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Notional Principal Contracts Regulations Offer Relief from Embedded Loan Rule

Treasury recently issued temporary regulations (which also serve as proposed regulations) amending the treatment of upfront, nonperiodic payments made or received pursuant to notional principal contracts ("NPC"). These temporary regulations provide that, subject to certain broadly applicable exceptions, an NPC 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.

These regulations are part of a larger publication project addressing the timing of contingent nonperiodic NPC payments addressed in 2004 proposed regulations. The Internal Revenue Service ("IRS") has indicated that it expects to publish the rest of the regulations in the near future.

Background

Final regulations issued in 1993 by Treasury provided that, where a significant nonperiodic payment was made by one party to another pursuant to an NPC, the payment was treated as a loan from the payor to the recipient. This "embedded loan" rule provides that the time value component associated with the loan is treated as interest income and expense, imputed to the parties, for all purposes, including for example withholding taxes. Upfront, nonperiodic payments are typically made because the terms of an NPC are "off market," i.e. the contract provides for a fixed rate payment that is not in line with the prevailing rate. Upfront, nonperiodic payments may also arise in a credit default swap that is being treated as an NPC.

The 1993 final regulations do not provide a definition of the term "significant," which has caused concern over the years.

Regulatory developments in the swaps market

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") imposes clearing and trade execution requirements on many standardized swap contracts. As part of implementing Dodd-Frank, the Commodity Futures Trading Commission ("CFTC") has mandated that certain swap contracts including NPCs be cleared through U.S.-registered derivatives clearing organizations. The US Securities and Exchange Commission has not yet mandated the clearing of any security-based swaps. To facilitate clearing and exchange trading, cleared contracts generally have standardized terms, which often give rise to upfront payments. Certain over-the-counter ("OTC") markets that are not yet subject to clearing rules have voluntarily begun to adopt standardized terms, further increasing the likelihood of upfront payments.

In addition, Dodd-Frank provides for the establishment of margin (in the case of cleared swaps) or collateral (in the case of uncleared swaps) requirements for swap contracts. These rules have the effect of causing cash to change hands between the parties at the commencement of a contact as well as during the term.

The impact of these Dodd-Frank rule changes is that many more contracts will have upfront payments that may be subject to the embedded loan rule for NPCs.

Impact of the new regulations

In response to comments received by Treasury over the years since 1993, and in particular to the information reporting obstacles when a clearing organization is imposed between the parties to a NPC, the temporary regulations seek to simplify the application of the embedded loan rule in several important ways:

1. Eliminate the exception from the embedded loan rule for non-significant periodic payments (thus eliminating the need to determine what is and what is not significant), which means that all NPCs with nonperiodic payments will be treated as having one or more embedded loans (unless the NPC falls within an exception below),

2. Provide an exception to the embedded loan rule for all NPCs with a term of one year or less (the "short term exception"), subject to a carve out relevant for tax exempt organizations,

3. Provide an exception to the embedded loan rule for all NPCs where there is an upfront payment made and the NPC is also subject to margin or collateral requirements, provided that the margin or collateral is posted in cash and that such margin or collateral fully collateralizes the mark-to-market exposure on the contract for the entire term of the contract (the "full margin exception").

These temporary regulations should have the desired effect of simplifying the embedded loan rules, and many taxpayers will be in a position to take advantage of the exceptions. In particular, tax exempt organizations that are parties to an NPC either directly or through a fund should be relieved from having unrelated business taxable income ("UBTI") from an embedded loan in an NPC that qualifies for the full margin exception; importantly, the short term exception is not available for purposes of the UBTI rules.

The temporary regulations do not provide a de minimis exemption from the embedded loan rule. Thus, a taxpayer that enters into an OTC NPC that does not meet the collateral requirements of the temporary regulations must treat the upfront payment under the embedded loan rule, and must consider all of the consequences of having interest income or expense as a result of the deemed loan.

In addition, the temporary regulations do not specifically provide an exemption from the embedded loan rule for NPCs that are marked to market for tax purposes, although in practice many of these contracts may still qualify for one of the exceptions discussed above. The Treasury Department and the IRS specifically requested comments on whether taxpayers that mark to market NPCs with non-periodic payments should be exempt from the embedded loan rule.

Effective dates

The general rule providing that all non-periodic payments are treated as embedded loans is effective for NPCs entered into on or after 180 days after May 8, 2015; however, taxpayers can apply the rule retroactively to NPCs entered into before that date. The new exceptions to the embedded loan rule apply to NPCs entered into on or after May 8, 2015, but taxpayers can apply those exceptions retroactively to NPCs entered into before that date.

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