Internal Revenue
bulletin

Bulletin No. 2012-11
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2012–9, page 475.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for March 2012.

T.D. 9569, page 465.
REG–145474–11, page 495.

Final, temporary, and proposed regulations under section 482 of the Code address concerns that taxpayers are taking unreasonable positions with respect to the determination of discount rates in applying the income method to determine taxable income in connection with cost sharing arrangements. The regulations provide guidance on a discount rate- related best method consideration for evaluating an application of the income method.

T.D. 9571, page 468.
REG–113903–10, page 486.

Temporary and proposed regulations under section 904 of the Code provide transition rules regarding the reduction of the number of separate foreign tax credit limitation categories. A public hearing on the proposed regulations is scheduled for April 3, 2012.

T.D. 9572, page 471.
REG–120282–10, page 487.

Temporary and proposed regulations under section 871 of the Code provide a definition of the term "specified notional principal contract." The temporary regulation also amend the provision of the Code to address the treatment of dividend equivalents. A public hearing on the proposed regulation is scheduled for April 27, 2012.

Notice 2012–23, page 483.

This notice answers several questions about the federal income tax consequences related to the receipt of a section 1603 payment, a cash reimbursement from the Department of Treasury for a portion of the cost of certain qualifying renewable energy projects. The section 1603 program was created by the American Recovery and Reinvestment Tax Act of 2009 and was extended for one year by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Rev. Proc. 2012–21, page 484.

This procedure provides guidance to individuals who fail to meet the eligibility requirements of section 911 of the Code because adverse conditions in a foreign country preclude the individual from meeting those requirements. A current list of countries for tax year 2011 and the dates those countries are subject to the section 911(d)(4) waiver is provided.

ADMINISTRATIVE

T.D. 9570, page 477.

Final regulations under section 6695 of the Code modify existing regulations related to the tax return preparer penalties.

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

26 CFR 1.482–7: Methods to determine taxable income in connection with a cost sharing arrangement.

T.D. 9569

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Use of Differential Income Stream as a Consideration in Assessing the Best Method

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that implement the use of the differential income stream as a consideration in assessing the best method in connection with a cost sharing arrangement. The text of these temporary regulations also serves as part of the text of proposed regulations contained in a cross-reference notice of proposed rulemaking (REG–145474–11) published in this issue of the Bulletin. This document also contains final regulations that provide cross-references in the final cost sharing regulations to relevant sections of these temporary regulations.

DATES: *Effective Date:* These regulations are effective on December 19, 2011.

Applicability Dates: For dates of applicability, see §1.482–7T(l).

FOR FURTHER INFORMATION CONTACT: Joseph L. Tobin or Mumal R. Hemrajani, (202) 435–5265 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

A notice of proposed rulemaking and notice of public hearing regarding additional guidance to improve compliance with, and administration of, the rules in connection with a cost sharing arrangement (CSA) were published in the Federal Register (70 FR 51116) (REG–144615–02, 2005–2 C.B. 625) on August 29, 2005 (2005 proposed regulations). A correction to the notice of proposed rulemaking and notice of public hearing was published in the Federal Register (70 FR 56611) on September 28, 2005. A public hearing was held on December 16, 2005.

The Treasury Department and the IRS received numerous comments on a wide range of issues addressed in the 2005 proposed regulations. In response to these comments, temporary and proposed regulations were published in the **Federal Register** (74 FR 340–01 and 74 FR 236–01) (REG–144615–02) on January 5, 2009 (2008 temporary regulations). Corrections to the 2008 temporary regulations were published in the **Federal Register** on February 27, 2009 (74 FR 8863–01), March 5, 2009 (74 FR 9570–01, 74 FR 9570–02, and 74 FR 9577–01), and March 19, 2009 (74 FR 11644–01). A public hearing was held on April 21, 2009.

The Treasury Department and the IRS received comments on a range of issues addressed in the 2008 temporary regulations. Final regulations were issued in a previous issue of the **Federal Register** (REG–144615–02) (T.D. 9568) in December 2011 ("final regulations"). Certain guidance regarding discount rates was reserved in the final regulations because the Treasury Department and the IRS believe it is appropriate to solicit public comments on that subject matter. As explained herein, these temporary regulations provide a portion of that reserved guidance on discount rates. Simultaneous with these temporary regulations, the other portion of such reserved guidance concerning discount rates is being provided in proposed

regulations elsewhere in this issue of the Bulletin (proposed regulations).

Explanation of Provisions

The Treasury Department and the IRS are aware that some taxpayers are taking unreasonable positions in applying the income method by using relatively low licensing discount rates, and relatively high cost sharing discount rates, without sufficiently considering the appropriate interrelationship of the discount rates and financial projections, thus deriving PCT Payments that are not in accordance with the arm's length standard.

In light of these concerns, the Treasury Department and the IRS are providing additional guidance as follows: (1) in the final regulations, further guidance on comparing the financial projections associated with the cost sharing alternative discounted at the rate appropriate for the cost sharing alternative with the financial projections associated with the licensing alternative discounted at the rate appropriate for the licensing alternative, and evaluating reliability considerations associated with such a comparison (§1.482–7(g)(4)(vi)(F)(*1*) (Reflection of similar risk profiles in cost sharing alternative and licensing alternative)); (2) in these temporary regulations, further guidance on evaluating results of application of the income method (§1.482–7T(g)(2)(v)(B)(*2*) (Implied discount rates) and (4)(vi)(F)(*2*) (Use of differential income stream as a consideration in assessing the best method)); and (3) in proposed regulations, a new specified application of the income method for directly determining the arm's length charge for PCT Payments (§1.482–7(g)(4)(v) (Application of income method using differential income stream)).

As discussed in the Preamble to the final regulations, any difference, if any, in market-correlated risks between the licensing and cost sharing alternatives is due solely to the different effects on risks of the PCT Payor's making licensing payments under the licensing alternative on the one hand, and the PCT Payor's making cost contributions and PCT Payments under the cost sharing alternative on the other hand. Thus, the difference in risk between the two scenarios should reflect solely (1) the incremental risk, if any, associated with the cost contributions taken on by the PCT Payor in developing cost shared intangibles under the cost sharing alternative, and (2) any difference in risk associated with the particular payment forms of the licensing payments and the PCT Payments, in light of the fact that the licensing payments in the licensing alternative are partially replaced by cost contributions and partially replaced by PCT Payments in the cost sharing alternative, each with its own payment form. Accordingly, the final regulations added §1.482–7(g)(4)(vi)(F)(*1*) (Reflection of similar risk profiles in cost sharing alternative and licensing alternative), which provides that an analysis under the income method that uses a different discount rate for the cost sharing alternative than the licensing alternative will be more reliable the greater the extent to which any difference between the two discount rates reflects solely those differences in risk profiles of these two alternatives.

These temporary regulations build upon §1.482–7(g)(4)(vi)(F)(*1*) of the final regulations by providing additional guidance relating to analysis of the interrelationship between the discount rate for the cost sharing alternative and the discount rate for the licensing alternative, and evaluation of the reasonableness of the implied discount rate that may be derived from the differential income stream between the licensing alternative and the cost sharing alternative. The differential income stream is the difference between the PCT Payor's undiscounted operating income under the cost sharing alternative (before PCT Payments) and the PCT Payor's undiscounted operating income under the licensing alternative. This difference equals the licensing payments to be made under the licensing alternative minus the PCT Payor's cost contributions to be made under the cost sharing alternative. The differential income stream should be discounted at an appropriate rate in order to evaluate the reliability of a determination of the arm's length charge for the PCT Payment. Accordingly, these temporary regulations add §1.482–7T(g)(4)(vi)(F)(*2*), which provides that an analysis under the income method that uses a different discount rate for the cost sharing alternative than for the licensing alternative will be more reliable the greater the extent to which the implied discount rate for the projected present value of the differential income stream is consistent with reliable direct evidence of the appropriate discount rate applicable for activities reasonably anticipated to generate an income stream with a similar risk profile to the differential income stream (such as those of the uncontrolled companies described in §1.482–7T(g)(4)(viii) *Example 8*). The Treasury Department and the IRS have added §1.482–7T(g)(4)(viii) *Example 8* to illustrate how §1.482–7T(g)(4)(vi)(F)(*2*) may be used to evaluate the reliability of a particular application of the income method.

The Treasury Department and the IRS are also proposing a new specified application of the income method in §1.482–7(g)(4)(v), which provides that the determination of the arm's length charge for the PCT Payment can be derived by discounting the differential income stream at an appropriate rate. The differential income stream approach to determining PCT Payments depends on reliably determining the discount rate associated with the differential income stream. This, in turn, requires an understanding of the economic meaning of the differential income stream. For example, assume a CSA in which the PCT Payor does not contribute any platform or operating contributions, and undertakes only routine exploitation activities for which it anticipates a routine return. In such case, the total undiscounted anticipated profits (before PCT Payments) to the CSA in the PCT Payor's territory can be thought of as comprising the anticipated routine exploitation profits plus the anticipated profits associated with the development of the cost shared intangibles in the PCT Payor's territory. Under the licensing alternative, on the other hand, the PCT Payor's total undiscounted anticipated profits consist solely of the anticipated routine exploitation profits. Thus, the differential income stream conceptually corresponds to the anticipated development profits of the cost shared intangibles. For these reasons, an appropriate discount rate for the differential income stream might be determined based, for example, on the weighted average cost of capital of uncontrolled companies whose activities consist primarily of developing intangibles similar to the cost shared intangibles, and whose resources, capabilities, or rights are similar to the

platform contributions and cost shared intangibles under the CSA. The proposed regulations also add §1.482–7(g)(4)(viii) *Example 9* to illustrate this newly specified application of the income method.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does 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 (CCASBA) for comment on their impact on small business. CCASBA had no comments.

Drafting Information

The principal authors of these regulations are Joseph L. Tobin and Mumal R. Hemrajani, Office of the Associate Chief Counsel (International). However, other personnel from the Internal Revenue Service and the Treasury Department participated in the development of the regulations.

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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 is amended by adding entries in numerical order to read as follows:

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

Sections 1.482–7 and 1.482–7T also issued under 26 U.S.C. 482. * * *

Par. 2. Section 1.482–7 is amended by revising paragraphs (g)(2)(v)(B)(*2*) and (g)(4)(vi)(F)(*2*), and adding *Example 8* to paragraph (g)(4)(viii), to read as follows:

§1.482–7 Methods to determine taxable income in connection with a cost sharing arrangement.

* * * * *

(g)* * *

(2)* * *

(v)* * *

(B)* * *

(*2*) [Reserved]. For further guidance, see §1.482–7T(g)(2)(v)(B)(*2*).

* * * * *

(4) * * *

(vi) * * *

(F) * * *

(*2*) [Reserved]. For further guidance, see §1.482–7T(g)(4)(vi)(F)(*2*).

* * * * *

(viii) * * *

Example 8. [Reserved]. For further guidance, see §1.482–7T(g)(4)(viii), *Example 8*.

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Par. 3. Section 1.482–7T is added to read as follows:

§1.482–7T Methods to determine taxable income in connection with a cost sharing arrangement (temporary).

(a) through (g)(2)(v)(B)(*1*) [Reserved]. For further guidance, see §1.482–7(a) through (g)(2)(v)(B)(*1*).

(*2*) *Implied discount rates.* In some circumstances, the particular discount rate or rates used for certain activities or transactions logically imply that certain other activities will have a particular discount rate or set of rates (implied discount rates). To the extent that an implied discount rate is inappropriate in light of the facts and circumstances, which may include reliable direct evidence of the appropriate discount rate applicable for such other activities, the reliability of any method is reduced where such method is based on the discount rates from which such an inappropriate implied discount rate is derived. See paragraphs (g)(4)(vi)(F)(*2*) and (g)(4)(viii), *Example 8* of this section.

(g)(2)(v)(B)(*3*) through (g)(4)(vi)(F)(*1*) [Reserved]. For further guidance, see §1.482–7(g)(2)(v)(B)(*3*) through (g)(4)(vi)(F)(*1*).

(*2*) *Use of differential income stream as a consideration in assessing the best method.* An analysis under the income method that uses a different discount rate for the cost sharing alternative than for the licensing alternative will be more reliable the greater the extent to which the implied discount rate for the projected present value of the differential income stream is consistent with reliable direct evidence of the appropriate discount rate applicable for activities reasonably anticipated to generate an income stream with a similar risk profile to the differential income stream. Such differential income stream is defined as the stream of the reasonably anticipated residuals of the PCT Payor's licensing payments to be made under the licensing alternative, minus the PCT Payor's cost contributions to be made under the cost sharing alternative. See, for example, *Example 8* of this paragraph (g)(4)(viii).

(g)(4)(vii) through (viii) (*Example 7*) [Reserved]. For further guidance, see §1.482–7(g)(4)(vii) through (g)(4)(viii) (*Example 7*).

(viii) *Example 8.* (i) The facts are the same as in *Example 1*, except that the taxpayer determines that the appropriate discount rate for the cost sharing alternative is 20%. In addition, the taxpayer determines that the appropriate discount rate for the licensing alternative is 10%. Accordingly, the taxpayer determines that the appropriate present value of the PCT Payment is $146 million.

(ii) Based on the best method analysis described in *Example 2*, the Commissioner determines that the taxpayer's calculation of the present value of the PCT Payments is outside of the interquartile range (as shown in the sixth column of *Example 2*), and thus warrants an adjustment. Furthermore, in evaluating the taxpayer's analysis, the Commissioner undertakes an analysis based on the difference in the financial projections between the cost sharing and licensing alternatives (as shown in column 11 of *Example 1*). This column shows the anticipated differential income stream of additional positive or negative income for FS over the duration of the CSA Activity that would result from undertaking the cost sharing alternative (before any PCT Payments) rather than the licensing alternative. This anticipated differential income stream thus reflects the anticipated incremental undiscounted profits to FS from the incremental activity of undertaking the risk of developing the cost shared intangibles and enjoying the value of its divisional interests. Taxpayer's analysis logically implies that the present value of this stream must be $146 million, since only then would FS have the same anticipated value in both the cost sharing and licensing alternatives. A present value of $146 million implies that the discount rate applicable to this stream is 34.4%. Based on a reliable calculation of discount rates applicable to the anticipated income streams of uncontrolled companies whose resources, capabilities, and rights consist primarily of software applications intangibles and research and development teams similar to USP's platform contributions to the CSA, and which income streams, accordingly, may be reasonably anticipated to reflect a similar risk

profile to the differential income stream, the Commissioner concludes that an appropriate discount rate for the anticipated income stream associated with USP's platform contributions (that is, the additional positive or negative income over the duration of the CSA Activity that would result, before PCT Payments, from switching from the licensing alternative to the cost sharing alternative) is 16%, which is significantly less than 34.4%. This conclusion further suggests that Taxpayer's analysis is unreliable. See paragraphs (g)(2)(v)(B)(*2*) and (4)(vi)(F)(*1*) and (*2*) of this section.

(iii) The Commissioner makes an adjustment of $296 million, so that the present value of the PCT Payments is $442 million (the median results as shown in column 6 of *Example 2*).

(g)(5) through (k) [Reserved]. For further guidance, see §1.482–7(g)(5) through (k).

(l) *Effective/Applicability Date*. Treas. Reg. §1.482–7T(g)(2)(v)(B)(*2*), (g)(4)(vi)(F)(*2*) and (g)(4)(viii), *Example 8* apply to taxable years beginning on or after December 19, 2011.

(m) [Reserved]. For further guidance, see §1.482–7(m).

(n) *Expiration date*. The applicability of this section expires on December 19, 2014.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved December 8, 2011.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 19, 2011, 11:15 a.m., and published in the issue of the Federal Register for December 23, 2011, 76 F.R. 80249)

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 861.—Income From Sources Within the United States

26 CFR 1.861–9T: Allocation and apportionment of interest expense (temporary).

T.D. 9571

Department of the Treasury Internal Revenue Service 26 CFR Part 1

Allocation and Apportionment of Interest Expense

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance regarding the allocation and apportionment of interest expense. These temporary regulations provide guidance concerning the allocation and apportionment of interest expense by corporations owning a 10 percent or greater interest in a partnership, as well as the allocation and apportionment of interest expense using the fair market value method. These temporary regulations also update the interest allocation regulations to conform to the statutory changes made by section 216 of the legislation commonly referred to as the Education Jobs and Medicaid Assistance Act (EJMAA), enacted on August 10, 2010, affecting the affiliation of certain foreign corporations for purposes of section 864(e). These regulations affect taxpayers that allocate and apportion interest expense. The text of these temporary regulations also serves as the text of the proposed regulations (REG–113903–10) set forth in the notice of proposed rulemaking on this subject published elsewhere in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective on January 17, 2012.

Applicability Dates: For dates of applicability, see §§1.861–9T(k) and 1.861–11T(h).

FOR FURTHER INFORMATION CONTACT: Jeffrey L. Parry, (202) 622–3850 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

I. Interest Expense Allocation by Partners

Section 1.861–9T(e) provides rules governing the apportionment of interest expense by a partner in a partnership. In general, §1.861–9T(e) adopts an aggregate, or look-through, approach to apportioning a partner's distributive share of interest expense incurred by the partnership. Section 1.861–9T(e)(1) provides the general rule that a partner's distributive share of the interest expense of a partnership is considered related to all income-producing activities and assets of the partner. Similarly, §1.861–9T(e)(2) requires that a corporate partner whose direct or indirect interest in the partnership is 10 percent or more apportion its distributive share of partnership interest expense by reference to the partner's assets, including the partner's *pro rata* share of the partnership's assets.

By contrast, limited partners (whether individual or corporate) and corporate general partners with a less-than-10-percent partnership interest are excepted from aggregate treatment. Under §1.861–9T(e)(4)(i), such partners must directly allocate their distributive share of partnership interest expense to their distributive share of partnership gross income. In addition, for purposes of allocating other interest expense incurred directly by such a partner, §1.861–9T(e)(4)(ii) provides that the relevant asset is the partner's interest in the partnership, and not the partner's share of the partnership assets.

This approach for such minority partners avoids the potential administrative burden that an aggregate approach would impose on such minority partners.

These temporary regulations revise §1.861–9T(e)(2) to clarify that a corporate partner with a 10 percent or greater interest in a partnership must allocate its direct interest expense to all of its assets, including its proportionate share of partnership assets. The IRS and the Treasury Department believe that an aggregate approach for corporate partners with a 10 percent or greater interest in the partnership is appropriate and consistent with the aggregate approach applicable to apportioning such partner's distributive share of interest expense incurred by the partnership.

These temporary regulations also revise §1.861–9T(e)(2) to provide that when a corporate partner with a 10 percent or greater interest in a partnership uses the tax book value or alternative tax book value method, and therefore must use the partnership's inside basis in its assets when allocating interest expense, the partnership's inside basis includes any section 734(b) adjustments and any section 743(b) adjustments of the corporate partner for this purpose. Section 1.861–9T(e)(3) is also revised to provide a similar rule for individual partners who are general partners or limited partners with a 10 percent or greater interest in the partnership.

II. Fair Market Value Method

Section 864(e)(2) requires that the allocation and apportionment of interest expense be made on the basis of assets and not gross income (the asset method). Under the asset method, interest expense is apportioned between (or among) statutory and residual groupings of gross income in proportion to the average total values of assets within each such grouping for the taxable year. For this purpose, taxpayers may elect to value assets based on their fair market value (the FMV method), tax book value, or alternative tax book value. §§1.861–8T(c)(2) and 1.861–9(i).

The temporary regulations set forth a multi-step methodology for determining the fair market value of a taxpayer's assets. Section 1.861–9T(h)(1) provides rules for determining the fair market value of the taxpayer's intangible assets. First, the taxpayer determines the aggregate value of assets that it and its subsidiaries own (Step 1); second, the taxpayer values its tangible assets, excluding any stock or indebtedness in a related person (Step 2); and third, it subtracts the amount determined in Step 2 from the amount determined in Step 1 to arrive at total intangible asset value (Step 3). The intangible assets owned by the taxpayer are then apportioned among the taxpayer's affiliates under §1.861–9T(h)(2) on the basis of net income (Step 4).

Once a taxpayer has determined the fair market value of its intangible assets, those assets must be characterized as provided in §1.861–9T(h)(3) (Step 5). Finally, the rules of §1.861–9T(h)(4) apply to determine the value of stock in a related person held by the taxpayer (or by another person related to the taxpayer) (Step 6). Under those rules, §1.861–9T(h)(4) states that the value of such stock is equal to the sum of the following amounts, less the taxpayer's *pro rata* share of liabilities of such related person: (i) the intangible assets apportioned to the related person in Step 4, above; (ii) the tangible assets (as determined in Step 2) held by the related person; and (iii) the total value of stock held in all other related persons held by the related person.

The IRS and the Treasury Department have become aware that certain taxpayers are taking the position that the language of Step 2 of the FMV method, which requires related party debt to be excluded as an asset as part of the process for determining total intangible asset value, means that such debt also is not treated as an asset in the hands of the taxpayer for the broader purpose of applying the asset method. In addition, for purposes of valuing the stock in related persons under Step 6, some taxpayers are taking the position that those rules exclude related party debt as an asset (because of the reference in §1.861–9T(h)(4) to §1.861–9T(h)(1)(ii)), but permit reduction of the value of the stock of the related person obligor by the amount of the related party debt as a liability (because the language of §1.861–9T(h)(4)(ii) does not limit the reduction for liabilities to unrelated party liabilities).

The IRS and the Treasury Department believe that interpreting the regulations to require that the related party debt be taken into account as a liability for purposes of valuing stock in the related person without also treating the related party debt as an asset in the creditor's hands distorts the relative values of assets assigned to each statutory grouping. This result is contrary to the general principles of the §1.861–9 regulations, which are based on the concept that interest expense must be apportioned on the basis of the value of all assets. Accordingly, these temporary regulations amend §1.861–9T(h)(4) to reflect the fact that related party debt is an asset that must be taken into account whether held by the taxpayer or a related person.

These temporary regulations first revise §1.861–9T(h)(4) by adding a new paragraph §1.861–9T(h)(4)(i) to provide for the valuation of related party debt. Prior to its revision by these temporary regulations, §1.861–9T(h)(4) provided for the valuation of the stock of a related person, but the regulations did not provide any explanation of how the related party debt is to be valued. As revised by these temporary regulations, §1.861–9T(h)(4)(i) provides that a related party debt obligation held by a taxpayer or another person related to the taxpayer has a value equal to the amount of the liability of the obligor related person. These temporary regulations also revise §1.861–9T(h)(4) by providing that the value of stock in a related person includes the taxpayer's *pro rata* share of related party debt held by the related person. Finally, these temporary regulations provide a new example illustrating the changes made to §1.861–9T(h)(4).

These amendments make clear that related party debt is an asset in the hands of the creditor for purposes of applying the asset method and is included in the valuation of stock of a related person. Very broadly, these changes ensure that both the receivable and the payable sides of related party debt are included for valuation purposes under the FMV method, and that the value of each side is determined in a consistent manner. No inference is intended regarding the interpretation of prior regulations as a result of these modifications.

III. Affiliated Groups

The interest expense of each member of an affiliated group is allocated and apportioned as if all members of such group were a single corporation. Section 864(e)(1). Prior to its amendment by the EJMAA, section 864(e)(5)(A) defined the

term "affiliated group" by reference to the rules under section 1504 for determining whether corporations are eligible to file consolidated returns. The section 1504 rules generally exclude foreign corporations from an affiliated group. Section 1.861–11T(d)(6)(ii) provides that certain foreign corporations are nevertheless treated as affiliated corporations for purposes of allocating and apportioning interest expense if (1) at least 80 percent of either the vote or value of the corporation's outstanding stock is owned directly or indirectly by members of an affiliated group, and (2) more than 50 percent of the corporation's gross income for the taxable year is effectively connected with the conduct of a trade or business in the United States (effectively connected income).

In the case of a foreign corporation that is treated as an affiliated corporation for interest allocation and apportionment purposes, §1.861–11T(d)(6)(ii) provides that the percentage of assets and income that is taken into account for purposes of applying the affiliated group interest apportionment rules depends on the percentage of the corporation's gross income that is effectively connected income. If 80 percent or more of the foreign corporation's gross income is effectively connected income, then all of the corporation's assets and interest expense are taken into account. If, instead, between 50 percent and 80 percent of the foreign corporation's gross income is effectively connected income, then only the corporation's assets that generate effectively connected income and a percentage of its interest expense equal to the percentage of its assets that generate effectively connected income are taken into account.

Section 864(e)(5)(A), as amended by the EJMAA, provides that a foreign corporation will be treated as a member of an affiliated group for interest allocation and apportionment purposes if (1) more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected income, and (2) at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group. In such event, all of the qualifying foreign corporation's assets and interest expense are taken into account for purposes of applying the affiliated group interest apportionment rules. These temporary regulations revise §1.861–11T(d)(6) to reflect these statutory changes.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also 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 the 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), these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Jeffrey L. Parry of the Office of Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

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 1.861–9T is amended by:

1. Revising the first two sentences of paragraph (e)(2), the fifth sentence of (e)(3), and paragraph (h)(4);

2. Adding four sentences before the last sentence of paragraph (k); and

3. Adding paragraph (l).

The revisions and additions read as follows:

§1.861–9T Allocation and apportionment of interest expense (temporary).

* * * * *

(e) * * *

(2) *Corporate partners whose interest in the partnership is 10 percent or more*. A corporate partner shall apportion its interest expense (including the partner's distributive share of partnership interest expense) by reference to the partner's assets, including the partner's *pro rata* share of partnership assets, under the rules of paragraph (f) of this section if the corporate partner's direct and indirect interest in the partnership (as determined under the attribution rules of section 318) is 10 percent or more. A corporation using the tax book value method or alternative tax book value method of apportionment shall use the partnership's inside basis in its assets, including adjustments under sections 734(b) and 743(b), if any, and adjusted to the extent required under §1.861–10T(d)(2). * * *

(3) *Individual partners who are general partners or who are limited partners with an interest in the partnership of 10 percent or more*. * * * An individual using the tax book value or alternative tax book value method of apportionment shall use the partnership's inside basis in its assets, including adjustments under sections 734(b) and 743(b), if any, and adjusted to the extent required under §1.861–10T(d)(2). * * *

* * * * *

(h) * * *

(4) *Valuing related party debt and stock in related persons* — (i) *Related party debt*. For purposes of this section, the value of a debt obligation of a related person held by the taxpayer or another person related to the taxpayer equals the amount of the liability of the obligor related person.

(ii) *Stock in related persons*. The value of stock in a related person held by the taxpayer or by another person related to the taxpayer equals the sum of the following amounts reduced by the taxpayer's *pro rata* share of liabilities of such related person:

(A) The portion of the value of intangible assets of the taxpayer and related persons that is apportioned to such related person under paragraph (h)(2) of this section;

(B) The taxpayer's *pro rata* share of tangible assets held by the related person (as determined under paragraph (h)(1)(ii) of this section);

(C) The taxpayer's *pro rata* share of debt obligations of any related person held by the related person (as valued under paragraph (h)(4)(i) of this section); and

(D) The total value of stock in all related persons held by the related person as determined under this paragraph (h)(4).

(iii) *Example*. (A) *Facts*. USP, a domestic corporation, wholly owns CFC1 and owns 80% of CFC2, both foreign corporations. The aggregate trading value of USP's stock traded on established securities markets at the end of Year 1 is $700 and the amount of USP's liabilities to unrelated persons at the end of Year 1 is $400. Neither CFC1 nor CFC2 has liabilities to unrelated persons at the end of Year 1. USP owns plant and equipment valued at $500, CFC1 owns plant and equipment valued at $400, and CFC2 owns plant and equipment valued at $250. The value of these assets has been determined using generally accepted valuation techniques, as required by §1.861–9T(h)(1)(ii). There is an outstanding loan from CFC2 to CFC1 in an amount of $100. There is also an outstanding loan from USP to CFC1 in an amount of $200.

(B) *Valuation of group assets*. Pursuant to §1.861–9T(h)(1)(i), the aggregate value of USP's assets is $1100 (the $700 trading value of USP's stock increased by $400 of USP's liabilities to unrelated persons).

(C) *Valuation of tangible assets*. Pursuant to §1.861–9T(h)(1)(ii), the value of USP's tangible assets and *pro rata* share of assets held by CFC1 and CFC2 is $1100 (the plant and equipment held directly by USP, valued at $500, plus USP's 100% *pro rata* share of the plant and equipment held by CFC1 valued at $400 and USP's 80% *pro rata* share of the plant and equipment held by CFC 2 valued at $200 (80% of $250)).

(D) *Computation of intangible asset value*. Pursuant to §1.861–9T(h)(1)(iii), the value of the intangible assets of USP, CFC1, and CFC2 is $0 (total aggregate group asset value ($1100) determined in paragraph (B) less total tangible asset value ($1100) determined in paragraph (C)). Because the intangible asset value is zero, the provisions of §1.861–9T(h)(2) and (3) relating to the apportionment and characterization of intangible assets do not apply.

(E) *Valuing related party debt obligations*. Pursuant to §1.861–9T(h)(4)(i), the value of the debt obligation of CFC1 held by CFC2 is equal to the amount of the liability, $100. The value of the debt obligation of CFC1 held by USP is equal to the amount of the liability, $200.

(F) *Valuing the stock of CFC1 and CFC2*. Pursuant to §1.861–9T(h)(4)(ii), the value of the stock of CFC2 held by USP is $280 (USP's 80% *pro rata* share of tangible assets of CFC2 included in paragraph (C) ($200) plus USP's 80% *pro rata* share of the debt obligation of CFC1 held by CFC2 valued in paragraph (E) ($80). The value of the stock of CFC1 held by USP is $100 (USP's 100% *pro rata* share of tangible assets of CFC1 included in paragraph (C) ($400) less USP's 100% *pro rata* share of the liabilities of CFC1 to USP and CFC2 ($300)).

* * * * *

(k) * * * Paragraphs (e)(2) and (3) apply to taxable years beginning after January 17, 2012. See 26 CFR §1.861–9T(e)(2) and (3) (revised as of April 1, 2011) for rules applicable to taxable years beginning on or before January 17, 2012. Paragraph (h)(4) applies to taxable years ending on or after January 17, 2012. See §1.861–9T(h)(4) (revised as of April 1, 2011) for rules applicable to taxable years ending before January 17, 2012.* * *

(l) *Expiration date*. The applicability date of paragraphs (e)(2), (e)(3), and (h)(4) expires on January 13, 2015.

Par. 4. Sec 1.861–11T is amended by revising paragraphs (d)(6)(ii) and (h) and adding paragraph (i) to read as follows:

§1.861–11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (temporary).

* * * * *

(6) * * *

(ii) Any foreign corporation if more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected with the conduct of a trade or business within the United States and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence).

* * * * *

(h) *Effective/applicability date*. In general, the rules of this section apply for taxable years beginning after December 31, 1986. Paragraph (d)(6)(ii) applies to taxable years beginning after August 10, 2010. See 26 CFR §1.861–11T(d)(6)(ii) (revised as of April 1, 2010) for rules applicable to taxable years beginning on or before August 10, 2010.

(i) *Expiration date*. The applicability date of paragraph (d)(6)(ii) expires on January 13, 2015.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved December 6, 2011.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 13, 2012, 8:45 a.m., and published in the issue of the Federal Register for January 17, 2012, 77 F.R. 2225)

Section 871.—Tax on Nonresident Alien Individuals

26 CFR 1.871–16T: Specified notional principal contracts (temporary).

T.D. 9572

Dividend Equivalents From Sources Within the United States

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to dividend equivalents for purposes of section 871(m) of the Internal Revenue Code (Code). The regulations provide guidance to nonresident aliens and foreign corporations that hold notional principal contracts (NPCs) providing for payments determined by reference to payments of dividends from sources within the United States. The text of the temporary regulations also serves as the text of the proposed regulations (REG–120282–10) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective January 23, 2012.

Applicability Date: For dates of applicability, see §§1.863–7T(f), 1.871–16T(g), 1.881–2T(f), 1.1441–2T(g), 1.1441–3T(k), 1.1441–4T(h), 1.1441–7T(h), and 1.1461–1T(j).

FOR FURTHER INFORMATION CONTACT: Mark E. Erwin or D. Peter Merkel at (202) 622–3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary regulations under section 871(m). Congress enacted section 871(m) (originally designated as section 871(l)) on March 18, 2010

in section 541 of the Hiring Incentives to Restore Employment Act (HIRE Act), Public Law 111–147 (124 Stat. 71).

Section 871(m) applies to securities loans, sale-repurchase transactions (repos), certain NPCs defined as "specified notional principal contracts" (specified NPCs), and any similar transactions that provide for a payment contingent upon or determined by reference to a U.S. source dividend (dividend equivalent). Section 871(m) treats a dividend equivalent as a dividend from sources within the United States for purposes of sections 871(a), 881, and 4948(a), and chapters 3 and 4 of subtitle A of the Code. Section 871(m) generally applies to any dividend equivalent made after September 14, 2010. With respect to payments made after March 18, 2012, section 871(m)(3)(B) provides that any NPC will be a specified NPC unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance.

Notice 2010–46, 2010–24 I.R.B. 757, outlined a proposed framework for limiting withholding in the case of a series of securities lending or sale-repurchase transactions. While the Treasury Department and the IRS anticipate issuing proposed regulations addressing the issues raised in Notice 2010–46, these regulations do not address these concerns. See §601.601(d)(2).

Explanation of Provisions

Section 1.871–16T(b) of these temporary regulations incorporates the definition of a specified NPC as provided in section 871(m)(3)(A). These temporary regulations extend the applicability of the section 871(m)(3)(A) statutory definition of a specified NPC through December 31, 2012. Proposed regulations set forth in the notice of proposed rulemaking in this issue of the Bulletin outline the proposed treatment of dividend equivalents under section 871(m) beginning January 1, 2013. The Treasury Department and the IRS believe that an extension of the statutory definition of the term specified NPC is necessary to allow taxpayers and withholding agents to modify their systems and other operating procedures to comply with the rules described in the notice of proposed rulemaking.

These temporary regulations also amend several regulations to clarify the application of section 871(m). For example, temporary regulations modify §1.863–7 to provide that that section does not apply to a dividend equivalent under section 871(m). Section 1.881–2T(b)(3) provides that section 871(m) and §1.871–16T apply to dividend equivalents received by foreign corporations. Certain regulations under section 1441 have been amended to require a withholding agent to withhold tax owed with respect to a dividend equivalent.

Notwithstanding these temporary regulations, the Commissioner may challenge transactions that are designed to avoid the application of these rules under applicable judicial doctrines. Nothing in these rules precludes the Commissioner from asserting that a contract labeled as an NPC or other equity derivative is in fact an ownership interest in the equity referenced in the contract.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. 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. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the special analyses section of the preamble to the cross-reference notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Code, these temporary regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact on small businesses.

Drafting Information

The principal author of these regulations is D. Peter Merkel, the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

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. 871(m) and 7805

* * *

Par. 2. Section 1.863–7 is amended by revising paragraph (a)(1) to read as follows:

§1.863–7 Allocation of income attributable to certain notional principal contracts under section 863(a).

(a) *Scope*—(1) *Introduction*. [Reserved]. For further guidance, see §1.863–7T(a)(1).

* * * * *

Par. 3. Section 1.863–7T is added as follows:

§1.863–7T Allocation of income attributable to certain notional principal contracts under section 863(a) (temporary).

(a) *Scope*—(1) *Introduction*. This section provides rules relating to the source and, in certain cases, the character of notional principal contract income. However, this section does not apply to income from a section 988 transaction within the meaning of section 988 and the regulations thereunder, relating to the treatment of certain nonfunctional currency transactions. Further, this section does not apply to a dividend equivalent as defined in section 871(m) or §1.871–15. Notional principal contract income is income attributable to a notional principal contract as defined in §1.446–3(c). 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.

(a)(2) through (e) [Reserved]. For further guidance, see §1.863–7(a)(2) through (e).

(f) *Effective/applicability date*. This section applies to payments made on or after January 23, 2012.

(g) *Expiration date*. This section expires January 16, 2015.

Par. 4. Section 1.871–15T is added and reserved to read as follows:

§1.871–15T Treatment of dividend equivalents (temporary). [Reserved]

Par. 5. Section 1.871–16T is added to read as follows:

§1.871–16T Specified notional principal contracts (temporary).

(a) [Reserved].

(b) *Specified notional principal contracts between March 18, 2012 and January 1, 2013*. With respect to payments made after March 18, 2012 and before January 1, 2013, the term specified notional principal contract means any notional principal contract (as defined in §1.446–3) if—

(1) In connection with entering into such contract, any long party to the contract transfers the underlying security to any short party to the contract;

(2) In connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract;

(3) The underlying security is not readily tradable on an established securities market; or

(4) In connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.

(c) through (f) [Reserved].

(g) *Effective/applicability date*. This section applies to payments made on or after January 23, 2012.

(h) *Expiration date*. This section expires on January 16, 2015.

Par. 6. Section 1.881–2 is amended by adding paragraph (b)(3) to read as follows:

§1.881–2 Taxation of foreign corporations not engaged in U.S. business.

* * * * *

(b) * * *

(3) [Reserved]. For further guidance, see §1.881–2T(b)(3).

* * * * *

Par. 7. Section 1.881–2T is added as follows:

§1.881–2T Taxation of foreign corporations not engaged in U.S. business (temporary).

(a) through (b)(2) [Reserved]. For further guidance, see §1.881–2(a) through (b)(2).

(3) *Dividend Equivalents*. For rules applicable to a foreign corporation's receipt of a dividend equivalent, see section 871(m) and §1.871–16T.

(c) through (e) [Reserved]. For further guidance, see §1.881–2(c) through (e).

(f) *Effective/applicability date*. This section applies on or after January 23, 2012.

(g) *Expiration date*. The applicability of this section expires on January 16, 2015.

Par. 8. Section 1.1441–2 is amended by adding paragraphs (b)(6) and (e)(7) to read as follows:

§1.1441–2 Amounts subject to withholding.

* * * * *

(b) * * *

(6) [Reserved]. For further guidance, see §1.1441–2T(b)(6).

* * * * *

(e) * * *

(7) [Reserved]. For further guidance, see §1.1441–2T(e)(7).

* * * * *

Par. 9. Section 1.1441–2T is added to read as follows:

§1.1441–2T Amounts subject to withholding (temporary).

(a) through (b)(5) [Reserved]. For further guidance, see §1.1441–2(a) through (b)(5).

(6) *Dividend equivalents*. Amounts subject to withholding include the payment of a dividend equivalent described in section 871(m). For this purpose, the term payment includes any gross amount that is used in computing any net amount that is transferred to or from the taxpayer under the terms of the contract.

(c) through (e)(6) [Reserved]. For further guidance, see §1.1441–2(c) through (e)(6).

(7) *Rules for dividend equivalents.* With respect to a dividend equivalent described in section 871(m), a payment is considered made to a person when any gross amount is used in computing any net amount that is transferred to or from the person under the terms of the contract pursuant to a transaction described in section 871(m)(2). When a dividend equivalent is used to determine a net payment, the person entitled to the gross dividend equivalent is considered to have received a payment even if that person receives no payment because the net payment equals zero or that person makes a net payment.

(f) [Reserved]. For further guidance, see §1.1441–2(f).

(g) *Effective/applicability date*. This section applies on or after January 23, 2012.

(h) *Expiration date*. The applicability of this section expires on January 16, 2015.

Par. 10. Section 1.1441–3 is amended by redesignating paragraph (h) as paragraph (j) and adding new paragraphs (h) and (i) to read as follows:

§1.1441–3 Determination of amounts to be withheld.

* * * * *

(h) [Reserved]. For further guidance, see §1.1441–3T(h).

(i) [Reserved]. For further guidance, see §1.1441–3T(i).

* * * * *

Par. 11. Section 1.1441–3T is added to read as follows:

§1.1441–3T Determination of amounts to be withheld (temporary).

(a) through (g) [Reserved]. For further guidance, see §1.1441–3(a) through (g).

(h) *Dividend equivalents*—(1) *In general*. The gross amount of a dividend equivalent described in section 871(m) is subject to withholding in an amount equal to the gross amount of the dividend equivalent used in computing any net amount that is transferred to or from the taxpayer.

(2) *Procedures for withholding with respect to a dividend equivalent paid prior to a notional principal contract (NPC) becoming a specified NPC*. [Reserved].

(i) *Estimate or other determination of the portion of a distribution attributable to a dividend equivalent*—(1) *In general*. In determining the amount subject to withholding as a dividend equivalent, a withholding agent may use a distributing corporation's estimate or other determination

with respect to the underlying security (as defined in section 871(m)(4)(C)) in applying the provisions of paragraphs (c)(2) through (c)(4) of this section. However, a withholding agent that elects to use any such estimate will be liable for the amount by which the actual amount required to be withheld exceeds the amount actually withheld and applicable penalties and interest resulting from its reliance on such estimate or determination. Failure of the withholding agent to withhold the required amount shall not be attributed to the distributing corporation.

(2) [Reserved]

(j) [Reserved]. For further guidance, see §1.1441–3(j).

(k) *Effective/applicability date*. This section applies on or after January 23, 2012.

(l) *Expiration date*. The applicability of this section expires on January 16, 2015.

Par. 12. Section 1.1441–4 is amended by revising paragraph (a)(3)(i) and adding paragraph (a)(3)(iii) to read as follows:

§1.1441–4 Exemptions from withholding for certain effectively connected income and other amounts.

(a)* * *

(3) * * *

(i) [Reserved]. For further guidance, see §1.1441–4T(a)(3)(i).

* * * * *

(iii) [Reserved]. For further guidance, see §1.1441–4T(a)(3)(iii).

* * * * *

Par. 13. Section 1.1441–4T is added to read as follows:

§1.1441–4T Exemptions from withholding for certain effectively connected income and other amounts (temporary).

(a)(1) through (a)(2) [Reserved]. For further guidance, see §1.1441–4(a)(1) through (a)(2).

(3) *Income on notional principal contracts*—(i) *General rule*. Except as otherwise provided in paragraph (a)(3)(iii) of this section, a withholding agent that pays amounts attributable to a notional principal contract described in §1.863–7T(a) or §1.988–2(e) shall have no obligation to withhold on the amounts paid under the terms of the notional principal contract regardless of whether a withholding certificate is provided. However, a withholding agent must file returns under §1.1461–1(b) and (c) reporting the income that it must treat as effectively connected with the conduct of a trade or business in the United States under the provisions of this paragraph (a)(3). Except as otherwise provided in paragraph (a)(3)(ii) of this section, a withholding agent must treat the income as effectively connected with the conduct of a U.S. trade or business if the income is paid to, or to the account of, a qualified business unit of a foreign person located in the United States or, if the payment is paid to, or to the account of, a qualified business unit of a foreign person located outside the United States, the withholding agent knows, or has reason to know, the payment is effectively connected with the conduct of a trade or business within the United States. Income on a notional principal contract does not include the amount characterized as interest under the provisions of §1.446–3(g)(4).

(ii) [Reserved]. For further guidance, see §1.1441–4(a)(3)(ii).

(iii) *Exception for specified notional principal contracts*. A withholding agent that makes a payment attributable to a specified notional principal contract described in section 871(m), or §1.871–16T that is not treated as effectively connected with the conduct of a trade or business within the United States shall have an obligation to withhold on the amount of such payment that is a dividend equivalent.

(b) through (g) [Reserved]. For further guidance, see §1.1441–4(b) through (g).

(h) *Effective/applicability date*. This section applies on or after January 23, 2012.

(i) *Expiration date*. The applicability of this section expires on January 16, 2015.

Par. 14. Section 1.1441–7 is amended by:

1. Redesignating paragraph (a)(2) as paragraph (a)(3) and revising newly designated paragraph (a)(3).

2. Adding a new paragraph (a)(2).

The revision and addition reads as follows:

§1.1441–7 General provisions relating to withholding agents.

(a) * * *

(2) [Reserved]. For further guidance, see §1.1441–7T(a)(2).

(3) *Examples*. The following examples illustrate the rules of paragraph (a) of this section:

* * * * *

Example 6. [Reserved]. For further guidance, see §1.1441–7T(a)(3) *Example 6*.

* * * * *

Par. 15. Section 1.1441–7T is added to read as follows:

§1.1441–7T General provisions relating to withholding agents (temporary).

(a)(1) [Reserved]. For further guidance, see §1.1441–7(a)(1).

(2) *Withholding agent with respect to dividend equivalents*. Each person that is a party to any contract or arrangement that provides for the payment of a dividend equivalent, as defined in section 871(m), shall be treated as having control and custody of such payment.

(3) *Examples*. The following examples illustrate the rules of paragraphs (a)(1) and (a)(2) of this section:

Example 1 through *Example 5* [Reserved]. For further guidance, see §1.1441–7(a)(3), *Example 1* through *Example 5*.

Example 6. FC, a foreign corporation, enters into a notional principal contract (NPC) with Bank X, a bank organized in the United States. The NPC is a specified NPC for purposes of section 871(m). FC is the long party to the contract and Bank X is the short party. The NPC references a specified number of shares of dividend-paying common stock issued by a domestic corporation. As the long party, FC receives payments from Bank X based on any appreciation in the value of the common stock and dividends paid with respect to the common stock. As the short party, Bank X receives payment from FC based on any depreciation in the value of the common stock and a payment based on LIBOR. Bank X is a withholding agent because Bank X is deemed to have control and custody of a dividend equivalent as a party to the NPC. If FC's tax liability under section 881 has not been satisfied in full by Bank X as withholding agent, FC is required to file a return on Form 1120–F (*U.S. Income Tax Return of a Foreign Corporation*).

(b)(1) through (g) [Reserved]. For further guidance, see §1.1441–7(b)(1) through (g).

(h) *Effective/applicability date*. This section applies on or after January 23, 2012.

(i) *Expiration date*. The applicability of this section expires on January 16, 2015.

Par. 16. Section 1.1461–1 is amended by:

1. Redesignating paragraphs (c)(2)(i)(L) and (c)(2)(i)(M) as (c)(2)(i)(M) and (c)(2)(i)(N), respectively.

3. Adding a new paragraph (c)(2)(i)(L).

The addition reads as follows:

§1.1461–1 Payment and returns of tax withheld.

* * * * *

(c) * * *

(2) * * *

(i) * * *

(L) [Reserved]. For further guidance, see §1.1461–1T(c)(2)(L).

* * * * *

Par. 17. Section 1.1461–1T is added as follows:

§1.1461–1T Payment and returns of tax withheld (temporary).

(a) through (c)(2)(i)(K) [Reserved]. For further guidance, see §1.1461–1(a) through (c)(2)(i)(K).

(L) Dividend equivalents as defined in section 871(m) and the regulations thereunder;

(c)(2)(i)(M) through (i) [Reserved]. For further guidance, see §1.1461–1(c)(2)(i)(M) through (i).

(j) *Effective/applicability date*. This section applies on or after January 23, 2012.

(k) *Expiration date*. The applicability of this section expires on January 16, 2015.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved January 3, 2012.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 19, 2012, 11:15 a.m., and published in the issue of the Federal Register for January 23, 2012, 77 F.R. 3108)

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for March 2012.

Rev. Rul. 2012–9

This revenue ruling provides various prescribed rates for federal income tax purposes for March 2012 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(1) for buildings placed in service during the current month. However, under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, and before December 31, 2013, shall not be less than 9%. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2012–9 TABLE 1

Applicable Federal Rates (AFR) for March 2012

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term				
AFR	.19%	.19%	.19%	.19%
110% AFR	.21%	.21%	.21%	.21%
120% AFR	.23%	.23%	.23%	.23%
130% AFR	.25%	.25%	.25%	.25%
Mid-term				
AFR	1.08%	1.08%	1.08%	1.08%
110% AFR	1.19%	1.19%	1.19%	1.19%
120% AFR	1.30%	1.30%	1.30%	1.30%
130% AFR	1.40%	1.40%	1.40%	1.40%
150% AFR	1.63%	1.62%	1.62%	1.61%
175% AFR	1.90%	1.89%	1.89%	1.88%
Long-term				
AFR	2.65%	2.63%	2.62%	2.62%
110% AFR	2.91%	2.89%	2.88%	2.87%
120% AFR	3.18%	3.16%	3.15%	3.14%
130% AFR	3.45%	3.42%	3.41%	3.40%

REV. RUL. 2012–9 TABLE 2

Adjusted AFR for March 2012

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	.26%	.26%	.26%	.26%
Mid-term adjusted AFR	1.05%	1.05%	1.05%	1.05%
Long-term adjusted AFR	3.47%	2.95%	2.94%	2.93%

REV. RUL. 2012–9 TABLE 3

Rates Under Section 382 for March 2012

Adjusted federal long-term rate for the current month	2.97%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	3.55%

REV. RUL. 2012–9 TABLE 4

Appropriate Percentages Under Section 42(b)(1) for March 2012

Note: Under Section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, and before December 31, 2013, shall not be less than 9%.

Appropriate percentage for the 70% present value low-income housing credit	7.43%
Appropriate percentage for the 30% present value low-income housing credit	3.18%

REV. RUL. 2012–9 TABLE 5	
Rate Under Section 7520 for March 2012	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	1.4%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 6695.—Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons

26 CFR 1.6695–2: Tax return preparer due diligence requirements for determining earned income credit eligibility.

T.D. 9570

Tax Return Preparer Penalties Under Section 6695

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that modify existing regulations related to the tax return preparer penalties under section 6695 of the Internal Revenue Code (Code). The final regulations are necessary to monitor and to improve compliance with the tax return preparer due diligence requirements of section 6695(g). The final regulations affect paid tax return preparers.

DATES: *Effective Date:* The final regulations are effective on December 20, 2011.

Applicability Date: For date of applicability, see §1.6695–2(e).

FOR FURTHER INFORMATION CONTACT: Spence Hanemann, (202) 622–4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in the final regulations was previously reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1570. The collection of information is in §1.6695–2(b)(1) and (b)(4) of the final regulations, and is an increase in the total annual burden from the burden in the prior regulations. The collection of this information will improve the IRS' ability to enforce compliance with the due diligence requirements under section 6695(g) with respect to determining eligibility for, or the amount of, the earned income credit (EIC) under section 32.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 6695 of the Code.

The Treasury Department and the IRS published a notice of proposed rulemaking (REG–140280–09, 2011–45 I.R.B. 709) in the **Federal Register,** 76 FR 62689, on October 11, 2011 (the NPRM). A public hearing was scheduled for November 7, 2011. The IRS did not receive any requests to testify at the public hearing, and the public hearing was cancelled. Written comments responding to the NPRM were received and are available for public inspection at *http://www.regulations.gov* or upon request. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions to the regulations are discussed in this preamble.

Summary of Comments and Explanation of Revisions

The IRS received nine written comments in response to the NPRM, and this section addresses those public comments. This section also describes the significant differences between the rules proposed in the NPRM and those adopted in the final regulations.

1. *2011 Amendment to Section 6695(g)*

On October 21, 2011, section 501 of the United States-Korea Free Trade Agreement Implementation Act, Public Law 112–41, 125 Stat 428, amended section 6695(g) of the Code by increasing the amount of the penalty from $100 to $500. To account for this change in the law, §1.6695–2(a) of the final regulations has been conformed to the statutory language of section 6695(g), as amended.

2. *Necessity of These Regulations*

Two commenters stated that the proposed amendments to the due diligence standards in the NPRM were unnecessary in light of recent regulatory changes requiring tax return preparers to register with the IRS and comply with the ethical standards governing practice before the IRS (Circular 230), as well as the tax return preparer penalties under section 6694. They suggested that the IRS can apply these existing provisions to address misconduct by tax return preparers, including improper determination of eligibility for, and amount of, EIC by both individual tax return preparers and firms.

As reflected in section 6695(g), Congress has determined that noncompliance with the EIC rules poses a sufficiently significant problem to merit imposing unique due diligence requirements on tax return preparers involved in determining eligibility for, or amount of, the EIC. By recently quintupling the amount of the penalty for

failure to comply with these requirements, Congress reaffirmed the need for specific rules to reduce EIC noncompliance. In order to address noncompliance with the EIC rules, the final regulations modify the due diligence requirements under section 6695(g) that have been in place for over a decade. Treasury and the IRS concluded that these regulations are consistent with section 6695(g), and no modification is made in the final regulations in response to these comments.

3. *Submission of Form 8867*

Section 1.6695–2(b)(1)(i) of the proposed regulations required that the Form 8867, "*Paid Preparer's Earned Income Credit Checklist*," be submitted to the IRS in the manner required by forms, instructions, or other appropriate guidance. One commenter noted, in part, that tax return preparers sometimes provide a paper copy of the completed tax return or claim for refund to the taxpayer for submission by the taxpayer. A tax return preparer's ability to provide a paper copy, as opposed to filing the tax return electronically, is subject to the rules and limitations in §301.6011–7 and related guidance. Another commenter stated that the proposed regulations were unclear in how they apply to nonsigning tax return preparers. The due diligence requirements and the penalty for failure to comply with them apply to any tax return preparer, including a nonsigning tax return preparer, who determines eligibility for, or amount of, the EIC.

After consideration of these comments, Treasury and the IRS have concluded that the rules in the regulations should be clarified to provide how tax return preparers who prepare a tax return or claim for refund but do not submit it directly to the IRS can satisfy the requirement under proposed §1.6695–2(b)(1)(i) to submit the completed Form 8867 to the IRS. In response to these comments, §1.6695–2(b)(1)(i) of the final regulations provides that tax return preparers who prepare a tax return or claim for refund but do not submit it directly to the IRS may satisfy this aspect of their due diligence obligation by providing the form to the taxpayer or the signing tax return preparer, as appropriate, for submission with the tax return or claim for refund.

One commenter suggested that the Form 8867 be a stand-alone form that the taxpayer signs and submits as an affidavit of EIC eligibility. After consideration of this comment, Treasury and the IRS have concluded that imposing such an obligation on taxpayers, rather than on tax return preparers, would be contrary to the purpose of section 6695(g), which is to discourage tax return preparers from preparing EIC tax returns or claims for refund without performing basic due diligence. No modification is made in the final regulations in response to this comment.

4. *Requirement to Verify Taxpayer Information*

Section 1.6695–2(b)(1)(i) of the proposed regulations required submission of Form 8867 to the IRS, and §1.6695–2(b)(4)(i)(C) of the proposed regulations required retention of a copy of any document that was provided by the taxpayer and on which the tax return preparer relied to complete Form 8867 or the Earned Income Credit Worksheet. Two commenters suggested that these additional requirements increased a tax return preparer's burden under the knowledge requirement of existing §1.6695–2(b)(3) because a tax return preparer would now be obligated to verify taxpayers' responses to the eligibility questions and also to verify nonsigning tax return preparers' (if any) completion of the Form 8867. The proposed regulations, however, do not expand tax return preparers' obligation to verify information provided by taxpayers and other tax return preparers under existing §1.6695–2(b)(3).

Under §1.6695–2(b)(3) of the current regulations, tax return preparers are already required to complete Form 8867, prohibited from ignoring the implications of information provided, obligated to make reasonable inquiries if the information provided appears incorrect, inconsistent, or incomplete, and required to contemporaneously document their reasonable inquiries and the taxpayer's responses. For purposes of §1.6695–2(b)(3), tax return preparers would not be held to a higher standard under the proposed regulations than they are under the existing regulations. A tax return preparer can generally rely on the information furnished by a taxpayer (or other tax return preparer who determines eligibility for, or amount of, the EIC) as long as the tax return preparer does not know, or have reason to know, that the information is incorrect, inconsistent, or incomplete. A signing tax return preparer who satisfies the knowledge requirement in §1.6695–2(b)(3), therefore, will ordinarily be able to rely on the information furnished to the signing tax return preparer by a taxpayer or nonsigning tax return preparer regarding the EIC. The additional requirements in proposed §1.6695–2(b)(1)(i) and (b)(4)(i)(C) are not unduly burdensome and will improve the IRS' ability to determine whether a tax return preparer has complied with the EIC due diligence requirements that already exist. No modification is made in the final regulations in response to these comments.

5. *Nonsigning Tax Return Preparers*

Two commenters expressed concern that expanding the due diligence requirements and penalty to nonsigning tax return preparers would subject individuals to the section 6695(g) penalty who are beyond the intended scope of these rules. The commenters provided the example of individuals hired by tax preparation software companies to answer discrete questions for taxpayers who are using tax preparation software to prepare their own tax return or claim for refund. These individuals provide general resource information for the taxpayers who are preparing their own tax return or claim for refund, and they do not know all of the specific facts relating to the taxpayer's tax return or claim for refund. The commenters reasoned that these individuals might be nonsigning tax return preparers and would arguably be subject to these due diligence requirements and related penalty.

The term "nonsigning tax return preparer" is specifically defined in §301.7701–15(b)(2) and is limited to those who prepare all or a substantial portion of a tax return or claim for refund within the meaning of §301.7701–15(b)(3). Under §301.7701–15(b)(3), a person who renders tax advice on a position that is directly relevant to the existence or amount of an entry on a tax return or claim for refund is regarded as having prepared that entry. Section 301.7701–15(b)(3) further provides that whether a schedule, entry, or

other portion of a tax return or claim for refund is a substantial portion is determined based upon whether the person knows or reasonably should know that the tax attributable to the schedule, entry, or other portion of a tax return or claim for refund is a substantial portion of the tax required to be shown on the tax return or claim for refund. Also, §301.7701–15(f)(1)(viii) provides an exception from the definition of tax return preparer for any individual providing only typing, reproduction, or other mechanical assistance in the preparation of a tax return or claim for refund.

Treasury and the IRS have concluded that, in the routine situation described by these commenters, the individuals employed at the tax preparation software companies as described in the comments are not nonsigning tax return preparers as long as they either (i) fall within the mechanical exception because they are not exercising independent judgment on the taxpayer's underlying tax positions, or (ii) do not know (and reasonably should not know) that any generic advice provided relating to the EIC is a substantial portion of the tax required to be shown. On the other hand, in rare instances when any such individual is both exercising independent judgment and knows or reasonably should know that specific advice provided to a taxpayer relating to EIC is a substantial portion of the tax return or claim for refund within the meaning of §301.7701–15(b)(3), the individual is a nonsigning tax return preparer subject to the due diligence rules. No modification is made to the final regulations in response to this comment.

6. *Penalizing Firms*

By replacing "signing tax return preparer" with "tax return preparer," §1.6695–2(a) of the proposed regulations effectively provided that a firm that employs a person to prepare for compensation a tax return or claim for refund may be subject to the penalty for its employee's failure to comply with the due diligence requirements. Two commenters questioned the proposed application of the due diligence requirements and penalty to firms. Section 6695(g) imposes a penalty on "[a]ny person who is a tax return preparer" that fails to comply with the due diligence requirements "with respect to determining eligibility for, or the amount of, the credit allowable by section 32." Under section 7701(a)(36), a "tax return preparer" is "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by title or any claim for refund of tax imposed by this title." After consideration of these comments, Treasury and the IRS have concluded that it is appropriate to apply the due diligence requirements to firms as provided in the proposed regulations. This position is consistent with the long-standing application of the section 6694 tax return preparer penalties to firms under the rules provided in §§1.6694–2(a)(2) and 1.6694–3(a)(2). No modification is made to the final regulations in response to these comments.

7. *Conditions Required for Imposing a Penalty on a Firm*

Proposed §1.6695–2(c) provided generally that a firm cannot be subject to a penalty under section 6695(g) unless one of the following three conditions is satisfied: (1) a member of the principal management of the firm knew of the failure to comply with the due diligence requirements; (2) the firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements; or (3) the firm failed to comply with its reasonable and appropriate compliance procedures through willfulness, recklessness, or gross indifference. Two commenters expressed concern with the conditions required for application of the penalty to a firm, as set forth in proposed §1.6695–2(c).

One of these commenters noted that, if management became aware through the firm's reasonable and appropriate compliance procedures that an employee failed to comply with the due diligence requirements, then the firm would be subject to a penalty under proposed §1.6695–2(c)(1) because management knew of the failure. The commenter suggested that the final regulations provide that the penalty not apply to the firm if management knew and took reasonable action to resolve the problem before the penalty is assessed. After consideration of this comment, Treasury and the IRS have concluded that, if management knows of the failure to comply prior to the date the tax return or claim for refund is filed, the only acceptable remedial action would be to satisfy the due diligence requirements prior to filing, in which case there would be no penalty. If, on the other hand, management does not know of the failure to comply until after the tax return or claim for refund is filed, the appropriate analysis is whether the firm had reasonable and appropriate compliance procedures and disregarded those procedures through willfulness, recklessness, or gross indifference, as described in §1.6695–2(c)(3), and management's knowledge is relevant only insofar as it is a factor in that analysis. In response to this comment, the final regulations provide that a firm is only subject to a penalty under §1.6695–2(c)(1) if the manager knew of an employee's failure to comply with the due diligence requirements prior to the date the tax return or claim for refund was filed.

The other commenter suggested that the IRS might determine under proposed §1.6695–2(c)(3) that a single failure to submit Form 8867 with a tax return by an otherwise compliant firm qualifies as disregard of reasonable and appropriate compliance procedures through gross indifference. Section 1.6695–2(c)(3) of the proposed regulations established a heightened standard, in part, by imposing liability for the penalty against a firm that disregarded its reasonable and appropriate compliance procedures through willfulness, recklessness, or gross indifference. A single, accidental failure to submit Form 8867 with a tax return by an otherwise compliant firm would not constitute disregard of compliance procedures through willfulness, recklessness, or gross indifference, and the firm would not be subject to the penalty in that situation. After consideration of this comment, Treasury and the IRS have concluded that the heightened standards in proposed §1.6695–2(c)(3) would adequately protect firms against isolated and inadvertent instances of disregard of their compliance procedures. No modification is made to the final regulations in response to this comment.

8. *Retention of Records*

Proposed §1.6695–2(b)(4)(ii) required that a tax return preparer must retain the records described in §1.6695–2(b)(4)(i)

for the period ending three years after the later of the date the tax return or claim for refund was due or the date it was filed. One commenter stated that the record retention date should not be tied to the date the tax return or claim for refund was filed because, if the tax return preparer who prepares the tax return or claim for refund is not the individual who files it, that tax return preparer might not know when it is filed and when the retention period expires. In response to the comment, the final regulations require a tax return preparer to retain the records described in §1.6695–2(b)(4)(i) for the period ending three years after the later of the date the tax return or claim for refund was due or the date it was transferred in final form by the tax return preparer to the next person in the course of the filing process. In the case of a signing tax return preparer who electronically files the tax return or claim for refund, the next step in the filing process will be to electronically file the tax return or claim for refund, so the relevant date is the date the tax return or claim for refund is filed. In the case of a signing tax return preparer who does not electronically file the tax return or claim for refund, the next person in the course of the filing process will be the taxpayer, so the relevant date is the date the tax return or claim for refund is presented to the taxpayer for signature. In the case of a nonsigning tax return preparer, the next person in the course of the filing process will be the signing tax return preparer, so the relevant date is the date the nonsigning tax return preparer submitted to the signing tax return preparer that portion of the tax return or claim for refund for which the nonsigning tax return preparer was responsible.

The record retention date under the final regulations will be the same for nonsigning tax return preparers supervised by a signing tax return preparer in the same firm and nonsigning tax return preparers who are employed by a different firm than the signing tax return preparer. In both cases, the records must be retained until three years from the later of the due date of the tax return or the date the tax return or claim for refund is submitted in final form to the signing tax return preparer. As a practical matter, however, a supervised nonsigning tax return preparer and the supervising signing tax return preparer can satisfy both of their record retention obligations under the final regulations by retaining a single paper or electronic copy of the records described in §1.6695–2(b)(4)(i). The supervised nonsigning tax return preparer's record retention period may, nevertheless, expire before the signing tax return preparer's record retention period. In such cases, the supervising signing tax return preparer is required to retain the records until the expiration of his or her record retention period under §1.6695–2(b)(4)(ii), regardless of when the supervised nonsigning tax return preparer's record retention period expires.

9. *Comment Period and Effective Date*

One commenter stated that the 30-day comment period provided under the proposed regulations was inadequate. Numerous substantive comments were, in fact, received addressing the proposed regulations. Treasury and the IRS have concluded that the duration of the comment period provided in the proposed regulations was in compliance with all of the applicable procedural rules and requirements governing regulations.

Three commenters stated that the proposed effective date of the regulations would not provide tax return preparers and computer software providers sufficient time to adjust their procedures and products to reflect the proposed amendments. The proposed regulations provided that they will apply to tax returns and claims for refund for tax years ending on or after December 31, 2011. The IRS publicly announced in Spring 2011 that the IRS was exploring the implementation of a new requirement for tax return preparers to submit the Form 8867 with a taxpayer's tax return or claim for refund. Treasury and the IRS have concluded that implementation of these rules for the upcoming filing season is consistent with the best interests of tax administration.

Special Analyses

It has been determined that this final rule is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. 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 the final regulations.

When an agency issues a rulemaking, the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), requires the agency to "prepare and make available for public comment an initial regulatory flexibility analysis" that will "describe the impact of the proposed rule on small entities." (5 U.S.C. 603(a)). Section 605 of the RFA provides an exception to this requirement if the agency certifies that the rulemaking will not have a significant economic impact on a substantial number of small entities.

The final rules affect tax return preparers who determine the eligibility for, or the amount of, EIC. The NAICS code that relates to tax preparation services (NAICS code 541213) is the appropriate code for tax return preparers subject to the final regulations. Entities identified as tax preparation services are considered small under the Small Business Administration size standards (13 CFR 121.201) if their annual revenue is less than $7 million. The IRS estimates that approximately 75 to 85 percent of the 550,000 persons who work at firms or are self-employed tax return preparers are operating as or employed by small entities. The IRS has determined that the final rules will have an impact on a substantial number of small entities.

The IRS has determined, however, that the economic impact on entities affected by the final rules will not be significant. The prior regulations under section 6695(g) required tax return preparers to complete the Form 8867 or otherwise record in their files the information necessary to complete the form. Tax return preparers were also required to maintain records of the checklists and EIC computations, as well as a record of how and when the information used to compute the EIC was obtained by the tax return preparer. The amount of time necessary to submit, record, and retain the additional information required in the final regulations, therefore, should be minimal for these tax return preparers.

Based on these facts, the IRS hereby certifies that the collection of information contained in the final regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a Regulatory Flexibility Analysis is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preced-

ing the final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business and no comments were received.

Drafting Information

The principal author of the final regulations is Spence Hanemann, Office of the Associate Chief Counsel (Procedure and Administration).

* * * * *

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 * * *

Section 1.6695–2 also issued under 26 U.S.C. 6695(g). * * *

Par. 2. In §1.6695–2, paragraphs (a), (b)(1), (b)(2), (b)(4), (c), and (d) are revised and new paragraph (e) is added to read as follows:

§1.6695–2 Tax return preparer due diligence requirements for determining earned income credit eligibility.

(a) *Penalty for failure to meet due diligence requirements.* A person who is a tax return preparer of a tax return or claim for refund under the Internal Revenue Code with respect to determining the eligibility for, or the amount of, the earned income credit (EIC) under section 32 and who fails to satisfy the due diligence requirements of paragraph (b) of this section will be subject to a penalty of $500 for each such failure.

(b) * * *

(1) *Completion and submission of Form 8867*—(i) The tax return preparer must complete Form 8867, "*Paid Preparer's Earned Income Credit Checklist*," or such other form and such other information as may be prescribed by the Internal Revenue Service (IRS), and—

(A) In the case of a signing tax return preparer electronically filing the tax return or claim for refund, must electronically file the completed Form 8867 (or successor form) with the tax return or claim for refund;

(B) In the case of a signing tax return preparer not electronically filing the tax return or claim for refund, must provide the taxpayer with the completed Form 8867 (or successor form) for inclusion with the filed tax return or claim for refund; or

(C) In the case of a nonsigning tax return preparer, must provide the signing tax return preparer with the completed Form 8867 (or successor form), in either electronic or non-electronic format, for inclusion with the filed tax return or claim for refund.

(ii) The tax return preparer's completion of Form 8867 (or successor form) must be based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained by the tax return preparer.

(2) *Computation of credit*—(i) The tax return preparer must either—

(A) Complete the Earned Income Credit Worksheet in the Form 1040 instructions or such other form and such other information as may be prescribed by the IRS; or

(B) Otherwise record in one or more documents in the tax return preparer's paper or electronic files the tax return preparer's EIC computation, including the method and information used to make the computation.

(ii) The tax return preparer's completion of the Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section) must be based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained by the tax return preparer.

* * * * *

(4) *Retention of records*—(i) The tax return preparer must retain—

(A) A copy of the completed Form 8867 (or successor form);

(B) A copy of the completed Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section); and

(C) A record of how and when the information used to complete Form 8867 (or successor form) and the Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section) was obtained by the tax return preparer, including the identity of any person furnishing the information, as well as a copy of any document that was provided by the taxpayer and on which the tax return preparer relied to complete Form 8867 (or successor form) or the Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section).

(ii) The items in paragraph (b)(4)(i) of this section must be retained for three years from the latest of the following dates, as applicable:

(A) The due date of the tax return (determined without regard to any extension of time for filing);

(B) In the case of a signing tax return preparer electronically filing the tax return or claim for refund, the date the tax return or claim for refund was filed;

(C) In the case of a signing tax return preparer not electronically filing the tax return or claim for refund, the date the tax return or claim for refund was presented to the taxpayer for signature; or

(D) In the case of a nonsigning tax return preparer, the date the nonsigning tax return preparer submitted to the signing tax return preparer that portion of the tax return or claim for refund for which the nonsigning tax return preparer was responsible.

(iii) The items in paragraph (b)(4)(i) of this section may be retained on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance (see §601.601(d)(2) of this chapter).

(c) *Special rule for firms.* A firm that employs a tax return preparer subject to a penalty under section 6695(g) is also subject to penalty if, and only if—

(1) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or, prior to the time the return was filed, knew of the failure to comply with the due diligence requirements of this section;

(2) The firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements of this section; or

(3) The firm disregarded its reasonable and appropriate compliance procedures through willfulness, recklessness, or gross indifference (including ignoring facts that

would lead a person of reasonable prudence and competence to investigate or ascertain) in the preparation of the tax return or claim for refund with respect to which the penalty is imposed.

(d) *Exception to penalty*. The section 6695(g) penalty will not be applied with respect to a particular tax return or claim for refund if the tax return preparer can demonstrate to the satisfaction of the IRS that, considering all the facts and circumstances, the tax return preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements of paragraph (b) of this section, and the failure to meet the due diligence requirements of paragraph (b) of this section with respect to the particular tax return or claim for refund was isolated and inadvertent. The preceding sentence does not apply to a firm that is subject to the penalty as a result of paragraph (c) of this section.

(e) *Effective/applicability date*. This section applies to tax returns and claims for refund for tax years ending on or after December 31, 2011.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved December 14, 2011.

Emily S. McMahon,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 19, 2011, 8:45 a.m., and published in the issue of the Federal Register for December 20, 2011, 76 F.R. 78816)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of March 2012. See Rev. Rul. 2012-9, page 475.

Part III. Administrative, Procedural, and Miscellaneous

Reimbursements Under Section 1603 of ARRTA 2009

Notice 2012–23

PURPOSE

This notice provides guidance in a question-and-answer format on tax-related issues involving cash payments for specified energy property in lieu of tax credits under Section 1603 of the American Recovery and Reinvestment Tax Act of 2009 (ARRTA), Division B of Pub. L. No. 111–5, 123 Stat. 115 (2009) (Section 1603) as amended by Section 707 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111–312. The Department of the Treasury established an email address (*1603Questions@do.treas.gov*) for Section 1603 questions, to which taxpayers and their representatives submitted some of the questions contained in this notice. The Internal Revenue Service received additional questions by telephone and facsimile. Any guidance, documents, interpretations, or approvals issued by Treasury relating to the Section 1603 program are not precedent for the federal income tax treatment of specified energy property under sections 45 and 48 of the Internal Revenue Code.

BACKGROUND

Section 1603 of ARRTA directs the Secretary of the Treasury (Treasury) to provide cash payments (Section 1603 payments) to eligible persons who place in service specified energy property and apply for such payments. The purpose of Section 1603 is to reimburse eligible applicants for a portion of the expense of such property. Treasury issued a Guidance Document (Program Guidance) to establish procedures for applying for payments under the Section 1603 program and to clarify the eligibility requirements under the program. Additionally, Treasury provides guidance on the Section 1603 program website in the form of two documents with frequently asked questions and answers: Frequently Asked Questions (FAQ1) and Frequently Asked Questions Regarding the Beginning of Construction. Each of these documents is available at *http://www.treasury.gov/recovery/1603.shtml*.

Treasury will make Section 1603 payments to qualified applicants in an amount generally equal to 10 percent or 30 percent of the basis of the specified energy property, depending on the type of property. Eligibility for a Section 1603 payment generally requires applicants to place the property in service during 2009, 2010, or 2011. Property placed in service after 2011 may qualify for a Section 1603 payment if construction began on the property during 2009, 2010, or 2011 and the applicant places the property in service by the date on which the related tax credit expires (the credit termination date). The Program Guidance describes these dates and percentages more fully.

Treasury will review applications submitted through the Treasury website and make payments within 60 days from the later of the date of the filing of the complete application or the date the applicant places the property in service. Taxpayers who receive payments for property under Section 1603 of ARRTA may not claim the renewable electricity production tax credit under section 45 of the Code (PTC) or the energy investment tax credit under section 48 of the Code (ITC) with respect to the same property for the taxable year of the payment or subsequent years. In addition, taxpayers must recapture any ITC previously allowed with respect to progress expenditures for the property.

Eligible property under the program includes only property used in a trade or business or held for the production of income. Nonbusiness energy property described in section 25C of the Code and residential energy efficient property described in section 25D of the Code do not qualify for payments under this program but may qualify for tax credits under those provisions.

QUESTIONS AND ANSWERS ON TAX-RELATED ISSUES IN SECTION 1603

Q–1: What are the federal income tax consequences to a taxpayer who receives a Section 1603 payment? How does the receipt of a Section 1603 payment affect the basis of specified energy property?

A–1: A Section 1603 payment is not includible in a taxpayer's gross income, and the taxpayer's basis in the specified energy property is reduced by 50 percent of the payment. Section 48(d)(3) of the Code. All project costs that are properly capitalized for purposes of determining the depreciation deduction are included in the cost basis of specified energy property. See Q&A #5, below, for tax consequences to a lessee who receives a Section 1603 payment.

Q–2. What are the federal income tax consequences to a taxpayer who receives a Section 1603 payment and a Department of Energy loan guarantee or an energy conservation subsidy from a public utility?

A–2: Receipt of an incentive in addition to a Section 1603 payment may reduce the eligible basis used in calculating the Section 1603 payment. (See FAQ1, Eligible Basis.) Receipt of a Department of Energy loan guarantee does not reduce the basis of specified energy property. Under section 136 of the Code, an energy conservation subsidy provided by a public utility to a customer for the purchase or installation of any energy conservation measure is excluded from income and reduces the basis of specified energy property by the amount of the exclusion.

Q–3: If a partnership that is eligible to receive a Section 1603 payment has as a partner a corporation that is a tax-exempt controlled entity (within the meaning of section 168(h)(6)(F)), does section 168(h)(6) apply for purposes of determining the partnership's depreciation deductions?

A–3: Section 168(h)(6) applies to any partnership that owns property and has a tax-exempt entity or a tax-exempt controlled entity as a partner even if the partnership is eligible for a Section 1603 payment. For purposes of section 168(h)(6), if 50 percent or more of the value of a corporation is owned by one or more tax-exempt entities, the corporation is a tax-exempt controlled entity and is treated as a tax-exempt entity. Section 168(h)(6) provides that, subject to certain exceptions, if a partnership has a tax-exempt entity part-

ner (including a tax-exempt controlled entity) and any allocation to that tax-exempt entity partner is not a qualified allocation, then an amount equal to the tax-exempt entity's proportionate share of such property (generally, the highest allocation of any item of income or gain to the tax-exempt entity) is treated as tax-exempt use property. See sections 168(h)(6)(B) and (C) for the rules concerning qualified allocations and the proportionate share to be treated as tax-exempt use property. The percentage of the property that is tax-exempt use property is depreciated using the longer Alternative Depreciation System (ADS) recovery periods, rather than the generally shorter periods under the Modified Accelerated Cost Recovery System (MACRS).

Certain tax-exempt entities described in Section 1603(g) of ARRTA may not receive a Section 1603 payment. Likewise, a partnership that has such tax-exempt entities as partners may not receive a Section 1603 payment unless these tax-exempt entities own their interests indirectly through taxable corporations. (See FAQ1, Applicant Eligibility.) The tax-exempt entities described in Section 1603(g) include, generally, the tax-exempt entities described in section 168(h), but Section 1603 does not require a tax-exempt controlled entity to be treated as a tax-exempt entity for purposes of determining eligibility for a Section 1603 payment.

Q–4: Under the Section 1603 program, the owner of multiple units of property that are located at the same site and that will be operated as a larger unit may elect to treat the units (and any property, such as a computer control system, that serves some or all such units) as a single unit of property for purposes of determining the beginning of construction and the date the property is placed in service. How will such a grouping election affect depreciation determinations for federal income tax purposes?

A–4: A taxpayer's grouping of the units for purposes of Section 1603 of ARRTA will not affect the determination of the unit of property for depreciation or the date that property is placed in service for purposes of calculating the depreciation deduction.

Q–5: If a project is sold and leased back more than three months after the seller/lessee originally placed the project in service, the seller/lessee is entitled to the Section 1603 payment. Must the seller/lessee report income equal to 50 percent of the amount of the Section 1603 payment ratably over the five-year recapture period?

A–5: In some cases, a lessor and lessee may elect to pass through the Section 1603 payment to the lessee. In such cases, the lessor does not reduce basis by 50 percent of the amount of the Section 1603 payment and the lessee must agree to include in gross income ratably over the five-year recapture period an amount equal to 50 percent of the amount of the Section 1603 payment. See Section VI of the Program Guidance. In this case, however, the sale-leaseback rules (also in Section VI of the Program Guidance) apply. Under those rules, the purchaser/lessor is not eligible for the Section 1603 payment and may not elect to pass through the Section 1603 payment to the seller/lessee because the project was sold and leased back more than three months after the project was placed in service. Instead, the seller/lessee is the person placing the property in service for purposes of Section 1603 and receives the Section 1603 payment. The seller/lessee reduces the basis of the project by 50 percent of the amount of the Section 1603 payment before determining gain or loss on the sale of the project to the purchaser/lessor. The seller/lessee is not required to report income equal to 50 percent of the amount of the Section 1603 payment ratably over the five-year recapture period.

DRAFTING INFORMATION

The principal author of this notice is Brian J. Americus of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Mr. Americus at (202) 622–3110 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also: Part I, § 911, 1.911–1.)

Rev. Proc. 2012–21

SECTION 1. PURPOSE

.01 This revenue procedure provides information to any individual who failed to meet the eligibility requirements of section 911(d)(1) of the Internal Revenue Code because adverse conditions in a foreign country precluded the individual from meeting those requirements for taxable year 2011.

.02 This revenue procedure lists the countries for which the eligibility requirements of section 911(d)(1) are waived for taxable year 2011.

SECTION 2. BACKGROUND

.01 Section 911(a) of the Code allows a "qualified individual," as defined in section 911(d)(1), to exclude foreign earned income and housing cost amounts from gross income. Section 911(c)(4) of the Code allows a qualified individual to deduct housing cost amounts from gross income.

.02 Section 911(d)(1) of the Code defines the term "qualified individual" as an individual whose tax home is in a foreign country and who is (A) a citizen of the United States and establishes to the satisfaction of the Secretary of the Treasury that the individual has been a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (B) a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.

.03 Section 911(d)(4) of the Code provides an exception to the eligibility requirements of section 911(d)(1). An individual will be treated as a qualified individual with respect to a period in which the individual was a *bona fide* resident of, or was present in, a foreign country, if the individual left the country during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business. An individual must establish that but for those conditions the individual could reasonably have been expected to meet the eligibility requirements.

.04 For 2011, the Secretary of the Treasury, in consultation with the Secretary of State, has determined that war, civil unrest, or similar adverse conditions precluded the normal conduct of business in the following countries beginning on the specified date:

	Date of Departure
Country	*On or after*
Egypt	February 1, 2011
Libya	February 21, 2011
Syria	April 25, 2011
Yemen	May 25, 2011

Accordingly, for purposes of section 911 of the Code, an individual who left one of the foregoing countries on or after the specified departure date during 2011 shall be treated as a qualified individual with respect to the period during which that individual was present in, or was a *bona fide* resident of, such foreign country, if the individual establishes a reasonable expectation of meeting the requirements of section 911(d) but for those conditions.

.06 To qualify for relief under section 911(d)(4) of the Code, an individual must have established residency, or have been physically present, in the foreign country on or prior to the date that the Secretary of the Treasury determines that individuals were required to leave the foreign country. Individuals who establish residency, or are first physically present, in the foreign country after the date that the Secretary prescribes shall not be treated as qualified individuals under section 911(d)(4) of the Code. For example, individuals who are first physically present or establish residency in Egypt after February 1, 2011, are not eligible to qualify for the exception provided in section 911(d)(4) of the Code for taxable year 2011.

SECTION 3. INQUIRIES

A taxpayer who needs assistance on how to claim this exclusion, or on how to file an amended return, should contact a local IRS Office or, for a taxpayer residing or traveling outside the United States, the nearest overseas IRS office.

SECTION 4. DRAFTING INFORMATION

The principal author of this revenue procedure is Kate Y. Hwa of the Office of Associate Chief Counsel (International). For further information regarding this revenue procedure, contact Kate Y. Hwa at (202) 622–3840 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Allocation and Apportionment of Interest Expense

REG–113903–10

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations that provide guidance relating to the allocation and apportionment of interest expense. The temporary regulations (T.D. 9571) provide guidance concerning the allocation and apportionment of interest expense by corporations owning a 10 percent or greater interest in a partnership, as well as the allocation and apportionment of interest expense using the fair market value asset method. The temporary regulations also update the interest allocation regulations to conform to the changes made to the applicable law by the legislation commonly referred to as the Education Jobs and Medicaid Assistance Act (EJMAA), enacted on August 10, 2010 (Public Law 111–226, 124 Stat. 2389 (2010)), which affect corporations owning certain foreign corporations engaged in the conduct of a trade or business in the United States. The text of those temporary regulations published in this issue of the Bulletin also serves as the text of these proposed regulations. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by March 13, 2012. Outlines of topics to be discussed at the public hearing scheduled for April 3, 2012, at 10:00 a.m. must be received by March 13, 2012.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–113903–10), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–113903–10), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–113903–10). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jeffrey L. Parry, (202) 622–3850; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing Oluwfunmilayo Taylor (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Temporary regulations in this issue of the Bulletin contain amendments to the Income Tax Regulations (26 CFR Part 1) which provide rules under section 861 relating to the affiliation of certain foreign corporations for purposes of section 864, the allocation and apportionment of interest expense by corporations owning a 10 percent or greater interest in a partnership, and the allocation and apportionment of interest expense using the fair market value method. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations and these proposed regulations. The regulations affect taxpayers that allocate and apportion interest expense under section 864.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also 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 the 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), these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 3, 2012, in the IRS auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by March 13, 2012, and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 13, 2012. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Jeffrey L. Parry of the Office of Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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. In §1.861–9, paragraphs (e)(2), (e)(3), (h)(4), and (k) are revised to read as follows:

§1.861–9 Allocation and apportionment of interest expense

* * * * *

(e) * * *

(2) and (3) [The text of the proposed amendments to §1.861–9(e)(2) and §1.861–9(e)(3) is the same as the text of §1.861–9T(e)(2) and §1.861–9T(e)(3) published elsewhere in this issue of the Bulletin.]

* * * * *

(h) * * *

(4) [The text of the proposed amendment to §1.861–9(h)(4) is the same as the text of §1.861–9T(h)(4) published elsewhere in this issue of the Bulletin.]

* * * * *

(k) [The text of the proposed amendment to §1.861–9(k) is the same as the text of §1.861–9T(k) published elsewhere in this issue of the Bulletin.]

Par. 3. In §1.861–11, paragraphs (d)(6)(ii) and (h) are revised to read as follows:

§1.861–11 Special rules for allocating and apportioning interest expense of an affiliated group of corporations.

* * * * *

(d) * * *

(6)(ii) [The text of proposed §1.861–11(d)(6)(ii) is the same as the text of §1.861–11T(d)(6)(ii) published elsewhere in this issue of the Bulletin.]

* * * * *

(h) [The text of the proposed amendment to §1.861–11(h) is the same as the text of §1.861–11T(h) published elsewhere in this issue of the Bulletin.]

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on January 13, 2012, 8:45 a.m., and published in the issue of the Federal Register for January 17, 2012, 77 F.R. 2240)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Dividend Equivalents From Sources Within the United States

REG–120282–10

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9572) that provide guidance on the definition of the term "specified notional principal contract" for purposes of section 871(m) of the Internal Revenue Code (Code) beginning after March 18, 2012 through December 31, 2012. The text of those regulations also serves as the text of the proposed regulations. The preamble to the temporary regulations explains the amendments added by the temporary regulations. The preamble to this notice of proposed rulemaking explains the proposed regulations, which provide guidance to nonresident aliens and foreign corporations that hold certain financial products providing for payments that are contingent upon or determined by reference to payments of dividends from sources within the United States. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 6, 2012. Outlines of topics to be discussed at the public hearing scheduled for April 27, 2012, at 10:00 a.m., must be received by April 6, 2012.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–120282–10), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–120282–10), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–120282–10). The public hearing will be held in the auditorium, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Mark E. Erwin or D. Peter Merkel at (202) 622–3870; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, Publications and Regulations Branch Specialist, at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 871. The temporary regulations extend the section 871(m)(3)(A) statutory definition of the term specified notional principal contract (specified NPC) through December 31, 2012. This document contains proposed regulations under section 871(m) of the Code that will be applicable as of January 1, 2013. The preamble to the temporary regulations provides a discussion of the background of section 871(m) and

explains the provisions contained in the temporary regulations and §1.871–16(b) of these proposed regulations.

1. *In General*

Section 1.871–15(a) of these proposed regulations treats a dividend equivalent as a dividend from sources within the United States for purposes of sections 871(a), 881, and 4948(a), and chapters 3 and 4 of subtitle A of the Code. As prescribed by section 871(m)(2), §1.871–15(b)(1) defines a dividend equivalent as (1) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that is contingent upon or determined by reference to the payment of a dividend from sources within the United States, (2) any payment made pursuant to a specified NPC that is contingent upon or determined by reference to the payment of a dividend from sources within the United States, or (3) any other payment substantially similar to such payments. The proposed regulations specify that a payment is not a dividend equivalent if it is determined by reference to an estimate of an expected (but not yet announced) dividend without reference to or adjustment for the amount of any actual dividend.

For purposes of determining a dividend equivalent, the term *payment* includes any gross amount used in computing any net amount transferred to or from the taxpayer. For example, the terms of a notional principal contract (NPC) may provide for periodic payments by each of the counterparties that occur at quarterly intervals. Because these payments may offset each other, in whole or in part, the terms of such contracts generally provide for payment of only the net amount owed between the counterparties (that is, the difference between the amounts owed between the counterparties). A dividend equivalent is equal to the gross amount that is contingent upon or determined by reference to a dividend used to determine a net amount, even if no net payment is made or the party entitled to a gross amount determined by reference to a dividend is required to make a net payment to the other contracting party.

Section 1.871–15(d) describes payments that are considered substantially similar to substitute dividends made pursuant to securities lending and sale-repurchase transactions and to payments made pursuant to specified NPCs. Substantially similar payments are (1) gross-up amounts paid by a short party in satisfaction of the long party's tax liability with respect to a dividend equivalent, and (2) payments calculated by reference to a dividend from sources within the United States that are made pursuant to an equity-linked instrument other than an NPC. The Treasury Department and the IRS will continue to monitor equity-linked transactions, and may identify in separate guidance other payments that are substantially similar to a substitute dividend payment or a payment made pursuant to a specified NPC.

2. *Definition of Specified Notional Principal Contract*

Section 1.871–16 defines the term specified NPC for payments made after March 18, 2012. Comments requested that rules promulgated under section 871(m) rely on objective factors for determining whether an NPC is a specified NPC. The Treasury Department and the IRS believe that the proposed regulations address these requests by providing objective rules that will be administrable and that identify NPCs entered into with the potential for tax avoidance.

A. *Transition Period*

To provide taxpayers with the time needed to implement withholding on specified NPCs, temporary regulations issued together with these proposed regulations provide that the term specified NPC will have the same meaning as provided in section 871(m)(3)(A) for payments made prior to January 1, 2013. Section 1.871–16(b) is the same as the temporary regulations accompanying this notice of proposed rulemaking. Thus, §1.871–16T(b) applies to payments made on or after March 18, 2012 and before January 1, 2013.

B. *Definition Applicable to Payments Made on or after January 1, 2013*

Beginning on January 1, 2013, an NPC generally will be a specified NPC for purposes of section 871(m) if: (1) the long party is "in the market" on the same day that the parties price the NPC or when the NPC terminates; (2) the underlying security is not regularly traded on a qualified exchange; (3) the short party posts the underlying security as collateral and the underlying security represents more than ten percent of the collateral posted by the short party; (4) the term of the NPC has fewer than 90 days; (5) the long party controls the short party's hedge; (6) the notional principal amount is greater than five percent of the total public float of the underlying security or greater than 20 percent of the 30-day daily average trading volume, as determined at the close of business on the day immediately preceding the first day of the term of the NPC; or (7) the NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

A long party is considered to be "in the market" if the long party sells the underlying security on the same day that the parties price an NPC or purchases the underlying security on the day that the parties terminate an NPC. An NPC is sometimes entered into in tranches that spread the execution over more than one day; in that case, the proposed regulations consider each day that a tranche is executed or settled as a testing date. Similarly, if the long party to an NPC sells or purchases an underlying security on a day other than the pricing date or the settlement date of an NPC, but sets the price to align with the price of the NPC (such as with a forward contract), the long party will be treated as in the market on that day.

The Code and regulations define "readily tradable on an established securities market" (and similar phrases) differently depending on the context. The Treasury Department and the IRS believe that "readily tradable on an established securities market," as used in section 871(m), is intended to ensure that the underlying securities trade in sufficient volume to provide ample liquidity in the position. The proposed regulations provide that if the underlying security is not regularly traded on a qualified exchange, an NPC referencing that security is a specified NPC. An underlying security is "regularly traded" for this purpose if it is traded on a qualified exchange and it was traded on at least 15 out of the 30 trading days prior to the date that the parties entered into an NPC.

Section 871(m)(3)(A)(iv) provides that prior to March 18, 2012, an NPC will be a specified NPC if the short party to the contract posts the underlying security as col-

lateral with any long party to the contract. The Treasury Department and the IRS believe that when a short party posts the underlying security as collateral with the long party the related NPC should be a specified NPC. In the event of default by the short party, the fact that the underlying security is posted as collateral guarantees that the value of the collateral moves in tandem with the contract. This concern is less applicable when the value of the underlying securities posted as collateral is a small portion of the total amount of cash or other property posted as collateral for the NPC. The proposed regulations treat an NPC as a specified NPC only if the underlying security is posted as collateral and the underlying security represents more than ten percent of the total fair market value posted as collateral on any day that the NPC is in effect.

The proposed regulations treat an NPC as a specified NPC if the term of the contract has fewer than 90 days. As the market for equity-linked NPCs grew and evolved, taxpayers began to purchase and sell NPCs in lieu of trading the underlying equities. Many transactions entered into to avoid U.S. withholding tax on dividends involved short-term equity swaps around an ex-dividend date. In many cases, the taxpayer entered into an NPC with a financial institution that acquired the underlying security as a hedge of a contract; the parties then settled or terminated that contract within days or weeks of the date it was entered into. When an NPC has a short duration and is in effect over an ex-dividend date, the source rule of section 871(m) should take precedence over the general source rule for NPC income in §1.863–7.

In some situations, the long party controls the acquisition of stock that the short party uses to hedge its position under the contract or has directed the short party to sell the short party's hedge to a particular purchaser at a specific price and date. The long party in these situations may exercise such control over the short party's hedge pursuant to terms of a written agreement or through course of conduct. The Treasury Department and the IRS believe that the source rule of section 871(m) should apply to an NPC when a long party exercises control over the short party's hedge. Accordingly, the proposed regulations treat an NPC as a specified NPC when a foreign investor controls the short party's hedge or participates in an underlying equity control program. An underlying equity control program is any system, whether carried out electronically or otherwise, that allows a long party to direct its counterparty's hedge of an NPC or that allows a long party to acquire economic exposure to an underlying security and to determine the form of the transaction later. An underlying equity control program, however, does not include an electronic trading platform that allows a customer to place an order to enter into an NPC with a dealer, provided that the dealer independently determines whether and how to hedge its position without customer direction.

The proposed regulations treat an equity swap as a specified NPC when the notional principal amount of an NPC is a significant percentage of the trading volume. Specifically, when the notional principal amount of the NPC is greater than five percent of the total public float or 20 percent of the 30-day average daily trading volume such contract is treated as a specified NPC. If a long party has multiple NPCs that reference the same underlying security, the notional principal amounts of those contracts must be aggregated when determining whether the notional principal amount represents a significant percentage of the trading volume.

A special dividend is a nonrecurring payment to shareholders that is in addition to any recurring dividend payment. The proposed regulations provide that any NPC is a specified NPC when the parties enter into the NPC after the announcement of a special dividend on the underlying stock. The Treasury Department and the IRS believe that an NPC entered into after the announcement of a special dividend and before the ex-dividend date is more likely to be entered into for the purpose of avoiding U.S. tax than an NPC referencing a stock that pays only a recurring dividend.

To prevent taxpayers from avoiding these rules through related parties, the proposed regulations provide that each related person (within the meaning of section 267(b) or 707(b)(1)) is treated as a party to the contract. The proposed regulations also provide that an NPC entered into between two related dealers is not a specified NPC if the NPC hedges risk associated with another NPC entered into with a third party. This rule is intended to avoid excessive withholding tax on transactions commonly employed by dealers to transfer risk from one entity to another within their affiliated group.

Notwithstanding these rules defining the term specified NPC, the Commissioner may challenge transactions that are designed to avoid the application of these rules under applicable judicial doctrines. Nothing in these rules precludes the Commissioner from asserting that a contract labeled as an NPC or other equity derivative is in fact an ownership interest in the equity referenced in the contract.

3. *Underlying Security*

The term *underlying security* means any security that pays a U.S. source dividend. If an NPC references more than one security, each reference security is treated as an underlying security of a separate NPC. If an NPC references a customized index, each component security of that index is treated as an underlying security in a separate NPC for purposes of this section. An index is treated as a customized index if it is (1) a narrow-based index or (2) any other index unless futures contracts or options contracts referencing the index trade on a qualified board or exchange. The definition of the "narrow-based index" is generally based on the definition of that term in the Securities Exchange Act of 1934, Section 3(a)(55)(B).

4. *Specified NPC Status Arising During Term of Contract; Liability of Withholding Agent; and Other Conforming Amendments*

These proposed regulations amend several regulations under section 1441 to require a withholding agent to withhold tax owed with respect to a dividend equivalent. If an NPC that is not a specified NPC on the date it is entered into becomes a specified NPC during the term of the contract, it will be treated as though it had been a specified NPC during the entire term of the contract. Payments made under the NPC by reference to the payment of a dividend from sources within the United States will be re-characterized as dividend equivalents and all tax owed with respect to such dividend equivalents will be due at the time of the next payment made under the NPC, including a termination payment. In cases where the tax owed is greater than

the next payment made under the specified NPC, the withholding agent is responsible for reporting and depositing the total amount due with the IRS. The mechanism by which a withholding agent collects the amount due from the taxpayer is left to the discretion of the withholding agent and the taxpayer, and is not specified in these proposed regulations. The withholding agent must deposit the total amount due even if it cannot collect the amount from the counterparty.

The proposed regulations provide that dividend equivalents are treated as income from investments in stock for purposes of section 892; taxpayers may rely on §1.892–3(a)(6) until final regulations are issued. Finally, the proposed regulations provide that a reduced rate of withholding tax provided by an income tax convention for dividends paid or derived by a foreign person applies to a dividend equivalent.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. 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. Because the regulation does 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 Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 27, 2012, beginning at 10:00 a.m. in the auditorium of the Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "**FOR FURTHER INFORMATION CONTACT**" section of this preamble. The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic by April 6, 2012. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is D. Peter Merkel, the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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. 871(m) and 7805 * * *

Par. 2. In §1.863–7, paragraph (a) is revised to read as follows:

§1.863–7 Allocation of income attributable to certain notional principal contracts under section 863(a).

(a) *Scope*—(1) *Introduction*. [The text of the proposed amendments to §1.863–7(a)(1) is the same as the text for §1.863–7T(a)(1) published elsewhere in this issue of the Bulletin].

* * * * *

Par. 3. Section 1.871–15 is added to read as follows:

§1.871–15 Treatment of dividend equivalents.

(a) *In general*. A dividend equivalent as defined in paragraph (b) of this section shall be treated as a dividend from sources within the United States for purposes of sections 871(a), 881, and 4948(a), and chapters 3 and 4 of subtitle A of the Code and the regulations thereunder.

(b) *Dividend equivalent*—(1) *Definition*. The term *dividend equivalent* means—

(i) Any substitute dividend made pursuant to a securities lending transaction, a sale-repurchase transaction, or a substantially similar transaction that (directly or indirectly) is contingent upon or determined by reference to the payment of a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States;

(ii) Any payment made pursuant to a specified notional principal contract (specified NPC) described in section 871(m) or §1.871–16 that (directly or indirectly) is contingent upon or determined by reference to the payment of a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States; and

(iii) Any substantially similar payment as defined in paragraph (d) of this section.

(2) *Exception*—(i) *In general*. The term dividend equivalent does not include any payment made pursuant to a specified NPC, or any substantially similar payment as defined in §1.871–15(d), if such payment is contingent upon or determined by reference to an estimate of expected dividends and the estimate of an expected dividend is not adjusted in any way for the amount of an actual dividend.

(ii) *Expected dividends*. For purposes of this section, an expected dividend is not considered an estimate of expected dividends on or after the date that the corporate issuer announces a dividend. A dividend announcement occurs on the earliest

date on which the corporation declares, announces, or agrees to the amount or payment of such dividend.

(c) *Payments determined on gross basis*. A payment includes any gross amount that is used in computing any net amount that is transferred to or from the taxpayer under the terms of the contract. For example, a dividend equivalent includes a gross amount determined by reference to a dividend that is used in computing a net payment even if the taxpayer makes a net payment or no payment is made because the net amount is zero.

(d) *Substantially similar payments*—(1) *In general*. For purposes of section 871(m), the following payments are considered payments substantially similar to payments described in paragraph (b)(1)(i) or (b)(1)(ii) of this section and are therefore dividend equivalents:

(i) Any payment of a beneficial owner's tax liability with respect to a dividend equivalent made by a withholding agent is a dividend equivalent received by the beneficial owner in an amount determined under the gross-up formula provided in §1.1441–3(f)(1).

(ii) Any payment, including the payment of the purchase price or an adjustment to the purchase price, is a dividend equivalent if made pursuant to an equity-linked instrument that is contingent upon or determined by reference to a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States.

(2) *Rules regarding equity-linked instruments*—(i) *In general*. An *equity-linked instrument* is a financial instrument or combination of financial instruments that references one or more underlying securities to determine its value, including a futures contract, forward contract, option, or other contractual arrangement.

(ii) *Equity-linked instruments treated as a notional principal contract*. An equity-linked instrument that provides for a payment that is a substantially similar payment within the meaning of paragraph (d) of this section is treated as a notional principal contract for purposes of section 871(m)(3), this section, and §1.871–16.

(e) *Anti-abuse rule*. If a taxpayer enters into a transaction or transactions with a principal purpose of avoiding the application of this section or §1.871–16, payments made with respect to such transaction or transactions may be treated as a dividend equivalent to the extent necessary to prevent the avoidance of these rules.

(f) *Effective/applicability date*. The rules of this section apply to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register.**

Par. 4. Section 1.871–16 is added to read as follows:

§1.871–16 Specified notional principal contracts.

(a) *Purpose and scope*. This section provides guidance with respect to the definition of a "specified notional principal contract" (specified NPC). Paragraph (b) of this section provides the definition of a specified NPC for payments made after March 18, 2012, through December 31, 2012. Paragraph (c) of this section provides the definition of a specified NPC for payments made after December 31, 2012. Paragraph (d) of this section provides rules with respect to a notional principal contract that becomes a specified NPC during the term of the contract. Paragraph (e) of this section provides rules with respect to the treatment of a specified NPC entered into by related parties. For purposes of section 871(m) and this section, the term *notional principal contract* (NPC) means an NPC as defined in §1.446–3(c)(1) and an equity-linked instrument as provided in §1.871–15(d).

(b) [The text of the proposed amendment to §1.871–16(b) is the same as the text for §1.871–16T(b) found elsewhere in this issue of the Bulletin].

(c) *Specified NPCs after December 31, 2012*. With respect to payments made after December 31, 2012, the term *specified NPC* means any NPC described in any of the paragraphs (c)(1) through (7) of this section.

(1) *Contemporaneous transfers of the underlying securities*. An NPC is described in this paragraph (c)(1) if the long party to the NPC is "in the market" with respect to the underlying security on the same day or days that the parties price the NPC or on the same day or days that the NPC terminates.

(i) *Determining when a long party is in the market*. The long party is "in the market" with respect to the underlying security if the long party—

(A) Sells or otherwise disposes of the underlying security on the same day or days that the parties price the NPC;

(B) Purchases or otherwise acquires the underlying security on the same day or days that the NPC terminates; or

(C) Either purchases or disposes of the underlying security at a price that is set or calculated in such a way as to be substantially identical to or determined by reference to an amount used to price or terminate the NPC.

(ii) *De minimis exception*. The long party will not be deemed to be in the market with respect to the underlying security if the amount of the underlying securities disposed of on a pricing date or acquired on a termination date is less than ten percent of the notional principal amount of the NPC.

(2) *Underlying security is not regularly traded*. An NPC is described in this paragraph (c)(2) if the underlying security in the NPC is not regularly traded.

(i) *Definition of regularly traded*—(A) *In general*. For purposes of this paragraph (c)(2), an underlying security is regularly traded if such security is listed on one or more qualified exchanges at the time the NPC is priced and the underlying security was traded on at least 15 trading days during the 30 trading days prior to the date the parties price the NPC.

(B) *Special rule for first 30 days following a public offering*. When a corporation initiates a public offering of a security, such security is regularly traded if such security is traded during at least 15 trading days on one or more qualified exchanges during the 30 trading days subsequent to the initial offering.

(C) *Days on which a security is considered traded*. The underlying securities will be considered traded only on those days in which the underlying securities are traded in quantities that exceed ten percent of the 30-day average daily trading volume.

(ii) *Qualified exchange*. For purposes of paragraph (c)(2)(i) of this section, the term *qualified exchange* means a national securities exchange that is registered with the Securities and Exchange Commission or the national market system established

pursuant to section 11A of the Securities Exchange Act of 1934 (15 U.S.C. 78f).

(3) *Underlying security posted as collateral*. An NPC is described in this paragraph (c)(3) if the short party to the NPC posts the underlying security with the long party as collateral and the underlying security posted as collateral represents more than ten percent of the total fair market value of all the collateral posted by the short party on any date that the NPC is outstanding.

(4) *The NPC has a term of fewer than 90 days*—(i) *In general*. An NPC is described in this paragraph (c)(4) if the NPC has a term of fewer than 90 days.

(ii) *Term of an NPC*. For purposes of this section, the term of any NPC is the number of days that the contract is actually outstanding, including the date on which the NPC is terminated, but not the date that the NPC was entered into. For purposes of determining whether a contract is a specified NPC, an NPC is treated as terminated, in whole or in part, on the date that a long party enters into any position within the meaning of §1.246–5(b)(3) to the extent that the position offsets a portion of the long party's position with respect to an underlying security in the NPC.

(5) *Long party controls short party's hedge*. An NPC is described in this paragraph (c)(5) if—

(i) The long party controls contractually or by conduct the short party's hedge of the short position; or

(ii) The long party enters into an NPC using an underlying equity control program (as defined in paragraph (f)(2) of this section).

(6) *Notional principal amount represents a significant percentage of trading volume*—(i) *In general*. An NPC is described in this paragraph (c)(6) if the notional principal amount of the underlying security in the NPC is greater than—

(A) Five percent of the total public float of that class of security; or

(B) Twenty percent of the 30-day average daily trading volume determined as of the close of the business day immediately preceding the first day in the term of an NPC.

(ii) *Aggregating certain NPCs*. When determining whether the notional principal amount of an NPC represents a significant percentage of the trading volume, a taxpayer must aggregate the notional principal amounts of all NPCs for which the taxpayer is the long party that reference the same underlying security.

(7) *NPC provides for the payment of a special dividend*. An NPC is described in this paragraph (c)(7) if the NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date. An announcement of a special dividend occurs on the earliest date on which the corporation declares, announces, or agrees to the amount or payment of such special dividend.

(d) *Specified NPC status arising during the term of the contract*—(1) *In general*. This section provides rules for determining the timing and amount of a dividend equivalent when an NPC is not a specified NPC on the date the parties enter into the NPC and subsequently becomes a specified NPC during the term of the transaction. If an NPC that is not a specified NPC on the date the parties enter into the contract subsequently becomes a specified NPC, any payment made during the term of the contract (including any payment during the period between the date the contract is entered into and the date the contract becomes a specified NPC) that is contingent upon or determined by reference to the payment of a dividend from sources within the United States is a dividend equivalent.

(2) *Determination of dividend equivalent*—(i) *In general*. For purposes of sections 871(a), 881, 4948(a), and chapters 3 and 4 of subtitle A of the Code, when an NPC becomes a specified NPC during the term of the contract, any tax owed with respect to a dividend equivalent made prior to the NPC becoming a specified NPC is payable when the next payment as described in §1.871–15(c), including a termination payment, is made pursuant to the contract.

(ii) *Payment to include amount equal to dividend equivalent with respect to current and prior payments*. In computing the amount of tax owed with respect to the termination of the specified NPC or the first payment that occurs after the NPC becomes a specified NPC, the dividend equivalent equals the sum of all the dividend equivalents with respect to the NPC arising before the date the NPC became a specified NPC and the amount of any dividend equivalent arising upon the termination or payment.

(3) *Example.* The rules of this paragraph (d) are illustrated by the following example:

Example. (i) *Facts.* Party A is a foreign corporation organized in a jurisdiction that does not have an income tax treaty with the United States. Party B is a domestic corporation and a dealer in NPCs. Party A and Party B enter into an NPC on Day 1 whereby Party A will pay Party B an amount equal to LIBOR multiplied by the notional value of a specified number of shares of Corporation X, a domestic corporation, plus any depreciation on the same number of shares of Corporation X upon settlement of the contract. In return, Party B will pay Party A an amount equal to any dividends paid on the same specified number of shares of Corporation X, plus any appreciation on those shares upon settlement of the contract. On Day 1, the NPC is not a specified NPC. On Day 30, Party B determines that it owes Party A $25 based on a dividend paid on the underlying security and that Party A owes Party B $125 on the LIBOR leg of the contract. Party A therefore makes a net payment of $100 to Party B. On Day 120, the NPC becomes a specified NPC within the meaning of section 871(m), §§1.871–15, and 1.871–16. On Day 120, Party A terminates the contract and makes a net termination payment to Party B. In calculating the net payment, Party B determined that it owes Party A $25 based on a dividend paid with respect to the shares of Corporation X and that Party A owes it $125 attributable to interest and the decrease in the value of the shares of Corporation X.

(ii) *Analysis*. On Day 120, Party A is treated as having received a dividend equivalent of $50. This dividend equivalent consists of the $25 payment made on Day 120 that is based on a dividend payment made with respect to the shares of Corporation X and the $25 dividend equivalent made prior to the contract being considered a specified NPC.

(e) *Related persons and parties to an NPC*—(1) *In general*. For purposes of this section, a related person is considered a party to an NPC. A related person is a person that is related within the meaning of section 267(b) or 707(b)(1) to one of the parties to the NPC.

(2) *NPC entered into between related dealers*. An NPC entered into between related persons is not a specified NPC when the NPC hedges another NPC (whether or not a specified NPC) entered into with an unrelated party and both NPCs were entered into by the related persons in the ordinary course of their business as a dealer in securities or commodities derivatives.

(f) *Definitions*—(1) *Underlying security*. For purposes of this section, the term *underlying security* means, for any NPC, the security with respect to which the dividend referred to in §1.871–15(b)(1)(ii) is paid. If an NPC references more than one security or a customized index, each security or component of such customized index is treated as an underlying security

in a separate NPC for purposes of section 871(m), §1.871–15, and this section.

(2) *Underlying equity control program*—(i) *In general*. The term *underlying equity control program* means any system or procedure that permits—

(A) A long party to an NPC to direct how a short party hedges its risk under such NPC; or

(B) A long party to acquire, or cause the short party to acquire, an underlying security in a transaction with a short party and to instruct the short party to execute such acquisition in the form of an NPC after acquiring such underlying security.

(ii) *Electronic trading*—(A) *In general*. The term *underlying equity control program* does not include an electronic trading platform that allows customers electronically to place an order to enter into an NPC with a dealer and through which the dealer determines whether and how to hedge its position.

(B) *Example*. Customer, a foreign corporation, and Dealer have entered into a master agreement that governs NPCs entered into between Customer and Dealer. Customer places an order with Dealer via Dealer's electronic trading platform to enter into an NPC with a long position in 100 shares of Corporation ABC, a domestic corporation. Dealer's electronic trading platform allows Customer to place an order using Dealer's computer program. Dealer's computer system confirms that Corporation ABC is not on its restricted list upon receipt of the order. Dealer's computer system automatically determines whether it has an internal hedge available to offset the risk of a short position in 100 shares of Corporation ABC. To the extent that an internal hedge is unavailable, Dealer's computer program automatically seeks to acquire the stock as a hedge in a market transaction. After obtaining its hedge, Dealer sends a confirmation that memorializes the NPC. The notional amount on the confirmation reflects the price of Dealer's hedge plus a market standard spread. Customer did not enter into the NPC using an underlying equity control program solely by placing the order through Dealer's electronic trading platform because Customer did not direct how Dealer hedged its position under the NPC.

(3) *Customized index*—(i) *In general*. For purposes of this section, the term *customized index* means any index, as determined on the date that the long party and short party enter into an NPC, that is—

(A) A narrow-based index; or

(B) Any other index unless futures contracts or option contracts on such index trade on a qualified board or exchange, as defined in section 1256(g)(7).

(ii) *Narrow-based index*. The term *narrow-based index* means an index—

(A) That has nine or fewer component securities;

(B) In which a component security comprises more than 30 percent of the index's weighting;

(C) In which the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or

(D) In which the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50,000,000 (or in the case of an index with 15 or more component securities, $30,000,000), except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security.

(iii) *Aggregate dollar value of average daily trading volume*. For purposes of determining whether an index is a narrow-based index, the method for determining the aggregate dollar value of average daily trading volume is the method described in Rule 3a55–1(b)(1), 17 CFR 240.3a55–1(b)(1), under the Securities Exchange Act of 1934, as in effect on January 23, 2012.

(4) *Long party*. The *long party* is the party with respect to an NPC entitled to receive any payment pursuant to such contract that is contingent upon or determined by reference to the payment of a dividend from sources within the United States on an underlying security.

(5) *Short party*. The *short party* is any party to an NPC who is not a long party.

(6) *Special dividend*. For purposes of this section, the term *special dividend* means a nonrecurring payment to shareholders of corporate assets that is in addition to a recurring dividend payment, if any (even if paid in conjunction with a recurring dividend).

(g) *Effective/applicability date*. The rules of this section apply to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 5. In §1.881–2, paragraph (b)(3) is added and paragraph (e) is revised to read as follows:

§1.881–2 Taxation of foreign corporations not engaged in U.S. business.

* * * * *

(b) * * *

(3) [The text of the proposed amendments to §1.881–2(b)(3) is the same as the text for §1.881–2T(b)(3) published elsewhere in this issue of the Bulletin].

* * * * *

(e) *Effective/applicability date*. Except as otherwise provided in this paragraph (e), this section applies for taxable years beginning after December 31, 1966. Paragraph (b)(2) of this section is applicable to payments made after November 13, 1997. Paragraph (b)(3) of this section applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**. For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.881–2 (Revised as of January 1, 1971).

Par. 6. Section 1.892–3 is added to read as follows:

§1.892–3 Income of foreign governments.

(a)(1) through (a)(5) [Reserved]. For further information, see §1.892–3T(a)(1) through (a)(5).

(6) *Dividend Equivalents*. Income from investments in stocks includes the payment of a dividend equivalent described in section 871(m) and §1.871–15.

(b) [Reserved]. For further information, see §1.892–3T(b).

(c) *Effective/applicability date*. Paragraph (a)(6) of this section applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**. See §1.892–3T(a) for the rules that apply before the date the regulations are published as final regulations in the **Federal Register**.

Par. 7. Section 1.894–1 is amended by redesignating paragraph (c) as (c)(1), adding paragraph (c)(2), and revising paragraph (e) to read as follows:

§1.894–1 Income affected by treaty.

* * * * *

(c) * * *

(2) *Dividend equivalents.* The provisions of an income tax convention relating to dividends paid to or derived by a foreign person apply to a dividend equivalent under section 871(m) and §1.871–15.

* * * * *

(e) *Effective/applicability date.* Paragraphs (a) and (b) of this section apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Except as otherwise provided in this paragraph, paragraph (c) of this section is applicable to payments made after November 1, 1997. Paragraph (c)(2) of this section applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**. See paragraph (d)(6) of this section for applicability dates for paragraph (d) of this section.

Par. 8. Section 1.1441–2 is amended by adding paragraphs (b)(6) and (e)(7), and revising paragraph (f) to read as follows:

§1.1441–2 Amounts subject to withholding.

* * * * *

(b) * * *

(6) [The text of the proposed amendments to §1.1441–2(b)(6) is the same as the text for §1.1441–2T(b)(6)) published elsewhere in this issue of the Bulletin].

* * * * *

(e) * * *

(7) [The text of the proposed amendments to §1.1441–2(e)(7) is the same as the text for §1.1441–2T(e)(7)) published elsewhere in this issue of the Bulletin].

(f) *Effective/applicability date.* Except as otherwise provided in this paragraph (f), this section applies to payments made after December 31, 2000. Paragraphs (b)(5) and (d)(4) of this section apply to payments made after August 1, 2006. Paragraphs (b)(6) and (e)(7) of this section apply to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

Par. 9. Section 1.1441–3 is amended by:

1. Redesignating paragraph (h) as paragraph (j), and revising newly designated paragraph (j).

2. Adding new paragraphs (h) and (i).

The revision and addition read as follows:

§1.1441–3 Determination of amounts to be withheld.

* * * * *

(h) *Dividend equivalents*—(1) *In general.* [The text of the proposed amendments to §1.1441–3(h)(1) is the same as the text for §1.1441–3T(h)(1) published elsewhere in this issue of the Bulletin].

(2) *Procedures for withholding with respect to a dividend equivalent paid prior to a notional principal contract (NPC) becoming a specified NPC.* In the event that an NPC becomes a specified NPC (as defined in §1.871–16) after the date that the parties enter into the NPC, the term dividend equivalent includes any payment that is made prior to the date the NPC becomes a specified NPC and that was (directly or indirectly) contingent upon or determined by reference to the payment of a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States. The withholding agent is required to withhold with respect to a dividend equivalent made prior to the NPC becoming a specified NPC when the next payment as described in §1.871–15(c), including a termination payment, is made pursuant to the contract. For purposes of section 6601 and the regulations thereunder, the last date prescribed for payment of tax imposed with respect to a dividend equivalent made prior to an NPC becoming a specified NPC is determined based on the date of the next payment as described in §1.871–15(c), including a termination payment, made pursuant to the contract. For further guidance regarding liability for penalties and interest, see §§1.1441–1(b)(7)(iii) and 1.1461–1(a)(2).

(3) *Effective/applicability date.* The rules of this paragraph (h)(2) apply to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

(i) [The text of the proposed amendments to §1.1441–3(i)(1) is the same as the text for §1.1441–3T(i)(1) published elsewhere in this issue of the Bulletin].

(j) *Effective/applicability date.* Except as otherwise provided in paragraphs (g), (h), and (i) of this section, this section applies to payments made after December 31, 2000.

Par. 10. Section 1.1441–4 is amended by:

1. Revising paragraph (a)(3)(i).

2. Adding paragraph (a)(3)(iii).

3. Revising paragraph (g)(1).

The revisions and addition read as follows:

§1.1441–4 Exemptions from withholding for certain effectively connected income and other amounts.

(a)* * *

(3)(i) [The text of the proposed amendments to §1.1441–4(a)(3)(i) is the same as the text for §1.1441–4T(a)(3)(i) published elsewhere in this issue of the Bulletin].

(ii) * * *

(iii) [The text of the proposed amendments to §1.1441–4(a)(3)(iii) is the same as the text for §1.1441–4T(a)(3)(iii) published elsewhere in this issue of the Bulletin].

* * * * *

(g) *Effective/applicability date*—(1) *General rule.* Except as otherwise provided in this paragraph (g)(1), this section applies to payments made after December 31, 2000. The rules of paragraph (a)(3)(iii) of this section apply to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

* * * * *

Par. 11. Section 1.1441–6 is amended by:

1. Revising paragraph (c)(2).

2. Redesignating paragraph (h) as paragraph (i) and revising newly designated paragraph (i).

3. Adding a new paragraph (h).

The revision and addition read as follows:

§1.1441–6 Claim of reduced withholding under an income tax treaty.

* * * * *

(c) * * *

(2) *Income to which special rules apply*. The income to which paragraph (c)(1) of this section applies is dividends and interest from stocks and debt obligations that are actively traded, dividends from any redeemable security issued by an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1), dividends, interest, or royalties from units of beneficial interest in a unit investment trust that are (or were upon issuance) publicly offered and are registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77a), and amounts paid with respect to loans of securities described in this paragraph (c)(2). With respect to a dividend equivalent as defined in section 871(m) and §1.871–15, this paragraph (c)(2) applies to the extent that the underlying security as defined in §1.871–16(f)(1) satisfies the requirements of this paragraph (c)(2). For purposes of this paragraph (c)(2), a stock or debt obligation is actively traded if it is actively traded within the meaning of section 1092(d) and §1.1092(d)–1 when documentation is provided.

* * * * *

(h) *Dividend equivalents*. The rate of withholding on a dividend equivalent may be reduced to the extent provided under an income tax treaty in effect between the United States and a foreign country. For this purpose, a dividend equivalent is treated as a dividend from sources within the United States. To receive a reduced rate of withholding with respect to a dividend equivalent, a foreign person must satisfy the other requirements described in this section.

(i) *Effective/applicability dates*—(1) *General rule*. This section applies to payments made after December 31, 2000, except for paragraph (g) of this section which applies to payments made after December 31, 2001, and paragraph (h) of this section which applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

(2) [Reserved]

Par. 12. Section 1.1441–7 is amended by:

1. Redesignating paragraph (a)(2) as paragraph (a)(3) and revising newly designated paragraph (a)(3).

2. Adding a new paragraph (a)(2).

3. Adding an entry for *Example 6* in paragraph (a)(3).

4. Revising paragraph (g).

The revision and addition read as follows:

§1.1441–7 General provisions relating to withholding agents.

(a) * * *

(2) [The text of the proposed amendments to §1.1441–7(a)(2) is the same as the text for §1.1441–7T(a)(2) published elsewhere in this issue of the Bulletin].

(3) [The text of the proposed amendments to §1.1441–7(a)(3) is the same as the text for §1.1441–7T(a)(3) published elsewhere in this issue of the Bulletin].

* * * * *

Example 6. [The text of the proposed amendments to §1.1441–7(a)(3), *Example 6* is the same as the text for §1.1441–7T(a)(3), *Example 6* published elsewhere in this issue of the Bulletin].

* * * * *

(g) *Effective/applicability date*. Except as otherwise provided in paragraph (f)(3) of this section and as otherwise provided in this paragraph (g), this section applies to payments made after December 31, 2000. Paragraph (a)(2) applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

Par. 13. Section 1.1461–1 is amended by:

1. Redesignating paragraph (c)(2)(i)(L) and (M) as paragraphs (c)(2)(i)(M) and (N) respectively.

2. Adding a new paragraph (c)(2)(i)(L).

3. Revising paragraph (i).

The addition reads as follows:

§1.1461–1 Payment and returns of tax withheld.

* * * * *

(c) * * *

(2) * * *

(i) * * *

(L) [The text of the proposed amendments to §1.1461–1(c)(2)(i)(L) is the same as the text for §1.1461–1T(c)(2)(i)(L) published elsewhere in this issue of the Bulletin].

* * * * *

(i) *Effective/applicability date*. Unless otherwise provided in this section and as otherwise provided in this paragraph (i), this section shall apply to returns required for payments made after December 31, 2000. The rules of paragraph (c)(2)(i)(L) of this section apply to returns for payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on January 19, 2012, 11:15 a.m., and published in the issue of the Federal Register for January 23, 2012, 77 F.R. 3202)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Proposed Rulemaking

Use of Differential Income Stream as an Application of the Income Method and as a Consideration in Assessing the Best Method

REG–145474–11

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and Notice of proposed rulemaking.

SUMMARY: In this issue of the Bulletin, temporary regulations (T.D. 9569) provide guidance on how an analysis of the differential income stream may provide a best method consideration for evaluating an application of the income method to determine taxable income in connection with a cost sharing arrangement. The text of those regulations also serves as the text of regulations that are proposed by cross-reference to the temporary regulations. This document also contains proposed regulations providing guidance on the use of the differential income stream as a specified application of the income method to determine taxable income in connection with a cost sharing arrangement.

DATE: Written or electronic comments and requests for a public hearing must be received by March 22, 2012.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–145474–11), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–145474–11), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–145474–11).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Joseph L. Tobin or Mumal R. Hemrajani, (202) 435–5265 (not a toll-free number); concerning submission of comments and/or requests for a hearing, *Richard.A.Hurst@irscounsel.treas.gov*.

SUPPLEMENTARY INFORMATION:

Background

A notice of proposed rulemaking and notice of public hearing regarding additional guidance to improve compliance with, and administration of, the rules in connection with a cost sharing arrangement (CSA) were published in the **Federal Register** (70 FR 51116) (REG–144615–02, 2005–2 C.B. 625) on August 29, 2005 (2005 proposed regulations). A correction to the notice of proposed rulemaking and notice of public hearing was published in the **Federal Register** (70 FR 56611) on September 28, 2005. A public hearing was held on December 16, 2005.

The Treasury Department and the IRS received numerous comments on a wide range of issues addressed in the 2005 proposed regulations. In response to these comments, temporary and proposed regulations were published in the **Federal Register** (74 FR 340–01 and 74 FR 236–01) (REG–144615–02) on January 5, 2009 (2008 temporary regulations). Corrections to the 2008 temporary regulations were published in the **Federal Register** on February 27, 2009 (74 FR 8863–01), March 5, 2009 (74 FR 9570–01, 74 FR 9570–02, and 74 FR 9577–01), and March 19, 2009 (74 FR 11644–01). A public hearing was held on April 21, 2009.

The Treasury Department and the IRS received comments on a range of issues addressed in the 2008 temporary regulations. Final regulations were issued in a previous issue of the Bulletin (REG–144615–02) (T.D. 9568) in December 2011 (final regulations). Certain guidance regarding discount rates was reserved in the final regulations because the Treasury Department and the IRS believe it is appropriate to solicit public comments on that subject matter.

Temporary regulations in this issue of the Bulletin contain amendments to the final regulations and implement the use of the differential income stream as a consideration in assessing the best method in connection with a CSA. The text of those regulations also serves as the text of the regulations contained in this document that are proposed by cross-reference to the temporary regulations (§1.482–7T(g)(2)(v)(B)(*2*) and (4)(vi)(F)(*2*)). This document also contains a proposed amendment to the regulations under section 482 that describes the specific application of the income method using the differential income stream (§1.482–7(g)(4)(v)).

Explanation of Provisions

See the Explanation of Provisions for the temporary cost sharing regulations published in this issue of the Bulletin for an explanation of how proposed §1.482–7(g)(2)(v)(B)(*2*) and (4)(vi)(F)(*2*) build upon and augment §1.482–7(g)(4)(vi)(F)(*1*) (Reflection of similar risk profiles in cost sharing alternative and licensing alternative) of the final regulations.

These proposed regulations also build upon and augment §1.482–7(g)(4)(vi)(F)(*1*) of the final regulations by providing a new specified application of the income method. Section 1.482–7(g)(4)(v) of the proposed regulations provides that the determination of the arm's length charge for the PCT Payment can be derived by discounting the differential income stream at an appropriate rate. The differential income stream approach to determining PCT Payments depends on reliably determining the discount rate associated with the differential income stream. This, in turn, requires an understanding of the economic meaning of the differential income stream. For example, assume a CSA in which the PCT Payor does not contribute any platform or operating contributions, and undertakes only routine exploitation activities for which it anticipates a routine return. In such case, the total undiscounted anticipated profits (before PCT Payments) to the CSA in the PCT Payor's territory can be thought of as comprising the anticipated routine exploitation profits plus the anticipated development value of the cost shared intangibles in the PCT Payor's territory. Under the licensing alternative, on the other hand, the PCT Payor's total undiscounted anticipated profits consist solely of the anticipated routine exploitation profits. Thus, the differential income stream conceptually corresponds to the development value of the cost shared intangibles. For these reasons, an appropriate discount rate for the differential income stream might be determined based, for example, on the weighted average cost of capital of uncontrolled companies whose activities consist primarily of developing intangibles similar to the cost shared intangibles, and whose resources, capabilities, or rights are similar to the platform contributions and cost shared intangibles under the CSA. These proposed regulations also add §1.482–7(g)(4)(viii) *Example 9* to illustrate this newly specified application of the income method.

Proposed Effective Dates

Prop. Treas. Reg. §1.482–7(g)(2)(v)(B)(*2*), (4)(vi)(F)(*2*) and (viii), *Example 8* are proposed to be applied to taxable years beginning on or after December 19, 2011.

Prop. Treas. Reg. §1.482–7(g)(4)(v) and (viii), *Example 9* are proposed to apply to taxable years beginning on or after the date of publication of a Treasury decision adopting such rules as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in

Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does 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 (CCASBA) for comment on their impact on small businesses. CCASBA had no comments.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. Treasury and the IRS request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Joseph L. Tobin and Mumal R. Hemrajani, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

Section 1.482–7 is also issued under 26 U.S.C. 482. * * *

Par. 2. Section 1.482–7 is amended by adding paragraphs (g)(2)(v)(B)(*2*), (g)(4)(v), and (g)(4)(vi)(F)(*2*), and *Examples 8* and *9* to paragraph (g)(4)(viii).

The additions read as follows:

§1.482–7 Methods to determine taxable income in connection with a cost sharing arrangement.

* * * * *

(g)* * *

(2)* * *

(v)* * *

(B)* * *

(2) [The text of the proposed amendment to §1.482–7(g)(2)(v)(B)(*2*) is the same as the text of §1.482–7T(g)(2)(v)(B)(*2*) published elsewhere in this issue of the Bulletin].

* * * * *

(4)* * *

(v) *Application of income method using differential income stream*. In some cases, the present value of an arm's length PCT Payment may be determined as the present value, discounted at the appropriate rate, of the PCT Payor's reasonably anticipated stream of additional positive or negative income over the duration of the CSA Activity that would result (before PCT Payments) from undertaking the cost sharing alternative rather than the licensing alternative (differential income stream). See *Example 9* of paragraph (g)(4)(viii) of this section.

* * * * *

(vi)* * *

(F)* * *

(*2*) [The text of the proposed amendment to §1.482–7(g)(4)(vi)(F)(*2*) is the same as the text of §1.482–7T(g)(4)(vi)(F)(*2*) published elsewhere in this issue of the Bulletin.]

* * * * *

(viii) * * *

Example 8 [The text of the proposed amendment to §1.482–7(g)(4)(viii) (*Example 8*) is the same as the text of §1.482–7T(g)(4)(viii) (*Example 8*) published elsewhere in this issue of the Bulletin.]

Example 9. The facts are the same as in *Example 1*, except that additional data on discount rates are available that were not available in *Example 1*. The Commissioner determines the arm's length charge for the PCT Payment by discounting at an appropriate rate the differential income stream associated with the rights contributed by USP in the PCT (that is, the stream of income in column (11) of *Example 1*). Based on an analysis of a set of public companies whose resources, capabilities, and rights consist primarily of resources, capabilities, and rights similar to those contributed by USP in the PCT, the Commissioner determines that 15% to 17% is an appropriate range of discount rates to use to assess the value of the differential income stream associated with the rights contributed by USP in the PCT. The Commissioner determines that applying a discount rate of 17% to the differential income stream associated with the rights contributed by USP in the PCT yields a present value of $446 million, while applying a discount rate of 15% to the differential income stream associated with the rights contributed by USP in the PCT yields a present value of $510 million. Because the taxpayer's result, $464 million, is within the interquartile range determined by the Commissioner, no adjustments are warranted. See paragraphs (g)(2)(v)(B)(*2*), (g)(4)(v), and (g)(4)(vi)(F)(*1*) of this section.

* * * * *

(l) *Effective/Applicability Dates*. Treas. Reg. §1.482–7(g)(2)(v)(B)(*2*), (g)(4)(vi)(F)(*2*) and (g)(4)(viii), *Example 8* apply to taxable years beginning on or after December 19, 2011. Treas. Reg. §1.482–7(g)(4)(v) and (viii), *Example 9* apply to taxable years beginning on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

* * * * *

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on December 19, 2011, 11:15 a.m., and published in the issue of the Federal Register for December 23, 2011, 76 F.R. 80249)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

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