INTERNAL REVENUE BULLETIN

IRS

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2015–41
October 13, 2015

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

REG–127895–14, page 556.

This document is a notice of proposed rulemaking by cross-reference to a temporary regulation (TD 9743). These proposed regulations relating to determining when a complex contract provides for a dividend equivalent payment and provides rules for qualified derivatives dealers.

REG–138344–13, page 557.

These proposed regulations propose standards to implement the exception to the "contemporaneous written acknowledgement" requirement for substantiating charitable contribution deductions of $250 or more. These proposed regulations provide rules concerning the time and manner for donee organizations to file information returns that report the required information about contributions (donee reporting).

REG–155164–09, page 560.

This document contains proposed regulations that provide rules regarding the treatment as United States property of property held by a controlled foreign corporation (CFC) in connection with certain transactions involving partnerships. In addition, the Department of Treasury (Treasury Department) and the IRS are issuing temporary regulations under sections 954 and 956, the text of which also serves as the text of certain provisions of these proposed regulations.

Notice 2015–66, page 541.

Notice 2015–66 announces that the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) intend to amend regulations under sections 1471–1474 to extend the time that certain FATCA transitional rules will apply. Specifically, the amendments will extend: (1) the date for when withholding on gross proceeds and foreign passthru payments will begin; (2) the use of limited branches and limited foreign financial institutions (limited FFIs); and (3) the deadline for a sponsoring entity to register its sponsored entities and redocument such entities with withholding agents. In addition, in order to reduce compliance burdens on withholding agents that hold collateral as a secured party, the notice announces that Treasury and the IRS intend to amend the regulations under chapter 4 to modify the rules for grandfathered obligations in relation to collateral. The notice also provides information on the exchange of information by Model 1 IGA jurisdictions with respect to 2014.

Notice 2015–67, page 546.

This notice finalizes and supersedes Notice 2014–17. It provides a general rule that per capita distributions to Indian tribe members made from funds held in trust by the Secretary of the Interior ("Trust Account") are excluded from the gross income of the members of the tribe receiving the per capita distributions. This notice also provides an exception to the general rule. Distributions to tribal members from a Trust Account will constitute gross income under 26 U.S.C. § 61 to the members of the tribe receiving the distributions if the Trust Account is used to mischaracterize taxable income as nontaxable per capita distributions.

Notice 2015–68, page 547.

Information Reporting on Minimum Essential Coverage. This notice provides guidance on issues under section 6055 of the Code. Comments are requested by November 16, 2015, on the application of the reasonable good cause rules under section 6724 of the Code to section 6055 reporting, in particular relating to TIN solicitation and reporting.

Notice 2015–69, page 550.

This notice explains the circumstances under which the 4-year replacement period under section 1033(e)(2) is extended for livestock sold on account of drought. The Appendix to this notice contains a list of counties that experienced exceptional, extreme, or severe drought conditions during the 12-month period ending August 31, 2015. Taxpayers may use this list to determine if an extension is available.

(Continued on the next page)

Finding Lists begin on page ii.

T.D. 9733, page 494.

This document contains temporary regulations that provide rules regarding the treatment as United States property of property held by a controlled foreign corporation (CFC) in connection with certain transactions involving partnerships. In addition, the temporary regulations provide rules regarding when a CFC is considered to derive rents and royalties in the active conduct of a trade or business for purposes of determining foreign personal holding company income (FPHCI).

T.D. 9734, page 500.

These regulations describes payments that are dividend equivalents for purposes of section 871(m) and explains how to calculation of the amount of a dividend equivalent. These proposed regulations also provide guidance regarding the amount of a dividend equivalent payment and withholding rules relating to these payments.

T.D. 9739, page 528.

Final regulations providing guidance regarding the qualification of a transaction as a corporate reorganization under section 368(a)(1)(F) by virtue of being a mere change of identity, form, or place of organization of one corporation (F reorganization). Also final regulations relating to F reorganizations in which the transferor corporation is a domestic corporation and the acquiring corporation is a foreign corporation (an outbound F reorganization). These regulations will affect corporations engaging in transactions that could qualify as F reorganizations (including outbound F reorganizations) and their shareholders.

ADMINISTRATIVE

Rev. Proc. 2015–49, page 555.

This procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under section 42(h)(3)(D) of the Code for calendar year 2015.

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.

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.

Actions Relating to Decisions of the Tax Court

It is the policy of the Internal Revenue Service to announce at an early date whether it will follow the holdings in certain cases. An Action on Decision is the document making such an announcement. An Action on Decision will be issued at the discretion of the Service only on unappealed issues decided adverse to the government. Generally, an Action on Decision is issued where its guidance would be helpful to Service personnel working with the same or similar issues. Unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent.

Actions on Decisions shall be relied upon within the Service only as conclusions applying the law to the facts in the particular case at the time the Action on Decision was issued. Caution should be exercised in extending the recommendation of the Action on Decision to similar cases where the facts are different. Moreover, the recommendation in the Action on Decision may be superseded by new legislation, regulations, rulings, cases, or Actions on Decisions.

Prior to 1991, the Service published acquiescence or nonacquiescence only in certain regular Tax Court opinions. The Service has expanded its acquiescence program to include other civil tax cases where guidance is determined to be helpful. Accordingly, the Service now may acquiesce or nonacquiesce in the holdings of memorandum Tax Court opinions, as well as those of the United States District Courts, Claims Court, and Circuit Courts of Appeal. Regardless of the court deciding the case, the recommendation of any Action on Decision will be published in the Internal Revenue Bulletin.

The recommendation in every Action on Decision will be summarized as acquiescence, acquiescence in result only, or nonacquiescence. Both "acquiescence" and "acquiescence in result only" mean that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. However, "acquiescence" indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions; whereas, "acquiescence in result only" indicates disagreement or concern with some or all of those reasons. "Nonacquiescence" signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a "nonacquiescence" indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.

The Actions on Decisions published in the weekly Internal Revenue Bulletin are consolidated semiannually and appear in the first Bulletin for July and the Cumulative Bulletin for the first half of the year. A semiannual consolidation also appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

The Commissioner does NOT ACQUIESCE in the following decision:

Morehouse v. Commissioner[1]
769 F.3d 616 (8th Cir. 2014) *rev'g* 140 T.C. 350 (2013)

[1]Nonacquiescence relating to whether Conservation Reserve Program payments constitute rentals from real estate for purposes of section 1402(a)(1) and thus not subject to self-employment tax.

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

26 CFR 1.954–2: Foreign personal holding company income.

26 CFR 1.954–2T: Foreign personal holding company income (temporary).

26 CFR 1.956–1: Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

26 CFR 1.956–1T: Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property (temporary).

T.D. 9733

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

United States Property Held by Controlled Foreign Corporations in Transactions Involving Partnerships; Rents and Royalties Derived in the Active Conduct of a Trade or Business

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations regarding the treatment as United States property of property held by a controlled foreign corporation (CFC) in connection with certain transactions involving partnerships. In addition, the temporary regulations provide rules regarding when a CFC is considered to derive rents and royalties in the active conduct of a trade or business for purposes of determining foreign personal holding company income (FPHCI). These regulations affect United States shareholders of CFCs. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Internal Revenue Bulletin.** The final regulations revise and add cross-references to coordinate the application of the temporary regulations.

DATES: *Effective Date*: These regulations are effective on September 2, 2015.

Applicability Dates: For dates of applicability, see §§ 1.954–2T(j) and 1.956–1T(g).

FOR FURTHER INFORMATION CONTACT: Rose E. Jenkins, (202) 317-6934 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 956 of the Internal Revenue Code (Code). Section 956 determines the amount that a United States shareholder (as defined in section 951(b)) of a CFC must include in gross income with respect to the CFC under section 951(a)(1)(B). This amount is determined, in part, based on the average amount of United States property held, directly or indirectly, by the CFC at the close of each quarter during its taxable year. Subject to certain exceptions, United States property generally includes obligations of United States persons that are related to the CFC. Sections 956(c)(1)(C), 956(c)(2)(F), and 956(c)(2)(L). In general, the amount taken into account for section 956 purposes with respect to any United States property is the adjusted basis of the property, reduced by any liability to which the property is subject. See section 956(a) and § 1.956–1(e).

Section 956(e) grants the Secretary authority to prescribe such regulations as may be necessary to carry out the purposes of section 956, including regulations to prevent the avoidance of section 956 through reorganizations or otherwise. In addition, section 956(d) grants the Secretary authority to prescribe regulations pursuant to which a CFC that is a pledgor or guarantor of an obligation of a United States person is considered to hold the obligation.

Section 1.956–1T(b)(4) provides in relevant part that, at the District Director's discretion, a CFC will be considered to hold indirectly investments in United States property acquired by any other foreign corporation that is controlled by the CFC if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the CFC.

This document also contains amendments to 26 CFR part 1 under section 954. Section 954 defines foreign base company income (FBCI), which generally is income earned by a CFC that is taken into account in computing the amount that a United States shareholder of the CFC must include in income under section 951(a)(1)(A). FBCI includes FPHCI, as defined in section 954(c), which, in turn, generally includes rents and royalties. Section 954(c)(1)(A). However, rents and royalties are excluded from FPHCI if they are received from a person other than a related person and derived in the active conduct of a trade or business within the meaning of section 954(c)(2)(A) and § 1.954–2(c) and (d) (active rents and royalties exception). Temporary regulations in this document provide guidance on the active rents and royalties exception, including the treatment of cost sharing arrangements for purposes of the exception.

Explanation of Provisions

1. *Modifications of Anti-Avoidance Rule in § 1.956–1T(b)(4)*

A. *Modifications of existing rules*

These regulations modify § 1.956–1T(b)(4) so that the rule can also apply when a foreign corporation controlled by a CFC is funded other than through capital contributions or debt. In addition, these temporary regulations add an example involving the funding of one CFC by another CFC that controls it to illustrate the application of the anti-avoidance rule when a principal purpose for funding the first CFC is to avoid the application of section 956 with respect to the funding CFC, even though there would be a section 956 inclusion with respect to the CFC that received the funding. This example illustrates that the CFCs' tax attributes associated with a section 956 inclusion (such as total earnings and profits, previously taxed earnings and profits, and foreign tax credit pools) are taken into account in determining whether a principal purpose of a funding was to avoid the application of section 956 with respect to the funding CFC. In addition, this example makes clear that if a CFC is considered to indirectly hold United States property pursuant to § 1.956–1T(b)(4), then the CFC that actually holds the United States property will not also be considered to hold the property for purposes of section 956. See *Example 3* in § 1.956–1T(b)(4)(iv).

These regulations also modify *Example 1* and *Example 2* of § 1.956–1T(b)(4) to more closely reflect the language of new § 1.956–1T(b)(4)(iv). The Department of the Treasury (Treasury Department) and the IRS do not view these modifications as a substantive change.

Moreover, § 1.956–1T(b)(4) applies if "one of the principal purposes" for the transaction is to avoid the application of section 956 with respect to the CFC. These temporary regulations apply when "a principal purpose" for the transaction is to avoid the application of section 956 with respect to the CFC. The Treasury Department and the IRS do not view this modification as a substantive change, since both formulations appropriately reflect that there may be more than one principal purpose for a transaction. Accordingly, § 1.956–1T(b)(4) may be applied if a principal purpose of a transaction is to avoid the application of section 956, even if there also were other principal purposes for the transaction.

Finally, the Treasury Department and the IRS have concluded that § 1.956–1T(b)(4) should apply without requiring the IRS to exercise its discretion, and, therefore, have modified the rule to be self-executing. This modification, as well as the modification to what constitutes a funding, is consistent with a previous change to a similar rule in § 1.304–4(b). See TD 9477, 74 FR 69021 (Dec. 30, 2009).

B. *New partnership rule*

Existing § 1.956–1T(b)(4) applies only to transactions that involve foreign corporations that are controlled by a CFC. The Treasury Department and the IRS understand that taxpayers may be using partnerships to structure transactions that are similar to the types of transactions addressed by § 1.956–1T(b)(4). For example, with a principal purpose of avoiding the application of section 956, a CFC may contribute cash to a partnership in exchange for an interest in the partnership, which in turn lends the cash to a United States shareholder of the CFC. In such a case, a taxpayer may take the position that the CFC is not treated as indirectly holding the entire obligation of the United States shareholder but instead is treated as holding the obligation only to the extent of the CFC's interest in the partnership under § 1.956–2(a)(3).

These types of partnership transactions raise concerns similar to those that are currently addressed by § 1.956–1T(b)(4). Accordingly, these temporary regulations expand § 1.956–1T(b)(4) to include transactions involving partnerships that are controlled by the CFC. These temporary regulations also contain a coordination rule in § 1.956–1T(b)(4)(iii), which provides that the new partnership rule in § 1.956–1T(b)(4)(i)(C) applies only to the extent that the amount of United States property that a CFC would be treated as holding under the rule exceeds the amount that it would be treated as holding under § 1.956–2(a)(3).

2. *New Rule Governing Foreign Partnership Distributions Funded by CFCs*

The Treasury Department and the IRS also understand that CFCs are engaging in transactions in which a CFC lends funds to a foreign partnership, which then distributes the proceeds from the borrowing to a U.S. partner who is related to the CFC and whose obligation would be United States property if it were held (or treated as held) by the CFC. Alternatively, the CFC could guarantee a loan to a foreign partnership, which then could distribute the loan proceeds to a related U.S. partner. Taxpayers take the position that section 956 does not apply to these transactions even though the CFC's earnings are effectively repatriated to a related U.S. partner.

In response to these transactions, the temporary regulations add § 1.956–1T(b)(5) to address certain cases in which a CFC funds a foreign partnership (or guarantees a borrowing by a foreign partnership) and the foreign partnership makes a distribution to a U.S. partner that is related to the CFC. For purposes of section 956, § 1.956–1T(b)(5) treats the partnership obligation as an obligation of the distributee partner to the extent of the lesser of the amount of the distribution that would not have been made but for the funding of the partnership or the amount of the foreign partnership obligation. For example, if a related United States shareholder of a CFC has an interest in a foreign partnership, the CFC lends $100 to the partnership, and the partnership distributes $100 to the United States shareholder in a distribution that would not have been made but for the loan from the CFC, then the entire $100 partnership obligation held by the CFC will be treated as an obligation of the United States shareholder that qualifies as United States property. Section 1.956–1T(b)(5) generally has the same purpose and effect as proposed § 1.956–4(c)(3) contained in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Internal Revenue Bulletin** (REG–155164–09) and will be removed upon the finalization of proposed § 1.956–4(c)(3).

3. *Active Rents and Royalties Exception to FPHCI*

Although rents and royalties generally are included in FPHCI under section 954(c)(1)(A), rents and royalties derived in the active conduct of a trade or business and received from a person that is not a related person are excluded from FPHCI under the active rents and royalties exception in section 954(c)(2)(A) and § 1.954–2(b)(6). The section 954 regulations provide the exclusive rules for determining whether rents and royalties are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A). Specifically, § 1.954–2(c) provides four alternative ways for rents to be derived in the active conduct of a trade or business, and § 1.954–2(d) provides two alternative ways for royalties to be derived in the active conduct of a trade or business. One way for a CFC to derive rents and royalties in the active conduct of a trade or business is to satisfy an "active development" test, which, among other things, requires the CFC to be "regularly engaged" either in the "manufacture or production of, or in the acquisition and addition of substantial value to," certain property (§ 1.954–2(c)(1)(i), applicable to rents); or in the "development, creation or production of, or in the acquisition of and addition of substantial value to," certain property (§ 1.954–2(d)(1)(i), applicable to royalties) (collectively, active development tests). Although certain of the alternative ways (specifically, the active management and marketing tests) in which a CFC can satisfy the active rents and royalties exception require that the relevant activities be performed by the CFC's own officers or staff of employees (§ 1.954–2(c)(1)(ii), (iv), and (d)(1)(ii)), the active development tests do not expressly contain this requirement. But see § 1.954–2(d)(3) *Example 5* (indicating that royalties received by a CFC that financed independent persons in development activities were not considered derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A)).

In addition to the active development tests, another way for a CFC to derive rents and royalties in the active conduct of a trade or business is to satisfy an "active marketing" test, which, among other things, requires the CFC to operate in a foreign country an organization that is regularly engaged in the business of marketing, or marketing and servicing, the leased or licensed property, and that is "substantial" in relation to the amount of rents or royalties derived from the leased or licensed property. See § 1.954–2(c)(1)(iv) and (d)(1)(ii). Pursuant to a safe harbor in the regulations, an organization is "substantial" if the active leasing or licensing expenses equal or exceed 25 percent of the adjusted leasing or licensing profits. See § 1.954–2(c)(2)(ii) and (d)(2)(ii). The regulations generally define active leasing expenses and active licensing expenses to mean, subject to certain exceptions, deductions that are properly allocable to rental or royalty income and that would be allowable under section 162 if the CFC were a domestic corporation. See § 1.954–2(c)(2)(iii) and (d)(2)(iii).

In general, the active rents and royalties exception is intended to distinguish between a CFC that passively receives investment income and a CFC that derives income from the active conduct of a trade or business. See S. Rep. No. 87–1881, 87th Cong., 2d Sess., at 83 (1962). Accordingly, the policy underlying the active rents and royalties exception requires that the CFC itself actively conduct the business that generates the rents or royalties. The Treasury Department and the IRS have determined that, consistent with this policy, the CFC must perform the relevant activities (that is, activities related to the manufacturing, production, development, or creation of, or, in the case of an acquisition, the addition of substantial value to, the property at issue) through its own officers or staff of employees in order to satisfy the active development tests. Thus, § 1.954–2T(c)(1)(i) and (d)(1)(i) expressly provide that the CFC lessor or licensor must perform the required functions through its own officers or staff of employees.

The Treasury Department and the IRS also have concluded that the policy of the active rents and royalties exception allows the relevant activities undertaken by a CFC through its officers or staff of employees to be performed in more than one foreign country. Thus, § 1.954–2T(c)(1)(iv) and (d)(1)(ii) provide that (i) a CFC's officers or staff of employees may be located in one or more foreign countries; and (ii) an organization that meets the requirements of the active marketing test can be maintained and operated by the officers or staff of employees either in a single foreign country or in multiple foreign countries collectively. Similarly, § 1.954–2T(c)(2)(ii) and (d)(2)(ii) indicate that an organization can be in a single foreign country or in multiple foreign countries collectively for purposes of determining the substantiality of the foreign organization.

In applying the active development tests and active marketing tests, questions have arisen as to the treatment of cost sharing arrangements under which a person other than the CFC actually conducts relevant activities. Consistent with the policy underlying the active rents and royalties exception that requires the CFC itself to conduct the relevant activities, § 1.954–2T(c)(2)(viii) and (d)(2)(v) clarify that CST Payments and PCT Payments (as defined in § 1.482–7(b)(1)) made by a CFC will not cause the CFC's officers and employees to be treated as undertaking the activities of the controlled participant to which the payments are made. This clarification applies for purposes of the active development tests and the active marketing tests, including for purposes of determining whether an organization that engages in marketing is substantial. Similarly, § 1.954–2T(c)(2)(iii)(E) and (d)(2)(iii)(E) provide that deductions for CST Payments and PCT Payments are excluded from the definition of active leasing expenses and active licensing expenses, respectively. Thus, CST Payments and PCT Payments are not active leasing expenses or active licensing expenses for purposes of determining whether an organization is "substantial" under the safe harbor test.

4. *Effective/Applicability Dates*

The rules in § 1.956–1T(b)(4) described in Part 1 of this preamble apply to taxable years of CFCs ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, with respect to property acquired, including property treated as acquired as the result of a deemed exchange of property pursuant to section 1001, on or after September 1, 2015. The rule in § 1.956–1T(b)(5) described in Part 2 of this preamble applies to taxable years of CFCs ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, in the case of distributions made on or after September 1, 2015. The rules regarding the active development test in § 1.954–2T(c)(1)(i) and (d)(1)(i) described in Part 3 of this preamble apply to rents or royalties, as applicable, received or accrued during taxable years of CFCs ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, but only with respect to property manufactured, produced, developed, or created, or, in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015. The rules regarding the active marketing test in § 1.954–2T(c)(1)(iv), (c)(2)(ii), (d)(1)(ii), and (d)(2)(ii) described in Part 3 of this preamble, as well as the rules regarding cost-sharing arrangements in § 1.954–2T(c)(2)(iii)(E), (c)(2)(viii), (d)(2)(iii)(E), and (d)(2)(v) also described in Part 3 of this preamble, apply to rents or royalties, as applicable, received or accrued during taxable years of CFCs ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, to the extent that such rents or royalties are received or accrued on or after September 1, 2015. No inference is intended as to the application of the provisions amended by these temporary regulations under current law. The IRS may, where appropriate, challenge transactions, including those described in these temporary regulations and this preamble, under currently applicable Code or regulatory provisions or judicial doctrines.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It has been determined that sections 553(b) and (d) of the Administrative Procedure Act (5 U.S.C. chapter 5) do not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the cross-referenced notice of proposed rulemaking published elsewhere in this issue of the **Internal Revenue Bulletin.** 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 for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Barbara E. Rasch and Rose E. Jenkins of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

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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 in part as follows:

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

* * * * *

Section 1.956–1T also issued under 26 U.S.C. 956(d) and 956(e).

* * * * *

Par. 2. Section 1.954–2 is amended by:

a. Revising paragraphs (c)(1)(i), (c)(1)(iv), and (c)(2)(ii);

b. Adding paragraphs (c)(2)(iii)(E) and (c)(2)(viii);

c. Revising paragraphs (d)(1)(i) and (ii) and (d)(2)(ii); and

d. Adding paragraphs (d)(2)(iii)(E), (d)(2)(v), and (j).

The revisions and additions read as follows:

§ 1.954–2 Foreign personal holding company income.

* * * * *

(c) * * *

(1) * * *

(i) [Reserved]. For further guidance, see § 1.954–2T(c)(1)(i).

* * * * *

(iv) [Reserved]. For further guidance, see § 1.954–2T(c)(1)(iv).

(2) * * *

(ii) [Reserved]. For further guidance, see § 1.954–2T(c)(2)(ii).

(iii) * * *

(E) [Reserved]. For further guidance, see § 1.954–2T(c)(2)(iii)(E).

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(viii) [Reserved]. For further guidance, see § 1.954–2T(c)(2)(viii).

* * * * *

(d) * * *

(1) * * *

(i) [Reserved]. For further guidance, see § 1.954–2T(d)(1)(i).

(ii) [Reserved]. For further guidance, see § 1.954–2T(d)(1)(ii).

(2) * * *

(ii) [Reserved]. For further guidance, see § 1.954–2T(d)(2)(ii).

(iii) * * *

(E) [Reserved]. For further guidance, see § 1.954–2T(d)(2)(iii)(E).

* * * * *

(v) [Reserved]. For further guidance, see § 1.954–2T(d)(2)(v).

* * * * *

(j) [Reserved]. For further guidance, see § 1.954–2T(j).

Par. 3. Section 1.954–2T is added to read as follows:

§ 1.954–2T Foreign personal holding company income (temporary).

(a)(1) through (c)(1) introductory text [Reserved]. For further guidance, see § 1.954–2(a)(1) through (c)(1) introductory text.

(i) Property that the lessor, through its own officers or staff of employees, has manufactured or produced, or property that the lessor has acquired and, through its own officers or staff of employees, added substantial value to, but only if the lessor, through its officers or staff of employees, is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;

(c)(1)(ii) and (iii) [Reserved]. For further guidance, see § 1.954–2(c)(1)(ii) and (c)(1)(iii).

(iv) Property that is leased as a result of the performance of marketing functions by such lessor through its own officers or staff of employees located in a foreign country or countries, if the lessor, through its officers or staff of employees, maintains and operates an organization either in such country or in such countries (collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

(c)(2)(i) [Reserved]. For further guidance, see § 1.954–2(c)(2)(i).

(ii) *Substantiality of foreign organization*. For purposes of paragraph (c)(1)(iv) of this section, whether an organization either in a foreign country or in foreign countries (collectively) is substantial in relation to the amount of rents is determined based on all the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of rents if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section. In addition, for purposes of aircraft or vessels leased in foreign commerce, an organization will be considered substantial if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 10 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section. For purposes of paragraphs (c)(1)(iv) and (c)(2) of this section and § 1.956–2(b)(1)(vi), the term *aircraft or vessels* includes component parts, such as engines that are leased separately from an aircraft or vessel.

(c)(2)(iii) introductory text through (c)(2)(iii)(D) [Reserved]. For further guidance, see § 1.954–2(c)(2)(iii) through (c)(2)(iii)(D).

(E) Deductions for CST Payments or PCT Payments (as defined in § 1.482–7(b)).

(c)(2)(iv) through (c)(2)(vii) [Reserved]. For further guidance, see § 1.954–2(c)(2)(iv) through (c)(2)(vii).

(viii) *Cost sharing arrangements (CSAs)*. For purposes of paragraphs (c)(1)(i) and (iv) of this section, CST Payments or PCT Payments (as defined in § 1.482–7(b)(1)) made by the lessor to another controlled participant (as defined in § 1.482–7(j)(1)(i)) pursuant to a CSA (as defined in § 1.482–7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the lessor's own officers or staff of employees.

(c)(3) and (d)(1) introductory text [Reserved]. For further guidance, see § 1.954–2(c)(3) and (d)(1) introductory text.

(i) Property that the licensor, through its own officers or staff of employees, has developed, created, or produced, or property that the licensor has acquired and, through its own officers or staff of employees, added substantial value to, but only so long as the licensor, through its officers or staff of employees, is regularly engaged in the development, creation, or production of, or in the acquisition and addition of substantial value to, property of such kind; or

(ii) Property that is licensed as a result of the performance of marketing functions by such licensor through its own officers or staff of employees located in a foreign country or countries, if the licensor, through its officers or staff of employees, maintains and operates an organization either in such foreign country or in such foreign countries (collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.

(d)(2)(i) [Reserved]. For further guidance, see § 1.954–2(d)(2)(i).

(ii) *Substantiality of foreign organization*. For purposes of paragraph (d)(1)(ii) of this section, whether an organization either in a foreign country or in foreign countries (collectively) is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of royalties if active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(d)(2)(iii) introductory text through (d)(2)(iii)(D) [Reserved]. For further guidance, see § 1.954–2(d)(2)(iii) introductory text through (d)(2)(iii)(D).

(E) Deductions for CST Payments or PCT Payments (as defined in § 1.482–7(b)).

(d)(2)(iv) [Reserved]. For further guidance, see § 1.954–2(d)(2)(iv).

(v) *Cost sharing arrangements (CSAs)*. For purposes of paragraphs (d)(1)(i) and (ii) of this section, CST Payments or PCT Payments (as defined in § 1.482–7(b)(1)) made by the licensor to another controlled participant (as defined in § 1.482–7(j)(1)(i)) pursuant to a CSA (as defined in § 1.482–7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the licensor's own officers or staff of employees.

(d)(3) through (i) [Reserved]. For further guidance, see § 1.954–2(d)(3) through (i).

(j) *Effective/applicability date*. Paragraphs (c)(1)(i) and (d)(1)(i) of this section apply to rents or royalties, as applicable, received or accrued during taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, but only with respect to property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015. Paragraphs (c)(1)(iv), (c)(2)(ii), (c)(2)(iii)(E), (c)(2)(viii), (d)(1)(ii), (d)(2)(ii), (d)(2)(iii)(E), and (d)(2)(v) of this section apply to rents or royalties, as applicable, received or accrued during taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, to the extent that such rents or royalties are received or accrued on or after September 1, 2015. See § 1.954–2(c)(1)(i), (c)(1)(iv), (c)(2)(ii), (c)(2)(iii), (d)(1)(i), (d)(1)(ii), (d)(2)(ii), and (d)(2)(iii), as contained in 26 CFR part 1 revised as of April 1, 2015, for rules applicable to rents or royalties, as applicable, received or accrued before September 1, 2015.

(k) *Expiration date*. The applicability of paragraphs (c)(1)(i), (c)(1)(iv), (c)(2)(ii), (c)(2)(iii)(E), (c)(2)(viii), (d)(1)(i), (d)(1)(ii), (d)(2)(ii), (d)(2)(iii)(E), and (d)(2)(v) of this section expires on or before Friday August 31, 2018.

Par. 4. Section 1.956–1 is amended by:

a. Adding paragraphs (b)(4), (b)(5), (f), and (g)(1) through (3).

b. Redesignating paragraph (e)(6)(vii) as paragraph (g)(4) and revising it.

The additions and revisions read as follows:

§ 1.956–1 Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

* * * * *

(b) * * *

(4) [Reserved]. For further guidance, see § 1.956–1T(b)(4).

(5) [Reserved]. For further guidance, see § 1.956–1T(b)(5).

* * * * *

(f) [Reserved]. For further guidance, see § 1.956–1T(f).

(g) introductory text through (g)(3) [Reserved]. For further guidance, see § 1.956–1T(g) introductory text through (g)(3).

(4) Paragraph (e)(6) of this section applies to property acquired in exchanges occurring on or after June 24, 2011. For transactions that occur prior to June 24, 2011, see § 1.956–1T(e)(6) as contained in 26 CFR Part 1 revised as of April 1, 2011.

Par. 5. Section 1.956–1T is amended by revising paragraph (b)(4), and adding paragraphs (b)(5), (e)(6), (g), and (h) to read as follows:

§ 1.956–1T Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property (temporary).

* * * * *

(b) * * *

(4) *Certain indirectly held United States property*—(i) *General rule*. For purposes of section 956, United States property held indirectly by a controlled foreign corporation includes—

(A) United States property held on behalf of the controlled foreign corporation by a trustee or a nominee;

(B) United States property acquired by any other foreign corporation that is controlled by the controlled foreign corporation if a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation; and

(C) Property acquired by a partnership that is controlled by the controlled foreign corporation if the property would be United States property if held directly by the controlled foreign corporation, and a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the partnership is to avoid the application of section 956 with respect to the controlled foreign corporation.

(ii) *Control*. For purposes of paragraphs (b)(4)(i)(B) and (C) of this section, a controlled foreign corporation controls a foreign corporation or partnership if the controlled foreign corporation and the other foreign corporation or partnership are related within the meaning of section 267(b) or section 707(b). For this purpose, in determining whether two corporations are members of the same controlled group under, a person is considered to own stock owned directly by such person, stock owned for the purposes of section 1563(e)(1), and stock owned with the application of section 267(c).

(iii) *Coordination rule*. Paragraph (b)(4)(i)(C) of this section applies only to the extent that the amount of United States property that is treated as held indirectly by a controlled foreign corporation under that paragraph exceeds the amount of United States property that is treated as held by the controlled foreign corporation under § 1.956–2(a)(3).

(iv) *Examples*. The following examples illustrate the rules of this paragraph (b)(4). In each example, unless otherwise provided, P is a domestic corporation that wholly owns two controlled foreign corporations, FS1 and FS2.

Example 1. (i) *Facts*. FS1 sells inventory to FS2 in exchange for trade receivables due in 60 days. Avoiding the application of section 956 with respect to FS1 was not a principal purpose of establishing the trade receivables. FS2 has no earnings and profits and FS1 has substantial accumulated earnings and profits. FS2 makes a loan to P equal to the amount it owes FS1 under the trade receivables. FS2 pays the trade receivables according to their terms.

(ii) *Result*. FS1 will not be considered to indirectly hold United States property under this paragraph (b)(4) because the funding of FS2 through the sale of inventory in exchange for the establishment of trade receivables was not undertaken with a principal purpose of avoiding the application of section 956 with respect to FS1.

Example 2. (i) *Facts*. The facts are the same as in Example 1, except that, with a principal purpose of avoiding the application of section 956 with respect to FS1, FS1 and FS2 agree to defer FS2's payment obligation, and FS2 does not timely pay the receivables.

(ii) *Result*. FS1 is considered to hold indirectly United States property under this paragraph (b)(4), because there was a funding of FS2, a principal purpose of which was to avoid the application of section 956 with respect to FS1.

Example 3. (i) *Facts*. FS1 has $100x of post-1986 undistributed earnings and profits and $100 post-1986 foreign income taxes, but does not have any cash. FS2 has earnings and profits of at least $100x, no post-1986 foreign income taxes, and substantial cash. Neither FS1 nor FS2 has earnings and profits described in section 959(c)(1) or section 959(c)(2). FS2 loans $100x to FS1. FS1 then loans $100x to P. An income inclusion by P of $100x under sections 951(a)(1)(B) and 956 with respect to FS1 would result in foreign income taxes deemed paid by P under section 960. A principal purpose of funding FS1 through the loan from FS2 is to avoid the application of section 956 with respect to FS2.

(ii) *Result*. Under paragraph (b)(4)(i)(B) of this section, FS2 is considered to indirectly hold the $100x obligation of P that is held by FS1. As a result, P has an income inclusion of $100x under sections 951(a)(1)(B) and 956 with respect to FS2, and the foreign income taxes deemed paid by P under section 960 is $0. P does not have an income inclusion under sections 951(a)(1)(B) and 956 with respect to FS1 related to the $100x loan from FS1 to P.

Example 4. (i) *Facts*. FS1 has substantial earnings and profits. P and FS1 are the only partners in a foreign partnership, FPRS. FS1 contributes $600x cash to FPRS in exchange for a 60% interest in the partnership, and P contributes real estate located outside the United States ($400x value) to FPRS in exchange for a 40% interest in the partnership. There are no special allocations in the FPRS partnership agreement. FPRS lends $100x to P. Under § 1.956–2(a)(3), FS1 is treated as holding United States property of $60x (60% x $100x) as a result of the FPRS loan to P. A principal purpose of creating, organizing, or funding FPRS is to avoid the application of section 956 with respect to FS1.

(ii) *Result*. Before taking into account paragraph (b)(4)(iii) of this section, because FS1 controls FPRS and a principal purpose of creating, organizing, or funding FPRS was to avoid the application of section 956 with respect to FS1, FS1 is considered under paragraph (b)(4)(i)(C) of this section to indirectly hold the $100x obligation of P that would be United States property if held directly by FS1. However, under paragraph (b)(4)(iii) of this section, FS1 is treated as holding United States property under paragraph (b)(4)(i)(C) only to the extent the amount held indirectly under paragraph (b)(4)(i)(C) of this section exceeds the amount of United States property that FS1 is treated as holding under § 1.956–2(a)(3). The amount of United States property that FS1 is treated as indirectly holding under paragraph (b)(4)(i)(C) of this section ($100x) exceeds the amount determined under § 1.956–2(a)(3) ($60x) by $40x. Thus, FS1 is considered to hold United States property within the meaning of section 956(c) in the amount of $100x ($60x under § 1.956–2(a)(3) and $40x under paragraphs (b)(4)(i)(C) and (b)(4)(iii) of this section).

(5) *Certain foreign partnership distributions funded by CFCs*—(i) *General rule*. For purposes of section 956, an obligation of a foreign partnership that is held (or that would be treated as held under § 1.956–2(c) if the obligation were an obligation of a United States person) by a controlled foreign corporation is treated as a separate obligation of a partner in the partnership when—

(A) The foreign partnership distributes an amount of money or property to the partner;

(B) The foreign partnership would not have made the distribution but for a funding of the partnership through the obligation; and

(C) The partner is related to the controlled foreign corporation within the meaning of section 954(d)(3).

(ii) *Amount of obligation*. Notwithstanding § 1.956–1(e), the amount that is treated as an obligation of the distributee partner pursuant to paragraph (b)(5)(i) of this section is equal to the lesser of the amount of the partnership distribution that would not have been made but for the funding of the partnership or the amount (as determined under § 1.956–1(e)) of the obligation of the foreign partnership that is held (or that would be treated as held under § 1.956–2(c) if the obligation were an obligation of a United States person) by the controlled foreign corporation.

(iii) *Example*. (A) *Facts*. P, a domestic corporation, wholly owns FS, a controlled foreign corporation. P owns a 70% interest in FPRS, a foreign partnership. A domestic corporation that is unrelated to P and FS owns the remaining 30% interest in FPRS. FPRS borrows $100x from FS, and distributes $80x to P. FPRS would not have made the distribution to P but for the funding by FS.

(B) *Result*. Under paragraph (b)(5)(i) of this section, a portion of the obligation of FPRS that FS holds is treated as an obligation of P, which constitutes United States property, because FPRS made a distribution to P that FPRS would not have made but for the funding of FPRS through the obligation held by FS. Under paragraph (b)(5)(ii) of this section, the amount that is treated as an obligation of P is the lesser of the amount of the distribution, $80x, or the amount of the entire obligation of FPRS held by FS, $100x. For purposes of section 956, therefore, on the date the loan to FPRS is made, FS is considered to hold United States property of $80x.

* * * * *

(e)(6) [Reserved]. For further guidance, see § 1.956–1(e)(6).

* * * * *

(g) *Effective/applicability date*. (1) Paragraph (b)(4) of this section applies to taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, with respect to property acquired on or after September 1, 2015. See paragraph (b)(4) of § 1.956–1T, as contained in 26 CFR part 1 revised as of April 1, 2015, for the rules applicable to taxable years of controlled foreign corporations ending before September 1, 2015, and property acquired before September 1, 2015. For purposes of this paragraph (g)(1), a deemed exchange of property pursuant to section 1001 on or after September 1, 2015, constitutes an acquisition of the property on or after that date.

(2) Paragraph (b)(5) of this section applies to taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, in the case of distributions made on or after September 1, 2015.

(3) [Reserved].

(4) [Reserved]. For further guidance, see § 1.956–1(g)(4).

(h) *Expiration date*. The applicability of paragraphs (b)(4) and (b)(5) of this section expires on or before **August 31, 2018**.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved: July 30, 2015.

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on September 1, 2015, 8:45 a.m., and published in the issue of the Federal Register for September 2, 2015, 80 F.R. 52976)

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26 CFR 1.871–14: Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.
26 CFR 1.871–15: Treatment of dividend equivalents.
26 CFR 1.871–15T: Treatment of dividend equivalents (temporary).
26 CFR 1.1441–1: Requirement for the deduction and withholding of tax on payments to foreign persons.
26 CFR 1.1441–1T: Requirement for the deduction and withholding of tax on payments to foreign persons (temporary).
26 CFR 1.1441–2: Amounts subject to withholding.
26 CFR 1.1441–3: Determination of amounts to be withheld.
26 CFR 1.1441–7: General provisions relating to withholding agents.
26 CFR 1.1461–1: Payments and returns of tax withheld.
26 CFR 1.1473–1: Section 1473 definitions.

T.D. 9734

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1
RIN 1545–BJ56

Dividend Equivalents from Sources within the United States

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and temporary regulations.

SUMMARY: This document provides guidance to nonresident alien individuals and foreign corporations that hold certain financial products providing for payments that are contingent upon or determined by reference to U.S. source dividend payments. This document also provides guidance to withholding agents that are responsible for withholding U.S. tax with respect to a dividend equivalent.

DATES: *Effective Date*: These regulations are effective on September 18, 2015.

Applicability Dates: For dates of applicability, see §§ 1.871–14(j)(4), 1.871–15(r), 1.871–15T(r)(4), 1.1441–1(f)(4), 1.1441–1T(f)(3), 1.1441–2(f), 1.1441–3(h)(3), 1.1441–7(a)(4), 1.1461–1(c)(2)(iii), and 1.1473–1(f).

FOR FURTHER INFORMATION CONTACT: D. Peter Merkel or Karen Walny at (202) 317-6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been 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 numbers 1545-0096 and 1545-1597. The collections of information in this final regulation are in § 1.871–15(p), and are an increase in the total annual burden in the current regulations under §§ 1.1441–1 through 1.1441–9, 1.1461–1, and 1.1474–1. This information is required to establish whether a payment is treated as a U.S. source dividend for purposes of section 871(m) of the Internal Revenue Code (Code). This information will be used for audit and examination purposes. The IRS intends that these information collection requirements will be satisfied by persons complying with revised chapter 3 reporting requirements and the requirements of the applicable QI revenue procedure to be revised by the IRS, or alternative certification and documentation requirements set out in these regulations. 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.

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. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Background

On January 23, 2012, the **Federal Register** published temporary regulations (TD 9572) at 77 FR 3108 (2012 temporary regulations), and a notice of proposed rulemaking by cross-reference to the temporary regulations and notice of public hearing at 77 FR 3202 (2012 proposed regulations, and together with the 2012 temporary regulations, 2012 section 871(m) regulations) under section 871(m). The 2012 section 871(m) regulations relate to dividend equivalents from sources within the United States paid to nonresident alien individuals and foreign corporations. Corrections to the 2012 temporary regulations were published on February 6, 2012, and March 8, 2012, in the **Federal Register** at 77 FR 5700 and 77 FR 13969, respectively. A correcting amendment to the 2012 temporary regulations was also published on August 31, 2012, in the **Federal Register** at 77 FR 53141. The Treasury Department and the IRS received written comments on the 2012 proposed regulations, and a public hearing was held on April 27, 2012.

On December 5, 2013, the **Federal Register** published final regulations and removal of temporary regulations (TD 9648) at 78 FR 73079 (2013 final regulations), which finalized a portion of the 2012 section 871(m) regulations. Also on December 5, 2013, the **Federal Register** published a withdrawal of notice of proposed rulemaking, a notice of proposed rulemaking, and a notice of public hearing at 78 FR 73128 (2013 proposed regulations). In light of comments on the 2012 proposed regulations, the 2013 proposed regulations described a new approach for determining whether a payment made pursuant to a notional principal contract (NPC) or an equity-linked instrument (ELI) is a dividend equivalent based on the delta of the contract. In response to written comments on the 2013 proposed regulations, the Treasury Department and the IRS released Notice 2014–14, 2014–13 IRB 881, on March 24, 2014 (see § 601.601(d)(2)(ii)(*b*)), stating that the Treasury Department and the IRS anticipated limiting the application of the rules with respect to specified ELIs described in the 2013 proposed regulations to ELIs issued on or after 90 days after the date of publication of final regulations.

The Treasury Department and the IRS received written comments on the 2013 proposed regulations, which are available at *www.regulations.gov*. The public hearing scheduled for April 11, 2013, was cancelled because no request to speak was received. This Treasury decision generally adopts the 2013 proposed regulations with the changes discussed in this preamble. This Treasury decision also includes temporary regulations, which provide new rules for determining whether certain complex derivatives are subject to section 871(m) and for payments to certain dealers in response to comments on the 2013 proposed regulations.

Summary of Comments and Explanation of Provisions

I. *In General*

The Treasury Department and the IRS received numerous comments regarding the 2013 proposed regulations. Most comments agreed that the approach taken in the 2013 proposed regulations, in particular the use of a test based on delta, was a fair and practical way to apply section 871(m) to financial instruments linked to one or more U.S. equity securities. Commenters, however, identified a number of issues with the 2013 proposed regulations. Many of the comments suggested modifications and clarifications to the 2013 proposed regulations before they are issued as final regulations. Those comments are summarized in Part II of this preamble. Part II also explains the changes made to the final regulations in response to those comments.

Several of the issues identified by commenters required more significant changes or additions to the 2013 proposed regulations. To allow taxpayers adequate opportunity to consider and comment on these changes, the Treasury Department and the IRS are issuing portions of the regulations as temporary and proposed regulations. Those provisions, and the relevant comments, are summarized in Part III of this preamble.

II. *Final Regulations*

A. *Source of a Dividend Equivalent*

The 2013 proposed regulations provide that a dividend equivalent is treated as a dividend from sources within the United States for purposes of sections 871(a), 881, 892, 894, and 4948(a), and chapters 3 and 4 of subtitle A of the Code. This rule follows section 871(m)(1) but adds the reference to section 894 to clarify (as provided in § 1.894–1(c)(2)) that a dividend equivalent is treated as a dividend for purposes of any provision regarding dividends in an income tax treaty. The final regulations retain the general sourcing provision. *See* § 1.871–15(b).

B. *Definition of a Dividend Equivalent*

The 2013 proposed regulations define a dividend equivalent as (1) any substitute dividend that references a U.S. source dividend made pursuant to a securities lending or sale-repurchase transaction, (2) any payment that references a U.S. source dividend made pursuant to a specified NPC, (3) any payment that references a U.S. source dividend made pursuant to a specified ELI, or (4) any other substantially similar payment. A payment references a U.S. source dividend if the payment is directly or indirectly contingent upon a U.S. source dividend or determined by reference to such a dividend. While the transactions described in (1) and (2) are transactions described in sections 871(m)(2)(A) and (B), respectively, the 2013 proposed regulations extend section 871(m) to the transactions described in (3) and (4) under the regulatory authority granted in section 871(m)(2)(C), which includes as a dividend equivalent "any other payment determined by the Secretary to be substantially similar to a payment described in subparagraph (A) or (B)" of section 871(m)(2). The final regulations retain this four-part definition of a dividend equivalent. *See* § 1.871–15(c)(1). The final regulations also provide certain exceptions to the term "dividend equivalent," which are described in section II.D of this preamble.

Section 871(m)(3)(A) provides a temporary definition of the term "specified notional principal contract." This definition is effective for payments made on or after September 14, 2010, and on or before March 18, 2012. Section 871(m)(3)(B) provides that, for payments made after March 18, 2012, a specified NPC includes "any notional principal contract unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance." The 2013 final regulations extend the applicability of the temporary statutory definition in section 871(m)(3)(A) (the four-part definition provided in paragraphs (3)(A)(i) through (iv)) to payments made before January 1, 2016. These final regulations amend the 2013 final regulations to extend the application of the temporary statutory definition adopted in the 2013 final regulations to payments made before January 1, 2017.

Pursuant to the grant of authority in section 871(m)(2)(C), the 2013 proposed regulations provide that certain payments made pursuant to a specified ELI are substantially similar to a dividend equivalent payment. Section 1.871–15(c)(1)(iii) of the 2013 proposed regulations defines a dividend equivalent to include any payment that references the payment of a dividend from an underlying security on a specified ELI. Section 1.871–15(a)(3) of the 2013 proposed regulations defines an ELI (whether or not specified) as any financial transaction (other than a securities lending or sale-repurchase transaction or an NPC) that references the value of one or more underlying securities. Forward contracts, futures contracts, options, debt instruments convertible into underlying securities, and debt instruments that have payments linked to underlying securities are common examples of an ELI.

C. *The Delta Test*

The 2012 proposed regulations used a multi-factor test to determine whether an NPC or ELI is a specified contract subject to withholding under section 871(m). The 2013 proposed regulations replace the multi-factor test with a single-factor test that employs a "delta" threshold to determine whether a transaction is a section 871(m) transaction. Delta refers to the ratio of a change in the fair market value of a contract to a small change in the fair market value of the property referenced by the contract. Delta is widely used by participants in the derivatives markets to measure and manage risk. Under the test in the 2013 proposed regulations, any NPC or ELI that had a delta of 0.70 or greater when the long party acquired the transaction would be a section 871(m) transaction subject to withholding.

The Treasury Department and the IRS proposed a delta-based standard after concluding that it would provide a comparatively simple, administrable, and objective framework that would also minimize potential avoidance of U.S. withholding tax. A financial instrument that provides an economic return that is substantially similar to the return on the underlying stock should be taxed in the same manner as the underlying stock for the purpose of section 871(m). The Treasury Department and the IRS concluded that the delta test was the best way to identify these instruments.

The Treasury Department and the IRS received many comments regarding the delta test. Commenters generally agreed that the delta test was both a fair and comprehensive way to implement section 871(m), but provided comments on several aspects of the test. The major concerns noted in the comments relate to: (1) the use of 0.70 as the delta threshold; (2) the time for testing delta; (3) the ability of parties to the transaction to obtain and track the necessary delta information; and (4) the difficulty of determining an initial delta with respect to certain complex equity derivatives (in contrast with simple contracts, as defined in Part II.C.4 of this preamble).

1. *Delta Threshold*

Comments on the 2013 proposed regulations recommended raising the delta threshold, with suggestions ranging from a delta of 0.80 to 0.95. The majority of comments preferred a delta threshold of 0.90 or greater. Comments maintained that a higher delta would more accurately capture transactions that are economically equivalent to stock ownership and likely to be used for tax-avoidance. One comment noted that a 0.80 delta standard, although not prescribed in regulatory guidance, is used by some practitioners as a yardstick to judge economic equivalence in other tax contexts.

The Treasury Department and the IRS agree that the 0.70 delta in the 2013 proposed regulations could apply to contracts with economic characteristics that do not sufficiently resemble the underlying security to be within the scope of section 871(m). On the other hand, a delta threshold that is 0.90 (or higher) would exclude many instruments that are surrogates for the underlying security, such as deep-in-the-money options. The final regulations adopt a delta threshold of 0.80, which strikes a balance between the potential over-inclusiveness of the 0.70 delta threshold and the likelihood that a 0.90 (or higher) threshold would exclude transactions with economic returns that closely resemble an underlying security.

Several comments noted that a delta ratio is intended to measure the sensitivity of the value of a contract to comparatively small changes in the market value of the referenced property and suggested that the regulations incorporate this qualification in the definition of delta. The final regulations accept this suggestion and clarify the definition of delta by specifying that delta is calculated with respect to a small change in the fair market value of the property referenced by the contract. Typically, a small change is a change of less than 1 percent.

2. *Time for Testing Delta*

Many comments stated that the requirement to test delta each time a contract is acquired would be extremely difficult to administer, especially for ELIs that trade frequently. Multiple testing events create the possibility that identical instruments acquired at different times would have different tax characteristics, which withholding systems are generally not designed to handle. To ease compliance, comments suggested that delta be tested only when a contract is issued. For derivatives that are listed and cleared through central clearinghouses, another comment suggested that the delta test would be more administrable if taxpayers were permitted to simplify their calculations. For example, delta could be calculated using the fair market value of an ELI determined as of the market close on the trading day prior to the date the ELI is acquired, even though this approach would result in a less accurate calculation. Other comments suggested that, in determining the delta of an option, only the stock price at the time the option is entered into should be considered.

The Treasury Department and the IRS are persuaded that the difficulties of testing delta each time an NPC or ELI is acquired outweigh the benefit of the increased accuracy of that approach. Accordingly, the final regulations provide that the delta of an ELI or NPC is determined only when the instrument is issued; it is not re-tested when the instrument is purchased or otherwise acquired in the secondary market. Consequently, only an NPC or ELI that has a delta of 0.80 or greater at the time it is issued is a specified NPC or specified ELI.

For purposes of § 1.871–15, an instrument is treated as "issued" when it is entered into, purchased, or otherwise acquired at its inception or original issuance, which includes an issuance that results from a deemed exchange pursuant to section 1001. The requirement to test delta only at the time an instrument is issued also extends to the rules for determining the amount of each dividend equivalent (as discussed in section F.1 of this preamble).

3. *Access to Delta Information*

Comments noted practical issues with obtaining delta information, particularly for exchange-traded positions where the dealer is not involved in determining pricing and the short party may not have the expertise to calculate delta. Comments suggested adopting an alternative test for identifying high-delta options based on their relative intrinsic value (amount by which the option is in-the-money) and relative extrinsic value (time value). This test would require the simpler calculation of determining the applicable strike price as a percentage of the current fair market value of the ELI and deeming ELIs at a certain percentage as passing or failing the delta threshold. Alternatively, comments suggested permitting the long party to rely on commonly available online tools to calculate delta for exchange-traded ELIs, provided that the taxpayer uses inputs that are within the range of commercially acceptable variation, uses a consistent methodology, and records its calculations contemporaneously. Comments also recommended relying on an anti-abuse rule for particularly complex derivatives for which delta information would be unavailable to any party other than the issuer, speculating that the increased cost and risk of complex transactions generally would outweigh any tax savings.

The Treasury Department and the IRS are concerned that these alternative tests or shorthand methods for determining delta may result in uncertainty for withholding agents and the IRS that could make it difficult to determine the status of potential section 871(m) transactions. Moreover, the changes to the final regulations to require that delta be tested only when a contract is first issued, accompanied by enhanced reporting rules (described in more detail later in this preamble), make these alternative tests unnecessary. Accordingly, the final regulations do not adopt these recommendations.

However, in order to simplify the delta calculation for contracts that reference multiple underlying securities, the final regulations provide that a short party may calculate delta using a single exchange-traded security in certain circumstances. More specifically, if a short party issues a contract that references a basket of 10 or more underlying securities and uses an exchange-traded security, such as an exchange-traded fund, that references substantially the same underlying securities to hedge the contract at the time it is issued, the short party may use the hedge security to determine the delta of the security it is issuing rather than determining the delta of each security referenced in the basket.

4. *Contracts with Indeterminate Deltas*

Although commenters generally agreed that the delta test was fair and practical for the majority of equity-linked derivatives, numerous comments explained that the delta test would be difficult or impossible to apply to certain more exotic equity derivatives. For example, contracts that have asymmetrical or binary payouts may reference a different number of shares of an underlying security at different payout points. Similarly, contracts that have path-dependent payouts may reference multiple underlying securities, with payouts that are interdependent on the performance of each underlying security. In each of these cases, comments noted that the delta is indeterminate because the number of shares of the underlying security that determine the payout of the derivative cannot be known at the time the contract is entered into.

The Treasury Department and the IRS agree that an alternative to the delta test is needed for contracts with indeterminate deltas. To address these contracts, the final regulations distinguish between simple contracts and complex contracts. Generally, a simple contract is a contract that references a single, fixed number of shares of one or more issuers to determine the payout. The number of shares must be known when the contract is issued. In addition, the contract must have a single maturity or exercise date on which all amounts (other than any upfront payment or any periodic payments) are required to be calculated with respect to the underlying security. The fact that a contract has more than one expiry, or a continuous expiry, does not preclude the contract from being a simple contract. Thus, an American-style option is a simple contract even though the option may be exercised by the holder at any time on or before the expiration of the option if amounts due under the contract are determined by reference to a single, fixed number of shares on the exercise date. Most NPCs and ELIs are expected to be simple contracts and remain subject to the delta test described above.

A complex contract is any contract that is not a simple contract. Contracts with indeterminate deltas are classified as complex contracts, which are subject to a new substantial equivalence test. That test is included in the temporary regulations, described in more detail in Part III of this preamble. The delta test in the final regulations therefore applies only to simple contracts.

D. *Exceptions for Certain Payments and Transactions*

Several comments requested that the final regulations exclude certain payments from the definition of "dividend equivalent" or exclude certain transactions from the definition of "section 871(m) transaction." These comments generally noted that the payment or transaction at issue either is already taxed under another provision of the Code or does not provide the long party with an opportunity to avoid gross basis taxation on U.S. source dividends.

1. *Payment Referencing Distributions That Are Not Dividends*

The 2013 proposed regulations provide that a payment referencing a distribution on an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to section 871 or section 881 if the long party owned the underlying security directly. The final regulations retain this provision. *See* § 1.871–15(c)(2)(i).

2. *Section 305 Coordination*

Under sections 305(b) and (c) and regulations authorized by section 305(c), a change to the conversion ratio or conversion price of a convertible debt instrument that is a convertible security for purposes of section 305 (a convertible security) may be treated as a distribution of property to which section 301 applies made to the holder of the convertible security. *See* § 1.305–7. To the extent such a distribution is treated under section 301(c)(1) as a dividend as defined in section 316 (a section 305 dividend), § 1.1441–2(d)(1) would require withholding on the section 305 dividend without regard to the fact that there is no payment at that time. Absent special rules, a section 305 dividend resulting from a change in conversion ratio or price of a convertible security that is a section 871(m) transaction could also be subject to withholding as a dividend equivalent.

The 2013 proposed regulations provide that a payment pursuant to a section 871(m) transaction is not a dividend equivalent to the extent that it is treated as a distribution taxable as a dividend pursuant to section 305. Comments noted that section 305 dividends and dividend equivalents under section 871(m) arise in different contexts and are determined differently. Moreover, section 305 dividends will reduce earnings and profits pursuant to section 312. Comments suggested that the regulations provide more detail to coordinate these two provisions, including guidance on how to reconcile withholding on the delta-based dividend equivalent in these regulations with withholding otherwise required on section 305 dividends.

After consideration of the comments, these final regulations clarify that a dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction. For example, if a change in the conversion ratio of a convertible security that is a section 871(m) transaction is treated as a section 305 dividend made to the holder of the convertible security, a dividend equivalent is reduced by the amount of the section 305 dividend arising from such change.

Although a transaction (for example, a change in conversion ratio of a convertible security) may give rise to both a dividend equivalent and a section 305 dividend, dividend equivalents and section 305 dividends have different characteristics. These final regulations do not alter any of the rules applicable to section 305 dividends. As noted in Part II.M. of this preamble, however, the changes made elsewhere in these final regulations should make section 871(m) inapplicable to most convertible debt instruments, including those that are convertible securities subject to section 305(c).

3. *Due Bills*

The 2013 proposed regulations reserve on the question of whether a due bill gives rise to a dividend equivalent and request comments regarding whether a payment made by a seller of stock to the purchaser pursuant to an agreement to deliver a pending U.S. source dividend after the record date (for example, a due bill) should be treated as a substantially similar payment.

One comment noted that a due bill may give rise to payments that appear to satisfy the criteria for a dividend equivalent. That comment expressed concern regarding the impact this treatment might have on the capital markets because of the relative frequency of due bills, as well as the administrative complexity of treating these payments as dividend equivalents. Another comment asserted that a due bill is not the economic equivalent of a dividend. Both comments requested that the regulations either address due bills under the anti-abuse rule or exclude them from the term dividend equivalent.

The final regulations provide that a dividend equivalent does not include a payment made pursuant to a due bill that arises from the actions of a securities exchange that apply to all transactions in the stock and when the relevant exchange has set an ex-dividend date that occurs after the record date. This rule is expected to apply in situations in which a securities exchange sets an ex-dividend date after the record date to accommodate a special dividend.

4. *Employee Compensation*

The 2013 proposed regulations do not specifically exclude payments of compensation for personal services of a nonresident alien individual from being treated as a dividend equivalent. Comments suggested that compensation arrangements should be excluded from dividend equivalent treatment because compensation is already subject to an existing tax withholding framework, compensatory transactions arise in a different context from other derivatives and do not have the potential to avoid U.S. withholding tax, and compensation should be subject to tax where the services are performed.

The Treasury Department and the IRS have determined that section 871(m) should not apply to compensation that is generally subject to withholding or has a specific exception therefrom. Accordingly, the final regulations provide that a dividend equivalent does not include the portion of equity-based compensation for personal services of a nonresident alien individual that is wages subject to withholding under section 3402, excluded from the definition of wages under § 31.3401(a)(6)–1, or exempt from withholding under § 1.1441–4(b). For example, when a restricted stock unit is paid as compensation and tax is collected by the employer at the time of payment through withholding, the payment will not also be a dividend equivalent subject to withholding. If the restricted stock unit results in the receipt of stock, however, dividends subsequently paid on that stock would be subject to withholding under section 871.

5. *Certain Corporate Acquisitions*

In response to comments, § 1.871–15(j) of the 2013 proposed regulations provides an exception to the definition of a section 871(m) transaction when a taxpayer enters into a transaction as part of a plan pursuant to which one or more persons (including the taxpayer) are obligated to acquire more than 50 percent of the entity issuing the underlying securities.

Comments requested that the acquisition threshold in this exception be lowered from 50 percent to 10 or 20 percent. Comments noted that corporate acquisitions generally would not provide an opportunity for avoiding dividend withholding. Further, comments noted that the anti-abuse rule should be sufficient to address any abuse that could occur through such transactions. Comments acknowledged that when a target company pays a pre-closing dividend and the purchase price is reduced for the dividend, this may allow the purchaser to avoid a subsequent dividend. However, comments observed that this event should be viewed as a purchase price adjustment rather than a dividend equivalent.

The final regulations do not change the 50 percent threshold. Requiring that an acquisition (as part of a plan by one or more person) total more than 50 percent of a corporation is appropriate because it indicates that the primary intent of the acquirer is to obtain a controlling interest rather than just a substantial investment in the target company. In circumstances where a taxpayer enters into a transaction pursuant to which the taxpayer is obligated to acquire 50 percent or less of the entity issuing the underlying securities, and the transaction is a section 871(m) transaction, any party to the transaction that is a broker, dealer, or intermediary, a short party, or a withholding agent, must comply with any requirements in the final regulation to make appropriate determinations, and satisfy reporting and withholding obligations, as applicable.

E. *Payment of a Dividend Equivalent*

Section 871(m)(5) provides that a "payment" includes any gross amount that references a U.S. source dividend and that is used to compute any net amount transferred to or from the taxpayer. The 2013 proposed regulations provide that a dividend equivalent includes any amount that references an actual or estimated payment of a U.S. source dividend, whether the reference is explicit or implicit. Thus, in addition to amounts equal to actual payments of dividends and estimated dividends, a dividend equivalent includes any other contractual term of a section 871(m) transaction that is calculated based on an actual or estimated dividend. For example, when a long party enters into an NPC that provides for payments based on the appreciation in the value of an underlying security but that does not explicitly entitle the long party to receive payments based on regular dividends (a price return swap), the 2013 proposed regulations treat the price return swap as a transaction that provides for the payment of a dividend equivalent because the anticipated dividend payments are presumed to be taken into account in determining other terms of the NPC, such as in the payments that the long party is required to make to the short party or in setting the price of the underlying securities referenced in the price return swap.

Comments objected to the provisions in the 2013 proposed regulations that include estimated and implicit dividends in the definition of a dividend equivalent. These comments noted that an estimated dividend is reflected as a price reduction or as an amount that the foreign investor does not have to pay rather than an amount the foreign investor affirmatively receives for holding the derivative, which suggests that there is no "payment" of a dividend equivalent to the foreign investor. Comments also noted that, while estimated dividends may be implicitly incorporated into the pricing of a derivative, the price is ultimately determined by supply and demand in the market and the expected dividend is not always explicitly used in computing the amount paid.

The Treasury Department and the IRS have concluded that the economic benefit of a dividend is present in transactions that implicitly incorporate estimated dividends to virtually the same extent as transactions that pay or adjust for actual dividends. Thus, the final regulations retain the rules in the 2013 proposed regulations that include estimated and implicit dividends as dividend equivalents. *See* § 1.871–15(i)(2). More specifically, the final regulations provide that any gross amount that references the payment of a dividend, whether actual or estimated, explicit or implicit, is treated as a dividend equivalent to the extent of the amount determined under the regulations. The final regulations change the time that withholding is required on a payment of a dividend equivalent, as discussed in Part II.N. of this preamble.

F. *Amount of a Dividend Equivalent*

1. *Calculation of Dividend Equivalent Amount*

Under the 2013 proposed regulations, the amount of a dividend equivalent for a specified NPC or specified ELI equals the per-share dividend amount with respect to the underlying security multiplied by the number of shares of the underlying security referenced in the contract (subject to adjustment), multiplied by the delta of the transaction with respect to the underlying security at the time when the amount of the dividend equivalent is determined. If a transaction provides for a payment based on an estimated or implicit estimated dividend, the actual dividend is used to calculate the amount of the dividend equivalent unless the short party identifies a reasonable estimated dividend amount in writing at the inception of the transaction. When a payment based on estimated dividends is supported by the required documentation, the per-share dividend amount used to compute the amount of a dividend equivalent is the lesser of the estimated dividend and the actual dividend.

Comments on the 2013 proposed regulations noted that recalculating the delta of a section 871(m) transaction each time the amount of a dividend equivalent is determined would add administrative complexity without necessarily improving accuracy. In the interest of simplicity, several comments recommended using the actual dividend amount rather than an amount adjusted for delta as the dividend equivalent amount. Other comments suggested using the delta at the time the transaction is issued or entered into for determining the dividend equivalent amount. For complex transactions for which the delta is indeterminate, comments suggested that withholding be based on the number of shares required by the short party to the transaction to hedge its initial position in the transaction.

The final regulations simplify the rules for determining the amount of a dividend equivalent in response to these comments. For a simple contract, the final regulations provide that the amount of the dividend equivalent for each underlying security equals the amount of the per-share dividend, multiplied by the number of shares referenced in the contract, multiplied by the applicable delta. In a change from the 2013 proposed regulations, the final regulations provide that this formula references the delta of the transaction at the time the simple contract is issued, rather than when the dividend is paid. For a complex contract, the amount of the dividend equivalent equals the amount of the per-share dividend multiplied by the number of shares that constitute the initial hedge of the complex contract (as that term is defined in § 1.871–15(a)(5) and discussed in Part III.A of this preamble).

Another simplifying rule applies to dividend equivalents paid with respect to baskets of more than 25 securities. If a section 871(m) transaction references a basket of more than 25 underlying securities, the short party is allowed to treat all of the dividends on the basket as paid on the last day of the calendar quarter.

2. *Specified NPCs and Specified ELIs with a Term of One Year or Less*

For a specified NPC or specified ELI with a term of one year or less when acquired, the 2013 proposed regulations provide that the amount of a dividend equivalent is determined when the long party disposes of the section 871(m) transaction. Therefore, a long party that acquires an option with a term of one year or less that is a specified ELI would not incur a withholding tax if the option lapses.

One comment noted that the rule providing that there is no dividend equivalent for options that have a term of one year or less and lapse unexercised is inappropriate in the case of written put options because put writers realize their maximum profit when puts lapse. Comments further noted that the one-year rule could have uneconomic consequences for options close to expiration and for options that are slightly in-the-money or slightly out-of-the-money because the delta could fluctuate materially in response to small changes in the price of the underlying stock.

Based on the comments received, the final regulations eliminate the special rule for contracts with terms of one year or less. Any benefit from the rule is outweighed by the complexity of creating systems to track contracts that differ only in term. Eliminating the special rule for contracts of one year or less means that a dividend equivalent amount must be determined for any option, including a short-term option, that is a specified ELI.

G. *Qualified Indices*

The 2013 proposed regulations revise rules provided in the 2012 proposed regulations pertaining to an exception for transactions that reference certain equity indices. Under the 2013 proposed regulations, a qualified index is any index that (1) references 25 or more underlying securities, (2) references only long positions in underlying securities, (3) contains no underlying security that represents more than 10 percent of the index's weighting, (4) rebalances based on objective rules at set intervals, (5) does not provide a dividend yield that is greater than 1.5 times the dividend yield of the S&P 500 Index, and (6) is referenced by futures or option contracts that trade on a national securities exchange or a domestic board of trade. In addition, the 2013 proposed regulations provide that a qualified index would become disqualified if a transaction references a qualified index and also references a short position in any component underlying security of the qualified index other than a short position with respect to the entire qualified index (such as a cap or a floor).

One comment recommended eliminating the exception for a qualified index. This comment noted that when a long party holds a total return swap referencing a basket of underlying securities, that swap is economically equivalent to multiple total return swaps that each reference a single underlying security. Similarly, when a long party holds a delta-one derivative that references an index, that derivative is economically equivalent to multiple delta-one derivatives each referencing a single component of the index; therefore, that long party is receiving the economic equivalent of all dividends paid with respect to each stock in the index. Thus, transactions that reference U.S. stock indices have no less potential for avoidance of gross basis withholding tax on dividends than transactions that reference single equities or that reference customized baskets of equities.

Another comment noted that the criteria in the 2013 proposed regulations provide a reasonable method for identifying legitimate indices that have not been designed to avoid withholding taxes. That comment noted that the rules would exclude most securities that are linked to an index and traded on U.S. stock exchanges from dividend taxation, while preventing customized indices from becoming a vehicle designed to evade U.S. dividend taxes.

The majority of comments, however, recommended that the scope of the index exception be expanded to include most of the indices that are represented by exchange traded funds. Several comments requested that the definition allow an index with fewer than 25 stocks to be a qualified index, noting that many sector indices have fewer than 25 names. Another comment suggested providing an exception to the requirement that an index be referenced by exchange-traded futures or options that would apply to indices that are sufficiently broad-based (for example, indices containing one hundred or more component securities). Comments also suggested eliminating the requirement that the stock of a single company cannot represent more than 10 percent of the index's weighting because some indices include component securities that grow rapidly. Several comments also noted that many indices would fail to satisfy the requirement that a qualified index rebalance based on objective rules at set intervals because many popular indices, including the S&P 500 Index, rebalance using a combination of objective and subjective factors.

Comments further requested that the permitted dividend yield be increased to 2.5 times the current dividend yield of the S&P 500 Index. The comments noted that an index may not satisfy the requirement based on 1.5 times the current dividend yield of the S&P 500 Index if the stocks in the index depreciated significantly relative to the general U.S. stock market. In addition, other indices would not qualify because some market sectors routinely pay dividends at a rate that is more than 1.5 times the average rate in the U.S. market.

Other comments suggested additional categories of indices that should be treated as qualified indices. Specifically, one comment recommended that any index that was published by a recognized independent index publisher should be a qualified index if the index is offered for license to third parties on similar terms and multiple third party industry participants actually license the index. The comments proposed defining a recognized independent index publisher as an organization that publishes indices that are created, calculated, and compiled by a group of employees that have no duties other than those related to the publication of the indices.

The rule in the 2013 proposed regulations that prevents taxpayers from using short positions to decrease their long position with respect to one or more components of an index was also noted by comments as too restrictive. Comments suggested permitting taxpayers to decrease risk with respect to a small percentage of the value of the stocks in the index without disqualifying the index. One comment suggested that an index should remain a qualified index unless the short position is used to establish a net long position in a narrow set of underlying securities for purposes of evading withholding.

The 2013 proposed regulations also included a safe harbor for global indices with 10 percent or less U.S. stocks. Comments recommended expanding this safe harbor because U.S. equities in a global index can comprise more than half of the index's weighting. The comments proposed increasing the threshold to allow U.S. stocks to represent 50 percent or more of the index. These comments also noted that global indices do not typically trade on U.S. securities or commodities exchanges and will not be qualified indices under the current provisions. Other comments suggested that the regulations except from withholding all global indices that are not created to avoid withholding tax, with a presumption that widely-used benchmark indices are not designed to avoid tax.

The Treasury Department and the IRS believe that the approach taken in the 2013 proposed regulations for identifying qualified indices appropriately balances the competing concerns. Accordingly, the final regulations generally retain the criteria of the 2013 proposed regulations with modifications to clarify the intent and improve the functionality of the qualified index rule. *See* § 1.871–15(l).

The final regulations add a paragraph stating that the purpose of the qualified index rule is to provide a safe harbor for transactions on passive indices that reference a diverse basket of securities and that are widely used by numerous market participants. The index exception is not intended to apply to any index that is customized or reflects a trading strategy, is unavailable to other investors, or targets special dividends. The final regulations further provide that an index will not be treated as a qualified index if treating the index as a qualified index would be contrary to this purpose.

To make the rules easier to administer, the final regulations modify the time for determining whether an index satisfies the qualified index criteria. Specifically, the final regulations provide that the determination of whether an index is a qualified index is made on the first business day of each calendar year, and that determination applies for all potential section 871(m) transactions issued during that calendar year.

In response to comments, a number of changes also were made to specific aspects of the qualified index definition. First, the final regulations delete the modifier "underlying" with respect to "securities," thereby allowing an index to qualify with fewer than 25 component underlying securities provided that the index contains a total of at least 25 component securities (in other words, a component security may include a security that does not give rise to U.S. source dividends). The index, however, will not qualify if it references five or fewer component underlying securities that together represent more than 40 percent of the weighting of the component securities in the index. Second, the final regulations increase the 10 percent limit for the maximum weighting of a single underlying security to 15 percent. Third, in response to concerns regarding the requirement that a qualified index rebalance based on objective rules, the final regulations do not require that an index be modified or rebalanced at set dates or intervals, and provide flexibility for how the rules governing the constitution of an index are applied. Instead, under the final regulations, an index that is periodically rebalanced by a board or committee that is allowed to exercise judgment in interpreting the rules governing the composition of the index will not be disqualified if the index is otherwise a qualified index.

The final regulations continue to require that an index be referenced by futures or options listed on a national securities exchange or board of trade to be a qualified index, which is consistent with the intent to provide a safe harbor only for non-customized and widely-available indices. The final regulations do, however, permit an index that trades on certain foreign exchanges to be a qualified index, provided that the referenced component underlying securities, in aggregate, comprise less than 50 percent of the weighting of the component securities in the index and the index otherwise meets the definition of a qualified index.

Similarly, the Treasury Department and the IRS have concluded that the proposed rule permitting no more than 1.5 times the current dividend yield of the S&P 500 Index is appropriate and have retained it in the final regulations. To reduce the number of required calculations, however, the final regulations provide that the annual yields of the tested index and of the S&P 500 Index are determined based on their annual yields for the immediately preceding calendar year, rather than requiring comparison of the annual yields for the month immediately preceding the date that the potential section 871(m) transaction is issued.

The Treasury Department and the IRS agree that de minimis short positions, whether as part of the index or entered into separately, should not disqualify an index. Accordingly, the final regulations permit a qualified index to reference one or more short positions (in addition to any short positions with respect to the entire qualified index, such as caps or floors, which were already permitted by the 2013 proposed regulations) that represent five percent or less, in the aggregate, of the value of the long positions in underlying securities in the qualified index.

H. *Combined Transactions*

The 2013 proposed regulations treat multiple transactions as a single transaction for purposes of determining if the transactions are a section 871(m) transaction when a long party (or a related person) enters into two or more transactions that reference the same underlying security and the transactions were entered into in connection with each other. The 2013 proposed regulations apply only to combine transactions in which the taxpayer is the long party, and typically would not combine transactions when a taxpayer is the long party with respect to an underlying security in one transaction and the short party with respect to the same underlying security in another transaction. The 2013 proposed regulations provide that a broker-dealer must use "reasonable diligence" to determine whether a transaction is a section 871(m) transaction. Under the 2013 proposed regulations, a withholding agent was not required to withhold on a dividend equivalent paid pursuant to a transaction that is combined with one or more other transactions unless the withholding agent knew that the long party (or a related person) entered into the potential section 871(m) transactions in connection with each other.

The Treasury Department and the IRS requested comments regarding whether and how the rules for combining separate transactions should apply in other situations, such as when a taxpayer holds both long and short positions with respect to the same underlying security (for example, a call spread). Comments also were requested regarding whether and how the remaining transaction (or transactions) should be retested when a long party terminates one or more, but not all, of the transactions that make up a combined position.

Several comments recommended that the regulations not provide a specific combination rule and instead rely on an anti-abuse rule. One comment endorsed the proposed regulations as they applied to combinations of long calls and written puts (two options that can be used to closely approximate the economics of stock ownership) but recommended that transactions not be combined if the transactions replicate the same or similar risks with respect to additional shares (for example, two purchased calls on the same underlying securities).

Many comments observed that determining whether transactions were entered into "in connection with" each other would be difficult for a withholding agent and that the regulations should adopt a different standard or clarify the meaning of the phrase. Comments asked that the final regulations conform the standard for combined transactions to the narrower withholding standard that requires "actual knowledge." Comments noted that the requirement in the 2013 proposed regulations for broker-dealers to use "reasonable diligence" to determine whether a transaction is a section 871(m) transaction could be interpreted to require broker-dealers to inquire whether transactions are entered into in connection with each other in order to determine whether they must be combined. These comments observed that this standard for combined transactions is impractical because broker-dealers are generally not in a position to discern the intent of their counterparties, even using "reasonable diligence."

Several comments recommended that a combination rule permit netting of long and short positions. Commenters observed that many standard option strategies involve multiple options positions, often combining positive and negative delta options. As a result, an approach that does not combine these positions would fail to reflect the economics of the transactions. Commenters suggested that when a taxpayer modifies an existing combined position that includes both long and short positions, the combined position should continue to be tested based on the net deltas of the component positions rather than test the delta for each position separately. None of the comments, however, proposed an administrable test that could be used to reliably combine long and short positions and net the resulting deltas.

The final regulations retain the general rules from the 2013 proposed regulations that define when transactions are combined. In response to questions about whether the rules were intended to combine transactions that had similar economic exposure, the final regulations add a requirement that the potential section 871(m) transactions, when combined, replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction. Thus, the purchase of two out-of-the-money call options would typically not be combined because each call option provides the taxpayer with exposure to appreciation, but not depreciation, on the referenced stock.

The Treasury Department and the IRS recognize the challenges that short parties could face in identifying transactions to be combined. The final regulations therefore provide brokers acting as short parties with two presumptions they can apply to determine their liability to withhold. First, a broker may presume that transactions are not entered into in connection with each other if the long party holds the transactions in separate accounts. Second, a broker may presume that transactions entered into two or more business days apart are not entered into in connection with each other. These presumptions are independent of each other. Thus, a broker acting as a short party is relieved of the obligation to withhold if either of the two presumptions is met. A broker cannot rely on the first presumption if it has actual knowledge that the long party created or used separate accounts to avoid section 871(m), however, and neither presumption applies if the broker has actual knowledge that transactions were entered into in connection with each other.

In addition, the final regulations provide that the Commissioner will presume that transactions that are properly reflected on separate trading books of the taxpayer are not entered into in connection with each other. The Commissioner will also presume that a long party did not enter into two or more transactions in connection with each other if the long party entered into the transactions two or more business days apart. These presumptions are rebuttable. The Commissioner may rebut the first presumption with facts and circumstances showing that separate trading books were created or used to avoid section 871(m), and may rebut either presumption with facts and circumstances showing that the transactions in question were entered into in connection with each other.

The Commissioner will also apply an affirmative presumption. The Commissioner will presume that transactions that are entered into fewer than two business days apart and reflected on the same trading book are entered into in connection with each other. In this case, the long party can rebut the presumption by presenting facts and circumstances showing that the transactions were not entered into in connection with each other. In applying the presumptions that are based on trades being separated by at least two business days, the regulations include a rule of convenience that generally allows parties to treat all of their transactions as entered into at 4:00 pm.

The presumptions are not available to the long party. A long party therefore must treat two or more transactions as combined transactions if the transactions satisfy the requirements to be a combined transaction. The long parties affected by this rule consist primarily of securities traders, who are in a position to know their securities positions and trading strategies and to monitor their compliance with section 871(m).

The Treasury Department and the IRS will continue to evaluate the possibility of expanding the combination rules to accommodate netting of long and short positions in light of future developments in transactional reporting and recordkeeping. Additional comments regarding combined transactions are welcome.

I. *Derivatives Referenced to Partnership Interests*

The 2013 proposed regulations treat a transaction that references an interest in an entity that is not a C corporation for Federal tax purposes as referencing the allocable portion of any underlying securities and potential section 871(m) contracts held directly or indirectly by that entity. The 2013 proposed regulations provide an exception for a transaction that references an interest in an entity that is not a C corporation if the underlying securities and potential section 871(m) transactions allocable to that interest represent, in the aggregate, 10 percent or less of the value of the interest in the referenced entity at the time the transaction is entered into. Comments recommended changing the threshold for applying the look-through rule from 10 percent to 50 percent unless the taxpayer controls the entity. Comments also noted that taxpayers would have difficulty determining the assets owned by referenced entities.

The final regulations revise the rules to provide that section 871(m) applies to derivatives that reference a partnership interest only when the partnership is either a dealer or trader in securities, has significant investments in securities, or holds an interest in a lower-tier partnership that engages in those activities. The final regulations define a security by cross-reference to section 475(c). When the rule in the final regulations applies, a potential section 871(m) transaction that references a partnership interest is treated as referencing the allocable share of underlying securities and the potential section 871(m) transactions in the partnership directly or indirectly allocable to that partnership interest. Even when a partnership is not covered by this rule, the anti-abuse rule in § 1.871–15(o) may still apply, or the transaction may be recharacterized under the substance-over-form doctrine or other common law doctrine.

J. *Anti-Abuse Rule*

The 2013 proposed regulations provide that the Commissioner may treat any payment made with respect to a transaction as a dividend equivalent if the taxpayer acquires the transaction with a principal purpose of avoiding the application of section 871(m). Comments generally agreed with the need for such a rule, and the final regulations retain this provision. *See* § 1.871–15(o).

In addition, the IRS may challenge the U.S. tax results claimed in connection with transactions that are designed to avoid the application of section 871(m) using all available statutory provisions and judicial doctrines (including the substance-over-form doctrine, the economic substance doctrine under section 7701(o), the step transaction doctrine, and tax ownership principles) as appropriate. For example, nothing in section 871(m) precludes the IRS from asserting that a contract labeled as an NPC or other equity derivative is in fact an ownership interest in an underlying security referenced in the contract.

K. *Reporting Obligations*

The 2013 proposed regulations provide rules for reporting and withholding. The preamble to the 2013 proposed regulations explains that most equity-linked transactions involve a financial institution acting as a broker, dealer, or intermediary and that the financial institution would be in the best position to report the tax consequences of a potential section 871(m) transaction. Accordingly, § 1.871–15(o) of the 2013 proposed regulations provides that when a broker or dealer is a party to a potential section 871(m) transaction, the broker or dealer is required to determine whether the transaction is a section 871(m) transaction, and if so, the amounts of the dividend equivalents. If no broker or dealer is a party to a transaction or both parties are brokers or dealers, the short party is required to determine whether the transaction is a section 871(m) transaction and the amounts of the dividend equivalents. Determinations made by the broker, dealer, or short party are binding on the parties to the section 871(m) transaction unless a party to the transaction knows or has reason to know that the information is incorrect. Those determinations, however, are not binding on the IRS.

Comments expressed concern that the delta information necessary for an investor to determine whether a transaction is subject to section 871(m) may not be available on a timely basis, and requested that the regulations expand the categories of persons permitted to request information about the status and calculations associated with potential section 871(m) transactions. Comments recommended requiring the information to be provided on an issuer's website at or prior to the time that the transaction is issued and updated regularly. Investors could then rely on such information between update intervals.

In response to these comments, the final regulations make several changes to the reporting obligations in the 2013 proposed regulations. The final regulations revise the period for providing requested information from 14 calendar days to 10 business days from the date of the request. In addition, the final regulations replace the list of persons entitled to request information in the 2013 proposed regulations with a simpler provision that entitles "any party to the transaction" to request information. The final regulations define "a party to the transaction" to include any agent acting on behalf of a long party or short party to a potential section 871(m) transaction, or any person acting as an intermediary with respect to a potential section 871(m) transaction. This simplification responds to the requests to expand the scope of persons entitled to request information. Several other changes that were requested, however, such as posting information electronically, were already permitted by the 2013 proposed regulations. Like the 2013 proposed regulations, the final regulations permit parties to a transaction to obtain information on potential section 871(m) transactions in a variety of ways, including through electronic publication (such as a website).

Comments also noted that a short party to a listed option will not be able to provide the long party with a written estimate of dividends at inception because the short party does not have a contractual relationship with the long party. These comments requested that the broker be required to provide the written estimates. As in the 2013 proposed regulations, the final regulations do not require any party to a transaction to provide written estimates of dividends. The final regulations have taken these comments into account, however, by increasing a taxpayer's ability to obtain information from other parties to the transaction. The final regulations accomplish this by expanding the definition of a "party to the transaction" to include a broker and by clarifying that either a dealer or a middleman is a "broker." Therefore, if written estimates of dividends are prepared when a transaction is issued, the long party should be able to obtain the information from another party to the transaction, whether the short party or a broker.

L. *Recordkeeping Rules*

The 2013 proposed regulations generally cross-reference the recordkeeping rules in § 1.6001–1 for how a taxpayer establishes whether a transaction is a section 871(m) transaction and whether a payment is a dividend equivalent. For clarity and to ensure that the IRS will have access to sufficient information to audit taxpayers and withholding agents that are parties to section 871(m) transactions, the final regulations provide more detailed recordkeeping rules. The final regulations provide that any person required to retain records must keep sufficient information to establish whether a transaction is a section 871(m) transaction and the amount of a dividend equivalent. To satisfy this requirement, a taxpayer must retain documentation and work papers supporting a delta calculation or substantial equivalence calculation (including the number of shares of the initial hedge) and written estimated dividends (if any). The records and documentation must be created substantially contemporaneously with the time the potential section 871(m) transaction is issued.

M. *Contingent and Convertible Debt Instruments*

1. *Contingent Debt Instruments*

Section 871(h)(1) generally provides that U.S. source portfolio interest received by a nonresident alien individual is not subject to the 30-percent U.S. tax imposed under section 871(a)(1). Section 871(h)(4)(A)(i), however, excludes certain contingent interest payments from the definition of portfolio interest. Section 871(h)(4)(A)(ii) grants the Secretary authority to impose tax on contingent interest other than the payments described in section 871(h)(4)(A)(i) when necessary or appropriate to prevent the avoidance of federal income tax.

Comments on the 2012 proposed regulations recommended narrowing the definition of a specified notional principal contract to clarify that the term does not include contingent or convertible debt. These comments suggested that section 871(m) should not override the portfolio interest exception. Section 871(h)(4)(A)(ii) expressly provides authority to the Secretary to treat interest as contingent interest if necessary or appropriate to prevent the avoidance of federal income tax. Consistent with this grant of authority, the 2013 proposed regulations provide that contingent interest will not qualify for the portfolio interest exemption to the extent that the contingent interest payment is a dividend equivalent. The final regulations retain this exception to the portfolio interest exemption. There is no reason that an equity derivative that otherwise would be a specified NPC or a specified ELI should receive different treatment because it is embedded in a debt instrument. A debt instrument that provides for a contingent interest payment determined by reference to a U.S. source dividend payment that would otherwise be a section 871(m) transaction is a transaction that has the potential for tax avoidance, and it is appropriate for section 871(m) to apply. The effect of this rule, however, is expected to be minimal because the delta of the embedded derivative in a contingent debt or convertible debt instrument is tested only at the time it is issued.

2. *Convertible Debt Instruments*

Numerous comments requested that convertible debt instruments be excluded from the definition of an ELI. Comments suggested that certain characteristics typical of convertible debt would discourage foreign investors from using these instruments to avoid U.S. withholding tax. Comments pointed, for example, to high transaction costs and certain discontinuities between the economic performance of the convertible debt and that of the underlying stock, such as the downside protection and creditors' rights afforded by convertible debt. Comments noted that convertible bonds are important capital markets instruments used by U.S. corporations to raise capital at lower rates. Comments also speculated that treating such bonds as specified ELIs could adversely impact capital markets by decreasing demand, reducing liquidity, and increasing costs.

The final regulations do not provide an exception from section 871(m) for convertible debt. When the stock price significantly exceeds the conversion price, convertible debt becomes a surrogate for the stock into which the debt can be converted. Accordingly, a convertible debt obligation is a specified ELI if the delta of the embedded option at the time the convertible debt is originally issued is 0.80 or higher. Moreover, the fact that convertible debt ordinarily has been issued with a delta on the embedded option of less than 0.80 is expected to significantly reduce the effect of these regulations on the convertible debt market. In response to uncertainty expressed by some market participants, the final regulations clarify that the delta of the convertible feature is tested separately from the delta of the debt instrument in making section 871(m) calculations.

N. *Amounts Subject to Withholding*

Section 1.1441–2(d)(5) of the 2013 proposed regulations provides that a withholding agent is not obligated to withhold on a dividend equivalent until the later of: (1) when the amount of the dividend equivalent is determined and (2) when any of the following occurs: (a) money or other property is paid pursuant to a section 871(m) transaction, (b) the withholding agent has custody or control of money or other property, or (c) there is an upfront payment or a prepayment of the purchase price.

Comments emphasized the burden of withholding on dividend equivalents absent actual payments, and noted that, in the absence of actual payment, continuous monitoring and withholding on each specified ELI over time is impractical. Certain comments suggested that a foreign broker only be required to withhold on dividend equivalents from ELIs when there is a final payment or a sale.

Comments also maintained that upfront payments should not be viewed as payments subject to withholding because such proceeds are received in exchange for issuing the instrument, are used by the issuer to purchase related hedging positions, and are not intended to be reserves for satisfying tax owed by the counterparty.

Some comments expressed concern regarding the practical difficulties in withholding from funds that the broker-dealer holds as collateral. Comments noted that the broker-dealer may not be legally entitled to use cash or property in one account to satisfy a withholding obligation in another account. In addition, foreign counterparties may hold different accounts through different affiliates of a broker-dealer. Comments indicated that it would be impractical to determine the existence of affiliate accounts and apply set-off rules on that basis.

After consideration of these comments, the Treasury Department and the IRS have concluded that the withholding agent's obligations should not arise until an actual payment is made or there is a final settlement of a transaction. Accordingly, the final regulations provide that a withholding agent is not obligated to withhold on a dividend equivalent until the later of when a payment is made with respect to a section 871(m) transaction or when the amount of a dividend equivalent is determined. A payment with respect to a section 871(m) transaction will generally occur when the long party receives or makes a payment, when there is a final settlement of the section 871(m) transaction, or when the long party sells or otherwise disposes of the section 871(m) transaction. For options and other contracts that typically require an upfront payment, the final regulations do not treat the premium or other upfront payment as a payment for withholding purposes. Thus, withholding on these section 871(m) transactions is not required until there is a final settlement (including, in the case of an option, a lapse) or the long party sells or otherwise disposes of the transaction. Consequently, if an option that is a section 871(m) transaction lapses, the short party is nonetheless required to withhold on any dividend equivalent associated with the option. Parties may need to modify contractual arrangements to ensure that there are sufficient funds available to satisfy withholding obligations.

III. *Temporary and Proposed Regulations*

A. *Test for Contracts with Indeterminate Deltas*

As noted in Part II of this preamble, many commenters stated that the delta test was workable for most equity derivatives but would be difficult or impossible to apply to more exotic equity derivatives. In particular, a contract that provides for payments based on a number of shares of stock that varies at different points, or that provides for a payment that does not vary with the price of the shares (often called "digital" options), have an indeterminate delta because the number of shares of the underlying security that determine the payout of the derivative cannot be known at the time the contract is entered into. Path-dependent contracts were also mentioned as problematic for the delta computation.

Indeterminate delta may, for example, occur in contracts commonly known as structured notes. Structured notes are financial instruments that combine aspects of debt with aspects of derivatives, such as equity options. As an example, in return for an upfront payment of a set amount, a structured note might provide the long party with leveraged upside return, meaning that the long party is entitled to receive a fixed percentage (for example, 200 percent) of any appreciation in the value of a referenced stock up to a capped amount (for example, 125 percent of the issue price) in addition to return of the upfront payment, while being exposed to 100 percent of any depreciation in the value of the referenced stock, with any such depreciation reducing the amount of the upfront payment that is returned to the long party. In such a structured note, the holder would have two times the "upside" up to the cap but only one times exposure to the "downside." The issuer of this kind of structured note cannot readily determine a delta for the note because it references a different number of shares at different payoff amounts. In other words, because delta is the ratio of the change in the fair market value of a contract to a small change in the fair market value of the property referenced by the contract, the value of the referenced property must be known to calculate delta. In the case of the structured note described in this paragraph, the number of shares of stock (and hence the value of the property) referenced by the contract will be different depending on whether the stock appreciates, and in such case whether the cap is reached, or whether the stock depreciates.

As explained in Part II.C.4 of this preamble, a contract with an indeterminate delta is not a simple contract, and therefore falls into the residual category as a complex contract. Because the delta test cannot accurately be applied to a complex contract, commenters had various suggestions for how to determine whether such a contract should be a section 871(m) transaction. One comment suggested that the delta should be calculated using the highest possible number of shares that could be referenced by the derivative at maturity. This comment further suggested that the regulations include a delta-specific anti-abuse rule to prevent issuers from manipulating the number of referenced shares to artificially reduce delta. Other comments suggested that the regulations should disaggregate a transaction into a series of components and then separately apply the delta test to each component. When multiple derivatives are embedded in a single instrument, a comment recommended that multiple pieces be aggregated into separate components (for example, aggregating all embedded calls and separately aggregating all embedded puts) using an ordering rule that would maximize the likelihood that the delta threshold would be met.

A majority of comments requested that some version of a "proportionality" test be applied to complex contracts or to contracts where the basic delta test is susceptible of manipulation. A proportionality test measures the likelihood that a contract's performance will track the performance of the referenced equity. That is, a proportionality test measures the same variability or economic equivalence that the delta test seeks to measure without needing to know the number of shares that the contract references at the outset. Like the delta test, a proportionality test is based on the principle that when the value of an NPC or ELI closely tracks the value of an underlying security, it is appropriate to treat the NPC or ELI as a surrogate for the underlying security.

To test whether a complex contract is a section 871(m) transaction, the temporary regulations adopt the "substantial equivalence" test. The substantial equivalence test is a version of a proportionality test that was advocated by many commenters, and it uses information easily accessible to most issuers of complex contracts. Generally, the substantial equivalence test measures the change in value of a complex contract when the price of the underlying security referenced by that contract is hypothetically increased by one standard deviation or decreased by one standard deviation (each, a "testing price") and compares that change to the change in value of the shares of the underlying security that would be held to hedge the complex contract at the time the contract is issued (the "initial hedge") at each testing price. The smaller the proportionate difference between the change in value of the complex contract and the change in value of its initial hedge at multiple testing prices, the more equivalence there is between the contract and the referenced underlying security. When this difference is equal to or less than the difference for a simple contract benchmark with a delta of 0.80 and its initial hedge, the complex contract is treated as substantially equivalent to the underlying security.

The Treasury Department and the IRS are aware that there may be NPCs or ELIs that even the substantial equivalence test may not adequately address. The temporary regulations provide that when the steps of the substantial equivalence test cannot be applied to a particular complex contract, a taxpayer must use the principles of the substantial equivalence test to reasonably determine whether the complex contract is a section 871(m) transaction with respect to each underlying security.

The Treasury Department and the IRS request comments regarding the substantial equivalence test described in the temporary regulations. In particular, comments are requested on whether the two testing points required for most transactions in the temporary regulations are adequate to ensure that the substantial equivalence test captures the appropriate types of transactions, and the administrability of the test and its application to complex contracts that reference multiple securities, including path-dependent instruments.

B. *Withholding Requirements and QDDs*

1. *Background*

Section 871(m)(1) generally treats a dividend equivalent as a dividend from sources within the United States without regard to the residence of the person paying the dividend equivalent. As a result, section 871(m) may apply to payments made by a foreign payor to a foreign payee. *See* Staff of J. Comm. on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," JCX–4–10, at 79 (Feb. 23, 2010) (explaining that section 871(m) may apply to a chain of dividend equivalents, including payments made by a foreign person pursuant to transactions described in Notice 97–66); *see also* Notice 97–66, 1997–2 C.B. 328, at § 5, Examples 3 and 4 (illustrating that a foreign person making a substitute dividend payment to another foreign person must withhold U.S. tax). Because Congress was concerned that this rule may result in over-withholding in some instances, Congress granted the Secretary authority in section 871(m)(6) to reduce tax on a chain of dividend equivalents, but only to the extent that the taxpayer can establish that tax has been paid with respect to another dividend equivalent in the chain, or is not otherwise due, or as the Secretary determines is appropriate to address the role of financial intermediaries in such chain. For purposes of section 871(m)(6), a dividend is treated as a dividend equivalent.

2. *Comments on the 2013 Proposed Regulations*

The 2013 proposed regulations address the role of financial intermediaries in a chain of dividend equivalents with a rule that provides that payments made to a "qualified dealer" are not treated as dividend equivalents if made pursuant to a transaction that is entered into by the qualified dealer in its capacity as a dealer in securities and the dealer is the long party. For purposes of this rule, a qualified dealer is any dealer that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized and that certifies to the short party that it is receiving the payment in its capacity as a dealer. The 2013 proposed regulations require the qualified dealer to certify as to its dealer status to a short party on a transaction-by-transaction basis, and do not apply to dividends paid to a qualified dealer.

Comments requested that the qualified dealer exception in the 2013 proposed regulations be expanded, noting that it would be impractical for dealers to certify that each transaction was entered into in a dealer capacity (and not as a proprietary trade) and that the rule did not accommodate transactions entered into as a hedge of another transaction. Some comments suggested that the regulations exclude transactions entered into in the ordinary course of the dealer's business for hedging purposes. Other comments recommended expanding the exception to include affiliates of qualified dealers that issue certain potential section 871(m) transactions. Comments further recommended that an affiliate in these circumstances should not be required to certify that it is acting in its capacity as a dealer. Several comments requested that, in addition to expanding the definition of qualified dealer, the final regulations provide rules similar to the proposed regulatory framework described in Notice 2010–46 (discussed in more detail in section III.B.4 of this preamble).

3. *Qualified Intermediaries Acting as Qualified Derivatives Dealers*

The comments received on both the 2012 proposed regulations and the 2013 proposed regulations consistently expressed the desire for a comprehensive withholding and documentation regime tailored to derivatives dealers. Rather than create a new regime for section 871(m) transactions, the Treasury Department and the IRS determined that the most comprehensive and efficient way to respond to the requests in the comments is to expand the existing qualified intermediary (QI) regime to accommodate taxpayers acting as financial intermediaries on section 871(m) transactions. Generally, a QI is an eligible person that enters into a QI agreement with the IRS and that acts as a QI under such agreement. *See* Rev. Proc. 2014–39, 2014–29 I.R.B. 150. A QI agreement typically requires the QI to assume certain documentation and withholding responsibilities in exchange for simplified information reporting for its foreign account holders and the ability to not disclose proprietary account holder information to a withholding agent that may be a competitor. A QI may either assume primary withholding responsibilities or may provide withholding information to a withholding agent from which it receives a payment.

QIs that hold stocks and bonds for customers often receive payments subject to withholding on behalf of their foreign account holders as custodians rather than as beneficial owners. In contrast, a broker that enters into derivative contracts as a principal typically receives dividends and dividend equivalents as part of a chain of transactions in which the broker is a counterparty to both long and short positions.

The Treasury Department and the IRS intend to implement the particular requirements of withholding and reporting on dividend equivalents received and paid by brokers by amending the QI agreement to include new provisions that will permit an eligible QI to act as a qualified derivatives dealer (QDD). A QI that acts as a QDD will not be subject to withholding on dividends or payments that may be dividend equivalents made with respect to potential section 871(m) transactions that the QDD receives while acting in its capacity as a dealer.

In order to act as a QDD, a QI must meet four requirements. First, the QDD must furnish to withholding agents a QI withholding certificate affirming that the recipient is acting as a QDD for dividends and dividend equivalent payments associated with the withholding certificate. Second, the QDD must agree to assume primary withholding and reporting responsibilities on all payments associated with the withholding certificate that the QDD receives and makes as a dealer, and to determine whether payments it makes are dividend equivalents. Third, a QDD must agree to remain liable for tax on any dividends and dividend equivalents it receives unless the QDD is obligated to make an offsetting dividend equivalent payment as the short party on the same underlying security. Finally, a QDD must comply with any compliance review procedures that are applicable to a QI acting as a QDD, as specified in the QI agreement.

The class of persons eligible to act as a QDD is narrower than the class of persons that are eligible to enter into a QI agreement. A QI will be allowed to act as a QDD if it is either (1) a securities dealer that is regulated as a dealer in the jurisdiction in which it was organized or operates, or (2) a bank that is regulated as a bank in the jurisdiction in which it was organized or operates (or a wholly-owned foreign affiliate of such a bank). To act as a QDD, a QI that is not a securities dealer also must issue potential section 871(m) transactions to customers and receive dividends or dividend equivalent payments incident to hedges of potential section 871(m) transactions that it issues. The latter category of QDDs is intended to allow banks and bank affiliates that issue equity-linked instruments on an occasional basis to still act as QDDs.

4. *Notice 2010–46*

Shortly after section 871(m) was enacted, the Treasury Department and the IRS published Notice 2010–46, 2010–24 I.R.B. 757. Notice 2010–46 addresses potential overwithholding in the context of securities lending and sale repurchase agreements. Notice 2010–46 provides a two-part solution to the problem of overwithholding on a chain of dividends and dividend equivalents. First, it provides an exception from withholding for payments to a qualified securities lender (QSL). Second, it provides a proposed framework to credit forward prior withholding on a chain of substitute dividends paid pursuant to a chain of securities loans or stock repurchase agreements. The QSL regime requires a person that agrees to act as a QSL to comply with certain withholding and documentation requirements. Notice 2010–46 and any QI agreement imposing QSL requirements will remain effective until final regulations implementing the QDD rules are published.

As stated above, Notice 2010–46 provided a proposed framework to credit forward prior withholding on a chain of substitute dividends paid pursuant to a chain of securities loans or stock repurchase agreements. The Treasury Department and the IRS will continue to consider whether a credit forward system for prior withholding would be appropriate in the context of a chain of dividend equivalents on NPCs or ELIs. While administrating the credit forward system described in Notice 2010–46, however, the IRS has had difficulty verifying that prior withholding in a chain of securities loans had in fact occurred in order to justify the crediting of prior withholding to a subsequent payment. The temporary regulations, therefore, reserve on the issue of a general credit forward system, and the Treasury Department and the IRS request comments on the need for such a system and how it could be implemented.

5. *Implementation of the QDD Regime and Phase-out of the QSL Regime*

All existing QI agreements expire on December 31, 2016. Prior to January 1, 2017, the Treasury Department and the IRS intend to publish an updated QI agreement and rules addressing the requirements for QDD status. Procedures for entering into a QI agreement that permits a QI to act as a QDD are expected to be set out in this agreement. QDD status will be effective no sooner than January 1, 2017. Until these temporary regulations are finalized and appropriate provisions are incorporated into a new QI agreement, the provisions for QSLs and the credit-forward rules under Notice 2010–46 will continue to apply for dividend equivalents that are substitute dividend payments made pursuant to a securities lending or a sale-repurchase transaction.

Once fully implemented, the new QDD status under the QI regime will replace and expand the QSL regime described in Notice 2010–46. To continue to be eligible for the exception from withholding, entities that have been treated as QSLs will be required to enter into a QI agreement to satisfy and comply with the requirements for QDD treatment provided in the temporary regulations and in the updated QI Agreement. When these temporary regulations are finalized, the Treasury Department and the IRS expect the final regulations to supplant the proposed regulatory framework described in Notice 2010–46.

C. *Certain Insurance Contracts*

The 2013 proposed regulations do not specifically address whether payments made on life insurance or annuity contracts are dividend equivalents when the payments are directly or indirectly contingent upon or determined by reference to the payment of a dividend from sources within the United States. Comments noted that treating annuity contract payments as dividend equivalents could conflict with section 72, which provides that the holder of an annuity contract is taxed only when an amount is received from the annuity. Comments further noted that when a foreign person receives payments or withdrawals from an annuity contract issued by a domestic insurance company, the payment is FDAP subject to 30% withholding to the extent such payment or withdrawal constitutes gross income as determined in accordance with section 72. Similarly, withdrawals of income from a life insurance contract issued by a domestic insurance company are generally U.S. source FDAP subject to withholding. Commenters argued that the existing rules that apply to life insurance and annuity contracts obviate the need for withholding under section 871(m).

The Treasury Department and the IRS agree that the taxation of life insurance and annuity contracts issued by domestic insurance companies is adequately addressed under current law. Therefore, the temporary regulations provide that there is no dividend equivalent associated with a payment that a foreign person receives pursuant to the terms of an annuity, endowment, or life insurance contract issued by a domestic insurance company (including the foreign or U.S. possession branch of the domestic insurance company).

The Treasury Department and the IRS are considering how section 871(m) should apply to annuity, endowment, and life insurance contracts that reference U.S. equities and that are issued by foreign life insurance companies. Until further guidance is issued, the temporary regulations provide that these contracts do not include a dividend equivalent when issued by a foreign corporation that is predominately engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation. Similarly, the temporary regulations do not treat any portion of a payment received by a foreign life insurance company as a dividend equivalent when the payment is made according to the terms of an insurance contract, such as reinsurance, by a foreign corporation meeting the same requirements. The Treasury Department and the IRS are also evaluating how section 871(m) should apply to reinsurance contracts. Taxpayers are encouraged to send comments on how section 871(m) should apply to foreign life insurance companies and the contracts they issue.

IV. *Effective/Applicability Date*

The final and temporary regulations are generally effective on September 18, 2015. To ensure that brokers have adequate time to develop the systems needed to implement the regulations, however, the final and temporary regulations generally apply to transactions issued on or after January 1, 2017. In addition, with respect to transactions issued on or after January 1, 2016, and before January 1, 2017, that are section 871(m) transactions, the regulations also apply to any payment of a dividend equivalent made on or after January 1, 2018. The regulations do not change the applicability date of § 1.871–15(d)(1)(i) for specified NPCs described in that section.

The chapter 4 regulations provide a coordinating effective date for the treatment of dividend equivalents as withholdable payments for purposes of chapter 4 withholding. Section 1.1471–2(b)(2)(i)(A)(*2*) provides that grandfathered obligations under chapter 4 include any obligation that gives rise to a withholdable payment solely because the obligation gives rise to a dividend equivalent pursuant to section 871(m) and the regulations thereunder. This grandfather rule applies only to obligations that are executed on or before the date that is six months after the date on which obligations of its type are first treated as giving rise to dividend equivalents.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that few, if any, small entities will be affected by these regulations. The regulations will primarily affect multinational financial institutions, which tend to be larger businesses, and foreign entities. Therefore, a Regulatory Flexibility Analysis is not required. 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.

Drafting Information

The principal authors of these regulations are D. Peter Merkel and Karen Walny of the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS also participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements

Adoption of 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 * * *

§ 1.871–14(h) also issued under 26 U.S.C. 871(h) and 871(m). * * *

§§ 1.871–15 and 1.871–15T also issued under 26 U.S.C. 871(m). * * *

Par. 2. Section 1.871–14 is amended by:

1. Redesignating paragraphs (h) and (i) as paragraphs (i) and (j), respectively.

2. Adding new paragraphs (h) and (j)(4).

The additions read as follows:

§ 1.871–14 Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.

* * * * *

(h) *Portfolio interest not to include certain contingent interest*—(1) *Dividend equivalents*. Contingent interest does not qualify as portfolio interest to the extent that the interest is a dividend equivalent within the meaning of section 871(m).

(2) *Amount of dividend equivalent that is not portfolio interest*. The amount that does not qualify as portfolio interest because it is a dividend equivalent equals the amount of the dividend equivalent determined pursuant to § 1.871–15(j). Unless otherwise excluded pursuant to section 871(h), any other interest paid on an obligation that is not a dividend equivalent may qualify as portfolio interest.

* * * * *

(j) * * *

(4) *Effective/applicability date*. The rules of paragraph (h) of this section apply beginning September 18, 2015.

Par. 3. Section 1.871–15 is amended by:

1. Redesignating paragraphs (d)(1)(i) as (d)(1)(i)(A), (d)(1) introductory text as (d)(1)(i), (d)(1)(ii) as (d)(1)(i)(B), (d)(1)(iii) as (d)(1)(i)(C), and (d)(1)(iv) as (d)(1)(i)(D).

2. Removing "2016" from newly redesignated paragraph (d)(1)(i) and adding "2017" in its place.

3. Removing "Specified NPCs before January 1, 2016" from newly redesignated paragraph (d)(1)(i) and adding "*In general*" in its place.

4. Adding new paragraphs (d)(1) introductory text, (d)(1)(ii) and (d)(2).

5. Redesignating paragraph (o) as paragraph (r)(2) and:

a. Revising the heading for newly redesignated paragraph (r)(2),

b. Removing the language "This" in paragraph (r)(2) and adding "Paragraph (d)(1)(i) of this" in its place, and

c. Adding new paragraphs (r)(1), (r)(3), (r)(4) and (q).

7. Adding new paragraphs (a) through (c), and (e) through (p).

The additions and revisions read as follows:

§ 1.871–15 Treatment of dividend equivalents.

(a) *Definitions*. For purposes of this section, the following terms have the meanings described in this paragraph (a).

(1) *Broker*. A *broker* is a broker within the meaning provided in section 6045(c).

(2) *Dealer*. A *dealer* is a dealer in securities within the meaning of section 475(c)(1).

(3) *Dividend*. A *dividend* is a dividend as described in section 316.

(4) *Equity-linked instrument*. An *equity-linked instrument* (*ELI*) is a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC, that references the value of one or more underlying securities. For example, a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of one or more underlying securities is an ELI.

(5) *Initial hedge*. An *initial hedge* is the number of underlying security shares that a short party would need to fully hedge an NPC or ELI (whether the NPC or ELI is a complex contract or a simple contract benchmark (within the meaning of paragraph (h)(2) of this section), as appropriate) with respect to an underlying security at the time the NPC or ELI is issued, even if the short party does not in fact fully hedge the NPC or ELI.

(6) *Issue*. An NPC or ELI is treated as issued at inception, original issuance, or at the time of an issuance as a result of a

deemed exchange pursuant to section 1001.

(7) *Notional principal contract*. A *notional principal contract* (*NPC*) is a notional principal contract as defined in § 1.446–3(c).

(8) *Option*. An *option* includes an option embedded in any debt instrument, forward contract, NPC, or other potential section 871(m) transaction.

(9) *Parties to the transaction*—(i) *Long party*. A *long party* is the party to a potential section 871(m) transaction with respect to an underlying security that would be entitled to receive a payment of a dividend equivalent (within the meaning of paragraph (i) of this section) described in paragraph (c) of this section.

(ii) *Short party*. A *short party* is the party to a potential section 871(m) transaction with respect to an underlying security that would be obligated to make a payment of a dividend equivalent (within the meaning of paragraph (i) of this section) described in paragraph (c) of this section.

(iii) *Party to the transaction*. A *party to the transaction* is any person that is a long party or a short party to a potential section 871(m) transaction, any agent acting on behalf of the long party or short party, or any person acting as an intermediary with respect to the potential section 871(m) transaction.

(iv) *Party to the transaction that is both a long party and a short party*—(A) *In general*. If a potential section 871(m) transaction references more than one underlying security, the long party and short party are determined separately with respect to each underlying security. A party to a potential section 871(m) transaction is both a long party and a short party when the party is entitled to a payment that references a dividend payment on an underlying security and the same party is obligated to make a payment that references a dividend payment on another underlying security pursuant to the potential section 871(m) transaction.

(B) *Example*. The following example illustrates the definitions in paragraph (a)(9) of this section:

Example. (i) Stock X and Stock Y are underlying securities. A and B enter into an NPC that entitles A to receive payments from B based on any appreciation in the value of Stock X and dividends paid on Stock X during the term of the contract and obligates A to make payments to B based on any depreciation in the value of Stock X during the term of the contract. In return, the NPC entitles B to receive payments from A based on any appreciation in the value of Stock Y and dividends paid on Stock Y during the term of the contract and obligates B to make payments to A based on any depreciation in the value of Stock Y during the term of the contract.

(ii) A is the long party with respect to Stock X, and the short party with respect to Stock Y. B is the long party with respect to Stock Y, and the short party with respect to Stock X.

(10) *Payment*. A *payment* has the meaning provided in paragraph (i) of this section.

(11) *Reference*. To *reference* means to be contingent upon or determined by reference to, directly or indirectly, whether in whole or in part.

(12) *Section 871(m) transaction and potential section 871(m) transaction*. A *section 871(m) transaction* is any securities lending or sale-repurchase transaction, specified NPC, or specified ELI. A *potential section 871(m) transaction* is any securities lending or sale-repurchase transaction, NPC, or ELI that references one or more underlying securities.

(13) *Securities lending or sale-repurchase transaction*. A *securities lending or sale-repurchase transaction* is any securities lending transaction, sale-repurchase transaction, or substantially similar transaction that references an underlying security. *Securities lending transaction* and *sale-repurchase transaction* have the same meaning as provided in § 1.861–3(a)(6).

(14) *Simple contracts and complex contracts*—(i) *Simple contract*. A *simple contract* is an NPC or ELI for which, with respect to each underlying security,

(A) All amounts to be paid or received on maturity, exercise, or any other payment determination date are calculated by reference to a single, fixed number of shares (as determined in paragraph (j)(3) of this section) of the underlying security, provided that the number of shares can be ascertained when the contract is issued, and

(B) The contract has a single maturity or exercise date with respect to which all amounts (other than any upfront payment or any periodic payments) are required to be calculated with respect to the underlying security. A contract has a single exercise date even though it may be exercised by the holder at any time on or before the stated expiration of the contract. An NPC or ELI that includes a term that discontinuously increases or decreases the amount paid or received (such as a digital option), or that accelerates or extends the maturity is not a simple contract. A simple contract that is an NPC is a *simple NPC*. A simple contract that is an ELI is a *simple ELI*.

(ii) *Complex contract*—(A) *In general*. A *complex contract* is any NPC or ELI that is not a simple contract. A complex contract that is an NPC is a *complex NPC*. A complex contract that is an ELI is a *complex ELI*.

(B) *Example*. An ELI entitles the long party to a return equal to 200 percent of the appreciation on 100 shares of Stock X, and obligates the long party to pay an amount equal to the actual depreciation on 100 shares of Stock X. Because the ELI does not provide the long party with an amount that is calculated by reference to a single, fixed number of shares of Stock X on the maturity date that can be ascertained at issuance, it is not a simple ELI. More specifically, upon maturity the ELI will either entitle the long party to receive a payment that is, in substance, measured by reference to 200 shares of stock or obligate the long party to make a payment measured by reference to 100 shares of stock. The ELI is a complex ELI because it is not a simple ELI.

(15) *Underlying security*. An *underlying security* is any interest in an entity if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to § 1.861–3, where applicable taking into account paragraph (m) of this section. Except as provided in paragraph (l) of this section, if a potential section 871(m) transaction references an interest in more than one entity described in the preceding sentence or different interests in the same entity, each referenced interest is a separate underlying security for purposes of applying the rules of this section.

(b) *Source of a dividend equivalent*. A dividend equivalent is treated as a dividend from sources within the United States for purposes of sections 871(a), 881, 892, 894, and 4948(a), and chapters 3 and 4 of subtitle A of the Internal Revenue Code.

(c) *Dividend equivalent*—(1) *In general*. Except as provided in paragraph (2), *dividend equivalent* means—

(i) Any payment that references the payment of a dividend from an underlying security pursuant to a securities lending or sale-repurchase transaction;

(ii) Any payment that references the payment of a dividend from an underlying security pursuant to a specified NPC described in paragraph (d) of this section;

(iii) Any payment that references the payment of a dividend from an underlying security pursuant to a specified ELI described in paragraph (e) of this section; and

(iv) Any other substantially similar payment as described in paragraph (f) of this section.

(2) *Exceptions*—(i) *Not a dividend*. A payment that references a distribution with respect to an underlying security is not a dividend equivalent to the extent that the distribution would not be subject to tax pursuant to section 871 or section 881 if the long party owned the underlying security. For example, if an NPC references stock in a regulated investment company that pays a dividend that includes a capital gains dividend described in section 852(b)(3)(C) that would not be subject to tax under section 871 or section 881 if paid directly to the long party, then an NPC payment is not a dividend equivalent to the extent that it is determined by reference to the capital gains dividend.

(ii) *Section 305 coordination*. A dividend equivalent with respect to a section 871(m) transaction is reduced by any amount treated in accordance with section 305(b) and (c) as a dividend with respect to the underlying security referenced by the section 871(m) transaction.

(iii) *Due bills*. A dividend equivalent does not include a payment made pursuant to a due bill arising from the actions of a securities exchange that apply to all transactions in the stock with respect to the dividend. For purposes of this section, a stock will be considered to trade with a due bill only when the relevant securities exchange has set an ex-dividend date with respect to a dividend that occurs after the record date.

(iv) *Certain payments pursuant to annuity, endowment, and life insurance contracts*. [Reserved]. For further guidance, see § 1.871–15T(c)(2)(iv).

(v) *Certain payments pursuant to employee compensation arrangements*. A dividend equivalent does not include the portion of equity-based compensation for personal services of a nonresident alien individual that is—

(A) Wages subject to withholding under section 3402 and the regulations under that section;

(B) Excluded from the definition of wages under § 31.3401(a)(6)–1; or

(C) Exempt from withholding under § 1.1441–4(b).

(d) *Specified NPCs*—(1) *Specified NPCs entered into before January 1, 2017*—(i) * * *

(ii) *Specified NPC status as of January 1, 2017*. An NPC that is treated as a specified NPC pursuant to paragraph (d)(1)(i) of this section will remain a specified NPC on or after January 1, 2017.

(2) *Specified NPCs on or after January 1, 2017*—(i) *Simple NPCs*. A simple NPC that has a delta of 0.8 or greater with respect to an underlying security when the NPC is issued is a specified NPC.

(ii) *Complex NPCs*. A complex NPC that meets the substantial equivalence test described in paragraph (h) of this section with respect to an underlying security when the NPC is issued is a specified NPC.

(e) *Specified ELIs*—(1) *Simple ELIs*. A simple ELI that has a delta of 0.8 or greater with respect to an underlying security when the ELI is issued is a specified ELI.

(2) *Complex ELIs*. A complex ELI that meets the substantial equivalence test described in paragraph (h) of this section with respect to an underlying security when the ELI is issued is a specified ELI.

(f) *Other substantially similar payments*. For purposes of this section, any payment made in satisfaction of a tax liability of the long party with respect to a dividend equivalent by a withholding agent is a dividend equivalent received by the long party. The amount of that dividend equivalent constitutes additional income to the payee to the extent provided in § 1.1441–3(f)(1).

(g) *Delta*—(1) *In general*. Delta is the ratio of the change in the fair market value of an NPC or ELI to a small change in the fair market value of the number of shares of the underlying security (as determined under paragraph (j)(3) of this section) referenced by the NPC or ELI. If an NPC or ELI contains more than one reference to a single underlying security, all references to that underlying security are taken into account in determining the delta with respect to that underlying security. If an NPC or ELI references more than one underlying security or other property, the delta with respect to each underlying security must be determined without taking into account any other underlying security or property. The delta of an equity derivative that is embedded in a debt instrument or other derivative is determined without taking into account changes in the market value of the debt instrument or other derivative that are not directly related to the equity element of the instrument. Thus, for example, the delta of an option embedded in a convertible note is determined without regard to the debt component of the convertible note. For purposes of this section, delta must be determined in a commercially reasonable manner. If a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is the delta used for purposes of this section.

(2) *Time for determining delta*. For purposes of applying the rules of this section, the delta of a potential section 871(m) transaction is determined only when the potential section 871(m) transaction is issued (as defined in paragraph (a)(6) of this section).

(3) *Simplified delta calculation for certain simple contracts that reference multiple underlying securities*. If an NPC or ELI references 10 or more underlying securities and the short party uses an exchange-traded security (for example, an exchange-traded fund) that references substantially all of the underlying securities (the hedge security) to hedge the NPC or ELI at the time it is issued, the delta of the NPC or ELI may be calculated by determining the ratio of the change in the fair market value of the simple contract to a small change in the fair market value of the hedge security. A delta determined under this paragraph (g)(3) must be used as the delta for each underlying security for purposes of calculating the amount of a dividend equivalent as provided in paragraph (j)(1)(ii) of this section.

(4) *Examples*. The following examples illustrate the rules of this paragraph (g). For purposes of these examples, Stock X and Stock Y are common stock of domestic corporations X and Y. LP is the long party to the transaction.

Example 1. Delta calculation for an NPC. The terms of an NPC require LP to pay the short party an amount equal to all of the depreciation in the value of 100 shares of Stock X and an interest-rate based return. In return, the NPC requires the short party to pay LP an amount equal to all of the appreciation in the value of 100 shares of Stock X and any dividends paid by X on those shares. The value of the NPC will change by $1 for each $0.01 change in the price of a share of Stock X. When LP entered into the NPC, Stock X had a fair market value of $50 per share. The NPC therefore has a delta of 1.0 ($1.00 / ($0.01 x 100)).

Example 2. Delta calculation for an option. LP purchases a call option that references 100 shares of Stock Y. At the time LP purchases the call option, the value of the option is expected to change by $0.30 for a $0.01 change in the price of a share of Stock Y. When LP purchases the option, Stock Y has a fair market value of $100 per share. The call option has a delta of 0.3 ($0.30 / ($0.01 x 100)).

(h) *Substantial Equivalence*. [Reserved]. For further guidance, see § 1.871–15T(h).

(i) *Payment of a dividend equivalent*—(1) *Payments determined on gross basis*. For purposes of this section, a payment includes any gross amount that references the payment of a dividend and that is used in computing any net amount transferred to or from the long party even if the long party makes a net payment to the short party or no amount is paid because the net amount is zero.

(2) *Actual and estimated dividends*—(i) *In general*. A payment includes any amount that references an actual or estimated payment of dividends, whether the reference is explicit or implicit. If a potential section 871(m) transaction provides for a payment based on an estimated dividend that adjusts to account for the amount of an actual dividend paid, the payment is treated as referencing the actual dividend amount and not an estimated dividend amount.

(ii) *Implicit dividends*. A payment includes an actual or estimated dividend payment that is implicitly taken into account in computing one or more of the terms of a potential section 871(m) transaction, including interest rate, notional amount, purchase price, premium, upfront payment, strike price, or any other amount paid or received pursuant to the potential section 871(m) transaction.

(iii) *Actual dividend presumption*. A short party to a section 871(m) transaction is treated as paying a per-share dividend amount equal to the actual dividend amount unless the short party to the section 871(m) transaction identifies a reasonable estimated dividend amount in writing at the time the transaction is issued. For this purpose, a reasonable estimated dividend amount stated in an offering document or the documents governing the terms at the time the transaction is issued will establish the estimated dividend amount. To qualify as an estimated dividend amount, the written estimated dividend amount must separately state the amount estimated for each anticipated dividend or state a formula that allows each dividend to be determined. If an underlying security is not expected to pay a dividend, a reasonable estimate of the dividend amount may be zero.

(iv) *Additions to estimated payments*. If a section 871(m) transaction provides for any payment in addition to an estimated dividend and that additional payment is determined by reference to a dividend (for example, a special dividend), both the estimated dividend and the additional payment are used to determine the per-share dividend amount.

(3) *Dividends for certain baskets*—(i) *In general*. If a section 871(m) transaction references long positions in more than 25 underlying securities, the short party may treat the dividends with respect to the referenced underlying securities as paid at the end of the applicable calendar quarter to compute the per-share dividend amount.

(ii) *Publicly available dividend yield*. For purposes of paragraph (i)(3)(i) of this section, if a section 871(m) transaction references the same underlying securities as a security (for example, stock in an exchange-traded fund) or index for which there is a publicly available quarterly dividend yield, the publicly available dividend yield may be used to determine the per-share dividend amount for the section 871(m) transaction with any adjustment for special dividends.

(iii) *Dividend yield for a section 871(m) transaction using the simplified delta calculation*. When the delta of a section 871(m) transaction is determined under paragraph (g)(3) of this section, the per-share dividend amount for that section 871(m) transaction must be determined using the dividend yield for the exchange-traded security that fully hedges the section 871(m) transaction.

(4) *Examples*. The following examples illustrate the rules of this paragraph (i). For purposes of these examples, Stock X is common stock of Corporation X, a domestic corporation, that historically pays quarterly dividends on Stock X. The parties anticipate that Corporation X will continue to pay quarterly dividends.

Example 1. Forward contract to purchase domestic stock. (i) When Stock X is trading at $50 per share, Foreign Investor enters into a forward contract to purchase 100 shares of Stock X in one year. Reasonable estimates of the quarterly dividend are specified in the transaction documents. The price in the forward contract is determined by multiplying the number of shares referenced in the contract by the current price of the shares and an interest rate, and subtracting the value of any dividends expected to be paid during the term of the contract. Assuming that the forward contract is priced using an interest rate of 4 percent and total estimated dividends with a future value of $1 per share during the term of the forward contract, the purchase price set in the forward contract is $5,100 (100 shares x $50 per share x 1.04 – ($1 x 100)).

(ii) Subject to paragraph (i)(2)(iv) of this section, the estimate dividend amounts are the per share dividend amounts because the estimate is reasonable and specified in accordance with paragraph (i)(2)(iii) of this section. The estimate dividend amounts are dividend equivalents for purposes of this section

Example 2. Price return only swap contract. (i) Foreign Investor enters into a price return swap contract that entitles Foreign Investor to receive payments based on the appreciation in the value of 100 shares of Stock X and requires Foreign Investor to pay an amount based on LIBOR plus any depreciation in the value of Stock X. The swap contract neither explicitly entitles Foreign Investor to payments based on dividends paid on Stock X during the term of the contract nor references an estimated dividend amount. The LIBOR rate in the swap contract, however, is reduced to reflect expected annual dividends on Stock X.

(ii) Because the LIBOR leg of the swap contract is reduced to reflect estimated dividends and the estimated dividend amounts are not specified, Foreign Investor is treated as receiving the actual dividend amounts in accordance with paragraph (i)(2) of this section. The actual per-share dividend amounts are dividend equivalents for purposes of this section.

(j) *Amount of dividend equivalent*—(1) *Calculation of the amount of a dividend equivalent*—(i) *Securities lending or sale-repurchase transactions*. For a securities lending or sale-repurchase transaction, the amount of the dividend equivalent for each underlying security equals the amount of the actual per-share dividend paid on the underlying security multiplied by the number of shares of the underlying security.

(ii) *Simple contracts*. For a simple contract that is a section 871(m) transaction, the amount of the dividend equivalent for each underlying security equals:

(A) The per-share dividend amount (as determined under either paragraph (i)(2) or (i)(3) of this section) with respect to the underlying security multiplied by;

(B) The number of shares of the underlying security multiplied by;

(C) The delta of the section 871(m) transaction with respect to the underlying security.

(iii) *Complex contracts*. For a complex contract that is a section 871(m) transaction, the amount of the dividend equivalent for each underlying security equals:

(A) The per-share dividend amount (as determined under paragraph (i)(2) or (i)(3) of this section) with respect to the underlying security multiplied by;

(B) The initial hedge for the underlying security.

(iv) *Other substantially similar payments*. In addition to any amount determined pursuant to paragraph (j)(1)(i), (ii), or (iii), the amount of a dividend equivalent includes the amount of any payment described in paragraph (f) of this section.

(2) *Time for determining the amount of a dividend equivalent*. The amount of a dividend equivalent is determined on the earlier of the date that is the record date of the dividend and the day prior to the ex-dividend date with respect to the dividend. For example, if a specified NPC provides for a payment at settlement that takes into account an earlier dividend payment, the amount of the dividend equivalent is determined on the earlier of the record date or the day prior to the ex-dividend date for that dividend.

(3) *Number of shares*. The number of shares of an underlying security generally is the number of shares of the underlying security stated in the contract. If the transaction modifies that number by a factor or fraction or otherwise alters the amount of any payment, the number of shares is adjusted to take into account the factor, fraction, or other modification. For example, in a transaction in which the long party receives or makes payments based on 200 percent of the appreciation or depreciation (as applicable) of 100 shares of stock, the number of shares of the underlying security is 200 shares of the stock.

(k) *Limitation on the treatment of certain corporate acquisitions as section 871(m) transactions*. A potential section 871(m) transaction is not a section 871(m) transaction with respect to an underlying security if the transaction obligates the long party to acquire ownership of the underlying security as part of a plan pursuant to which one or more persons (including the long party) are obligated to acquire underlying securities representing more than 50 percent of the value of the entity issuing the underlying securities.

(l) *Rules relating to indices*—(1) *Purpose*. The purpose of this section is to provide a safe harbor for potential section 871(m) transactions that reference certain passive indices that are based on a diverse basket of publicly-traded securities and that are widely used by numerous market participants. Notwithstanding any other provision in this paragraph (l), an index is not a qualified index if treating the index as a qualified index would be contrary to the purpose described in this paragraph.

(2) *Qualified index not treated as an underlying security*. For purposes of this section, a qualified index is treated as a single security that is not an underlying security. The determination of whether an index referenced in a potential section 871(m) transaction is a qualified index is made at the time the transaction is issued based on whether the index is a qualified index on the first business day of the calendar year in which the transaction is issued.

(3) *Qualified index*. A *qualified index* means an index that—

(i) References 25 or more component securities (whether or not the security is an underlying security);

(ii) Except as provided in paragraph (l)(6)(ii) of this section, references only long positions in component securities;

(iii) References no component underlying security that represents more than 15 percent of the weighting of the component securities in the index;

(iv) References no five or fewer component underlying securities that together represent more than 40 percent of the weighting of the component securities in the index;

(v) Is modified or rebalanced only according to publicly stated, predefined criteria, which may require interpretation by the index provider or a board or committee responsible for maintaining the index;

(vi) Did not provide an annual dividend yield in the immediately preceding calendar year from component underlying securities that is greater than 1.5 times the annual dividend yield of the S&P 500 Index as reported for the immediately preceding calendar year; and

(vii) Is traded through futures contracts or option contracts (regardless of whether the contracts provide price only or total return exposure to the index or provide for dividend reinvestment in the index) on—

(A) A national securities exchange that is registered with the Securities and Exchange Commission or a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission; or

(B) A foreign exchange or board of trade that is a qualified board or exchange as determined by the Secretary pursuant to section 1256(g)(7)(C) or that has a staff no action letter from the CFTC permitting direct access from the United States that is effective on the applicable testing date, provided that the referenced component underlying securities, in the aggregate, comprise less than 50 percent of the weighting of the component securities in the index.

(4) *Safe harbor for certain indices that reference assets other than underlying securities*. Notwithstanding paragraph (l)(3) of this section, an index is a qualified index if the referenced component underlying securities in the aggregate comprise 10 percent or less of the weighting of the component securities in the index.

(5) *Weighting of component securities*. For purposes of this paragraph (l), the weighting of a component security of an index is the percentage of the index's value represented, or accounted for, by the component security.

(6) *Transactions that reference a qualified index and one or more component securities or indices*—(i) *In general*. When a potential section 871(m) transaction references a qualified index and one or more component securities or other indices, the qualified index remains a qualified index only if the potential section 871(m) transaction does not reference a short position in any referenced component security of the qualified index, other than a short position with respect to the entire qualified index (for example, a cap

or floor) or a de minimis short position described in paragraph (l)(6)(ii) of this section. If, in connection with a potential section 871(m) transaction that references a qualified index, a taxpayer (or a related person within the meaning of section 267(b) or section 707(b)) enters into one or more transactions that reduce exposure to any referenced component security of the index, other than transactions that reduce exposure to the entire index, then the potential section 871(m) transaction is not treated as referencing a qualified index.

(ii) *Safe harbor for de minimis short positions*. Notwithstanding paragraphs (l)(3)(ii) and (l)(6)(i) of this section, an index may be a qualified index if the short position (whether part of the index or entered into separately by the taxpayer or related person within the meaning of section 267(b) or section 707(b)) reduces exposure to referenced component securities of a qualified index (excluding any short positions with respect to the entire qualified index) by five percent or less of the value of the long positions in component securities in the qualified index.

(7) *Transactions that indirectly reference a qualified index*. If a potential section 871(m) transaction references a security (for example, stock in an exchange-traded fund) that tracks a qualified index, the potential section 871(m) transaction will be treated as referencing a qualified index.

(m) *Rules relating to derivatives that reference partnerships*—(1) *In general*. When a potential section 871(m) transaction references a partnership interest, the assets of the partnership will be treated as referenced by the potential section 871(m) transaction only if the partnership carries on a trade or business of dealing or trading in securities, holds significant investments in securities (either of which is a covered partnership), or directly or indirectly holds an interest in a lower-tier partnership that is a covered partnership. For purposes of this section, if a covered partnership directly or indirectly holds assets that are underlying securities or potential section 871(m) transactions, any potential section 871(m) transaction that references an interest in the covered partnership is treated as referencing the shares of the underlying securities, including underlying securities of potential section 871(m) transactions, directly or indirectly allocable to that partnership interest. For purposes of this paragraph (m), a security is defined in section 475(c).

(2) *Significant investments in securities*—(i) *In general*. For purposes of this paragraph (m), a partnership holds significant investments in securities if either—

(A) 25 percent or more of the value of the partnership's assets consist of underlying securities or potential section 871(m) transactions; or

(B) The value of the underlying securities or potential section 871(m) transactions equals or exceeds $25 million.

(ii) *Determining the value of the partnership's assets*. For purposes of this paragraph (m)(2), the value of a partnership's assets is determined at the time the potential 871(m) transaction referencing that partnership interest is issued based on the value of the assets held by the partnership on the last day of the partnership's prior taxable year unless the long party or the short party has actual knowledge that a subsequent transaction has caused the partnership to cross either of the thresholds described in paragraph (m)(2)(i). The value of a partnership's assets is equal to their fair market value, except that the value of any NPC, futures contract, forward contract, option, and any similar financial instrument held by the partnership is deemed to be the value of the notional securities referenced by the transaction.

(n) *Combined transactions*—(1) *In general*. For purposes of determining whether a potential section 871(m) transaction is a section 871(m) transaction, two or more potential section 871(m) transactions are treated as a single transaction with respect to an underlying security when—

(i) A person (or a related person within the meaning of section 267(b) or section 707(b)) is the long party with respect to the underlying security for each potential section 871(m) transaction;

(ii) The potential section 871(m) transactions reference the same underlying security;

(iii) The potential section 871(m) transactions, when combined, replicate the economics of a transaction that would be a section 871(m) transaction if the transactions had been entered into as a single transaction; and

(iv) The potential section 871(m) transactions are entered into in connection with each other (regardless of whether the transactions are entered into simultaneously or with the same counterparty).

(2) *Section 871(m) transactions*. If a potential section 871(m) transaction is a section 871(m) transaction, either by itself or as a result of a combination with one or more other potential section 871(m) transactions, it does not cease to be a section 871(m) transaction as a result of applying paragraph (n) of this section or disposing of one or more of the potential section 871(m) transaction with which it is combined.

(3) *Short party presumptions regarding combined transactions*—(i) *Transactions in separate accounts*. A short party that is a broker may presume that transactions are not entered into in connection with each other for purposes of paragraph (n)(1) of this section if a long party holds or reflects the transactions in separate accounts maintained by the short party, unless the short party has actual knowledge that the transactions held or reflected in separate accounts by the long party were entered into in connection with each other or that separate accounts were created or used to avoid section 871(m).

(ii) *Transactions separated by at least two business days*. A short party that is a broker may presume that transactions entered into two or more business days apart are not entered into in connection with each other for purposes of paragraph (n)(1) of this section unless the short party has actual knowledge that the transactions were entered into in connection with each other.

(4) *Presumptions Commissioner will apply to long party*—(i) *Transactions in separate trading books*. The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other for purposes of paragraph (n)(1) of this section if the long party properly reflected those transactions on separate trading books. The Commissioner may rebut this presumption with facts and circumstances showing that transactions reflected on separate trading books were entered into in connection with each other or that separate trading books were created or used to avoid section 871(m).

(ii) *Transactions separated by at least two days*. The Commissioner will presume that a long party did not enter into two or more transactions in connection with each other for purposes of paragraph (n)(1) of this section if the long party entered into the transactions two or more business days apart. The Commissioner may rebut this presumption with facts and circumstances showing that the transactions entered into two or more business days apart were entered into in connection with each other.

(iii) *Transactions separated by less than two days and reflected in the same trading book*. The Commissioner will presume that transactions that are entered into less than two business days apart and reflected on the same trading book are entered into in connection with each other. A long party can rebut this presumption with facts and circumstances showing that the transactions were not entered into in connection with each other.

(5) *Rules of application*—(i) *Two business days rule*. For the purpose of determining the number of business days between transactions, the short party may, and the Commissioner will, assume that all transactions are entered into at 4:00 pm on the date the transaction becomes effective in the jurisdiction of the long party.

(ii) *No long party presumptions*. Notwithstanding the presumptions described in paragraphs (n)(3) and (n)(4) of this section, the long party must treat two or more transactions as combined transactions if the transactions are described in paragraph (n)(1) of section.

(6) *Ordering rule for transactions entered into in connection with each other*. If a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), a short party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security. Thus, for example, if a taxpayer has sold one at-the-money put and purchased two at-the-money calls, each with respect to 100 shares of the same underlying security, the put and one call are combined. Similarly, a purchased call on 100 shares and a sold put on 200 shares of the same underlying security can be combined for 100 shares with 100 shares of the put remaining separate. The two calls are not combined because they do not provide the long party with economic exposure to depreciation in the underlying security. Similarly, if a long party enters into more than two potential section 871(m) transactions that could be combined under this paragraph (n), but have not been combined by a short party, the long party is required to apply paragraph (n)(1) of this section by combining transactions in a manner that results in the most transactions with a delta of 0.8 or higher with respect to the referenced underlying security.

(7) *More than one underlying security referenced*. If potential section 871(m) transactions reference more than one underlying security, paragraph (n)(1) of this section applies separately with respect to each underlying security.

(o) *Anti-abuse rule*. If a taxpayer (directly or through the use of a related person within the meaning of section 267(b) or section 707(b)) acquires (whether by entering into, purchasing, accepting by transfer, by exchange, or by conversion, or otherwise acquiring) or disposes of (whether by sale, offset, exercise, termination, expiration, maturity, or other means) a transaction or transactions with a principal purpose of avoiding the application of this section, the Commissioner may treat any payment (as described in paragraph (i) of this section) made with respect to that transaction or transactions as a dividend equivalent to the extent necessary to prevent the avoidance of this section. Therefore, notwithstanding any other provision of this section, the Commissioner may, for example, adjust the delta of a transaction, change the number of shares, adjust an estimated dividend amount, change the maturity, adjust the timing of payments, treat a transaction that references a partnership interest as referencing the assets of the partnership, combine, separate, or disregard transactions, indices, or components of indices to reflect the substance of the transaction or transactions, or otherwise depart from the rules of this section as necessary to determine whether the transaction includes a dividend equivalent or the amount or timing of a dividend equivalent. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). When a withholding agent knows that the taxpayer acquired or disposed of a transaction or transactions with a principal purpose of avoiding the application of this section and the Commissioner treats a payment made with respect to any transaction as a dividend equivalent, the withholding agent may be liable for any tax pursuant to section 1461.

(p) *Information required to be reported regarding a potential section 871(m) transaction*—(1) *In general*. If a broker or dealer is a party to a potential section 871(m) transaction with a counterparty or customer that is not a broker or dealer, the broker or dealer is required to determine whether the potential section 871(m) transaction is a section 871(m) transaction. If both parties to a potential section 871(m) transaction are brokers or dealers, or neither party to a potential section 871(m) transaction is a broker or dealer, the short party must determine whether the potential section 871(m) transaction is a section 871(m) transaction. The party to the transaction that is required to determine whether a transaction is a section 871(m) transaction must also determine and report to the counterparty or customer the timing and amount of any dividend equivalent (as described in paragraphs (i) and (j) of this section). Except as otherwise provided in paragraph (n)(3) of this section, the party required to make the determinations described in this paragraph is required to exercise reasonable diligence to determine whether a transaction is a section 871(m) transaction, the amount of any dividend equivalents, and any other information necessary to apply the rules of this section. The information must be provided in the manner prescribed in paragraphs (p)(2) and (p)(3) of this section. The determinations required by paragraph (p) of this section are binding on the parties to the potential section 871(m) transaction and on any person who is a withholding agent with respect to the potential section 871(m) transaction unless the person knows or has reason to know that the information received is incorrect. The determinations are not binding on the Commissioner.

(2) *Reporting requirements*. For rules regarding the reporting requirements of

withholding agents with respect to dividend equivalents described in this section, see §§ 1.1461–1(b) and (c) and 1.1474–1(c) and (d).

(3) *Additional information available to a party to a potential section 871(m) transaction*—(i) *In general*. Upon request by any person described in paragraph (p)(3)(ii) of this section, the party required to report information pursuant to paragraph (p)(1) of this section must provide the requester with information regarding the amount of each dividend equivalent, the delta of the potential section 871(m) transaction, the amount of any tax withheld and deposited, the estimated dividend amount if specified in accordance with paragraph (i)(2)(iii) of this section, the identity of any transactions combined pursuant to paragraph (n) of this section, and any other information necessary to apply the rules of this section. The information requested must be provided within a reasonable time, not to exceed 10 business days, and communicated in one or more of the following ways:

(A) By telephone, and confirmed in writing;

(B) By written statement sent by first class mail to the address provided by the requesting party;

(C) By electronic publication available to all persons entitled to request information; or

(D) By any other method agreed to by the parties, and confirmed in writing.

(ii) *Persons entitled to request information*. Any party to the transaction described in paragraph (a)(9) of this section may request the information specified in paragraph (p) of this section with respect to a potential section 871(m) transaction from the party required by paragraph (p)(3)(i) of this section to provide the information.

(iii) *Reliance on information received*. A person described in paragraph (p)(1) or (p)(3)(ii) of this section that receives information described in paragraph (p)(1) or (p)(3)(i) of this section may rely on that information to provide information to any other person unless the recipient knows or has reason to know that the information received is incorrect. When the recipient knows or has reason to know that the information received is incorrect, the recipient must make a reasonable effort to determine and provide the information described in paragraph (p)(1) or (p)(3)(i) of this section to any person described in paragraph (p)(1) or (p)(3)(ii) of this section that requests information from the recipient.

(4) *Recordkeeping rules*—(i) *In general*. For rules regarding recordkeeping requirements sufficient to establish whether a transaction is a section 871(m) transaction and whether a payment is a dividend equivalent and the amount of gross income treated as a dividend equivalent, see § 1.6001–1.

(ii) *Records sufficient to establish whether a transaction is a section 871(m) transaction and any dividend equivalent amount*. Any person required to retain records must keep sufficient information to establish whether a transaction is a section 871(m) transaction and the amount of a dividend equivalent (if any), including documentation and work papers supporting the delta calculation or the substantial equivalence test (including the number of shares of the initial hedge), as applicable, and written estimated dividends (if any). The records and documentation must be created substantially contemporaneously. A record will be considered to have been created substantially contemporaneously if it was created within 10 business days of the date the potential section 871(m) transaction is issued.

(q) *Dividend and dividend equivalent payments to a qualified derivatives dealer*. [Reserved]. For further guidance, see § 1.871–15T(q).

(r) *Effective/applicability date*—(1) *In general*. This section applies to payments made on or after September 18, 1015 except as provided in paragraphs (r)(2), (3), and (4) of this section.

(2) *Effective/applicability date for paragraph (d)(1)(i)*. * * *

(3) *Effective/applicability date for paragraphs (d)(2) and (e)*. Paragraphs (d)(2) and (e) apply to any payment made on or after January 1, 2017, with respect to any transaction issued on or after January 1, 2017, and to any payment made on or after January 1, 2018, with respect to any transaction issued on or after January 1, 2016, and before January 1, 2017.

(4) *Effective/applicability date for paragraphs (c)(2)(iv), (h), and (q)*. [Reserved]. For further guidance, see § 1.871–15T(r)(4).

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

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

(a) through (b) [Reserved]. For further guidance, see § 1.871–15(a) through (b).

(c) [Reserved]. For further guidance, see § 1.871–15(c)(1) through (c)(2)(iii).

(iv) *Payments made pursuant to annuity, endowment, and life insurance contracts*—(A) *Insurance contracts issued by domestic insurance companies*. A payment made pursuant to a contract that is an annuity, endowment, or life insurance contract issued by a domestic corporation (including its foreign or U.S. possession branch) that is a life insurance company described in section 816(a) does not include a dividend equivalent if the payment is subject to tax under section 871(a) or section 881.

(B) *Insurance contracts issued by foreign insurance companies*. A payment does not include a dividend equivalent if it is made pursuant to a contract that is an annuity, endowment, or life insurance contract issued by a foreign corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.

(C) *Insurance contracts held by foreign insurance companies*. A payment made pursuant to a policy of insurance (including a policy of reinsurance) does not include a dividend equivalent if it is made to a foreign corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.

(v) [Reserved]. For further guidance, see § 1.871–15(c)(2)(v).

(d) through (g) [Reserved]. For further guidance, see § 1.871–15(d) through (g).

(h) *Substantial equivalence test*—(1) *In general*. The substantial equivalence test described in this paragraph (h) applies to determine whether a complex contract is a section 871(m) transaction. The substantial equivalence test assesses whether a complex contract substantially replicates the economic performance of the underlying security by comparing, at various testing prices for the underlying security, the differences between the expected changes in value of that complex contract and its initial hedge with the differences between the expected changes in value of a simple contract benchmark (as described in paragraph (h)(2) of this section) and its initial hedge. If the complex contract contains more than one reference to a single underlying security, all references to that underlying security are taken into account for purposes of applying the substantial equivalence test with respect to that underlying security. With respect to an equity derivative that is embedded in a debt instrument or other derivative, the substantial equivalence test is applied to the complex contract without taking into account changes in the market value of the debt instrument or other derivative that are not directly related to the equity element of the instrument. The complex contract is a section 871(m) transaction with respect to an underlying security if, for that underlying security, the expected change in value of the complex contract and its initial hedge is equal to or less than the expected change in value of the simple contract benchmark and its initial hedge when the substantial equivalence test described in this paragraph (h) is calculated at the time the complex contract is issued. To the extent that the steps of the substantial equivalence test set out in this paragraph (h) cannot be applied to a particular complex contract, a taxpayer must use the principles of the substantial equivalence test to reasonably determine whether the complex contract is a section 871(m) transaction with respect to each underlying security. For purposes of this section, the test must be applied and the inputs must be determined in a commercially reasonable manner. If a taxpayer calculates any relevant input for non-tax business purposes, that input ordinarily is the input used for purposes of this section.

(2) *Simple contract benchmark*. The simple contract benchmark is a closely comparable simple contract that, at the time the complex contract is issued, has a delta of 0.8, references the applicable underlying security referenced by the complex contract, and has the same maturity as the complex contract with respect to the applicable underlying security. Depending on the complex contract, the simple contract benchmark might be, for example, a call option, a put option, or a collar.

(3) *Substantial equivalence*. A complex contract is a section 871(m) transaction with respect to an underlying security if the complex contract calculation described in paragraph (h)(4) of this section results in an amount that is equal to or less than the amount of the benchmark calculation described in paragraph (h)(5) of this section.

(4) *Complex contract calculation*—(i) *In general*. The complex contract calculation for each underlying security referenced by a potential section 871(m) transaction that is a complex contract is computed by:

(A) Determining the change in value (as described in paragraph (h)(4)(ii) of this section) of the complex contract with respect to the underlying security at each testing price (as described in paragraph (h)(4)(iii) of this section);

(B) Determining the change in value of the initial hedge for the complex contract at each testing price;

(C) Determining the absolute value of the difference between the change in value of the complex contract determined in paragraph (h)(4)(i)(A) of this section and the change in value of the initial hedge determined in paragraph (h)(4)(i)(B) of this section at each testing price;

(D) Determining the probability (as described in paragraph (h)(4)(iv) of this section) associated with each testing price;

(E) Multiplying the absolute value for each testing price determined in paragraph (h)(4)(i)(C) of this section by the corresponding probability for that testing price determined in paragraph (h)(4)(i)(D) of this section;

(F) Adding the product of each calculation determined in paragraph (h)(4)(i)(E) of this section; and

(G) Dividing the sum determined in paragraph (h)(4)(i)(F) of this section by the initial hedge for the complex contract.

(ii) *Determining the change in value*. The change in value of a complex contract is the difference between the value of the complex contract with respect to the underlying security at the time the complex contract is issued and the value of the complex contract with respect to the underlying security if the price of the underlying security were equal to the testing price at the time the complex contract is issued. The change in value of the initial hedge of a complex contract with respect to the underlying security is the difference between the value of the initial hedge at the time the complex contract is issued and the value of the initial hedge if the price of the underlying security were equal to the testing price at the time the complex contract is issued.

(iii) *Testing price*. The testing prices must include the prices of the underlying security if the price of the underlying security at the time the complex contract is issued were alternatively increased by one standard deviation and decreased by one standard deviation, each of which is a separate testing price. In circumstances where using only two testing prices is reasonably likely to provide an inaccurate measure of substantial equivalence, a taxpayer must use additional testing prices as necessary to determine whether a complex contract satisfies the substantial equivalence test. If additional testing prices are used for the substantial equivalence test, the probabilities as described in paragraph (h)(4)(iv) of this section must be adjusted accordingly.

(iv) *Probability*. For purposes of paragraphs (h)(4)(i)(D) and (E) of this section, the probability of an increase by one standard deviation is the measure of the likelihood that the price of the underlying security will increase by any amount from its price at the time the complex contract is issued. For purposes of paragraphs (h)(4)(i)(D) and (E) of this section, the probability of a decrease by one standard deviation is the measure of the likelihood that the price of the underlying security will decrease by any amount from its price at the time the complex contract is issued.

(5) *Benchmark calculation*. The benchmark calculation with respect to each underlying security referenced by the potential section 871(m) transaction is determined by using the computation methodology described in paragraph (h)(4) of this section with respect to a simple contract benchmark for the underlying security.

(6) *Substantial equivalence calculation for certain complex contracts that reference multiple underlying securities*. If a

complex contract references 10 or more underlying securities and the short party uses an exchange-traded security (for example, an exchange-traded fund) that references substantially all of the underlying securities (the hedge security) to hedge the complex contract at the time it is issued, the substantial equivalence calculations for the complex contract may be calculated by treating the hedge security as the underlying security. When the hedge security is used for the substantial equivalence calculation pursuant to this paragraph (h)(6), the initial hedge is the number of shares of the hedge security for purposes of calculating the amount of a dividend equivalent as provided in paragraph (j)(1)(iii) of this section.

(7) *Example*. The following example illustrates the rules of paragraph (h) of this section. For purposes of this example, Stock X is common stock of domestic corporation X. FI is the financial institution that structures the transaction described in the example, and is the short party to the transaction. Investor is a nonresident alien individual.

Example. Complex contract that is not substantially equivalent. (i) FI issues an investment contract (the Contract) that has a stated maturity of one year, and Investor purchases the Contract from FI at issuance for $10,000. At maturity, the Contract entitles Investor to a return of $10,000 (i) plus 200 percent of any appreciation in Stock X above $100 per share, capped at $110, on 100 shares or (ii) minus 100 percent of any depreciation in Stock X below $90 on 100 shares. At the time FI issues the Contract, the price of Stock X is $100 per share. Thus, for example, Investor will receive $11,000 if the price of Stock X is $105 per share at maturity of the Contract, but Investor will receive $9,000 if the price of Stock X is $80 per share when the Contract matures. At issuance, FI acquires 64 shares of Stock X to fully hedge the Contract issued to Investor.

(ii) The Contract references an underlying security and is not an NPC, so it is classified as an ELI under paragraph (a)(4) of this section. At issuance, the Contract does not provide for an amount paid at maturity that is calculated by reference to a single, fixed number of shares of Stock X. When the Contract matures, the amount paid is effectively calculated based on either 200 shares of Stock X (if the price of Stock X has appreciated up to $110) or 100 shares of Stock X (if the price of Stock X has declined below $90). Consequently, the Contract is a complex contract described in paragraph (a)(14) of this section.

(iii) Because it is a complex ELI, FI applies the substantial equivalence test described in paragraph (h) of this section to determine whether the Contract is a specified ELI. FI determines that the price of Stock X would be $120 if the price of Stock X were increased by one standard deviation, and $79 if the price of Stock X were decreased by one standard deviation. Based on these results, FI next determines the change in value of the Contract to be $2,000 at the testing price that represents an increase by one standard deviation ($12,000 testing price minus $10,000 issue price) and a negative $1,100 at the testing price that represents a decrease by one standard deviation ($10,000 issue price minus $8,900 testing price). FI performs the same calculations for the 64 shares of Stock X that constitute the initial hedge, determining that the change in value of the initial hedge is $1,280 at the testing price that represents an increase by one standard deviation ($6,400 at issuance compared to $7,680 at the testing price) and negative $1,344 at the testing price that represents a decrease by one standard deviation ($6,400 at issuance compared to $5,056 at the testing price).

(iv) FI then determines the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents an increase by one standard deviation and a decrease by one standard deviation. Increased by one standard deviation, the absolute value of the difference is $720 ($2,000 – $1,280); decreased by one standard deviation, the absolute value of the difference is $244 (negative $1,100 minus negative $1,344). FI determines that there is a 52% chance that the price of Stock X will have increased in value when the Contract matures and a 48% chance that the price of Stock X will have decreased in value at that time. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents an increase by one standard deviation by 52%, which equals $374.40. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the Contract at the testing price that represents a decrease by one standard deviation by 48%, which equals $117.12. FI adds these two numbers and divides by the number of shares that constitute the initial hedge to determine that the complex contract calculation is 7.68 ((374.40 plus 117.12) divided by 64).

(v) FI then performs the same calculation with respect to the simple contract benchmark, which is a one-year call option that references one share of Stock X, settles on the same date as the Contract, and has a delta of 0.8. The one-year call option has a strike price of $79 and has a cost (the purchase premium) of $22. The initial hedge for the one-year call option is 0.8 shares of Stock X.

(vi) FI first determines that the change in value of the simple contract benchmark is $19.05 if the testing price is increased by one standard deviation ($22.00 at issuance to $41.05 at the testing price) and negative $20.95 if the testing price is decreased by one standard deviation ($22.00 at issuance to $1.05 at the testing price). Second, FI determines that the change in value of the initial hedge is $16.00 at the testing price that represents an increase by one standard deviation ($80 at issuance to $96 at the testing price) and negative $16.80 at the testing price that represents a decrease by one standard deviation ($80.00 at issuance to $63.20 at the testing price).

(vii) FI determines the absolute value of the difference between the change in value of the initial hedge and the one-year call option at the testing price that represents an increase by one standard deviation is $3.05 ($16.00 minus $19.05). FI next determines the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents a decrease by one standard deviation is $4.15 (negative $16.80 minus negative $20.95). FI multiplies the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents an increase by one standard deviation by 52%, which equals $1.586. FI multiplies the absolute value of the difference between the change in value of the initial hedge and the option at the testing price that represents a decrease by one standard deviation by 48%, which equals $1.992. FI adds these two numbers and divides by the number of shares that constitute the initial hedge to determine that the benchmark calculation is 4.473 ((1.586 plus 1.992) divided by .8).

(viii) FI concludes that the Contract is not a section 871(m) transaction because the complex contract calculation of 7.68 exceeds the benchmark calculation of 4.473.

(i) through (p) [Reserved]. For further guidance, see § 1.871–15(i) through (p).

(q) *Dividend and dividend equivalent payments to a qualified derivatives dealer*—(1) *In general*. Except as otherwise provided in this paragraph (q), a qualified derivatives dealer described in § 1.1441–1(e)(6) that receives a dividend or the payment of a dividend equivalent (within the meaning of paragraph (i) of this section) in its dealer capacity will not be liable for tax under section 871 or section 881 provided that the qualified derivatives dealer complies with its obligations under the qualified intermediary agreement described in §§ 1.1441–1(e)(5) and 1.1441–1(e)(6). If a qualified derivatives dealer receives a dividend or dividend equivalent payment on or determined by reference to an underlying security and the offsetting dividend equivalent payment the qualified derivatives dealer is contractually obligated to make on the same underlying security is less than the dividend and dividend equivalent amount received (including when the qualified derivatives dealer is not contractually obligated to make an offsetting dividend equivalent payment), the qualified derivatives dealer is liable for tax under section 871 or section 881 for the difference. For purposes of this paragraph (q), a dividend or dividend equivalent is not treated as received by a qualified derivatives dealer acting in its dealer capacity if the dividend or dividend equivalent is received by the qualified derivatives dealer acting as a proprietary trader. Transactions properly reflected in a qualified derivatives dealer's dealer book are presumed to be held by a dealer in its dealer capacity for purposes of this paragraph (q).

(2) *Examples*. The following examples illustrate the rules of this paragraph (q):

Example 1. Forward contract entered into by a foreign dealer. (i) *Facts*. FB is a foreign bank that is a qualified intermediary that acts as a qualified derivatives dealer. On April 1, Year 1, FB enters into a cash settled forward contract initiated by a foreign customer (Customer) that entitles Customer to receive from FB all of the appreciation and dividends on 100 shares of Stock X, and obligates Customer to pay FB any depreciation on 100 shares of Stock X, at the end of three years. FB hedges the forward contract by entering into a total return swap contract with a domestic broker (U.S. Broker) and maintains the swap contract as a hedge for the duration of the forward contract. The swap contract entitles FB to receive an amount equal to all of the dividends on 100 shares of Stock X and obligates FB to pay an amount referenced to a floating interest rate each quarter, and also entitles FB to receive from or pay to U.S. Broker, as the case may be, the difference between the value of 100 shares of Stock X at the inception of the swap and the value of 100 shares of Stock X at the end of 3 years. FB provides valid documentation to U.S. Broker that FB will receive payments under the swap contract in its capacity as a qualified derivatives dealer, and FB contemporaneously enters both the swap contract with U.S. Broker and the forward contract with Customer on its dealer books. Stock X pays a quarterly dividend of $0.25 per share.

(ii) *Application of rules*. FB is a long party on a delta one contract (the total return swap) and a short party on a delta one contract (the forward contract with Customer). U.S. Broker is not obligated to withhold on the dividend equivalent payments to FB on the swap contract that are referenced to Stock X dividends, however, because U.S. Broker has received valid documentation that it may rely upon to treat the payment as made to FB acting as a qualified derivatives dealer. Similarly, FB is not obligated to pay tax on the payments it receives from U.S. Broker referenced to Stock X dividends because at the time it received the payments FB was contractually obligated to make fully offsetting dividend equivalent payments as the short party with respect to 100 shares of Stock X to Customer. FB is required to withhold on dividend equivalent payments to Customer on the forward contract in accordance with § 1.1441–2(e)(8).

Example 2. At-the-money option contract entered into by a foreign dealer. (i) *Facts*. The facts are the same as Example 1, but customer purchases from FB an at-the-money call option on 100 shares of Stock X with a term of one year. The call option has a delta of 0.5 and FB hedges the call option by purchasing 50 shares of Stock X, which are held in an account with U.S. Broker, who also acts as paying agent.

(ii) *Application of rules*. FB is a long party on 50 shares of Stock X and a short party on an option. Because the option has a delta of less than 0.8 on the date it was issued, it is not a section 871(m) transaction. U.S. Broker is not obligated to withhold on the Stock X dividends paid to FB because U.S. Broker has received valid documentation that it may rely upon to treat the dividends as paid to FB acting as a qualified derivatives dealer. FB is liable for tax under section 871 or section 881 on the Stock X dividends it receives from U.S. Broker, however, because at the time it received the dividends FB was not contractually obligated to make an offsetting dividend equivalent payment to Customer. FB is not required to make an offsetting dividend equivalent payment to Customer because the option has a delta of 0.5; therefore, it is not a section 871(m) transaction.

Example 3. In-the-money option contract entered into by a foreign dealer. (i) *Facts*. The facts are the same as Example 2, but Customer purchases from FB an in-the-money call option on 100 shares of Stock X with a term of one year. The call option has a delta of 0.8 and FB hedges the call option by purchasing 80 shares of Stock X, which are held in an account with U.S. Broker, who also acts as paying agent. The price of Stock X declines substantially and the option lapses unexercised.

(ii) *Application of rules*. FB is a long party on 80 shares of Stock X and a short party on an option. Because the option has a delta of 0.8 on the date it was issued, it is a section 871(m) transaction. U.S. Broker is not obligated to withhold on the Stock X dividends paid to FB because U.S. Broker has received valid documentation that it may rely upon to treat the dividends as paid to FB acting as a qualified derivatives dealer. Similarly, FB is not obligated to pay tax on the Stock X dividends it receives from U.S. Broker to the extent that FB is contractually obligated to make offsetting dividend equivalent payments as the short party to Customer. FB is required to withhold on dividend equivalent payments to Customer on the option contract in accordance with § 1.1441–2(e)(8). FB is also liable for tax under section 871 or section 881 on Stock X dividends, if any, that exceed the dividend equivalent payment to Customer.

(r)(1) through (3) [Reserved]. For further guidance, see § 1.871–15(r)(1) through (3).

(4) *Effective/applicability date*. This section applies to payments made on or after January 1, 2017.

(s) *Expiration date*. This section expires September 17, 2018.

Par. 5. Section 1.1441–1 is amended by:

1. Redesignating paragraph (b)(4)(xxi) as (b)(4)(xxiv).

2. Adding paragraphs (b)(4)(xxi) through (xxiii).

3. Adding new paragraphs (e)(3)(ii)(F) and (6).

4. Adding new paragraph (f)(4).

The additions read as follows:

§ 1.1441–1 Requirement for the deduction and withholding of tax on payments to foreign persons.

* * * * *

(b) * * *

(4) * * *

(xxi) Amounts paid with respect to a notional principal contract described in § 1.871–15(a)(7), an equity-linked instrument described in § 1.871–15(a)(4), or a securities lending or sale-repurchase transaction described in § 1.871–15(a)(13) are exempt from withholding under section 1441(a) as dividend equivalents under section 871(m) if the transaction is not a section 871(m) transaction within the meaning of § 1.871–15(a)(12), if the transaction is subject to the exception described in § 1.871–15(k), or if the payment is not a dividend equivalent pursuant to § 1.871–15(c)(2). However, the amounts may be subject to withholding under section 1441(a) if they are subject to tax under any section other than section 871(m). For purposes of this withholding exemption, it is not necessary for the payee to provide documentation establishing that a notional principal contract or equity-linked instrument has a delta (as described in § 1.871–15(g)) that is less than 0.80 or does not have substantial equivalence (as defined in § 1.871–15(h)) with the underlying security. For purposes of the withholding exemption regarding corporate acquisitions described in § 1.871–15(k), the exemption only applies if the long party furnishes, under penalties of perjury, a written statement to the withholding agent certifying that it satisfies the requirements of § 1.871–15(k).

(xxii) Certain payments to qualified derivatives dealers (as described in paragraph (e)(6) of this section). For purposes of this withholding exemption, the qualified derivatives dealer must furnish to the withholding agent the documentation described in paragraph (e)(3)(ii) of this section. A withholding agent that makes a payment of a dividend or a divided equivalent to a qualified intermediary that is acting as a qualified derivatives dealer is not required to withhold on the payment if the withholding agent can reliably associate the payment with a valid qualified intermediary withholding certificate as described in paragraph (e)(3)(ii) of this section, including the certification described in paragraph (e)(3)(ii)(E).

(xxiii) Amounts paid with respect to a potential section 871(m) transaction that is only a section 871(m) transaction as a result of applying § 1.871–15(n) to treat certain transactions as combined transactions, if the withholding agent is able to rely on one or more of the presumptions provided in § 1.871–15(n)(3)(i) or (ii) (applying those paragraphs whether or not the withholding agent is a short party by substituting "withholding agent" for "short party"), and the withholding agent does not otherwise have actual knowledge that the long party (or a related person within the meaning of section 267(b) or section 707(b)) entered into the potential section 871(m) transaction in connection with any other potential section 871(m) transactions. The ability of one or more withholding agents to rely on the presumptions provided in section 1.871–15(n)(3) does not affect the withholding tax obligations or liability of any party to the transaction that cannot rely on the presumptions. Notwithstanding the withholding exemption provided to the withholding agent in this paragraph (b)(4)(xxii), the long party may still be liable for tax on dividend equivalent amounts with respect to such combined transactions under section 871(m).

* * * * *

(e)(3)(ii)(E) [Reserved]. For further guidance, see § 1.1441–1T(e)(3)(ii)(F).

* * * * *

(6) *Qualified derivatives dealers*. [Reserved]. For further guidance, see § 1.1441–1T(e)(6).

(f) * * *

(4) *Effective/applicability date*. Paragraphs (b)(4)(xxi) through (b)(4)(xxiii) of this section, and paragraphs (e)(3)(ii)(E) and (e)(6) of this section apply to payments made on or after September 18, 2015.

Par. 6. Section 1.1441–1T is amended by:

1. Redesignating paragraph (e)(3)(ii)(E) as paragraph (e)(3)(ii)(F).

2. Adding new paragraphs (e)(3)(ii)(E) and (e)(6).

3. Revising paragraph (e)(5)(i).

4. Amending paragraph (f)(3) by removing "This section" and adding in its place "Except for paragraphs (e)(3)(ii)(E) and (e)(6), this section" and adding a third sentence.

5. Amending paragraph (g) by removing "The applicability" and adding in its place "Except for paragraphs (e)(3)(ii)(E) and (e)(6), the applicability" and adding a third sentence.

The additions and revisions read as follows:

§ 1.1441–1T Requirement for the deduction and withholding of tax on payments to foreign persons (temporary).

* * * * *

(e) * * *

(3) * * *

(ii) * * *

(E) In the case of dividends or dividend equivalents received by a qualified intermediary acting as a qualified derivatives dealer, a certification that the qualified intermediary meets the requirements to act as a qualified derivatives dealer as further described in paragraph (e)(6) of this section and that the qualified derivatives dealer assumes primary withholding and reporting responsibilities under chapters 3, 4, and 61, and section 3406 with respect to any dividend equivalent payments;

* * * * *

(5) *Qualified intermediaries*—(i) *In general*. A qualified intermediary, as defined in paragraph (e)(5)(ii) of this section, may furnish a qualified intermediary withholding certificate to a withholding agent. The withholding certificate provides certifications on behalf of other persons for the purpose of claiming and verifying reduced rates of withholding under section 1441 or 1442 and for the purpose of reporting and withholding under other provisions of the Internal Revenue Code, such as the provisions under chapter 61 and section 3406 (and the regulations under those provisions). Furnishing such a certificate is in lieu of transmitting to a withholding agent withholding certificates or other appropriate documentation for the persons for whom the qualified intermediary receives the payment, including interest holders in a qualified intermediary that is fiscally transparent under the regulations under section 894. Although the qualified intermediary is required to obtain withholding certificates or other appropriate documentation from beneficial owners, payees, or interest holders pursuant to its agreement with the IRS, it is generally not required to attach such documentation to the intermediary withholding certificate. Notwithstanding the preceding sentence, a qualified intermediary must provide a withholding agent with the Forms W–9, or disclose the names, addresses, and taxpayer identifying numbers, if known, of those U.S. non-exempt recipients for whom the qualified intermediary receives reportable amounts (within the meaning of paragraph (e)(3)(vi) of this section) to the extent required in the qualified intermediary's agreement with the IRS. When a qualified intermediary is acting as a qualified derivatives dealer, the withholding certificate entitles a withholding agent to make payments of dividend equivalents and dividends to the qualified derivatives dealer free of withholding. Paragraph (e)(6) of this section contains detailed rules prescribing the circumstances in which a qualified intermediary can act as a qualified derivatives dealer. A person may claim qualified intermediary status before an agreement is executed with the IRS if it has applied for such status and the IRS authorizes such status on an interim basis under such procedures as the IRS may prescribe.

* * * * *

(6) *Qualified derivatives dealers*—(i) *In general*. To act as a qualified derivatives dealer under a qualified intermediary agreement, a qualified intermediary must be an eligible entity as described in paragraph (e)(6)(ii) of this section and, in accordance with the qualified intermediary agreement, must—

(A) Furnish to a withholding agent a qualified intermediary withholding certificate (described in paragraph (e)(3)(ii) of this section) that indicates that the qualified intermediary is a qualified derivatives dealer with respect to the applicable dividends and dividend equivalent payments;

(B) Agree to assume the primary withholding and reporting responsibilities, including the documentation provisions under chapters 3, 4, and 61, and section 3406, the regulations under those provisions, and other withholding provisions of the Internal Revenue Code, on all dividends and dividend equivalents that it receives and makes in its dealer capacity. For this purpose, a qualified derivatives dealer is required to obtain a withholding certificate or other appropriate documentation from each counterparty to whom the qualified derivatives dealer pays a dividend equivalent. The qualified derivatives dealer is also required to determine whether a payment it makes to a counterparty is, in whole or in part, a dividend equivalent;

(C) Agree to remain liable for tax under section 871 and section 881 on any dividend or payment of a dividend equivalent (within the meaning of § 1.871–15(i)) it receives in its dealer capacity to the extent that the offsetting dividend equivalent payment on an underlying security the qualified derivatives dealer is contractually obligated to make is less than the dividend and dividend equivalent amount the qualified derivatives dealers received on or with respect to the same underlying security (including when the qualified derivatives dealer is not contractually obligated to make an offsetting dividend equivalent payment); and

(D) Comply with the compliance review procedures applicable to a qualified intermediary that acts as a qualified derivatives dealer under a qualified intermediary agreement, which will specify the time and manner in which a qualified derivatives dealer must:

(*1*) Certify to the IRS that it has complied with the obligations to act as a qualified derivatives dealer (including its performance of a periodic review applicable to a qualified derivatives dealer);

(*2*) Report to the IRS the dividend equivalent payments that it made and the dividends and dividend equivalent amounts received in determining offsetting payments (as described in § 1.871–15(q)(1)); and

(*3*) Respond to inquiries from the IRS about obligations it has assumed as a qualified derivatives dealer in a timely manner.

(ii) *Definition of eligible entity*. An eligible entity is a qualified intermediary that is—

(A) A dealer in securities subject to regulatory supervision as a dealer by a governmental authority in the jurisdiction in which it was organized or operates; or

(B) A bank subject to regulatory supervision as a bank by a governmental authority in the jurisdiction in which it was organized or operates or an entity that is wholly-owned by a bank subject to regulatory supervision as a bank by a governmental authority in the jurisdiction in which it was organized or operates and that—

(*1*) Issues potential section 871(m) transactions to customers; and

(*2*) Receives dividends with respect to stock or dividend equivalent payments pursuant to potential section 871(m) transactions that hedge potential section 871(m) transactions that it issued.

(iii) *Crediting prior withholding to a subsequent dividend equivalent payment*. [Reserved].

* * * * *

(f)(3) * * * Paragraphs (e)(3)(ii)(E) and (e)(6) apply beginning September 18, 2015.

(g) * * * Paragraphs (e)(3)(ii)(E) and (e)(6) of this section expire September 17, 2018.

Par. 7. Section 1.1441–2 is amended by adding paragraph (e)(8) and adding a sentence to the end of paragraph (f) to read as follows:

§ 1.1441–2 Amounts subject to withholding.

* * * * *

(e) * * *

(8) *Payments of dividend equivalents*—(i) *In general*. A payment of a dividend equivalent is not considered to be made until the later of when—

(A) The amount of a dividend equivalent is determined as provided in § 1.871–15(j)(2), and

(B) A payment occurs with respect to the section 871(m) transaction.

(ii) *Payment*. For purposes of paragraph (e)(8) of this section, a payment occurs with respect to a section 871(m) transaction when—

(A) Money or other property is paid to or by the long party;

(B) In the case of a section 871(m) transaction described in § 1.871–15(i)(3), a payment is treated as being made at the end of the applicable calendar quarter; or

(C) The long party sells, exchanges, transfers, or otherwise disposes of the section 871(m) transaction (including by settlement, offset, termination, expiration, lapse, or maturity).

(iii) *Premiums and other upfront payments*. When a long party pays a premium or other upfront payment to the short party at the time a section 871(m) transaction is issued, the premium or other upfront payment is not treated as a payment for purposes of paragraph (e)(8)(ii)(A) of this section.

* * * * *

(f) * * * Paragraph (e)(8) of this section applies to payments made on or after September 18, 2015.

Par. 8. Section 1.1441–3 is amended by:

1. Adding a second sentence to paragraph (h)(1).
2. Redesignating paragraph (h)(2) as (h)(3) and revising newly redesignated paragraph (h)(3).
3. Adding new paragraph (h)(2).

The additions and revisions read as follows:

§ 1.1441–3 Determination of amounts to be withheld.

* * * * *

(h)* * *

(1) * * * Withholding is required on the amount of the dividend equivalent calculated under § 1.871–15(j).

(2) *Reliance by withholding agent on reasonable determinations*. For purposes of determining whether a payment is a dividend equivalent and the timing and amount of a dividend equivalent under section 871(m), a withholding agent may rely on the information received from the party to the transaction that is required (as provided in § 1.871–15(p)) to make those determinations, unless the withholding agent knows or has reason to know that the information is incorrect. When a withholding agent fails to withhold the required amount because the party described in § 1.871–15(p) fails to reasonably determine or timely provide information regarding whether a transaction is a section 871(m) transaction, the timing and amount of any dividend equivalent, or any other information required to be provided pursuant to § 1.871–15(p), and the withholding agent relied, absent actual knowledge to the contrary, on that party's determination or did not timely receive required information, then the failure to withhold is imputed to the party required to make the determinations described in § 1.871–15(p). In that case, the IRS may collect any underwithheld amount from the party to the transaction that was required to make the determinations described in § 1.871–15(p) or timely

provide the information and subject that party to applicable interest and penalties as if the party were a withholding agent with respect to the payment of the dividend equivalent made pursuant to the section 871(m) transaction.

(3) *Effective/applicability date*. Except for the first sentence of paragraph (h)(1), this paragraph (h) applies to payments made on or after September 18, 2015. The first sentence of paragraph (h)(1) of this section, applies to payments made on or after January 23, 2012.

* * * * *

Par. 9. Section 1.1441–7 is amended by:

1. Adding *Example 7* to paragraph (a)(3).

2. Adding a second sentence to paragraph (a)(4).

The additions read as follows:

§ 1.1441–7 General provisions relating to withholding agents.

(a) * * *

(3) * * *

Example 7. CO is a domestic clearing organization. CO serves as a central counterparty clearing and settlement service provider for derivatives exchanges in the United States. CB is a broker organized in Country X, a foreign country, and a clearing member of CO. CB is a nonqualified intermediary, as defined in § 1.1441–1(c)(14). FC is a foreign corporation that has an investment account with CB. FC instructs CB to purchase a call option that is a specified ELI (as described in § 1.871–15(e)). CB effects the trade for FC on the exchange. The exchange matches FC's order with an order for a written call option with the same terms. The exchange then sends the matched trade to CO, which clears the trade. CB and the clearing member representing the call option seller settle the trade with CO. Upon receiving the matched trade, the option contracts are novated and CO becomes the counterparty to CB and the counterparty to the clearing member representing the call option seller. To the extent that there is a dividend equivalent with respect to the call option, both CO and CB are withholding agents as described in paragraph (a)(1) of this section.

(4) * * * *Example 7* of paragraph (a)(3) of this section applies to payments made on or after September 18, 2015.

* * * * *

Par. 10. Section 1.1461–1 is amended by:

1. Redesignating paragraphs (c)(2)(i)(N) as (c)(2)(i)(O) and (c)(2)(i)(M) as (c)(2)(i)(N).

2. Adding paragraph (c)(2)(i)(M).

3. Redesignating paragraph (c)(2)(ii)(K) as (c)(2)(ii)(L) and redesignating paragraph (c)(2)(ii)(J) as (c)(2)(ii)(K)

4. Adding paragraph (c)(2)(ii)(J).

5. Adding a second sentence to paragraph (c)(2)(iii).

The additions read as follows:

§ 1.1461–1 Payments and returns of tax withheld.

* * * * *

(c) * * *

(2) * * *

(i) * * *

(M) Any dividend or any payment that references the payment of a dividend from an underlying security pursuant to a securities lending or sale-repurchase transaction paid to a qualified derivatives dealer even when the withholding agent is not required to withhold on the payment pursuant to § 1.1441–1(b)(4)(xxi), (xxii), or (xxiii);

* * * * *

(ii) * * *

(J) Except as provided in § 1.1461–1(c)(2)(i)(M), any payment to a qualified derivatives dealer when the withholding agent is not required to withhold on the payment pursuant to § 1.1441–1(b)(4)(xxi), (xxii), or (xxiii);

* * * * *

(iii) * * * Paragraphs (c)(2)(i)(M) and (c)(2)(ii)(J) of this section apply beginning September 18, 2015.

Par. 11. Section 1.1473–1 is amended by:

1. Adding new paragraph (a)(4)(viii).

2. Adding a sentence to the end of paragraph (f).

The additions read as follows:

§ 1.1473–1 Section 1473 definitions.

(a) * * *

(4) * * *

(viii) *Certain dividend equivalents*. Amounts paid with respect to a notional principal contract described in § 1.871–15(a)(7), an equity-linked instrument described in § 1.871–15(a)(4), or a securities lending or sale-repurchase transaction described in § 1.871–15(a)(13) that are exempt from withholding under section 1441(a) as dividend equivalents under section 871(m) if the transaction is not a section 871(m) transaction within the meaning of § 1.871–15(a)(12), if the transaction is subject to the exception described in § 1.871–15(k), or to the extent the payment is not a dividend equivalent pursuant to § 1.871–15(c)(2).

* * * * *

(f) * * * Paragraph (a)(4)(viii) of this section applies to payments made on or after September 18, 2015.

John Dalrymple
Deputy Commissioner for Services and Enforcement.

Approved: July 20, 2015

Mark J. Mazur
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on September 17, 2015, 8:45 a.m., and published in the issue of the Federal Register for September 18, 2015, 80 F.R. 56866)

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26 CFR 1.367(a)–1: Transfers to foreign corporations subject to 367(a): In general.
26 CFR 1.368–2: Definition of terms.

T.D. 9739

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Reorganizations Under Section 368(a)(1)(F); Section 367(a) and Certain Reorganizations Under Section 368(a)(1)(F)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that provide guidance regarding the qualification of a transaction as a corporate reorganization under section 368(a)(1)(F) by virtue of being a mere change of identity, form, or place of organization of one corporation (F reorganization). This document also contains final regulations relating to F reorganizations in which the transferor corporation is a domestic corporation and the acquiring

corporation is a foreign corporation (an outbound F reorganization). These regulations will affect corporations engaging in transactions that could qualify as F reorganizations (including outbound F reorganizations) and their shareholders.

DATES: *Effective date*: These final regulations are effective on September 21, 2015.

Applicability date: For dates of applicability, *see* §§ 1.367(a)–1(g)(4) and 1.368–2(m)(5).

FOR FURTHER INFORMATION CONTACT: Douglas C. Bates, (202) 317-6065 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

1. Introduction

This Treasury decision contains final regulations (the Final Regulations) that amend 26 CFR part 1 under sections 367 and 368 of the Internal Revenue Code (Code). These Final Regulations provide guidance relating to the qualification of transactions as F reorganizations and the treatment of outbound F reorganizations.

In general, upon the exchange of property, gain or loss must be recognized if the new property differs materially, in kind or extent, from the old property. *See* § 1.1001–1(a); § 1.368–1(b). The purpose of the reorganization provisions of the Code is to except from the general rule of section 1001 certain specifically described exchanges that are required by business exigencies and effect only a readjustment of continuing interests in property under modified corporate forms. *See* § 1.368–1(b). These exchanges, described in sections 354, 356, and 361, must be made in pursuance of a plan of reorganization. *See* § 1.368–1(c).

Section 368(a)(1) describes several types of transactions that constitute reorganizations. One of these, described in section 368(a)(1)(F), is "a mere change in identity, form, or place of organization of one corporation, however effected" (a Mere Change). One court has described the F reorganization as follows:

> [The F reorganization] encompass[es] only the simplest and least significant of corporate changes. The (F)-type reorganization presumes that the surviving corporation is the same corporation as the predecessor in every respect, except for minor or technical differences. For instance, the (F) reorganization typically has been understood to comprehend only such insignificant modifications as the reincorporation of the same corporate business with the same assets and the same stockholders surviving under a new charter either in the same or in a different State, the renewal of a corporate charter having a limited life, or the conversion of a U.S.-chartered savings and loan association to a State-chartered institution.

Berghash v. Commissioner, 43 T.C. 743, 752 (1965) (citation and footnotes omitted), *aff'd*, 361 F.2d 257 (2d Cir. 1966).

Although the statutory description of an F reorganization is short, and courts have described F reorganizations as simple, questions have arisen regarding the requirements of F reorganizations. In particular, when a corporation changes its identity, form, or place of incorporation, questions have arisen as to what other changes (if any) may occur, either before, during, or after the Mere Change, without affecting the status of the Mere Change (that is, what other changes are compatible with the Mere Change). These questions can become more pronounced if the transaction intended to qualify as an F reorganization is composed of a series of steps occurring over a period of days or weeks. Moreover, changes in identity, form, or place of organization are often undertaken to facilitate other changes that are difficult to effect in the corporation's current form or place of organization.

2. Related Regulations

On January 16, 1990, the Treasury Department and the IRS published temporary regulations (TD 8280) in the **Federal Register** (55 FR 1406) under sections 367(a), (b), and (e). A notice of proposed rulemaking (INTL–704–87) cross-referencing these temporary regulations was published the same day under RIN 1545–AL35 in the **Federal Register** (55 FR 1472) (1990 Proposed Regulations). No public hearing was requested or held. Prior to the publication of the 1990 Proposed Regulations, the Treasury Department and the IRS had issued two notices and a revenue ruling providing that, in an outbound F reorganization, the transferor corporation's taxable year closes, and clarifying that, in such F reorganizations, there is an actual or constructive transfer of assets and an exchange of stock. *See* Notice 88–50, 1988–1 CB 535; Notice 87–29, 1987–1 CB 474; Rev. Rul. 87–27, 1987–1 CB 134. The 1990 Proposed Regulations, in relevant part, proposed the rules described in Notice 88–50, Notice 87–29, and Rev. Rul. 87–27. No comments were received on this aspect of the 1990 Proposed Regulations. While this aspect of the 1990 Proposed Regulations has not yet been finalized, final regulations (TD 8834) regarding the primary subject of the 1990 Proposed Regulations—guidance under sections 367(e)(1) and 367(e)(2) regarding outbound distributions under sections 355 and 332—have since been issued. *See*, *for example*, TD 8834, 64 FR 43072 (Aug. 9, 1999). A new RIN (RIN 1545–BM78, REG–117141–15) has been issued under which the portion of the 1990 Proposed Regulations relating to outbound F reorganizations will be finalized.

On August 12, 2004, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–106889–04) (2004 Proposed Regulations) in the **Federal Register** (69 FR 49836) regarding the requirements for F reorganizations. The 2004 Proposed Regulations are discussed in more detail in section 3. of this Background section of this preamble. In the preamble to the 2004 Proposed Regulations, the Treasury Department and the IRS requested comments from the public. One written comment was received with respect to the 2004 Proposed Regulations. No public hearing was requested or held.

On February 25, 2005, the Treasury Department and the IRS published final regulations (TD 9182) (2005 Regulations) in the **Federal Register** (70 FR 9219) adopting a portion of the 2004 Proposed Regulations. The 2005 Regulations provide that the continuity of interest and continuity of business enterprise requirements applicable to reorganizations in general do not apply to reorganizations under section 368(a)(1)(E) or section 368(a)(1)(F). The preamble to the 2005 Regulations stated that the Treasury Department and the IRS would continue to study the other issues addressed in the 2004 Proposed Regulations and would welcome further comments from the public. One written comment was received with regard to the 2005 Regulations.

3. The 2004 Proposed Regulations

A corporation that continues to inhabit its corporate shell can change in many respects. Although these changes may have federal income tax consequences, they do not result in the corporation being treated for federal income tax purposes as a new corporation or as transferring its assets. Nor do these changes cause the corporation's taxable year to close. Unlike a partnership that might terminate for federal income tax purposes upon the transfer of a given percentage of the partnership interests, a corporation that continues to inhabit a single corporate shell continues to exist for federal tax purposes, independent of the identity of its shareholders or the composition of its assets.

The underlying premise of the 2004 Proposed Regulations was that, if a corporate enterprise changes its corporate shell while adhering to four proposed requirements for a Mere Change, the resulting corporation should be treated as the functional equivalent of the transferor corporation.

A. Mere Change

As noted in section 1. of this Background, questions have arisen as to whether other changes are compatible with a Mere Change. In addressing these questions, the 2004 Proposed Regulations embraced the principles derived from the language of section 368(a)(1)(F), the historic practice of the IRS and courts in applying that statutory definition, and functional differences between F reorganizations and other types of reorganizations.

Like other types of reorganizations, an F reorganization generally involves, in form, two corporations, one (a Transferor Corporation) that transfers (or is deemed to transfer) assets to the other (a Resulting Corporation). However, the statute describes an F reorganization as being with respect to "one corporation" and provides for treatment that differs from that accorded other types of reorganizations in which assets are transferred from one corporation to another (Asset Reorganizations). As noted in the preamble to the 2004 Proposed Regulations, "an F reorganization is treated for most purposes of the Code as if the reorganized corporation were the same entity as the corporation in existence before the reorganization." Thus, the tax treatment accorded an F reorganization is more consistent with that of a single continuing corporation in that (1) the taxable year of the Transferor Corporation does not close and includes the operations of the Resulting Corporation for the remainder of the year, and (2) the Resulting Corporation's losses may be carried back to taxable years of the Transferor Corporation.

Because an F reorganization must involve "one corporation," and continuation of the taxable year and loss carrybacks from the Resulting Corporation to the Transferor Corporation are allowed, the statute cannot accommodate transactions in which the Resulting Corporation has preexisting activities or tax attributes. *See* H. Rep. Conf. Rep't. 97–760, 97th Cong., 2d Sess., at pp. 540–41 (1982). Accordingly, the 2004 Proposed Regulations did not allow for more than de minimis activities or very limited assets or tax attributes in the Resulting Corporation from sources other than the Transferor Corporation. This is one of the principal distinctions between F reorganizations and Asset Reorganizations. The proposed rule was consistent with the historical interpretation of the statute in this regard.

Similarly, the requirement that there be "one corporation" means that the status of the Resulting Corporation as the successor to the Transferor Corporation must be unambiguous. Accordingly, and consistent with the historical interpretation of the statute, the 2004 Proposed Regulations required that, for a transaction to qualify as a Mere Change, the Transferor Corporation be liquidated for tax purposes.

In *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), the Supreme Court noted that "a transaction which shifts the ownership of the proprietary interest in a corporation is hardly a 'mere change in identity, form, or place of incorporation' within the meaning of [the F reorganization provision]." The 2004 Proposed Regulations also adopted this principle by providing that an F reorganization could not be used as a vehicle to introduce new owners into the corporate enterprise.

Based on these principles, the 2004 Proposed Regulations would have imposed four requirements for an F reorganization, with limited exceptions. First, all the stock of the Resulting Corporation, including stock issued before the transfer, would have had to be issued in respect of stock of the Transferor Corporation. Second, a change in the ownership of the corporation in the transaction would not have been allowed, except a change that had no effect other than that of a redemption of less than all the shares of the corporation. Third, the Transferor Corporation would have had to completely liquidate in the transaction. Fourth, the Resulting Corporation would not have been allowed to hold any property or possess any tax attributes (including those specified in section 381(c)) immediately before the transfer.

As discussed in the preamble to the 2004 Proposed Regulations, the first two requirements reflected the Supreme Court's holding in *Helvering v. Southwest Consolidated Corp.*, *supra*, that a transaction cannot be a Mere Change if it shifts the ownership of the proprietary interests in a corporation. These requirements would have prevented a transaction involving the introduction of a new shareholder or new equity capital into the corporation from qualifying as an F reorganization. Notwithstanding these requirements, the first requirement would have allowed the Resulting Corporation to issue a nominal amount of stock not in respect of stock of the Transferor Corporation to facilitate the organization of the Resulting Corporation.

Under the second requirement (no change in ownership), redemptions of less than all the shares of the corporation would have been allowed. The law was not completely clear as to the effect of redemptions on the qualification of a transaction as an F reorganization. Some authorities supported the proposition that changes in ownership resulting from redemptions were compatible with an F reorganization. *See Reef Corp. v. U.S.*, 368 F.2d 125 (5th Cir. 1966) (holding that a redemption of 48 percent of the stock of a corporation that occurred during a change in place of incorporation did not cause the transaction to fail to qualify as an F reorganization, because the redemption was functionally separate from the F reorganization even if coincident in time); § 1.301–1(l) (relating in part to the treatment of a distribution with respect to stock that is in substance separate from a reincorporation); Rev. Rul. 66–284, 1966–2 CB 115 (concluding that a transaction could qualify as an F reorganization even though there was less than a one percent change in a corporation's shareholders as a result of stock held by dissenting shareholders being redeemed in the transaction); *cf. Casco Products Corp. v. Commissioner*, 49 T.C. 32 (1967) (reaching a comparable result without finding an F reorganization where a nine percent shareholder was redeemed in the transaction).

The third requirement and the fourth requirement implemented the statutory requirement that an F reorganization involve only one corporation. Although the third requirement was that the Transferor Corporation completely liquidate in the transaction, a legal dissolution was not required. This accommodation allowed the value of the Transferor Corporation's charter to be preserved. Further, the Proposed Regulations would have allowed the Transferor Corporation to retain a nominal amount of assets to preserve its legal existence.

The fourth requirement would have precluded the Resulting Corporation from holding any property or having any tax attributes immediately before the transfer. Nevertheless, the Proposed Regulations would have allowed the Resulting Corporation to hold or to have held a nominal amount of assets to facilitate its organization or preserve its existence, and to have tax attributes related to these assets. In addition, the Proposed Regulations provided that the fourth requirement would not be violated if, before the transfer, the Resulting Corporation held the proceeds of borrowings undertaken in connection with the transaction.

B. Related Transactions

i. Series of Transactions Constituting a Mere Change

The Treasury Department and the IRS concluded that the words "however effected" in the statutory definition of F reorganization reflect a Congressional intent to treat as an F reorganization a series of transactions that together result in a Mere Change. The 2004 Proposed Regulations reflected this view by providing that a series of related transactions that together result in a Mere Change may qualify as an F reorganization. This view is consistent with the IRS's historical interpretation of the statute.

ii. Mere Change Within a Larger Transaction

The Treasury Department and the IRS also recognized that an F reorganization may be a step in a larger transaction that effects more than a Mere Change. For example, in Situation 1 of Rev. Rul. 96–29, 1996–1 CB 50, the IRS ruled that a reincorporation qualified as an F reorganization even though it was a step in a transaction in which the reincorporated entity issued common stock in a public offering and redeemed preferred stock having a value of 40 percent of the aggregate value of its outstanding stock immediately prior to the offering. In Situation 2 of the same ruling, the IRS ruled that a reincorporation of a corporation in another state qualified as an F reorganization even though it was a step in a transaction in which the reincorporated entity acquired the business of another entity.

Consistent with Rev. Rul. 96–29, the 2004 Proposed Regulations provided that events occurring before or after a transaction or series of transactions that otherwise constitutes a Mere Change and related thereto would not cause the Mere Change to fail to qualify as an F reorganization (the Related Events Rule). The 2004 Proposed Regulations further provided that the qualification of the Mere Change as an F reorganization would not alter the treatment of the other events.

The Related Events Rule would have operated in tandem with the proposal, which was made a final rule in the 2005 Regulations, that the continuity of interest and continuity of business enterprise requirements of § 1.368–1(d) and (e) that are generally applicable to reorganizations under section 368 do not apply to F reorganizations. These rules, together, would have focused the F reorganization analysis on the discrete step or series of steps (to use the words of many observers, those steps occurring "in a bubble") that may satisfy the four requirements for a Mere Change, even if these steps constitute part of a larger series of steps. In other words, these rules rejected the application of step transaction principles to integrate all the steps of the overall plan or agreement to accomplish the larger transaction and thereby potentially prevent the transaction from qualifying as an F reorganization. *See* Rev. Rul. 75–456, 1975–2 CB 128 (F reorganization of the acquiring corporation in a stock reorganization under section 368(a)(1)(B) did not prevent that provision's "solely for voting stock" requirement from being satisfied); *see also* Rev. Rul. 79–250, 1979–2 CB 156 (F reorganization of issuing corporation immediately after forward triangular merger did not prevent the transaction from satisfying requirements of section 368(a)(2)(D)).

C. Net Effect of the Proposed Regulations

Overall, the 2004 Proposed Regulations would have found certain changes occurring in connection with a change in identity, form, or place of organization to be compatible with the Mere Change requirement. Some changes could have been effected simultaneously with the transaction or series of transactions otherwise qualifying as an F reorganization because these changes would not have violated any of the four proposed requirements for a Mere Change. Thus, for example, a corporation could have bought, sold, or exchanged property, borrowed money, or repaid debt because the 2004 Proposed Regulations would not have required an identity of assets between the Transferor Corporation and the Resulting Corporation. Other changes could not have been effected simultaneously with the potential F reorganization, but could have occurred before or after the F reorganization "in a bubble," for example, the issuance of new equity capital or the transfer of shares to new shareholders.

D. Distributions

Prior to the issuance of the 2004 Proposed Regulations, much commentary had focused on whether distributions of money or other property in F reorganizations were distributions to which section 356 applied, or whether sections 301 and 302, and related provisions, governed the treatment of these distributions. The Treasury Department and the IRS believed it appropriate to treat these distributions as transactions separate from the F reorganization, even if they occurred immediately before or immediately after the F reorganization, after some of the transactions making up the F reorganization and before other transactions making up the F reorganization, or as part of the same plan as the F reorganization. *See*, for example, § 1.301–1(l). Accordingly, the 2004 Proposed Regulations provided that, if a shareholder received money or other property (including in exchange for its shares) from the Transferor Corporation or the Resulting Corporation in a transaction that constituted an F reorganization, the money or other property would be treated as distributed by the Transferor Corporation immediately before the transaction, and that section 356 would not apply.

Explanation of Revisions

1. Overview

After consideration of the comments received with respect to the 2004 Proposed Regulations and the 2005 Regulations, the Treasury Department and the IRS are publishing, in this Treasury decision, additional Final Regulations regarding F reorganizations. The Final Regulations generally adopt the provisions of the 2004 Proposed Regulations not previously adopted in the 2005 Regulations, with changes discussed in the remainder of this preamble, and several clarifying, nonsubstantive changes. The Final Regulations also include rules regarding outbound F reorganizations by adopting, without substantive change, the provisions of the 1990 Proposed Regulations relating to section 367(a) and making conforming revisions to other regulations.

Like the 2004 Proposed Regulations, the Final Regulations are based on the premise that it is appropriate to treat the Resulting Corporation in an F reorganization as the functional equivalent of the Transferor Corporation and to give its corporate enterprise roughly the same freedom of action as would be accorded a corporation that remains within its original corporate shell. The Final Regulations provide that a transaction that involves an actual or deemed transfer of property by a Transferor Corporation to a Resulting Corporation is a Mere Change that qualifies as an F reorganization if six requirements are satisfied (with certain exceptions). The Final Regulations provide that a transaction or a series of related transactions to be tested against the six requirements (a Potential F Reorganization) begins when the Transferor Corporation begins transferring (or is deemed to begin transferring) its assets to the Resulting Corporation, and ends when the Transferor Corporation has distributed (or is deemed to have distributed) the consideration it receives from the Resulting Corporation to its shareholders and has completely liquidated for federal income tax purposes. The concept of a Potential F Reorganization was added to the Final Regulations to aid in determining which steps in a multi-step transaction should be considered when applying the six requirements to a potential mere change (that is, which steps are "in the bubble").

In the context of determining whether a Potential F Reorganization qualifies as a Mere Change, deemed asset transfers include, but are not limited to, those transfers treated as occurring as a result of an entity classification election under paragraph § 301.7701–3(c)(1)(i), as well as transfers resulting from the application of step transaction principles. One example of such a transfer would be the deemed asset transfer by the Transferor Corporation to the Resulting Corporation resulting from a so-called "liquidation- reincorporation" transaction. *See*, *for example*, *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966); § 1.331–1(c) (liquidation-reincorporation may be a tax-free reorganization). Another example of such a deemed asset transfer would include the deemed transfer of the Transferor Corporation's assets to the Resulting Corporation in a so-called "drop-and-check" transaction in which a newly formed Resulting Corporation acquires the stock of a Transferor Corporation from its shareholders and, as part of the plan, the Transferor Corporation liquidates into the Resulting Corporation. *See*, *for example*, steps (d) and (c) of Rev. Rul. 2015–10, 2015–21 IRB 973; Rev. Rul. 2004–83, 2004–2 CB 157; Rev. Rul. 67–274, 1967–2 CB 141.

Four of the six requirements are generally adopted from the 2004 Proposed Regulations, and the fifth and sixth requirements address comments received with respect to the Proposed Regulations regarding "overlap transactions" (for example, transactions involving the Transferor Corporation's transfer of its assets to a potential successor corporation other than the Resulting Corporation in a transaction that could also qualify for nonrecognition treatment under a different provision of the Code). Viewed together, these six requirements ensure that an F reorganization involves only one continuing corporation and is neither an acquisitive transaction nor a divisive transaction. Thus, an F reorganization does not include a transaction that involves a shift in ownership of the enterprise, an introduction of assets in exchange for equity (other than that raised by the Transferor Corporation prior to the F reorganization), or a division of assets or tax attributes of a Transferor Corporation between or among the Resulting Corporation and other acquiring corporations. An F reorganization also does not include a transaction that leads to multiple potential acquiring corporations having competing claims to the Transferor Corporation's tax attributes under section 381.

Certain exceptions, similar to those of the 2004 Proposed Regulations, apply to these six requirements. Three of these exceptions allow de minimis departures from the six requirements for purposes unrelated to federal income taxation.

2. F Reorganization Requirements and Certain Exceptions

A. Resulting Corporation Stock Issuances and Identity of Stock Ownership

As in the 2004 Proposed Regulations, the first and the second requirements of the Final Regulations reflect the Supreme Court's holding in *Helvering v. Southwest Consolidated Corp*, *supra*, that a transaction that shifts the ownership of the proprietary interests in a corporation cannot qualify as a Mere Change. Thus, the Final Regulations provide that a transaction that involves the introduction of a new shareholder or new equity capital into the corporation "in the bubble" does not qualify as an F reorganization.

Consistent with the 2004 Proposed Regulations, the first requirement in the Final Regulations is that immediately after the Potential F Reorganization, all the stock of the Resulting Corporation must have been distributed (or deemed distributed) in exchange for stock of the Transferor Corporation in the Potential F Reorganization. The 2004 Proposed Regulations focused on the issuance of the stock of the Resulting Corporation in respect of stock of the Transferor Corporation. The Treasury and the IRS believe, however, that a focus on the distribution of the stock of the Resulting Corporation better matches the transactions that occur (or are deemed to occur) in reorganizations.

Also consistent with the 2004 Proposed Regulations, the second requirement is that, subject to certain exceptions, the same person or persons own all the stock of the Transferor Corporation at the beginning of the Potential F Reorganization and all of the stock of the Resulting Corporation at the end of the Potential F Reorganization, in identical proportions.

Notwithstanding these requirements and also consistent with the Proposed Regulations, the Final Regulations allow the Resulting Corporation to issue a de minimis amount of stock not in respect of stock of the Transferor Corporation, to facilitate the organization or maintenance of the Resulting Corporation. This rule is designed to allow, for example, reincorporation in a jurisdiction that requires minimum capitalization, two or more shareholders, or ownership of shares by directors. It is also intended to allow a transfer of assets to certain pre-existing entities, for reasons explained further in section 2.B. of this Explanation of Revisions.

In addition, the Final Regulations allow changes of ownership that result from either (i) a holder of stock in the Transferor Corporation exchanging that stock for stock of equivalent value in the Resulting Corporation having terms different from those of the stock in the Transferor Corporation or (ii) receiving a distribution of money or other property from either the Transferor Corporation or the Resulting Corporation, whether or not in redemption of stock of the Transferor Corporation or the Resulting Corporation. In other words, the corporation involved in a Mere Change may also recapitalize, redeem its stock, or make distributions to its shareholders, without causing the Potential F Reorganization to fail to qualify as an F reorganization. These exceptions reflect the determination of the Treasury Department and the IRS that allowing certain transactions to occur contemporaneously with an F reorganization is appropriate so long as one corporation could effect the transaction without undergoing an F reorganization. These exceptions also reflect the case law, discussed in section 3.A. of the Background, holding that certain transactions qualify as F reorganizations even if some shares are redeemed in the transaction, and rulings by the IRS that a recapitalization may happen at the same time as an F reorganization. See, for example, Rev. Rul. 2003–19, 2003–1 CB 468, and Rev. Rul. 2003–48, 2003–1 CB 863 (both providing that certain demutualization transactions may involve both E Reorganizations and F reorganizations).

B. Resulting Corporation's Assets or Attributes and Liquidation of Transferor Corporation

As in the 2004 Proposed Regulations, the third requirement (limiting the assets and attributes of the Resulting Corporation immediately before the transaction) and the fourth requirement (requiring the liquidation of the Transferor Corporation) under the Final Regulations reflect the statutory mandate that an F reorganization involve only one corporation. Although the Final Regulations generally require the Resulting Corporation not to hold any property or have any tax attributes immediately before the Potential F Reorganization, as in the 2004 Proposed Regulations, the Resulting Corporation is allowed to hold a de minimis amount of assets to facilitate its organization or preserve its existence (and to have tax attributes related to these assets), and the Resulting Corporation is allowed to hold proceeds of borrowings undertaken in connection with the Potential F Reorganization.

A commenter responding to the 2004 Proposed Regulations stated that the Final Regulations should allow the Resulting Corporation to hold, in addition to the proceeds of borrowings, cash proceeds of stock issuances before the Mere Change. The Treasury Department and the IRS do not believe that the Resulting Corporation should be allowed to issue more than a de minimis amount of stock before a transaction constituting a Mere Change because that would allow a substantial investment of new capital and/or new shareholders, or an acquisition of assets from more than one corporation. This rule does not, however, preclude the Transferor Corporation from issuing new stock before a Potential F Reorganization constituting an F reorganization. Nor does it preclude the Resulting Corporation from issuing new stock after the Potential F Reorganization.

Under the fourth requirement in the Final Regulations, the Transferor Corporation must completely liquidate in the Potential F Reorganization for federal income tax purposes. Nevertheless, as in the 2004 Proposed Regulations, the Transferor Corporation is not required to legally dissolve and is allowed to retain a de minimis amount of assets for the sole purpose of preserving its legal existence.

C. One Section 381(a) Acquiring Corporation, One Section 381(a) Transferor Corporation

The fifth requirement under the Final Regulations is that immediately after the Potential F Reorganization, no corporation other than the Resulting Corporation may hold property that was held by the

Transferor Corporation immediately before the Potential F Reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in section 381(c). Thus, a transaction that divides the property or tax attributes of a Transferor Corporation between or among acquiring corporations, or that leads to potential competing claims to such tax attributes, will not qualify as a Mere Change.

The sixth requirement under the Final Regulations is that immediately after the Potential F Reorganization, the Resulting Corporation may not hold property acquired from a corporation other than the Transferor Corporation if the Resulting Corporation would, as a result, succeed to and take into account the items of such other corporation described in section 381(c). Thus, a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations (such as the transaction described in Rev. Rul. 58–422, 1958–2 CB 145) will not qualify as a Mere Change.

These requirements address a comment received with respect to the second requirement of the 2004 Proposed Regulations that there not be a change in the ownership of the corporation in the transaction, except a change that has no effect other than a redemption of less than all the shares of the corporation. The comment stated that allowing a corporation to distribute property in redemption of less than all of its shares could result in satisfying both the requirements for an F reorganization with respect to one transferee corporation and the requirements of another nonrecognition provision with respect to a different transferee corporation. The result would be uncertainty as to which corporation should succeed to the Transferor Corporation's tax attributes.

For example, assume that corporation P owns all of the stock of corporation T, and T operates two separate businesses, Business 1 (worth $297) and Business 2 (worth $3). Further assume that T merges into newly formed corporation R, and that, pursuant to the merger agreement, P receives Business 1 and all of R's stock in exchange for surrendering all of the T stock, and R receives Business 2. Under the 2004 Proposed Regulations, the transaction could have qualified as an F reorganization, with T as the Transferor Corporation and R as the Resulting Corporation, because the only change in ownership is a redemption of less than all of the T shares. However, because T transfers 99 percent of its historic business assets (Business 1) to P in exchange for all of T's stock, the transaction might also qualify as a complete liquidation under sections 332 and 337 or an upstream reorganization under section 368(a)(1)(C) of T into P. This overlap – with two potential acquiring corporations – would present unintended complexities. For example, as discussed above, there would be uncertainty as to which corporation should succeed to T's tax attributes.

Accordingly, notwithstanding the overall flexibility provided with respect to transactions occurring contemporaneously with a Mere Change, the Final Regulations provide that a Mere Change cannot accommodate transactions that occur at the same time as the Potential F Reorganization if those other transactions could result in a corporation other than the Resulting Corporation acquiring the tax attributes of the Transferor Corporation.

The same commenter requested clarification of the treatment of combinations of several corporations into a single, newly-created corporation. Consistent with the statutory language of section 368(a)(1)(F), the Treasury Department and the IRS believe that a Mere Change involves only one Transferor Corporation and one Resulting Corporation. Thus, the Final Regulations provide that only one Transferor Corporation can transfer property to the Resulting Corporation in the Potential F Reorganization. If more than one corporation transfers assets to the Resulting Corporation in a Potential F Reorganization, none of the transfers would constitute an F reorganization.

3. Series of Transactions

In some cases, business or legal considerations may require extra steps to complete a transaction that is intended to qualify as a Mere Change. As discussed in section 3.B.i. of the Background, the Treasury Department and the IRS concluded that the words "however effected" in the statutory definition of F reorganization reflect a Congressional intent to treat a series of transactions that together result in a Mere Change as an F reorganization, even if the transfer (or deemed transfer) of property from the Transferor Corporation to the Resulting Corporation occurs indirectly. The Final Regulations confirm this conclusion by providing that a Potential F Reorganization consisting of a series of related transactions that together result in a Mere Change may qualify as an F reorganization, whether or not certain steps in the series, viewed in isolation, might, for example, be treated as a redemption under section 304(a), as a complete liquidation under section 331 or section 332, or as a transfer of property under section 351. For example, the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation. However, *see* § 1.368–2(k) for completed reorganizations that will not be recharacterized as a Mere Change as a result of one or more subsequent transfers of assets or stock, such as where a Transferor Corporation transfers all of its assets to its parent corporation in liquidation, followed by the parent corporation's retransfer of those assets to a new corporation. *See also* Rev. Rul. 69–617, 1969–2 CB 57 (an upstream merger followed by a contribution of all the target assets to a new subsidiary corporation is a reorganization under sections 368(a)(1)(A) and 368(a)(2)(C)).

4. Mere Change within Larger Transaction

As discussed in section 3.B.ii. of the Background, the Treasury Department and the IRS recognized that an F reorganization may be a step, or a series of steps, before, within, or after other transactions that effect more than a Mere Change, even if the Resulting Corporation has only a transitory existence following the Mere Change. In some cases an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the Transferor Corporation before the commencement of the F reorganization. Although an F reorganization may facilitate another transaction that is part of the same plan, the Treasury Department and the IRS have concluded that step transaction principles generally should not recharacterize F reorganizations because F reorganizations involve only one corporation and do not resemble sales of assets. From a federal income tax perspective, F reorganizations are generally neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c) without a limitation on the carryback of losses. *See*, *for example*, Rev. Rul. 96–29 (discussed in section 3.B.ii. of the Background); § 1.381(b)–1(a)(2).

The Final Regulations adopt the Related Events Rule of the 2004 Proposed Regulations, which provided that related events preceding or following the Potential F Reorganization that constitutes a Mere Change generally would not cause that Potential F Reorganization to fail to qualify as an F reorganization. Notwithstanding the Related Events Rule, in the cross-border context, related events preceding or following an F reorganization may be relevant to the tax consequences under certain international provisions that apply to F reorganizations. For example, such events may be relevant for purposes of applying certain rules under section 7874 and for purposes of determining whether stock of the Resulting Corporation should be treated as stock of a controlled foreign corporation for purposes of section 367(b). *See*, *for example*, section 2.03(b)(iv), *Example 2* in Notice 2014–52, 2014–52 IRB 712; Rev. Rul. 83–23, 1983–1 CB 82.

The Final Regulations also adopt the provision of the 2004 Proposed Regulations that the qualification of a Potential F Reorganization as an F reorganization would not alter the treatment of other related transactions. For example, if an F reorganization is part of a plan that includes a subsequent merger involving the Resulting Corporation, the qualification of a Potential F Reorganization as an F reorganization will not alter the tax consequences of the subsequent merger.

5. Transactions Qualifying under Other Provisions of Section 368(a)(1)

A comment to the Proposed Regulations stated that, in some cases, an asset transfer that would constitute a step in an F reorganization is also a necessary step for characterizing a larger transaction as a nonrecognition transaction that would not constitute an F reorganization. For example, assume that corporation P acquires all of the stock of unrelated corporation T in exchange for consideration consisting of $50 cash and P voting stock with $50 value (without making an election under section 338), and, immediately thereafter and as part of the same plan, T is merged into corporation S, a newly-formed corporation wholly owned by P. Viewed in isolation, the merger of T into S appears to constitute a Mere Change. Provided the requirements for Asset Reorganization treatment are otherwise satisfied, however, the step transaction doctrine is applied to integrate the steps and treat the transaction as a statutory merger of T into S in which S acquires T’s assets in exchange for $50 cash, $50 of P voting stock and assumption of T’s liabilities, and T distributes the cash and P stock to its shareholders. This merger qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), and P’s momentary ownership of T stock is disregarded. *See* Situation 2 of Rev. Rul. 2001–46, 2001–2 CB 321 (same). The stock of S is not treated as issued for the assets of T; the historic shareholders of T are replaced by P as the shareholder of the resulting corporation (S); and the transaction is not a Mere Change.

To clarify this and similar situations, the Treasury Department and the IRS have determined that, if the Potential F Reorganization or a step thereof involving a transfer of property from the Transferor Corporation to the Resulting Corporation is also a reorganization or part of a reorganization in which a corporation in control (within the meaning of section 368(c)) of the Resulting Corporation is a party to the reorganization (within the meaning of section 368(b)), the Potential F Reorganization is not a Mere Change and does not qualify as an F reorganization. This rule will apply to transactions qualifying as reorganizations (i) under section 368(a)(1)(C) by reason of the parenthetical language therein, (ii) under section 368(a)(1)(A) by reason of section 368(a)(2)(D), and (iii) under sections 368(a)(1)(A) or (C) by reason of section 368(a)(2)(C).

The IRS has long taken the position that, if a Transferor Corporation’s transfer of property qualifies as a step in both an F reorganization and another type of reorganization in which the Resulting Corporation is the acquiring corporation, the transaction qualifies for the benefits accorded to an F reorganization. *See*, *for example*, Rev. Rul. 57–276, 1957–1 CB 126 (section 381(b) applies such that the parts of the Transferor Corporation’s taxable year before and after an F reorganization constitute a single taxable year of the Acquiring Corporation, notwithstanding that the transaction also qualifies as another type of reorganization under section 368(a)(1)); Rev. Rul. 79–289, 1979–2 CB 145 (section 357(c) does not apply to an F reorganization even if the transaction also qualifies as another type of reorganization to which section 357(c) applies); § 1.381(b)–1(a)(2) (providing for rules applicable to F reorganizations, regardless of whether such reorganizations also qualify as another type of reorganization).

To avoid confusion in the application of the reorganization provisions, the Treasury Department and the IRS have decided that, except as provided earlier in this section 5. of the Explanation of Revisions, if a Potential F Reorganization qualifies as a reorganization under section 368(a)(1)(F) and would also qualify as a reorganization under section 368(a)(1)(A), 368(a)(1)(C), or 368(a)(1)(D), then for all federal income tax purposes the Potential F Reorganization qualifies only as a reorganization under section 368(a)(1)(F). This rule does not apply to a reorganization within the meaning of sections 368(a)(1)(E) (*see* Rev. Rul. 2003–19, 2003–1 CB 468, and Rev. Rul. 2003–48, 2003–1 CB 863 (providing that certain demutualization transactions may involve both E Reorganizations and F reorganizations)) or 368(a)(1)(G) (*see* section 368(a)(3)(C)).

6. Distributions

As described in section 3.D. of the Background, the 2004 Proposed Regulations provided that, if a shareholder received money or other property (including in exchange for its shares) from the Transferor Corporation or the Resulting Corporation in a transaction that constituted an F reorganization, the money or other property would be treated as distributed by the Transferor Corporation immediately before the transaction, not as additional consideration under section 356(a). The preamble to the 2004 Proposed Regulations indicated that this treatment would also be appropriate for distributions of money or other property in E reorganizations.

Although the Treasury Department and the IRS considered whether a distribution occurring during a Potential F Reorganization should prevent it from qualifying as an F reorganization, the Treasury Department and the IRS determined to allow flexibility for such distributions. Nevertheless, unlike other types of reorganizations, which generally involve substantial changes in economic position, F reorganizations are mere changes in form. Accordingly, the Treasury Department and the IRS have concluded that any concurrent distribution should be treated as a transaction separate from the F reorganization. *See* § 1.301–1(l); *see also Bazley v. Commissioner*, 331 U.S. 737 (1947) (distribution in the context of a purported E reorganization treated as a dividend).

An F reorganization is a Mere Change involving only one continuing corporation and is neither an acquisitive transaction nor a divisive transaction. From a federal income tax perspective, F reorganizations generally are neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c). A distribution that occurs at the same time as a Mere Change is, in substance, a distribution from one continuing corporation and is functionally separate from the Mere Change. The Treasury Department and the IRS believe that a distribution from one continuing corporation should not be treated the same as an exchange of money or other property for stock of a target corporation in an acquisitive reorganization. Instead, the distribution should be treated as a separate transaction occurring at the same time. Although the 2004 Proposed Regulations would have treated a distribution as occurring immediately before the transaction qualifying as an F reorganization, the Treasury Department and the IRS believe it is sufficient to treat the distribution as a separate transaction that occurs at the same time as the F reorganization.

7. Entities Treated as Corporations for Federal Tax Purposes

As explained in this preamble, the first requirement of the Final Regulations is that all of the stock of the Resulting Corporation be distributed in exchange for stock of the Transferor Corporation. Certain entities may be treated as corporations for federal tax purposes even though they do not have owners that could be treated as shareholders for federal tax purposes to whom the profits of the corporation would inure (for example, some charitable organizations described in section 501(c)(3)). Nevertheless, these entities may be able to engage in corporate reorganizations. Thus, no inference should be drawn from the use of the terms "stock" or "shareholders" in these Final Regulations with respect to the ability of such entities to engage in reorganizations under section 368(a)(1)(F).

8. Employer Identification Numbers

The Treasury Department and the IRS are studying how to assign (or reassign) employer identification numbers (EINs) to taxpayers following an F reorganization, including in cases in which the Transferor Corporation remains in existence as a disregarded entity, and comments on this issue are welcome.

Effective Date

These final regulations are effective for transactions occurring on or after September 21, 2015.

Effect on Other Documents

The following publications are obsolete as of September 21, 2015:

Rev. Rul. 57–276, 1957–1 CB 126; Rev. Rul. 58–422, 1958–2 CB 145; Rev. Rul. 66–284, 1966–2 CB 115; Rev. Rul. 79–250, 1979–2 CB 156; Rev. Rul. 79–289, 1979–2 CB 145; and Rev. Rul. 96–29, 1996–1 CB 50; are obsoleted. Rev. Rul. 87–27, 1987–1 CB 134; and Rev. Rul. 88–25, 1988–1 CB 116; are obsoleted in part (with respect to the determination of whether a transaction qualifies as a reorganization under section 368(a)(1)(F)).

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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 these 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) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses, and no comments were received.

Drafting Information

The principal author of these final regulations is Douglas C. Bates of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

Availability of IRS Documents

IRS revenue rulings, revenue procedures, and notices cited in this Treasury decision are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

* * * * *

Adoption of 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 * * *

§ 1.269B–1 [Amended]

Par. 2. Section 1.269B–1 is amended by removing the language in paragraph (c) "1.367(a)–1T(e), (f)" and adding "1.367(a)–1(e), (f)" in its place.

Par. 3. Section 1.367(a)–1 is amended by:

1. Revising paragraph (d)(4) through (d)(5).
2. Adding paragraphs (e) and (f).
3. Revising paragraphs (g)(1) through (g)(3).
4. Adding two sentences at the end of paragraph (g)(4).

The additions and revisions read as follows:

§ 1.367(a)–1 Transfers to foreign corporations subject to section 367(a): In general.

* * * * *

(d) * * *

(4) through (5) [Reserved]. For further guidance, *see* § 1.367(a)–1T(d)(4) through (5).

(e) *Close of taxable year in certain section 368(a)(1)(F) reorganizations*. If a domestic corporation is the transferor corporation in a reorganization described in section 368(a)(1)(F) after March 30, 1987, in which the acquiring corporation is a foreign corporation, then the taxable year of the transferor corporation shall end with the close of the date of the transfer and the taxable year of the acquiring corporation shall end with the close of the date on which the transferor's taxable year would have ended but for the occurrence of the transfer. With regard to the consequences of the closing of the taxable year, *see* section 381 and the regulations thereunder.

(f) *Exchanges under sections 354(a) and 361(a) in certain section 368(a)(1)(F) reorganizations*—(1) *Rule*. In every reorganization under section 368(a)(1)(F), where the transferor corporation is a domestic corporation, and the acquiring corporation is a foreign corporation, there is considered to exist—

(i) A transfer of assets by the transferor corporation to the acquiring corporation under section 361(a) in exchange for stock (or stock and securities) of the acquiring corporation and the assumption by the acquiring corporation of the transferor corporation's liabilities;

(ii) A distribution of the stock (or stock and securities) of the acquiring corporation by the transferor corporation to the shareholders (or shareholders and security holders) of the transferor corporation; and

(iii) An exchange by the transferor corporation's shareholders (or shareholders and security holders) of their stock (or stock and securities) of the transferor corporation for stock (or stock and securities) of the acquiring corporation under section 354(a).

(2) *Rule applies regardless of whether a continuance under applicable law*. For purposes of paragraph (f)(1) of this section, it shall be immaterial that the applicable foreign or domestic law treats the acquiring corporation as a continuance of the transferor corporation.

(g)(1) through (3) [Reserved]. For further guidance, *see* § 1.367(a)–1T(g)(1) through (3).

(4) * * * The rules in paragraph (e) of this section apply to transactions occurring on or after March 31, 1987. The rules in paragraph (f) of this section apply to transactions occurring on or after January 1, 1985.

Par. 4. Section 1.367(a)–1T is amended by revising paragraphs (e) and (f) to read as follows:

§ 1.367(a)–1T Transfers to foreign corporations subject to section 367(a): In general (temporary).

* * * * *

(e) [Reserved]. For further guidance, *see* § 1.367(a)–1(e).

(f) [Reserved]. For further guidance, *see* § 1.367(a)–1(f).

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Par. 5. Section 1.368–2 is amended by adding paragraph (m) to read as follows:

§ 1.368–2 Definition of terms.

* * * * *

(m) *Qualification as a reorganization under section 368(a)(1)(F)*—(1) *Mere change*. To qualify as a reorganization under section 368(a)(1)(F), a transaction must result in a mere change in identity, form, or place of organization of one corporation, however effected (a mere change). A mere change can consist of a transaction that involves an actual or deemed transfer of property from one corporation (a transferor corporation) to one other corporation (a resulting corporation). Such a transaction is a mere change and qualifies as a reorganization under section 368(a)(1)(F) only if all the requirements set forth in paragraphs (m)(1)(i) through (vi) of this section are satisfied. For purposes of this paragraph (m), a transaction or a series of related transactions that can be tested against the requirements set forth in paragraphs (m)(1)(i) through (vi) of this section (a potential F reorganization) begins when the transferor corporation begins transferring (or is deemed to begin transferring) its assets, directly or indirectly, to the resulting corporation, and it ends when the transferor corporation has distributed (or is deemed to have distributed) to its shareholders the consideration it receives (or is deemed to receive) from the resulting corporation and has completely liquidated for federal income tax purposes. For purposes of this paragraph (m), deemed transfers include, for example, those provided in § 301.7701–3(g)(1)(iv) of this chapter (when an entity disregarded as separate from its owner elects under paragraph § 301.7701–3(c)(1)(i) of this chapter to be classified as an association, the owner of the entity is deemed to transfer all of the assets and liabilities of the entity to the association in exchange for stock of the association). Deemed transfers also include those resulting from the application of step transaction principles. For example, step transaction principles may disregard a transitory holding of property by an individual after a liquidation of the transferor corporation and before a subsequent transfer of the transferor corporation's property to the resulting corporation. Step transaction principles may also treat a contribution of all the stock of the transferor corporation to the resulting corporation, followed by a liquidation (or deemed liquidation) of the transferor corporation, as a deemed transfer of the transferor corporation's property to the resulting corporation, followed by a distribution of stock of the resulting corporation in complete liquidation of the transferor corporation.

(i) *Resulting corporation stock distributed in exchange for transferor corporation stock*. Immediately after the potential F reorganization, all the stock of the resulting corporation, including any stock of the resulting corporation issued before the potential F reorganization, must have been distributed (or deemed distributed) in exchange for stock of the transferor corporation in the potential F reorganization. However, for purposes of this paragraph (m)(1)(i) and paragraph (m)(1)(ii) of this section, a de minimis amount of stock issued by the resulting corporation other than in respect of stock of the transferor corporation to facilitate the organization of the resulting corporation or maintain its legal existence is disregarded.

(ii) *Identity of stock ownership*. The same person or persons must own all of the stock of the transferor corporation, determined immediately before the potential F reorganization, and of the resulting corporation, determined immediately after the potential F reorganization, in identical proportions. However, this requirement is not violated if one or more holders of stock in the transferor corporation exchange stock in the transferor corporation for stock of equivalent value in the resulting corporation, but having different terms from those of the stock in the transferor corporation, or receive a distribution of money or other property from either the transferor corporation or the resulting corporation, whether or not in exchange for stock in the transferor corporation or the resulting corporation.

(iii) *Prior assets or attributes of resulting corporation*. The resulting corporation may not hold any property or have any tax attributes (including those specified in section 381(c)) immediately before the potential F reorganization. However, this requirement is not violated if the resulting corporation holds or has held a de minimis amount of assets to facilitate its organization or maintain its legal existence, and has tax attributes related to holding those assets, or holds the proceeds of borrowings undertaken in connection with the potential F reorganization.

(iv) *Liquidation of transferor corporation*. The transferor corporation must completely liquidate, for federal income tax purposes, in the potential F reorganization. However, the transferor corporation is not required to dissolve under applicable law and may retain a de minimis amount of assets for the sole purpose of preserving its legal existence.

(v) *Resulting corporation is the only acquiring corporation*. Immediately after the potential F reorganization, no corporation other than the resulting corporation may hold property that was held by the transferor corporation immediately before the potential F reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in section 381(c).

(vi) *Transferor corporation is the only acquired corporation*. Immediately after the potential F reorganization, the resulting corporation may not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as a result, succeed to and take into account the items of such other corporation described in section 381(c).

(2) *Non-application of continuity of interest and continuity of business enterprise requirements*. A continuity of the business enterprise and a continuity of interest are not required for a potential F reorganization to qualify as a reorganization under section 368(a)(1)(F). *See* § 1.368–1(b).

(3) *Related transactions*—(i) *Series of transactions.* A potential F reorganization consisting of a series of related transactions that together result in a mere change of one corporation may qualify as a reorganization under section 368(a)(1)(F), whether or not certain steps in the series, viewed in isolation, could be subject to other Code provisions, such as sections 304(a), 331, 332, or 351. However, *see* paragraph (k) of this section for transactions that qualify as reorganizations under section 368(a) and will not be recharacterized as a mere change as a result of one or more subsequent transfers of assets or stock.

(ii) *Mere change within a larger transaction*. A potential F reorganization that qualifies as a reorganization under section 368(a)(1)(F) may occur before, within, or after other transactions that effect more than a mere change, even if the resulting corporation has only transitory existence. Related events that precede or follow the potential F reorganization generally will not cause that potential F reorganization to fail to qualify as a reorganization under section 368(a)(1)(F). Qualification of a potential F reorganization as a reorganization under section 368(a)(1)(F) will not alter the character of other transactions for federal income tax purposes, and step transaction principles may be applied to other transactions without regard to whether certain steps qualify as a reorganization or part of a reorganization under section 368(a)(1)(F).

(iii) *Distributions treated as separate transactions*. As provided in paragraph (m)(1)(ii) of this section, a potential F reorganization may qualify as a mere change even though a holder of stock in the transferor corporation receives a distribution of money or other property from either the transferor corporation or the resulting corporation. If a shareholder receives money or other property (including in exchange for its shares) from the transferor corporation or the resulting corporation in a potential F reorganization that qualifies as a reorganization under section 368(a)(1)(F), then the receipt of money or other property (including any exchanged for shares) is treated as an unrelated, separate transaction from the reorganization, whether or not connected in a formal sense. *See* § 1.301–1(l).

(iv) *Transactions also qualifying under other provisions of section 368(a)(1)*. In certain cases, a potential F reorganization would (but for this paragraph (m)(3)(iv)) qualify both as a reorganization under section 368(a)(1)(F) and as a reorganization or part of a reorganization under another provision of section 368(a)(1). The following rules determine which of these overlapping qualifications applies.

(A) If the potential F reorganization or a step thereof qualifies as a reorganization or part of a reorganization under another provision of section 368(a)(1), and if a corporation in control (within the meaning of section 368(c)) of the resulting corporation is a party to such other reorganization (within the meaning of section 368(b)), the potential F reorganization will not qualify as a reorganization under section 368(a)(1)(F).

(B) Except as provided in paragraph (m)(3)(iv)(A) of this section, if, but for this paragraph (m)(3)(iv)(B), the potential F reorganization would qualify as a reorganization under both section 368(a)(1)(F) and one or more of sections 368(a)(1)(A), 368(a)(1)(C), or 368(a)(1)(D), then for all federal income tax purposes the potential F reorganization will qualify as a reorganization only under section 368(a)(1)(F).

(4) *Examples*. The following examples illustrate the application of this paragraph (m). Unless the facts otherwise indicate,

A, B, and C are domestic individuals; P, S, T, X, Y, and Z (and similar designations) are domestic corporations; each transaction is entered into for a valid business purpose; all persons and transactions are unrelated; and all other relevant facts are set forth in the examples.

Example 1. Cash contribution and redemption – no mere change. C owns all of the stock of X, a State A corporation. The net value of X's assets and liabilities is $1,000,000. Y, a State B corporation, seeks to acquire the assets of X for cash. To effect the acquisition, Y and X enter into an agreement under which Y will contribute $1,000,000 to Z, a newly formed corporation of which Y is the sole shareholder, in exchange for Z stock and X will merge into Z. In the merger, C surrenders all of the X stock and receives the $1,000,000 Y contributed to Z. C receives no Z stock in the transaction. After the merger, Y holds all of the Z stock, and Z holds all of the assets and liabilities previously held by X. Z stock is not distributed to the shareholders of X in exchange for their stock in X as required by paragraph (m)(1)(i) of this section, and the transaction results in a change in the ownership of X that does not result from an exchange or distribution described in paragraph (m)(1)(ii) of this section. Therefore, the merger of X into Z is not a mere change of X and does not qualify as a reorganization under section 368(a)(1)(F).

Example 2. Cash redemption – mere change. A owns 75%, and B owns 25%, of the stock of X, a State A corporation. The management of X determines that it would be in the best interest of X to reorganize under the laws of State B. Accordingly, X forms Y, a State B corporation, and X and Y enter into an agreement under which X will merge into Y. A does not wish to own stock in Y. In the merger, A surrenders A's X stock and receives cash, and B surrenders all of B's X stock and receives all the stock of Y. The change in ownership caused by A's surrender of X stock results from a distribution and exchange described in paragraph (m)(1)(ii) of this section. Therefore, the merger of X into Y is a mere change of X and qualifies as a reorganization under section 368(a)(1)(F). Under paragraph (m)(3)(iii) of this section, A's surrender of X stock for cash is treated as a transaction, separate from the reorganization, to which section 302(a) applies.

Example 3. Pre-transaction de minimis stock issuance – mere change – other provisions of section 368(a)(1). P owns all of the stock of S, a Country A corporation. The management of P determines that it would be in the best interest of S to change its place of incorporation to Country B. Under Country B law, a corporation must have at least two shareholders to enjoy limited liability. P is advised by its Country B advisors that the new corporation should issue 1% of its stock to a shareholder that is not P's nominee to assure satisfaction of the two-shareholder requirement. As part of an integrated plan, C, an officer of S, organizes Y, a Country B corporation with 1,000 shares of common stock authorized, and contributes cash to Y in exchange for ten of the common shares. S then merges into Y under the laws of Country A and Country B. Pursuant to the plan of merger, P surrenders its shares of S stock and receives 990 shares of Y common stock. The ten shares of Y stock issued to C not in respect of the S stock are de minimis and are used to facilitate the organization of Y within the meaning of paragraph (m)(1)(i) of this section. Therefore, the issuance of this stock to a new shareholder does not prevent the merger of S into Y from qualifying as a mere change of S. Accordingly, the merger is a reorganization under section 368(a)(1)(F). Without regard to the merger's qualification under section 368(a)(1)(F), the merger would also qualify as a reorganization under both section 368(a)(1)(A) and section 368(a)(1)(D). Under paragraph (m)(3)(iv)(B) of this section, if a potential F reorganization qualifies as a reorganization under section 368(a)(1)(F), and would also qualify under one or more of sections 368(a)(1)(A) or 368(a)(1)(D), the potential F reorganization qualifies only as a reorganization under 368(a)(1)(F), and neither section 368(a)(1)(A) nor section 368(a)(1)(D) will apply.

Example 4. Pre-transaction assets, attributes – no mere change. A owns all of the stock of P, and P owns all of the stock of S, which is engaged in a manufacturing business. P has owned the stock of S for many years. P owns no assets other than the stock of S. A decides to eliminate the holding company structure by merging P into S. Because it operates a manufacturing business, the potential resulting corporation, S, holds property and has tax attributes immediately before the potential F reorganization. Therefore, under paragraph (m)(1)(iii) of this section, the merger of P into S is not a mere change of P and does not qualify as a reorganization under section 368(a)(1)(F). The same result would occur under paragraph (m)(1)(iii) of this section if, instead of P merging into S, S merged into P, because P, the potential resulting corporation, holds property (the stock of S) and has tax attributes immediately before the potential F reorganization.

Example 5. Series of related transactions – mere change. P owns all of the stock of S1, a State A corporation. The management of P determines that it would be in the best interest of S1 to change its place of incorporation to State B. Accordingly, under an integrated plan, P forms S2, a new State B corporation; P contributes the S1 stock to S2; and S1 merges into S2 under the laws of State A and State B. Under paragraph (m)(3)(i) of this section, a series of transactions that together result in a mere change of one corporation may qualify as a reorganization under section 368(a)(1)(F). The contribution of S1 stock to S2 and the merger of S1 into S2 together constitute a mere change of S1. Therefore, the potential F reorganization qualifies as a reorganization under section 368(a)(1)(F). Without regard to its qualification under section 368(a)(1)(F), the potential F reorganization would also qualify as a reorganization under both section 368(a)(1)(A) and section 368(a)(1)(D). Under paragraph (m)(3)(iv)(B) of this section, if a potential F reorganization qualifies as a reorganization under section 368(a)(1)(F) and would also qualify under one or more of sections 368(a)(1)(A) or 368(a)(1)(D), it qualifies only as a reorganization under 368(a)(1)(F), and neither section 368(a)(1)(A) nor section 368(a)(1)(D) will apply. The result would be the same with respect to qualification under section 368(a)(1)(F) if, instead of merging into S2, S1 completely liquidates or is deemed to liquidate by reason of a conversion into an entity disregarded as separate from its owner under § 301.7701–3(g)(1)(iii) of this chapter.

Example 6. Post-transaction stock sale – mere change. P owns all of the stock of S1, a State A corporation. The management of P determines that it would be in the best interest of S1 to change its place of incorporation to State B. Accordingly, P forms S2, a new State B corporation. S1 then merges into S2 under the laws of State A and State B. Immediately thereafter, and as part of the same plan, P sells all of its stock in S2 to an unrelated party. Without regard to P's sale of S2 stock, the merger of S1 into S2 is a potential F reorganization that qualifies as a mere change of S1 within the meaning of paragraph (m)(1) of this section. Under paragraph (m)(3)(ii) of this section, related events that occur before or after a potential F reorganization that qualifies as a mere change generally do not cause that potential F reorganization to fail to qualify as a reorganization under section 368(a)(1)(F). Therefore, P's sale of the S2 stock is disregarded in determining whether the merger of S1 into S2 is a mere change of S1. Accordingly, the merger of S1 into S2 qualifies as a reorganization under section 368(a)(1)(F). The result would be the same if, instead of the S2 stock being sold by P, S2 merges into a previously unrelated corporation and terminates its separate existence.

Example 7. Post-transaction redemption – mere change. A owns all of the stock of T. Each of T, P, and S is a State A corporation engaged in a manufacturing business. The following transactions occur pursuant to a single plan. First, T merges into S with A receiving solely stock in P. Second, P changes its state of incorporation to State B by merging into newly incorporated New P under the laws of State A and State B. Third, New P redeems all the New P stock issued to A in respect of A's P stock (initially issued to A in respect of A's T stock) for cash. Without regard to the other steps, the merger of P into New P is a potential F reorganization that qualifies as a reorganization under section 368(a)(1)(F). Under paragraph (m)(3)(ii) of this section, related events that occur before or after a potential F reorganization that qualifies as a mere change generally do not prevent that potential F reorganization from qualifying as a reorganization under section 368(a)(1)(F). Therefore, the merger of P into New P qualifies as a reorganization under section 368(a)(1)(F). Under paragraph (m)(3)(ii) of this section, the qualification of the merger of P into New P as a reorganization under section 368(a)(1)(F) does not alter the tax treatment of the merger of T into S. Because the P shares received by A in respect of the T shares (exchanged for New P shares in the mere change of P into New P) are redeemed for cash pursuant to the plan, the merger of T into S does not satisfy the continuity of interest requirement of § 1.368–1(e) and therefore does not qualify as a reorganization under section 368(a).

Example 8. Series of related transactions – mere change. P owns all of the stock of S, a State A corporation. The management of P determines that it would be in the best interest of S to change its form from a State A corporation to a State A limited partnership but to continue to be treated as a corporation for federal tax purposes. Accordingly, P contributes 1% of the S stock to newly formed LLC, a limited liability company, in exchange for all of the membership interests in LLC. P is the sole member of LLC. Under § 301.7701–3 of this chapter, LLC is disregarded as an entity separate from its owner, P. Then, under a State A statute, S converts to a State A limited partnership. In the conversion, P's interest as a 99% shareholder of S is converted into a 99% limited partner interest, and LLC's interest as a 1% shareholder of S is converted into a 1% general partner interest. S also elects, under § 301.7701–3(c) of this chapter, to be classified as a corporation for federal income tax purposes, effective on the same day as the conversion. Under paragraph (m)(3)(i) of this section, the conversion of S from a State A corporation to a State A limited partnership, together with the election to treat S as a corporation for federal tax purposes, results in a mere change of S and qualifies as a reorganization under section 368(a)(1)(F).

Example 9. Other acquiring corporation – no mere change. P owns 80%, and A owns 20%, of the stock of S. A and the management of P determine that it would be in the best interest of S to completely liquidate while A continues to operate part of the business of S in corporate form. Accordingly, S distributes 80% of its assets to P and 20% of its assets to A; S dissolves; and A contributes the assets it receives from S to newly incorporated New S in exchange for all of the stock of New S. S's distribution of 80% of its property to P as part of the complete liquidation of S meets the requirements of section 332. Thus, section 381(a)(1) applies to P's acquisition of 80% of the property held by S immediately before the transaction. Under paragraph (m)(1)(v) of this section, the potential F reorganization in which 20% of the property held by S immediately before the transaction is transferred to New S cannot be a mere change of S, because section 381(a) applies to P's acquisition of property held by S immediately before the potential F reorganization. Accordingly, sections 331 and 336 apply to A's acquisition of property from S and S's distribution of property to A, and section 351 applies to A's contribution of that property to New S.

Example 10. Other acquiring corporation – no mere change. P owns all of the stock of S1. The management of P determines that it would be in the best interest of S1 to merge S1 into P. Accordingly, pursuant to a state merger statute, S1 merges into P. Immediately afterward and as part of the same plan, P contributes 50% of the former assets of S1 to newly incorporated S2 in exchange for all of the stock of S2. The transaction does not qualify as a complete liquidation of S1 under section 332 (because of the reincorporation of some of S1's assets) but does qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(C) and paragraph (k) of this section. Under paragraph (m)(1)(v) of this section, the potential F reorganization in which some of the former assets of S1 are transferred (in form) first to P, and then to S2, is not a mere change of S1, because section 381(a) applies to P's acquisition of property held by S1 immediately before the potential F reorganization. Furthermore, under paragraph (m)(3)(iv)(A) of this section, P, the corporation in control of S2 within the meaning of section 368(c), is a party to the reorganization within the meaning of section 368(b). Thus, the indirect transfer of property from S1 to S2 does not qualify under section 368(a)(1)(F).

Example 11. Other acquiring corporation – mere change. P owns all of the stock of S1. S1's only asset is all of the equity interest in LLC2, a domestic limited liability company. Under § 301.7701–3 of this chapter, LLC2 is disregarded as an entity separate from its owner, S1. Pursuant to an integrated plan to undergo a reorganization under 368(a)(1)(F), S1 and LLC2 undergo the following two state law conversions. First, under state law LLC2 converts into S2, a corporation. Second, under state law S1 converts into LLC1, a domestic limited liability company. Under § 301.7701–3 of this chapter, LLC1 is disregarded as an entity separate from its owner, P. As a result of the two conversions, S1 is deemed to transfer its assets to S2 in exchange for all of the stock in S2 and then distribute the S2 stock to P in complete liquidation of S1. The two conversions, viewed as a potential F reorganization, constitute a mere change of S1, and that potential F reorganization qualifies as a reorganization under section 368(a)(1)(F). The result would be the same if, instead of converting into S2 pursuant to state law, LLC2 elected under § 301.7701–3(c) to change its classification for federal tax purposes and be treated as an association taxable as a corporation, provided the effective date of the election (and its resulting deemed transactions) occurs before the conversion of S1.

Example 12. Other acquiring corporation – no mere change. The facts are the same facts as in *Example 11*, except that S1 converts into LLC1 prior to the conversion of LLC2 into S2. As a result of these conversions, S1 is deemed to distribute all of its assets to P in exchange for all of P's S1 stock, and P is deemed to transfer all of those assets to S2 in exchange for all of the stock in S2. The transaction does not qualify as a complete liquidation of S1 under section 332 (because of the reincorporation of S1's assets), but does qualify as a reorganization under section 368(a)(1)(C) by reason of section 368(a)(2)(C) and paragraph (k) of this section. Under paragraph (m)(1)(v) of this section, the potential F reorganization in which the former assets of S1 are deemed transferred, first by S1 to P, and then by P to S2, is not a mere change of S1 because section 381(a) applies to P's acquisition of property held by S1 immediately before the potential F reorganization. Furthermore, the corporation in control of S2, within the meaning of section 368(c), is a party to the reorganization within the meaning of section 368(b). Thus, the indirect transfer of property from S1 to S2 does not qualify under section 368(a)(1)(F).

Example 13. Series of related transactions – no mere change. X owns all of the stock of T. P acquires all of the stock of T in exchange for consideration consisting of $50 cash and P voting stock with $50 value. No election is made under section 338. Immediately thereafter and as part of the same plan, P forms S as a wholly-owned subsidiary, and T is merged into S. Viewed in isolation as a potential F reorganization, the merger of T into S appears to constitute a mere change of T. However, the acquisition of the T stock by P and the merger of T into S, viewed together, qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D). The step transaction doctrine is applied treat the transaction as a statutory merger of T into S in exchange for $50 cash and $50 of P's voting stock (and S's assumption of T's liabilities), P's momentary ownership of T stock is disregarded. Under paragraph (m)(3)(iv)(A) of this section, P, the corporation in control of S, is a party to the reorganization within the meaning of section 368(b). Thus, the transfer of property from T to S does not qualify under section 368(a)(1)(F).

Example 14. Multiple transferor corporations – no mere change. P owns all the stock of S1 and S2. The management of P determines it would be in the best interest of S1 and S2 to operate as a single corporation. P forms S3 and, under applicable corporate law,S1 and S2 simultaneously merge into S3. Immediately after the merger, P owns all the stock of S3. Each of the mergers can be tested as a potential F reorganization. However, immediately after the simultaneous mergers. the resulting corporation, S3, holds property acquired from a corporation other than the transferor corporation, and section 381(a) would apply to the acquisition of such property. Therefore, under paragraph (m)(1)(vi) of this section, neither potential F reorganization is a mere change, and neither merger into S3 qualifies as a reorganization under section 386(a)(1)(F). The result would be different if the mergers were not simultaneous. If S1 completed its merger into S3 before S2 began its merger into S3, the merger of S1 into S3 would qualify as a reorganization under section 368(a)(1)(F), but the merger of S2 into S3 would not so qualify (although it would qualify as a reorganization under sections 368(a)(1)(A) and 368(a)(1)(D)).

(5) *Effective/Applicability Date*. This paragraph (m) applies to transactions occurring on or after September 21, 2015.

§ 1.381(b)–1 [Amended]

Par. 6. Section 1.381(b)–1 is amended by removing the language in paragraph (a)(1) "1.367(a)–1T(e)" and adding "1.367(a)–1(e)" in its place.

John M. Dalrymple
Deputy Commissioner for Services and Enforcement.

Approved: September 9, 2015

Mark J. Mazur
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on September 18, 2015, 8:45 a.m., and published in the issue of the Federal Register for September 21, 2015, 80 F.R. 56904)

Section 42.—Low-Income Housing Credit

Guidance is provided to state housing credit agencies of qualified states that request an allocation of unused housing credit carryover under section 42(h)(3)(D) of the Internal Revenue Code. See Rev. Proc. 2015–49.

Part III. Administrative, Procedural, and Miscellaneous

Extension of FATCA Transitional Rules for Gross Proceeds, Foreign Passthru Payments, Limited Branches and Limited FFIs, and Sponsored Entities; Modification to Grandfathered Obligation Rule with Respect to Collateral; and Reporting of 2014 Information under a Model 1 IGA

Notice 2015–66

I. PURPOSE

This notice announces that the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) intend to amend the regulations under chapter 4 (sections 1471–1474) to extend the period of time that certain transitional rules will apply. Specifically, the amendments will extend: (1) the date for when withholding on gross proceeds and foreign passthru payments will begin; (2) the use of limited branches and limited foreign financial institutions (limited FFIs); and (3) the deadline for a sponsoring entity to register its sponsored entities and redocument such entities with withholding agents. In addition, in order to reduce compliance burdens on withholding agents that hold collateral as a secured party, this notice announces that Treasury and the IRS intend to amend the regulations under chapter 4 to modify the rules for grandfathered obligations with respect to collateral.

The transitional rules provided in this notice are intended to facilitate an orderly transition for withholding agents and FFIs regarding Foreign Account Tax Compliance Act (FATCA) compliance and respond to comments regarding how the phase-out of transitional rules may affect information reporting and withholding systems. In light of these comments and the successful engagement of Treasury and partner jurisdictions to conclude intergovernmental agreements to implement FATCA (IGAs), this notice provides additional time for withholding agents and FFIs to modify their systems in stages as necessary to address the phase-out of the above-mentioned transitional rules consistent with the information reporting and compliance objectives of FATCA.

Finally, this notice also provides information on the exchange of information by Model 1 IGA jurisdictions with respect to 2014.

II. BACKGROUND

A. The Final and Temporary Chapter 4 Regulations

1. Withholdable Payments

On March 18, 2010, the Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111–147 (H.R. 2847), added chapter 4 to Subtitle A of the Internal Revenue Code (sections 1471–1474 (commonly known as “FATCA”)). Chapter 4 generally requires withholding agents to withhold 30 percent on certain payments to a foreign financial institution (FFI) unless the FFI has entered into an agreement (FFI agreement) to obtain status as a participating FFI and to, among other things, report certain information with respect to U.S. accounts. On January 17, 2013, Treasury and the IRS published final regulations under chapter 4 (T.D. 9610, 78 Fed. Reg. 5873). On February 20, 2014, Treasury and the IRS published temporary regulations under chapter 4 (T.D. 9657, 79 Fed. Reg. 12,812) that clarify and modify certain provisions of the final regulations (the temporary and final regulations, together, the chapter 4 regulations).

The amounts subject to withholding under chapter 4 are “withholdable payments.” Under § 1.1473–1(a), the term “withholdable payment” generally means any payment of U.S. source fixed or determinable annual or periodical (FDAP) income, and for sales or other dispositions occurring after December 31, 2016, any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends that are U.S. source FDAP income. Withholding on withholdable payments of U.S. source FDAP income generally began on July 1, 2014. The transitional rule that provides for gross proceeds withholding after December 31, 2016, allows FFIs and withholding agents to implement FATCA in stages to minimize burdens consistent with ensuring that the information reporting objectives of FATCA are met and maintained.

Several transitional rules exist with respect to withholding under chapter 4 on withholdable payments of U.S. source FDAP income.

Under a transitional rule in § 1.1473–1(a)(4)(vi), a payment made on or before December 31, 2016, with respect to an “offshore obligation” is not treated as a withholdable payment if the payment is made by a person that is not acting as an intermediary (including a qualified securities lender and excluding any insurance broker with respect to premiums), withholding foreign partnership, or withholding foreign trust with respect to the payment.

Under § 1.1471–2(b), a withholdable payment does not include a payment made under a “grandfathered obligation.” A grandfathered obligation includes any obligation, as defined in § 1.1471–2(b)(2)(ii), outstanding on July 1, 2014. Under § 1.1471–2(b)(2)(i)(A)(*3*), a grandfathered obligation also includes an agreement requiring a secured party to make a payment with respect to collateral posted to secure a grandfathered obligation. If collateral secures both grandfathered and non-grandfathered obligations, the collateral posted to secure the grandfathered obligations must be determined by allocating, pro rata by value, the collateral to all outstanding obligations secured by the collateral (the pro rata rule).

Furthermore, under a transitional rule in § 1.1473–1(a)(4)(vii), a payment made on or before December 31, 2016, by a secured party, or to a secured party other than a nonparticipating FFI, with respect to collateral securing one or more transactions under a collateral arrangement is not treated as a withholdable payment, provided that only a commercially reasonable amount of collateral is held by the secured party (or by a third party for the benefit of the secured party) as part of the collateral arrangement.

2. Foreign Passthru Payments

Chapter 4 provides that, in order for an FFI to obtain the status of a participating

FFI, it must agree to all the requirements of being a participating FFI, including withholding on passthru payments made to recalcitrant account holders and nonparticipating FFIs. See section 1471(b)(1)(D)(i). A passthru payment is defined in the regulations to mean a withholdable payment and any foreign passthru payment. The chapter 4 regulations reserve on the definition of the term "foreign passthru payment." See § 1.1471–5(h)(2). A transitional rule in § 1.1471–4(b)(4) provides that a participating FFI is not required to withhold tax on a foreign passthru payment made to a recalcitrant account holder or a nonparticipating FFI before the later of January 1, 2017, or the date of publication in the Federal Register of final regulations defining foreign passthru payment.

3. Limited Branches and Limited FFIs

In order for an FFI that is a member of an expanded affiliated group (EAG) to obtain the status of a participating FFI or registered deemed-compliant FFI, § 1.1471–4(a)(4) requires that each FFI that is a member of the EAG have the chapter 4 status of a participating FFI, deemed-compliant FFI, or exempt beneficial owner. The final regulations include two transitional rules to provide limited relief to FFIs with branches or affiliates that are located in jurisdictions whose laws prohibit such branches or affiliates from complying with an FFI agreement. These transitional rules are intended to provide jurisdictions additional time to enter into an IGA with the United States or to modify their domestic laws to allow FFIs not covered by an IGA to be able to comply with the terms of the FFI agreement.

Under the transitional rule for a "limited branch," an FFI that otherwise satisfies the requirements for participating FFI status can become a participating FFI, notwithstanding that one or more branches cannot satisfy the requirements of a participating FFI, provided that all noncompliant branches satisfy the conditions for limited branch status and the FFI meets the other requirements described in § 1.1471–4(e)(2)(i). Under the transitional rule for a "limited FFI," an FFI can become either a participating FFI or a registered deemed-compliant FFI, notwithstanding that one or more other FFIs in its EAG cannot comply with all of the requirements of a participating FFI, provided that any such noncompliant FFIs meet the definition of a "limited FFI" under § 1.1471–4(e)(3). Under §§ 1.1471–4(e)(2)(v) and (3)(iv), limited branch and limited FFI statuses will be unavailable after December 31, 2015.

4. Sponsored Entity GIINs

Under section 1471, a withholding agent is not generally required to withhold on payments to an FFI that is deemed to comply with the requirements of section 1471(b) (a deemed-compliant FFI). The chapter 4 regulations provide that a registered deemed-compliant FFI includes an FFI that satisfies the requirements of § 1.1471–5(f)(1)(i)(F)(*1*) or (*2*) to qualify as either a sponsored investment entity or a sponsored controlled foreign corporation (a sponsored registered deemed-compliant FFI). A sponsoring entity of a sponsored registered deemed-compliant FFI must agree to perform, on behalf of the FFI, all due diligence, withholding, reporting, and other requirements that the FFI would have been required to perform if it were a participating FFI. A sponsoring entity must register with the IRS as a sponsoring entity and must also register the sponsored registered deemed-compliant FFI by the later of January 1, 2016, or the date that the FFI identifies itself as qualifying as a registered deemed-compliant FFI under § 1.1471–5(f)(1)(i)(F)(*1*) or (*2*). The chapter 4 regulations include a transitional due diligence rule providing that for payments prior to January 1, 2016, a withholding agent may rely on a withholding certificate provided by a sponsored registered deemed-compliant FFI that includes only the global intermediary identification number (GIIN) of the FFI's sponsoring entity. See § 1.1471–3(e)(3)(iv)(B) (cross-referenced in § 1.1471–3(d)(4)(i)) for additional due diligence requirements that apply in such cases.

Under section IV(B)(3)(c) of Annex II of the Model 1 IGA, if the sponsoring entity of a sponsored investment entity or sponsored controlled foreign corporation identifies any U.S. reportable accounts, the sponsoring entity must register the sponsored entity with the IRS on or before the later of December 31, 2015, and the date that is 90 days after such account is first identified. Under section IV(B)(3)(c) of Annex II of the Model 2 IGA, the sponsoring entity must register the sponsored entity prior to December 31, 2015.

Under section 1472, a withholding agent generally is required to withhold on payments to a nonfinancial foreign entity (NFFE) unless the NFFE provides the withholding agent with certain information identifying the NFFE's substantial U.S. owners (or a certification that the NFFE does not have any such owners), and the withholding agent reports such information to the IRS. The final regulations except withholding agents from withholding or reporting under section 1472 with respect to payments beneficially owned by entities qualifying as excepted NFFEs. The temporary regulations issued under chapter 4 add direct reporting NFFEs as a class of excepted NFFEs. A direct reporting NFFE is an NFFE that elects to report information about its substantial U.S. owners directly to the IRS (rather than to its withholding agent) and that meets the requirements of § 1.1472–1(c)(3). A direct reporting NFFE must register with the IRS and obtain a GIIN.

A direct reporting NFFE may elect to be treated as a sponsored direct reporting NFFE if another entity, other than a nonparticipating FFI, agrees to act as its sponsoring entity for performing all of the due diligence, reporting, and other requirements that the NFFE would have been required to perform as a direct reporting NFFE. A sponsoring entity of a sponsored direct reporting NFFE must register with the IRS as a sponsoring entity and must register the NFFE. The temporary regulations include a transitional due diligence rule for payments prior to January 1, 2016, that allows a withholding agent to rely on a withholding certificate provided by a sponsored direct reporting NFFE that includes only the GIIN of the NFFE's sponsoring entity. See § 1.1471–3(e)(3)(iv)(B) for additional due diligence requirements that apply in such cases.

B. IGAs

During 2012, Treasury released the Model 1 IGA and the Model 2 IGA to facilitate the implementation of FATCA and to address foreign legal impediments that otherwise would limit an FFI's ability to comply with FATCA. On April 2, 2014, Treasury and the IRS published Announcement 2014–17 (2014–18 I.R.B. 1001), providing that jurisdictions treated as having an IGA in effect would include jurisdictions that, before July 1, 2014, reached agreements in substance with the United States on the terms of an IGA and consented to be included on the list of such jurisdictions, in addition to jurisdictions that had already signed IGAs. An FFI that is resident in, or organized under the laws of, a jurisdiction that is treated as having an IGA in effect is permitted to register on the FATCA registration website and to certify to a withholding agent its status as an FFI covered by an IGA. On December 1, 2014, Treasury and the IRS published Announcement 2014–38 (2014–51 I.R.B. 951), providing that certain jurisdictions that reached an agreement in substance after June 30, 2014, and before November 30, 2014, also would be treated as having an IGA in effect. Furthermore, Announcement 2014–38 provided that jurisdictions that are treated as if they have an IGA in effect would retain such status, provided that the jurisdiction continues to demonstrate firm resolve to sign the IGA as soon as possible.

As of the publication of this notice, 112 jurisdictions are treated as having an IGA in effect. A complete list can be found on Treasury's website, available at *http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx*.

1. Treatment of Limited Branches and Limited FFIs under IGAs

Article 4(5) of the Model 1 IGA and Article 3(5) of the Model 2 IGA generally provide that, in order for an FFI resident in or organized under the laws of the partner jurisdiction to be compliant with the IGA and be treated as a participating FFI, deemed-compliant FFI, or exempt beneficial owner, as appropriate, all of the FFI's related entities or branches must be FATCA-compliant. However, the Model 1 and Model 2 IGAs also provide that if a resident FFI has a related entity or branch that operates in a jurisdiction that prevents such entity or branch from complying with FATCA, or the FFI has a related entity or branch that is treated as a non-participating FFI solely due to the expiration of the transitional rule for limited FFIs and limited branches under the chapter 4 regulations, such FFI shall continue to be in compliance with the IGA and be treated as a participating FFI, deemed-compliant FFI, or exempt beneficial owner, as appropriate, if the conditions described in subparagraphs (a) through (c) of Article 4(5) of the Model 1 IGA or Article 3(5) of the Model 2 IGA are satisfied.

2. Exchange of 2014 Information under a Model 1 IGA

There are two versions of the Model 1 IGA. A Model 1A IGA provides for reciprocal information exchange between the United States and the partner jurisdiction. The obligation to exchange information generally begins after the IGA enters into force under Article 10(1) of the IGA and the competent authorities provide notification that each is satisfied that the other jurisdiction has in place the necessary safeguards to ensure that the information received will remain confidential and be used solely for tax purposes and the infrastructure necessary for an effective exchange relationship. See Articles 3(8) and 3(9) of the Model 1A IGA.

A Model 1B IGA provides for information to be exchanged only by the partner jurisdiction. Under a Model 1B IGA, the obligation for a partner jurisdiction to exchange information with the United States begins when the IGA enters into force under Article 10(1) or Article 12(1) (as applicable) of the IGA.

Once an IGA has entered into force and any relevant notifications described above for the Model 1A IGA have been provided, Article 2 of both versions of the Model 1 IGA requires the partner jurisdiction to obtain and exchange specified information with respect to each U.S. reportable account. Under Article 3(5) of the Model 1 IGA, the partner jurisdiction is obligated to obtain and exchange information within nine months after the end of the calendar year to which the information relates. In the case of information required to be obtained and exchanged with respect to 2014 pursuant to a Model 1 IGA that is in force, the 2014 information should be exchanged by the partner jurisdiction by September 30, 2015.

III. EXTENSION OF DATES FOR WHEN WITHHOLDING BEGINS FOR PAYMENTS OF GROSS PROCEEDS AND PASSTHRU PAYMENTS

Many U.S. and foreign financial institutions, foreign governments, Treasury, the IRS, and other stakeholders have devoted resources to implementing FATCA withholding on withholdable payments, which (subject to certain exceptions) began on July 1, 2014, as well as for the first U.S. account reporting under FATCA, which was due for certain FFIs starting in March 2015. At the same time, 112 jurisdictions are now treated as if they have an IGA in effect, which allows for the information reporting goals of FATCA to be satisfied for FFIs covered by such IGAs. In order to continue to facilitate an orderly phase-in of FATCA withholding, Treasury and the IRS intend to amend the chapter 4 regulations under section 1473 to extend the start date of gross proceeds withholding by providing that the definition of the term withholdable payment means any payment of U.S. source FDAP income, and for sales or other dispositions occurring after December 31, 2018, any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends that are U.S. source FDAP income. Additionally, Treasury and the IRS intend to amend the regulations under section 1471 to extend the start date of withholding on foreign passthru payments to provide that a participating FFI is not required to withhold tax on a foreign passthru payment made to a recalcitrant account holder or a nonparticipating FFI before the later of January 1, 2019, or the date of publication in the Federal Register of final regulations defining the term foreign passthru payment.

IV. EXTENSION OF LIMITED BRANCH AND LIMITED FFI STATUSES

Currently, 112 jurisdictions are treated as if they have an IGA in effect, which highlights the overwhelming support of FATCA partner jurisdictions in implementing the information reporting goals of FATCA. FFIs and other stakeholders continue to express strong support for IGAs as a way to facilitate effective and efficient FATCA implementation while avoiding conflicts with local law.

While Treasury remains open to entering into IGA discussions based on the published models, there may be jurisdictions that have not been able or willing to agree to an IGA and that continue to impose legal restrictions that prevent FFIs resident or organized there, or branches located there, from complying with the terms of an FFI agreement. If an FFI that is not covered by an IGA has a branch located in, or an FFI affiliate subject to the laws of, a jurisdiction that prohibits compliance with the terms of an FFI agreement, that FFI will no longer be able to obtain or maintain status as a participating or deemed-compliant FFI once limited branch and limited FFI status expire.

To provide FFIs and other stakeholders additional time to determine whether to continue operating in jurisdictions where limited branches or limited FFIs exist, Treasury and the IRS intend to amend the regulations under section 1471 to provide that the availability of limited branch and limited FFI statuses will terminate on January 1, 2017. A limited FFI or limited branch that becomes able to comply with the terms of the FFI agreement or becomes a participating FFI or deemed-compliant FFI pursuant to an applicable IGA should amend its registration to reflect its modified status. FFIs that continue to operate after December 31, 2016, in jurisdictions where they cannot comply with the terms of an FFI agreement due to local law will jeopardize the chapter 4 status of participating FFIs and registered deemed-compliant FFIs (other than FFIs covered by an IGA) in the group. Branches that continue to operate after December 31, 2016, in jurisdictions where they cannot comply with the terms of an FFI agreement due to local law will jeopardize the participating FFI status of the FFI of which the branch is part (as well as jeopardize any branches of the FFI that have participating FFI status under the FFI agreement), subject to the terms of an applicable IGA.

After December 31, 2015, all limited FFI and limited branch registrations will be placed in "registration incomplete" status on their online FATCA account. Limited FFIs and limited branches that seek to continue such status during the 2016 calendar year will be required to edit and resubmit their registrations after December 31, 2015, on the FATCA registration website.

V. EXTENSION OF TIME TO REGISTER SPONSORED ENTITIES AND EXTENSION OF RELIANCE ON SPONSORING ENTITY GIINS

As previewed in Notice 2013–69 (2013–46 I.R.B. 503), the IRS is developing a streamlined process for sponsoring entities to register their sponsored entities on the FATCA registration website. The IRS anticipates that this registration process will be available in the coming months and intends to update the FATCA registration user guide to include this process. In order to provide sufficient time for sponsored entity registration, Treasury and the IRS intend to amend the regulations under sections 1471 and 1472 to provide that sponsoring entities must register their sponsored registered deemed-compliant FFIs and sponsored direct reporting NFFEs by January 1, 2017. Beginning on such date, sponsoring entities must use the GIIN of the sponsored entity when reporting with respect to the sponsored entity on Form 8966 (FATCA Report) and must provide the GIIN to withholding agents making payments to the sponsored entity.

Sponsored investment entities and sponsored controlled foreign corporations covered by Annex II of a Model 1 IGA will maintain their deemed-compliant status as long as they are registered by the sponsoring entity on or before the later of December 31, 2016, and the date that is 90 days after a U.S. reportable account is first identified. Sponsored investment entities and sponsored controlled foreign corporations covered by Annex II of a Model 2 IGA will maintain their deemed-compliant status as long as they are registered by the sponsoring entity on or before December 31, 2016.

In addition, Treasury and the IRS intend to amend the regulations under section 1471 to provide that withholding agents can continue to rely on withholding certificates from sponsored registered deemed-compliant FFIs and sponsored direct reporting NFFEs that have only the sponsoring entity's GIIN for payments made prior to January 1, 2017. For a payment made on or after January 1, 2017, a withholding agent will be required to obtain the GIIN of a payee that is a sponsored registered deemed-compliant FFI or a sponsored direct reporting NFFE by obtaining either: (1) a withholding certificate from the payee that includes its GIIN, or (2) if the withholding agent already has on file a withholding certificate for the payee that includes the GIIN of the sponsoring entity, oral or written confirmation of the payee's GIIN (such as by e-mail). If a withholding agent obtains oral or written confirmation of the payee's GIIN, it will be required to retain a record of such information, which will become part of the withholding certificate. Whether the withholding agent receives the GIIN through a new withholding certificate, or by oral or written confirmation, the withholding agent will have 90 days from the date it obtains the GIIN to verify its accuracy against the published IRS FFI list. Because withholding agents will be required to obtain the GIIN of each sponsored entity for payments made after December 31, 2016, sponsoring entities should consider registering to obtain GIINs well in advance of January 1, 2017, in order to give withholding agents sufficient time to complete this requirement (and thereby avoid being withheld upon).

VI. TREATMENT OF COLLATERAL UNDER THE GRANDFATHERED OBLIGATION RULE

A. Modifications to Pro Rata Rule for Pooled Collateral

Treasury and the IRS have received comments stating that it would be burdensome for financial institutions to comply with the pro rata rule described in § 1.1471–2(b)(2)(i)(A)(*3*) for collateral that secures both grandfathered obligations and obligations that are not grandfathered. Commenters have stated that they would prefer to treat any collateral that secures both grandfathered obligations and obligations that are not grandfathered as posted to secure only obligations that are not grandfathered, rather than applying the pro rata rule, and accordingly to withhold on all payments made with respect to the collateral.

Treasury and the IRS agree that, in order to ease administrative burdens when collateral secures both grandfathered obligations and obligations that are not grandfathered, the secured party should be permitted either to withhold on all collateral or to apply the pro rata approach with respect to such collateral. Therefore, Treasury and the IRS intend to amend § 1.1471–2(b)(2)(i)(A)(*3*) to provide that the pro rata rule is not mandatory.

B. Substitute Payments Made with Respect to a Grandfathered Obligation

The chapter 4 regulations treat obligations that are outstanding on July 1, 2014, as grandfathered obligations. If, after July 1, 2014, a payee pledges a grandfathered obligation as collateral, and the secured party acts as an intermediary for payments made under the grandfathered obligation that is posted as collateral, then payments made by the secured party to the payee with respect to such collateral remain covered by the grandfathered obligation rule and are not treated as withholdable payments. Commenters have noted, however, that the definition of a grandfathered obligation does not include an obligation that is created as a result of the posting of collateral that is itself a grandfathered obligation. As a result, to the extent that a secured party is treated as the beneficial owner of collateral that is a grandfathered obligation, payments made by the secured party would not be payments made under a grandfathered obligation, but would instead be substitute payments made under a newly created obligation that is not covered by the grandfathered obligation rule. Commenters have noted that without a rule to cover these substitute payments, it would be difficult to determine the proper treatment of collateral that is itself a grandfathered obligation, as collateral is frequently rehypothecated and the secured party cannot readily determine which collateral was rehypothecated (giving rise to substitute payments to the payee) and which collateral has been retained.

In balancing the benefits and burdens of the information reporting and withholding rules under FATCA, Treasury and the IRS agree that a substitute payment made with respect to a grandfathered obligation that has been posted as collateral should also be treated as a payment made under a grandfathered obligation, and therefore not subject to withholding under section 1471 or section 1472. Therefore, Treasury and the IRS intend to amend the definition of grandfathered obligation in § 1.1471–2(b)(2)(i)(A) to include any obligation that gives rise to substitute payments and that is created as a result of the payee posting collateral that is otherwise treated as a grandfathered obligation under § 1.1471–2(b)(2)(i)(A)(*1*).

VII. TIMING OF EXCHANGE OF 2014 INFORMATION UNDER A MODEL 1 IGA

A. Model 1 IGAs for which the Obligation to Exchange Has Not Taken Effect

Many partner jurisdictions that have signed IGAs or reached an agreement in substance on the text of an IGA continue to work through their internal procedures to bring the IGA into force. Pursuant to its authority under section 1471(b)(2)(B), and consistent with Announcement 2014–38, for Model 1 IGAs that have not yet entered into force on September 30, 2015, Treasury intends to continue to treat FFIs covered by the IGA as complying with, and not subject to withholding under, FATCA so long as the partner jurisdiction continues to demonstrate firm resolve to bring the IGA into force and any information that would have been reportable under the IGA on September 30, 2015, is exchanged by September 30, 2016, together with any information that is reportable under the IGA on September 30, 2016.

This policy is consistent with memoranda of understanding (MOUs) that the United States has entered into with certain partner jurisdictions and letters that Treasury has sent to certain other partner jurisdictions. This notice clarifies that this policy applies to all partner jurisdictions that have signed or agreed in substance to a Model 1 IGA, even if such a jurisdiction has not entered into the MOU or received the letter described above. This notice does not affect the timing of when FFIs should report information to a partner jurisdiction, which remains governed by local law.

B. Model 1 IGAs for which the Obligation to Exchange Is in Effect

For Model 1B IGA jurisdictions that have an IGA in force pursuant to Article 10(1) or Article 12(1) (as applicable) of the IGA, and for Model 1A IGA jurisdictions for which the obligation to exchange information has taken effect pursuant to Articles 3(9) and 10(1) of the IGA, Article 3(5) of the IGA requires the partner jurisdiction to exchange information on U.S. reportable accounts with respect to 2014 by September 30, 2015.

Treasury and the IRS understand that partner jurisdictions are continuing to develop and implement the systems needed for automatic information exchange and may not have those systems in place by September 30, 2015. In addition, several partner jurisdictions are in the process of enacting legislation to implement their IGAs, without which they are not able to exchange information with the United States.

Notice 2014–33 (2014–21 I.R.B. 1033) states that calendar years 2014 and 2015 are regarded as a transition period for purposes of IRS enforcement and administration of the due diligence, reporting, and withholding provisions under chapter 4. Consistent with treating 2014 and 2015 as a transition period, Treasury and the IRS will treat FFIs covered by an IGA as complying with, and not subject to withholding under, FATCA even if the relevant partner jurisdiction has not exchanged 2014 information by September 30, 2015, as long as the partner jurisdiction notifies the U.S. competent authority before September 30, 2015, of the delay and provides assurance that the jurisdiction is making good faith efforts to exchange the information as soon as possible. This notice does not affect the timing of when FFIs should report information to a partner jurisdiction, which remains governed by local law.

VIII. TAXPAYER RELIANCE

Prior to the issuance of the amendments described in sections III, IV, V, and VI of this notice, taxpayers may rely on the provisions of this notice.

IX. DRAFTING INFORMATION

The principal author of this notice is Kamela Nelan of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Nelan at (202) 317-6942 (not a toll-free number).

Per Capita Distributions of Funds Held in Trust by the Secretary of the Interior

Notice 2015–67

PURPOSE

In Notice 2014–17, 2014–13 I.R.B. 881, the Internal Revenue Service and the Treasury Department issued interim guidance concerning the federal income tax treatment of per capita distributions made to members of Indian tribes from funds held in trust by the Secretary of the Interior. This notice supersedes Notice 2014–17 and provides final guidance.

BACKGROUND

The Department of the Interior (DOI), primarily through the Office of the Special Trustee for American Indians (OST), is responsible for holding in trust certain funds received on behalf of individual Indians and federally recognized Indian tribes.

Current DOI regulations under 25 C.F.R. §§ 115.700–703 provide that certain funds may be accepted by the Secretary of the Interior on behalf of federally recognized Indian tribes and certain individual Indians who have an interest in trust lands, trust resources, or trust assets. Funds accepted on behalf of Indian tribes are deposited into tribal "Trust Accounts" as defined at 25 C.F.R. § 115.002 (Trust Accounts). The OST has the responsibility to manage the funds and make them available to the tribe upon request.

Funds held in tribal Trust Accounts by the DOI may be distributed per capita to members of the tribes. Prior to the enactment of the Per Capita Act, Pub. L. No. 98–64, 97 Stat. 365, 25 U.S.C. §§ 117a–117c, in 1983, the DOI had the sole authority for making per capita distributions out of tribal Trust Accounts. However, the Per Capita Act provided Indian tribes authority to make per capita distributions directly to members of the tribe out of the tribe's tribal Trust Account. 25 U.S.C. § 117a.

APPLICABLE PROVISIONS OF LAW

Section 61(a) of the Internal Revenue Code, 26 U.S.C. § 61, states that, except as otherwise provided by law, gross income means all income from whatever source derived, including but not limited to compensation, gross income derived from business, and dividends. Under 26 U.S.C. § 61, Congress intends to tax all gains and undeniable accessions to wealth, clearly realized, over which taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), 1955–1 C.B. 207.

Indians are U.S. citizens subject to the requirement to pay income taxes. *Squire v. Capoeman*, 351 U.S. 1 (1956), 1956–1 C.B. 605. There is no provision in the Internal Revenue Code that exempts an individual from the payment of federal income tax solely because he or she is an Indian. Therefore, exemption of individual Indians from the payment of tax must derive plainly from treaties or agreements with the Indian tribes concerned or an act of Congress. *See* Rev. Rul. 67–284, 1967–2 C.B. 55.

The Per Capita Act (25 U.S.C. §§ 117a–117c) provides authority to Indian tribes to make per capita distributions to members of the tribe out of funds held in a tribal Trust Account. Under 25 U.S.C. § 117a, funds subject to that section may be distributed by either the Secretary of the Interior or the tribe at the request of the governing body of the tribe and subject to the approval of the Secretary of the Interior. In practice, proceeds from trust assets or trust resources (both defined at 25 C.F.R. § 115.002) are deposited into a tribal Trust Account for a tribe and that tribe can subsequently make a per capita distribution using funds from that tribal Trust Account.

The Indian Tribal Judgment Funds Use or Distribution Act, Pub. L. No. 93–134, 87 Stat. 466, 25 U.S.C. §§ 1401–1408, concerns the distribution of certain judgment funds to Indian tribes. Under 25 U.S.C. § 117b(a), per capita distributions made pursuant to 25 U.S.C. § 117a are subject to the provisions of 25 U.S.C. § 1407. Pursuant to 25 U.S.C. § 1407, none of the funds that are distributed per capita or held in trust pursuant to a plan approved under 25 U.S.C. § 1401 *et. seq*, including all interest and investment income accrued on the funds while held in trust, are subject to federal income taxes. See also H.R. Rep. No. 98–230 at 3 (1983), which provides that per capita distributions of tribal trust revenue "shall be subject to the provisions of [25 U.S.C. § 1407] with respect to tax exemptions." However, per capita distributions to tribal members of "net revenues" from Indian gaming activity that are subject to the Indian Gaming Regulatory Act (net gaming revenues) are subject to federal income taxation and are subject to the information reporting and withholding requirements of 26 U.S.C. §§ 6041 and 3402(r). *See* 25 U.S.C. §§ 2701–2721 and 25 C.F.R. Part 290. Under the Indian Gaming Regulatory Act, net gaming revenues means "gross revenues of an Indian gaming activity less amounts paid out as, or paid for, prizes and total operating expenses, excluding management fees." 25 U.S.C. § 2703(9).

Under 25 C.F.R. § 115.703, the Secretary of the Interior accepts and deposits into tribal Trust Accounts only funds from sources listed in the table in 25 C.F.R. § 115.702. The 25 C.F.R. § 115.702 table provides that the Secretary of the Interior will accept, among other payments, payments resulting from money directly derived from title conveyance or use of trust lands, payments resulting from penalties for trespass on trust lands, and payments resulting from a final order from a court of competent jurisdiction for a cause of action related to trust assets. The Secretary of the Interior also accepts deposits of funds derived directly from trust lands, restricted fee lands, or trust resources. See 25 C.F.R. § 115.702 for a full list of funds that the Secretary of the Interior accepts and deposits into tribal Trust Accounts.

FEDERAL INCOME TAX TREATMENT OF PER CAPITA DISTRIBUTIONS OF TRIBAL TRUST ACCOUNT FUNDS

a. General Rule

Under 25 U.S.C. § 117b(a) and 25 U.S.C. § 1407, per capita distributions made from funds the Secretary of the Interior holds in a tribal Trust Account are generally excluded from the gross income of the members of the tribe receiving the per capita distributions. For example, if proceeds from timber sales, an agricultural lease, or a grazing permit are deposited into a tribe's tribal Trust Account and that tribe subsequently makes a per capita distribution using funds from the tribal Trust Account, the per capita distributions are excluded from the tribal members' gross income.

b. Exception

Distributions to tribal members from a tribal Trust Account constitute gross income under 26 U.S.C. § 61 to the members of the tribe receiving the distributions if a tribal Trust Account is used to mischaracterize what would otherwise be taxable income as nontaxable per capita distributions. For example, distributions from a tribal Trust Account constitute gross income under 26 U.S.C. § 61 if, based on the facts and circumstances, the distributions are mischaracterized compensation to tribal members for their services, mischaracterized distributions of business profits, or mischaracterized gaming revenues.

The following examples illustrate situations in which distributions from a tribal Trust Account are not treated as nontaxable per capita distributions and are included in gross income under 26 U.S.C. § 61.

Example 1 – Mischaracterized Compensation

B is a housing authority established by Tribe C, a federally recognized Indian tribe. The Director and the Assistant Director of B are both members of Tribe C. During each of the 2011, 2012, and 2013 taxable years, the Director and the Assistant Director are each paid bonuses in the amount of $15x. In the 2014 taxable year, members of Tribe C's Tribal Council authorize per capita distributions out of the tribe's tribal Trust Account in the amount of $1x to every member of the tribe and an additional $2x in per capita distributions to every elder in the tribe. In addition, the members of Tribe C's Tribal Council authorize distributions out of the tribal Trust Account to the Director and Assistant Director in the amount of $15x each, instead of paying bonuses to the Director and the Assistant Director. The distributions of $15x to the Director and the Assistant Director are mischaracterized compensation and, therefore, are included in their gross income under 26 U.S.C. § 61.

Example 2 – Mischaracterized Distributions of Business Profits

Tribe D is a federally recognized Indian tribe. A group of Tribe D members own Corporation E, an information technology company that provides call center services. Corporation E's headquarters is located on land held in trust by the Secretary of the Interior for the benefit of Tribe D. Tribe D charges Corporation E rent at fair market value for its headquarters. However, the lease agreement with Tribe D includes a provision whereby Corporation E also deposits an amount approximating its net revenues into Tribe D's tribal Trust Account, characterizing the revenue as additional rent. Subsequently, members of Tribe D's Tribal Council authorize per capita distributions out of the tribal Trust Account in an aggregate amount equal to the purported "additional rent" to the group of Tribe D members who own Corporation E. The distributions of the mischaracterized business profits from the tribal Trust Account constitute gross income under 26 U.S.C. § 61 to the members receiving the distributions.

Example 3 – Mischaracterized Gaming Revenues

Tribe F is a federally recognized Indian tribe. Tribe F owns all of Corporation G, which owns and operates a casino located on land held in trust by the Secretary of the Interior for the benefit of Tribe F. All of Corporation G's gaming revenues are subject to the Indian Gaming Regulatory Act. After paying out all prizes and all administrative expenses (excluding management fees), Corporation G distributes 50% of its net gaming revenues to Tribe F. Also, under a lease agreement with Tribe F, Corporation G deposits the remaining 50% of its net gaming revenues into Tribe F's tribal Trust Account, characterizing the deposits as rent for use of the land for the casino. Subsequently, members of Tribe F's Tribal Council authorize per capita distributions to every member of the tribe out of the net gaming revenues that are held in the tribal Trust Account. The distributions out of the tribal Trust Account are mischaracterized gaming revenues. Because per capita distributions of net gaming revenues are subject to federal income taxation, the distributions constitute gross income under 26 U.S.C. § 61 to the members of the tribe receiving the distributions.

LIMITATION

This notice applies only to per capita distributions made by the Secretary of the Interior or an Indian tribe out of a tribal Trust Account. This notice does not affect the federal income taxation of distributions made from individual Indian trust accounts, from which per capita distributions cannot be made. This notice also does not affect the federal income taxation of and withholding from distributions made pursuant to a Revenue Allocation Plan under the Indian Gaming Regulatory Act, Pub. L. No. 100–497, 102 Stat. 2475, 25 U.S.C. §§ 2701–2721.

EFFECT ON OTHER DOCUMENTS

Notice 2014–17 is superseded.

DRAFTING INFORMATION

The principal author of this notice is Dave Rifkin of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). For further information, please contact Mr. Rifkin at (202) 317-5800 (not a toll-free number).

Information Reporting on Minimum Essential Coverage

Notice 2015–68

PURPOSE

This notice advises taxpayers that the Treasury Department and the Internal Revenue Service intend to propose regulations under § 6055 of the Internal Revenue Code (1) providing that health insurance issuers must report coverage in catastrophic health insurance plans described in § 1302(e) of the Affordable Care Act enrolled in through an Affordable Insurance Exchange (Exchange, also known as a Health Insurance Marketplace), (2) allowing electronic delivery of statements reporting coverage under expatriate health plans unless the recipient explicitly refuses consent or requests a paper statement, (3) allowing filers reporting on insured group health plans to use a truncated taxpayer identification number (TTIN) to identify the employer on the statement furnished to a taxpayer, and (4) specifying when a provider of minimum essential coverage is not required to report coverage of an individual who has other minimum essential coverage. This notice also invites comments on issues relating to solicitation of taxpayer identification numbers (TINs) of covered individuals; advises that the governments of United States possessions or territories, namely American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands, are not required to report coverage under Medicaid and the Children's Health Insurance Program (CHIP); and provides that the state government agency sponsoring coverage under the Basic Health Program is required to report Basic Health Program coverage.

BACKGROUND

Requirement to have minimum essential coverage

Under § 5000A, nonexempt individuals have the choice of maintaining minimum essential coverage or making an individual shared responsibility payment with their income tax returns. Minimum essential coverage is defined in § 5000A(f) and includes health insurance coverage offered in the individual market (such as a qualified health plan offered through an Exchange), an employer-sponsored plan, and government-sponsored programs such as Medicare, Medicaid, CHIP, and TRICARE. The Secretary of Health and Human Services, in coordination with the Secretary of the Treasury, may designate health benefits coverage not specified in § 5000A as minimum essential coverage. Under § 5000A(f)(4), bona fide residents (within the meaning of § 937(a) and accompanying regulations) of U.S. possessions or territories are treated as having minimum essential coverage.

Information reporting of minimum essential coverage

Section 6055 requires all persons providing minimum essential coverage to file annual information returns with the IRS reporting information about the coverage and about each covered individual, including each covered individual's TIN and months of coverage, and to furnish a statement to the taxpayer. This reporting allows taxpayers to establish and the IRS to verify that individuals have minimum essential coverage.

Under § 1.6055–1(c)(1)(i), (c)(3)(ii), and (d)(1) of the Income Tax Regulations, health insurance issuers or carriers must report on most insured minimum essential coverage. However, under § 36B(f)(3) and § 1.36B–5, Exchanges must report information on coverage in individual market qualified health plans enrolled in through an Exchange, including each covered individual's SSN and months of coverage, and must furnish a statement to a taxpayer. Because Exchange reporting under § 36B(f)(3) includes the information reported and furnished under § 6055, regulations provide that health insurance issuers are not required to report on coverage in individual market qualified health plans enrolled in through an Exchange. See § 1.6055–1(d).

If a group health plan is self-insured, the plan sponsor (generally the employer) must report the coverage for all covered individuals. See § 1.6055–1(c)(1)(ii) and (c)(2).

Section 1.6055–1(c)(1)(iii) requires that the executive department or agency of a government unit that provides coverage under a government-sponsored program must file the information return under § 6055. Section 1.6055–1(c)(3)(i) provides that the state agency that administers the Medicaid program under Title XIX of the Social Security Act or the CHIP program under Title XXI of the Social Security Act, must report the coverage under § 6055.

Employer's EIN

Section 6055(b) and § 1.6055–1(e) require that health insurance issuers and carriers reporting coverage under insured group health plans report information about the employer sponsoring the plan, including the employer's EIN, to the IRS. Section 6055(c) and § 1.6055–1(g) require that health insurance issuers and carriers reporting information to the IRS furnish a statement to a taxpayer providing information about the filer and the covered individuals. Section 301.6109–4(a)(1) of the Procedure and Administration Regulations provides that the TIN of a person other than the filer, including an EIN, may be truncated on statements furnished to taxpayers, unless otherwise prohibited by statute or regulations. Section 1.6055–1(g)(3) allows filers to truncate the TINs of individuals identified on the statement, but does not address the use of a TTIN for the employer.

Expatriate health plans

Section 1.6055–2 allows filers of information returns under § 6055 to furnish a statement to an individual in electronic format only if the individual affirmatively consents. However, under § 3(b)(2) of the Expatriate Health Coverage Clarification Act of 2014, Division M of the Consolidated and Further Continuing Appropriations Act, 2015, Public Law 113–235 (EHCCA), a recipient of the Form 1095–B reporting minimum essential coverage under an expatriate health plan (defined in EHCCA § 3(d)(2)) is deemed to consent to delivery in electronic format unless the recipient explicitly refuses consent.

Supplemental coverage

To ensure that the IRS receives a report for every individual with minimum essential coverage, every provider of minimum essential coverage generally must report information for every covered individual. However, § 1.6055–1(d)(2) provides that reporting is not required for minimum essential coverage that supplements or provides benefits in addition to other minimum essential coverage if (1) the primary and supplemental coverage have the same plan sponsor, or (2) the coverage supplements government-sponsored coverage such as Medicare.

TIN solicitation and penalties

Information reporting under § 6055 is subject to the penalty provisions of §§ 6721 and 6722 for failure to file a correct information return or to furnish a correct statement. See § 1.6055–1(h). Penalties may be waived under § 6724(a) if the failure is due to reasonable cause and not willful neglect; that is, if a reporting entity demonstrates that it acted in a responsible manner and that the failure is due to significant mitigating factors or events beyond the reporting entity's control. See § 301.6724–1(a)(1). Under § 301.6724–1(e), a reporting entity acts in a responsible manner in soliciting a TIN if the reporting entity makes (1) an initial solicitation when an account is opened or a relationship is established, (2) a first annual solicitation by December 31 of the year the account is opened (or January 31 if the account is opened in December), and (3) a second annual solicitation by December 31 of the following year.

Basic Health Program

Section 1331 of the Affordable Care Act allows states to establish a Basic Health Program, which provides an additional option to provide health coverage to certain individuals not eligible for Medicaid. See 42 CFR Part 600. The Basic Health Program is designated as minimum essential coverage under 42 CFR 600.5.

GUIDANCE

1. *Anticipated regulations*

a. *Coverage in catastrophic health plans*

Section 1302(e) of the Affordable Care Act provides for catastrophic health plans. These plans are minimum essential coverage and qualified health plans, may be offered only in the individual market, and may be enrolled in through an Exchange, but taxpayers may not claim the premium tax credit for this coverage. See § 36B(c)(3)(A).

For purposes of reporting by Exchanges under § 36B(f)(3) on coverage in a qualified health plan, the term qualified health plan has the same meaning as in § 1301(a) of the Affordable Care Act except that it does not include a catastrophic plan described in § 1302(e) of the Affordable Care Act. Section 1.36B–1(c). Accordingly, Exchanges do not report on catastrophic coverage. Section 1.36B–1(c), –5(a). The § 6055 regulations, however, provide that health insurance issuers need not report on coverage in a qualified health plan in the individual market enrolled in through an Exchange, because that information is generally reported by Exchanges under § 36B(f)(3). As a result, at present neither the Exchanges nor health insurance issuers have the responsibility for reporting minimum essential coverage under a catastrophic plan.

To ensure that there is reporting of catastrophic health plans enrolled in through an Exchange, the Treasury Department and the IRS intend to propose regulations under § 6055 requiring issuers of these plans to report the coverage on Form 1095–B. The Treasury Department and the IRS anticipate that the regulations will apply to coverage in 2016 and to returns and statements filed and furnished in 2017. Health insurance issuers may report on 2015 catastrophic coverage (on returns and statements filed and furnished in 2016) and are encouraged to do so. An issuer that reports on 2015 catastrophic coverage will not be subject to penalties for these returns.

b. *Employer's EIN*

The Treasury Department and the IRS anticipate publishing regulations under § 6055 to clarify that health insurance issuers and carriers reporting on insured group health plans may use the TTIN of the employer sponsoring the plan on the statement furnished to the taxpayer.

c. *Statements to individuals covered by expatriate healthplans*

Proposed § 6055 regulations also will provide that statements reporting coverage under an expatriate healthplan may be furnished in electronic format unless the recipient affirmatively refuses consent or requests a paper statement. Reporting entities may apply these rules for coverage under expatriate health plans that are issued or renewed on or after July 1, 2015, and may rely on Notice 2015–43, 2015–29 I.R.B. 73, which addresses the definition of "expatriate health plans" and provides transition relief.

d. *Supplemental coverage*

The supplemental coverage rule in § 1.6055–1(d)(2) is intended to eliminate duplicate reporting of an individual's minimum essential coverage under circumstances when there is reasonable certainty that the provider of the "primary" coverage will report. This rule has proven to be confusing. Accordingly, the Treasury Department and the IRS anticipate proposing regulations that would replace this rule with rules providing that (1) if an individual is covered by multiple minimum essential coverage plans or programs provided by the same provider, reporting is required for only one of them; and (2) reporting generally is not required for an individual's minimum essential coverage for which an individual is eligible only if the individual is covered by other minimum essential coverage for which § 6055 reporting is required.

These rules would apply month by month and individual by individual. Thus, under the first rule (that is, the rule for reporting multiple minimum essential coverage plans or programs of the same provider), if for a month an individual is enrolled in a self-insured group health plan and also has a self-insured health reimbursement arrangement (HRA) from the same employer, the provider (the employer) is required to report only one type of coverage for that individual. If an employee is covered under both arrangements for some months of the year but retires or otherwise drops coverage under the non-HRA group health plan and is covered only under the HRA, the employer must report coverage under the HRA for the months after the employee retires or drops the non-HRA coverage. The employer must report the coverage in an arrangement of any individual who is covered by only one arrangement.

Under the second rule (that is, the rule for reporting minimum essential coverage for which an individual is eligible only if the individual is covered by other minimum essential coverage), reporting would not be required for Medicare or TRICARE supplements and Medicaid coverage providing benefits only to an individual enrolled in other coverage for which reporting is required, such as employer coverage or a qualified health plan. Reporting also would not be required under the second rule for an HRA that is available only to employees and other individuals who enroll in an employer's insured group health plan for months that the individual is enrolled in the insured group health plan. It is anticipated that, for employer coverage, this rule will apply only if the two types of coverage are eligible employer-sponsored coverage of the same employer. For example, if an employee is enrolled in both his employer's HRA and insured group health plan, the employer is not required to report the employee's coverage under the HRA. However, if an employee is enrolled in an employer's HRA and in a spouse's non-HRA group health plan, the employee's employer would be required to report for the HRA, and the employee's spouse's employer (or the health insurance issuer or carrier, if the plan is insured) would be required to report for the non-HRA group health plan coverage.

2. *Other guidance*

a. *Relief from penalties for reasonable cause*

A reporting entity that fails to comply with the filing and statement furnishing requirements of § 6055 may be subject to penalties for failure to file a correct information return (§ 6721) or to furnish a correct payee statement (§ 6722). The preamble to the § 6055 regulations (T.D. 9660, 79 FR 13220) provides short-term relief from reporting penalties for 2015 coverage. Specifically, the IRS will not impose penalties under §§ 6721 and 6722 on reporting entities that can show that they have made good faith efforts to comply with the information reporting requirements. This relief applies to incorrect or incomplete information, including TINs or dates of birth, reported on a return or statement.

The preamble to the § 6055 regulations also notes the general rule that, under § 6724 and the related regulations, the §§ 6721 and 6722 penalties may be waived if a failure is due to reasonable cause, that is, the reporting entity demonstrates that it acted in a responsible manner and the failure is due to significant mitigating factors or events beyond the reporting entity's control. Section 301.6724–1(e) provides specific procedures for soliciting TINs which, if followed, establish that a reporting entity that does not report a TIN has acted in a responsible manner.

Nonetheless, reporting entities have expressed concerns that § 6055 reporting has significant differences from other information reporting provisions that are not adequately addressed by the regulations under § 6724 for establishing reasonable cause. For example, reporting entities asserted that the requirements for TIN solicitation under § 301.6724–1(e) are not practical in the context of § 6055 reporting.

The Treasury Department and the IRS request comments on the application of the reasonable good cause rules under § 6724 to § 6055 reporting, and in particular the rules under § 301.6724–1(e) relating to TIN solicitation and reporting. Pending the issuance of additional guidance, reporting entities will not be subject to penalties for failure to report a TIN if they comply with the requirements of § 301.6724–1(e) with the following modifications: (1) the initial solicitation is made at an individual's first enrollment or, if already enrolled on September 17, 2015, the next open season, (2) the second solicitation is made at a reasonable time thereafter, and (3) the third solicitation is made by December 31 of the year following the initial solicitation. Additionally, a reporting entity is not required to solicit a TIN from an individual whose coverage is terminated.

b. *Bona fide residents of U.S. possessions or territories*

The governments of American Samoa, the Commonwealth of the Northern Mariana Islands, Guam, Puerto Rico, and the U.S. Virgin Islands provide Medicaid and CHIP coverage to their eligible residents. Because bona fide residents of U.S. possessions or territories are treated as having minimum essential coverage under § 5000A(f)(4), reporting of Medicaid and CHIP coverage for these taxpayers is not needed for administration of the individual shared responsibility requirement. Therefore, Medicaid and CHIP agencies in U.S. possessions or territories are not required to report that coverage under § 6055.

c. *Basic Health Program*

Section 5000A(f) does not identify the Basic Health Program as a government-sponsored program, but it closely resembles government-sponsored coverage such as Medicaid and CHIP. Accordingly, like Medicaid and CHIP, the state agency that administers the Basic Health Program is the entity that must report that coverage under § 6055.

REQUEST FOR COMMENTS

Comments may be submitted in writing on or before November 16, 2015. Comments should be submitted to Internal Revenue Service, CC:PA:LPD:PR (Notice 2015–68), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044, or electronically to *Notice.Comments@irscounsel.treas.gov*. Please include "Notice 2015–68" in the subject line of any electronic communications. Alternatively, comments may be hand delivered between the hours of 8:00 a.m. and 4:00 p.m. Monday to Friday to CC:PA:LPD:PR (Notice 2015–68), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, D.C. All comments will be available for public inspection and copying.

FURTHER INFORMATION

For further information on this notice, contact Andrew Braden at (202) 317-7006 (not a toll-free number).

Extension of Replacement Period for Livestock Sold on Account of Drought

Notice 2015–69

SECTION 1. PURPOSE

This notice provides guidance regarding an extension of the replacement period under § 1033(e) of the Internal Revenue Code for livestock sold on account of drought in specified counties.

SECTION 2. BACKGROUND

.01 *Nonrecognition of Gain on Involuntary Conversion of Livestock*. Section 1033(a) generally provides for nonrecognition of gain when property is involuntarily converted and replaced with property that is similar or related in service or use. Section 1033(e)(1) provides that a sale or exchange of livestock (other than poultry) held by a taxpayer for draft, breeding, or dairy purposes in excess of the number that would be sold following the taxpayer's usual business practices is treated as an involuntary conversion if the livestock is sold or exchanged solely on account of drought, flood, or other weather-related conditions.

.02 *Replacement Period*. Section 1033(a)(2)(A) generally provides that gain from an involuntary conversion is recognized only to the extent the amount realized on the conversion exceeds the cost of replacement property purchased during the replacement period. If a sale or exchange of livestock is treated as an involuntary conversion under § 1033(e)(1) and is solely on account of drought, flood, or other weather-related conditions that result in the area being designated as eligible for assistance by the federal government, § 1033(e)(2)(A) provides that the replacement period ends four years after the close of the first taxable year in which any part of the gain from the conversion is realized. Section 1033(e)(2)(B) provides that the Secretary may extend this replacement period on a regional basis for such additional time as the Secretary determines appropriate if the weather-related conditions that resulted in the area being designated as eligible for assistance by the federal government continue for more than three years. Section 1033(e)(2) is effective for any taxable year with respect to which the due date (without regard to extensions) for a taxpayer's return is after December 31, 2002.

SECTION 3. EXTENSION OF REPLACEMENT PERIOD UNDER § 1033(e)(2)(B)

Notice 2006–82, 2006–2 C.B. 529, provides for extensions of the replacement period under § 1033(e)(2)(B). If a sale or exchange of livestock is treated as an involuntary conversion on account of drought and the taxpayer's replacement period is determined under § 1033(e)(2)(A), the replacement period will be extended under § 1033(e)(2)(B) and Notice 2006–82 until the end of the taxpayer's first taxable year ending after the first drought-free year for the applicable region. For this purpose, the first drought-free year for the applicable region is the first 12-month period that (1) ends August 31; (2) ends in or after the last year of the taxpayer's 4-year replacement period determined under § 1033(e)(2)(A); and (3) does not include any weekly period for which exceptional, extreme, or severe drought is reported for any location in the applicable region. The applicable region is the county that experienced the drought conditions on account of which the livestock was sold or exchanged and all counties that are contiguous to that county.

A taxpayer may determine whether exceptional, extreme, or severe drought is reported for any location in the applicable region by reference to U.S. Drought Monitor maps that are produced on a weekly basis by the National Drought Mitigation Center. U.S. Drought Monitor maps are archived at *http://droughtmonitor.unl.edu/MapsAndData/MapArchive.aspx*.

In addition, Notice 2006–82 provides that the Internal Revenue Service will publish in September of each year a list of counties, boroughs, cities, parishes, or municipalities (hereinafter "counties") for which exceptional, extreme, or severe drought was reported during the preceding 12 months. Taxpayers may use this list instead of U.S. Drought Monitor maps to determine whether exceptional, extreme, or severe drought has been reported for any location in the applicable region.

The Appendix to this notice contains the list of counties for which exceptional, extreme, or severe drought was reported during the 12-month period ending August 31, 2015. Under Notice 2006–82, the 12-month period ending on August 31, 2015, is not a drought-free year for an applicable region that includes any county on this list. Accordingly, for a taxpayer who qualified for a four-year replacement period for livestock sold or exchanged on account of drought and whose replacement period is scheduled to expire at the end of 2015 (or, in the case of a fiscal year taxpayer, at the end of the taxable year that includes August 31, 2015), the replacement period will be extended under § 1033(e)(2) and Notice 2006–82 if the applicable region includes any county on this list. This extension will continue until the end of the taxpayer's first taxable year ending after a drought-free year for the applicable region.

SECTION 4. DRAFTING INFORMATION

The principal author of this notice is Andrew Braden of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice contact Mr. Braden at (202) 317-4725 (not a toll-free number).

APPENDIX

Alabama

Counties of Autauga, Baldwin, Barbour, Bibb, Blount, Bullock, Butler, Calhoun, Chambers, Cherokee, Chilton, Choctaw, Clarke, Clay, Cleburne, Coffee, Colbert, Conecuh, Coosa, Covington, Crenshaw, Cullman, Dale, Dallas, DeKalb, Elmore, Escambia, Etowah, Fayette, Franklin, Geneva, Greene, Hale, Henry, Houston, Jefferson, Lamar, Lawrence, Lee, Lowndes, Macon, Marengo, Marion, Marshall, Mobile, Monroe, Montgomery, Morgan, Perry, Pickens, Pike, Randolph, Russell, Saint Clair, Shelby, Sumter, Talladega, Tallapoosa, Tuscaloosa, Walker, Washington, Wilcox, Winston.

Alaska

Boroughs of Denali, Fairbanks North Star, Juneau, Kenai Peninsula, Ketchikan Gateway, Matanuska-Susitna, Sitka. Cities of Juneau and Sitka. Census Areas of Bethel, Prince of Wales-Outer Ketchikan, Skagway-Hoonah-Angoon, Southeast Fairbanks, Valdez-Cordova, Wrangell-Petersburg, Yukon-Koyukuk. Municipality of Anchorage.

Arizona

Counties of Apache, Cochise, Coconino, Gila, Graham, Greenlee, La Paz, Maricopa, Mohave, Navajo, Pima, Pinal, Santa Cruz, Yavapai, Yuma.

Arkansas

Counties of Arkansas, Ashley, Benton, Boone, Bradley, Calhoun, Chicot, Clay, Cleburne, Cleveland, Columbia, Craighead, Crawford, Crittenden, Cross, Desha, Drew, Faulkner, Garland, Grant, Greene, Hempstead, Hot Spring, Independence, Izard, Jackson, Jefferson, Lafayette, Lawrence, Lee, Lincoln, Little River, Lonoke, Madison, Marion, Miller, Mississippi, Monroe, Nevada, Ouachita, Perry, Phillips, Poinsett, Polk, Prairie, Pulaski, Randolph, Saint Francis, Saline, Sevier, Sharp, Stone, Union, Washington, White, Woodruff.

California

Counties of Alameda, Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Fresno, Glenn, Humboldt, Imperial, Inyo, Kern, Kings, Lake, Lassen, Los Angeles, Madera, Marin, Mariposa, Mendocino, Merced, Modoc, Mono, Monterey, Napa, Nevada, Orange, Placer, Plumas, Riverside, Sacramento, San Benito, San Bernardino, San Diego, San Francisco, San Joaquin, San

Luis Obispo, San Mateo, Santa Barbara, Santa Clara, Santa Cruz, Shasta, Sierra, Siskiyou, Solano, Sonoma, Stanislaus, Sutter, Tehama, Trinity, Tulare, Tuolumne, Ventura, Yolo, Yuba.

Colorado

Counties of Alamosa, Archuleta, Baca, Bent, Cheyenne, Conejos, Costilla, Crowley, Delta, Dolores, Eagle, El Paso, Garfield, Grand, Gunnison, Hinsdale, Huerfano, Jackson, Kiowa, Kit Carson, La Plata, Las Animas, Lincoln, Mesa, Mineral, Moffat, Montezuma, Montrose, Otero, Ouray, Pitkin, Prowers, Pueblo, Rio Blanco, Rio Grande, Routt, Saguache, San Juan, San Miguel.

Connecticut

Counties of Fairfield, Hartford, Litchfield, Middlesex, New Haven, New London, Tolland, Windham.

Florida

Counties of Baker, Bradford, Brevard, Broward, Clay, Collier, Columbia, Duval, Escambia, Franklin, Gadsden, Glades, Hamilton, Hendry, Holmes, Indian River, Jackson, Jefferson, Leon, Liberty, Madison, Martin, Miami-Dade, Monroe, Nassau, Okaloosa, Okeechobee, Palm Beach, Saint Johns, Saint Lucie, Santa Rosa, Suwannee, Taylor, Union, Wakulla, Walton, Washington.

Georgia

Counties of Appling, Atkinson, Bacon, Baker, Baldwin, Bartow, Ben Hill, Berrien, Bibb, Bleckley, Brantley, Brooks, Bryan, Bulloch, Burke, Butts, Calhoun, Camden, Candler, Carroll, Charlton, Chattahoochee, Chattooga, Cherokee, Clay, Clinch, Cobb, Coffee, Colquitt, Columbia, Cook, Coweta, Crawford, Crisp, Dade, Decatur, Dodge, Dooly, Dougherty, Early, Echols, Effingham, Emanuel, Evans, Fayette, Floyd, Glascock, Glynn, Grady, Greene, Hancock, Haralson, Harris, Heard, Henry, Houston, Irwin, Jasper, Jeff Davis, Jefferson, Jenkins, Johnson, Jones, Lamar, Lanier, Laurens, Lee, Liberty, Lowndes, Macon, Marion, McDuffie, McIntosh, Meriwether, Miller, Mitchell, Monroe, Montgomery, Morgan, Muscogee, Newton, Paulding, Peach, Pickens, Pierce, Pike, Polk, Pulaski, Putnam, Quitman, Randolph, Richmond, Screven, Seminole, Spalding, Stewart, Sumter, Talbot, Taliaferro, Taylor, Telfair, Terrell, Thomas, Tift, Toombs, Treutlen, Troup, Turner, Twiggs, Upson, Walker, Ware, Warren, Washington, Wayne, Webster, Wheeler, Wilcox, Wilkinson, Worth.

Hawaii

Counties of Hawaii, Honolulu, Kalawao, Kauai, Maui.

Idaho

Counties of Ada, Adams, Bannock, Bear Lake, Benewah, Bingham, Blaine, Boise, Bonner, Bonneville, Boundary, Butte, Camas, Canyon, Caribou, Cassia, Clark, Clearwater, Custer, Elmore, Franklin, Fremont, Gem, Gooding, Idaho, Jefferson, Jerome, Kootenai, Latah, Lemhi, Lewis, Lincoln, Madison, Minidoka, Nez Perce, Oneida, Owyhee, Payette, Power, Shoshone, Teton, Twin Falls, Valley, Washington.

Illinois

Counties of Alexander, Jo Daviess, Massac, Pope.

Indiana

Counties of Bartholomew, Clark, Crawford, Dearborn, Decatur, Dubois, Floyd, Harrison, Jackson, Jefferson, Jennings, Lawrence, Ohio, Orange, Perry, Ripley, Scott, Spencer, Switzerland, Warrick, Washington.

Iowa

Counties of Allamakee, Dickinson, Dubuque, Emmet, Lyon, Osceola, Plymouth, Sioux, Woodbury.

Kansas

Counties of Allen, Anderson, Barber, Barton, Bourbon, Brown, Butler, Chase, Chautauqua, Cherokee, Cheyenne, Clark, Clay, Cloud, Coffey, Comanche, Cowley, Crawford, Decatur, Dickinson, Douglas, Edwards, Elk, Ellis, Ellsworth, Finney, Ford, Franklin, Geary, Gove, Graham, Grant, Gray, Greeley, Greenwood, Hamilton, Harper, Harvey, Haskell, Hodgeman, Jackson, Jewell, Kearny, Kingman, Kiowa, Labette, Lane, Lincoln, Linn, Logan, Lyon, Marion, Marshall, McPherson, Meade, Mitchell, Montgomery, Morris, Morton, Nemaha, Neosho, Ness, Norton, Osage, Osborne, Ottawa, Pawnee, Phillips, Pottawatomie, Pratt, Rawlins, Reno, Republic, Rice, Riley, Rooks, Rush, Russell, Saline, Scott, Sedgwick, Seward, Shawnee, Sheridan, Sherman, Smith, Stafford, Stanton, Stevens, Sumner, Thomas, Trego, Wabaunsee, Wallace, Washington, Wichita, Wilson, Woodson.

Kentucky

Counties of Allen, Anderson, Ballard, Barren, Bath, Bell, Boone, Bourbon, Boyd, Boyle, Bracken, Breathitt, Breckinridge, Bullitt, Butler, Caldwell, Calloway, Campbell, Carlisle, Carroll, Carter, Casey, Christian, Clark, Clay, Crittenden, Daviess, Edmonson, Elliott, Estill, Fayette, Fleming, Floyd, Franklin, Fulton, Gallatin, Garrard, Grant, Graves, Grayson, Green, Hancock, Hardin, Harlan, Harrison, Hart, Henry, Hickman, Hopkins, Jackson, Jefferson, Jessamine, Johnson, Kenton, Knott, Knox, Larue, Lawrence, Lee, Leslie, Letcher, Lincoln, Livingston, Logan, Lyon, Madison, Magoffin, Marion, Marshall, Martin, Mason, McCracken, McLean, Meade, Menifee, Mercer, Metcalfe, Montgomery, Morgan, Muhlenberg, Nelson, Nicholas, Ohio, Oldham, Owen, Owsley, Pendleton, Perry, Pike, Powell, Robertson, Rockcastle, Rowan, Scott, Shelby, Simpson, Spencer, Taylor, Todd, Trigg, Trimble, Warren, Washington, Webster, Wolfe, Woodford.

Louisiana

Parishes of Acadia, Allen, Ascension, Assumption, Avoyelles, Beauregard, Bienville, Bossier, Caddo, Calcasieu, Caldwell, Cameron, Catahoula, Claiborne, Concordia, De Soto, East Baton Rouge, East Feliciana, Evangeline, Franklin, Grant, Iberia, Iberville, Jackson, Jefferson Davis, Jefferson, La Salle, Lafayette, Lafourche, Lincoln, Livingston, Madison, Morehouse, Natchitoches, Orleans, Ouachita, Plaquemines, Pointe Coupee, Rapides, Red River, Richland, Sabine, Saint Bernard, Saint Charles, Saint Helena, Saint James, Saint John the

Baptist, Saint Landry, Saint Martin, Saint Mary, Saint Tammany, Tangipahoa, Terrebonne, Union, Vermilion, Vernon, Washington, Webster, West Baton Rouge, West Carroll, West Feliciana, Winn.

Maine

Counties of Androscoggin, Cumberland, Lincoln, Oxford, Sagadahoc, York.

Massachusetts

Counties of Barnstable, Berkshire, Bristol, Dukes, Essex, Franklin, Hampden, Hampshire, Middlesex, Nantucket, Norfolk, Plymouth, Suffolk, Worcester.

Michigan

Counties of Gogebic, Keweenaw.

Minnesota

Counties of Aitkin, Anoka, Becker, Beltrami, Benton, Big Stone, Blue Earth, Brown, Carlton, Carver, Cass, Chippewa, Chisago, Clay, Clearwater, Cook, Cottonwood, Crow Wing, Dakota, Dodge, Douglas, Faribault, Freeborn, Goodhue, Grant, Hennepin, Hubbard, Isanti, Itasca, Jackson, Kanabec, Kandiyohi, Kittson, Koochiching, Lac qui Parle, Lake, Lake of the Woods, Le Sueur, Lincoln, Lyon, Mahnomen, Marshall, Martin, McLeod, Meeker, Mille Lacs, Morrison, Murray, Nicollet, Nobles, Norman, Olmsted, Otter Tail, Pennington, Pine, Pipestone, Polk, Pope, Ramsey, Red Lake, Redwood, Renville, Rice, Rock, Roseau, Saint Louis, Scott, Sherburne, Sibley, Stearns, Steele, Stevens, Swift, Todd, Traverse, Wabasha, Wadena, Waseca, Washington, Watonwan, Wilkin, Wright, Yellow Medicine.

Mississippi

Counties of Adams, Amite, Attala, Benton, Bolivar, Carroll, Claiborne, Clarke, Clay, Coahoma, Copiah, Covington, DeSoto, Forrest, Franklin, George, Greene, Hancock, Harrison, Hinds, Holmes, Humphreys, Issaquena, Jackson, Jasper, Jefferson, Jefferson Davis, Jones, Kemper, Lamar, Lauderdale, Lawrence, Leake, Leflore, Lincoln, Lowndes, Madison, Marion, Marshall, Neshoba, Newton, Noxubee, Pearl River, Perry, Pike, Rankin, Scott, Sharkey, Simpson, Smith, Stone, Sunflower, Tallahatchie, Tate, Tunica, Walthall, Warren, Washington, Wayne, Wilkinson, Yazoo.

Missouri

Counties of Barton, Camden, Cedar, Christian, Dade, Dallas, Douglas, Dunklin, Greene, Hickory, Jasper, Laclede, Lawrence, McDonald, Mississippi, New Madrid, Newton, Ozark, Pemiscot, Polk, Pulaski, Stone, Taney, Vernon, Webster, Wright.

Montana

Counties of Beaverhead, Blaine, Broadwater, Cascade, Chouteau, Deer Lodge, Flathead, Gallatin, Glacier, Granite, Hill, Jefferson, Lake, Lewis and Clark, Liberty, Lincoln, Madison, Meagher, Mineral, Missoula, Park, Phillips, Pondera, Powell, Ravalli, Sanders, Silver Bow, Teton, Toole, Valley.

Nebraska

Counties of Adams, Antelope, Boone, Boyd, Brown, Buffalo, Cedar, Chase, Cherry, Custer, Dakota, Dawson, Dixon, Dundy, Franklin, Frontier, Furnas, Gage, Gosper, Greeley, Hall, Hamilton, Harlan, Hayes, Hitchcock, Holt, Howard, Jefferson, Johnson, Kearney, Keya Paha, Knox, Lancaster, Lincoln, Madison, Merrick, Nance, Nemaha, Nuckolls, Otoe, Pawnee, Perkins, Phelps, Pierce, Platte, Red Willow, Richardson, Rock, Sherman, Valley, Wayne, Webster, Wheeler.

Nevada

Carson City. Counties of Churchill, Clark, Douglas, Elko, Esmeralda, Eureka, Humboldt, Lander, Lincoln, Lyon, Mineral, Nye, Pershing, Storey, Washoe, White Pine.

New Hampshire

Counties of Belknap, Carroll, Cheshire, Grafton, Hillsborough, Merrimack, Rockingham, Strafford, Sullivan.

New Jersey

Counties of Bergen, Essex, Hudson, Hunterdon, Mercer, Middlesex, Monmouth, Morris, Passaic, Somerset, Sussex, Union, Warren.

New Mexico

Counties of Bernalillo, Catron, Chaves, Cibola, Colfax, Curry, DeBaca, Dona Ana, Eddy, Grant, Guadalupe, Harding, Hidalgo, Lea, Los Alamos, Luna, McKinley, Mora, Otero, Quay, Rio Arriba, Roosevelt, San Juan, San Miguel, Sandoval, Santa Fe, Sierra, Socorro, Taos, Torrance, Union, Valencia.

New York

Counties of Albany, Bronx, Clinton, Columbia, Delaware, Dutchess, Franklin, Fulton, Greene, Hamilton, Herkimer, Jefferson, Kings, Lewis, Montgomery, Nassau, New York, Orange, Oswego, Putnam, Queens, Rensselaer, Richmond, Rockland, Saint Lawrence, Saratoga, Schenectady, Schoharie, Suffolk, Sullivan, Ulster, Warren, Washington, Westchester.

North Carolina

Counties of Alamance, Alexander, Anson, Avery, Bertie, Buncombe, Burke, Cabarrus, Caldwell, Caswell, Catawba, Chatham, Cleveland, Cumberland, Davidson, Davie, Duplin, Durham, Edgecombe, Forsyth, Franklin, Gaston, Granville, Greene, Guilford, Halifax, Harnett, Haywood, Henderson, Iredell, Jackson, Johnston, Lincoln, Macon, Madison, Martin, McDowell, Mecklenburg, Mitchell, Nash, Northampton, Orange, Person, Pitt, Polk, Rockingham, Rowan, Rutherford, Sampson, Stanly, Stokes, Surry, Swain, Transylvania, Union, Vance, Wake, Warren, Watauga, Wayne, Wilkes, Wilson, Yadkin, Yancey.

North Dakota

Counties of Barnes, Benson, Cass, Cavalier, Dickey, Eddy, Emmons, Foster, Grand Forks, Griggs, LaMoure, Logan, McIntosh, Nelson, Pembina, Ramsey, Ransom, Richland, Sargent, Steele, Stutsman, Traill, Walsh.

Ohio

Counties of Adams, Brown, Clermont, Hamilton, Highland.

Oklahoma

Counties of Adair, Alfalfa, Atoka, Beaver, Beckham, Blaine, Bryan, Caddo, Canadian, Carter, Cherokee, Choctaw, Cimarron, Cleveland, Coal, Comanche, Cotton, Craig, Creek, Custer, Delaware, Dewey, Ellis, Garfield, Garvin, Grady, Grant, Greer, Harmon, Harper, Hughes, Jackson, Jefferson, Johnston, Kay, Kingfisher, Kiowa, Latimer, Le Flore, Lincoln, Logan, Love, Major, Marshall, Mayes, McClain, McCurtain, Murray, Muskogee, Noble, Nowata, Okfuskee, Oklahoma, Okmulgee, Osage, Ottawa, Pawnee, Payne, Pittsburg, Pontotoc, Pottawatomie, Pushmataha, Roger Mills, Rogers, Seminole, Sequoyah, Stephens, Texas, Tillman, Tulsa, Wagoner, Washington, Washita, Woods, Woodward.

Oregon

Counties of Baker, Benton, Clackamas, Clatsop, Columbia, Coos, Crook, Curry, Deschutes, Douglas, Gilliam, Grant, Harney, Hood River, Jackson, Jefferson, Josephine, Klamath, Lake, Lane, Lincoln, Linn, Malheur, Marion, Morrow, Multnomah, Polk, Sherman, Tillamook, Umatilla, Union, Wallowa, Wasco, Washington, Wheeler, Yamhill.

Pennsylvania

Counties of Berks, Bucks, Carbon, Chester, Lancaster, Lehigh, Luzerne, Monroe, Montgomery, Northampton, Pike, Schuylkill, Wayne.

Puerto Rico

Municipalities (Municipios) of Aguas Buenas, Aibonito, Arecibo, Arroyo, Barceloneta, Barranquitas, Bayamon, Cabo Rojo, Caguas, Canovanas, Carolina, Catano, Cayey, Ceiba, Ciales, Cidra, Coamo, Comerio, Corozal, Culebra, Dorado, Fajardo, Florida, Guayama, Guayanilla, Guaynabo, Gurabo, Hatillo, Hormigueros, Humacao, Jayuya, Juana Diaz, Juncos, Las Piedras, Loiza, Luquillo, Manati, Maunabo, Mayaguez, Morovis, Naguabo, Naranjito, Orocovis, Patillas, Penuelas, Ponce, Rio Grande, Salinas, San German, San Juan, San Lorenzo, Santa Isabel, Toa Alta, Toa Baja, Trujillo Alto, Utuado, Vega Alta, Vega Baja, Vieques, Villalba, Yabucoa, Yauco.

Rhode Island

Counties of Bristol, Kent, Newport, Providence, Washington.

South Carolina

Counties of Aiken, Allendale, Bamberg, Barnwell, Beaufort, Berkeley, Calhoun, Cherokee, Chester, Chesterfield, Clarendon, Colleton, Darlington, Dillon, Dorchester, Edgefield, Fairfield, Florence, Georgetown, Greenville, Hampton, Horry, Jasper, Kershaw, Lancaster, Laurens, Lee, Lexington, Marion, McCormick, Newberry, Oconee, Orangeburg, Pickens, Richland, Saluda, Spartanburg, Sumter, Union, Williamsburg, York.

South Dakota

Counties of Aurora, Beadle, Bon Homme, Brookings, Brown, Brule, Buffalo, Butte, Campbell, Charles Mix, Clark, Clay, Codington, Corson, Custer, Davison, Day, Deuel, Dewey, Douglas, Edmunds, Faulk, Grant, Gregory, Haakon, Hamlin, Hand, Hanson, Harding, Hughes, Hutchinson, Hyde, Jackson, Jerauld, Jones, Kingsbury, Lake, Lincoln, Lyman, Marshall, McCook, McPherson, Meade, Mellette, Miner, Minnehaha, Moody, Pennington, Perkins, Potter, Roberts, Sanborn, Shannon, Spink, Stanley, Sully, Todd, Tripp, Turner, Union, Walworth, Yankton, Ziebach.

Tennessee

Counties of Anderson, Benton, Blount, Campbell, Carroll, Cheatham, Chester, Claiborne, Cocke, Crockett, Davidson, Decatur, Dickson, Dyer, Fayette, Gibson, Grainger, Greene, Hamblen, Hancock, Hardeman, Hardin, Hawkins, Haywood, Henderson, Henry, Houston, Humphreys, Jefferson, Knox, Lake, Lauderdale, Loudon, Madison, McNairy, Monroe, Montgomery, Morgan, Obion, Perry, Roane, Robertson, Sevier, Shelby, Stewart, Sullivan, Sumner, Tipton, Union, Washington, Weakley.

Texas

Counties of Anderson, Andrews, Angelina, Aransas, Archer, Armstrong, Atascosa, Austin, Bailey, Bandera, Bastrop, Baylor, Bee, Bell, Bexar, Blanco, Borden, Bosque, Bowie, Brazoria, Brazos, Brewster, Briscoe, Brooks, Brown, Burleson, Burnet, Caldwell, Calhoun, Callahan, Cameron, Camp, Carson, Cass, Castro, Chambers, Cherokee, Childress, Clay, Cochran, Coke, Coleman, Collin, Collingsworth, Colorado, Comal, Comanche, Concho, Cooke, Coryell, Cottle, Crane, Crockett, Crosby, Dallam, Dallas, Dawson, Deaf Smith, Delta, Denton, DeWitt, Dickens, Dimmit, Donley, Eastland, Ector, Edwards, El Paso, Ellis, Erath, Falls, Fannin, Fayette, Fisher, Floyd, Foard, Fort Bend, Franklin, Freestone, Frio, Gaines, Galveston, Garza, Gillespie, Glasscock, Goliad, Gonzales, Gray, Grayson, Gregg, Grimes, Guadalupe, Hale, Hall, Hamilton, Hansford, Hardeman, Hardin, Harris, Harrison, Hartley, Haskell, Hays, Hemphill, Henderson, Hidalgo, Hill, Hockley, Hood, Hopkins, Houston, Howard, Hudspeth, Hunt, Hutchinson, Jack, Jackson, Jasper, Jeff Davis, Jefferson, Jim Hogg, Jim Wells, Johnson, Jones, Karnes, Kaufman, Kendall, Kenedy, Kent, Kerr, Kimble, King, Kinney, Kleberg, Knox, La Salle, Lamar, Lamb, Lampasas, Lavaca, Lee, Leon, Liberty, Limestone, Lipscomb, Live Oak, Llano, Loving, Lubbock, Lynn, Madison, Marion, Martin, Mason, Matagorda, Maverick, McCulloch, McLennan, McMullen, Medina, Menard, Midland, Milam, Mills, Mitchell, Montague, Montgomery, Moore, Morris, Motley, Nacogdoches, Navarro, Newton, Nolan, Nueces, Ochiltree, Oldham, Orange, Palo Pinto, Panola, Parker, Parmer, Pecos, Polk, Potter, Presidio, Rains, Randall, Reagan, Real, Red River, Reeves, Refugio, Roberts, Robertson, Rockwall, Runnels, Rusk, Sabine, San Augustine, San Jacinto, San Patricio, San Saba, Schleicher, Scurry, Shackelford, Shelby, Sherman, Smith, Somervell, Starr, Stephens, Sterling, Stonewall, Sutton, Swisher, Tarrant, Taylor, Terrell, Terry, Throckmorton, Titus, Tom Green, Travis, Trinity, Tyler, Upshur, Upton, Uvalde, Val Verde, Van Zandt, Victoria, Walker, Waller, Ward, Washington, Webb, Wharton, Wheeler, Wichita, Wilbarger, Willacy, Williamson, Wilson, Winkler, Wise, Wood, Yoakum, Young, Zapata, Zavala.

Utah

Counties of Beaver, Box Elder, Cache, Carbon, Daggett, Davis, Duchesne, Emery, Garfield, Grand, Iron, Juab, Kane, Millard, Morgan, Piute, Rich, Salt Lake, San Juan, Sanpete, Sevier, Summit, Tooele, Uintah, Utah, Wasatch, Washington, Wayne, Weber.

Virginia

Norton City. Counties of Buchanan, Dickenson, Lee, Scott, Wise.

Vermont

Counties of Bennington, Orange, Rutland, Windham, Windsor.

Washington

Counties of Adams, Asotin, Benton, Chelan, Clallam, Clark, Columbia, Cowlitz, Douglas, Ferry, Franklin, Garfield, Grant, Grays Harbor, Island, Jefferson, King, Kitsap, Kittitas, Klickitat, Lewis, Lincoln, Mason, Okanogan, Pacific, Pend Oreille, Pierce, San Juan, Skagit, Skamania, Snohomish, Spokane, Stevens, Thurston, Wahkiakum, Walla Walla, Whatcom, Whitman, Yakima.

Wisconsin

Counties of Ashland, Barron, Bayfield, Brown, Buffalo, Burnett, Calumet, Chippewa, Clark, Crawford, Douglas, Dunn, Eau Claire, Fond du Lac, Forest, Grant, Green Lake, Iowa, Iron, Jackson, Juneau, Kewaunee, Lafayette, Langlade, Lincoln, Manitowoc, Marathon, Marquette, Menominee, Oconto, Oneida, Outagamie, Pepin, Pierce, Polk, Portage, Price, Richland, Rusk, Saint Croix, Sauk, Sawyer, Shawano, Sheboygan, Taylor, Trempealeau, Vernon, Vilas, Washburn, Waupaca, Waushara, Winnebago, Wood.

West Virginia

Counties of Boone, Cabell, Kanawha, Lincoln, Logan, McDowell, Mingo, Raleigh, Wayne, Wyoming.

Wyoming

Counties of Carbon, Lincoln, Park, Sublette, Sweetwater, Teton, Uinta.

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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, § 42; 1.42–14.)

Rev. Proc. 2015–49

SECTION 1. PURPOSE

This revenue procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) of the Internal Revenue Code for calendar year 2015.

SECTION 2. BACKGROUND

Rev. Proc. 92–31, 1992–1 C.B. 775, provides guidance to state housing credit agencies of qualified states on the procedure for requesting an allocation of unused housing credit carryovers under § 42(h)(3)(D). Section 4.06 of Rev. Proc. 92–31 provides that the Internal Revenue Service will publish in the Internal Revenue Bulletin the amount of unused housing credit carryovers allocated to qualified states for a calendar year from a national pool of unused credit authority (the National Pool). This revenue procedure publishes these amounts for calendar year 2015.

SECTION 3. PROCEDURE

The unused housing credit carryover amount allocated from the National Pool by the Secretary to each qualified state for calendar year 2015 is as follows:

Qualified State	*Amount Allocated*
California	388,272
Connecticut	35,990
Delaware	9,362
Florida	199,060
Georgia	101,038
Idaho	16,355
Illinois	128,888
Kansas	29,059
Maine	13,309
Maryland	59,802
Massachusetts	67,497
Michigan	99,162
Minnesota	54,607
Nebraska	18,827
New Jersey	89,439
New Mexico	20,869
New York	197,588
North Carolina	99,503
Ohio	116,016
Oklahoma	38,805
Oregon	39,728
Pennsylvania	127,954
Puerto Rico	35,507
South Dakota	8,537
Tennessee	65,535
Texas	269,741
Utah	29,448
Virginia	83,316
Washington	70,660
West Virginia	18,515
Wisconsin	57,612

EFFECTIVE DATE

This revenue procedure is effective for allocations of housing credit dollar amounts attributable to the National Pool component of a qualified state's housing credit ceiling for calendar year 2015.

DRAFTING INFORMATION

The principal author of this revenue procedure is James A. Holmes of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mr. Holmes at (202) 317-4137 (not a toll-free number).

Part IV. Items of General Interest

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

Dividend Equivalents from Sources within the United States

26 CFR Part 1
REG–127895–14
RIN 1545–BM33

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY:

DATES: Written or electronic comments must be received by December 17, 2015. Outlines of topics to be discussed at the public hearing scheduled for January 15, 2016, at 10 a.m. must be received by December 17, 2015.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–127895–14), 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–127895–14), 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–127895–14). 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, D. Peter Merkel or Karen Walny at (202) 317-6938; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing Oluwfunmilayo Taylor at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Final and temporary regulations in the Rules and Regulations section of this issue of the **Internal Revenue Bulletin** contain amendments to the Income Tax Regulations (26 CFR Part 1) which provide rules for determining when a payment made pursuant to certain financial products will be treated as a dividend equivalent for purposes of section 871(m). These proposed regulations provide guidance relating to the substantial equivalence test, which is used to determine whether a complex contract is a section 871(m) transaction. These proposed regulations also provide guidance to qualified derivatives dealers. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the final and temporary regulations explains the temporary regulations and these proposed regulations. The regulations affect nonresident alien individuals, foreign corporations, and withholding agents.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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 comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or upon request.

A public hearing has been scheduled for January 14, 2016, beginning at 10 a.m. in the Auditorium of the 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 an outline of the topics to be discussed and the time to be devoted to each topic by December 17, 2015. Submit a signed paper or electronic copy of the outline as prescribed in this preamble under the "Addresses" heading. 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 authors of these regulations are D. Peter Merkel and Karen Walny of the Office of Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

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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 * * *

§ 1.871–15 also issued under 26 U.S.C. 871(m). * * *

Par. 2. Section 1.871–15 is amended by revising paragraph (c)(2)(vi), paragraph (h), and paragraph (q) to read as follows:

§ 1.871–15 Treatment of dividend equivalents.

* * * * *

(c) * * *

(2) * * *

(iv) [The text of the proposed amendments to § 1.871–15(c)(2)(iv) is the same as the text of § 1.871–15T(c)(2)(iv) published elsewhere in this issue of the **Internal Revenue Bulletin**.]

* * * * *

(h) [The text of the proposed amendments to § 1.871–15(h) is the same as the text of § 1.871–15T(h) published elsewhere in this issue of the **Internal Revenue Bulletin**.]

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(q) [The text of the proposed amendments to § 1.871–15(q) is the same as the text of § 1.871–15T(q) published elsewhere in this issue of the **Internal Revenue Bulletin**.]

Par. 3. Section 1.1441–1 is amended by revising paragraph (e)(3)(ii)(E) and paragraph (e)(6) to read as follows:

§ 1.1441–1 Requirement for the deduction and withholding of tax on payments to foreign persons.

* * * * *

(e) * * *

(3) * * *

(ii) * * *

(E) [The text of the proposed amendments to § 1.1441–1(e)(3)(ii)(E) is the same as the text of § 1.1441–1T(e)(3)(ii)(E) published elsewhere in this issue of the **Internal Revenue Bulletin**.]

* * * * *

(5) [The text of the proposed amendments to § 1.1441–1(e)(5) is the same as the text of § 1.1441–1T(e)(5) published elsewhere in this issue of the **Internal Revenue Bulletin**.]

(6) [The text of the proposed amendments to § 1.1441–1(e)(6) is the same as the text of § 1.1441–1T(e)(6) published elsewhere in this issue of the **Internal Revenue Bulletin**.]

John Dalrymple
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on September 17, 2015, 8:45 a.m., and published in the issue of the Federal Register for September 18, 2015, 80 F.R. 56415)

Notice of proposed rulemaking Substantiation Requirement for Certain Contributions

REG–138344–13

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations to implement the exception to the "contemporaneous written acknowledgement" requirement for substantiating charitable contribution deductions of $250 or more. These proposed regulations provide rules concerning the time and manner for donee organizations to file information returns that report the required information about contributions (donee reporting).

DATES: Written or electronic comments must be received by December 16, 2015.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–138344–13), room 5203, Internal Revenue Service, POB 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–138344–13), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–138344–13).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Robert Basso at (202) 317-7011 (not a toll-free number); concerning comments or a request for a public hearing, Oluwafunmilayo Taylor at (202) 317-6901 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking will be submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by November 16, 2015. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in these proposed regulations is in § 1.170A–13(f)(18) of the Income Tax Regulations. The collection of information is necessary to properly substantiate charitable contribution deductions under the exception to the general requirements for substantiating charitable contribution deductions of $250 or more. The collection of information is required to comply with the provisions of section 170(f)(8)(D) of the Internal Revenue Code (Code). The respondents are entities that receive charitable contributions and donors to such entities. The burden for the collection of information contained in proposed regulation § 1.170A–13(f)(18) will be reflected in the burden estimate for a form that the IRS intends to create to request the information specified in the proposed regulation. Once a draft form is available, comments will be invited via a notice in the Federal Register and on the IRS website.

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.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under Code section 170(f)(8) governing the substantiation of charitable contributions of $250 or more. Section 170(f)(8) was enacted by Section 13172(a) of the Omnibus Budget Reconciliation Act of 1993, Public Law 103–66 (107 Stat. 312, 455 (1993)), effective for contributions made on or after January 1, 1994. Section 1.170A–13(f) provides rules on substantiation of charitable contributions of $250 or more. See TD 8690 (1997–1 CB 68).

Section 170(f)(8)(A) requires a taxpayer who claims a charitable contribution deduction for any contribution of $250 or more to obtain substantiation in the form of a contemporaneous written acknowledgment (CWA) from the donee organization. Under section 170(f)(8)(B), while the CWA need not be in any particular form, it must contain the following information: (1) the amount of cash and a description of any property other than cash contributed; (2) whether any goods and services were provided by the donee organization in consideration for the contribution; and (3) a description and good faith estimate of the value of any goods and services provided by the donee organization or a statement that such goods and services consist solely of intangible religious benefits.

The CWA must also be contemporaneous. Under sections 170(f)(8)(C) and 1.170A–13(f)(3), a CWA is contemporaneous if it is obtained by the taxpayer on or before the earlier of the date the taxpayer files an original return for the taxable year in which the contribution was made or the due date (including extensions) for filing the taxpayer's original return for that year. In the preamble to TD 8690, the Treasury Department and the IRS further emphasized this requirement, noting that "[a] written acknowledgment obtained after a taxpayer files the original return for the year of the contribution is not contemporaneous within the meaning of the statute." TD 8690 (1997–1 CB 68).

Section 170(f)(8)(D) provides an exception to the CWA requirement. Under the exception, a CWA is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the information described in section 170(f)(8)(B). When issuing TD 8690 in 1997, the Treasury Department and the IRS specifically declined to issue regulations under section 170(f)(8)(D) to effectuate donee reporting. The present CWA system works effectively, with minimal burden on donors and donees, and the Treasury Department and the IRS have received few requests since the issuance of TD 8690 to implement a donee reporting system.

In recent years, some taxpayers under examination for their claimed charitable contribution deductions have argued that a failure to comply with the CWA requirements of section 170(f)(8)(A) may be cured if the donee organization files an amended Form 990, "Return of Organization Exempt From Income Tax," that includes the information described in section 170(f)(8)(B) for the contribution at issue. These taxpayers argue that an amended Form 990 constitutes permissible donee reporting within the meaning of section 170(f)(8)(D), even if the amended Form 990 is submitted to the IRS many years after the purported charitable contribution was made. The IRS has consistently maintained that the section 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished. Moreover, the Treasury Department and the IRS have concluded that the Form 990 is unsuitable for donee reporting.

Explanation of Provisions

The framework established by these proposed regulations for donee reporting under the section 170(f)(8)(D) exception is intended to provide for timely reporting, while also minimizing reporting burdens on donees and protecting donor privacy.

Manner of Donee Reporting

The present CWA process requires that the acknowledgement provided to the donor contain information useful in preparing the donor's tax return for the year of the contribution. To effectively substitute for the CWA, any donee reporting process would require not only that an information return be filed with the IRS, but also that a copy be provided to the donor for use in preparing the donor's federal income tax return for the year of the contribution.

In order to better protect donor privacy, the Treasury Department and the IRS have concluded that the Form 990 series should not be used for donee reporting. Instead, before finalization of these proposed regulations, the IRS intends to develop a specific-use information return for donee reporting. Donees are not required to adopt donee reporting. Donees who opt to use donee reporting will be required to provide a copy of the information return to the donor at the address the donor provides for this purpose, and the information return will contain only the information related to that donor. The proposed regulations are reserved on the particular form that will be prescribed for this purpose.

Section 170(f)(8)(D) provides that a donee organization must include the information described in section 170(f)(8)(B) on its return for the donor to qualify for the donee reporting exception. Accordingly, the proposed regulations require that donees who opt to use donee reporting must report that information as well as the donor's name, address, and taxpayer identification number. The donor's taxpayer identification number is necessary in order to properly associate the donation information with the correct donor. Unlike a CWA, which is not sent to the IRS, the donee reporting information return will be sent to the IRS, which must have a means to store, maintain, and readily retrieve the return information for a specific taxpayer if and when substantiation is required in the course of an examination. The Treasury Department and the IRS request comments on the scope of the information necessary to verify substantiation of charitable contribution deductions under donee reporting.

The Treasury Department and the IRS are concerned about the potential risk for identity theft involved with donee reporting given that donees will be collecting donors' taxpayer identification numbers and maintaining those numbers for some period of time. The Treasury Department and the IRS request comments on whether additional guidance is necessary regarding the procedures a donee should use in soliciting and maintaining a donor's taxpayer identification number and address to mitigate the risk.

In order to minimize the burden on donees, the proposed regulations provide that donee reporting is not required, but may be done at the option of a donee organization. If a contribution is not reported using donee reporting, then the donor must obtain a CWA. The Treasury Department and the IRS request comments on these provisions and whether additional guidance is necessary to clarify the requirements for donors and donees if the donee chooses to use donee reporting for some or all of the contributions it receives. Also, because of the potential burden on donee organizations, the Treasury Department and the IRS request comments on how the donee reporting process might be better designed to minimize donee burden, and how it may interact with the requirement under section 6115 to provide donors information regarding quid pro quo contributions.

Time of Donee Reporting

Section 170(f)(8) is premised on donors receiving timely substantiation of their donations of $250 or more. The CWA assists a donor preparing a return (as well as the IRS examining the return) in determining whether, and in what amount, a donor may claim a charitable contribution deduction. H.R. Rept. No. 103–111, at 783, 785 (1993), 1993–3 CB 167, 359, 361; *Viralam v. Commissioner*, 136 T.C. 151, 171 (2011); *Addis v. Commissioner*, 118 T.C. 528, 536 (2002), *aff'd*, 374 F.3d 881 (9th Cir. 2004); *DiDonato v. Commissioner*, T.C. Memo. 2011–153. It would be inconsistent with the purpose of section 170(f)(8) to allow an exception to the CWA requirement of section 170(f)(8)(A) based on information that might be reported by a donee on a return that is filed many years after the purported charitable contribution was made. Rather, any alternative method to using a CWA for substantiating charitable contributions through donee reporting must provide timely information to both the IRS and the donor in order to satisfy the purpose of section 170(f)(8).

Accordingly, the proposed regulations provide that any information return under section 170(f)(8)(D) must be filed by the donee no later than February 28th of the year following the year in which the contribution is made, and the donee organization must provide a copy of the information return to the donor by the same date. An information return that is not filed timely with the IRS, with a copy provided to the donor, will not qualify under section 170(f)(8)(D).

February 28th is the date when numerous other information returns concerning transactions with other persons must be filed. See, for example, § 1.6041–6 (information at source), § 1.6045–1(j) (returns of brokers), and § 1.6049–4(g) (returns regarding payment of interest). The requirement that a donee organization provide a copy of the information return to the donor no later than February 28th of the year following the year in which the contribution is made is intended to provide donors with timely information needed to claim appropriate charitable contribution deductions on their returns, as well as to ensure sound tax administration – objectives that will not be met if donee reporting is allowed to occur long after the contribution was made. In addition, for donors to be relieved of the obligation to obtain a CWA, the donee must file the donee reporting information return, and communicate that it has done so to the donor, before the due date for the donor's return. The Treasury Department and the IRS request comments on the use of February 28th as the due date for filing a return and furnishing a copy to a donor.

Proposed Effective Date

The regulations are proposed to apply to contributions made on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact 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.

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that, to the extent a donee reporting system is implemented under section 170(f)(8)(D), the statute itself specifies the bulk of the information that needs to be collected for purposes of these regulations. The proposed regulations require that, in order for a donor to be relieved of the current CWA requirement, a donee organization that uses donee reporting must file a return with the IRS reporting certain information and must furnish a copy of the return to the donor whose contribution is reported on such return. These regulations provide the content of the return under section 170(f)(8)(D), the time for filing the return, and the requirement to furnish a copy to the donor. Moreover, any burden associated with the collection of information under the proposed regulations is minimized by the fact that donee reporting under the proposed regulations is optional on the part of any donee, including small entities. Donees need not use this donee reporting process and donors can continue to use the current CWA process. Given the effectiveness and minimal burden of the CWA process, it is expected that donee reporting will be used in an extremely low percentage of cases.

Based on these facts, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at *http://www.regulations.gov* or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits 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 regulations are Martin L. Osborne and Robert Basso of the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

* * * * *

Proposed Amendment 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. Section 170A–13 is amended by revising paragraph (f)(18) and adding paragraph (f)(19) to read as follows:

§ 1.170A–13. Recordkeeping and return requirements for deductions for charitable contributions.

* * * * *

(f) * * *

(18) *Donee organization reporting*—(i) *Prescribed form.* [Reserved]

(ii) *Content of return*. A document will not qualify as a return for purposes of section 170(f)(8)(D) unless it contains all of the following information:

(A) The name and address of the donee;

(B) The name and address of the donor;

(C) The taxpayer identification number of the donor;

(D) The amount of cash and a description (but not necessarily the value) of any property other than cash contributed by the donor to the donee;

(E) Whether any goods and services were provided by the donee organization in consideration, in whole or in part, for the contribution by the donor; and

(F) A description and good faith estimate of the value of any goods and services provided by the donee organization or a statement that such goods and services consist solely of intangible religious benefits.

(iii) *Time for filing return*. Every donee organization filing a return described in section 170(f)(8)(D) shall file such return on or before February 28 of the year following the calendar year in which the contribution was made. If the return is not filed timely, the return does not qualify under section 170(f)(8)(D), and section 170(f)(8)(A) through (C) applies to the contribution.

(iv) *Furnishing a copy to donor*. Every donee organization filing a return described in section 170(f)(8)(D) shall furnish a copy of the return to the donor whose contribution is reported on such return on or before February 28 of the year following the calendar year in which the contribution was made. The copy of the return shall be provided to the donor at the address the donor provides for this purpose.

(v) *Donee organization reporting at option of donee*. Donee organization reporting is not required. Donee reporting is available solely at the option of a donee organization, and the requirements of section 170(f)(8)(A) through (C) apply to all contributions that are not reported using donee reporting.

(19) *Effective/applicability date*. Paragraphs (f)(1) through (17) of this section apply to contributions made on or after December 16, 1996. However, taxpayers may rely on the rules of paragraphs (f)(1) through (17) for contributions made on or after January 1, 1994. Paragraph (f)(18) of this section applies to contributions made on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on September 16, 2015, 8:45 a.m., and published in the issue of the Federal Register for September 17, 2015, 80 F.R. 55802)

Notice of proposed rulemaking; notice of proposed rulemaking by cross-reference to temporary regulation

United States Property Held by Controlled Foreign Corporations in Transactions Involving Partnerships; Rents and Royalties Derived in the Active Conduct of a Trade or Business

REG–155164–09

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of proposed rulemaking by cross-reference to temporary regulation.

SUMMARY: This document contains proposed regulations that provide rules regarding the treatment as United States property of property held by a controlled foreign corporation (CFC) in connection with certain transactions involving partnerships. In addition, in the Rules and Regulations section of this issue of the Internal revenue **Internal Revenue Bul-**

letin, the Department of Treasury (Treasury Department) and the IRS are issuing temporary regulations under sections 954 and 956, the text of which also serves as the text of certain provisions of these proposed regulations. The proposed regulations affect United States shareholders of CFCs.

DATES: Written or electronic comments and requests for a public hearing must be received by December 1, 2015.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–155164–09), room 5203, Internal Revenue Service, P.O. 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–155164–09), 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–155164–09).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Rose E. Jenkins, (202) 317-6934; concerning submissions of comments or requests for a public hearing, Regina Johnson, (202) 317-6901 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 956. Section 956 determines the amount that a United States shareholder (as defined in section 951(b)) of a CFC must include in gross income with respect to the CFC under section 951(a)(1)(B). This amount is determined, in part, based on the average amount of United States property held, directly or indirectly, by the CFC at the close of each quarter during its taxable year. For this purpose, in general, the amount taken into account with respect to any United States property is the adjusted basis of the property, reduced by any liability to which the property is subject. See section 956(a) and § 1.956–1(e).

Section 956(e) grants the Secretary authority to prescribe such regulations as may be necessary to carry out the purposes of section 956, including regulations to prevent the avoidance of section 956 through reorganizations or otherwise. In addition, section 956(d) grants the Secretary authority to prescribe regulations pursuant to which a CFC that is a pledgor or guarantor of an obligation of a United States person is considered to hold the obligation.

The current regulations under section 956 do not specifically address when the obligations of a foreign partnership will be treated as United States property. The preamble to proposed regulations under section 954(i) (REG–106418–05), published in the **Federal Register** on January 17, 2006 (71 FR 2496), requested comments regarding the application of section 956 to loans made by a CFC to a foreign partnership in which one or more partners are United States shareholders of the CFC. After considering the comments received, the Treasury Department and the IRS have determined to issue these regulations that propose new rules concerning the treatment of obligations of, and United States property held by, a foreign partnership for purposes of section 956.

The temporary regulations in the Rules and Regulations section of this issue of the **Internal Revenue Bulletin** amend the Income Tax Regulations (26 CFR part 1) relating to sections 954 and 956. The text of the temporary regulations also serves as the text of certain provisions of the proposed regulations herein. The preamble to the temporary regulations explains the temporary regulations and the corresponding proposed regulations.

Explanation of Provisions

1. *Obligations of Foreign Partnerships*

A. *General rule*

Comments received in response to the request for comments in the preamble to the proposed regulations under section 954(i) recommended that the general rule under section 956 should treat an obligation of a foreign partnership held by a CFC as an obligation of a foreign person, rather than as an obligation of its partners, including any partners that are United States persons. Those comments noted that the inclusion of a domestic partnership in the definition of a United States person in section 7701 causes an obligation of a domestic partnership to be treated as an obligation of a United States person for purposes of section 956. Based on that observation, the comments asserted that section 956 implicitly treats both domestic and foreign partnerships as entities, rather than as aggregates of their partners, for purposes of determining whether an obligation of a partnership is United States property, such that an obligation of a foreign partnership with one or more partners that are United States persons should not be treated as an obligation of a United States person for purposes of section 956. The comments further stated that a general rule that treated an obligation of a foreign partnership as an obligation of a foreign person, rather than a United States person, would be consistent with the purposes of section 956.

The definition of United States person in section 7701(a)(30) includes a domestic partnership, such that an obligation of a domestic partnership generally is an obligation of a United States person for purposes of section 956. In contrast, section 7701 contains no corresponding definition of foreign person that includes a foreign partnership, nor any residual definition treating a person that is not a United States person as a foreign person. Moreover, section 956 does not address the status of an obligation of a foreign partnership as an obligation of a United States person or as United States property. Section 956(e), however, provides that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of section 956, including regulations to prevent the avoidance of section 956. Additionally, the Code and Regulations alternately treat partnerships either as aggregates of their partners or as entities, depending on the context and relevant policy considerations. For example, current law under section 956 employs both approaches with regard to domestic partnerships, applying an aggregate approach with respect to United States property held through a domestic partnership and an entity approach with respect to the obligations of a domestic partnership.

Section 956 is intended to prevent a United States shareholder of a CFC from inappropriately deferring U.S. taxation of CFC earnings and profits by "prevent[ing] the repatriation of income to the United States in a manner which does not subject it to U.S. taxation." H.R. Rep. No. 87–1447, 87th Cong., 2d Sess., at 58 (1962). In the absence of section 956, a United States shareholder of a CFC could access the CFC's funds (untaxed earnings and profits) in a variety of ways other than by the payment of an actual taxable dividend, such that there would be no reason for the United States shareholder to incur the dividend tax. Section 956 ensures that, to the extent CFC earnings are made available for use in the United States or for use by the United States shareholder, the United States shareholder of the CFC is subject to current U.S. taxation with respect to such amounts. Accordingly, under section 956, the investment by a CFC of its earnings and profits in United States property is "taxed to the [CFC's] shareholders on the grounds that this is substantially the equivalent of a dividend." S. Rep. No. 87–1881, 87th Cong., 2d Sess., at 88 (1962).

The Treasury Department and the IRS have determined that failing to treat an obligation of a foreign partnership as an obligation of its partners could allow deferral of U.S. taxation of CFC earnings and profits in a manner inconsistent with the purposes of section 956. When a United States shareholder can conduct operations through a foreign partnership using deferred CFC earnings, those earnings effectively have been made available to the United States shareholder. Additionally, because assets of a partnership generally are available to the partners without additional U.S. tax, a United States shareholder potentially could directly access deferred CFC earnings lent to a foreign partnership in which the United States shareholder is a partner without those earnings becoming subject to current U.S. tax by causing the partnership to make a distribution.

In light of these considerations, these proposed regulations treat an obligation of a foreign partnership as an obligation of its partners for purposes of section 956, subject to the exception described in Part 1.B of this preamble for obligations of foreign partnerships in which neither the lending CFC nor any person related to the lending CFC is a partner. More specifically, proposed § 1.956–4(c)(1) generally treats an obligation of a foreign partnership as an obligation of the partners to the extent of each partner's share of the obligation as determined in accordance with the partner's interest in partnership profits. The Treasury Department and the IRS have considered various methods for determining a partner's share of a partnership obligation, including the regulations under section 752 for determining a partner's share of partnership liabilities, the partner's liquidation value percentage (discussed in Part 3 of this preamble), and the partner's interest in partnership profits. Using the partner's interest in partnership profits to determine a partner's share of a partnership obligation is consistent with the observation that, to the extent the proceeds of a partnership borrowing are used by the partnership to invest in profit-generating activities, partners in the partnership (including service partners with limited or no partnership capital) will benefit from the partnership obligation to the extent of their interests in the partnership profits. Taking this into account along with considerations of administrability, the Treasury Department and the IRS believe that it is appropriate to determine a partner's share of a foreign partnership's obligation in accordance with the partner's interest in partnership profits. However, the Treasury Department and the IRS solicit comments on whether the liquidation value percentage method or another method would be a more appropriate basis for determining a partner's share of a foreign partnership's obligation.

The determination of a partner's share of the obligation will be made as of the close of each quarter of the CFC's taxable year in connection with the calculation of the amount of United States property held by the CFC for purposes of section 956(a)(1)(B). Thus, for example, if a partner in a foreign partnership is a United States shareholder of a CFC, an obligation of the partnership that is held by the CFC will be treated as United States property (subject to the exception described in Part 1.B of this preamble for obligations of foreign partnerships in which neither the lending CFC nor any person related to the lending CFC is a partner) to the extent of the United States shareholder partner's share of the obligation as determined in accordance with the partner's interest in partnership profits as of the close of each quarter of the CFC's taxable year.

The general rule in proposed § 1.956–4(c)(1) also applies to determine the extent to which a CFC guarantees or otherwise supports an obligation of a related United States person when the related United States person is a partner in a foreign partnership that incurred the obligation that is the subject of the CFC's credit enhancement. Likewise, if a CFC is a partner in a foreign partnership that owns property that would be United States property if held by the CFC, and the property is subject to a liability that would constitute a specific charge within the meaning of § 1.956–1(e)(1), the CFC's share of the liability, as determined under proposed § 1.956–4(c)(1), would be treated as a specific charge that, under § 1.956–1(e)(1), could reduce the amount taken into account by the CFC in determining the amount of its share of the United States property, as determined under proposed § 1.956–4(b).

One commenter asserted that if a United States shareholder of a CFC is a partner in a foreign partnership and is treated as having an inclusion under section 956 when the CFC makes a loan to the partnership, as can occur under these proposed regulations, and that partner later receives an actual distribution from the partnership, the partner could have an inappropriate second inclusion when it is deemed to receive a distribution from the partnership upon the partnership's repayment of the loan. The second inclusion in this fact pattern could arise under subchapter K to the extent the partner is required to reduce its basis in its partnership interest under section 733 on the actual distribution and again reduce its basis as a result of a deemed distribution under section 752(b) when its share of the loan is repaid. If the distributions exceed the partner's basis in its partnership, including the increase to basis under section 752(a) when the partnership originally undertook the obligation, the partner could recognize gain under section 731. The commenter suggested that having inclusions under both section 956 and subchapter K in this fact pattern is inappropriate and that changes should be made to the subchapter K rules to prevent this result.

The Treasury Department and the IRS have determined that these proposed regulations and the existing rules under subchapter K and section 959 provide the appropriate result in the fact pattern described in the comment. The potential for gain under subchapter K in the fact pattern exists regardless of the application of section 956. The required inclusion under these proposed regulations to the extent a CFC is treated as holding an obligation of a United States person reflects policy considerations distinct from the policy considerations underlying the potential results under subchapter K. Moreover, in the fact pattern, the United States property held by the CFC in connection with its loan to the partnership generates previously taxed earnings and profits described in section 959(c)(1)(A) that, in general, are available for distribution by the CFC to its United States shareholder without further U.S. tax on the distributed amount. Accordingly, these proposed regulations do not include rules under subchapter K to address this comment.

B. *Exception for obligations of partnerships in which neither the lending CFC nor any person related to the lending CFC is a partner*

The Treasury Department and the IRS have determined that certain obligations of foreign partnerships should not be treated as United States property. Under section 956(c)(2)(L), obligations of a domestic partnership are excluded from the definition of United States property if neither the CFC nor any related person (as defined in section 954(d)(3)) is a partner in the domestic partnership immediately after the acquisition by the CFC of any obligation of the partnership. The Treasury Department and the IRS have determined that the policy considerations underlying this rule are also relevant for comparable foreign partnerships. See H.R. Conf. Rep. No. 108–755, 108th Cong., 2d Sess., at 391 (2004); H.R. Rep. No. 108–548, 108th Cong., 2d Sess., at 198 (2004); S. Rep. No. 108–192, 108th Cong., 1st Sess., at 46 (2003). Accordingly, proposed § 1.956–4(c)(2) provides that an obligation of a foreign partnership is treated as an obligation of the foreign partnership (and not as an obligation of its partners) for purposes of determining whether a CFC holds United States property if neither the CFC nor any person related to the CFC (within the meaning of section 954(d)(3)) is a partner in the partneship.

C. *Special obligor rule in the case of certain distributions*

The proposed regulations include a special rule that increases the amount of a foreign partnership obligation that is treated as United States property under the general rule when the following requirements are satisfied: (i) a CFC lends funds (or guarantees a loan) to a foreign partnership whose obligation is, in whole or in part, United States property with respect to the CFC pursuant to proposed § 1.956–4(c)(1); (ii) the partnership distributes the proceeds to a partner that is related to the CFC (within the meaning of section 954(d)(3)) and whose obligation would be United States property if held by the CFC; (iii) the foreign partnership would not have made the distribution but for a funding of the partnership through an obligation held (or treated as held) by the CFC; and (iv) the distribution exceeds the partner's share of the partnership obligation as determined in accordance with the partner's interest in partnership profits. When these requirements are satisfied, proposed § 1.956–4(c)(3) provides that the amount of the partnership obligation that is treated as an obligation of the distributee partner (and thus as United States property held by the CFC) is the lesser of the amount of the distribution that would not have been made but for the funding of the partnership and the amount of the partnership obligation. For example, assume a United States shareholder of a CFC that is related to the CFC within the meaning of section 954(d)(3) has a 60 percent interest in the profits of a foreign partnership and the CFC lends $100 to the partnership. If the partnership, in turn, distributes $100 to the United States shareholder in a distribution that would not have been made but for the funding by the CFC, the CFC will be treated as holding United States property in the amount of $100.

Section 1.956–1T(b)(5) of the temporary regulations published elsewhere in the Rules and Regulations section of this issue of the **Internal Revenue Bulletin** under section 956 also addresses the funded distribution fact pattern discussed above. That temporary rule also provides that the obligation of the foreign partnership is treated as an obligation of the distributee partner when similar conditions are satisfied. The Treasury Department and the IRS expect to withdraw § 1.956–1T(b)(5) as unnecessary when proposed § 1.956–4(c), including § 1.956–4(c)(3), is adopted as a final regulation.

2. *Pledges and Guarantees*

Existing § 1.956–2(c)(1) provides that, subject to an exception, any obligation of a United States person with respect to which a CFC is a pledgor or guarantor is considered for purposes of section 956 to be United States property held by the CFC. In order to better align the regulations with the statutory text of section 956(d), these regulations propose to revise § 1.956–2(c)(1) to clarify that a CFC that is a pledgor or guarantor of an obligation of a United States person is treated as holding the obligation. Accordingly, under the proposed rule, the general exceptions to the definition of United States property would apply to the obligation treated as held by the CFC.

A. *Pledges and guarantees of foreign partnership obligations by CFCs*

These proposed regulations provide that the pledge and guarantee rules under § 1.956–2(c) apply to a CFC that directly or indirectly guarantees an obligation of a foreign partnership that is treated as an obligation of a United States person under proposed § 1.956–4(c). Accordingly, if an obligation of a foreign partnership is treated as an obligation of a United States person pursuant to proposed § 1.956–4(c) and a CFC directly or indirectly guarantees the partnership obligation, the CFC will be treated as holding an obligation of the United States person.

B. *Pledges and guarantees of United States persons' obligations by domestic or foreign partnerships*

These proposed regulations extend the pledge and guarantee rule in § 1.956–

2(c)(1) to pledges and guarantees made by partnerships. Thus, proposed § 1.956–2(c)(1) provides that a partnership that guarantees an obligation of a United States person will be treated as holding the obligation for purposes of section 956. As a result, as discussed in Parts 2.D and 3 of this preamble, proposed § 1.956–4(b) will then treat the partners of the partnership that is the pledgor or guarantor as holding shares of that obligation. For example, if a partnership with one CFC partner guarantees an obligation of the CFC's United States shareholder, the CFC will be treated as holding a share of the obligation under proposed §§ 1.956–1(e)(2), 1.956–2(c)(1), and 1.956–4(b).

Under current § 1.956–2(c)(2), a CFC is treated as a pledgor or guarantor of an obligation of a United States person if its assets serve at any time, even though indirectly, as security for the performance of the obligation. Consistent with this rule, a partnership should be considered a pledgor or guarantor of an obligation of a United States person if the partnership's assets serve indirectly as security for the performance of the obligation, for example, because the partnership agrees to purchase the obligation at maturity if the United States person does not repay it. Thus, proposed § 1.956–2(c)(2) applies the indirect pledge or guarantee rule to domestic and foreign partnerships.

In the case of a partnership that is considered a pledgor or guarantor of an obligation under proposed § 1.956–2(c)(2), however, it would not be appropriate to separately apply § 1.956–2(c)(2) directly to a CFC partner in the partnership to treat the partner as a pledgor or guarantor (in addition to treating the partnership as a pledgor or guarantor) solely as a result of the partnership's indirect pledge or guarantee. Therefore, proposed § 1.956–2(c)(2) provides that when a partnership is considered a pledgor or guarantor of an obligation, a CFC that is a partner in the partnership will not be treated as a pledgor or guarantor of the obligation solely as a result of its ownership of an interest in the partnership. Accordingly, the CFC will be treated under proposed § 1.956–4(b) as holding its share of the obligation to which the pledge or guarantee relates as described in Part 2.D of this preamble but will not also be treated as a separate indirect pledgor or guarantor of the obligation. As a result, the CFC will not be treated as holding more than its share of the obligation, as determined under proposed § 1.956–4(b).

C. *Pledges and guarantees of United States persons' obligations by CFC partners*

As discussed in Part 1.A of this preamble, under proposed § 1.956–4(c) an obligation of a foreign partnership generally is treated as an obligation of the partners in the partnership. In addition, as discussed in Part 3 of this preamble, a partner in a partnership is treated as holding its attributable share of property held by the partnership. The application of these two rules and the proposed indirect pledge or guarantee rule could create uncertainty. For example, if a CFC and a related United States person were the only partners in a foreign partnership that borrowed from a person unrelated to the partners, an issue could arise as to whether the partnership assets attributed to the CFC under proposed § 1.956–4(b) are considered under proposed § 1.956–2(c)(2) to indirectly serve as security for the performance of the portion of the partnership obligation that is treated as an obligation of the United States person under proposed § 1.956–4(c).

A CFC that is a partner in a partnership should not be treated as a pledgor or guarantor of an obligation of the partnership merely because the CFC partner is treated under proposed § 1.956–4(b) as owning a portion of the partnership assets that support an obligation that is allocated under proposed § 1.956–4(c) to a partner that is a United States person. Accordingly, proposed § 1.956–4(d) provides that, for purposes of section 956 and proposed § 1.956–2(c)(2), if a CFC is a partner in a partnership, the attribution of the assets of the partnership to the CFC under proposed § 1.956–4(b) does not in and of itself give rise to an indirect pledge or an indirect guarantee of an obligation of the partnership that is allocated under proposed § 1.956–4(c) to a partner that is a United States person. This rule is consistent with the new rule under proposed § 1.956–2(c)(2) providing that a CFC that is a partner in a partnership will not be treated, solely as a result of its interest in the partnership, as a pledgor or guarantor of an obligation with respect to which the partnership is considered to be a pledgor or guarantor. However, as under current law, the determination of whether a CFC's assets serve as security for the performance of an obligation for purposes of proposed § 1.956–2(c)(2) is based on all of the facts and circumstances. In appropriate circumstances, the existence of other factors, such as the use of proceeds from a partnership borrowing, the use of partnership assets as security for a partnership borrowing, or special allocations of partnership income or gain, may result in a CFC partner being considered a pledgor or guarantor of an obligation of the partnership pursuant to proposed § 1.956–2(c)(2) when taken into account in conjunction with the attribution of the assets of the partnership to the CFC.

D. *Amount taken into account with respect to pledges or guarantees*

Under existing § 1.956–1(e)(2), the amount taken into account by a CFC in determining the amount of its United States property with respect to a pledge or guarantee described in § 1.956–2(c)(1) is the unpaid principal amount of the obligation with respect to which the CFC is a pledgor or guarantor. In connection with the proposed revision to § 1.956–2(c)(1), which treats a partnership as holding an obligation with respect to which it is a pledgor or guarantor (as discussed in Part 2.B of this preamble), these regulations propose to revise § 1.956–1(e)(2) to also apply in cases in which partnerships are pledgors or guarantors of an obligation.

Accordingly, under proposed § 1.956–1(e)(2), as under current law, each pledgor or guarantor is treated as holding the entire unpaid principal amount of the obligation to which its pledge or guarantee relates. As a result, in cases in which there are, with respect to a single obligation, multiple pledgors or guarantors that are CFCs or partnerships in which a CFC is a partner, the aggregate amount of United States property treated as held by CFCs may exceed the unpaid principal amount of the obligation. To the extent that the CFCs have sufficient earnings and profits, there could be multiple section 951 inclusions with respect to the same obligation that exceed, in the aggregate, the unpaid principal amount of the obligation.

The Treasury Department and the IRS are considering whether to exercise the authority granted under section 956(e) to prescribe regulations as may be necessary to carry out the purposes of section 956 to allocate the amount of the obligation among the relevant CFCs so as to eliminate the potential for multiple inclusions and, instead, limit the aggregate inclusions to the unpaid principal amount of the obligation. Comments are requested on whether the Treasury Department and the IRS should adopt such a limitation, and if such a limitation were adopted, on methods to implement the limitation. One approach to implementing such a limitation would be to allow a taxpayer to allocate the unpaid principal amount of the obligation among the guarantor CFCs and partnerships based on any consistently applied, reasonable method selected by the taxpayer that results in aggregate section 951 inclusions equal to the unpaid principal amount.

Alternatively, the Treasury Department and the IRS could seek to establish a generally applicable method for allocating the unpaid principal amount of the obligation among the various guarantors. Allocating the unpaid principal amount of the obligation among multiple CFCs and partnerships in accordance with their available credit capacities measured, for example, by the relative net values of their assets might be broadly consistent with a creditor's analysis of the support for the obligation, but such an approach would give rise to administrability concerns. A more administrable option would be to require taxpayers to allocate the unpaid principal amount of the obligation based on the earnings and profits of the CFCs that are treated as holding the obligation (or portion thereof). Several allocation methods based on earnings and profits are possible, including methods that allocate the unpaid principal amount of the obligation: (i) to all of the CFCs in accordance with their applicable earnings; (ii) to all of the CFCs in accordance with their earnings and profits described in section 959(c)(3); or (iii) first to the CFCs with only earnings and profits described in section 959(c)(3) (in accordance with their section 959(c)(3) earnings and profits), and then to the remainder of the CFCs, based on applicable earnings. All of these approaches could result in aggregate section 951 inclusions (for the year) totaling less than the unpaid principal amount of the obligation (for example, where one or more CFCs has previously taxed earnings and profits that reduce its section 951 inclusion).

In considering the options, the Treasury Department and the IRS will consider whether it is appropriate to select a method that could result in aggregate section 951 inclusions for a year totaling less than the unpaid principal amount of the obligation, the extent to which a particular method creates planning opportunities inconsistent with the policies underlying sections 956 and 959, and how administrable and effective the method is over multiple years. In particular, the Treasury Department and the IRS are concerned that certain proration methods could create an incentive for taxpayers to include as additional pledgors or guarantors of an obligation CFCs with substantial amounts of previously taxed earnings and profits, solely to allocate substantial portions of the obligation to these CFCs and thereby minimize the current section 951 inclusions. There are also a number of complexities that could affect the application of a rule that limits multiple inclusions, including differences in taxable years among the relevant CFCs and fluctuations in the unpaid principal amount of the obligation as well as the earnings and profits of the CFCs. The Treasury Department and the IRS request that comments on potential allocation methods address the issues described in this paragraph.

3. *Partnership Property Indirectly Held by a CFC Partner*

Under current § 1.956–2(a)(3), if a CFC is a partner in a partnership that holds property that would be United States property if held directly by the CFC partner, the CFC partner is treated as holding an interest in the property based on its interest in the partnership. These proposed regulations provide rules on the determination of the amount that the CFC partner is treated as holding under this rule, which is redesignated in these proposed regulations as proposed § 1.956–4(b).

Under proposed § 1.956–4(b), a CFC partner will be treated as holding its share of partnership property determined in accordance with the CFC partner's liquidation value percentage, taking into account any special allocation of income, or, where appropriate, gain from that property that is not disregarded or reallocated under section 704(b) or any other Code section, regulation, or judicial doctrine and that does not have a principal purpose of avoiding the purposes of section 956. See § 1.704–1(b)(1)(iii). This rule serves, in general, as a reasonable measure of a partner's interest in property held by a partnership because it generally results in an allocation of specific items of property that corresponds with each partner's economic interest in that property, including any income, or gain, that may be subject to special allocations.

These proposed regulations include examples illustrating the application of this proposed rule, including an example that illustrates a case in which it is appropriate to take into account a special allocation of gain because the property is anticipated to appreciate in value but generate relatively little income. Although proposed § 1.956–4(b) would apply only to property acquired on or after publication in the **Federal Register** of the Treasury decision adopting the rule as a final regulation, it generally would be reasonable to use the method set forth in proposed § 1.956–4(b) to determine a partner's interest in property acquired prior to finalization.

Although the method provided by proposed § 1.956–4(b) generally should reflect a partner's economic interest in partnership property, the Treasury Department and the IRS solicit comments on whether there may be situations in which the method would not reflect the partners' economic interest in the partnership or its property, and, if so, whether there are alternative measures or rules to better address such circumstances. Furthermore, the Treasury Department and the IRS solicit comments on whether a single method should be used as the general rule for determining both a partner's share of a partnership obligation (as determined under proposed § 1.956–4(c), discussed in Part 1.A of this preamble) and a partner's share of partnership assets, and, if so, whether the appropriate measure would be a partner's interest in partnership profits, a partner's liquidation value percentage, or an alternative measure.

4. *Trade or Service Receivables Acquired from Related United States Persons*

Section 956(c)(3) provides that United States property generally includes trade or service receivables acquired from a related United States person in a factoring transaction when the obligor with respect to the receivables is a United States person. Section 1.956–3T(b)(2) provides rules for determining whether a trade or service receivable has been indirectly acquired from a related United States person for purposes of section 956(c)(3). These provisions include a rule that applies to receivables held on a CFC's behalf by a partnership in which the CFC owns (directly or indirectly) a beneficial interest. See § 1.956–3T(b)(2)(ii)(A). This rule is similar to the rule in both current § 1.956–2(a)(3) and proposed § 1.956–4(b). Section 1.956–3T(b)(2) also includes a rule that applies to receivables held on a CFC's behalf by another foreign corporation controlled by the CFC if one of the principal purposes for creating, organizing, or funding such other foreign corporation (through capital contributions or debt) is to avoid the application of section 956. See § 1.956–3T(b)(2)(ii)(B). This rule is similar to a rule in § 1.956–1T(b)(4).

The Treasury Department and the IRS have determined that the rules in § 1.956–3T(b)(2)(ii) applicable to factoring transactions involving partnerships should be consistent with the rules provided in § 1.956–1T(b)(4) and proposed § 1.956–4(b), which generally apply when partnerships own property that would be United States property in the hands of a CFC partner. Accordingly, these proposed regulations propose to revise the rules governing factoring transactions so that rules similar to the rules in current § 1.956–1T(b)(4) and proposed § 1.956–4(b) apply to factoring transactions involving partnerships. These proposed regulations also propose to revise the rules governing factoring transactions to remove the reference to S corporations, which are treated as partnerships for purposes of subpart F, including section 956. See section 1373(a).

5. *Obligations of Disregarded Entities and Domestic Partnerships*

The Treasury Department and the IRS understand that issues have arisen as to the proper treatment under section 956 of obligations of entities that are disregarded as entities separate from their owner for federal tax purposes. Accordingly, these proposed regulations state explicitly in proposed § 1.956–2(a)(3) that, for purposes of section 956, an obligation of a disregarded entity is treated as an obligation of the owner of the disregarded entity. Thus, for example, an obligation of a disregarded entity that is owned by a domestic corporation is treated as an obligation of the domestic corporation for purposes of section 956. The rule in proposed § 1.956–2(a)(3) follows from the application of the entity classification rules of § 301.7701–3 and is therefore not a change from current law.

In addition, proposed § 1.956–4(e) confirms that, for purposes of section 956, an obligation of a domestic partnership is an obligation of a United States person, regardless of whether the partners in the partnership are United States persons. Under section 956(c)(1)(C), an obligation of a United States person generally is United States property for purposes of section 956 unless an exception in section 956(c)(2) applies to the obligation. For example, as noted in Part 1.B of this preamble, section 956(c)(2)(L) would apply to exclude an obligation of a domestic partnership held by a CFC from the definition of United States property if neither the CFC nor a person related to the CFC (within the meaning of section 954(d)(3)) were a partner in the partnership.

6. *Proposed Effective/Applicability Dates*

These proposed regulations are proposed to be effective for taxable years of CFCs ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and taxable years of United States shareholders in which or with which such taxable years end. Most of these rules are proposed to apply to property acquired, or pledges or guarantees entered into, on or after September 1, 2015, including property considered acquired, or pledges or guarantees considered entered into, on or after September 1, 2015, as a result of a deemed exchange pursuant to section 1001. See proposed § 1.956–4(c) (dealing with obligations of foreign partnerships, described in Part 1 of this preamble); proposed §§ 1.956–2(c), 1.956–4(d), and 1.956–1(e)(2) (dealing with pledges or guarantees, including pledges or guarantees either by a partnership or with respect to obligations of a foreign partnership, described in Part 2 of this preamble); and proposed § 1.956–3 (dealing with trade or service receivables acquired from related United States persons, described in Part 4 of this preamble). Two rules, however, are proposed to apply to obligations held on or after the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations. See proposed §§ 1.956–2(a)(3) and 1.956–4(e) (dealing with obligations of disregarded entities and domestic partnerships, respectively, described in Part 5 of this preamble). Finally, proposed § 1.956–4(b) (dealing with partnership property indirectly held by a CFC, described in Part 3 of this preamble) is proposed to apply to property acquired on or after the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations. No inference is intended as to the application of the provisions proposed to be amended by these proposed regulations under current law, including in transactions involving obligations of foreign partnerships. The IRS may, where appropriate, challenge transactions under currently applicable Code or regulatory provisions or judicial doctrines.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. 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), this notice of proposed rulemaking has been submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. Treasury and the IRS request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits electronic or 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 Barbara E. Rasch and Rose E. Jenkins of the Office of Associate Chief Counsel (International). However, 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 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805.

* * * * *

Section 1.956–1 also issued under 26 U.S.C. 956(d) and 956(e).

Section 1.956–2 also issued under 26 U.S.C. 956(d) and 956(e).

Section 1.956–3 also issued under 26 U.S.C. 864(d)(8) and 956(e).

Section 1.956–4 also issued under 26 U.S.C. 956(d) and 956(e).

* * * * *

Par. 2. Section 1.954–2 is amended by revising paragraphs (c)(1)(i), (c)(1)(iv), (c)(2)(ii), (c)(2)(iii)(E), (c)(2)(viii), (d)(1)(i) and (ii), (d)(2)(ii), (d)(2)(iii)(E), (d)(2)(v), and (j) to read as follows:

§ 1.954–2 Foreign personal holding company income.

* * * * *

(c) * * *

(1) * * *

(i) [The text of proposed amendments to § 1.954–2(c)(1)(i) is the same as the text of § 1.954–2T(c)(1)(i) published elsewhere in this issue of the **Internal Revenue Bulletin**].

* * * * *

(iv) [The text of proposed amendments to § 1.954–2(c)(1)(iv) is the same as the text of § 1.954–2T(c)(1)(iv) published elsewhere in this issue of the **Internal Revenue Bulletin**].

(2) * * *

(ii) [The text of proposed amendments to § 1.954–2(c)(2)(ii) is the same as the text of § 1.954–2T(c)(2)(ii) published elsewhere in this issue of the **Internal Revenue Bulletin**].

(iii) * * *

(E) [The text of proposed amendments to § 1.954–2(c)(2)(iii)(E) is the same as the text of § 1.954–2T(c)(2)(iii)(E) published elsewhere in this issue of the **Internal Revenue Bulletin**].

* * * * *

(viii) [The text of proposed amendments to § 1.954–2(c)(2)(viii) is the same as the text of § 1.954–2T(c)(2)(viii) published elsewhere in this issue of the **Internal Revenue Bulletin**].

* * * * *

(d) * * *

(1) * * *

(i) [The text of proposed amendments to § 1.954–2(d)(1)(i) is the same as the text of § 1.954–2T(d)(1)(i) published elsewhere in this issue of the **Internal Revenue Bulletin**].

(ii) [The text of proposed amendments to § 1.954–2(d)(1)(ii) is the same as the text of § 1.954–2T(d)(1)(ii) published elsewhere in this issue of the **Internal Revenue Bulletin**].

(2) * * *

(ii) [The text of proposed amendments to § 1.954–2(d)(2)(ii) is the same as the text of § 1.954–2T(d)(2)(ii) published elsewhere in this issue of the **Internal Revenue Bulletin**].

(iii) * * *

(E) [The text of proposed amendments to § 1.954–2(d)(2)(iii)(E) is the same as the text of § 1.954–2T(d)(2)(iii)(E) published elsewhere in this issue of the **Internal Revenue Bulletin**].

* * * * *

(v) [The text of proposed amendments to § 1.954–2(d)(2)(v) is the same as the text of § 1.954–2T(d)(2)(v) published elsewhere in this issue of the **Internal Revenue Bulletin**].

* * * * *

(j) [The text of proposed amendments to § 1.954–2(j) is the same as the text of § 1.954–2T(j) published elsewhere in this issue of the **Internal Revenue Bulletin**].

Par. 3. Section 1.956–1 is amended by revising paragraphs (b)(4) and (5), (e)(2), and (g), to read as follows:

§ 1.956–1 Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

* * * * *

(b) * * *

(4) [The text of proposed amendments to § 1.956–1(b)(4) is the same as the text of § 1.956–1T(b)(4) published elsewhere in this issue of the **Internal Revenue Bulletin**].

(5) [The text of proposed amendments to § 1.956–1(b)(5) is the same as the text of § 1.956–1T(b)(5) published elsewhere in this issue of the **Internal Revenue Bulletin**].

* * * * *

(e) * * *

(2) *Rule for pledges and guarantees.* For purposes of this section, the amount of an obligation treated as held (before application of § 1.956–4(b)) as a result of a pledge or guarantee described in § 1.956–2(c) is the unpaid principal amount of the obligation on the applicable determination date.

* * * * *

(g) through (g)(2) [The text of proposed amendments to § 1.956–1(g) through (g)(2) is the same as the text of § 1.956–1T(g) through (g)(2) published elsewhere in this issue of the **Internal Revenue Bulletin**].

(3) Paragraph (e)(2) of this section applies to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, and taxable years of United States shareholders in which or with which such taxable years end, with respect to pledges or guarantees entered into on or after September 1, 2015. For purposes of this paragraph (g)(3), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

* * * * *

Par. 4. Section 1.956–2 is amended by:

a. Revising paragraphs (a)(3) and (c)(1) and (2);

b. Adding *Example 4* to paragraph (c)(3);

c. Adding reserved paragraph (g); and

d. Adding paragraph (h).

The revisions and additions read as follows:

§ 1.956–2 Definition of United States property.

(a) * * *

(3) *Treatment of disregarded entities*. For purposes of section 956, an obligation of a business entity (as defined in § 301.7701–2(a) of this chapter) that is disregarded as an entity separate from its owner for federal tax purposes under §§ 301.7701–1 through 301.7701–3 of this chapter is treated as an obligation of its owner.

* * * * *

(c) * * *(1) *General rule*. Except as provided in paragraph (c)(4) of this section, for purposes of section 956, any obligation of a United States person with respect to which a controlled foreign corporation or a partnership is a pledgor or guarantor will be considered to be held by the controlled foreign corporation or the partnership, as the case may be. See § 1.956–1(e)(2) for rules that determine the amount of the obligation treated as held by a pledgor or guarantor under this paragraph (c). For rules that treat an obligation of a foreign partnership as an obligation of the partners in the foreign partnership for purposes of section 956, see § 1.956–4(c).

(2) *Indirect pledge or guarantee*. If the assets of a controlled foreign corporation or a partnership serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then, for purposes of paragraph (c)(1) of this section, the controlled foreign corporation or partnership will be considered a pledgor or guarantor of that obligation. If a partnership is considered a pledgor or guarantor of an obligation, a controlled foreign corporation that is a partner in the partnership will not also be treated as a pledgor or guarantor of the obligation solely as a result of its ownership of an interest in the partnership. For purposes of this paragraph, a pledge of stock of a controlled foreign corporation representing at least 66 2/3 percent of the total combined voting power of all classes of voting stock of such corporation will be considered an indirect pledge of the assets of the controlled foreign corporation if the pledge is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion to dispose of assets and/or incur liabilities other than in the ordinary course of business. See § 1.956–4(d) for guidance on the treatment of indirect pledges or guarantees of an obligation of a partnership attributed to its partners under § 1.956–4(c).

(3) * * *

* * * * *

Example 4. (i) *Facts*. USP, a domestic corporation, owns 70% of the stock of FS, a controlled foreign corporation, and a 90% interest in FPRS, a foreign partnership. X, an unrelated foreign person, owns 30% of the stock of FS. Y, an unrelated foreign person, owns a 10% interest in FPRS. There are no special allocations in the FPRS partnership agreement. FPRS borrows $100x from Z, an unrelated person. FS pledges its assets as security for FPRS's performance of its obligation to repay the $100x loan. USP's share of the $100x FPRS obligation, determined in accordance with its interest in partnership profits, is $90x. Under § 1.956–4(c), $90x of the FPRS obligation is treated as an obligation of USP for purposes of section 956.

(ii) *Result*. For purposes of section 956, under paragraph (c)(1) of this section, FS is considered to hold an obligation of USP in the amount of $90x, and thus is treated as holding United States property in the amount of $90x.

* * * * *

(h) *Effective/applicability date*. (1) Paragraph (a)(3) of this section applies to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, and taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations held on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation.

(2) Paragraphs (c)(1), (c)(2), and *Example 4* of paragraph (c)(3) of this section apply to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting these rules as final regulations, and taxable years of United States shareholders in which or with which such taxable years end, with respect to pledges and guarantees entered into on or after September 1, 2015. For purposes of this paragraph (h)(2), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

Par. 5. Section 1.956–3 is added to read as follows:

§ 1.956–3 Certain trade or service receivables acquired from United States persons.

(a) through (b)(2)(i) [Reserved]. For further guidance, see § 1.956–3T(a) through (b)(2)(i).

(ii) *Acquisition by nominee, pass-through entity, or related foreign corporation*. A controlled foreign corporation is treated as holding a trade or service receivable that is held by a nominee on its behalf, or by a simple trust or other pass-through entity (other than a partnership) to the extent of its direct or indirect ownership or beneficial interest in such simple trust or other pass-through entity. See §§ 1.956–1T(b)(4) and 1.956–4(b) for rules that may treat a controlled foreign corporation as indirectly holding a trade or service receivable held by a foreign corporation or partnership. A controlled foreign corporation that is treated as holding a trade or service receivable held by another person (the *direct holder*) (or that would be treated as holding the receivable if the receivable were United States property or would be United States property if held directly by the controlled foreign corporation) is considered to have acquired the receivable from the person from whom the direct holder acquired the receivable. This paragraph (b)(2)(ii) does not limit the application of paragraph (b)(2)(iii) of this section. The following examples illustrate the application of this paragraph (b)(2)(ii):

Example 1. (i) *Facts*. A domestic corporation, P, wholly owns a controlled foreign corporation, FS, with substantial earnings and profits. FS contributes $200x of cash to a partnership, PRS, in exchange for an 80% partnership interest. An unrelated foreign person contributes real estate located in a foreign country with a fair market value of $50x to PRS for the remaining 20% partnership interest. There are no special allocations in the PRS partnership agreement. PRS uses the $200x of cash received from FS to purchase trade receivables from P. The obligors with respect to the trade receivables are United States persons that are not related to any partner in PRS. The liquidation value percentage, as determined under § 1.956–4(b), for FS with respect to PRS is 80%. A principal purpose of funding PRS (through FS's cash contribution) is to avoid the application of section 956 with respect to FS.

(ii) *Result*. Under § 1.956–4(b)(1), FS is treated as holding 80% of the trade receivables acquired by PRS from P, with a basis equal to $160x (80% x $200x, PRS's basis in the trade receivables). However, because FS controls PRS and a principal purpose of FS funding PRS was to avoid the application of section 956 with respect to FS, under § 1.956–1T(b)(4), if the trade receivables would be United States property if held directly by FS, FS additionally would be treated as holding the trade receivables to the extent that they exceed the amount of the receivables it holds under § 1.956–4(b), which is $40x ($200x – $160x). Accordingly, under this paragraph (b)(2)(ii), FS is treated as having acquired from P, a related United States person, the trade receivables that it is treated as holding with a basis equal to $200x ($160x + $40x). Thus, FS is treated as holding United States property with a basis of $200x under paragraph (a) of this section.

Example 2. (i) *Facts*. A domestic corporation, P, wholly owns a controlled foreign corporation, FS1, that has earnings and profits of at least $300x. FS1 organizes a foreign corporation, FS2, with a $200x cash contribution. FS2 uses the cash contribution to purchase trade receivables from P. The obligors with respect to the trade receivables are unrelated United States persons. A principal purpose of funding FS2 (through FS1's cash contribution) is to avoid the application of section 956 with respect to FS1.

(ii) *Result*. Under § 1.956–1T(b)(4), if the trade receivables held by FS2 were United States property, FS1 would be treated as holding the trade receivables held by FS2 because FS1 controls FS2 and a principal purpose of FS1 funding FS2 was to avoid the application of section 956 with respect to FS1. Accordingly, under this paragraph (b)(2)(ii), FS1 is treated as having acquired from P, a related United States person, the trade receivables that it would be treated as holding with a basis equal to $200x. Thus, FS1 is treated as holding United States property with a basis of $200x under paragraph (a) of this section.

(b)(2)(iii) through (c) [Reserved]. For further guidance, see § 1.956–3T(b)(2)(iii) through (c).

(d) *Effective/applicability date*. Paragraph (b)(2)(ii) of this section applies to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, and taxable years of United States shareholders in which or with which such taxable years end, with respect to trade or service receivables acquired on or after September 1, 2015. For purposes of this paragraph (d), a significant modification, within the meaning of § 1.1001–3(e), of a trade or service receivable on or after September 1, 2015, constitutes an acquisition of the trade or service receivable on or after that date.

Par. 6. Section 1.956–4 is added to read as follows:

§ 1.956–4 Certain rules applicable to partnerships.

(a) *Overview*. This section provides rules concerning the application of section 956 to certain obligations of and property held by a partnership. Paragraph (b) of this section provides rules concerning United States property held indirectly by a controlled foreign corporation through a partnership. Paragraph (c) of this section provides rules that generally treat obligations of a foreign partnership as obligations of the partners in the foreign partnership, as well as a special rule that treats a partner that is a United States person as owing additional amounts of a partnership obligation in certain circumstances. Paragraph (d) of this section sets forth a rule concerning the application of the indirect pledge or guarantee rule to obligations of partnerships. Paragraph (e) of this section provides that obligations of a domestic partnership are obligations of a United States person. Paragraph (f) of this section provides effective and applicability dates. See §§ 1.956–1T(b)(4) and 1.956–2(c) for additional rules applicable to partnerships.

(b) *Property held indirectly through a partnership*—(1) *General rule*. For purposes of section 956, a partner in a partnership is treated as holding its attributable share of any property held by the partnership (including an obligation that the partnership is treated as holding as a result of the application of § 1.956–2(c)). A partner's attributable share of partnership property is determined under the rules set forth in paragraph (b)(2) of this section. An upper-tier partnership's attributable share of the property of a lower-tier partnership is treated as property of the upper-tier partnership for purposes of applying this paragraph (b)(1) to the partners of the upper-tier partnership. For purposes of section 956, a partner's adjusted basis in the property of the partnership equals the partner's attributable share of the partnership's adjusted basis in the property (taking into account any adjustments to basis under section 743(b) (with respect to the partner) or section 734(b) or any similar adjustments to basis), as determined under the rules set forth in paragraph (b)(2) of this section. The rules in § 1.956–1(e)(2) apply to determine the amount of an obligation treated as held by a partnership as a result of the application of § 1.956–2(c). See § 1.956–1T(b)(4) for special rules that may treat a controlled foreign corporation as holding a greater amount of United States property held by a partnership than the amount determined under this section.

(2) *Methodology*—(i) *Liquidation value percentage*. Except as otherwise provided in paragraph (b)(2)(ii) of this section, for purposes of paragraph (b)(1) of this section, a partner's attributable share of partnership property is determined in accordance with the partner's liquidation value percentage. For purposes of this paragraph (b)(2)(i), the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, immediately after the occurrence of the most recent event described in

§ 1.704–1(b)(2)(iv)(*f*)(*5*) or § 1.704–1(b)(2)(iv)(*s*)(*1*) (a *revaluation event*), or, if there has been no revaluation event, immediately after the formation of the partnership, as the case may be, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in § 1.752–7), paid an unrelated third party to assume all of its § 1.752–7 liabilities in a fully taxable transaction, and then liquidated. A partner's liquidation value percentage, which is determined upon the formation of a partnership and redetermined upon any revaluation event, irrespective of whether the capital accounts of the partners are adjusted under § 1.704–1(b)(2)(iv)(*f*), is the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership divided by the aggregate liquidation value of all of the partners' interests in the partnership.

(ii) *Special allocations*. For purposes of paragraph (b)(1) of this section, if a partnership agreement provides for the allocation of income (or, where appropriate, gain) from partnership property to a partner that differs from the partner's liquidation value percentage in a particular taxable year (a *special allocation*), then the partner's attributable share of that property is determined solely by reference to the partner's special allocation with respect to the property, provided the special allocation does not have a principal purpose of avoiding the purposes of section 956.

(3) *Examples*. The following examples illustrate the rule of this paragraph (b):

Example 1. (i) *Facts*. USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, which, in turn, owns an interest in FPRS, a foreign partnership. The remaining interest in FPRS is owned by an unrelated foreign person. FPRS holds non-depreciable property, with an adjusted basis of $100x, that would be United States property ("US property") if held by FS directly. At the close of quarter 1 of year 1, the liquidation value percentage, as determined under paragraph (b)(2) of this section, for FS with respect to FPRS is 25%. There are no special allocations in the FPRS partnership agreement.

(ii) *Result*. Under paragraph (b)(1) of this section, for purposes of section 956, FS is treated as holding its attributable share of the property held by FPRS with an adjusted basis equal to its attributable share of FPRS's adjusted basis in the property. Under paragraph (b)(2) of this section, FS's attributable share of FPRS's property is determined in accordance with FS's liquidation value percentage, which is 25%. Thus, FS's attributable share of property held by FPRS is 25%, and its attributable share of FPRS's basis in the property is $25x. Accordingly, for purposes of determining the amount of US property held by FS as of the close of quarter 1 of year 1, FS is treated as holding US property with an adjusted basis of $25x.

Example 2. (i) *Facts*. The facts are the same as in Example 1, except that the FPRS partnership agreement, which satisfies the requirements of section 704(b), specially allocates 80% of the income with respect to US property to FS. The special allocation does not have a principal purpose of avoiding the purposes of section 956.

(ii) *Result*. Under paragraph (b)(1) of this section, for purposes of section 956, FS is treated as holding its attributable share of the property held by FPRS with an adjusted basis equal to its attributable share of FPRS's adjusted basis in the property. In general, FS's attributable share of FPRS property is determined in accordance with FS's liquidation value percentage. However, under paragraph (b)(2)(ii) of this section, FS's attributable share of US property is determined in accordance with its special allocation. FS's special allocation percentage for US property is 80%, and thus FS's attributable share of US property held by FPRS is 80% and its attributable share of FPRS's basis in US property is $80x. Accordingly, for purposes of determining the amount of US property held by FS as of the close of quarter 1 of year 1, FS is treated as holding US property with an adjusted basis of $80x.

Example 3. (i) *Facts*. USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, which, in turn, owns an interest in FPRS, a foreign partnership. USP owns the remaining interest in FPRS. FPRS holds property (the "FPRS property") that would be United States property ("US property") if held by FS directly. The FPRS property is anticipated to appreciate in value but generate relatively little income. The US property has an adjusted basis of $100x. The FPRS partnership agreement, which satisfies the requirements of section 704(b), specially allocates 80% of the income with respect to the FPRS property to USP and 80% of the gain with respect to the disposition of FPRS property to FS. The special allocation does not have a principal purpose of avoiding the purposes of section 956.

(ii) *Result*. Under paragraph (b)(2)(ii) of this section, the partners' attributable shares of the FPRS property are determined in accordance with the special allocation of gain. Accordingly, for purposes of determining the amount of US property held by FS in each year that FPRS holds FPRS property, FS's attributable share of the FPRS property is 80% and its attributable share of FPRS's basis in US property is $80x. Thus, FS is treated as holding US property with an adjusted basis of $80x.

(c) *Obligations of a foreign partnership*—(1) *In general*. Except as provided in paragraphs (c)(2) and (3) of this section, for purposes of section 956, an obligation of a foreign partnership is treated as a separate obligation of each of the partners in the partnership to the extent of each partner's share of the obligation. A partner's share of the partnership's obligation is determined in accordance with the partner's interest in partnership profits. The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. An upper-tier partnership's share of an obligation of a lower-tier partnership is treated as an obligation of the upper-tier partnership for purposes of applying this paragraph (c)(1) to the partners of the upper-tier partnership.

(2) *Exception for obligations of partnerships in which neither the lending controlled foreign corporation nor any person related to the lending controlled foreign corporation is a partner*. For purposes of applying section 956 with respect to a controlled foreign corporation, an obligation of a foreign partnership is treated as an obligation of a foreign partnership, and not as an obligation of its partners, if neither the controlled foreign corporation nor any person related to the controlled foreign corporation within the meaning of section 954(d)(3) is a partner in the partnership. For purposes of section 956, an obligation treated as an obligation of a foreign partnership pursuant to this paragraph (c)(2) is not an obligation of a United States person.

(3) *Special obligor rule in the case of certain partnership distributions*. For purposes of determining a partner's share of a foreign partnership's obligation under section 956, if the foreign partnership distributes an amount of money or property to a partner that is related to a controlled foreign corporation within the meaning of section 954(d)(3) and whose obligation would be United States property if held (or if treated as held) by the controlled foreign corporation, and the foreign partnership would not have made the distribution but for a funding of the partnership through an obligation held (or treated as held) by a controlled foreign corporation, notwithstanding § 1.956–1(e), the partner's share of the partnership obligation is the greater of—

(i) The partner's share of the partnership obligation as determined under paragraph (c)(1) of this section; and

(ii) The lesser of the amount of the distribution that would not have been made but for the funding of the partnership and the amount of the obligation (as determined under § 1.956–1(e)).

(4) *Examples*. The following examples illustrate the rules of this paragraph (c):

Example 1. (i) *Facts*. USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, and owns a 90% interest in the partnership profits of FPRS, a foreign partnership. X, a foreign person that is unrelated to USP or FS, owns a 10% interest in the partnership profits of FPRS. FPRS borrows $100x from FS. FS's basis in the FPRS obligation is $100x.

(ii) *Result*. Under paragraph (c)(1) of this section, for purposes of section 956, the obligation of FPRS is treated as obligations of its partners (USP and X) to the extent of each partner's interest in the partnership profits of FPRS. Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), the exception in paragraph (c)(2) of this section does not apply. Based on its interest in FPRS's profits, USP's attributable share of the FPRS obligation is $90x. Accordingly, for purposes of section 956, $90x of the FPRS obligation held by FS is treated as an obligation of USP and is United States property within the meaning of section 956(c). Therefore, on the date the loan is made, FS is treated as holding United States property of $90x.

Example 2. (i) *Facts*. The facts are the same as in Example 1, except that USP owns 40% of the stock of FS and is not a related person (as defined in section 954(d)(3)) with respect to FS. Y, a United States person that is unrelated to USP or X, owns the remaining 60% of the stock of FS.

(ii) *Result*. Because neither FS nor any person related to FS within the meaning of section 954(d)(3) is a partner in FPRS, the exception in paragraph (c)(2) of this section applies to treat the FPRS obligation as an obligation of a foreign partnership and not an obligation of a United States person. Therefore, paragraph (c)(1) of this section does not apply, and FS is not treated as holding United States property.

Example 3. (i) *Facts*. USP, a domestic corporation, wholly owns FS, a controlled foreign corporation. USP has a 60% interest in the partnership profits of FPRS, a foreign partnership. FS has a 30% interest in the partnership profits of FPRS. USC, a domestic corporation that is unrelated to USP and FS, has a 10% interest in the partnership profits of FPRS. FPRS borrows $100x from an unrelated person. FS guarantees the FPRS obligation.

(ii) *Result*. Under paragraph (c)(1) of this section, for purposes of section 956, the obligation of FPRS is treated as obligations of its partners (USP, FS, and USC) to the extent of each partner's interest in the partnership profits of FPRS. Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), and because FS is a partner in FPRS, the exception in paragraph (c)(2) of this section does not apply. Based on their interests in partnership profits, USP's attributable share of the FPRS obligation is $60x, and USC's attributable share of the FPRS obligation is $10x. For purposes of section 956, $60x of the FPRS obligation is treated as an obligation of USP, and $10x of the FPRS obligation is treated as an obligation of USC. Under § 1.956–2(c)(1), FS is treated as holding the obligations of USP and USC that FS guaranteed. All of the exceptions to the definition of United States property contained in section 956 and § 1.956–2 apply to determine whether the obligations of USP and USC treated as held by FS constitute United States property. Accordingly, the obligation of USC is not United States property under section 956(c)(2)(F) and § 1.956–2(b)(1)(viii). The obligation of USP, however, is United States property within the meaning of section 956(c). Therefore, on the date the guarantee is made, FS is treated as holding United States property of $60x.

Example 4. (i) *Facts*. USP, a domestic corporation, wholly owns FS, a controlled foreign corporation. USP has a 70% interest in the partnership profits of FPRS, a foreign partnership. A domestic corporation that is unrelated to USP and FS has a 30% interest in the partnership profits of FPRS. FPRS borrows $100x from FS and makes a distribution of $80x to USP. FPRS would not have made the distribution to USP but for the funding of FPRS by FS.

(ii) *Result*. Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), the exception in paragraph (c)(2) of this section does not apply. Moreover, an obligation of USP held by FS would be United States property. USP's attributable share of the FPRS obligation as determined under paragraph (c)(1) of this section in accordance with USP's interest in partnership profits is $70x. Under paragraph (c)(3) of this section, USP's share of the FPRS obligation is the greater of (i) USP's attributable share of the obligation, $70x, or (ii) the lesser of the amount of the distribution, $80x, or the amount of the obligation, $100x. For purposes of section 956, therefore, $80x of the FPRS obligation is treated as an obligation of USP and is United States property within the meaning of section 956(c). Thus, on the date the loan is made, FS is treated as holding United States property of $80x.

(d) *Limitation on a partner's indirect pledge or guarantee*. For purposes of section 956 and § 1.956–2(c), a controlled foreign corporation that is a partner in a partnership is not considered a pledgor or guarantor of the portion of an obligation of the partnership attributed to its partners that are United States persons under paragraph (c) of this section solely as a result of the attribution of a portion of the partnership's assets to the controlled foreign corporation under paragraph (b) of this section.

(e) *Obligations of a domestic partnership*. For purposes of section 956, an obligation of a domestic partnership is an obligation of a United States person. See section 956(c)(2)(L) for an exception from the treatment of such an obligation as United States property.

(f) *Effective/applicability dates*. (1) Paragraph (b) of this section applies to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, and taxable years of United States shareholders in which or with which such taxable years end, with respect to property acquired on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation. For purposes of this paragraph (f)(1), a deemed exchange of property pursuant to section 1001 on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation constitutes an acquisition of the property on or after that date.

(2) Paragraph (c) of this section applies to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, and taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations acquired, or pledges or guarantees entered into, on or after September 1, 2015. For purposes of this paragraph (f)(2), a significant modification, within the meaning of § 1.1001–3(e), of an obligation on or after September 1, 2015, constitutes an acquisition of the obligation on or after that date. Furthermore, for purposes of this paragraph (f)(2), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

(3) Paragraph (d) of this section applies to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, and taxable years of United States shareholders in which or with which such taxable years end, with respect to pledges or guarantees entered into on or after September 1, 2015. For purposes of this paragraph (f)(3), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

(4) Paragraph (e) of this section applies to taxable years of controlled foreign corporations ending on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation, and to taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations held on or after the date of publication in the **Federal Register** of the Treasury decision adopting this rule as a final regulation.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

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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.

Numerical Finding List[1]

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