



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-120282-10]

RIN 1545-BJ56

Dividend Equivalents from Sources within the United States.

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing temporary regulations that provide guidance on the definition of the term “specified notional principal contract” for purposes of section 871(m) of the Internal Revenue Code (Code) beginning after March 18, 2012 through December 31, 2012.

The text of those regulations also serves as the text of the proposed regulations. The preamble to the temporary regulations explains the amendments added by the temporary regulations. The preamble to this notice of proposed rulemaking explains the proposed regulations, which provide guidance to nonresident aliens and foreign corporations that hold certain financial products providing for payments that are contingent upon or determined by reference to payments of dividends from sources within the United States. This document also provides a notice of a public hearing on these proposed regulations.

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

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

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

**SUPPLEMENTARY INFORMATION:**

**Background**

Temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** amend the Income Tax Regulations (26 CFR part 1) relating to section 871. The temporary regulations extend the section 871(m)(3)(A) statutory definition of the term specified notional principal contract (specified NPC) through December 31, 2012. This document contains proposed regulations under section

871(m) of the Code that will be applicable as of January 1, 2013. The preamble to the temporary regulations provides a discussion of the background of section 871(m) and explains the provisions contained in the temporary regulations and §1.871-16(b) of these proposed regulations.

#### 1. In General

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

For purposes of determining a dividend equivalent, the term payment includes any gross amount used in computing any net amount transferred to or from the taxpayer. For example, the terms of a notional principal contract (NPC) may provide for periodic payments by each of the counterparties that occur at quarterly intervals. Because these payments may offset each other, in whole or in part, the terms of such contracts generally provide for payment of only the net amount owed between the

counterparties (that is, the difference between the amounts owed between the counterparties). A dividend equivalent is equal to the gross amount that is contingent upon or determined by reference to a dividend used to determine a net amount, even if no net payment is made or the party entitled to a gross amount determined by reference to a dividend is required to make a net payment to the other contracting party.

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

## 2. Definition of Specified Notional Principal Contract

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

### A. Transition Period

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

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

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

A long party is considered to be “in the market” if the long party sells the underlying security on the same day that the parties price an NPC or purchases the underlying security on the day that the parties terminate an NPC. An NPC is sometimes

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

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

Section 871(m)(3)(A)(iv) provides that prior to March 18, 2012, an NPC will be a specified NPC if the short party to the contract posts the underlying security as collateral with any long party to the contract. The Treasury Department and the IRS believe that when a short party posts the underlying security as collateral with the long party the related NPC should be a specified NPC. In the event of default by the short party, the fact that the underlying security is posted as collateral guarantees that the value of the collateral moves in tandem with the contract. This concern is less applicable when the

value of the underlying securities posted as collateral is a small portion of the total amount of cash or other property posted as collateral for the NPC. The proposed regulations treat an NPC as a specified NPC only if the underlying security is posted as collateral and the underlying security represents more than ten percent of the total fair market value posted as collateral on any day that the NPC is in effect.

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

In some situations, the long party controls the acquisition of stock that the short party uses to hedge its position under the contract or has directed the short party to sell the short party's hedge to a particular purchaser at a specific price and date. The long party in these situations may exercise such control over the short party's hedge pursuant to terms of a written agreement or through course of conduct. The Treasury Department and the IRS believe that the source rule of section 871(m) should apply to an NPC when a long party exercises control over the short party's hedge. Accordingly, the proposed regulations treat an NPC as a specified NPC when a foreign investor

controls the short party's hedge or participates in an underlying equity control program. An underlying equity control program is any system, whether carried out electronically or otherwise, that allows a long party to direct its counterparty's hedge of an NPC or that allows a long party to acquire economic exposure to an underlying security and to determine the form of the transaction later. An underlying equity control program, however, does not include an electronic trading platform that allows a customer to place an order to enter into an NPC with a dealer, provided that the dealer independently determines whether and how to hedge its position without customer direction.

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

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



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

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

### 3. Underlying Security

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

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

These proposed regulations amend several regulations under section 1441 to require a withholding agent to withhold tax owed with respect to a dividend equivalent. If an NPC that is not a specified NPC on the date it is entered into becomes a specified NPC during the term of the contract, it will be treated as though it had been a specified NPC during the entire term of the contract. Payments made under the NPC by reference to the payment of a dividend from sources within the United States will be re-characterized as dividend equivalents and all tax owed with respect to such dividend equivalents will be due at the time of the next payment made under the NPC, including a termination payment. In cases where the tax owed is greater than the next payment made under the specified NPC, the withholding agent is responsible for reporting and depositing the total amount due with the IRS. The mechanism by which a withholding agent collects the amount due from the taxpayer is left to the discretion of the withholding agent and the taxpayer, and is not specified in these proposed regulations. The withholding agent must deposit the total amount due even if it cannot collect the amount from the counterparty.

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

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory

assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Public Hearing**

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

A public hearing has been scheduled for April 27, 2012, beginning at 10:00 a.m. in the auditorium of the Internal Revenue Service Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “**FOR FURTHER INFORMATION CONTACT**” section of this preamble. The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present

oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic by April 6, 2012. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### **Drafting Information**

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

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

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

#### **PART 1-- INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 871(m) and 7805 \* \* \*

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

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

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

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

§1.871-15 Treatment of dividend equivalents.

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

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

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

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

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

(2) Exception--(i) In general. The term dividend equivalent does not include any payment made pursuant to a specified NPC, or any substantially similar payment as defined in §1.871-15(d), if such payment is contingent upon or determined by reference

to an estimate of expected dividends and the estimate of an expected dividend is not adjusted in any way for the amount of an actual dividend.

(ii) Expected dividends. For purposes of this section, an expected dividend is not considered an estimate of expected dividends on or after the date that the corporate issuer announces a dividend. A dividend announcement occurs on the earliest date on which the corporation declares, announces, or agrees to the amount or payment of such dividend.

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

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

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

(ii) Any payment, including the payment of the purchase price or an adjustment to the purchase price, is a dividend equivalent if made pursuant to an equity-linked

instrument that is contingent upon or determined by reference to a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States.

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

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

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

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

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

§1.871-16 Specified notional principal contracts.

(a) Purpose and scope. This section provides guidance with respect to the definition of a “specified notional principal contract” (specified NPC). Paragraph (b) of this section provides the definition of a specified NPC for payments made after March

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

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

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

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

(i) Determining when a long party is in the market. The long party is “in the market” with respect to the underlying security if the long party--

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

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



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

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

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

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

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

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

(ii) Qualified exchange. For purposes of paragraph (c)(2)(i) of this section, the term qualified exchange means a national securities exchange that is registered with

the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities Exchange Act of 1934 (15 U.S.C. 78f).

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

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

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

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

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

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

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

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

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

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

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

(d) Specified NPC status arising during the term of the contract--(1) In general. This section provides rules for determining the timing and amount of a dividend equivalent when an NPC is not a specified NPC on the date the parties enter into the NPC and subsequently becomes a specified NPC during the term of the transaction. If an NPC that is not a specified NPC on the date the parties enter into the contract subsequently becomes a specified NPC, any payment made during the term of the contract (including any payment during the period between the date the contract is entered into and the date the contract becomes a specified NPC) that is contingent

upon or determined by reference to the payment of a dividend from sources within the United States is a dividend equivalent.

(2) Determination of dividend equivalent--(i) In general. For purposes of sections 871(a), 881, 4948(a), and chapters 3 and 4 of subtitle A of the Code, when an NPC becomes a specified NPC during the term of the contract, any tax owed with respect to a dividend equivalent made prior to the NPC becoming a specified NPC is payable when the next payment as described in §1.1871-15(c), including a termination payment, is made pursuant to the contract.

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

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

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

NPC becomes a specified NPC within the meaning of section 871(m), §§1.871-15, and 1.871-16. On Day 120, Party A terminates the contract and makes a net termination payment to Party B. In calculating the net payment, Party B determined that it owes Party A \$25 based on a dividend paid with respect to the shares of Corporation X and that Party A owes it \$125 attributable to interest and the decrease in the value of the shares of Corporation X.

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

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

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

(f) Definitions--(1) Underlying security. For purposes of this section, the term underlying security means, for any NPC, the security with respect to which the dividend referred to in §1.871-15(b)(1)(ii) is paid. If an NPC references more than one security or a customized index, each security or component of such customized index is treated as an underlying security in a separate NPC for purposes of section 871(m), §1.871-15, and this section.

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

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

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

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

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

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

(A) A narrow-based index; or

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

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

(A) That has nine or fewer component securities;

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

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

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

(iii) Aggregate dollar value of average daily trading volume. For purposes of determining whether an index is a narrow-based index, the method for determining the aggregate dollar value of average daily trading volume is the method described in Rule 3a55-1(b)(1), 17 CFR 240.3a55-1(b)(1), under the Securities Exchange Act of 1934, as in effect on **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

(4) Long party. The long party is the party with respect to an NPC entitled to receive any payment pursuant to such contract that is contingent upon or determined by

reference to the payment of a dividend from sources within the United States on an underlying security.

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

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

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

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

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

\* \* \* \* \*

(b) \* \* \*

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

\* \* \* \* \*

(e) Effective/applicability date. Except as otherwise provided in this paragraph (e), this section applies for taxable years beginning after December 31, 1966. Paragraph (b)(2) of this section is applicable to payments made after November 13, 1997. Paragraph (b)(3) of this section applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the



**Federal Register.** For corresponding rules applicable to taxable years beginning before January 1, 1967, see 26 CFR 1.881–2 (Revised as of January 1, 1971).

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

§1.892-3 Income of foreign governments.

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

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

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

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

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

§1.894-1 Income affected by treaty.

\* \* \* \* \*

(c) \* \* \*

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

\* \* \* \* \*

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

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

§1.1441-2 Amounts subject to withholding.

\* \* \* \* \*

(b) \* \* \*

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

\* \* \* \* \*

(e) \* \* \*

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

(f) Effective/applicability date. Except as otherwise provided in this paragraph (f), this section applies to payments made after December 31, 2000. Paragraphs (b)(5) and (d)(4) of this section apply to payments made after August 1, 2006. Paragraphs (b)(6)

and (e)(7) of this section apply to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

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

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

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

The revision and addition read as follows:

§1.1441-3 Determination of amounts to be withheld.

\* \* \* \* \*

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

(2) Procedures for withholding with respect to a dividend equivalent paid prior to a notional principal contract (NPC) becoming a specified NPC. In the event that an NPC becomes a specified NPC (as defined in §1.871-16) after the date that the parties enter into the NPC, the term dividend equivalent includes any payment that is made prior to the date the NPC becomes a specified NPC and that was (directly or indirectly) contingent upon or determined by reference to the payment of a dividend (including payments pursuant to a redemption of stock that gives rise to a dividend under section 301) from sources within the United States. The withholding agent is required to withhold with respect to a dividend equivalent made prior to the NPC becoming a specified NPC when the next payment as described in §1.871-15(c), including a termination payment, is made pursuant to the contract. For purposes of section 6601

and the regulations thereunder, the last date prescribed for payment of tax imposed with respect to a dividend equivalent made prior to an NPC becoming a specified NPC is determined based on the date of the next payment as described in §1.871-15(c), including a termination payment, made pursuant to the contract. For further guidance regarding liability for penalties and interest, see §§1.1441-1(b)(7)(iii) and 1.1461-1(a)(2).

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

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

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

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

1. Revising paragraph (a)(3)(i).
2. Adding paragraph (a)(3)(iii).
3. Revising paragraph (g)(1).

The revisions and addition read as follows:

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

(a)\* \* \*

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

(ii) \* \* \*

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

\* \* \* \* \*

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

\* \* \* \* \*

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

1. Revising paragraph (c)(2).
2. Redesignating paragraph (h) as paragraph (i) and revising newly designated paragraph (i).
3. Adding a new paragraph (h).

The revision and addition read as follows:

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

\* \* \* \* \*

(c) \* \* \*

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

\* \* \* \* \*

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

(i) Effective/applicability dates--(1) General rule. This section applies to payments made after December 31, 2000, except for paragraph (g) of this section which applies to payments made after December 31, 2001, and paragraph (h) of this section which

applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

(2) [Reserved]

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

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

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

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

4. Revising paragraph (g).

The revision and addition read as follows:

§1.1441-7 General provisions relating to withholding agents.

(a) \* \* \*

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

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

\* \* \* \* \*

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

\* \* \* \* \*

(g) Effective/applicability date. Except as otherwise provided in paragraph (f)(3) of this section and as otherwise provided in this paragraph (g), this section applies to payments made after December 31, 2000. Paragraph (a)(2) applies to payments made

on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**.

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

1. Redesignating paragraph (c)(2)(i)(L) and (M) as paragraphs (c)(2)(i)(M) and (N) respectively.
2. Adding a new paragraph (c)(2)(i)(L).
3. Revising paragraph (i).

The addition reads as follows:

§1.1461-1 Payment and returns of tax withheld.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(i) \* \* \*

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

\* \* \* \* \*

(i) Effective/applicability date. Unless otherwise provided in this section and as otherwise provided in this paragraph (i), this section shall apply to returns required for



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

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

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