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Regulations provide exception to “United States property” for upfront payments on certain notional principal contracts

The Treasury Department and IRS today released for publication in the *Federal Register* temporary regulations ([T.D. 9589](#)) and, by cross-reference, proposed regulations ([REG-107548-11](#)) concerning the federal income tax treatment of upfront payments made pursuant to notional principal contracts.

The temporary regulations establish an exception to the definition of “United States property” (as defined under section 956(c)) for obligations of “United States persons” arising from certain upfront payments made by a controlled foreign corporation (CFC) that is a dealer in securities or commodities with respect to certain contracts that are properly classified as notional principal contracts for U.S. federal income tax purposes and are cleared by a derivative clearing organization or clearing agency.

Background

Section 956 requires U.S. shareholders of a CFC that invests certain earnings and profits in “United States property” to include the amount of the earnings and profits into income because they are deemed to be substantially the equivalent of a dividend.

The amount to be included under section 956 is the lesser of:

- The shareholder's pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter of such tax year, less the amount of earnings and profits of the CFC with respect to the shareholder
- The shareholder's pro rata share of the applicable earnings of the CFC

Under these rules, “United States property” is defined to include the stock of a domestic corporation and an obligation of a U.S. person. The term “obligation” includes any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness—whether or not issued at a discount and whether or not bearing interest.

When a notional principal contract includes a significant non-periodic payment, the contract is generally treated as two separate transactions:

- One is an on-market, level payment swap;
- The other is a loan.

If a party to a notional principal contract makes below-market periodic payments or receives above-market periodic payments under the terms of the contract, typically that party will make a nonperiodic payment—such as an upfront payment—to the counterparty in order to compensate for the off-market coupon payments specified in the contract.

As explained in the preamble to today's release, Treasury and the IRS have observed that certain contracts (cleared contracts)—including some credit default swaps and interest rate swaps—have begun to be cleared through U.S.-registered derivatives clearing organizations or clearing agencies. Contracts cleared through a U.S.-registered clearinghouse generally are required to have standardized terms.

Consequently, except in rare instances when the market coupon rate for a particular credit default swap is exactly 100 or 500 basis points, a credit default swap with a standardized coupon will be off-market and will require an upfront payment to equalize the present value of the payment obligations under the contract. It is expected that the volume of contracts cleared by U.S.-registered clearinghouses will increase substantially as a result of the Dodd-Frank Act.

Temporary regulations provide an exception

The temporary regulations establish an exception to the definition of U.S. property for obligations of U.S. persons arising from upfront payments made with respect to certain cleared contracts that are properly classified as notional principal contracts.

Accordingly, the temporary regulations provide that obligations of U.S. persons arising from such upfront payments by a CFC that is a dealer in securities or commodities do not constitute U.S. property for purposes of section 956(a).

To qualify for the exception:

- The upfront payment must be required under a contract that is cleared by a derivatives clearing organization under the Commodity Exchange Act (or a clearing agency that is registered as a clearing agency under the Securities Exchange Act of 1934).

- The CFC must make the upfront payment to or through a U.S. person that is a clearing member of the derivatives clearing organization or clearing agency, or directly to the derivatives clearing organization or clearing agency if the CFC is a clearing member of such derivatives clearing organization or clearing agency.
- The upfront payment must be made, directly or indirectly, to the counterparty to the contract.
- The counterparty to the contract must be required to make (on the same day that the CFC makes the upfront payment) a payment to the derivatives clearing organization or clearing agency in the nature of initial variation margin that is equal (before taking into account any change in the value of the contract between the time the contract is entered into and the time at which the payment is made) to the amount of the upfront payment made by the CFC.
- The payment in the nature of initial variation margin must be paid, directly or indirectly, to the CFC.

As stated in the preamble to the temporary regulations, Treasury and the IRS do not believe that an obligation of a U.S. person created by an upfront payment resulting from a cleared contract that satisfies these requirements is the type of transaction intended to be covered by section 956—whether or not the payment is treated as a loan under the notional principal contract rules of section 446.

While the section 956 exception in today's temporary regulations currently is limited to cleared contracts, Treasury and the IRS intended to continue to study this area and request comments on whether and under what circumstances it would be appropriate to extend the exception to contracts that are not cleared by a U.S.-registered clearinghouse, but that would otherwise meet the criteria set forth in these temporary regulations.

Effective date

The temporary regulations apply to payments made on Friday, May 11, 2012—the date when they will be published in the Federal Register. Alternatively, taxpayers may apply the rules of these regulations retroactively to payments made before May 11, 2012.

Concerning the proposed regulations, comments and requests for a public hearing must be received by a date that is 90 days after they are published in the *Federal Register*, also on May 11, 2012.

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