agreement under paragraph (f)(2) of this section.

*Example 3. Assignment of swap with yield adjustment fee.* (a) The facts are the same as in *Example 2*, except that on January 1, 1995, *Q* paid *P* a yield adjustment fee to enter into the seven year interest rate swap. In accordance with paragraph (f)(2) of this section, *P* and *Q* included the ratable daily portions of that nonperiodic payment in their net income or net deduction from the contract for 1995 and 1996. On January 1, 1997, $300,000 of the nonperiodic payment has not yet been recognized by *P* and *Q*.

(b) Under paragraph (h)(2) of this section, *P* recognizes a loss of $1,595,393 ($1,895,393–$300,000) in 1997. *R* accounts for the termination payment in the same way it did in *Example 2*; the existence of an unamortized payment with respect to the original swap has no effect on *R*.

*Example 4. Assignment of one leg of a swap.* (a) On January 1, 1995, *S* enters into an interest rate swap agreement with unrelated counterparty *T* under which, for a term of five years, *S* will make annual payments at 10% and *T* will make annual payments at LIBOR on a notional principal amount of $50 million. On January 1, 1996, unrelated party U pays *T* $15,849,327 for the right to receive the four remaining $5,000,000 payments from *S*. Under the terms of the agreement between *S* and *T*, *S* is notified of this assignment, and *S* is contractually bound thereafter to make its payments to *U* on the appropriate payment dates. *S*'s obligation to pay *U* is conditioned on *T* making its LIBOR payment to *S* on the appropriate payment dates.

(b) Because *T* has assigned to *U* its rights to the fixed rate payments, but not its floating rate obligations under the notional principal contract, *U*'s payment to *T* is not a termination payment as defined in paragraph (h)(1) of this section, but is covered by paragraph (h)(4)(i) of this section. The economic substance of the transaction between *T* and *U* is a loan that does not affect the way that *S* and *T* account for the notional principal contract under this section.

(i) *Anti-abuse rule.* If a taxpayer enters into a transaction with a principal purpose of applying the rules of this section to produce a material distortion of income, the Commissioner may depart from the rules of this section as necessary to reflect the appropriate timing of income and deductions from the transaction.

(j)(1) *Effective/applicability date.* These regulations are effective for notional principal contracts entered into on or after December 13, 1993.

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

[T.D. 8491, 58 FR 53128, Oct. 14, 1993; 59 FR 9411, Feb. 28, 1994, as amended by T.D. 8554, 59 FR 36358, July 18, 1994; T.D. 9719, 80 FR 26440, May 8, 2015; 80 FR 34051, June 15, 2015]

## §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).* Paragraph (g)(4)(i) of this section and paragraph (g)(6) *Example 2* of this section apply to notional principal contracts entered into on or after the later of January 1, 2017, or 180 days after the date of publication of the Treasury decision adopting these rules as final regulations in the FEDERAL REGISTER. Paragraph (g)(4)(ii) of this section applies to notional principal contracts entered into on or after May 8, 2015. However, before the later of January 1, 2017, or 180 days after the date of publication of the Treasury decision adopting paragraph (g)(4)(i) of this section as final regulations in the FEDERAL REGISTER, taxpayers may rely on the provision in §1.446–3(g)(4), as contained in 26 CFR part 1, revised April 1, 2015, which (except for purposes of section 956) limits the application of the embedded loan rule to nonperiodic payments that are significant, even if the requirements for the exceptions in paragraph (g)(4)(ii) of this section are not met. Taxpayers may apply paragraph (g)(4)(i) of this section, paragraph (g)(4)(ii) of this section, or both to notional principal contracts entered into before the dates set forth in this paragraph (j)(2).

(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.

[T.D. 9719, 80 FR 26440, May 8, 2015, as amended by 80 FR 61308, Oct. 13, 2015]

## § 1.446–4 Hedging transactions.

(a) *In general.* Except as provided in this paragraph (a), a hedging transaction as defined in §1.1221–2(b) (whether or not the character of gain or loss from the transaction is determined under §1.1221–2) must be accounted for under the rules of this section. To the extent that provisions of any other regulations governing the timing of income, deductions, gain, or loss are inconsistent with the rules of this section, the rules of this section control.

(1) *Trades or businesses excepted.* A taxpayer is not required to account for hedging transactions under the rules of this section for any trade or business in which the cash receipts and disbursements method of accounting is used or in which §1.471–6 is used for inventory valuations if, for all prior taxable years ending on or after September 30, 1993, the taxpayer met the $5,000,000 gross receipts test of section 448(c) (or would have met that test if the taxpayer were a corporation or partnership). A taxpayer not required to use the rules of this section may nonetheless use a method of accounting that is consistent with these rules.

(2) *Coordination with other sections.* This section does not apply to—

(i) Any position to which section 475(a) applies;

(ii) An integrated transaction subject to §1.1275–6;

(iii) Any section 988 hedging transaction if the transaction is integrated under §1.988–5 or if other regulations issued under section 988(d) (or an advance ruling described in 1.988–5(e))