§ 1.446-3(g)(6), Ex. 2 and -3(g)(6), Ex. 3. The regulations describe the value comparison in terms that are somewhat imprecise, and do not provide numerical results in the two examples. Practitioners have expressed different views regarding these numerical results. Compare, e.g., Peter J. Connors and Stephen C. Lessard, IRS Proposes to Revise the Treatment of Nonperiodic Payments, 148TAX NOTES 83 (TA), (July 6, 2015) (stating that the present values of the nonperiodic payments as a percentage of the fixed payments are 9.1% and 40% in Reg. §§ 1.446-3(g)(6), Ex. 2 and Ex. 3 respectively) with Andrea Kramer, FINANCIAL PRODUCTS: TAXATION, REGULATION AND DESIGN, § 6.11, Note 254 (stating the percentages as 10% and 67% respectively). Further ambiguity arises because the regulations appear to require taxpayers to identify which payments under an NPC are "fixed payments," but do not describe how to do so in the not unlikely event that the NPC does not provide for payments determined by multiplying a fixed rate by a fixed notional principal amount. See Reg. §§ 1.446-3(g)(6), Ex. 2 and -3(g)(6), Ex. 3.

\textsuperscript{16} Temp. Reg. § 1.446-3T(g)(4)(i).

\textsuperscript{17} Temp. Reg. § 1.446-3T(g)(4)(ii)(A).

\textsuperscript{18} Temp. Reg. § 1.446-3T(g)(4)(ii)(B). The short term NPC exception does not apply for purposes of sections 514 or 956. Id.

\textsuperscript{19} Temp. Reg. § 1.446-3T(j)(2), as amended in 80 Fed. Reg. 61308 (Oct. 13, 2015). The exceptions from Embedded Loan Treatment provided in the 2015 Embedded Loan Regulations apply to NPCs entered into on or after May 8, 2015, and taxpayers may also apply them to NPCs entered into before May 8, 2015. Id.
with the purposes expressed by Treasury and the Service, such as encouraging the use of cleared swaps, and providing taxpayers and the Service with administrative convenience.\textsuperscript{20}

Although we, too, would adopt a bright-line approach, our approach is guided by the principle that Embedded Loan Treatment should apply only if the NPC’s loan element is economically substantial compared to the NPC’s overall economics, or if the NPC is entered into for the purpose of making or receiving a loan, which we would not expect to be the case for most NPCs.\textsuperscript{21}

Taxpayers enter into many transactions that involve various combinations of credit risk, extensions of credit, economic returns affected by prevailing market interest rates or the time value of money. Transactions that involve delivery of money on one date and delivery of property or services on another date generally fall into this broad category.

The items of income, deductions, gain and loss that these transactions give rise to generally are treated as interest for tax purposes only if they involve debt.\textsuperscript{22} For some transaction categories, however, the tax law requires imputation of interest even if the parties do not enter into a debt instrument.\textsuperscript{23} Interest imputation provisions also apply to certain debt instruments that lack adequate stated interest.\textsuperscript{24}

\textsuperscript{20} In issuing the 2015 Embedded Loan Regulations, Treasury and the IRS indicated that the existing Embedded Loan rules did not serve their intended purpose of administrative convenience, and noted that a goal of Dodd-Frank was encouraging central clearing of swaps. T.D. 9719 Preamble, 80 F.R. at 26439.

\textsuperscript{21} As discussed in note 12 above, Treasury and the Service are not compelled to provide in regulations that all Upfront Payments, whether substantial or not, are treated as loans for tax purposes. Instead, Treasury and the Service are free to choose to take the approach we recommend -- delineating between substantial Upfront Payments that require loan treatment, and insubstantial payments that generally do not. Treasury and the Service adopted a conceptually-similar approach in regulations governing the determination of whether payments on NPC or an equity linked instrument (an “ELI”) are dividend equivalents under section 871(m). See T.D. 9734, 80 Fed. Reg. 56866 (Sep. 18, 2015). Those regulations set out two bright-line tests: one for simple NPCs and ELIs, see Reg. § 1.871-15(d)(2)(i) and -15(e)(1), and one for complex NPCs and ELIs, see Reg. § 1.871-15(d)(2)(ii) and -15(e)(2) and Temp. Reg. § 1.871-15T(h). They also include an anti-abuse rule to cover cases where an arrangement is inconsistent with the purpose of the regulations even though it may meet one of the bright line tests. See Reg. § 1.871-15(o).

\textsuperscript{22} See Deputy v. Du Pont, 308 U.S. 488 (1940) (noting that interest is compensation for the use of money under a debt obligation). See also United States v. Midland-Ross Corp., 381 U.S. 54 (1965).

\textsuperscript{23} Section 483 imputes interest in some property sale contexts even though the parties to the transaction do not enter into a debt instrument. Where some or all of the payments under a contract for the sale (or exchange) of property are due more than one year after the sale and the contract does not provide for sufficient interest, section 483 generally requires the parties to impute interest with respect to payments due more than six months after the date of sale. I.R.C. § 483. See also Reg. § 15a.453-1(c)(2)(ii) (regarding application of section 483 to installment sale contracts).
Where they apply, these interest imputation provisions generally require accrual of interest at the applicable federal rate ("AFR"). The AFR is based on the market yields of Treasury securities. Accordingly, interest generally is imputed at a below-market rate where these provisions apply.

Where these interest imputation provisions do not apply, the tax law generally does not separate a financial instrument's time value of money components into a debt instrument separate from its other components or otherwise require reporting of interest income and expense with respect to the instrument. The Embedded Loan rule is an exception to this general rule, requiring both bifurcation and interest recharacterization.

Section 7872 also imputes interest in certain situations regardless of whether a debt instrument is present. These situations include gift loans, compensation-related loans, corporation-shareholder loans, and any below-market loan one of the principal purposes of which is the avoidance of any federal tax. I.R.C. §§ 7872(c)(1)(A)-(D). Congress also provided regulatory authority to extend section 7872's interest imputation requirements to loans having a significant tax effect on either party (significant effect loans), but regulations exercising such authority have not been issued. See I.R.C. § 7872(c)(1)(E). Transactions treated as "loans" for purposes of section 7872 are not limited to transactions involving debt instruments. For purposes of section 7872, loans include any extension of credit, and any transaction under which the owner of money permits another person to use the money for a period of time after which the money is to be retransferred to the lender. Temp. Reg. § 1.7872-2T(a)(1)

24 See I.R.C. § 1274 and the regulations thereunder.

25 See I.R.C. §§ 483(b), 1274(b), and 7872(e); Reg. § 1.1274-4.

26 See I.R.C. § 1274(d)(1).

27 Because Treasury's borrowing rate is lower than that of all or nearly all taxpayers, the AFR is a below-market rate of interest for all or nearly all taxpayers.

28 The fact that a financial instrument has a significant time value component generally does not suffice to require interest imputation or reporting. Consider forward contracts, for example. A forward contract price reflects (among other things) a time value of money return on the amount of cash that would be invested in acquiring the underlying property at execution of the contract and holding it until the purchase date (or delivery date). See Joint Committee on Taxation, Present Law and Issues Related to the Taxation of Financial Instruments and Products, JCX-56-11 (Dec. 2, 2011) (hereinafter "JCX-56-11"), at 36-37 (explaining that the price of a forward contract reflects the current spot price, plus the cost to carry (a time value of money return on the cash that would be invested in acquiring the underlying item at execution of the contract and holding it until the final delivery date, together with any warehousing or similar expenses), minus projected cash returns (such as periodic dividend or interest payments) over the contract term). No interest imputation or reporting is required under the tax law generally governing forward contracts, See Lucas v. North Tex. Lumber Co., 281 U.S. 11 (1930) (entry into "executory contract of sale" (i.e., a forward contract) was not a taxable event, but sale of the underlying property in a subsequent year was); I.R.C. § 483(c) (conditioning the imputation of interest on the date of property is sold rather than on the date a forward contract for the sale is entered into). Also, no interest imputation of reporting is required under
Given the general tax principles, Treasury and the Service are not compelled to issue regulations that treat all nonperiodic payments as Embedded Loans. Rather, Treasury and the Service may adopt a rule that requires taxpayers to treat NPCs as interest-bearing debt only where the debt element is a substantial portion of the overall transaction, or the transaction is entered into with the purpose of creating a debt. That is the approach we recommend.

It is appropriate, in our view, to apply the Embedded Loan rule to NPCs that have loan elements that are economically substantial in comparison to the NPCs' overall economics, and NPCs that are entered into for the purpose of making or receiving a loan. Most NPC transactions, however, do not meet either of these criteria. We believe that NPCs that lack loan elements that are economically substantial in comparison to the NPCs' overall economics, and are not entered into for the purpose of making or receiving a loan should not be subjected to Embedded Loan Treatment. Excepting such NPCs from Embedded Loan Treatment would be beneficial both to taxpayers and to the Service because there are numerous complications that arise from application of the Embedded Loan rule to an NPC.

Embedded Loan Treatment entails treating a portion of an NPC as a loan for tax purposes, and the Embedded Loan's time value component -- the Embedded Loan Interest -- is treated as interest. There are many federal income tax rules that either apply only to interest income or expense, apply to interest income or expense differently than they do to other items of income or expense, or apply to property acquired with borrowed funds differently than they do to other property. Embedded Loan Treatment requires taxpayers to apply these rules with respect to the Embedded Loan. These rules include, for example:

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provisions specifically governing regulated futures contracts (i.e., exchange-traded forward contracts). See I.R.C. § 1256(a), (b)(1)(A), (g)(1).

Regarding the principle that financial instruments are generally not separated into debt and non-debt components for tax purposes, see Chock Full O’Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971) (convertible debt not bifurcated) and Universal Castings Corp. v. Comm’r, 303 F.2d 620 (7th Cir. 1962) (notes issued by taxpayer were not debt for tax purposes where they were stapled to taxpayers' stock so that neither the note nor the stock could be sold without the other). But see Farley Realty Corp. v. Comm’r, 279 F.2d 701 (2d Cir. 1960) (real estate mortgage loan bifurcated into debt and equity components).

29 See Reg. § 1.446-3(g)(4); Temp. Reg. § 1.446-3T(g)(4)(i).

30 See the discussion in note 28 above.

31 Temp. Reg. § 1.446-3T(g)(4)(i). An NPC may be treated as having more than one Embedded Loan under this rule. Id. The rule states that the Embedded Loan Interest is treated as interest for all purposes of the Code. Id.
• Apportionment of interest expense;\textsuperscript{32}
• Deduction deferral and disallowance rules that apply to specific types of interest;\textsuperscript{33}
• Income and deduction timing rules generally applicable to interest;\textsuperscript{34}
• Net investment income rules;\textsuperscript{35}
• Real estate investment trust ("REIT") qualification testing;\textsuperscript{36}
• Unrelated business income tax ("UBIT") rules applicable to debt-financed income;\textsuperscript{37} and
• Withholding rules, including withholding under Chapter 3 of the Code (which may apply to NPC periodic payments characterized as Embedded Loan Interest),\textsuperscript{38} and withholding under Chapter 4 of the Code (which may apply to include Embedded Loan Interest, and to gross proceeds of sales or dispositions of NPCs subject to Embedded Loan Treatment, including NPC payments characterized as principal payments on Embedded Loans).\textsuperscript{39}

There are other special rules that apply to debt obligations, including section 956. Section 956 generally applies to amounts invested by controlled foreign corporations ("CFCs") in United States property, including investments in certain debt obligations.\textsuperscript{40} Generally speaking, such investments by a CFC may require its United States shareholders to include for affected taxable years their ratable shares of the amounts so invested in their gross income.\textsuperscript{41} Embedded Loans may trigger the application of section 956, because obligations of United States persons generally are investments in United States property.\textsuperscript{42} Temporary regulations issued in 2012, however, exclude from the

\textsuperscript{32} See I.R.C. § 861 and the regulations thereunder.

\textsuperscript{33} See, e.g., I.R.C. §§ 163(e)(3), 163(e)(5), 163(h), and 163(j).

\textsuperscript{34} See, e.g., I.R.C. § 163(e)(1); Reg. §§ 1.446-2, 1.1272-1.

\textsuperscript{35} See I.R.C. § 1411 and the regulations thereunder.

\textsuperscript{36} See I.R.C. § 856(c).

\textsuperscript{37} See I.R.C. § 514 and the regulations thereunder.

\textsuperscript{38} See, e.g., I.R.C. § 1441(b).

\textsuperscript{39} See, e.g., I.R.C. §§ 1471 through 1474.

\textsuperscript{40} See I.R.C. §§ 956(a) and 956(c)(1)(C).

\textsuperscript{41} I.R.C. § 951(a)(1)(B). For a taxable year, the amount included generally is limited to the amount of the CFC’s non-previously taxed earnings and profits attributable to the shareholder. See I.R.C. § 956(a).

\textsuperscript{42} See I.R.C. § 956(c)(1)(C).
definition of United States property nonperiodic payments made by CFCs that are dealers in securities or commodities under certain cleared NPCs.\footnote{Temp. Reg. § 1.956-2T(b)(1)(ix) (first issued in T.D. 9589 (May 11, 2012), and amended by T.D. 9719 (May 8, 2015)). This exception applies only to certain cleared NPCs that are subject to margin or collateral requirements. \textit{Id.} These Comments do not address these temporary regulations under section 956 with respect to Embedded Loans, or any policy considerations that may particularly apply to them.}

Because of these and other special tax rules applicable to interest and debt obligations, a taxpayer that has entered into an NPC faces significant added administrative burden and complexity under the tax law if Embedded Loan Treatment applies. Employees of the Service examining NPC transactions would face similar burdens. We do not view imposition of this additional complexity as beneficial to the tax system in the majority of NPC cases, where the NPC does not have loan elements that are economically substantial in comparison to the NPC's overall economics, and is not entered into for the purpose of making or receiving a loan.

In addition, significant added administrative burden and complexity is likely to arise for financial accounting and regulatory purposes if Embedded Loan Treatment applies. We are not aware of any other accounting or regulatory rule requiring taxpayers to bifurcate NPCs in the same manner that Embedded Loan Treatment requires. As a consequence of the resulting book-tax differences, financial or regulatory accounting for an NPC would be more complex if Embedded Loan Treatment applies than if it does not.\footnote{\textit{See generally} Accounting Standards Codification (ASC) 740 (providing rules for accounting for book-tax differences that companies using United States generally accepted accounting principles (GAAP) generally must apply for financial accounting purposes) and Statement of Statutory Accounting Principles (SSAP) 101 (providing rules for accounting for book-tax differences that United States insurance companies generally must apply for financial accounting purposes).}

Accordingly, we recommend adding to and broadening the exceptions to the Embedded Loan rule, and broadening the scope of the Embedded Loan anti-abuse rule to act as a safeguard against potential misuse of these expanded exceptions.

\section*{II. Recommendations}

\subsection*{1. We Recommend Providing a De Minimis Exception to Embedded Loan Treatment}

\subsubsection*{a. Providing a De Minimis Exception Would Simplify Tax Administration and Compliance}

We recommend that Treasury and the Service provide a \textit{de minimis} exception to Embedded Loan Treatment. Treasury and the Service have stated that the exception from Embedded Loan Treatment provided in 1993 for nonperiodic payments that are not
significant (the "Nonsignificant Exception") did not result in the administrative convenience intended.\textsuperscript{45}

The Preamble to the 2015 Embedded Loan Regulations introduces the new operative Embedded Loan rule under the heading "Simplification of the Embedded Loan Rule."\textsuperscript{46} We agree that simplification is an appropriate goal, and urge Treasury and the Service to consider simplification of tax administration and compliance together with simplification of the Embedded Loan rule itself.

We believe that providing a bright-line de minimis exception to Embedded Loan Treatment would provide the intended administrative convenience. Doing so would result in significant tax administration and compliance simplification.

Where it applies, Embedded Loan Treatment carries with it significant tax compliance complexity, as noted above. We do not view this additional complexity as helpful in cases where an NPC's loan elements are not economically substantial in comparison to the NPCs' overall economics, and the NPC is not entered into for the purpose of making or receiving a loan. In such cases, our view is that the significant additional complexity Embedded Loan Treatment carries outweighs any policy reason that potentially favors requiring Embedded Loan Treatment.

Adding a de minimis exception to Embedded Loan Treatment would eliminate unnecessary complexity and provide administrative convenience. For an NPC with a de minimis nonperiodic payment, taxpayers and the Service would account for each NPC payment under one set of rules, and would not need to add various interest-specific rules to their analysis.

\textbf{b. We Recommend Providing a De Minimis Threshold that Includes Two Alternative Tests: a Notional Principal Amount-Based Test for Simplicity, and a Present Value-Based Test}

The Nonsignificant Exception under the 1993 regulations applied based on a comparative present value test. Treasury and the IRS could add an administrable de minimis exception to the 2015 Embedded Loan Regulations that is similarly based on a comparative present value test. To augment administrability and effectiveness, however, we recommend adding a de minimis exception to Embedded Loan Treatment for nonperiodic payments that do not exceed the greater of: (a) a fixed percentage of the NPC's notional principal amount\textsuperscript{47} and (b) a higher fixed percentage of the net present value of the fixed payments scheduled under the NPC. For example, the de minimis

\textsuperscript{45} See T.D. 9719 Preamble, 80 F.R. at 26439.

\textsuperscript{46} Id.

\textsuperscript{47} Alternatively, for NPCs with a variable notional principal amount, the NPC's weighted average notional principal amount, computed in any reasonable manner, could be used.
exception to Embedded Loan Treatment could be extended to nonperiodic payments that do not exceed the greater of: (a) two percent (2%) of the NPC's notional principal amount and (b) ten percent (10%) of the net present value of the fixed payments scheduled under the NPC.

This approach provides two alternatives for an NPC to qualify for the *de minimis* exception. The notional principal amount-based computation provides simplicity, and the net present value alternative uses an approach similar to that employed by section 1.446-3(g)(6), Examples 2 and 3 of the 1993 regulations, with certain revisions to improve clarity.

**i. Including a Notional Principal Amount-Based Alternative in the De Minimis Test Would Provide a Significant Simplification Benefit**

Applying the proposed *de minimis* threshold would be straightforward for taxpayers and the Service. The notional principal-based element of this test would provide simplicity. Most NPCs have one fixed notional principal amount. Applying a fixed percentage to the notional principal amount is much simpler than applying a present value-based test.

Adopting a *de minimis* test with this simpler element would likely result in more taxpayers being well-positioned to quickly apply the test on or before entering into an NPC. A derivatives trader (or other employee of a taxpayer) could quickly and readily apply the notional principal-based element of the *de minimis* test on or before the date the taxpayer enters into a swap. If the swap's upfront payment did not exceed the designated fixed percentage of its notional principal amount, the trader could conclude immediately that the *de minimis* exception applied, without interrupting his or her business activities to perform a present value calculation for tax purposes. An employee of the Service could make a similarly swift determination.

**ii. Including a Present Value-Based Alternative in the De Minimis Test**

We recommend including a notional principal amount-based element in the *de minimis* test because we view its simplicity as a virtue. We also recommend a present value-based component, an alternative which requires a more complex calculation and may be viewed as more sophisticated. This element would provide that the *de minimis* exception applies for swaps with nonperiodic payments with a present value that does not exceed a

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48 Each component of this recommended *de minimis* test provides a rough measure of a nonperiodic payment's economic significance that supplies a clear result with no gray areas. *De minimis* characterization under the test is intended to apply to NPCs which, like most, contain loan elements that are not economically substantial in comparison to the other aspects of the NPC, and are not entered into for the purposes of making or receiving a loan. As noted below, we recommend expanding the scope of the Embedded Loan anti-abuse rule to cover arrangements entered into in an attempt to use the *de minimis* exception to avoid Embedded Loan Treatment where the loan component is the dominant economic driver of the contract.
fixed percentage of the present value of all fixed payments scheduled to be made to any party under the NPC.

It would be important for the regulations to set forth clearly how to apply this type of present value test, to enable taxpayers and the Service to determine easily which payments will be included in the calculation. We accordingly recommend that regulations set out the present value-based *de minimis* test component in a manner that differs from the approach taken by the 1993 regulations.

The present value test under the Nonsignificant Exception adopted in 1993 uses the NPC's "fixed payments" as the basis for the present value comparison. In transactions that involve fixed-for-floating interest rate swaps, applying the Nonsignificant Exception is relatively straightforward, and provides simplification. When considering NPCs that are not fixed-for-floating interest rate swaps, however, it may not be possible for taxpayers or the Service to adhere to the 1993 regulations' approach, and uncertainty may result.

The 1993 regulations do not describe how to identify which payments under an NPC are "fixed payments," and they are ambiguous in cases where the NPC does not provide for payments determined by multiplying (a) a fixed rate by (b) a fixed notional principal amount. These cases are not uncommon. We therefore recommend that regulations define "fixed payments" for this purpose in a manner that clearly directs how to identify an NPC's "fixed payments" in any factual situation and not just in a fixed-for-floating context. Where this definition (or a similar principle) would require treating payments that are not actually fixed as "fixed payments" for purposes of the test, we recommend that regulations endorse the principles of regulation section 1.1275-5 (governing variable rate debt instruments) in computing present value. For example, regulations could define "fixed payments" as (a) fixed nonperiodic payments under the NPC, and (b) either (i) the payments under the NPC computed by application of a fixed rate to one or more notional principal amounts denominated in the taxpayer's functional currency (or in the absence of notional principal amounts denominated in the taxpayer's functional currency, notional principal amounts denominated in another currency), (ii) in the absence of payments described in (i) above, the payments under the NPC computed by application of a qualifying floating rate (within the meaning of regulation section 1.1275-5(b)) to one or more notional principal amounts denominated in the taxpayer's functional currency (or in the absence of notional principal amounts denominated in the taxpayer's functional currency, notional principal amounts denominated in another currency), (iii) in the absence of payments described in (i) or (ii) above, the payments under the NPC computed by application of an objective rate (within the meaning of regulation section

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49 Reg. §§ 1.446-3(g)(4), -3(g)(6), Ex. 2 and -3(g)(6), Ex. 3.

50 See id.

51 Such cases may include, for example, basis swaps (i.e., floating rate for floating rate swaps), certain currency swaps, and equity swaps.
1.1275-5(c)) to one or more notional principal amounts denominated in the taxpayer's functional currency (or in the absence of notional principal amounts denominated in the taxpayer's functional currency, notional principal amounts denominated in another currency), or (iv) in the absence of payments described in (i), (ii), or (iii) above, the payments under the NPC most similar to payments of the sort described in (i) above, determined under any reasonable, consistently applied method.

As noted above, we recommend that all fixed payments scheduled under the NPC, including fixed nonperiodic payments (such as Upfront Payments) be included in the present value calculation. Consider, for example, two five-year fixed-to-floating interest rate swaps with $100 million notional amounts entered into on the same day. Assume that, if these were on market swaps, their fixed-for-floating rates would be London Interbank Offered Rate (LIBOR)-for-1.5%. Each swap is off-market by 0.5%, however, and each requires the same amount of upfront payment. On the first swap, taxpayer A pays one percent (1.0%) and taxpayer B pays LIBOR. On the second swap, taxpayer A pays two percent (2.0%) and taxpayer B pays LIBOR. Taxpayer A will receive an Upfront Payment on the first swap of $X, and will make an Upfront Payment of $X on the second. The present value component of the de minimis test should take the $X into account in both cases, regardless of which party pays it.\textsuperscript{52}

We further recommend that the regulations generally permit taxpayers to choose the discount rate used for the present-value based de minimis test component in any reasonable manner, consistently applied. We also recommend that regulations state that it is reasonable for this purpose for a taxpayer to choose to use a discount rate derived from objective financial information (as defined in regulation section 1.446-3(c)(4)(ii)) that is regularly used by the taxpayer for the purpose of determining or negotiating the price of similar NPCs.

The present value test under the Nonsignificant Exception of the 1993 regulations illustrates the discounting of payments by using a single fixed rate that the examples state was the rate used to compute the amount of the nonperiodic payment.\textsuperscript{53} The examples presenting this approach involve LIBOR-for-fixed rate interest swaps, with the market fixed rate for such swaps presented in each example and the amount of the nonperiodic payment computed with reference to this market rate.\textsuperscript{54} Where transactions presenting such facts arise, this approach is relatively straightforward and appropriate.

\textsuperscript{52} The $X Upfront Payment is included as a positive number for the first swap, and a negative number for the second. In other words, the fixed payments subjected to the present value test are: (1) for the first swap, (a) five years of periodic payments at 1.0%, plus (b) the $X nonperiodic payment, and (2) for the second swap, (a) five years of periodic payments at 2.0%, minus (b) the $X nonperiodic payment.

\textsuperscript{53} Reg. §§ 1.446-3(g)(4), -3(g)(6), Ex. 2, -3(g)(6), Ex. 3.

\textsuperscript{54} Reg. §§ 1.446-3(g)(4), -3(g)(6), Ex. 2, -3(g)(6), Ex. 3.
In practice, however, some transactions present facts similar to those used in the 1993 examples and some do not. We therefore recommend adopting a broader view toward the choice of an appropriate discount rate. We recommend modifying the approach used in the 1993 examples for three reasons. First, computation of a nonperiodic payment amount often requires discounting using a yield curve, rather than a single fixed rate. Second, some taxpayers may not be aware of the yield curve (or fixed rate yield) that was used to compute the amount of the nonperiodic payment. Third, taxpayers in some circumstances may negotiate a nonperiodic payment amount based on factors extrinsic to what the terms of an on-market swap are (or would be).

We therefore recommend that, if Treasury and the Service provide a present value-based test, the regulations permit taxpayers to choose the discount rate used for the present test.

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55 Market participants often refer to yield curves. By comparison, the constant yield method specified in Reg. 1.1272-1 represents a simpler approach to debt economics. Regarding the use of yield curves in swap pricing, consider one tax commentator's discussion of Upfront Payments on cleared credit default swaps ("CDS"):

Very generally speaking, the market quoted level for a CDS is determined primarily by reference to (a) an estimate of the probability of default by the reference entity, and (b) an appropriate (interest rate) discount curve.

* * *

Calculating the upfront payment is not for the faint of heart. Fortunately, in order to avoid disputes, the market has developed a standard “converter” that can be used to convert market coupons into an upfront payment. The converter is based on a number of simplifying assumptions with respect to both the terms of a CDS and key economic variables.

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In particular, the converter uses a yield curve derived from certain money market deposits and interest rate swaps maturing at different times and using flat forward rates to determine the yield for interpolated dates (dates on which no deposit or swap matures). The converter also derives an assumed probability of default for a series of specified dates (the survival curve)—analogous to looking at interest rates for specified dates—and assumes that the probability of default is constant between those dates. The probability of default is determined by reference to the ratio between the risk-free interest rate and the credit spread for the particular reference entity. The assumed yield curve and survival curve are then input into a formula that is beyond me to describe, having cheerfully forgotten all the calculus I ever knew.


56 Certain taxpayers are more likely to be aware of the yield curve or rate used, such as investment banks or investment funds that employ derivatives traders. Other taxpayers are less likely to be aware of the yield curve or rate used, such as corporations conducting businesses other than financial services businesses and investors and investment partnerships that do not employ sophisticated derivatives traders.

57 Such factors might include the returns earned on margin (or collateral), or the market borrowing rate of one of the counterparties.
value-based *de minimis* test component in any reasonable manner, consistently applied. We also recommend that regulations state that it is reasonable for this purpose to choose a discount rate derived from objective financial information (as defined in regulation section 1.446-3(c)(4)(ii)) that is regularly used by the taxpayer for the purpose of pricing similar NPCs.

### c. We Do Not Recommend Including a Fixed Dollar Component in the De Minimis Test

The *de minimis* test we recommend above has two alternative components, a notional principal amount-based test and a present value-based test, both of which are rough measures of a nonperiodic payment's relative economic significance. Our proposed *de minimis* test does not have a fixed dollar component. Although we considered including a fixed dollar component in the *de minimis* test, we do not recommend doing so because a fixed dollar amount does not measure a nonperiodic payment's relative economic significance.\(^{58}\)

A fixed dollar component could add simplicity when paired with one or more complex elements. Our recommended *de minimis* test pairs a very simple element (a flat percentage of notional principal amount) with a more complex one (a present value test). Because the notional principal amount-based component already supplies simplicity, a fixed dollar amount component would supply little more.

A difficulty presented by any fixed dollar-based *de minimis* test is that the relative scale of any fixed dollar amount will vary widely in relation to the activities of different taxpayers. For example, a fixed dollar component that may represent a small amount in relation to transactions conducted by a large business may represent a much larger amount in relation to transactions conducted by a smaller business.\(^ {59}\)

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\(^{58}\) Note that, while these Comments do not recommend adopting a fixed dollar-based approach in a *de minimis* exception context, they do recommend use of a fixed dollar-based threshold for a different purpose, relating to margin variations. These Comments propose amending the Margin Exception to permit minor margin (or collateral) variations, up to a specified dollar amount. We recommend a fixed dollar amount approach in that area based on developing regulatory practices, as discussed below.

\(^{59}\) To illustrate some of difficulties that could result, consider a fixed dollar *de minimis* threshold that is meaningful to very large businesses. All of the nonperiodic payments made by a small business may be less than this fixed dollar threshold, permitting all of them to qualify for the *de minimis* exception, even NPCs with nonperiodic payments that are economically substantial in relation to the other elements of the NPC.

Conversely, consider a fixed dollar *de minimis* threshold that is meaningful in relation to transactions undertaken by small businesses. All of the nonperiodic NPC payments made by a large business may exceed this fixed dollar threshold, precluding applicability of the *de minimis* exception to any of them, even NPCs with nonperiodic payments that are economically insubstantial in comparison to the other elements of the NPC.
Another reason to approach fixed dollar *de minimis* threshold components with caution is that challenging a taxpayer on anti-abuse or similar grounds may be much more difficult for the Service if the taxpayer relies on a fixed dollar *de minimis* threshold. These Comments, in addition to recommending expansion of the exceptions to the Embedded Loan Treatment, recommend extending the scope of the Embedded Loan anti-abuse rule to all such exceptions, as discussed below. It might be much easier for a taxpayer to argue that it is not avoiding the Embedded Loan rule (or its purposes) if it is relying on a fixed dollar *de minimis* threshold rather than a *de minimis* threshold intended to provide some rough measure of a nonperiodic payment's relative economic significance.60 In accordance with the above discussion, we do not recommend including a fixed dollar component in the *de minimis* test.

### d. Protecting Against Manipulation of the De Minimis Test

Providing a *de minimis* test would provide an administrability advantage to both taxpayers and to the Service. We recognize that both the notional principal- and the present value-based components of our suggested *de minimis* test potentially would be subject to manipulation absent an anti-abuse rule.61 To protect against such unintended results, we recommend expanding the scope of the Embedded Loan anti-abuse rule.

An NPC's notional principal amount is an imprecise measure of its economic significance. Two NPCs with identical notional principal amounts may provide economic exposures that differ in magnitude. The economic significance of a certain percentage of an NPC's notional principal amount may vary depending on the specified index each NPC references,62 and on each NPC's term (*i.e.*, term to maturity).

Taxpayers have broad latitude in designing a specified index that meets the definition provided in the regulations.63 As a result, if taxpayers wished to alter their economic exposure on a particular NPC in relation to the notional principal amount, they may be able to do so by changing the specified indices. Absent an anti-abuse test, it is conceivable that taxpayers might seek to avoid Embedded Loan Treatment by, for example, using a specified index with relatively little variability and a high notional principal amount.64

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60 The relative difficulty of such arguments might depend in part on how the Embedded Loan anti-abuse rule is drafted.

61 Other notional principal- or present value-based tests are similarly subject to potential manipulation.

62 See Reg. § 1.446-3(c)(2) (defining "specified index" broadly).

63 See id.

64 As an illustration, assume swap A has a $100,000,000 notional principal amount, where one party pays LIBOR and the other pays ten percent (10%) fixed. The parties could instead enter into swap B on day 1,
Similarly, the present value of an NPC's fixed payments is an imprecise measure of its economic significance. Two NPCs with vastly different fixed payment present values may provide similar or identical economic exposures. The economic significance of an NPC's fixed payment present value may vary depending on its specified index, and its term (i.e., term to maturity).

Consider, for example, two five-year fixed-to-floating interest rate swaps with $100 million notional amounts entered into on the same day. On the first, taxpayer A pays one percent (1%) and taxpayer B pays LIBOR. On the second swap, taxpayer A pays ten percent (10%) and taxpayer B pays LIBOR plus nine percent (LIBOR + 9%). The economic significance of the two swaps is nearly identical. Therefore, the upfront payments required (if any) with respect to the two swaps would be nearly identical. The present value of the second swap's fixed payments (which are based on a ten percent fixed rate), however, is much greater than that of the first swap (which are based on a one percent rate).

A taxpayer entering into multiple NPCs (or other contracts) generally will treat each contract as separate for tax purposes. Applying this principle together with a de minimis exception might lead to inappropriate results in the case of multiple offsetting contracts. For example, consider two taxpayers entering into two NPCs to engage in a loan transaction to avoid Embedded Loan Treatment. Under NPC 1, Taxpayer A receives a $1 million Upfront Payment and a $25 million long position in Index A, while Taxpayer B receives variable rate X on $25 million. Under NPC 2, Taxpayer A receives variable rate Y on $25 million, while Taxpayer B receives a $25 million long position in Index A. X is greater than Y. Netting the two NPCs, the taxpayers' cash flows will be similar to a $1 million loan from B to A which A will repay in variable rate installments. We recommend expanding the scope of the Embedded Loan anti-abuse rule as discussed below (under a separate heading) to prevent this and other types of arrangements from avoiding Embedded Loan Treatment.

having a $1,000,000,000 notional amount, under which the first party pays one tenth of LIBOR and the second pays one percent (1%) fixed. The economic significance of the two swaps is substantially identical, and the Upfront Payment required on each swap would be substantially identical. Assume, for example, that the second party, the fixed rate payer, would be $10,000,000 out of the money on day 1 under either swap A or swap B. This $10,000,000 Upfront Payment would represent ten percent (10%) of swap A's notional principal amount, but only one percent (1%) of swap B's.

65 See Reg. § 1.446-3(c)(2) (defining "specified index" broadly).

66 Economic differences may exist due to credit risk or other factors extrinsic to the example's facts.
e. Accounting for De Minimis Nonperiodic Payments

The 1993 regulations provide detailed alternative rules for taxpayers to apply to determine when to account for nonperiodic payments during the term of an NPC. For simplicity's sake, we recommend adding a permissive rule for payments that qualify for the de minimis exception to Embedded Loan Treatment. We recommend that regulations permit taxpayers applying the de minimis rule to apply any reasonable method of accounting for the de minimis nonperiodic payment, and state that level-payment amortization and straight-line amortization over the remaining term of an NPC are generally reasonable methods of accounting for such payments.

2. We Recommend Expanding the Scope of and Removing Rigidity from the Margin Exception

a. Margin and Collateral Requirements Differentiate Certain Nonperiodic Payments from Loans

Margin and collateral arrangements are widely used in the swap markets. These generally include margin arrangements for cleared swaps and collateral arrangements for noncleared swaps.

Treasury and the Service concluded in issuing the 2015 Embedded Loan Regulations that an Upfront Payment (or other nonperiodic NPC payment) that carries an offsetting margin or collateral payment requirement does not bear the indicia of a loan. We agree with this conclusion. Treasury and the Service accordingly provided in the 2015 Embedded Loan Regulations an exception to Embedded Loan Treatment for NPCs that satisfy certain margin or collateral requirements (the “Margin Exception”).

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67 Reg. § 1.446-3(f)(2).

68 The regulations already provide that level payment amortization is a permissible method of accounting for certain nonperiodic payments that do not receive Embedded Loan Treatment. Reg. § 1.446-3(f)(2)(iii)(A). It is our view that the difference between applying the level payment method and the straight line method to amortize a de minimis nonperiodic payment is insignificant from a tax policy perspective. Consequently, we believe it is generally appropriate to permit use of level-payment or straight-line amortization for de minimis nonperiodic payments.

69 See T.D. 9719 Preamble, 80 F.R. at 26439.

70 For example, where a taxpayer enters into an NPC position that is $100,000 out of the money, receives a $100,000 Upfront Payment (from its counterparty or from a clearing organization) and must make a $100,000 margin or collateral transfer (to its counterparty or to a clearing organization), the taxpayer does not acquire funds to use in the same manner as in the case of a loan.
b. Goals of the Margin Exception

We view the Margin Exception as an important, welcome, and helpful aspect of the 2015 Embedded Loan Regulations. The Margin Exception is responsive to concerns expressed by some market participants and industry groups regarding potentially widespread applicability of 1993 regulations' embedded loan rule to cleared swaps and noncleared collateralized swaps.

The Margin Exception provides a major simplification of the tax rules where it applies. We also believe that the Margin Exception is an important step toward a goal of Dodd-Frank -- to encourage the use of cleared swaps. To the extent that the Margin Exception provides taxpayers who are parties to regulated collateralized swap arrangements from the Embedded Loan rule's considerable tax compliance burden, it also encourages regulated collateralized over-the-counter (“OTC”) swap arrangements, which we believe also furthers the purposes of Dodd-Frank.

We recommend broadening and removing rigidity from the Margin Exception to further these same purposes. To the extent that the Margin Exception does not relieve parties to regulated collateralized swap arrangements from this tax compliance burden, or imposes compliance burdens on parties to such arrangements that it does not impose on parties to non-collateralized swaps, it does not appear to encourage collateralized swap arrangements.

c. We Recommend Broadening and Clarifying the Margin Exception to Further Its Goals

Under the terms of the Margin Exception, an upfront payment on an NPC is not subject to Embedded Loan Treatment if: (i) the parties are required to post initial variation margin (or collateral) in an amount equal to the upfront payment (adjusted for intraday price changes), (ii) the parties are required to post daily variation margin (or collateral) in an amount equal to the daily change in fair market value of the NPC, (iii) the first two requirements are imposed by a registered derivatives clearing organization or a registered

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clearing agency that clears the contract, a federal regulator or the terms of the contract, and (iv) the variation margin (or collateral) is paid in cash.

We believe this formulation of the Margin Exception addresses the tax policy objectives noted above to a significant extent. We also believe that these sound tax policy objectives would be better served by a broader version of the Margin Exception, and we recommend that some of the rigidity in the terms of the exception be removed.

In particular, we recommend that the final regulations provide that: (a) netting of Margin amounts is equivalent to transfer of the same amounts of cash Margin; (b) the Margin Exception permits small variances between the Margin requirements and the amount of an Upfront Payment; (c) the Margin Exception permits the use of certain types of non-cash Margin, (d) Treasury and the Service acknowledge (in the preamble or one or more examples) that NPCs cleared through non-U.S. registered clearing organizations may qualify for the Margin Exception; (e) the Margin Exception may apply to an NPC entered into through settlement of an option or forward contract; and (f) the excess Margin rule (described below) is eliminated.

i. We Recommend Expressly Permitting Netting under the Margin Exception

Treasury and the Service discussed prevailing and expected market Margin requirements in some detail in the preamble to the 2015 Embedded Loan Regulations, particularly focusing on circumstances where Margin requirements are intended to fully collateralize the credit risk on a contract.74 The Margin Exception applies only to NPCs with a mark-to-market exposure that is "fully collateralized."75

The preamble acknowledged that arrangements intended to fully collateralize credit risk may in practice often result in a party to an NPC who receives an Upfront Payment posting a Margin amount that is not equal to the Upfront Payment amount.76 As noted in the preamble, one typical reason the Upfront Payment and Margin amount may be unequal is the netting of positions between parties or in an account.77 Netting is a very widespread business practice with respect to NPCs (and other financial instruments) subject to Margin requirements.

Where netting applies and a taxpayer receives an Upfront Payment, the amount of Margin the taxpayer is required to post is not necessarily equal to the amount by which the NPC

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73 For ease of reading, this letter generally refers to margin and collateral collectively as "Margin."


75 Temp. Reg. §§ 1.446-3T(g)(4)(ii)(A) and -3T(g)(4)(ii)(B).


77 See id.
position in question is out of the money. Instead, the amount of Margin the taxpayer is required to post generally is determined by taking into account the amount by which the NPC position is out of the money, increased or decreased by the amounts by which the taxpayer's other positions are in or out of the money. The result may be that the taxpayer is obligated to post an amount of Margin that is more than or less than the Upfront Payment, or alternatively the taxpayer may be entitled to receive Margin rather than post it.

The preamble neither states that netting should disqualify an NPC from the Margin Exception, nor notes any policy reason why a Margin netting arrangement should not qualify. In the same paragraph where it acknowledges the practice of netting, the preamble concludes that swaps cleared with United States-registered clearinghouses should be considered “fully collateralized,” and notes that when viewed on a transaction-by-transaction (i.e., non-netted, gross basis), the Upfront Payment (or swap value) and the variation margin payments should be equal.

Reading the preamble alone, one would expect the Margin Exception to permit netting arrangements to qualify (and to permit minor Margin variances attributable to other aspects of regular business practice).

The text of the 2015 Embedded Loan Regulations, however, does not expressly permit netting. Instead, the Margin Exception is worded in a manner that might be read to exclude NPCs subject to netting arrangements. While it appears that result is not

78 For example, assume a taxpayer enters into Swap C on Day 1, an NPC position that is $100,000 out of the money and subject to full Margin requirements. The taxpayer receives a $100,000 Upfront Payment (from its counterparty or from a clearing organization) on Day 1. The taxpayer has two other preexisting NPC positions that are subject to the same margin (or collateral) requirements, Swap A and Swap B. On Day 1, Swap A increases in value (from taxpayer’s perspective) by $50,000, and Swap B decreases in value by $20,000. Where netting applies, the taxpayer's margin posting requirement on Day 1 is $70,000 ($100,000 minus $50,000 plus $20,000). The taxpayer is not required to post Margin equal to the $100,000 Swap C Upfront Payment.


80 See id (“on a transaction-by-transaction basis, the payment of initial variation margin [by one swap party] should equal (or closely approximate) [the other swap party's] upfront payment when any daily variation margin is treated as separate from the initial variation margin posted on that day”).

81 See Temp. Reg. §§ 1.446-3T(g)(4)(ii)(A) and 3T(g)(4)(ii)(B). The regulations state that an NPC will be fully collateralized only if initial variation margin (or collateral) must be posted "in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes)", and only if variation margin (or collateral) must be posted "in an amount equal to the daily change in the fair market value of the contract." Temp. Reg. §§ 1.446-3T(g)(4)(ii)(A) and -3T(g)(4)(ii)(B). Their literal language might be read to require margin (or collateral) that relates precisely to the particular NPC in question so that any netting will cause the NPC to fail to qualify. In light of the discussion in the preamble, however, the determination of whether a particular swap is “subject to” the necessary margin (or collateral) requirements might be applied on a transaction-by-transaction (i.e., non-netted gross) basis and NPCs subject to netting arrangements permitted to qualify for the Margin Exception.
intended, the language is not explicit on this point, and the potential for unintended ambiguity or confusion arises.

We believe that permitting netting arrangements to qualify for the Margin Exception is consistent with the purposes of the 2015 Embedded Loan Regulations and of Dodd-Frank. We recommend that the Embedded Loan regulations expressly provide that the determination of whether an NPC is fully collateralized be made on a grossed-up \( (i.e. \text{ non-netted}) \) transaction-by-transaction basis, rather than by comparing single-position, mark-to-market values with multiple-position netted Margin amounts.

One way to accomplish this would be to revise the regulations to expressly state that applying an NPC's mark-to-market value to offset the mark-to-market values of other positions that are subject to the same Margin contract arrangement is equivalent to a cash transfer of Margin for purposes of the Embedded Loan Rule. Under the amended rule, it should be sufficient if margin (or collateral) is provided or received under the contract in an amount that equals the net amount determined by taking into account the initial value\(^{82}\) of any NPCs that have become subject to the contract plus or minus the mark-to-market values of the other positions that are subject to the contract.\(^{83}\) This amendment should clearly permit NPCs subject to Margin netting arrangements to qualify for the Margin Exception.

\textit{ii. We Recommend Permitting Minor Margin (or Collateral) Variances under the Margin Exception}

As noted above, only fully collateralized NPCs can qualify for the Margin Exception under the 2015 Embedded Loan Regulations, and the regulations define "fully collateralized" strictly.\(^{84}\) For example, a literal reading of the definition of "fully collateralized" strictly.\(^{84}\)

\(^{82}\) We recommend a rewording that replaces the words "the nonperiodic payment" with "the initial value of the contract." This rewording would serve two purposes. First, as discussed above, it would help the regulations clearly permit NPCs subject to Margin (or collateral) netting arrangements to qualify for the Margin Exception. Second, as discussed below under a separate heading, this rewording would clearly allow NPCs entered into through options or forward contracts to qualify for the Margin Exception.

\(^{83}\) It may be necessary to expressly exclude or require adjustment for \( (i.e., \text{ backing out of}) \) collateral provided in respect of initial margin (or independent amounts) from this calculation. In some cases standard industry documentation requires the determination of those amounts separately from variation margin, but that is not always the case. For example, the 1994 ISDA Credit Support Annex determines the amount of daily margin to be provided by taking into account both changes to variation margin and changes to initial margin, while the 2013 and 2014 ISDA Credit Support Annexes measure changes to variation margin separately from changes to initial margin. (Initial margin is a performance bond intended to secure potential future exposure, as opposed to variation margin which is intended to secure current exposure. Initial margin generally does not correspond to the current fair market value of the relevant swap positions. The term “independent amounts” refers to the same performance bond concept as initial margin, as used in certain noncleared contexts.)

\(^{84}\) See Temp. Reg. §§ 1.446-3T(g)(4)(ii)(A) and -3T(g)(4)(ii)(B).
collateralized" might render the Margin Exception inapplicable if a one dollar ($1.00) discrepancy between the mark-to-market exposure on an NPC and the Margin posting requirement exists (or is permitted to exist under the applicable contract and regulatory scheme). 85

In our view, this strict formulation would treat as Embedded Loans numerous NPCs that lack loan elements that are economically substantial compared to the NPCs' overall economics, and were not entered into for the purpose of making or receiving a loan. As noted above, we believe that excepting such NPCs from Embedded Loan Treatment would provide a simplification benefit for both taxpayers and the Service.

A. Minor Margin (or Collateral) Variations in Practice

Domestically-cleared swaps (and potentially other NPCs) may satisfy the Margin Exception's strict definition of full collateralization because they require initial variation Margin in an amount equal to their initial value (adjusted for intraday price changes) and daily variation margin (or collateral) in an amount equal to the daily change in fair market value. Many other NPCs, however -- particularly non-cleared swaps -- typically permit the variation Margin posted to vary somewhat from the Upfront Payment or daily change in value.

Common mechanisms for permitting such variances include minimum transfer thresholds and rounding of Margin amounts. For example, (i) a party to an NPC may not be required to post Margin at all if the value of its total swap exposure to a particular counterparty is below a certain threshold (the "Exposure Threshold"); (ii) daily changes in value may not lead to the posting of additional Margin or the recall of outstanding Margin unless and until the cumulative change in value reaches a particular threshold (the "Minimum Transfer Amount"); and (iii) the value of Margin required to be posted may be rounded off to values above or below the actual value of the NPC exposure ("Rounding"). We recommend that the Margin Exception apply to NPCs that are subject to these types of variances provided the potential variances are sufficiently small.

B. Rationale and Mechanism for Permitting Minor Margin (or Collateral) Variances

The rationale for permitting small variances is essentially similar to the purposes of the de minimis exception to the Embedded Loan Treatment recommended above. Taxpayers and the Service both would benefit from regulations that avoid the administrative challenges associated with Embedded Loan Treatment in the case of a minor difference between the terms of the NPC in question and the terms of an NPC that is “fully collateralized” under the 2015 Embedded Loan Regulations.

Regardless of whether there is a general de minimis exception to Embedded Loan Treatment, we recommend determining whether the Margin variance is (or would be)

85 See id.
minor (and may therefore warrant exception from the Embedded Loan Rules) by applying a simple fixed dollar (or other appropriate currency) amount. Master agreements for derivatives transactions typically provide for an Exposure Threshold, a Minimum Transfer Amount and/or Rounding thresholds as a fixed amount, regardless of the number or size of the transactions executed. That is because these provisions are there for operational and administrative simplicity, and are not transaction-specific.

For many NPCs, such as non-cleared swaps between swap dealers and other financial entities, the maximum-permitted minimum transfer thresholds will be determined by regulators.⁸⁶ We recommend that a minor Margin variance threshold be established for purposes of the Margin Exception that is at least as high as those thresholds, and that it is linked to regulatory requirements so that it adjusts if regulatory thresholds are modified. We recommend that the potential variances that could arise be tested against this threshold. If the terms of the applicable contract and regulatory scheme provide that the

⁸⁶ United States federal banking regulators, for example, have recently promulgated a final rule that sets a maximum-permitted minimum transfer amount of $500,000. Bank Regulators' Final Rule, Advance Version, § __.5(b), at 235. In other words, the Bank Regulators' final rule does not require a covered swap entity to collect or post margin from or to any individual counterparty unless and until the combined amount of initial and variation margin that must be collected or posted under the final rule, but has not yet been exchanged with the counterparty, is greater than $500,000. (As mentioned in note 83 above, initial margin is a performance bond intended to secure potential future exposure, as opposed to variation margin which is intended to secure current exposure.) We understand that the United States Commodity Futures Trading Commission is expected to promulgate a similar rule. See, e.g., Silla Brush and Jesse Hamilton, Wall Street Poised for Swaps Collateral Victory at CFTC, Bloomberg Business (Nov. 25, 2015), available at http://www.bloomberg.com/news/articles/2015-11-25/wall-street-said-poised-for-swaps-collateral-victory-at-cftc.

International regulators in 2013 agreed to a common standard for maximum Minimum Transfer Amounts of €500,000. See Basel Committee on Bank Supervision and International Organization of Securities Commissions margin requirements for non-centrally cleared derivatives (Sep. 2013), available at http://www.bis.org/publ/bcbs261.pdf, at 9 (the "BCBS/IOSCO 2013 Standard."). The regulators retained this €500,000 standard when issuing an amended set of standards in 2015. See Basel Committee on Bank Supervision and International Organization of Securities Commissions margin requirements for non-centrally cleared derivatives (Mar. 2015) § 2.3, available at https://www.iosco.org/library/pubdocs/pdf/IOSCPD480.pdf, at 10 (the "BCBS/IOSCO 2015 Standard") ("all margin transfers between parties may be subject to a de-minimis minimum transfer amount not to exceed €500,000").

The $500,000 standard promulgated in the Bank Regulators' Final Rule is intended to correspond to the €500,000 international standard, and the regulators "expect to consider periodically the numerical amounts expressed in the final rule and their relation to amounts denominated in other currencies in differing jurisdictions. The [regulators] will then propose adjustments, as appropriate, to these amounts." Bank Regulators Final Rule, Advance Version, Preamble at 46.

Rounding is not addressed directly by these rules, but we understand that a general current market standard rounds delivery amounts up or down to the nearest $10,000.
variances in the aggregate cannot exceed this threshold, the variances would be considered minor and would not preclude the application of the Margin Exception.

The test for permissible minor Margin variances we are proposing is a "pass-fail" test (alternately, a "set it and forget it" approach). If the margin (or collateral) variation that is permitted under the contract is not minor (i.e., exceeds the threshold), then the Margin Exception does not apply to any portion of the NPC, even if the actual variations are under the threshold. This pass-fail approach is very important, in our view, for the simplification benefits we are recommending that the regulations provide. We accordingly recommend that the regulations provide for permitted minor Margin variances in a way that allows taxpayers (and the Service) to test an NPC on the day it is entered into and determine whether that NPC is eligible for the Margin Exception with no subsequent retesting, re-measurement, or re-estimation permitted or required.

iii. We Recommend Permitting Certain Non-Cash Margin (or Collateral) Payments under the Margin Exception

Another restrictive element of the Margin Exception under the 2015 Embedded Loan Regulations is the requirement that Margin transfers be made in cash (the "Cash Collateral Requirement"). The Cash Collateral Requirement diverges from United States and international regulatory standards for OTC swaps. United States regulators permit non-cash Margin transfers by some OTC swap parties, and require that cash

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87 As an example, assume that new regulations are issued, and that these regulations permit NPCs to qualify for the Margin Exception where the contract permits margin variations with respect to Exposure Thresholds and Minimum Transfer Amounts of $500,000 or less. Taxpayer enters into NPC X on day 1, when it is $400,000 off-market in Taxpayer's favor. Taxpayer makes a $400,000 Upfront Payment on day 1, and does not collect any Margin from its counterparty on day 1. The contract requires Margin transfer only where a $1,000,000 Exposure Threshold or Minimum Transfer Amount is exceeded. Under a pass-fail (or set it and forget it) approach, the Margin exception would not apply to NPC X because the contract permits a Margin variation of $1,000,000, which exceeds the $500,000 permitted variation amount. Under this approach, no retesting, re-measurement, or re-estimating of the amount of Margin transferred and attributable to NPC X is required or permitted.

88 We considered whether to suggest that any variance that exceeds the permitted Margin variance amount threshold should give rise to an Embedded Loan with respect to such excess of the actual variance over the permitted variance amount, rather than to the full amount of the nonperiodic payment. We do not recommend such an approach, however, because measuring an Embedded Loan Amount with respect to actual Margin variances would appear to require retesting and re-computing Embedded Loan-related items throughout the term of an NPC, which would run counter to the simplification purposes we are supporting here.

Margin transfers be made by others.\textsuperscript{90} International standards permit the use of non-cash Margin.\textsuperscript{91}

The United States and international standards for OTC swap collateral have been considered and promulgated to further the purposes of Dodd-Frank and similar objectives.\textsuperscript{92} Burdening parties complying with these swap regulatory regimes with additional tax compliance complexity in the form of the Embedded Loan rule does not appear to serve the same objectives.\textsuperscript{93}

Additionally, the Cash Collateral Requirement would treat as Embedded Loans some NPCs that we do not believe should be within the purview of the regulations -- NPCs that lack loan elements that are economically substantial compared to the NPCs' overall economics, and were not entered into for the purpose of making or receiving a loan. As noted above, we believe that excepting such NPCs from Embedded Loan Treatment would provide a simplification benefit for both taxpayers and the Service.

Many domestically-cleared swaps (and potentially other NPCs) may satisfy the Margin Exception's Cash Collateral Requirement. Other NPCs, however -- particularly non-cleared swaps -- may permit Margin to be posted in a range of acceptable forms such as cash, Treasury bills, agency securities, money market fund shares, foreign sovereign debt, corporate debt, or equity securities.

We believe that it is logical for the Margin Exception to permit those forms of Margin. Posting securities (rather than cash) as collateral is a common business practice. The regulations and preamble do not expressly state why the Cash Collateral Requirement was included, and thus it is difficult to address the underlying concern. To the extent that the Cash Collateral Requirement is the result of a belief that Upfront Payments generally should be treated as loans, and that exceptions to that treatment therefore should be narrow, we request reconsideration of the premise. While the list of authorities addressing the dividing line between debt and derivatives is not long, it does not support the bifurcation and the treatment of Upfront Payments as indebtedness as a general matter. Rather, it treats Upfront Payments as indebtedness only in abusive cases.\textsuperscript{94}

\textsuperscript{90} Bank Regulators Final Rule, Advance Version, § __.6, at 236-243.


\textsuperscript{92} See, e.g., Bank Regulators Final Rule, Advance Version, Preamble at 4-6.

\textsuperscript{93} The 2015 Embedded Loan Regulations would impose tax compliance burdens on parties to regulated collateralized swap arrangements that they would not impose on parties to non-collateralized swap arrangements by permitting the use of cash Margin only, permitting no Margin variances, and requiring daily testing of Margin amounts and assets transferred.

\textsuperscript{94} See, e.g., Notice 89-21, 1989-1 C.B. 651 (upfront payments on swaps generally must be amortized over the life of a swap, under clear reflection of income principles); Revenue Ruling 2003-7, 2003-1 C.B. 363 (prepaid forward contract is treated as a forward contract, not a loan and a post-paid forward contract);
Moreover, bifurcating an NPC into an NPC with different terms and a loan is inconsistent with the general rule of common law that a single legal instrument is not bifurcated, absent abuse.⁹⁵

The requirement that collateral be provided in the form of cash (including certain foreign currencies) is particularly difficult to understand in the context of the cross-reference to the embedded loan regulations contained in temporary regulation section 1.956-2T(b)(xi). Temporary regulation section 1.956-2T(b)(xi) excludes nonperiodic payments made on certain collateralized NPC payments from the scope of section 956.⁹⁶ That provision, as originally issued in 2012, did not contain a cash collateral requirement,⁹⁷ but was amended with issuance of the 2015 Embedded Loan Regulations to incorporate the new Cash Collateral Requirement by cross reference.⁹⁸

Adopting the Cash Collateral Requirement appears inconsistent with the approach Congress has employed with respect to section 956. Congress has provided statutory exceptions from section 956 that apply to certain deposits and obligations related to sale and repurchase agreements ("Repo Obligations"); these exceptions require the posting of collateral but do not limit the collateral to cash.⁹⁹ Section 956(c)(2)(J) expressly provides that an obligation of a United States person (arising from a loan from an affiliated CFC that is a dealer in securities or commodities) is not treated as an investment in United

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⁹⁵ Compare Chock Full O’Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971) (rejecting argument that convertible bond should be decomposed into a non-convertible discount bond and a warrant, in part because the two components were integrally linked and could not be separated) with Farley Realty Corp., TC Memo. 1959-93 (component of real estate mortgage treated as separate equity interest where it could exist after repayment of principal of related debt, and amount uncertain because it depended on the value of the real estate), aff’d 279 F.2d 701 (2d Cir. 1960).

⁹⁶ Temp. Reg. § 1.956-2T(b)(1)(ix). As noted above, this provision shields qualifying NPCs from triggering inclusions in United States shareholders’ income by excluding nonperiodic payments made by CFCs that are dealers in securities or commodities on certain collateralized NPCs from the definition of United States property. Id.

⁹⁷ Temp. Reg. § 1.956-2T(b)(1)(ix) (as issued in T.D. 9589 (May 11, 2012)).

⁹⁸ Temp. Reg. § 1.956-2T(b)(1)(ix) (as amended by T.D. 9719 (May 8, 2015)).

⁹⁹ I.R.C. § 956(c)(2)(I) (providing the exception for deposits) and I.R.C. § 956(c)(2)(J) (providing the exception for Repo Obligations, and also for other obligations for which collateral is posted or received by a securities or commodities dealer in the ordinary course of its business).
States property to the extent that readily marketable securities are posted by the United States person to the CFC as collateral.

We believe that section 956(c)(2)(J) should be understood to evidence a Congressional belief that readily marketable securities are the equivalent of cash. Accordingly, we recommend that Treasury and the Service adopt the view of Congress in this regard and provide that the transfer of Margin consisting of readily marketable securities (within the meaning of section 956(c)(2)(J)) will permit NPCs to qualify for the Margin Exception.\footnote{As discussed below, we also suggest that the regulations provide that for purposes of the Margin Exception, the term “readily marketable securities” includes any securities permitted to be provided under regulatory rules applicable to swaps in the relevant country, whether or not the particular swap is in fact subject to regulation.}

Broadening the Margin Exception in this manner would be consistent with what we understand to be one of the purposes of the 2015 Embedded Loan Regulations, namely to update the rules to reflect the new regulatory environment for swaps. To the extent that non-cash collateral is permitted by United States regulators for OTC swaps, it would be anomalous for tax regulations to be more restrictive, absent abuse.

United States regulators have promulgated a final rule addressing OTC swap margin arrangements that requires the payment and collection of variation margin for some OTC swaps, but not for others.\footnote{See generally Bank Regulators' Final Rule, Advance Version, Preamble at 18-19.} Where variation margin arrangements are required, the final rule in some cases requires cash Margin and in other cases does not.\footnote{See Bank Regulators' Final Rule, Advance Version, § .6, at 236-241.}

The rule generally applies to swap entities\footnote{The Bank Regulators' Final Rule defines swap entity as "a person that is registered with the Commodity Futures Trading Commission as a swap dealer or major swap participant pursuant to the Commodity Exchange Act of 1936 (7 U.S.C. 1 et seq.), or a person that is registered with the U.S. Securities and Exchange Commission as a security-based swap dealer or a major security-based swap participant pursuant to the Securities Exchange Act of 1934 (15 U.S.C 78a et seq.)." Bank Regulators' Final Rule, Advance Version, § .2, at 231.} that enter into OTC swaps. It requires cash collateral for variation margin transfers if the swap entity's counterparty is another swap entity.\footnote{Bank Regulators' Final Rule, Advance Version, § .6(a), at 236. Cash eligible for these transfers includes United States dollars, the currency of settlement for the swap, or any major currency. Id.} If the swap entity's counterparty is not another swap entity but is a financial end user, various types of collateral may be used for variation margin.\footnote{Bank Regulators' Final Rule, Advance Version, § .6(b), at 239-241. The final rule subjects certain types of collateral to valuation "haircuts" intended to ensure their sufficiency even in the event of a severe economic downturn. Bank Regulators' Final Rule, Advance Version, § .6(c), at 241-242. See also Bank Regulators' Final Rule, Advance Version, Preamble at 20.}

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100\footnote{As discussed below, we also suggest that the regulations provide that for purposes of the Margin Exception, the term “readily marketable securities” includes any securities permitted to be provided under regulatory rules applicable to swaps in the relevant country, whether or not the particular swap is in fact subject to regulation.}

101\footnote{See generally Bank Regulators' Final Rule, Advance Version, Preamble at 18-19.}

102\footnote{See Bank Regulators' Final Rule, Advance Version, § .6, at 236-241.}

103\footnote{The Bank Regulators' Final Rule defines swap entity as "a person that is registered with the Commodity Futures Trading Commission as a swap dealer or major swap participant pursuant to the Commodity Exchange Act of 1936 (7 U.S.C. 1 et seq.), or a person that is registered with the U.S. Securities and Exchange Commission as a security-based swap dealer or a major security-based swap participant pursuant to the Securities Exchange Act of 1934 (15 U.S.C 78a et seq.)." Bank Regulators' Final Rule, Advance Version, § .2, at 231.}

104\footnote{Bank Regulators' Final Rule, Advance Version, § .6(a), at 236. Cash eligible for these transfers includes United States dollars, the currency of settlement for the swap, or any major currency. Id.}

105\footnote{Bank Regulators' Final Rule, Advance Version, § .6(b), at 239-241. The final rule subjects certain types of collateral to valuation "haircuts" intended to ensure their sufficiency even in the event of a severe economic downturn. Bank Regulators' Final Rule, Advance Version, § .6(c), at 241-242. See also Bank Regulators' Final Rule, Advance Version, Preamble at 20.}
Variation margin collateral generally is not required to be paid and collected with respect to OTC swaps between a swap entity and a counterparty that is neither a swap entity or a financial end user, such as a hedging non-financial entity, community bank, or captive finance company. Although variation margin arrangements are not required, parties in these situations may choose to enter into such margin arrangements employing cash or non-cash collateral. Variation margin arrangements are similarly free to employ cash or non-cash collateral where neither party to the OTC swap is a swap entity (or an affiliate or a subsidiary of a swap entity).

Qualifying for the Margin Exception involves meeting requirements that are stricter than the regulatory standards that apply to regulated collateralized OTC swaps. Additionally, the 2015 Embedded Loan Regulations would impose tax compliance burdens on parties to regulated collateralized swap arrangements that they would not impose on parties to non-collateralized swap arrangements. In this particular regard, the 2015 Embedded Loan Regulations might not be viewed as serving the purposes of Dodd-Frank. On the other hand, to the extent that the Margin Exception provides taxpayers who are parties to

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106 See, e.g., Bank Regulators’ Final Rule, Advance Version, Preamble at 18-19 ("under §__.1(d) of the final rule, the [regulators’] margin requirements do not apply to a swap or security-based swap with a counterparty that: (1) qualifies for an exception from clearing under section 2(h)(7)(A) of the Commodity Exchange Act or section 3C(g)(1) of the Securities Exchange Act (i.e., a non-financial entity using the swap or security-based swap to hedge or mitigate commercial risk, certain small financial institutions, and captive finance companies); (2) qualifies for an exemption from clearing under section 4(c)(1) of the Commodity Exchange Act for cooperative entities that would otherwise be subject to the requirement to clear; or (3) satisfies the criteria for the affiliate exception from clearing pursuant to section 2(h)(7)(D) of the Commodity Exchange Act or section 3C(g)(4) of the Securities Exchange Act for treasury affiliates that act as agent"). See also Bank Regulators’ Final Rule, Advance Version, Preamble at 28 ("[the regulators] anticipate that community banks will not engage in swap activity to the level that would require them to register as a swap dealer, major swap participant, security-based swap dealer, or major security-based swap participant; and therefore, are unlikely to fall within the definition of a covered swap entity. Because the final rule imposes requirements on covered swap entities, no community bank will likely be directly subject to the rule. Thus, a community bank that enters into non-cleared interest rate swaps with its commercial customers will not be required to apply to those swaps the final rule’s requirements for initial margin or variation margin") and Bank Regulators’ Final Rule, Advance Version, Preamble at 24 ("a covered swap entity is not required to post initial margin to an affiliate that is not also a covered swap entity but must calculate the amount of initial margin that would be required to be posted to such an affiliate and provide documentation to each affiliate on a daily basis").

107 The 2015 Embedded Loan Regulations impose tax compliance burdens on parties to regulated collateralized swap arrangements that they would not impose on parties to non-collateralized swap arrangements by permitting the use of cash Margin only, permitting no Margin variances, and requiring daily testing of Margin amounts and assets transferred.

108 As noted above, we believe that encouraging collateralized OTC swap arrangements furthers the purposes of Dodd-Frank. See Pub. L. No. 111-203, Preamble (the purposes of Dodd-Frank included promoting the financial stability of the United States by reducing risk, improving accountability, and increasing transparency in the financial system). See also Bank Regulators’ Final Rule, Advance Version, Preamble at 4-14 (discussing certain objectives and requirements of Dodd-Frank regarding regulation of OTC swaps and certain actions taken by regulators with respect to those objectives and requirements).
regulated collateralized swap arrangements relief from the Embedded Loan rule's considerable tax compliance burden, it encourages regulated collateralized OTC swap arrangements, which may be viewed as furthering the purposes of Dodd-Frank.\textsuperscript{109} We do not have sufficient information, however, to determine whether or not the 2015 Embedded Loan Regulations would provide an incentive for taxpayers to choose to enter into either collateralized or non-collateralized swaps to the extent (if any) that they are permitted to choose.\textsuperscript{110}

United States regulators permit the use of non-cash collateral for some OTC swaps where collateralization is required, as outlined above.\textsuperscript{111} In addition, some foreign clearing organizations may, in accordance with applicable regulators' rules, permit non-cash collateral,\textsuperscript{112} in which case the Cash Collateral Requirement again would be inconsistent with a regulatory determination.

We view as unhelpful to taxpayers and the Service potential differences between the asset classes approved by tax regulations with respect to the Margin Exception and those approved for Margin transfers by swap market regulators. Any such differences would provide undue complexity and would not appear to serve any significant tax policy goal.\textsuperscript{113}

Accordingly, we suggest that the Cash Collateral Requirement be eliminated, that the Margin transfers of readily marketable securities be permitted to qualify for the Margin Exception, and that the term "readily marketable securities" include for this purpose both "readily marketable securities" within the meaning of section 956(c)(2)(J) and any securities permitted to be transferred as Margin under regulatory rules applicable to swaps in the relevant country, whether or not the particular swap is in fact subject to regulation.

\textsuperscript{109} See Note 108, above.

\textsuperscript{110} The extent to which taxpayers may choose to enter into non-collateralized OTC swaps may depend on the nature of their business activities and the applicable jurisdiction. See, e.g., Bank Regulators' Final Rule, Advance Version, Preamble at 18-19, 24 and 28 (quoted in Note 106 above).

\textsuperscript{111} Bank Regulators' Final Rule, Advance Version, § __.6(b), at 236-241.


\textsuperscript{113} The preamble to the 2015 Embedded Loan Regulations does not cite or discuss any tax policy or precedent that favors adoption of the Cash Collateral requirement, see T.D. 9719 Preamble, 80 Fed. Reg. at 26437-40. It merely notes the market practice of posting cash collateral with respect to NPCs cleared through United States-registered clearing organizations, and states that Treasury and the Service have concluded that cash Margin transfers obviate loan concerns with respect to Upfront Payments. \textit{Id} at 26438 and 26439.
We acknowledge the possibility that Treasury and the Service might have concerns that we are not aware of. We believe that, if any such concerns exist, they should be allayed by the expansion of the anti-abuse rule to cover all exceptions from Embedded Loan Treatment, as recommended below.

As a corollary to replacing the Cash Collateral Requirement with a rule permitting the use of readily marketable securities for margin (or collateral) purposes, we recommend removing the "cash and other property" rule of temporary regulation section 1.446-3T(g)(4)(ii)(C)(3) (the "Cash and Other Property Rule"). The Cash and Other Property Rule provides that where the parties to an NPC post both cash and non-cash Margin, the exposure not offset by a transfer of cash Margin is subject to the Embedded Loan Rule.\textsuperscript{114} The rule is worded so that it is triggered by the Margin transfers actually made by the parties, rather than by what the applicable contract terms and regulatory schemes permit. As a result, the Cash and Other Property Rule appears to require a daily measurement of the amounts of cash and non-cash Margin and daily recomputation of the Embedded Loan portions of an NPC, including the Embedded Loan Interest -- a tax compliance task of daunting complexity.

The Cash and Other Property Rule would not be necessary if our recommendation regarding permissible Margin is accepted. If our recommendation regarding permissible Margin is not accepted, we question whether the Cash and Other Property Rule is workable. It appears to present a compliance requirement that is extremely complex and is therefore unhelpful both to taxpayers and to the Service.

To illustrate the complexity, it is important to understand that the credit support documents for noncleared swaps typically determine the net collateral required based on all collateral obligations for all transactions,\textsuperscript{115} and then permit the parties to provide any of the types of collateral that they have agreed are acceptable. We assume for purposes of these examples that the parties' contract permits cash and Treasuries.

Example 1: Parties A and B enter into an at-market swap on day 1, and therefore provide no collateral. On day 2, the swap moves in Party A’s favor by $50. Party B provides $20 of cash and $30 of Treasuries to Party A as collateral.

Comment: In this case, there is no significant reason why the tax rules should differentiate between the types of collateral provided.

Example 2: Parties A and B enter into a swap on day 1 that is $20 in-the-money in Party B’s favor. Party B makes a $20 upfront payment to Party A, and Party A provides $20 of cash collateral to Party B. On day 2, the swap moves in Party A’s

\textsuperscript{114} See Temp. Reg. § 1.446-3T(g)(4)(ii)(C)(3).

\textsuperscript{115} As noted earlier, there may be separate calculations for initial margin. Our examples disregard the existence of any initial margin requirements.
favor by $50, for a net in-the-money value to Party A of $30. Party B transfers $20 of cash and $30 of Treasuries to Party A as collateral. On a cumulative basis, therefore, Party B has provided $30 of Treasuries to Party A as collateral.

Comments: In this case, Party A provided $20 of cash collateral on day 1, so that no net cash was transferred between the parties. Party B has provided exactly the same collateral on day 2 as in Example 1. It is not clear why this should affect the treatment of the day 1 transaction.

If the day 2 variation margin does affect the extent to which the day 1 upfront payment is treated as collateralized by cash, it is not clear what the effect is on day 2. Does a $20 Embedded Loan from Party B to Party A spring into existence on that day? If so, if on the next day Party A transfers $15 of cash collateral to Party B, is $15 of the $20 Embedded Loan treated as repaid?

Example 3: Parties A and B have entered into multiple swap transactions, some of which had upfront payments. Assume that the net value of those transactions at the beginning of day 3 is zero. On day 3, the parties enter into another swap that is $25 in-the-money to Party B, and Party B would be required to make a $25 upfront payment to Party A. At the same time, the existing swap transactions move $10 in Party B’s favor. Party A provides $20 of cash and $15 of Treasuries to Party B.

Comment: Based on these facts, it is not clear whether the $20 of cash should be treated as a partial cash collateralization of the new swap’s $25 upfront payment, or as allocated to some or all existing swaps that had upfront payments, or in some other manner.

Example 4: Same as Example 3, except that on day 4 the swap entered into on day 3 moves $50 in Party A’s favor (and there is no change to the value of any of the other swap transactions), and Party B therefore transfers $20 of cash and $30 of Treasuries to Party A as collateral.

Comment: Party B has provided exactly the same collateral on day 4 as it did on day 2 in Example 1. It is not clear why this should affect the treatment of the day 3 transaction.

Example 5: Same as Example 3, except that on day 3 the existing swap transactions move $10 in Party A’s favor. Party A provides $5 of cash and $10 of Treasuries to Party B as collateral.

Comment: Same comment as Example 3; how should the cash collected be allocated among the various transactions? If on day 4, there is no change to the mark-to-market value of the swap, but if (a) Party A replaces the $10 of Treasuries with cash, does that cause all Embedded Loans to
vanish, or (b) Party A replaces the $5 of cash collateral with Treasuries, does that cause additional Embedded Loans to spring into existence?

We cannot discern any tax policy goal for such a burdensome rule and believe in any event that the Cash or Other Property Rule is unworkable. Consequently, we recommend that it be eliminated in favor of a "pass-fail" (or "set it and forget it") approach that permits taxpayers and the Service to test an NPC on the date it is executed and determine whether the NPC is eligible for the Margin Exception.\footnote{We discussed the advantages of a "pass-fail" approach to Margin Exception testing above, in the context of our recommendation to permit minor margin variances.} Under the pass-fail approach, the contract would be tested at inception to determine whether the assets the parties are permitted to transfer as Margin render the contract eligible for the Margin Exception.\footnote{As an example, assume that Taxpayer enters into NPC Y on day 1, when it is $5,000,000 off-market in Taxpayer’s favor. Taxpayer makes $5,000,000 million cash upfront payment on day 1, offset by collection of $5,000,000 of cash Margin from its counterparty. The contract allows use of various asset categories as Margin, including Margin Exception-eligible assets (such as cash), and Margin-Exception ineligible assets (such as commodity futures). Under a pass-fail (or set it and forget it) approach, the Margin Exception would not apply to NPC Y because the contract permits the transfer of non-Margin Exception-eligible assets (commodity futures) as Margin. Under this approach, no retesting, re-measurement, or re-estimating the types of assets transferred as Margin attributable to NPC Y is required or permitted.}

Therefore, even if Treasury and the Service decline to follow our recommendation to replace the Cash Collateral Requirement, the Cash and Other Property Rule should be eliminated or revised so that retesting, re-measurement, or re-estimation of Margin transfers attributable to an NPC is neither permitted nor required.

\textbf{iv. We Recommend Acknowledging (in a Preamble or One or More Examples) that NPCs Cleared through Non-United States-Registered Clearing Organizations May Qualify for the Margin Exception}

It would be helpful if Treasury and the Service expressly acknowledge in the preamble to final regulations or in one or more examples that NPCs cleared through non-United States-registered clearing organizations may qualify for the Margin Exception. We believe that the 2015 Embedded Loan Regulations permit such NPCs to qualify, but we also believe that the regulations’ wording may create ambiguity on this point.

Temporary regulation section 1.446-3T(g)(4)(ii)(B)(2) provides that NPCs may qualify for the Margin Exception if the terms of the contract require the parties to post margin (or collateral) to fully collateralize the mark-to-market exposure on the NPCs on a daily basis for the term of the contract (the "(B)(2) Rule").\footnote{Temp. Reg. § 1.446-3T(g)(4)(ii)(B)(2).} The terms of a cleared NPC typically incorporate or are subject to the rules of a clearing organization as well as relevant...
regulatory rules. In this case, we believe that the margin (or collateral) requirements of the clearing organization and the regulatory rules that apply to the NPC are properly considered required "pursuant to the terms of the contract" within the meaning of the (B)(2) Rule.\(^{119}\) The (B)(2) Rule appears to be broad enough to cover NPCs cleared through United States-registered clearing organizations, NPCs cleared through non-United States-registered clearing organizations, and non-cleared NPCs.

Temporary regulation section 1.446-3T(g)(4)(ii)(B)(1), however, provides a parallel rule specifically for NPCs cleared through United States-registered clearing organizations (the "(B)(1) Rule"). While clear enough on its own, the (B)(1) Rule may create unintended ambiguity when combined with the (B)(2) Rule.

Even though the (B)(2) Rule's plain meaning supports the ability of NPCs cleared through non-United States-registered clearing organizations to qualify for the Margin Exception, an alternate interpretation that stresses avoidance of superfluity or an *expressio unius* approach\(^{120}\) might be seen as supporting the conclusion that the (B)(2) Rule is applicable only to non-cleared swaps, and that NPCs cleared through non-United States-registered clearing organizations are ineligible for the Margin Exception.

To avoid potential confusion or unintended ambiguity, we recommend Treasury and the Service expressly acknowledge in the preamble or in one or more examples that NPCs cleared through a non-United States-registered clearing organizations may qualify for the Margin Exception.\(^{121}\)

**v. We Recommend Permitting an NPC Entered Into through Settlement of an Option or Forward Contract to Qualify for the Margin Exception by Replacing the Words "the Nonperiodic Payment" with "the Initial Value of the Contract" in the (B)(1) Rule and in the (B)(2) Rule**

We recommend rewording the language "including the exposure on the periodic payment" and "equal to the nonperiodic payment" that appears in both the (B)(1) Rule and the (B)(2) Rule. Doing so would clearly permit an NPC entered into through settlement of an option or forward contract to qualify for the Margin Exception.

\(^{119}\) *See id.*

\(^{120}\) That is, an approach arguing that the express inclusion of one category -- United States-registered clearing organizations -- connotes implied exclusion of another -- non-United States-registered clearing organizations.

\(^{121}\) Alternately, Treasury and the Service might decide to combine the (B)(1) and (B)(2) rules into a single rule. If feasible, doing so would streamline the regulations and could help avoid potential confusion regarding applicability to NPCs cleared through non-United States-registered clearing organizations.
A. NPCs Entered Into through Settlement of an Option or Forward Contract

Some taxpayers regularly enter into options to enter into NPCs. Typically these are options to enter into swaps, known as "swaptions." Also, some taxpayers regularly enter into forward contracts to enter into NPCs. Typically these are forward contracts to enter into swaps, known as "forward starting swaps." These instruments require one party to make a payment (of the option premium or forward price) in advance of the date on which an NPC will be (or may be) entered into under the terms of the option or forward contract.

In many cases, swaptions or forward starting swaps are subject to contractual arrangements that require a margin or collateral adjustment equal to the amount of the option premium or forward price (adjusted for intraday price changes) on the date the swaption or forward contract is executed. Margin amounts are thereafter adjusted with changes to the contract value. This is generally the case with cleared swaptions or forward starting swaps.\(^{122}\)

In a second scenario, a swaption is not subject to Margin requirements (or is not subject to “full” Margin requirements), but the underlying swap is subject to such requirements. This may be the case, for example, with OTC options on cleared swaps.\(^{123}\) Both of these cases involve swaps which, in our view, are appropriately characterized as fully collateralized for purposes of the Margin Exception.

As the regulations stand, however, it is unclear whether the swaps described above meet the definition of "fully collateralized" contained in the (B)(1) Rule and the (B)(2) Rule.\(^{124}\) This incongruity seems to arise because the (B)(1) Rule and (B)(2) Rule do not appear to consider a specific rule for option premium and forward price payments contained elsewhere in the NPC regulations.

Under regulation section 1.446-3(g)(3), any payment with respect to an option or forward contract that obligates or entitles a person to enter into an NPC is treated as a nonperiodic payment on the NPC if and when the NPC is entered into.\(^ {125}\) This rule facilitates

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\(^{122}\) In such cases, a margin (or collateral) payment is made immediately following entry into the option (or forward contract) equal (subject to intraday price changes) to the option premium (or forward contract price), and daily margin (or collateral) equal to the change in value is exchanged throughout the terms of both the option (or forward contract) and the swap.

\(^{123}\) In such a case, the option premium (or forward contract price) payment is not necessarily accompanied by an equal and offsetting payment of margin (or collateral payment). Upon settlement into the swap, however, margin (or collateral) amounts (or adjustments) are required equal to the value of the swap.

\(^{124}\) See Reg. § 1.446-3(g)(3); Temp. Reg. §§ 1.446-3T(g)(4)(ii)(B)(1) and -3T(g)(4)(ii)(B)(2).

\(^{125}\) Reg. § 1.446-3(g)(3).
accounting for swaption premium and forward price payments where the forward or exercised option results in delivery of an NPC.\textsuperscript{126}

To do so, it establishes a deemed nonperiodic payment date for tax purposes -- the date the NPC is executed. Since the date of this payment is a tax fiction, even a fully collateralized NPC arrangement will not entail a margin (or collateral) adjustment that corresponds directly to it.

Consider the following example of a forward starting swap.\textsuperscript{127} On January 4, 2017, a taxpayer enters a forward-starting 1\%-to-LIBOR swap (e.g., a market-agreed coupon swap) cleared through a United States-registered clearing organization as the fixed rate payer, with a swap effective date of March 16, 2017. The taxpayer will receive an upfront forward price payment of $310 because the fixed side of the swap is out-of-the-money. At the end of the day on January 4, the taxpayer's position in the swap remains $310 out-of-the-money. The taxpayer receives the $310 forward price and makes an initial variation margin payment (or adjustment) of $310 on January 5, 2017.\textsuperscript{128} Daily variation margin payments (or adjustments) based on changes in value are made on each day thereafter. The forward starting swap contract is a prepaid forward contract from January 4 through March 15, 2017 and settles into a swap (which is an NPC) on March 16, 2017. On March 16, 2017, the taxpayer's position in the swap is $200 out-of-the-money. Under regulation section 1.446-3(g)(3), the taxpayer must treat the $310 upfront forward price payment as a nonperiodic payment received under the NPC on March 16, 2017.\textsuperscript{129} The Margin requirement with respect to the NPC on March 16, 2017, however, is equal to its $200 out-of-the-money value,\textsuperscript{129} not the $310 upfront forward price payment.

\textsuperscript{126}In these situations, Regulation section 1.446-3(f)(2) provides specific rules that govern accounting for the option premium or forward price payments over the term of the NPC.

\textsuperscript{127} We use a forward starting swap rather than a swaption as our example here because we also request below an exception from Embedded Loan Treatment for nonperiodic payments in the nature of option premium, which generally would apply to swaption premium payments.

\textsuperscript{128} The difference of one business day between the January 4 trade and mark-to-market measurement and the January 5 settlement margin payment (or adjustment) in this example is typical of arrangements governing these sorts of transactions. Under such arrangements, the amount of margin (or collateral) payment or (adjustment) made each business day is based on the prior day's end-of-the-day mark-to-market values.

\textsuperscript{129} This initial $200 margin (or collateral) requirement on the NPC would potentially be satisfied via a combination of (a) retention of the outstanding margin (or collateral) on the forward (or option) and (b) payment (or receipt) of the necessary amount to bring the outstanding margin (or collateral) to the appropriate daily value. For example, if the clearing organization held $190 of variation margin on the forward from the prior day and settled the forward into a swap with a value of $200, the clearing organization would generally retain the $190 of margin and the taxpayer would make a variation margin payment of $10 (for a total of $200).
It is not clear whether the Margin Exception would apply to the NPC in this example. The (B)(1) and (B)(2) rules both contain these two requirements: (1) the parties to the contract are required to post and collect "margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment)" and (2) full collateralization must subject the contract to initial variation margin or collateral "in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes)."

In our example, the taxpayer is subject to a $310 margin (or collateral) requirement with respect to the forward contract on January 4, 2017 and a $200 margin (or collateral) requirement with respect to the NPC on March 16, 2017, and is treated as receiving the $310 forward contract price under the NPC on March 16. While the attorneys participating in the drafting of this letter have differing views as to whether the NPC may be able to qualify for the Margin Exception under the (B)(1) or (B)(2) rules as currently drafted, they unanimously agree that the NPC ought to qualify for the Margin Exception and that it would certainly be helpful if the regulations were revised to clearly permit the NPC to qualify.

Accordingly, we recommend that the (B)(1) Rule and the (B)(2) Rule be revised to provide that (1) the parties to the contract are required to post and collect "margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the initial value of the contract)" and (2) full collateralization must subject the contract to initial variation margin or collateral "in an amount equal to the initial value of the contract (except for variances permitted by intraday price changes)."

**vi. We Recommend Eliminating or Revising the Excess Margin Rule**

The 2015 Embedded Loan Regulations contain a provision that applies if Margin is posted in excess of the amount necessary to fully collateralize the value of the swap (the "Excess Margin Rule"). The Excess Margin Rule states: "For purposes of paragraph (g)(4)(ii)(B)(2) of this section, if the amount of cash margin or collateral posted and collected is in excess of the amount necessary to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) on a daily basis for the entire term of the contract, any excess is subject to the rule in paragraph (g)(4)(i) of this section." We recommend that the Excess Margin Rule be eliminated.

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130 This revision entails replacing certain references to "the upfront payment" with references to references to "the initial value of the contract." The “contract” referenced here is the NPC; the NPC will qualify for the Margin Exception so long as the initial variation margin (or collateral) payment (or adjustment) equals the initial value of the NPC and daily variation margin is exchanged (or adjusted) equal to the daily change in value of the swap. This would clarify that the Margin Exception applies to the swaps in the example described above, so long as the NPC is subject to full margin requirements (and regardless of whether or not the option or forward contract is).

131 Reg. § 1.446-3T(g)(4)(ii)(c)(2).

132 Id.
Because Margin arrangements generally yield some interest return to the depositor, it is unclear why treating excess Margin as an Embedded Loan yielding Embedded Loan Interest might be viewed as helpful. It would seem more appropriate to recognize the actual interest accrued or paid than to require computation of Embedded Loan Interest under the Embedded Loan rule.

In our view, treating any excess Margin posted as a nonperiodic payment on the swap that is subject to the Embedded Loan rule is an unnecessary complication of the tax rules. Accordingly, we recommend removing the Excess Margin Rule of Regulation section 1.446-3T(g)(4)(C)(2). To the extent that Treasury and the Service have concerns about taxpayers who might seek to camouflage loan arrangements under cover of the Margin Exception through the use of substantial amounts of excess Margin, we hope that such concerns would be allayed by the expansion of the Embedded Loan anti-abuse rule to cover all exceptions from Embedded Loan Treatment, as recommended below.

As stated, because taxpayers generally treat Margin transfers as loans, we believe that the Excess Margin Rule is unnecessary and should be eliminated. If the Excess Margin Rule is to remain in the regulations, however, we recommend that it be harmonized with our recommendation above to permit minor Margin variances, tested against the threshold recommended above.

3. We Recommend Providing an Exception for Option Premium Payments

We recommend providing an exception from Embedded Loan Treatment for nonperiodic payments that are in the nature of option premiums, such as swaption premiums and payments for caps and floors. Because such payments are not economically similar to loans, we can discern no tax policy reason to treat them as loans. We believe that the specific methods for accounting for nonperiodic payments provided in the 1993 regulations remain appropriate for governing nonperiodic payments that are in the nature of option premium.

a. Options, Caps, and Floors in General

An option is a contract between two parties that gives the holder of the option the right, but not the obligation, to buy from, or sell to, the counterparty a specified amount of property at a fixed price (the “strike price”) at a specified time. The option buyer pays the option writer (or seller) a premium for the option.

133 See Reg. § 1.446-3(f)(2).
134 See, e.g., JCX-56-11 at 32.
135 See id. at 33.
Where the option in question is an option to enter into an NPC, an option premium payment generally represents payments for an option right, not an extension of credit.\textsuperscript{136} Caps generally are economically equivalent to a series of options, and the same is true of floors.\textsuperscript{137}

An option purchaser's exchange of option premium for the option written by the option seller generally is not a taxable event; contractual options generally receive open transaction treatment, and the option holder generally does not recognize gain or loss upon exercise of the option.\textsuperscript{138} Caps and floors generally are subject to regulation section

\textsuperscript{136} As recognized in case law, an option consists of (1) a continuing offer by the option writer do to so something (or forbear from doing something), and (2) an agreement to keep this offer open to the option holder for a specified period (or a reasonable period) of time. See, e.g., Savianno v. Comm'r, 80 T.C. 955, 969 (1985); Koch v. Comm'r, 67 T.C. 71, 82 (1976). In the case of an option to enter into an NPC, we generally see little or no similarity between it and a loan. Additionally, the value of this option right, called its time value, decreases over time (to zero at the option's expiration date) in a way that does not resemble the decrease to the value of money over time; the latter is a key concept in loan economics which is often called the "time value of money." See, e.g., Peter Moles and Nicholas Terry, THE HANDBOOK OF INTERNATIONAL FINANCIAL TERMS, at 555 (1997) (providing different definitions for "time value of an option" and "time value of money"). Certain options deep in the money at issuance, however, may have different economic characteristics and may in some circumstances be considered equivalent to forward contracts, as we discuss further below.

\textsuperscript{137} Caps are generally viewed as economically similar to series of cash settled, European put options on a debt instrument, while floors as generally viewed as economically similar to a series of cash-settled European call options. See American Bar Association Tax Section Report on Interest Rate Caps, Floors and Collars (Dec. 16, 1988) ___ TAX NOTES 2944 (Dec. 29, 1988) at 2946 (citing Haghani and Stovis, Interest Rate Caps and Floors: Tools for Asset/Liability Management (Salomon Brothers, May 1986) and Smith, Putting the Cap on Options, Euromoney Corporate Finance (Jan. 1987). See also Satyajit Das, SWAP & DERIVATIVE FINANCING (Rev. Ed. 1994) at 106.

\textsuperscript{138} See Virginia Iron Coal & Coke Co. v. Comm'r, 99 F.2d 919, 921 (4th Cir. 1938); Koch v. Comm'r, 67 T.C. 71 (1976). See also Rev. Rul. 1978-182, 1978-1 C.B. 265; Reg. § 1.263(a)-4(d)(2)(i)(C)(7). Where the option holder exercises the option and receives delivery of the underlying property from the option writer, the option writer includes the option premium in its amount realized upon sale of the property, and the option holder includes the premium in its tax basis in the property. See Rev. Rul. 78-182. For certain forward contracts, statutory exceptions to this open transaction rule provide mark to market accounting for options, see I.R.C. §§ 475 and 1256, or realization upon delivery of the underlying asset pursuant to the forward contract. See I.R.C. §§ 988(c)(5), 1256(c)(1), and 1260(f) (exceptions for certain situation where the tax treatment of gain or loss on the forward contract differs from that of gain or loss of the underlying asset). Also, where the option is terminated other than through delivery of the underlying property and the underlying property consists of securities, the option writer (if not a dealer in securities) generally realizes short term capital gain or loss (regardless of the length of the option's term), see I.R.C. § 1234(b), and the option holder recognizes gain or loss of the same character that it would recognize upon disposition of the underlying property. See I.R.C. § 1234(a). Again, exceptions may apply to certain types or taxpayers or transactions; for example, special rules apply to dealers in securities. See I.R.C. §§ 475, 1234(b). See also Rev. Rul. 1993-76, 1993 C.B. 235.
1.446-3, which provides specific rules governing nonperiodic payments made to purchase or sell caps and floors.

b. Options to Enter into NPCs, Caps and Floors and the NPC Regulations

As noted above, some taxpayers regularly enter into options to enter into NPCs, known as "swaptions." A taxpayer that exercises a swaption becomes a party to a swap contract. When this occurs (assuming the swap is an NPC), regulation section 1.446-3(g)(3) treats the swaption premium as a nonperiodic payment on the NPC. The parties to the NPC account for the premium payment under the rules of regulation section 1.446-3(f)(2). These rules generally require recognition of the ratable daily portion of the payment for the taxable year to which the payment relates. The 1993 regulations set forth various specific methods -- one involving allocation in accordance with forward rates (or forward prices), and various alternative methods applicable only to taxpayers not acting in a swap dealer capacity.

Similarly, the 1993 regulations set forth alternate specific methods of accounting for nonperiodic NPC payments made to purchase or sell caps and floors -- one involving allocation in accordance with the prices of cash-settled options, and various alternative methods applicable only to a taxpayer who enters into the NPC to hedge a debt instrument issued (or to be issued) by the taxpayer and did not enter into the NPC in question in a swap dealer capacity.

Nonperiodic payments in the nature of option premium are subject to these specific accounting rules under the 1993 regulations, unless they are significant nonperiodic payments under the embedded loan rule. The 2015 Embedded Loan Regulations, however, would render these specific accounting methods generally inapplicable. They would require taxpayers to treat an NPC entered into through exercise of an option as an option premium.

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139 See Reg. § 1.446-3(c)(1)(i).
140 Reg. §§ 1.446-3(f)(2)(iv) and -3(f)(2)(v).
141 See Reg. § 1.446-3(f)(2).
142 See Reg. § 1.446-3(f)(2)(i).
143 See Reg. § 1.446-3(f)(2)(ii).
144 See Reg. § 1.446-3(f)(2)(iii).
145 See Reg. § 1.446-3(f)(2)(iv).
146 See Reg. § 1.446-3(f)(2)(v) .
Embedded Loan in part. Our recommendation is to except payments in the nature of option premium from Embedded Loan Treatment.

c. Excepting Payments in the Nature of Option Premium from Embedded Loan Treatment

As noted above, option premium payments generally represent payments for an option right, not an extension of credit. Because no element of the option contract or NPC is economically equivalent to a loan, we recommend that regulations provide an exception from Embedded Loan Treatment for payments in the nature of option premium, such as payments for swaptions, caps, and floors.

d. Forward Contracts to Enter into NPCs, and Options Economically Similar to Forward Contracts

We do not recommend adding to the regulations an exception for forward contract purchase price payments similar to the exception we are recommending for option premium payments.

Some taxpayers regularly enter into forward contracts with respect to NPCs. Typically these are forward contracts to enter into swaps, known as "forward starting swaps." If and when the forward is settled into the swap (assuming the swap is an NPC), regulation section 1.446-3(g)(3) treats the forward contract price paid as a nonperiodic payment on the NPC.

Under current law, these payments are subject to the specific methods of accounting for nonperiodic payments provided in the 1993 regulations if and when the forward is settled into the swap (unless they are significant nonperiodic payments under the 1993 regulations' embedded loan rule). The 2015 Embedded Loan Regulations would change this treatment, and would require taxpayers to treat the forward price paid as an Embedded Loan. Like option premium payments, forward contract price payments generally receive open transaction treatment under federal tax law. The fact that these

147 Temp. Reg. § 1.446-3T(g)(4)(i). Embedded Loan Treatment would not apply, however, if either the short term exception or the margin exception applies. Temp. Reg. § 1.446-3T(g)(4)(ii).

148 See Reg. § 1.446-3(f)(2).

149 See Reg. § 1.446-3(f)(2).

150 Temp. Reg. § 1.446-3T(g)(4)(i). Embedded Loan Treatment would not apply, however, if either the short term exception or the Margin Exception applies. Temp. Reg. § 1.446-3T(g)(4)(ii).

151 See Lucas v. North Tex. Lumber Co., 281 U.S. 11 (1930) (entry into "executory contract of sale" was not a taxable event, sale in subsequent year was). For certain forward contracts, statutory exceptions to open transaction treatment provide mark to market accounting for forward contracts (or futures contracts, which are exchange traded forward contracts), see I.R.C. §§ 475 and 1256, or realization upon delivery of the
two types of payments both generally fail to trigger immediate tax consequences should not obscure the fact that the two types of payments are very different economically.

Unlike option premium pricing, forward contract pricing contains a substantial time value of money element. Among other things, a forward price reflects a time value of money return on the amount of cash that would be invested in acquiring the underlying property at execution of the contract and holding it until the purchase date (or delivery date). Based on the economic differences between option premiums and forward prices, we do not recommend excepting all forward price payments from Embedded Loan Treatment.

We further recognize that under some circumstances, although uncommon in swap markets, an option may nearly be economically equivalent to a forward contract. For example, an option that is deep in the money at issuance with respect to an underlying asset of relatively low volatility could be nearly economically equivalent to a forward contract. The parties to such an option may be substantially certain at the time the option is issued that the option holder will exercise the option and acquire the asset.

Accordingly, we recommend adding to the regulations a safeguard to prevent an option to acquire an NPC, if it is the sort of option described in the preceding paragraph, from qualifying for the option exception from Embedded Loan Treatment we recommend here. We believe that the Embedded Loan anti-abuse rule may be used as such a safeguard, and we recommend making that rule potentially applicable to all exceptions to Embedded Loan Treatment, as further discussed below.

4. We Recommend Broadening the Scope of the Anti-Abuse Rule So That It May Apply to All Exceptions from Embedded Loan Treatment, Including the New Exceptions Recommended in These Comments

We have noted that the foundation of our view on the Embedded Loan rule is our observation that the majority of NPCs executed by taxpayers do not have loan elements that are economically substantial in comparison to the NPCs' overall economics, and are not entered into for the purpose of making or receiving a loan. We have also described the administrative burden that making Embedded Loan calculations represents to taxpayers and to the Service. Accordingly, these Comments include various specific recommendations designed to broaden the exceptions to Embedded Loan Treatment.

underlying asset pursuant to the forward contract, see I.R.C. §§ 988(c)(5), 1256(c)(1), and 1260(f) (exceptions for certain situations where the tax treatment of gain or loss on the forward contract differs from that of gain or loss of the underlying asset).

152 See JCX-56-11, at 36-37 (explaining that the price of a forward contract reflects the current spot price, plus the cost to carry (a time value of money return on the cash that would be invested in acquiring the underlying item at execution of the contract and holding it until the final delivery date, together with any warehousing or similar expenses), minus projected cash returns (such as periodic dividend or interest payments) over the contract term).
As a general matter, however, we also recognize that taxpayers may employ NPCs in arrangements that economically resemble other financial instruments such as debt or corporate stock. Further, we recognize that the exceptions to Embedded Loan Treatment discussed in these Comments might be susceptible to misuse absent an Embedded Loan anti-abuse rule.

Accordingly, as noted above, we recommend broadening the scope of the Embedded Loan anti-abuse rule to cover all exceptions to Embedded Loan Treatment (not just the short term NPC exception). Under this approach, the Embedded Loan anti-abuse rule would apply to transactions or arrangements entered into with the principal purpose (or if Treasury and the Service prefer, a principal purpose) of avoiding Embedded Loan Treatment. This scope expansion would allow the anti-abuse rule to safeguard against inappropriate application of any of the exceptions to Embedded Loan Treatment, including, for example, the de minimis and option premium exceptions recommended in these Comments.

5. Facilitate Information Reporting (Form 1099 Reporting) and Withholding Consistency and Accuracy

We recommend that Treasury and the Service consider the question of whether Embedded Loans and Embedded Loan Interest should be subject to the information reporting rules generally applicable to debt, and issue regulations that clearly implement their determination in this regard. We request that Treasury and the Service weigh considerations such as administrative convenience and facilitating accurate self-reporting in making their decision. We lack sufficient information to weigh these considerations, so these Comments do not include a specific recommendation on this point.

a. Information Reporting with respect to Debt and Interest in General

Generally, debt instruments are potentially subject to information reporting requirements with respect to interest (including original issue discount ("OID")), tax basis, and disposition proceeds. Where these requirements apply, interest must be reported on

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153 See, e.g., Reg. § 1.446-3(g)(6), Ex. 3.
154 See, e.g., I.R.C. § 871(m)(3).
155 Alternately, the anti-abuse rule might be worded so that a purpose to avoid interest or debt treatment for federal tax purposes (rather than a purpose to avoid Embedded Loan Treatment) could trigger it.
156 See generally Reg. §§ 1.6049-4 and -5.
157 See generally Reg. § 1.6045-1.
158 See generally Reg. § 1.6045-1.
Form 1099-INT or Form 1099-OID, and tax basis and disposition proceeds must be reported on Form 1099-B.

There are numerous exceptions to the general information reporting requirements for debt. For example, where the recipient of the interest or disposition proceeds is an exempt recipient, information reporting is not required. Exempt recipients include (but are not limited to): corporations (or, with respect to sales proceeds and tax basis, corporations other than S corporations), tax exempt organizations, governmental entities, foreign governments and their agencies, dealers in securities, and real estate investment trusts (REITs), United States-registered investment companies, and financial institutions such as banks.

b. Information Reporting with respect to Embedded Loans and Embedded Loan Interest

i. Interest Information Reporting

Under current law, Embedded Loan Interest is expressly excepted from interest information reporting by regulation section 1.6041-1(d)(5) (the "Embedded Loan Interest 1099 Exception"). In addition to setting out this exception from Form 1099-INT and

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159 See Reg. § 1.6049-4(a). See also Internal Revenue Service 2015 Instructions for Forms 1099-INT and 1099-OID (Sep. 25, 2014) ("1099-INT/OID Instructions").

160 See Reg. §§ 1.6045-1(c), -1(d)(5) and -1(d)(6). See also Internal Revenue Service 2015 Instructions for Form 1099-B (Jan. 14, 2015) ("1099-B Instructions").

161 Whether interest information reporting applies under section 6049 would depend on various factors, such as: (i) whether the interest in question is described in Reg. § 1.6049-5(a) (categories of interest subject to information reporting) or Reg. § 1.6049-5(b) (categories of interest not subject to information reporting) and (ii) whether the payee is an exempt recipient, see Reg. § 1.6049-4(c). Whether disposition proceeds and tax basis information reporting applies under section 6045 would depend on various factors, such as: (i) whether the transaction involves a broker and a customer as defined in the regulations, see Reg. §§ 1.6045-1(a)(1) and -1(a)(2), (ii) whether the debt is acquired in an account and acquired for cash within the meaning of the regulations, see Reg. §§ 1.6045-1(a)(15)(i) and -1(a)(15)(ii), and (iii) whether the debt falls into the category of simpler debt instruments, such as debt instruments with a single fixed payment schedule, for which tax basis reporting has an earlier effective date, or more complex debt instruments, such as variable rate debt, for which tax basis reporting has a later effective date, see Reg. § 1.6045-1(n), and (iv) whether the recipient of disposition proceeds is an exempt recipient, see Reg. § 1.6045-1(c)(3)(i).

162 Reg. § 1.6049-4(c) (exempt recipients with respect to interest), Reg. § 1.6045-1(c)(3)(i) (exempt recipients with respect to disposition proceeds and tax basis).

163 See generally Reg. §§ 1.6049-4(c), and 1.6045-1(c)(3)(i).

164 Reg. § 1.6041-1(d)(5) (added in T.D. 8734, 62 Fed. Reg. 53387 (Oct. 14, 1997)). See also Reg. 1.6049-5T(b)(16). This interest reporting exception does not apply, however, for the purposes of Reg. § 1.1461-
Form 1099-OID reporting, that regulation generally requires payment-based information reporting (on Form 1099-MISC) for net periodic and nonperiodic payments made under NPCs.\textsuperscript{165}

Other guidance, however, seems to contradict the Embedded Loan Interest 1099 Exception. First, temporary regulation section 1.446-3T(g)(4)(i) states that Embedded Loan Interest is treated as interest "for all purposes of the Internal Revenue Code."\textsuperscript{166} If the Embedded Loan Interest 1099 Exception will continue to govern, one would expect the Embedded Loan regulation to so indicate. For example, it might state that the Embedded Loan Interest is treated as interest "for all purposes of the Internal Revenue Code except for the purposes of sections 6041, 6045, and 6049."

Second, the Service's instructions for Form 1099-INT and Form 1099-OID require Form 1099 reporting of Embedded Loan Interest.\textsuperscript{167} The instructions for Box 1 of these Forms read, in part: "include interest of $600 or more paid in the course of your trade or business not meeting the above criteria, such as ... interest attributable to a swap with significant nonperiodic payments."\textsuperscript{168}

The Service's instructions for Form 1099-MISC do not refer to the Embedded Loan Interest 1099 Exception.\textsuperscript{169} They merely note that 1099-MISC is to be used to report "generally, the cash paid from a notional principal contract to an individual, partnership, or estate."\textsuperscript{170}

Although the Embedded Loan Interest 1099 Exception is reasonably clear by its own terms, it is not consistent with the language of the 2015 Embedded Loan Regulations and the 1099-INT/OID Instructions. Accordingly, clarification with respect to the continuing applicability of the Embedded Loan Interest 1099 Exception would be helpful.

\textsuperscript{1(c)(1) (generally requiring Form 1042-S reporting of interest payments made to foreign persons). See Reg. § 1.6041-1(d)(5). See also Reg. § 1.1461-1(c)(1).}

\textsuperscript{165} Reg. § 1.6041-1(d)(5).

\textsuperscript{166} Temp. Reg. § 1.446-3T(g)(4)(i).

\textsuperscript{167} See 1099-INT/OID Instructions, at 3.

\textsuperscript{168} 1099-INT/OID Instructions, at 3.

\textsuperscript{169} See Internal Revenue Service 2015 Instructions for Form 1099-MISC (Oct. 2, 2014) ("1099-MISC Instructions").

\textsuperscript{170} See 1099-MISC Instructions, at 1.
ii. Disposition Proceeds and Tax Basis Reporting

Although not free from doubt, it appears that Embedded Loans are also potentially subject to sale proceeds and tax basis information reporting under regulation section 1.6045-1. As noted above, regulations state that the Embedded Loan Interest on an Embedded Loan is treated as interest "for all purposes of the Internal Revenue Code."171 They do not include a corresponding statement that the Embedded Loan itself is treated as debt for all purposes of the Code.172 However, the logical implication of finding Embedded Loan Interest is that the Embedded Loan is deemed a debt instrument for tax purposes.173

If so, the Embedded Loan would meet the regulation section 1.1275-1(d) definition of "debt instrument," and would apparently be considered a debt instrument for purposes of section 6045.174 It may be, however, that taxpayers will perceive ambiguity on this point, particularly if the scope of the Embedded Loan Interest 1099 Exception is not clarified.

c. We Recommend Adopting a Consistent Approach to All Information Reporting with Respect to Embedded Loan Interest and Embedded Loans

We recommend that Treasury and the Service adopt a consistent approach that either "turns off" or "turns on" interest, disposition proceeds, and tax basis information reporting with respect to Embedded Loan Interest and Embedded Loans across the board. As discussed above, the rules currently governing these matters do not adopt a

171 Temp. Reg. § 1.446-3T(g)(4)(i).

172 See id.

173 See Temp. Reg. § 1.446-3T(g)(4)(i) (characterizing the Embedded Loan as a loan, i.e., as indebtedness), Reg. § 1.1275-1(d) (defining "debt instrument" as "any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law").

174 Reg. § 1.6045-1(a)(17). Whether information reporting applies under section 6045 would depend on various factors, such as: (i) whether the Embedded Loan involves a broker and a customer as defined in the regulations, see Reg. §§ 1.6045-1(a)(1) and -1(a)(2), (ii) whether payments on the Embedded Loan constitute gross proceeds-reportable "sales" within the meaning of Reg. § 1.6045-1(a)(9) particularly (we note that T.D. 9616 modified the definition of a sale set forth therein in two important respects: (1) it was modified to cover "a partial retirement attributable to a principal payment received on or after January 1, 2014;" and (2) it was modified to provide that a sale includes "any closing transaction" … "[i]n the case of an option, a regulated futures contract, a securities futures contract or a futures contract…"), (iii) whether the Embedded Loan is acquired in an account and acquired for cash within the meaning of the regulations (for determining whether cost basis reporting under IRC § 6045(g) is applicable, see Reg. §§ 1.6045-1(a)(15)(i) and -1(a)(15)(ii)), and (iv) whether the Embedded Loan falls into the category of simpler debt instruments, such as debt instruments with a single fixed payment schedule, for which tax basis reporting has an earlier effective date, or more complex debt instruments, such as variable rate debt, for which tax basis reporting has a later effective date, see Reg. § 1.6045-1(n).
coordinated approach to Embedded Loan Interest and Embedded Loans, and, as a result, give rise to uncertainty.

The information reporting regime applicable to securities and contract payments generally does adopt a coordinated approach.\(^\text{175}\) We believe that such an approach facilitates accurate and consistent information reporting, and we believe that taxpayers and the Service both benefit from this approach. Accordingly, we request that Treasury and the Service consider what coordinated approach they would like to employ for Embedded Loan Interest and Embedded Loans, and issue regulations implementing that approach. More specifically, we recommend that such regulations implement one of the following two coordinated approaches.

The first alternative coordinated approach is the approach that most closely adheres to current market practice. This approach would be to except expressly both the Embedded Loan Interest and the Embedded Loans from interest, proceeds, and tax basis information reporting under sections 6049 and 6045. This approach would retain the Embedded Loan Interest 1099 Exception provided in regulation section 1.6041-1(d)(5), and provide a similar Embedded Loan exception from section 6045.

The second coordinated approach would provide expressly that Embedded Loan Interest may be subject to interest information reporting under section 6049 and Embedded Loans may be subject to information reporting with respect to the disposition proceeds and tax basis under section 6045. That is, the second alternative approach would eliminate the Embedded Loan Interest 1099 Exception in regulation section 1.6041-1(d)(5), and provide no Embedded Loan exception from section 6045.

The former approach provides administrative convenience.\(^\text{176}\) The latter approach would better facilitate accurate self-reporting of income by certain recipients of Embedded Loan Interest.\(^\text{177}\)

We request that Treasury and the Service weigh these considerations and decide between them. Another factor Treasury and the Service may wish to consider is the degree to which NPC parties are exempt recipients for whom no information reporting would be

\(^{175}\) See generally I.R.C. §§ 6041, 6045, 6045A, and 6049, and the regulations thereunder.


\(^{177}\) See generally Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, JCS-38-82 (Dec. 31, 1982), at 172 et seq. (discussing significant changes to tax information reporting and withholding law made in 1982 under the heading "Section C. Provisions Designed to Improve Taxpayer Compliance").
required regardless of which approach is adopted. We lack sufficient information to weigh these considerations, so we are not providing any recommendation on this point.\textsuperscript{178}

6. We Recommend Amending the 2015 Embedded Loan Regulations' General Effective Date to the Later of (a) January 1, 2017, or (b) One Year after Publication of Final Regulations

Originally, the Embedded Loan Treatment rule had a general effective date of November 4, 2015.\textsuperscript{179} Treasury and the Service have already amended the effective date provision of the 2015 Embedded Loan Regulations, postponing the general effective date to the later of (a) January 1, 2017, or (b) 180 days after publication of final regulations.\textsuperscript{180} We commend Treasury and the Service for making this important and helpful amendment.

Historically, many taxpayers entering into NPCs that involved Upfront Payments (or other nonperiodic payments) determined that Embedded Loan Treatment was not required and accordingly set up no systems and procedures to account for Embedded Loans and Embedded Loan Interest. Taxpayers who concluded that Embedded Loan Treatment did apply to one or more of their NPCs often set up ad hoc systems and procedures to account for the Embedded Loans and Embedded Loan Interest.

Combined with the increased prevalence of Upfront Payments, the broader and clearer definition of Embedded Loans provided in the 2015 Embedded Loan Regulations will likely result in increased prevalence of Embedded Loan Treatment. Accordingly, most participants in the NPC market will need to establish new systems, procedures and controls to account for Embedded Loans and Embedded Loan Interest. We understand that the time required to properly do so may be approximately one year. We therefore request that the Embedded Loan rule's general effective date be changed to the later of (a) January 1, 2017, or (b) one year after the publication of final regulations.

\[\textsuperscript{178} \text{The members of the working group drafting these Comments collectively have substantial experience analyzing and advising on procedures and systems for information reporting and withholding in general. However, we have considerably less experience providing such analysis and advice with respect to Embedded Loan Interest and Embedded Loan information reporting.}\]

\[\textsuperscript{179} \text{As originally issued, the 2015 Embedded Loan Regulations generally apply to NPCs entered into on or after November 4, 2015. Temp. Reg. § 1.446-3T(j)(2), as issued May 8, 2015 and prior to amendment on Oct. 13, 2015. The exceptions to Embedded Loan Treatment, however, apply to NPCs entered into on or after May 8, 2015. Temp. Reg. § 1.446-3T(j)(2). Further, taxpayers may rely on these exceptions for NPCs entered into earlier. Id. We commend Treasury and the Service for adopting the effective date provisions applicable to the exceptions and recommend adopting similar effective date provisions with respect to the additional exceptions recommended in this letter.}\]

a. Tax Reporting Dates Potentially Applicable to Embedded Loan Interest and Embedded Loans

Taxpayers will need to gather and process data relating to Embedded Loans once the new Embedded Loan rule is in effect. To illustrate the timeframes within which taxpayers must do so, we summarize here when a number of these reporting requirements would apply to transactions occurring in 2017.

i. Income Tax Reporting

If the general effective date of the 2015 Embedded Loan Regulations will be in 2017, taxpayers may be required to report Embedded Loan Interest and Embedded Loans on their 2017 income tax returns. For entities and individuals whose taxable year ends in December 2017, the general due date for corporate income tax returns will be April 16, 2018, and the same date will apply for individuals' 2017 returns. The general due date for partnerships' federal income tax returns generally will be March 15, 2018, and the same date will apply for S corporations.

Although these return filing due dates generally may be extended by up to six months, the due dates for the payment of income tax generally may not.

ii. Information Reporting

If information reporting for interest, disposition proceeds, or tax basis will be required for Embedded Loan Interest and Embedded Loans, and the new Embedded Loan rule

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181 Other reporting requirements, such as financial and regulatory reporting requirements, may also apply to affected taxpayers.

182 The filing due dates for information return and withholding tax reporting shown here are in some cases (as reflected in the relevant footnotes) extrapolated from the Service's 2015 tax form instructions. The Service has not yet issued the relevant 2017 tax form instructions.


184 See I.R.C. § 6072(b).

185 See I.R.C. § 6072(b).

186 See I.R.C. §§ 6081(a) and (b).

187 See I.R.C. § 6151(a).
becomes effective in 2017, Embedded Loan Interest paid in 2017 with respect to NPCs entered into on or after the effective date would be reportable on 2017 Forms 1099, unless an exception applies.\(^{189}\)

If no exception applies,\(^{190}\) Embedded Loan Interest paid in 2017 would be reportable on Forms 1099 filed with the Service in February 28 or March 31 of 2018, and provided to the payment recipient by January 31, 2018.\(^{191}\) In addition, the same Form 1099 filing deadlines would apply to any information reporting required under regulation section 1.6045-1 for sales (and other dispositions) of Embedded Loans.\(^{192}\)

### iii. Withholding

Sections 871(a)(1) and 881(a)(1) generally impose withholding tax ("Chapter 3 Withholding") on U.S. source interest paid to foreign persons.\(^{193}\) Interest and principal payments to foreign entities (regardless of source) are potentially subject to further withholding requirements under the Foreign Account Tax Compliance Act (FATCA) provisions ("Chapter 4 Withholding").\(^{194}\) Whether withholding applies in a particular case depends on a host of factors.\(^{195}\)

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188 In the discussion above, we have recommended that Treasury and the Service adopt a coordinated, across the board approach that either "turns off" or "turns on" such information reporting.

189 Reg. § 1.6049-4(a). See also 1099-INT/OID Instructions.

190 As discussed above, the Embedded Loan Interest on Embedded Loans appears expressly excepted from interest information reporting (i.e., Form 1099-INT/OID reporting) by the rule set out in regulation section 1.6045-1(d)(5). This rule does not, however, provide any exception to information reporting with respect to disposition proceeds and tax basis (i.e., Form 1099-B reporting).

191 Forms 1099 are generally required to be filed on an annual calendar year basis by the February 28 following the close of the calendar year (March 31 if filed electronically), with a copy sent to the payment or proceeds recipient by January 31. See Internal Revenue Service 2015 General Instructions for Certain Information Returns, at 24-26 (Jan. 6, 2015).

192 See id.

193 See I.R.C. §§ 871 and 881 and the regulations thereunder. Sections 1441 and 1442 generally govern the withholding. See I.R.C. §§ 1441 and 1442 and the regulations thereunder. Payments under an NPC that are not Embedded Loan Interest are generally not subject to Chapter 3 Withholding because they are sourced to the residence of the payee. See Reg. §§ 1.863-7(a)(1), 1.863-7(b)(1), and 1.1441-4(a)(3)(i).

194 I.R.C. §§ 1471 through 1474 and the regulations thereunder. Chapter 4 Withholding may apply both to interest payments under a deemed loan and to the gross proceeds from the sale, retirement or redemption of all or part of a deemed loan. See I.R.C. § 1473(1)(A)(ii); Reg. § 1.1473-1(a)(1)(ii). For this purpose, sales might include NPC terminations and payments of embedded loan principal. See Reg. §§ 1.1473-1(a)(3)(I), 1.6045-1(a)(9). Chapter 4 Withholding with respect to gross proceeds will be applicable, however, only to sales and dispositions occurring after December 31, 2018. Notice 2015-66, Section III, 2015-41 I.R.B. 541, at 543 (announcing that Treasury and the Service intend to issue regulations postponing the applicability
Applying these factors to Embedded Loans raises some substantive tax law questions, and resolution of these questions may require taxpayers to perform time-consuming investigation. For example, in certain cases, some difficulty may arise in determining whether the portfolio interest exemption applies to Embedded Loan Interest. Also, where withholding is required, in certain cases, difficulties may arise in timely determining which taxpayer should withhold from NPC payments with respect to cleared swaps.

Withholding under section 1441 and under FATCA generally must be reported for each calendar year to the Service by the following March 15. Depositing the amounts withheld with the Service or holding them in escrow may be required. In some circumstances, deposits of amounts withheld is required within three (3) business days of regulations requiring Chapter 4 withholding with respect to gross proceeds of sales and dispositions).

Whether Chapter 3 Withholding applies would depend on various factors, such as: (i) the residence of the payee, see Reg. §§ 1.1441–1(b)(1), (ii) whether the portfolio interest exception applies, see § 871(h), Reg. §§ 1.1441–1(b)(4)(i), and (iii) whether the payee is eligible for treaty benefits, see Reg. §§ 1.1441–1(b)(4)(iv), 1.1441–6. Whether Chapter 4 withholding applies under sections 1471 and 1472 would depend on various factors, such as: (i) the residence of the payee, see Reg. §§ 1.1471–2(a)(1), § 1.1472–1(a)(1), and (ii) whether the payee is an exempt FFI (foreign financial institution), see Reg. § 1.1471–2(a)(4). The “portfolio interest” exemption from Chapter 3 Withholding does not apply for purposes of Chapter 4 Withholding. See I.R.C. § 1473(1)(A)(i); Reg. § 1.1473–1(a)(2)(i)(C).

One issue that may arise under the portfolio interest exemption rules is whether Embedded Loan Interest on an NPC is “received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business,” and therefore generally ineligible for the portfolio interest exemption. See I.R.C. § 881(c)(3)(A). Another is how, in an NPC context, to properly apply the 10% shareholder test of section 871(h)(3), which excepts certain interest from the portfolio interest exemption.

In this regard, taxpayers may find helpful the example involving a clearing organization, a broker, and an exchange traded option recently added in T.D. 9734 to the regulations defining "withholding agent" for Chapter 3 Withholding purposes. See Reg. § 1.1441–7(a)(3), Ex. 7. That example concludes that the clearing organization and broker are both withholding agents on the facts presented. Reg. § 1.1441–7(a)(3), Ex. 7.

See Internal Revenue Service Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities, at 42 (2015). Instructions for Form 1042–S, at 2 (Feb 9, 2015). The same March 15 deadline applies to these forms whether they are filed on paper or electronically. See, e.g., Instructions for Form 1042–S, at 2 (Feb 9, 2015).

after the end of the quartermonthly period (*i.e.*, the period ending 7th, 15th, 22nd, and last day of the calendar month) in which the payment subject to withholding was made).

**b. Effective Date Amendment Request**

To sum up the how the deadlines mentioned above would apply to 2017 Embedded Loan Interest and Embedded Loans under the new Embedded Loan rule: (i) taxpayers would be required to report Embedded Loan Interest income and deductions on their income tax returns, generally due March 15 or April 15, 2018 for calendar year taxpayers; (ii) if the Embedded Loan Interest is subject to withholding, taxpayers would be required to report the withholding to the Service by March 15, 2018, and may be required to deposit amounts withheld with the Service during 2017; and (iii) where the Embedded Loan Interest amounts or Embedded Loan proceeds are subject to information reporting, the reporting deadlines would be January 31 and either March 31 or February 28 of 2018.

To facilitate reporting of Embedded Loan Interest and Embedded Loans, certain taxpayers such as withholding agents will likely need to establish new technology systems and compliance procedures. It is our general understanding that technology systems often take at least a year or more to develop, test, and implement. Effective compliance generally may require assessment of NPC transactions at the time the NPCs are executed each taxable year, rather than at a later time such as the time the tax return is prepared. We are concerned, that if taxpayers are provided a period of less than one year between the final regulations’ publication date and effective date, that period could be inadequate for taxpayers to develop and implement the necessary compliance processes and related technology. We therefore request that the Embedded Loan rule's general effective date be changed to the later of (a) January 1, 2017 or (b) one year after the publication of final regulations.

While the 2015 Embedded Loan Regulations have a general effective date of the later of (a) January 1, 2017 or (b) 180 days after the publication of final regulations, their effective date with regard to the exceptions from Embedded Loan Treatment is May 8, 2015. Further, they permit taxpayers to rely on the exceptions for earlier transactions.

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200 Id.

201 They generally apply to NPCs entered into on or after November 4, 2015. Temp. Reg. § 1.446-3T(j)(2).

202 With respect to the exceptions, the regulations apply to NPCs entered into on or after May 8, 2015. Temp. Reg. § 1.446-3T(j)(2).

203 Temp. Reg. § 1.446-3T(j)(2).
We commend Treasury and the Service for including the effective date provisions relating to the exceptions, since they greatly aid administrability.\(^{204}\) We request that any new proposed, temporary, or final regulations addressing Embedded Loans continue to authorize taxpayers remain able to rely on all exceptions to the Embedded Loan rule in a similar manner.

### 7. We Recommend Expressly Providing an Exception for Contingent Nonperiodic Payments

Treasury and the Service issued proposed regulations addressing NPCs with contingent periodic payments on February 26, 2004.\(^{205}\) These proposed regulations have not been finalized. We understand that Treasury and the Service plan to propose new regulations that would govern contingent nonperiodic NPC payments.

Treasury, the Service, and commentators have expressed views on accounting methods potentially suitable to apply to contingent nonperiodic payments.\(^{206}\) None have ever suggested, as far as we are aware, that Deemed Loan Treatment should be applied to an NPC by virtue of the NPC providing for one or more contingent nonperiodic payments.\(^{207}\) Further, no situation is known to us where taxpayers or the Service have applied

\(^{204}\) We note that the regulations also permit taxpayers to begin applying the new Embedded Loan rule prior to its general effective date. See Reg. § 1.446-3T(j)(2). The effective date provision appears to permit one party to an NPC entered into prior to the general effective date to adopt the new Embedded Loan rule early, treating the NPC as containing an Embedded Loan while the other party does not. We do not view this result as desirable, and accordingly do not view the early adoption aspect of the effective date provision as helpful. It is possible that this undesirable result will rarely be seen in practice, given that most swap market participants, in our experience, are content not to apply Embedded Loan Treatment to NPCs where the tax law does not compel them to apply it.


\(^{207}\) One likely reason for this is that contingent nonperiodic payments generally cannot be cast as an advance or repayment of a sum certain. As such, contingent nonperiodic payments are not consistent with a traditional tax law view of what constitutes a payment under a debt or loan instrument. Under case law, debt has been characterized as “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof.” Gilbert v. Comm’r, 248 F.2d 399, 402 (2d Cir. 1957), on remand, 17 T.C.M. 29 (1958), aff’d, 262 F.2d 512 (2d Cir.), cert. denied, 359 U.S. 1002 (1959). See also John Kelley Co. v. Comm’r, 326 U.S. 521 (1946); Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968). In the decades since these decisions, contingent debt instruments have become much more common, both in the commercial arena and in the tax law. See, e.g., Treas. Reg. §1.1275-4.
Embedded Loan Treatment to a contingent nonperiodic payment (as defined in the 2004 proposed regulations). Accordingly, it would be appropriate and helpful to expressly except contingent nonperiodic payments from Embedded Loan Treatment, subject to an anti-abuse provision.

Excepting contingent nonperiodic payments from Embedded Loan Treatment would require defining contingent nonperiodic payments in the regulations. We recommend that Treasury and the Service do so, taking the definition provided in the 2004 proposed regulations as a starting point, and taking into account matters that Treasury and the Service have considered to date with respect to issuance of new proposed regulations governing contingent nonperiodic payments.

We also recommend that the contingent nonperiodic payment exception discussed here not apply to a nonperiodic payment in which the realistic range of possible results is relatively narrow, such as a nonperiodic payment with a very large noncontingent portion and a small contingent portion. We believe that the Embedded Loan anti-abuse rule (with expanded scope as discussed above) may be relied on appropriately limit the application of the contingent nonperiodic payment exception. We also recognize that there may be other ways of achieving this result; Treasury and the Service may have some under consideration in connection with their development of regulations to govern contingent nonperiodic payments. If the Embedded Loan anti-abuse rule will be relied on for this purpose, however, providing an example that involves a payment of the type described in this paragraph would be helpful.

8. Some Considerations Relating to Whether an Exception from Embedded Loan Treatment Should Be Provided for Taxpayers Who Mark NPCs to Market

In response to the request made by Treasury and the Service, we briefly discuss here certain considerations relevant to the question of whether regulations should provide an exception to Embedded Loan Treatment for taxpayers who mark NPCs to market under section 475. These Comments do not provide any specific recommendation with respect to that question, however, because the attorneys participating in the drafting hold differing views.

208 In proposing a timing regime specifically for contingent nonperiodic payments, the 2004 proposed regulations defined a contingent nonperiodic payment as any nonperiodic payment that is not a noncontingent nonperiodic payment. Prop. Reg. § 1.446-3(g)(6)(i)(A). They defined a noncontingent nonperiodic payment as "a nonperiodic payment that either is fixed on or before the end of the taxable year in which a contract commences or is equal to the sum of amounts that would be periodic payments if they are paid when they become fixed (including amounts determined as interest accruals).” Prop. Reg. § 1.446-3(g)(6)(i)(B).

Section 475 provides a system of mark-to-market ("MTM") accounting that is mandatory for dealers in securities, and elective for dealers in commodities and traders in securities or commodities. A taxpayer subject to the MTM rules generally must mark its securities (or commodities) to market each taxable year. MTM accounting represents an exception to the realization requirement that is a longstanding component of the general tax rules governing gain and loss recognition.

A taxpayer applying the MTM rules to securities (an "MTM Taxpayer") who enters into NPCs with Embedded Loans generally will be required to apply MTM accounting to the Embedded Loan component and to the NPC component of each such NPC. For nontax purposes, the NPC and the Embedded Loan will constitute one instrument, and will be neither separately negotiable nor subject to separate valuations.

To compute its annual gain or loss, an MTM Taxpayer treated as a holder of an Embedded Loan will be required to mark two hypothetical instruments to market for tax purposes only. MTM Taxpayers treated as the issuer of (obligor on) an Embedded Loan, however, will only apply MTM accounting to one hypothetical instrument - the NPC component. Taxpayers treated as the obligor on an Embedded Loan will not mark the Embedded Loan to market because regulation section 1.475(c)-2(a)(2) provides that debt instruments issued by a taxpayer are not a "security" for purposes of section 475 in the hands of that taxpayer.

These mark-to-market procedures will add complexity to tax compliance. Providing an exception to the Embedded Loan Treatment for MTM Taxpayers would eliminate this additional complexity.

210 I.R.C. § 475(a)(2) (applicable to non-inventory securities (or commodities). The taxpayer generally will hold its inventory securities at fair market value. I.R.C. § 475(a)(1).


212 Where an NPC contains an embedded loan, the Embedded Loan and the NPC (exclusive of the Embedded Loan) portion both generally constitute "securities" for purposes of section 475. See I.R.C. § 475(c)(2)(C) (debt instruments as securities) and (c)(2)(E) (securities derivatives as securities). See also Temp. Reg. § 1.446-3T(g)(4)(i) (characterizing Embedded Loans as loans, i.e., as indebtedness), Reg. § 1.1275-1(d) (defining "debt instrument" as "any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law"). In some cases, NPCs may constitute commodities for purposes of section 475. See I.R.C. § 475(e)(B). There are also exceptions to section 475’s definitions of securities and commodities; this letter does not discuss them.

213 Similar complexity arises for non-MTM taxpayers when a realization event occurs with respect to an NPC with an Embedded Loan. At that time, the MTM taxpayer will be required to allocate its amount realized between the Embedded Loan and NPC components, and recover its tax basis, if any (which also
In addition to generally recognizing their gain and loss with respect to securities each year, MTM Taxpayers characterize such gain and loss as ordinary.\textsuperscript{214} As a result, MTM Taxpayers generally are indifferent to general tax timing and character rules. This general indifference to tax timing and character rules might be proposed as a reason to question the necessity of applying Embedded Loan Treatment to such taxpayers’ NPCs.

MTM Taxpayers' general indifference to timing and character rules does not extend, however, to interest characterization. An important focus of the Embedded Loan rule -- perhaps its principal focus -- is determining whether certain NPC payments (or adjustments) are treated as interest for tax purposes. The MTM accounting rules of section 475 do not affect whether an item is characterized as interest or as a loan for tax purposes.

Under various interest- and debt-specific tax rules, as discussed above, many tax consequences (which are not general timing and character consequences) are implicated by interest loan characterization. For example, an item's characterization as interest may affect interest expense allocation,\textsuperscript{215} result in interest deduction disallowance or limitation,\textsuperscript{216} or trigger withholding tax.\textsuperscript{217} Loan characterization may affect UBIT liability for exempt organizations,\textsuperscript{218} and section 956 income inclusions for United States shareholders of CFCs.\textsuperscript{219}

Whether a taxpayer applies MTM accounting to its securities ordinarily has no effect on application of these interest- and debt-specific rules to the taxpayer. Providing an exception to the Embedded Loan Treatment for MTM Taxpayers, however, would affect those taxpayers' consequences under these rules.

It appears that an exception to Embedded Loan Treatment for MTM Taxpayers could permit arrangements that are loans in substance to avoid loan (and interest) characterization, which may not be appropriate. Consider these three examples:

\begin{itemize}
  \item must be allocated between the two components. Providing an exception from Embedded Loan Treatment that applies to MTM taxpayers would not mitigate this complexity.
  \item See I.R.C. § 861 and the regulations thereunder.
  \item See, e.g., I.R.C. § 163(e)(3), (e)(5), (h), and (j).
  \item See, e.g., I.R.C. § 1441(b) (Chapter 3 Withholding), and I.R.C. §§ 1471 through 1474 (Chapter 4 Withholding).
  \item See I.R.C. § 514 and the regulations thereunder.
  \item See I.R.C. §§ 951(a)(1)(B) and 956(a).
\end{itemize}
Example 1: US Sub is a domestic corporation. Foreign Parent is a foreign corporation and owns 100% of US Sub's stock. US Sub and Foreign Parent are both MTM Taxpayers, and enter into an NPC under which Foreign Parent makes a $100 million upfront payment to US Sub. US Sub takes the position that no portion of its payments to Foreign Parent is interest subject to disallowance (deferral) under section 163(j).

Example 2: Corporation A and Bank B are MTM Taxpayers and domestic corporations. Corporation A and Bank B enter into an NPC under which (b) Bank B makes a $100 million upfront payment to Corporation A, (b) Corporation A will make periodic payments to Bank B having a value of $7 million per year and $100 million on the day that is four years after the NPC is executed, and (c) all payments from Corporation A to Bank B will be made in stock of Corporation A. Corporation A takes the position that no portion of its payments to Bank is interest subject to disallowance under section 163(l).

Example 3: US Partnership is a domestic partnership and a MTM Taxpayer. US Individual is a US resident who owns a 99% interest in US Partnership. Bank B is a MTM Taxpayer. US Partnership and Bank B enter into an NPC under which Bank B makes a $100 million upfront payment to US Partnership. US Partnership takes the position that no portion of its payments or obligations to Bank B are treated as interest or as a loan. US Individual takes the position that no portion of his or her distributive share of deductions with respect to US Partnership's payments or obligations to Bank B is interest subject to limitation under section 163(d) or disallowance under section 265(a)(2).

While the Service might seek to challenge tax positions such as those described in the three examples above on anti-abuse or similar grounds, it may be difficult for the Service to prevail in such a case where the taxpayer relies on a regulation that excepts MTM Taxpayers from Embedded Loan Treatment.220

Another consideration bearing on the potential addition of an exception for MTM Taxpayers is how that exception would apply in a withholding tax context or in a context where it is not clear to an affected taxpayer whether all parties to an NPC are MTM Taxpayers. These contexts raise the question of whether a workable exception from the Embedded Loan rule may be provided for MTM Taxpayers without conditioning one taxpayer's required tax treatment or withholding obligations on whether its counterparty (or, in the case of a clearing organization, both counterparties) is a MTM Taxpayer.

While these Comments have summarized certain considerations relevant to the question of whether regulations should provide an exception to the Embedded Loan rule for MTM

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220 For example, an MTM Taxpayer might contest the assertion of a principal purpose-based anti-abuse test by arguing that adherence to a statutorily required (or permitted) accounting method under which Embedded Loan Treatment does not apply should not be held to have a principal purpose of tax avoidance.
Taxpayers, it does not provide any recommendation with respect to that question because the attorneys participating in the drafting hold differing views.

III. Conclusion

We commend Treasury and the Service for issuing the 2015 Embedded Loan Regulations; the principle of bright-line guidance that these regulations embrace will help taxpayers and the government determine where to apply Embedded Loan Treatment. The 2015 Embedded Loan Regulations also give rise to ambiguity and practical concerns. These should be addressed in order to improve the regulations' administrability and effectiveness. We are pleased to offer these Comments setting forth recommendations regarding certain matters addressed by these regulations.