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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9719]

RIN 1545–BM62

Notional Principal Contracts; Swaps With Nonperiodic Payments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations amending the treatment of nonperiodic payments made or received pursuant to certain notional principal contracts. These regulations provide that, subject to certain exceptions, a notional principal contract with a nonperiodic payment, regardless of whether it is significant, must be treated as two separate transactions consisting of one or more loans and an on-market, level payment swap. This document also contains temporary regulations regarding an exception from the definition of United States property. These regulations affect parties making and receiving payments under notional principal contracts, including United States shareholders of controlled foreign corporations and tax-exempt organizations. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG–102656–15) on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date.* These regulations are effective on May 8, 2015.

Applicability Date. For the dates of applicability, see §§ 1.446–3T(j)(2) and 1.956–2T(f).

FOR FURTHER INFORMATION CONTACT: Regarding the regulations under section 446, Alexa T. Dubert or Anna H. Kim at (202) 317–6895; regarding the regulations under section 956, Kristine A. Crabtree at (202) 317–6934 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. Embedded Loan Rule

On October 14, 1993, the Treasury Department and the IRS published final regulations (TD 8491) under section 446(b) of the Internal Revenue Code (Code) in the **Federal Register** (58 FR 53125) relating to the timing of income, deduction, gain, or loss with respect to payments, including nonperiodic payments, made or received pursuant to a notional principal contract (NPC) (the 1993 Regulations). See § 1.446–3. Under the 1993 Regulations, when an NPC includes a ''significant'' nonperiodic payment, the contract is generally treated as two separate transactions consisting of an on-market, level payment swap and a loan (the embedded loan rule). The loan must be accounted for by the parties to the contract separately from the swap. The time-value component associated with the loan is recognized as interest for all purposes of the Code.

A nonperiodic payment commonly arises when a party to an NPC makes below-market periodic payments or receives above-market periodic payments under the terms of the contract. A party making below-market periodic payments or receiving above-market periodic payments would also typically be required to make an upfront payment to the counterparty to compensate for the off-market coupon payments specified in the contract. For example, if A and B enter into an off-market interest rate swap the terms of which require A to make periodic below-market, fixed rate payments to B in exchange for A receiving periodic on-market, floating-rate payments from B, then A typically will compensate B for receiving the below-market fixed rate payments by making an upfront payment at the outset of the interest rate swap so that the present value of the fixed rate leg of the swap will equal the present value of the floating rate leg of the swap.

II. Nonperiodic (Upfront) Payments Arising From the Standardization of Contract Terms

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 111–203, 124 Stat. 1376, Title VII (the Dodd-Frank Act), among other things: (1) Provides for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposes clearing and trade execution requirements on many standardized swap contracts; (3) creates rigorous recordkeeping and real-time reporting regimes; and (4) enhances rulemaking and enforcement authority of various federal regulators with respect to entities and intermediaries within their jurisdiction. As part of implementing the Dodd-Frank Act, the Commodity Futures Trading Commission (CFTC) has mandated that certain swap contracts (cleared contracts), including swaps that are NPCs under § 1.446–3, be cleared through U.S.-registered derivatives clearing organizations. The Securities and Exchange Commission (SEC) has not yet mandated clearing of any security-based swaps through clearing agencies (which, together with derivatives clearing organizations, are referred to herein as U.S.-registered clearinghouses).

To facilitate clearing and exchange trading, cleared contracts generally have standardized terms, which often give rise to upfront payments. For example, a Market Agreed Coupon interest rate swap (MAC) has standardized terms, including a standardized coupon rate (or fixed rate). Because the fixed rate is set in advance, it is unlikely that the fixed rate will equal the market rate on the start date of the MAC. Consequently, except for the rare instance when the market rate for a particular MAC equals the fixed rate, a MAC with a standardized coupon rate will be off-market and will require an upfront payment to equalize the present value of the payment obligations under the contract.

Certain over-the-counter markets in swap contracts not subject to clearing with U.S.-registered clearinghouses (uncleared contracts) also have voluntarily begun to adopt terms similar to the MAC, including pre-defined, market-agreed start and end dates, payment dates, and fixed coupons to achieve greater standardization of contract terms. Similar to cleared contracts, these uncleared contracts are resulting in an increasing number of upfront payments.

III. Margin Requirements

As part of establishing a risk-management framework, the SEC, CFTC, and certain other federal regulators (collectively, the Regulators) are required by the Dodd-Frank Act to propose and adopt collateral requirements for cleared contracts and certain uncleared contracts. These requirements are typically referred to as ''margin'' requirements in the context of contracts between entities that are regulated by the Regulators (regulated entities) and, in these temporary regulations, the term ''margin'' is used in the context of cleared and uncleared contracts between regulated entities and the term ''collateral'' is used in the context of uncleared contracts between unregulated entities.

A. Margin Requirements on Cleared Contracts

U.S.-registered clearinghouses manage credit risk (the risk of counterparty default) in part by requiring that each party to a cleared contract provide various types of margin in an amount that fully collateralizes the credit risk on the contract. Because credit risk starts at the inception of the contract and continues throughout the term of the contract, the requirement to exchange margin sufficient to fully collateralize credit risk begins when the parties enter into the contract. To ensure that credit risk on the contract is fully collateralized, the contract is marked to market on a daily basis (beginning on the day the contract is entered into) and margin is exchanged by the parties based on the mark-to-market value.

For example, if A and B enter into a cleared off-market interest rate swap contract the terms of which require A to make periodic below-market, fixed rate payments to B in exchange for A receiving periodic on-market, floating-rate payments from B, then A will make an upfront payment to the clearinghouse (to be passed on to B) so that the present value of the fixed rate leg of the swap will equal the present value of the floating rate leg of the swap. A has credit risk with respect to that payment because, if the clearinghouse (or A's clearing member) were to default, A may not receive the full benefit of receiving on-market, floating rate payments in exchange for making below-market fixed rate payments for the term of the contract. When the U.S.-registered clearinghouse makes the upfront payment to B, the U.S.-registered clearinghouse similarly has credit risk with respect to B (or B's clearing member). To eliminate the credit risk to A and B, the parties are required to post margin. More specifically, B (the ultimate recipient of the upfront payment) is required to make a payment of initial variation margin to the U.S.-registered clearinghouse, generally no later than the end of the business day on which the upfront payment is made, in an amount that is equal (or substantially equal) to the amount of the upfront payment.[1] After receiving B's initial variation margin payment, the U.S.-registered clearinghouse will pay the same amount to A.[2] Consequently, A is fully collateralized on the exposure on the swap contract at the end of the day the upfront payment is made.

In addition to initial variation margin, U.S.-registered clearinghouses manage credit risk by requiring that each party to a cleared contract provide daily variation margin. Daily variation margin is a cash payment made on a daily or intra-day basis between the counterparties to a contract to protect against the risk of counterparty default. The rules of U.S.-registered clearinghouses generally require that daily variation margin be paid in an amount equal to the change in the fair market value of the contract (the mark-to-market value). Thus, A and B will continue to mark to market the cleared contract and exchange daily variation margin based on those values on a daily basis for the entire term of the contract.

B. Margin Requirements on Uncleared Contracts Between Regulated Entities and the Exchange of Collateral on Uncleared Contracts Between Unregulated Entities

The margin requirements proposed by the Regulators for uncleared contracts are expected to appropriately address the credit risk posed by a counterparty that is a regulated entity and the risks associated with an uncleared contract and are expected to be as stringent as those required for cleared contracts.[3] In addition, unregulated entities that enter into uncleared contracts may exchange collateral sufficient to fully collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract (beginning on the day the contract is entered into).

IV. Other Recent Guidance and Comments Regarding the Embedded Loan Rule as Applied to Upfront Payments on Cleared and Uncleared Contracts

The Dodd-Frank Act has led to significant changes in market practices for cleared and uncleared contracts, including the increased volume of cleared and uncleared contracts with upfront payments. Under the 1993 Regulations, the parties to an NPC with an upfront payment are required to determine whether the upfront payment is a significant nonperiodic payment. If the payment is significant, the embedded loan rule will apply. In addition, under the 1993 Regulations, for purposes of section 956 (regarding United States property), the Commissioner may treat any nonperiodic payment, whether or not significant, as one or more loans.

On May 11, 2012, the Treasury Department and the IRS published temporary regulations under section 956 (TD 9589) in the **Federal Register** (77 FR 27612). On the same date, a notice of proposed rulemaking (REG–107548–11) by cross-reference to the temporary regulations was published in the **Federal Register** (77 FR 27669). These regulations excepted from the definition of United States property under section 956 certain obligations arising from upfront payments on cleared contracts with respect to which full initial variation margin is posted (the Section 956 Regulations). In response to the request for comments and, more generally, because of the growing number of upfront payments on cleared and uncleared contracts, the Treasury Department and the IRS have received several comment letters noting the potentially burdensome tax consequences associated with treating an upfront payment as one or more

[1] The total amount of initial variation margin posted by B may not equal the amount of A's upfront payment due to either: (1) The netting of B's notional exposure to A, or to the U.S.-registered clearinghouse, as a result of other transactions; or (2) changes in the value of the contract between the time the contract is entered into and the time when the required margin is paid, requiring daily variation margin to be added to or subtracted from B's initial variation margin payment, as the case may be. However, on a transaction-by-transaction basis, the payment of initial variation margin by B should equal (or closely approximate) A's upfront payment when any daily variation margin is treated as separate from the initial variation margin posted on that day.

[2] In each case, unless A and B are clearing members of the U.S.-registered clearinghouse, the payment is made to or through each party's clearing member (that is, a futures commission merchant, broker, or dealer who is a member of the clearinghouse), which may be an affiliate of that party.

[3] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 (October 3, 2014); Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO), Margin Requirements for Non-centrally Cleared Derivatives (September 2013).

loans. For example, the 1993 Regulations do not define what constitutes a ''significant'' nonperiodic payment. Instead, examples in the 1993 Regulations illustrate contracts with and without significant nonperiodic payments and explain how to determine significance by comparing the nonperiodic payment to the present value of the total amount of payments due under the contract. Commenters have noted that the lack of a definition in the embedded loan rule for when such a payment is significant creates uncertainty and that taxpayers have developed different ways to determine ''significance'' for this purpose.

In addition, commenters have argued that receiving an upfront payment and posting cash margin back to the payor of the upfront payment lacks the most important attribute of indebtedness because the recipient lacks discretion as to the payment's use. Commenters also have raised concerns of increased compliance burdens arising from withholding and information reporting resulting from the increasing number of upfront payments treated as loans. Commenters specifically cite the difficulty of satisfying information reporting on upfront payments arising from cleared contracts because a U.S-registered clearinghouse is interposed between the first party and second party once a contract is submitted and accepted for clearing.

Commenters also have raised concerns that receipt by a tax-exempt organization of an upfront payment arising from entering into a standardized cleared or uncleared contract (the loan separated from the on-market swap under the embedded loan rule) may cause income earned on the tax-exempt organization's deployment of the upfront payment to constitute unrelated business taxable income under the debt-financed property rules of section 514. Finally, commenters have requested that the exception in the Section 956 Regulations be extended to uncleared contracts with upfront payments with respect to which full initial variation margin is posted.

Explanation of Provisions

The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**. The temporary regulations under section 446 simplify the embedded loan rule and provide two exceptions to that rule. The temporary regulations under section 956 provide an exception to the definition of United States property with respect to certain notional principal contracts subject to margin or collateral requirements as described in the temporary regulations under section 446.

I. Simplification of the Embedded Loan Rule

Because excepting non-significant nonperiodic payments from the embedded loan rule is not functioning as a rule of administrative convenience as intended, these temporary regulations eliminate that exception. Instead, other than contracts for which there is an explicit exception, the temporary regulations treat all notional principal contracts that have nonperiodic payments as including one or more loans. The Treasury Department and the IRS have determined that, unless an exception applies, the economic loan that is inherent in a nonperiodic payment should be taxed as one or more loans, and that it is reasonable to require taxpayers to separate the loan or loans from an NPC in the case of any nonperiodic payment, regardless of the relative size of such payment. Taxpayers may implement this change upon publication in the **Federal Register**, but for those taxpayers that need additional time, the temporary regulations delay the applicability date of this rule until November 4, 2015.

II. Exceptions to the Embedded Loan Rule

The temporary regulations provide two independent exceptions from the embedded loan rule. First, except for purposes of sections 514 and 956, the temporary regulations provide an exception for a nonperiodic payment made under an NPC with a term of one year or less (short-term exception).

Second, the temporary regulations provide an exception for certain NPCs with nonperiodic payments that are subject to prescribed margin or collateral requirements. The embedded loan rule is intended to address situations when one party to a contract provides cash to the counterparty and is compensated for that cash with a direct or indirect interest payment. The Treasury Department and the IRS have concluded, however, that the same concerns do not exist when a party pays or receives an upfront payment and must immediately collect or post an equivalent amount of cash margin or collateral. Accordingly, in those circumstances, the Treasury Department and the IRS have determined that the embedded loan rule should not apply to the upfront payment.

In order to qualify for the exception, the regulations require both that the margin or collateral posted and collected be paid in cash and that the parties to the contract be required to post and collect margin or collateral in an amount that fully collateralizes 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. The mark-to-market exposure on a cleared contract will be fully collateralized only if the contract is subject to both initial variation margin in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin in an amount equal to the daily change in the fair market value of the contract, and on an uncleared contract if it is subject to equivalent margin or collateral requirements (full margin exception). A taxpayer may use the full margin exception without regard to whether the contract qualifies for the short-term exception.

The Treasury Department and the IRS request comments on whether there are other circumstances in which the embedded loan rule should not apply. For example, there may be circumstances in which time value is appropriately accounted for under the contract because applying the embedded loan rule would not alter the tax consequences of the contract. In particular, the Treasury Department and the IRS request comments on whether it is necessary to require taxpayers to apply the embedded loan rule to NPCs with nonperiodic payments that are subject to mark-to-market accounting.

Finally, the Treasury Department and the IRS request comments on all other aspects of the temporary and proposed rules, including but not limited to any anticipated effects on market participants' behavior, the applicability of the full margin exception only in cases in which cash margin is posted, or possible effects on the goal of the Dodd-Frank Act to encourage centralized clearing of swaps.

III. Exception to the Definition of United States Property

The temporary regulations under section 956 provide an exception to the definition of United States property for certain obligations of United States persons arising from upfront payments made with respect to notional principal contracts that qualify for the full margin exception to the embedded loan rule in the temporary regulations under section 446. To qualify for the United States property exception, the upfront payment must be made by a controlled foreign corporation (as defined in section 957(a)) that is either a dealer in securities under section 475(c)(1) or a dealer in commodities.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13653. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small entities.

Drafting Information

The principal authors of these regulations are Alexa T. Dubert and Anna H. Kim of the Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.446–3 is amended by:

■ 1. Revising paragraph (g)(4).

■ 2. Revising paragraph (g)(6), *Examples 2, 3* and *4.*

■ 3. Redesignating paragraph (j) as (j)(1) and revising the paragraph heading of paragraph (j)(1).

■ 4. Adding paragraphs (j)(2) and (k).

The revisions and addition to read as follows:

§ 1.446–3 Notional principal contracts.

* * * * *

(g) * * *

(4) [Reserved]. For further guidance, see § 1.446–3T(g)(4).

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(6) * * *

Example 2. [Reserved]. For further guidance, see § 1.446–3T(g)(6), *Example 2.*

Example 3. [Reserved]. For further guidance, see § 1.446–3T(g)(6), *Example 3.*

Example 4. [Reserved]. For further guidance, see § 1.446–3T(g)(6), *Example 4.*

* * * * *

(j) *Effective/applicability date*—(1) * * *

(2) [Reserved]. For further guidance, see § 1.446–3T(j)(2).

(k) [Reserved]. For further guidance, see § 1.446–3(k).

■ **Par. 3.** Section 1.446–3T is added to read as follows:

§ 1.446–3T Notional principal contracts (temporary).

(a) through (g)(3) [Reserved]. For further guidance, see § 1.446–3(a) through (g)(3).

(4) *Notional principal contracts with nonperiodic payments*—(i) *General rule.* Except as provided in paragraph (g)(4)(ii) of this section, a notional principal contract with one or more nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and one or more loans. The loan(s) must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan(s) is not included in the net income or net deduction from the swap under § 1.446–3(d), but it is recognized as interest for all purposes of the Internal Revenue Code. See paragraph (g)(6) *Example 2* of this section.

(ii) *Exceptions*—(A) *Notional principal contract with a term of one year or less*—(*1*) *General rule.* Except for purposes of sections 514 and 956, paragraph (g)(4)(i) of this section does not apply to a notional principal contract if the term of the contract is one year or less. For purposes of this paragraph (g)(4)(ii)(A), the term of a notional principal contract is the stated term of the contract, inclusive of any extensions (optional or otherwise) provided for in the terms of the contract, without regard to whether any extension is unilateral, is subject to approval by one or both parties to the contract, or is based on the occurrence or non-occurrence of a specified event.

(*2*) *Anti-abuse rule.* For purposes of determining the term of a contract under paragraph (g)(4)(ii)(A)(*1*) of this section, the Commissioner may treat two or more contracts as a single contract if a principal purpose of entering into separate contracts is to qualify for the exception set forth in paragraph (g)(4)(ii)(A)(*1*) of this section. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(B) *Notional principal contract subject to margin or collateral requirements.* Subject to the requirements in paragraph (g)(4)(ii)(C) of this section, paragraph (g)(4)(i) of this section does not apply to a notional principal contract if the contract is described in paragraph (g)(4)(ii)(B)(*1*) or (*2*) of this section. See § 1.956–2T(b)(1)(xi) for a related exception under section 956.

(*1*) The contract is cleared by a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or by a clearing agency (as such term in defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)) that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, and the derivatives clearing organization or clearing agency requires the parties to the contract 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) on a daily basis for the entire term of the contract. The mark-to-market exposure on a contract will be fully collateralized only if the contract is subject to both initial variation margin in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin in an amount equal to the daily change in the fair market value of the contract. See paragraph (g)(6) *Example 3* of this section.

(*2*) The parties to the contract are required, pursuant to the terms of the contract or the requirements of a federal regulator, 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) on a daily basis for the entire term of the contract. The mark-to-market exposure on a contract will be fully collateralized only if the contract is subject to both initial variation margin or collateral in an amount equal to the nonperiodic payment (except for variances permitted by intraday price changes) and daily variation margin or collateral in an amount equal to the daily change in the fair market value of the contract. For purposes of this paragraph (g)(4)(ii)(B)(*2*), the term ''federal regulator'' means the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Act. See paragraph (g)(6) *Example 4* of this section.

(C) *Limitations and special rules*—(*1*) *Cash requirement.* A notional principal contract is described in paragraph (g)(4)(ii)(B) of this section only to the extent the parties post and collect margin or collateral to fully collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment) by paying and receiving the required margin or collateral in cash. The term ''cash'' includes U.S. dollars or cash in any currency in which payment obligations under the notional principal contract are denominated.

(*2*) *Excess margin or collateral.* 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.

(*3*) *Margin or collateral paid and received in cash and other property.* If the parties to the contract post and collect both cash and other property to satisfy margin or collateral requirements to collateralize the mark-to-market exposure on the contract (including the exposure on the nonperiodic payment), any excess of the nonperiodic payment over the cash margin or collateral posted and collected is subject to the rule in paragraph (g)(4)(i) of this section.

(5) [Reserved]. For further guidance, see § 1.446–3(g)(5).

(6) *Examples* through *Example 1.* [Reserved]. For further guidance, see § 1.446–3(g)(6), *Examples* through *Example 1.*

Example 2. Nonperiodic payment. (i) On January 1, 2016, unrelated parties M and N enter into an interest rate swap contract. Under the terms of the contract, N agrees to make five annual payments to M equal to LIBOR times a notional principal amount of $100 million. In return, M agrees to pay N 6% of $100 million annually, plus an upfront payment of $15,163,147 on January 1, 2016. At the time M and N enter into the contract, the rate for similar on-market swaps is LIBOR to 10%, and N provides M with information that the amount of the upfront payment was determined as the present value, at 10% compounded annually, of five annual payments from M to N of $4,000,000 (4% of $100,000,000). The contract does not require the parties to post and collect margin or collateral to collateralize the mark-to-market exposure on the contract on a daily basis for the entire term of the contract.

(ii) The exceptions in paragraphs (g)(4)(ii)(A) and (B) of this section do not apply. Under paragraph (g)(4)(i) of this section, the transaction is recharacterized as consisting of both a $15,163,147 loan from M to N that N repays in installments over the term of the contract and an interest rate swap between M and N in which M immediately pays the installment payments on the loan back to N as part of its fixed payments on the swap in exchange for the LIBOR payments by N.

(iii) The upfront payment is recognized over the life of the contract by treating the $15,163,147 as a loan that will be repaid with level payments over five years. Assuming a constant yield to maturity and annual compounding at 10%, M and N account for the principal and interest on the loan as follows:

	Level payment	Interest component	Principal component
2016	$4,000,000	$1,516,315	$2,483,685
2017	4,000,000	1,267,946	2,732,054
2018	4,000,000	994,741	3,005,259
2019	4,000,000	694,215	3,305,785
2020	4,000,000	363,636	3,636,364
	20,000,000	4,836,853	15,163,147

(iv) M recognizes interest income, and N claims an interest deduction, each taxable year equal to the interest component of the deemed installment payments on the loan. These interest amounts are not included in the parties' net income or net deduction from the swap contract under § 1.446–3(d). The principal components are needed only to compute the interest component of the level payment for the following period and do not otherwise affect the parties' net income or net deduction from this contract.

(v) N also makes swap payments to M based on LIBOR and receives swap payments from M at a fixed rate that is equal to the sum of the stated fixed rate and the rate calculated by dividing the deemed level annual payments on the loan by the notional principal amount. Thus, the fixed rate on this swap is 10%, which is the sum of the stated rate of 6% and the rate calculated by dividing the annual loan payment of $4,000,000 by the notional principal amount of $100,000,000, or 4%. Using the methods provided in § 1.446–3(e)(2), the fixed swap payments from M to N of $10,000,000 (10% of $100,000,000) and the LIBOR swap payments from N to M are included in the parties' net income or net deduction from the contract for each taxable year.

Example 3. Full margin—cleared contract. (i) A, a domestic corporation enters into an interest rate swap contract with unrelated counterparty B. The contract is required to be cleared and is accepted for clearing by a U.S.-registered derivatives clearing organization (DCO). The standardized terms of the contract provide that A, for a term of X years, will pay B a fixed coupon of 1% per year and receive a floating coupon on a notional principal amount of $Y. When A and B enter into the interest rate swap, the market coupon for similar interest rate swaps is 2% per year. The DCO requires A to make an upfront payment to compensate B for the below-market annual coupon payments that B will receive, and A makes the upfront payment in cash. The DCO also requires B to post initial variation margin in an amount equal to the upfront payment and requires each party to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract. B posts the initial variation margin in U.S. dollars, and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in paragraph (g)(4)(ii)(B)(*1*) of this section and paragraph (g)(4)(i) of this section does not apply to the contract.

Example 4. Full margin—uncleared contract. (i) On June 1, 2016, P, a domestic corporation, enters into an interest rate swap contract with an unrelated domestic counterparty, CP. Under the terms of the contract, CP agrees to make five annual payments to P equal to a specified contract rate of 3% times the notional amount of $10,000,000 plus an upfront payment of $1,878,030. In exchange, P agrees to make five annual payments to CP equal to the same notional amount times LIBOR. At the time the parties enter into the contract, the fixed rate for an on-market swap is 7.52%. The contract is not required to be cleared and is not accepted for clearing by a U.S.-registered derivatives clearing organization. However, pursuant to the terms of the contract, P is obligated to post $1,878,030 as collateral with CP, and P and CP are obligated to post and collect collateral each business day in an amount equal to the daily change in the fair market value of the contract for the entire term of the contract. All collateral on the contract is required to be in U.S. dollars.

(ii) Because the contract is required to be collateralized in an amount equal to the upfront payment and changes in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in paragraph (g)(4)(ii)(B)(*2*) of this section and paragraph (g)(4)(i) of this section does not apply to the contract.

(h) through (j)(1) [Reserved]. For further guidance, see § 1.446–3(h) through (j)(1).

(2) *Application of § 1.446–3T(g)(4).* The rules provided in paragraph (g)(4)(i) of this section apply to notional principal contracts entered into on or after November 4, 2015. Taxpayers may apply the rules provided in paragraph (g)(4)(i) of this section to notional principal contracts entered into before November 4, 2015. The rules provided in paragraph (g)(4)(ii) of this section apply to notional principal contracts entered into on or after May 8, 2015. Taxpayers may apply the rules provided in paragraph (g)(4)(ii) of this section to notional principal contracts entered into before May 8, 2015. For the rules that apply to notional principal contracts with nonperiodic payments entered into before the dates set forth in this paragraph (j)(2), see § 1.446–3(g)(4) as contained in 26 CFR part 1, revised April 1, 2015.

(k) *Expiration date.* The applicability of paragraph (g)(4) of this section and paragraph (g)(6) *Examples 2, 3* and *4* of this section expires May 7, 2018.

■ **Par. 4.** Section 1.956–2T is amended by revising paragraphs (b)(1)(xi), (f) and (g) to read as follows:

§ 1.956–2T Definition of United States property (temporary).

* * * * *

(b) * * *

(1) * * *

(xi) An obligation of a United States person arising from a nonperiodic payment by a controlled foreign corporation (within the meaning of section 957(a)) with respect to a notional principal contract described in § 1.446–3T(g)(4)(ii)(B)(*1*) or (*2*) if the following conditions are satisfied—

(A) The controlled foreign corporation that makes the nonperiodic payment is either a dealer in securities (within the meaning of section 475(c)(1)) or a dealer in commodities; and

(B) The conditions set forth in § 1.446–3T(g)(4)(ii)(C)(*1*) (relating to full margin or collateral in cash) are satisfied.

(C) *Examples.* The following examples illustrate the application of this paragraph (b)(1)(xi):

Example 1. Full margin—cleared contract. (i) A domestic corporation (U.S.C.) wholly owns a controlled foreign corporation (CFC) that is a dealer in securities under section 475(c)(1). CFC enters into an interest rate swap contract with unrelated counterparty B. The contract is required to be cleared and is accepted for clearing by a U.S.-registered derivatives clearing organization (DCO). CFC is not a member of the DCO. CFC uses a U.S. affiliate (CM), which is a member of the DCO, as its clearing member to submit the contract to be cleared. CM is a domestic corporation that is wholly owned by U.S.C.. The standardized terms of the contract provide that, for a term of X years, CFC will pay B a fixed coupon of 1% per year and receive a floating coupon on a notional principal amount of $Y. When CFC and B enter into the contract, the market coupon for similar interest rate swaps is 2% per year. The DCO requires CFC to make an upfront payment to compensate B for the below-market annual coupon payments that B will receive, and CFC makes the upfront payment in cash. CFC makes the upfront payment through CM to the DCO, which then makes the payment to B. The DCO also requires B to post initial variation margin in an amount equal to the upfront payment and requires each party to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract. B posts the initial variation margin in U.S. dollars, which is received by CFC (through DCO and CM), and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in § 1.446–3T(g)(4)(ii)(B)(*1*). Furthermore, because the additional conditions set forth in this paragraph (b)(1)(xi) are satisfied, the obligation of CM arising from the upfront payment by CFC does not constitute United States property for purposes of section 956.

Example 2. Full margin—uncleared contract. (i) Assume the same facts as in *Example 1,* except for the following. CFC's counterparty to the contract is U.S.C., CM is not involved, and the contract is not required to be cleared and is not accepted for clearing by a U.S.-registered derivatives clearing organization. The contract requires CFC to make an upfront payment to compensate U.S.C. for the below-market annual coupon payments that U.S.C. will receive, and CFC makes the upfront payment in U.S. dollars. Pursuant to the requirements of a federal regulator, U.S.C. is obligated to post initial variation margin with CFC in an amount equal to CFC's upfront payment, and U.S.C. and CFC are obligated to post and collect daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract. U.S.C. posts the initial variation margin in U.S. dollars, which is received by CFC, and the parties post and collect daily variation margin in U.S. dollars.

(ii) Because the contract is subject to initial variation margin in an amount equal to the upfront payment and daily variation margin in an amount equal to the change in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in § 1.446–3T(g)(4)(ii)(B)(*2*). Furthermore, because the additional conditions set forth in this paragraph (b)(1)(xi) are satisfied, the obligation of U.S.C. arising from the upfront payment by CFC does not constitute United States property for purposes of section 956.

* * * * *

(f) *Effective/applicability date.* Paragraph (b)(1)(xi) of this section applies to payments described in § 1.956–2T(b)(1)(xi) made on or after May 8, 2015. Taxpayers may apply the rules of paragraph (b)(1)(xi) to payments made before May 8, 2015.

(g) *Expiration date.* The applicability of paragraph (b)(1)(xi) of this section expires on May 7, 2018.

John M. Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: April 29, 2015.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 117

[Docket No. USCG–2015–0366]

Drawbridge Operation Regulation; Navesink (Swimming) River, Middletown and Rumson, NJ

AGENCY: Coast Guard, DHS.

ACTION: Notice of deviation from drawbridge regulation.

SUMMARY: The Coast Guard has issued a temporary deviation from the operating schedule that governs the operation of the Oceanic Bridge across the Navesink (Swimming) River, mile 4.5, between Middletown and Rumson, New Jersey. This deviation allows the bridge owner to perform structural repairs at the bridge. This deviation allows the bridge to open only one of the two moveable spans for passage of vessels traffic. This temporary deviation would help facilitate repairs to the bascule span bearing while continuing to meet the reasonable needs of navigation.

DATES: This deviation is effective from May 26, 2015 through June 12, 2015.

ADDRESSES: The docket for this deviation, [USCG–2015–0366] is