

*Example.* Allocation of unstated interest to deferred payments—(i) *Facts.* On July 1, 1996, A sells his personal residence to B for a stated purchase price of \$1,297,143.66. The property is not personal use property (within the meaning of section 1275(b)(3)) in the hands of B. Under the loan agreement, B is required to make two installment payments of \$648,571.83 each, the first due on June 30, 1998, and the second due on June 30, 2000. Both A and B use the cash receipts and disbursements method of accounting and use a calendar year for their taxable year.

(ii) *Amount of unstated interest.* Under section 483, the agreement does not provide for adequate stated interest. Thus, the loan's yield is the test rate of interest determined under § 1.483-3. Assume that both A and B use annual accrual periods and that the test rate of interest is 9.2 percent, compounded annually. Under § 1.483-2, the present value of the deferred payments is \$1,000,000. Thus, the agreement has unstated interest of \$297,143.66.

(iii) *First two accrual periods.* Under paragraph (d)(1) of this section, the issue price at the beginning of the first accrual period is \$1,000,000 (the amount described in § 1.483-2(a)(1)(i)). Under paragraph (c) of this section, the amount of interest that accrues for the first accrual period is \$92,000 ( $\$1,000,000 \times .092$ ) and the amount of interest that accrues for the second accrual period is \$100,464 ( $\$1,092,000 \times .092$ ). Thus, \$192,464 of interest has accrued as of the end of the second accrual period. Under paragraph (e)(1) of this section, the \$648,571.83 payment made on June 30, 1998, is treated first as a payment of interest to the extent of \$192,464. The remainder of the payment (\$456,107.83) is treated as a payment of principal. Both A and B take the payment of interest (\$192,464) into account in 1998.

(iv) *Second two accrual periods.* The adjusted issue price at the beginning of the third accrual period is \$543,892.17 ( $\$1,092,000 + \$100,464 - \$648,571.83$ ). The amount of interest that accrues for the third accrual period is \$50,038.08 ( $\$543,892.17 \times .092$ ) and the amount of interest that accrues for the final accrual period is \$54,641.58, the excess of the amount payable at maturity (\$648,571.83), over the adjusted issue price at the beginning of the accrual period (\$593,930.25). As of the date the second payment becomes due, \$104,679.66 of interest has accrued. Thus, of the \$648,571.83 payment made on June 30, 2000, \$104,679.66 is treated as interest and \$543,892.17 is treated as principal. Both A and B take the payment of interest (\$104,679.66) into account in 2000.

(i) [Reserved]

(j) *Effective date.* This section applies to debt instruments issued on or after April 4, 1994, and to lending transactions, sales, and exchanges that

occur on or after April 4, 1994. Taxpayers, however, may rely on this section for debt instruments issued after December 21, 1992, and before April 4, 1994, and for lending transactions, sales, and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994]

**§ 1.446-3 Notional principal contracts.**

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*§ 1.446-3 Notional principal contracts.*

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(b) *Purpose.* The purpose of this section is to enable the clear reflection of the income and deductions from notional principal contracts by prescribing accounting methods that reflect the economic substance of such contracts.

(c) *Definitions and scope*—(1) *Notional principal contract*—(i) *In general.* A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself. Notional principal contracts governed by this section include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. A collar is not itself a notional principal contract, but certain caps and floors that comprise a collar may be treated as a single notional principal contract under paragraph (f)(2)(v)(C) of this section. A contract may be a notional principal contract governed by this section even though the term of the contract is subject to termination or extension. Each confirmation under a master agreement to enter into agreements governed by this section is treated as a separate notional principal contract.

(ii) *Excluded contracts.* A contract described in section 1256(b), a futures contract, a forward contract, and an option are not notional principal contracts. An instrument or contract that constitutes indebtedness under general principles of Federal income tax law is not a notional principal contract. An option or forward contract that entitles or obligates a person to enter into a notional principal contract is not a notional principal contract, but payments made under such an option or forward contract may be governed by paragraph (g)(3) of this section.

(iii) *Transactions within section 475.* To the extent that the rules provided in paragraphs (e) and (f) of this section are inconsistent with the rules that apply to any notional principal contract that is governed by section 475 and regulations thereunder, the rules of section 475 and the regulations thereunder govern.

(iv) *Transactions within section 988.* To the extent that the rules provided in this section are inconsistent with the rules that apply to any notional principal contract that is also a section 988 transaction or that is integrated with other property or debt pursuant to section 988(d), the rules of section 988 and the regulations thereunder govern.

(2) *Specified index.* A specified index is—

(i) A fixed rate, price, or amount;

(ii) A fixed rate, price, or amount applicable in one or more specified periods followed by one or more different fixed rates, prices, or amounts applicable in other periods;

(iii) An index that is based on objective financial information (as defined in paragraph (c)(4)(ii) of this section); and

(iv) An interest rate index that is regularly used in normal lending transactions between a party to the contract and unrelated persons.

(3) *Notional principal amount.* For purposes of this section, a notional principal amount is any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract. The notional principal amount may vary over the term of the

contract, provided that it is set in advance or varies based on objective financial information (as defined in paragraph (c)(4)(ii) of this section).

(4) *Special definitions*—(i) *Related person and party to the contract*. A related person is a person related (within the meaning of section 267(b) or 707(b)(1)) to one of the parties to the notional principal contract or a member of the same consolidated group (as defined in § 1.1502-1(h)) as one of the parties to the contract. For purposes of this paragraph (c), a related person is considered to be a party to the contract.

(ii) *Objective financial information*. For purposes of this paragraph (c), objective financial information is any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock). Thus, for example, a notional principal amount may be based on a broadly-based equity index or the outstanding balance of a pool of mortgages, but not on the value of a party's stock.

(iii) *Dealer in notional principal contracts*. A dealer in notional principal contracts is a person who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in notional principal contracts with customers in the ordinary course of a trade or business.

(d) *Taxable year of inclusion and deduction*. For all purposes of the Code, the net income or net deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year. The net income or net deduction from a notional principal contract for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year under paragraph (e) of this section and all of the nonperiodic payments that are recognized from that contract for the taxable year under paragraph (f) of this section.

(e) *Periodic payments*—(1) *Definition*. Periodic payments are payments made or received pursuant to a notional principal contract that are payable at in-

tervals of one year or less during the entire term of the contract (including any extension periods provided for in the contract), that are based on a specified index described in paragraph (c)(2)(i), (iii), or (iv) of this section (appropriately adjusted for the length of the interval), and that are based on either a single notional principal amount or a notional principal amount that varies over the term of the contract in the same proportion as the notional principal amount that measures the other party's payments. Payments to purchase or sell a cap or a floor, however, are not periodic payments.

(2) *Recognition rules*—(i) *In general*. All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.

(ii) *Rate set in arrears*. If the amount of a periodic payment is not determinable at the end of a taxable year because the value of the specified index is not fixed until a date that occurs after the end of the taxable year, the ratable daily portion of a periodic payment that relates to that taxable year is generally based on the specified index that would have applied if the specified index were fixed as of the last day of the taxable year. If a taxpayer determines that the value of the specified index as of the last day of the taxable year does not provide a reasonable estimate of the specified index that will apply when the payment is fixed, the taxpayer may use a reasonable estimate of the specified index each year, provided that the taxpayer (and any related person that is a party to the contract) uses the same method to make the estimate consistently from year to year and uses the same estimate for purposes of all financial reports to equity holders and creditors. The taxpayer's treatment of notional principal contracts with substantially similar specified indices will be considered in determining whether the taxpayer's estimate of the specified index is reasonable. Any difference between the amount that is recognized under this

paragraph (e)(2)(ii) and the corresponding portion of the actual payment that becomes fixed under the contract is taken into account as an adjustment to the net income or net deduction from the notional principal contract for the taxable year during which the payment becomes fixed.

(iii) *Notional principal amount set in arrears.* Rules similar to the rules of paragraph (e)(2)(ii) of this section apply if the amount of a periodic payment is not determinable at the end of a taxable year because the notional principal amount is not fixed until a date that occurs after the end of the taxable year.

(3) *Examples.* The following examples illustrate the application of paragraph (e) of this section.

*Example 1. Accrual of periodic swap payments.* (a) On April 1, 1995, *A* enters into a contract with unrelated counterparty *B* under which, for a term of five years, *A* is obligated to make a payment to *B* each April 1, beginning April 1, 1996, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined on the immediately preceding April 1, multiplied by a notional principal amount of \$100 million. Under the contract, *B* is obligated to make a payment to *A* each April 1, beginning April 1, 1996, in an amount equal to 8% multiplied by the same notional principal amount. *A* and *B* are calendar year taxpayers that use the accrual method of accounting. On April 1, 1995, LIBOR is 7.80%.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and both LIBOR and a fixed interest rate of 8% are specified indices under paragraph (c)(2) of this section. All of the payments to be made by *A* and *B* are periodic payments under paragraph (e)(1) of this section because each party's payments are based on a specified index described in paragraphs (c)(2)(iii) and (c)(2)(i) of this section, respectively, are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

(c) Under the terms of the swap agreement, on April 1, 1996, *B* is obligated to make a payment to *A* of \$8,000,000 ( $8\% \times \$100,000,000$ ) and *A* is obligated to make a payment to *B* of \$7,800,000 ( $7.80\% \times \$100,000,000$ ). Under paragraph (e)(2)(i) of this section, the ratable daily portions for 1995 are the amounts of these periodic payments that are attributable to *A*'s and *B*'s taxable year ending December 31, 1995. The ratable daily portion of the 8% fixed leg is \$6,010,929 (275 days/366 days  $\times$  \$8,000,000), and the ratable daily portion of the floating leg is \$5,860,656 (275 days/

366 days  $\times$  \$7,800,000). The net amount for the taxable year is the difference between the ratable daily portions of the two periodic payments, or \$150,273 ( $\$6,010,929 - \$5,860,656$ ). Accordingly, *A* has net income of \$150,273 from this swap for 1995, and *B* has a corresponding net deduction of \$150,273.

(d) The \$49,727 unrecognized balance of the \$200,000 net periodic payment that is made on April 1, 1996, is included in *A*'s and *B*'s net income or net deduction from the contract for 1996.

(e) If the parties had entered into the contract on February 1, 1995, the result would not change because no portion of either party's obligation to make a payment under the swap relates to the period prior to April 1, 1995. Consequently, under paragraph (e)(2) of this section, neither party would accrue any income or deduction from the swap for the period from February 1, 1995, through March 31, 1995.

*Example 2. Accrual of periodic swap payments by cash method taxpayer.* (a) On April 1, 1995, *C* enters into a contract with unrelated counterparty *D* under which, for a period of five years, *C* is obligated to make a fixed payment to *D* each April 1, beginning April 1, 1996, in an amount equal to 8% multiplied by a notional principal amount of \$100 million. *D* is obligated to make semi-annual payments to *C* each April 1 and October 1, beginning October 1, 1995, in an amount equal to one-half of the LIBOR amount as of the first day of the preceding 6-month period multiplied by the notional principal amount. The payments are to be calculated using a 30/360 day convention. *C* is a calendar year taxpayer that uses the accrual method of accounting. *D* is a calendar year taxpayer that uses the cash receipts and disbursements method of accounting. LIBOR is 7.80% on April 1, 1995, and 7.46% on October 1, 1995.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and LIBOR and the fixed interest rate of 8% are each specified indices under paragraph (c)(2) of this section. All of the payments to be made by *C* and *D* are periodic payments under paragraph (e)(1) of this section because they are each based on appropriate specified indices, are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

(c) Under the terms of the swap agreement, *D* pays *C* \$3,900,000 ( $0.5 \times 7.8\% \times \$100,000,000$ ) on October 1, 1995. In addition, *D* is obligated to pay *C* \$3,730,000 ( $0.5 \times 7.46\% \times \$100,000,000$ ) on April 1, 1996. *C* is obligated to pay *D* \$8,000,000 on April 1, 1996. Under paragraph (e)(2)(i) of this section, *C*'s and *D*'s ratable daily portions for 1995 are the amounts of the periodic payments that are attributable to their taxable year ending December 31, 1995. The ratable daily portion of the 8% fixed leg is \$6,000,000 (270 days/360 days  $\times$  \$8,000,000), and

the ratable daily portion of the floating leg is  $\$5,765,000$  ( $\$3,900,000 + (90 \text{ days}/180 \text{ days}) \times \$3,730,000$ ). Thus, *C*'s net deduction from the contract for 1995 is  $\$235,000$  ( $\$6,000,000 - \$5,765,000$ ) and *D* reports  $\$235,000$  of net income from the contract for 1995.

(d) The net unrecognized balance of  $\$135,000$  ( $\$2,000,000$  balance of the fixed leg— $\$1,865,000$  balance of the floating leg) is included in *C*'s and *D*'s net income or net deduction from the contract for 1996.

*Example 3. Accrual of swap payments on index set in arrears.* (a) The facts are the same as in *Example 1*, except that *A*'s obligation to make payments based upon LIBOR is determined by reference to LIBOR on the day each payment is due. LIBOR is 8.25% on December 31, 1995, and 8.16% on April 1, 1996.

(b) On December 31, 1995, the amount that *A* is obligated to pay *B* is not known because it will not become fixed until April 1, 1996. Under paragraph (e)(2)(ii) of this section, the ratable daily portion of the periodic payment from *A* to *B* for 1995 is based on the value of LIBOR on December 31, 1995 (unless *A* or *B* determines that the value of LIBOR on that day does not reasonably estimate the value of the specified index). Thus, the ratable daily portion of the floating leg is  $\$6,198,770$  ( $\frac{275 \text{ days}}{366 \text{ days}} \times 8.25\% \times \$100,000,000$ ), while the ratable daily portion of the fixed leg is  $\$6,010,929$  ( $\frac{275 \text{ days}}{366 \text{ days}} \times \$8,000,000$ ). The net amount for 1995 on this swap is  $\$187,841$  ( $\$6,198,770 - \$6,010,929$ ). Accordingly, *B* has  $\$187,841$  of net income from the swap in 1995, and *A* has a net deduction of  $\$187,841$ .

(c) On April 1, 1996, *A* makes a net payment to *B* of  $\$160,000$  ( $\$8,160,000$  payment on the floating leg— $\$8,000,000$  payment on the fixed leg). For purposes of determining their net income or net deduction from this contract for the year ended December 31, 1996, *B* and *A* must adjust the net income and net deduction they recognized in 1995 by  $\$67,623$  ( $\frac{275 \text{ days}}{366 \text{ days}} \times (\$8,250,000 \text{ presumed payment on the floating leg} - \$8,160,000 \text{ actual payment on the floating leg})$ ).

(f) *Nonperiodic payments*—(1) *Definition.* A nonperiodic payment is any payment made or received with respect to a notional principal contract that is not a periodic payment (as defined in paragraph (e)(1) of this section) or a termination payment (as defined in paragraph (h) of this section). Examples of nonperiodic payments are the premium for a cap or floor agreement (even if it is paid in installments), the payment for an off-market swap agreement, the prepayment of part or all of one leg of a swap, and the premium for an option to enter into a swap if and when the option is exercised.

(2) *Recognition rules*—(i) *In general.* All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.

(ii) *General rule for swaps.* A nonperiodic payment that relates to a swap must be recognized over the term of the contract by allocating it in accordance with the forward rates (or, in the case of a commodity, the forward prices) of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the forward rates or prices used to determine the amount of the nonperiodic payment will be respected, if reasonable. See paragraph (f)(4) *Example 7* of this section.

(iii) *Alternative methods for swaps.* Solely for purposes of determining the timing of income and deductions, a nonperiodic payment made or received with respect to a swap may be allocated to each period of the swap contract using one of the methods described in this paragraph (f)(2)(iii). The alternative methods may not be used by a dealer in notional principal contracts (as defined in paragraph (c)(4)(iii) of this section) for swaps entered into or acquired in its capacity as a dealer.

(A) *Prepaid swaps.* An upfront payment on a swap may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level payment method), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The discount rate used in this calculation must be the rate (or rates) used by the parties to determine the amount of the nonperiodic payment. If that rate is not readily ascertainable, the discount rate used must be a rate that is reasonable under the circumstances. Under this method, an upfront payment is allocated by dividing each equal payment into its principal recovery and time

value components. The principal recovery components of the equal payments are treated as periodic payments that are deemed to be made on each of the dates that the swap contract provides for periodic payments by the payor of the nonperiodic payment or, if none, on each of the dates that the swap contract provides for periodic payments by the recipient of the nonperiodic payment. The time value component is needed to compute the amortization of the nonperiodic payment, but is otherwise disregarded. See paragraph (f)(4) *Example 5* of this section.

(B) *Other nonperiodic swap payments.* Nonperiodic payments on a swap other than an upfront payment may be amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties. The discount rate (or rates) used in determining the deemed upfront payment and the time value component of the deemed loan is the same as the rate (or rates) used in the level payment method. The single upfront payment is then amortized under the level payment method described in paragraph (f)(2)(iii)(A) of this section. The time value component of the loan is not treated as interest, but, together with the amortized amount of the deemed upfront payment, is recognized as a periodic payment. See paragraph (f)(4) *Example 6* of this section. If both parties make nonperiodic payments, this calculation is done separately for the nonperiodic payments made by each party.

(iv) *General rule for caps and floors.* A payment to purchase or sell a cap or floor must be recognized over the term of the agreement by allocating it in accordance with the prices of a series of cash-settled option contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the option pricing used by the parties to determine the total amount paid for the cap or floor will be respected, if reasonable. Only the portion of the purchase price that is allocable to the option contract or contracts that expire during a particular period is recognized for that period. Thus, under this paragraph (f)(2)(iv), straight-line or accelerated

amortization of a cap premium is generally not permitted. See paragraph (f)(4) *Examples 1* and *2* of this section.

(v) *Alternative methods for caps and floors that hedge debt instruments.* Solely for purposes of determining the timing of income and deductions, if a cap or floor is entered into primarily to reduce risk with respect to a specific debt instrument or group of debt instruments held or issued by the taxpayer, the taxpayer may amortize a payment to purchase or sell the cap or floor using the methods described in this paragraph (f)(2)(v), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The alternative methods may not be used by a dealer in notional principal contracts (as defined in paragraph (c)(4)(iii) of this section) for caps or floors entered into or acquired in its capacity as a dealer.

(A) *Prepaid caps and floors.* A premium paid upfront for a cap or a floor may be amortized using the "level payment method" described in paragraph (f)(2)(iii)(A) of this section. See paragraph (f)(4) *Example 3* of this section.

(B) *Other caps and floors.* Nonperiodic payments on a cap or floor other than an upfront payment are amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties as described in paragraph (f)(2)(iii)(B) of this section. Under the level payment method, a cap or floor premium paid in level annual installments over the term of the contract is effectively included or deducted from income ratably, in accordance with the level payments. See paragraph (f)(4) *Example 4* of this section.

(C) *Special method for collars.* A taxpayer may also treat a cap and a floor that comprise a collar as a single notional principal contract and may amortize the net nonperiodic payment to enter into the cap and floor over the term of the collar in accordance with the methods prescribed in this paragraph (f)(2)(v).

(vi) *Additional methods.* The Commissioner may, by a revenue ruling or a

revenue procedure published in the Internal Revenue Bulletin, provide alternative methods for allocating nonperiodic payments that relate to a notional principal contract to each year of the contract. See § 601.601(d)(2)(ii)(b) of this chapter.

(3) *Term of extendible or terminable contracts.* For purposes of this paragraph (f), the term of a notional principal contract that is subject to extension or termination is the reasonably expected term of the contract.

(4) *Examples.* The following examples illustrate the application of paragraph (f) of this section.

*Example 1. Cap premium amortized using general rule.* (a) On January 1, 1995, when LIBOR is 8%, *F* pays unrelated party *E* \$600,000 for a contract that obligates *E* to make a payment to *F* each quarter equal to one-quarter of the excess, if any, of three-month LIBOR over 9% with respect to a notional principal amount of \$25 million. Both *E* and *F* are calendar year taxpayers. *E* provides *F* with a schedule of allocable premium amounts indicating that the cap was priced according to a reasonable variation of the Black-Scholes option pricing formula and that the total premium is allocable to the following periods:

|            | Pricing allocation |
|------------|--------------------|
| 1995 ..... | \$55,000           |
| 1996 ..... | 225,000            |
| 1997 ..... | 320,000            |
|            | \$600,000          |

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and LIBOR is a specified index under paragraph (c)(2)(iii) of this section. Any payments made by *E* to *F* are periodic payments under paragraph (e)(1) of this section because they are payable at periodic intervals of one year or less throughout the term of the contract, are based on an appropriate specified index, and are based on a single notional principal amount. The \$600,000 cap premium paid by *F* to *E* is a nonperiodic payment as defined in paragraph (f)(1) of this section.

(c) The Black-Scholes model is recognized in the financial industry as a standard technique for pricing interest rate cap agreements. Therefore, because *E* has used a reasonable option pricing model, the schedule generated by *E* is consistent with the economic substance of the cap, and may be used by both *E* and *F* for calculating their ratable daily portions of the cap premium. Under paragraph (f)(2)(iv) of this section, *E* recog-

nizes the ratable daily portion of the cap premium as income, and *F* recognizes the ratable daily portion of the cap premium as a deduction based on the pricing schedule. Thus, *E* and *F* account for the contract as follows:

|            | Ratable daily portion |
|------------|-----------------------|
| 1995 ..... | \$55,000              |
| 1996 ..... | 225,000               |
| 1997 ..... | 320,000               |
|            | \$600,000             |

(d) Any periodic payments under the cap agreement (that is, payments that *E* makes to *F* because LIBOR exceeds 9%) are included in the parties' net income or net deduction from the contract in accordance with paragraph (e)(2) of this section.

*Example 2. Cap premium allocated to proper period.* (a) The facts are the same as in *Example 1*, except that the cap is purchased by *F* on November 1, 1994. The first determination date under the cap agreement is January 31, 1995 (the last day of the first quarter to which the contract relates). LIBOR is 9.1% on December 31, 1994, and is 9.15% on January 31, 1995.

(b) *E* and *F* recognize \$9,192 (61 days/365 days×\$55,000) as the ratable daily portion of the nonperiodic payment for 1994, and include that amount in their net income or net deduction from the contract for 1994. If *E*'s pricing model allocated the cap premium to each quarter covered by the contract, the ratable daily portion would be 61 days/92 days times the premium allocated to the first quarter.

(c) Under paragraph (e)(2)(ii) of this section, *E* and *F* calculate the payments using LIBOR as of December 31, 1994. *F* recognizes as income the ratable daily portion of the presumed payment, or \$4,144 (61 days/92 days×.25×.001×\$25,000,000). Thus, *E* reports \$5,048 of net income from the contract for 1994 (\$9,192-\$4,144), and *F* reports a net deduction from the contract of \$5,048.

(d) On January 31, 1995, *E* pays *F* \$9,375 (.25×.0015×\$25,000,000) under the terms of the cap agreement. For purposes of determining their net income or net deduction from this contract for the year ended December 31, 1995, *E* and *F* must adjust their respective net income and net deduction from the cap by \$2,072 (61 days/92 days×(\$9,375 actual payment under the cap on January 31, 1995—\$6,250 presumed payment under the cap on December 31, 1994)).

*Example 3. Cap premium amortized using alternative method.* (a) The facts are the same as in *Example 1*, except that the cap provides for annual payments by *E* and is entered into by *F* primarily to reduce risk with respect to a debt instrument issued by *F*. *F* elects to

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amortize the cap premium using the alternative level payment method provided under paragraph (f)(2)(v)(A) of this section. Under that method, *F* amortizes the cap premium by assuming that the \$600,000 is repaid in 3

equal annual payments of \$241,269, assuming a discount rate of 10%. Each payment is divided into a time value component and a principal component, which are set out below.

|            | Level payment | Time value component | Principal component |
|------------|---------------|----------------------|---------------------|
| 1995 ..... | \$241,269     | \$60,000             | \$181,269           |
| 1996 ..... | 241,269       | 41,873               | 199,396             |
| 1997 ..... | 241,269       | 21,934               | 219,335             |
|            | \$723,807     | \$123,807            | \$600,000           |

(b) The net of the ratable daily portions of the principal component and the payments, if any, received from *E* comprise *F*'s annual net income or net deduction from the cap. The time value components are needed only to compute the ratable daily portions of the cap premium, and are otherwise disregarded.

*Example 4. Cap premium paid in level installments and amortized using alternative method.*

(a) The facts are the same as in *Example 3*, except that *F* agrees to pay for the cap in three level installments of \$241,269 (a total of

\$723,807) on December 31, 1995, 1996, and 1997. The present value of three payments of \$241,269, discounted at 10%, is \$600,000. For purposes of amortizing the cap premium under the alternative method provided in paragraph (f)(2)(v)(B) of this section, *F* is treated as paying \$600,000 for the cap on January 1, 1995, and borrowing \$600,000 from *E* that will be repaid in three annual installments of \$241,269. The time value component of the loan is computed as follows:

|            | Loan balance | Time value component | Principal component |
|------------|--------------|----------------------|---------------------|
| 1995 ..... | \$600,000    | \$60,000             | \$181,269           |
| 1996 ..... | 418,731      | 41,873               | 199,396             |
| 1997 ..... | 219,335      | 21,934               | 219,335             |
|            |              | \$123,807            | \$600,000           |

(b) *F* is treated as making periodic payments equal to the amortized principal components from a \$600,000 cap paid in advance (as described in *Example 3*), increased by the time value components of the \$600,000 loan, which totals \$241,269 each year. The time value components of the \$600,000 loan are included in the periodic payments made by *F*, but are not characterized as interest income or expense. The effect of the alternative method in this situation is to allow *F* to amortize the cap premium in level installments, the same way it is paid. The net of the ratable daily portions of *F*'s deemed periodic payments and the payments, if any, received from *E* comprise *F*'s annual net income or net deduction from the cap.

*Example 5. Upfront interest rate swap payment amortized using alternative method.* (a) On January 1, 1995, *G* enters into an interest rate swap agreement with unrelated counterparty *H* under which, for a term of five years, *G* is obligated to make annual payments at 11% and *H* is obligated to make annual payments at LIBOR on a notional principal amount of \$100 million. At the time *G* and *H* enter into this swap agreement, the rate for similar on-market swaps is LIBOR

to 10%. To compensate for this difference, on January 1, 1995, *H* pays *G* a yield adjustment fee of \$3,790,786. *G* provides *H* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10% compounded annually, of five annual payments of \$1,000,000 (1%×\$100,000,000). *G* and *H* are calendar year taxpayers.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section. The yield adjustment fee is a nonperiodic payment as defined in paragraph (f)(1) of this section.

(c) Under the alternative method described in paragraph (f)(2)(iii)(A) of this section, the yield adjustment fee is recognized over the life of the agreement by assuming that the \$3,790,786 is repaid in five level payments. Assuming a constant yield to maturity and annual compounding at 10%, the ratable daily portions are computed as follows:

|            | Level payment | Time value component | Principal component |
|------------|---------------|----------------------|---------------------|
| 1995 ..... | \$1,000,000   | \$379,079            | \$620,921           |
| 1996 ..... | 1,000,000     | 316,987              | 683,013             |
| 1997 ..... | 1,000,000     | 248,685              | 751,315             |
| 1998 ..... | 1,000,000     | 173,554              | 826,446             |
| 1999 ..... | 1,000,000     | 90,909               | 909,091             |
|            | \$5,000,000   | \$1,209,214          | \$3,790,786         |

(d) *G* also makes swap payments to *H* at 11%, while *H* makes swap payments to *G* based on LIBOR. The net of the ratable daily portions of the 11% payments by *G*, the LIBOR payments by *H*, and the principal component of the yield adjustment fee paid by *H* determines the annual net income or net deduction from the contract for both *G* and *H*. The time value components are needed only to compute the ratable daily portions of the yield adjustment fee paid by *H*, and are otherwise disregarded.

*Example 6. Backloaded interest rate swap payment amortized using alternative method.*

|            | Loan balance | Time value component | Principal component |
|------------|--------------|----------------------|---------------------|
| 1995 ..... | \$3,790,786  | \$379,079            | 0                   |
| 1996 ..... | 4,169,865    | 416,987              | 0                   |
| 1997 ..... | 4,586,852    | 458,685              | 0                   |
| 1998 ..... | 5,045,537    | 504,554              | 0                   |
| 1999 ..... | 5,550,091    | 555,009              | 6,105,100           |

(b) The amortization of *H*'s yield adjustment fee is equal to the amortization of a yield adjustment fee of \$3,790,786 paid in advance (as described in *Example 5*), increased by the time value component of the \$3,790,786 deemed loan from *G* to *H*. Thus, the amount of *H*'s yield adjustment fee that is allocated to 1995 is \$1,000,000 (\$620,921 + \$379,079). The time value components of the \$3,790,786 loan are included in the periodic payments paid by *H*, but are not characterized as interest income or expense. The net of the ratable daily portions of the 11% swap payments by *G*, and the LIBOR payments by *H*, added to the principal components from *Example 5* and the time value components from this *Example 6*, determines the annual net income or net deduction from the contract for both *G* and *H*.

*Example 7. Nonperiodic payment on a commodity swap amortized under general rule.* (a) On January 1, 1995, *I* enters into a commodity swap agreement with unrelated counterparty *J* under which, for a term of three years, *I* is obligated to make annual payments based on a fixed price of \$2.35 per bushel times a notional amount of 100,000 bushels of corn and *J* is obligated to make annual payments equal to the spot price times the same notional amount. Assume that on January 1, 1995, the price of a one

(a) The facts are the same as in *Example 5*, but *H* agrees to pay *G* a yield adjustment fee of \$6,105,100 on December 31, 1999. Under the alternative method in paragraph (f)(2)(iii)(B) of this section, *H* is treated as paying a yield adjustment fee of \$3,790,786 (the present value of \$6,105,100, discounted at a 10% rate with annual compounding) on January 1, 1995. Solely for timing purposes, *H* is treated as borrowing \$3,790,786 from *G*. Assuming annual compounding at 10%, the time value component is computed as follows:

year forward for corn is \$2.40 per bushel, of a two year forward \$2.55 per bushel, and of a 3 year forward \$2.75 per bushel. To compensate for the below-market fixed price provided in the swap agreement, *I* pays *J* \$53,530 for entering into the swap. *I* and *J* are calendar year taxpayers.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and \$2.35 and the spot price of corn are specified indices under paragraphs (c)(2)(i) and (iii) of this section, respectively. The \$53,530 payment is a nonperiodic payment as defined by paragraph (f)(1) of this section.

(c) Assuming that *I* does not use the alternative methods provided under paragraph (f)(2)(iii) of this section, paragraph (f)(2)(ii) of this section requires that *I* recognize the nonperiodic payment over the term of the agreement by allocating the payment to each forward contract in accordance with the forward price of corn. Solely for timing purposes, *I* treats the \$53,530 nonperiodic payment as a loan that *J* will repay in three

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installments of \$5,000, \$20,000, and \$40,000, the expected payouts on the in-the-money forward contracts. With annual compounding at

8%, the ratable daily portions are computed as follows:

|            | Expected forward payment | Time value component | Principal component |
|------------|--------------------------|----------------------|---------------------|
| 1995 ..... | \$5,000                  | \$4,282              | \$718               |
| 1996 ..... | 20,000                   | 4,225                | 15,775              |
| 1997 ..... | 40,000                   | 2,963                | 37,037              |
|            | \$65,000                 | \$11,470             | \$53,530            |

(d) The ratable daily portion of the principal component is added to *F*'s periodic payments in computing its net income or net deduction from the notional principal contract for each taxable year. The time value components are needed only to compute the principal components, and are otherwise disregarded.

(g) *Special rules*—(1) *Disguised notional principal contracts*. The Commissioner may recharacterize all or part of a transaction (or series of transactions) if the effect of the transaction (or series of transactions) is to avoid the application of this section.

(2) *Hedged notional principal contracts*. If a taxpayer, either directly or through a related person (as defined in paragraph (c)(4)(i) of this section), reduces risk with respect to a notional principal contract by purchasing, selling, or otherwise entering into other notional principal contracts, futures, forwards, options, or other financial contracts (other than debt instruments), the taxpayer may not use the alternative methods provided in paragraphs (f)(2)(iii) and (v) of this section. Moreover, where such positions are entered into to avoid the appropriate timing or character of income from the contracts taken together, the Commissioner may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole.

(3) *Options and forwards to enter into notional principal contracts*. An option or forward contract that entitles or obligates a person to enter into a notional principal contract is subject to the general rules of taxation for options or forward contracts. Any payment with respect to the option or forward contract is treated as a nonperiodic payment for the underlying notional principal contract under the rules of paragraphs (f) and (g)(4) or (g)(5) of this section if and when the underlying notional principal contract is entered into.

(4) *Swaps with significant nonperiodic payments*. A swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is not included in the net income or net deduction from the swap under paragraph (d) of this section, but is recognized as interest for all purposes of the Internal Revenue Code. See paragraph (g)(6) *Example 3* of this section. For purposes of section 956, the Commissioner may treat any nonperiodic swap payment, whether or not it is significant, as one or more loans.

(5) *Caps and floors that are significantly in-the-money*. [Reserved]

(6) *Examples*. The following examples illustrate the application of paragraph (g) of this section.

*Example 1. Cap hedged with options.* (a) On January 1, 1995, *K* sells to unrelated counterparty *L* three cash settlement European-style put options on Eurodollar time deposits with a strike rate of 9%. The options have exercise dates of January 1, 1996, January 1, 1997, and January 1, 1998, respectively. If LIBOR exceeds 9% on any of the exercise dates, *L* will be entitled, by exercising the relevant option, to receive from *K* an amount that corresponds to the excess of LIBOR over 9% times \$25 million. *L* pays *K* \$650,000 for the three options. Furthermore, *K* is related to *F*, the cap purchaser in paragraph (f)(4) *Example 1* of this section.

(b) *K*'s option agreements with *L* reduce risk with respect to *F*'s cap agreement with *E*. Accordingly, under paragraph (g)(2) of this

section, *F* cannot use the alternative methods provided in paragraph (f)(2)(v) of this section to amortize the premium paid under the cap agreement. *F* must amortize the cap premium it paid in accordance with paragraph (f)(2)(iv) of this section.

(c) The method that *E* may use to account for its agreement with *F* is not affected by the application of paragraph (g)(2) of this section to *F*.

*Example 2. Nonperiodic payment that is not significant.* (a) On January 1, 1995, *G* enters into an interest rate swap agreement with unrelated counterparty *H* under which, for a term of five years, *G* is obligated to make annual payments at 11% and *H* is obligated to make annual payments at LIBOR on a notional principal amount of \$100 million. At the time *G* and *H* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 1995, *H* pays *G* a yield adjustment fee of \$3,790,786. *G* provides *H* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10% compounded annually, of five annual payments of \$1,000,000 (1%×\$100,000,000). *G* and *H* are calendar year taxpayers. (These facts are the same as in paragraph (f)(4) *Example 5* of this section.)

(b) In this situation, the yield adjustment fee of \$3,790,786 is not a significant nonperiodic payment within the meaning of paragraph (g)(4) of this section, in light of the amount of the fee in proportion to the present value of the total amount of fixed payments due under the contract. Accordingly, no portion of the swap is recharacterized as a loan for purposes of this section.

|            | Level payment | Interest component | Principal component |
|------------|---------------|--------------------|---------------------|
| 1995 ..... | \$4,000,000   | \$1,516,315        | \$2,483,685         |
| 1996 ..... | 4,000,000     | 1,267,946          | 2,732,054           |
| 1997 ..... | 4,000,000     | 994,741            | 3,005,259           |
| 1998 ..... | 4,000,000     | 694,215            | 3,305,785           |
| 1999 ..... | 4,000,000     | 363,636            | 3,636,364           |
|            | \$20,000,000  | \$4,836,853        | \$15,163,147        |

(d) *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 paragraph (d) of this section. 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.

*Example 3. Significant nonperiodic payment.*

(a) On January 1, 1995, 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 \$15,163,147 on January 1, 1995. At the time *M* and *N* enter into this swap agreement the rate for similar on-market swaps is LIBOR to 10%, and *N* provides *M* with information that the amount of the initial 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).

(b) Although the parties have characterized this transaction as an interest rate swap, the \$15,163,147 payment from *M* to *N* is significant when compared to the present value of the total fixed payments due under the contract. Accordingly, under paragraph (g)(4) 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 agreement, 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*.

(c) The yield adjustment fee is recognized over the life of the agreement 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 |
|------------|---------------|--------------------|---------------------|
| 1995 ..... | \$4,000,000   | \$1,516,315        | \$2,483,685         |
| 1996 ..... | 4,000,000     | 1,267,946          | 2,732,054           |
| 1997 ..... | 4,000,000     | 994,741            | 3,005,259           |
| 1998 ..... | 4,000,000     | 694,215            | 3,305,785           |
| 1999 ..... | 4,000,000     | 363,636            | 3,636,364           |
|            | \$20,000,000  | \$4,836,853        | \$15,163,147        |

(e) *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 paragraph (e)(2) of this section, the 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 4. Swaps recharacterized as a loan.*

(a) The facts are the same as in *Example 3*, except that on January 1, 1995, *N* also enters into an interest rate swap agreement with unrelated counterparty *O* under which, for a term of five years, *N* is obligated to make annual payments at 12% and *O* is obligated to make annual payments at LIBOR on a notional principal amount of \$100 million. At the time *N* and *O* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, *O* pays *N* an upfront yield adjustment fee of \$7,581,574. This yield adjustment fee equals the present value, at 10% compounded annually, of five annual payments of \$2,000,000 (2% of \$100,000,000).

(b) In substance, these two interest rate swaps are the equivalent of a fixed rate borrowing by *N* of \$22,744,721 (\$15,163,147 from *M* plus \$7,581,574 from *O*). Under paragraph (g)(2) of this section, if these positions were entered into to avoid interest character on a net loan position, the Commissioner may recharacterize the swaps as a loan which *N* will repay with interest in five annual installments of \$6,000,000 each (the difference between the 12% *N* pays under the swap with *O* and the 6% *N* receives under the swap with *M*, multiplied by the \$100,000,000 notional principal amount).

(c) *N* recognizes no net income or net deduction from these contracts under paragraph (d) of this section because, as to *N*, there is no notional principal contract income or expense. However, the recharacterization of *N*'s separate transactions as a loan has no effect on the way *M* and *O* must each account for their notional principal contracts under paragraphs (d) through (g) of this section.

(h) *Termination payments*—(1) *Definition*. A payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract is a termination payment to the party making the termination payment and the party receiving the payment. A termination payment includes a payment made between the original parties to the contract (an extinguishment), a payment made between one party to the contract and a third party (an assignment), and any gain or loss realized on the exchange of one notional principal contract for another. Where one party assigns its remaining rights and obligations to a third party, the original non-

assigning counterparty realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event under section 1001.

(2) *Taxable year of inclusion and deduction by original parties*. Except as otherwise provided (for example, in section 453, section 1092, or § 1.446-4), a party to a notional principal contract recognizes a termination payment in the year the contract is extinguished, assigned, or exchanged. When the termination payment is recognized, the party also recognizes any other payments that have been made or received pursuant to the notional principal contract, but that have not been recognized under paragraph (d) of this section. If only a proportionate part of a party's rights and obligations is extinguished, assigned, or exchanged, then only that proportion of the unrecognized payments is recognized under the previous sentence.

(3) *Taxable year of inclusion and deduction by assignees*. A termination payment made or received by an assignee pursuant to an assignment of a notional principal contract is recognized by the assignee under the rules of paragraphs (f) and (g)(4) or (g)(5) of this section as a nonperiodic payment for the notional principal contract that is in effect after the assignment.

(4) *Special rules*—(i) *Assignment of one leg of a contract*. A payment is not a termination payment if it is made or received by a party in exchange for assigning all or a portion of one leg of a notional principal contract at a time when a substantially proportionate amount of the other leg remains unperformed and unassigned. The payment is either an amount loaned, an amount borrowed, or a nonperiodic payment, depending on the economic substance of the transaction to each party. This paragraph (h)(4)(i) applies whether or not the original notional principal contract is terminated as a result of the assignment.

(ii) *Substance over form*. Any economic benefit that is given or received by a taxpayer in lieu of a termination payment is a termination payment.

(5) *Examples.* The following examples illustrate the application of this paragraph (h). The contracts in the examples are not hedging transactions as defined in § 1.1221-2(b), and all of the examples assume that no loss-deferral rules apply.

*Example 1. Termination by extinguishment.*

(a) On January 1, 1995, *P* enters into an interest rate swap agreement with unrelated counterparty *Q* under which, for a term of seven years, *P* is obligated to make annual payments based on 10% and *Q* is obligated to make semi-annual payments based on LIBOR and a notional principal amount of \$100 million. *P* and *Q* are both calendar year taxpayers. On January 1, 1997, when the fixed rate on a comparable LIBOR swap has fallen to 9.5%, *P* pays *Q* \$1,895,393 to terminate the swap.

(b) The payment from *P* to *Q* extinguishes the swap contract and is a termination payment, as defined in paragraph (h)(1) of this section, for both parties. Accordingly, under paragraph (h)(2) of this section, *P* recognizes a loss of \$1,895,393 in 1997 and *Q* recognizes \$1,895,393 of gain in 1997.

*Example 2. Termination by assignment.*(a)

The facts are the same as in *Example 1*, except that on January 1, 1997, *P* pays unrelated party *R* \$1,895,393 to assume all of *P*'s rights and obligations under the swap with *Q*. In return for this payment, *R* agrees to pay 10% of \$100 million annually to *Q* and to receive LIBOR payments from *Q* for the remaining five years of the swap.

(b) The payment from *P* to *R* terminates *P*'s interest in the swap contract with *Q* and is a termination payment, as defined in paragraph (h)(1) of this section, for *P*. Under paragraph (h)(2) of this section, *P* recognizes a loss of \$1,895,393 in 1997. Whether *Q* also has a termination payment with respect to the payment from *P* to *R* is determined under section 1001.

(c) Under paragraph (h)(3) of this section, the assignment payment that *R* receives from *P* is a nonperiodic payment for an interest rate swap. Because the assignment payment is not a significant nonperiodic payment within the meaning of paragraph (g)(1) of this section, *R* amortizes the \$1,895,393 over the five year term of the swap 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) *Effective date.* These regulations are effective for notional principal contracts entered into on or after December 13, 1993.

[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]

**§ 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