

balancing authority and transmission operator responsibilities during a system emergency.<sup>109</sup>

### III. Information Collection Statement

100. The Commission's information collection requirements are typically subject to review by the Office of Management and Budget (OMB) under section 3507(d) of the Paperwork Reduction Act of 1995.<sup>110</sup> However, by remanding the TOP and IRO Reliability Standards, any information collection requirements are unchanged. With regard to proposed Reliability Standard TOP-006-3, the Commission estimates that the information collection burden will not change as compared to the currently-effective standard. The reporting requirements for transmission operators and balancing authorities remain unchanged because the new requirements clarify the existing standard that the transmission operators report transmission information, while the balancing authorities report generation information.

### IV. Environmental Analysis

101. The Commission is required to prepare an Environmental Assessment or an Environmental Impact Statement for any action that may have a significant adverse effect on the human environment.<sup>111</sup> The Commission has categorically excluded certain actions from this requirement as not having a significant effect on the human environment. Included in the exclusion are rules that are clarifying, corrective, or procedural or that do not substantially change the effect of the regulations being amended.<sup>112</sup> The actions proposed herein fall within this categorical exclusion in the Commission's regulations.

### V. Regulatory Flexibility Act Certification

102. The Regulatory Flexibility Act of 1980 (RFA)<sup>113</sup> generally requires a description and analysis of final rules that will have significant economic impact on a substantial number of small entities. The RFA mandates consideration of regulatory alternatives that accomplish the stated objectives of a proposed rule and that minimize any significant economic impact on a

substantial number of small entities. The Small Business Administration's (SBA) Office of Size Standards develops the numerical definition of a small business.<sup>114</sup> The SBA has established a size standard for electric utilities, stating that a firm is small if, including its affiliates, it is primarily engaged in the transmission, generation and/or distribution of electric energy for sale and its total electric output for the preceding twelve months did not exceed four million megawatt hours.<sup>115</sup> The RFA is not implicated by this NOPR because the Commission is proposing to remand the TOP and IRO Reliability Standards and not proposing any modifications to the existing burden or reporting requirements. With no changes to the TOP and IRO Reliability Standards as approved, the Commission certifies that this NOPR will not have a significant economic impact on a substantial number of small entities.

103. In addition, for proposed Reliability Standard TOP-006-3, the Commission estimates that there will be no material change in burden for all small entities because the effect of the changes merely clarify that transmission operators are responsible for reporting transmission information while balancing authorities are responsible for reporting generation information.

### VI. Comment Procedures

104. The Commission invites interested persons to submit comments on the matters and issues proposed in this notice to be adopted, including any related matters or alternative proposals that commenters may wish to discuss. Comments are due February 3, 2014. Comments must refer to Docket No. RM13-15-000, and must include the commenter's name, the organization they represent, if applicable, and their address in their comments.

105. The Commission encourages comments to be filed electronically via the eFiling link on the Commission's Web site at <http://www.ferc.gov>. The Commission accepts most standard word processing formats. Documents created electronically using word processing software should be filed in native applications or print-to-PDF format and not in a scanned format. Commenters filing electronically do not need to make a paper filing.

106. Commenters that are not able to file comments electronically must send an original of their comments to: Federal Energy Regulatory Commission, Secretary of the Commission, 888 First Street NE., Washington, DC 20426.

107. All comments will be placed in the Commission's public files and may be viewed, printed, or downloaded remotely as described in the Document Availability section below. Commenters on this proposal are not required to serve copies of their comments on other commenters.

### VII. Document Availability

108. In addition to publishing the full text of this document in the **Federal Register**, the Commission provides all interested persons an opportunity to view and/or print the contents of this document via the Internet through the Commission's Home Page (<http://www.ferc.gov>) and in the Commission's Public Reference Room during normal business hours (8:30 a.m. to 5:00 p.m. Eastern time) at 888 First Street NE., Room 2A, Washington, DC 20426.

109. From the Commission's Home Page on the Internet, this information is available on eLibrary. The full text of this document is available on eLibrary in PDF and Microsoft Word format for viewing, printing, and/or downloading. To access this document in eLibrary, type the docket number excluding the last three digits of this document in the docket number field.

110. User assistance is available for eLibrary and the Commission's Web site during normal business hours from the Commission's Online Support at (202) 502-6652 (toll free at 1-866-208-3676) or email at [ferconlinesupport@ferc.gov](mailto:ferconlinesupport@ferc.gov), or the Public Reference Room at (202) 502-8371, TTY (202) 502-8659. Email the Public Reference Room at [public.referenceroom@ferc.gov](mailto:public.referenceroom@ferc.gov).

By direction of the Commission.  
**Nathaniel J. Davis, Sr.**,  
*Deputy Secretary.*

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**BILLING CODE 6717-01-P**

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## 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:** Withdrawal of notice of proposed rulemaking, notice of proposed rulemaking and notice of public hearing.

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<sup>109</sup> *Electric Reliability Organization Interpretation of Transmission Operations Reliability Standard*, 136 FERC ¶ 61,176 (2011).

<sup>110</sup> 44 U.S.C. 3507(d) (2012).

<sup>111</sup> Order No. 486, Regulations Implementing the National Environmental Policy Act, 52 FR 47897 (Dec. 17, 1987), FERC Stats. & Regs. Preambles 1986-1990 ¶ 30,783 (1987).

<sup>112</sup> 18 CFR 380.4(a)(2)(ii).

<sup>113</sup> 5 U.S.C. 601-612.

<sup>114</sup> 13 CFR 121.201.

<sup>115</sup> *Id.* n.22.

**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 and to withholding agents. It withdraws proposed regulations under section 871(m) that were published in the **Federal Register** on January 23, 2012 (77 FR 3202). This document also provides a notice of a public hearing on these proposed regulations.

**DATES:** Written or electronic comments must be received by March 5, 2014. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for April, 11, 2014, at 10 a.m., must be received by March 5, 2014.

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-120282-10), 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-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, beginning at 10 a.m., at the Internal Revenue Service Building, 1111 Constitution Avenue NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, D. Peter Merkel or Karen Walny at (202) 317-6938 (not a toll-free number); concerning submission of comments, the hearing, or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, Publications and Regulations Branch Specialist, at (202) 317-6901 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Paperwork Reduction Act**

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Office 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 February 3, 2014. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through 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 collections of information in this notice of proposed rulemaking are in §§ 1.871-15(j) and (o), 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. Under § 1.871-15(o), a broker, dealer, or short party is required to provide information relating to a potential section 871(m) transaction in a commercially reasonable fashion. The information may include whether the transaction is a section 871(m) transaction, the delta of the transaction, estimates of dividends, and the amount of the dividend equivalents. This information is required to establish whether a payment is treated as a U.S. source dividend for purposes of section 871(m). This information will be used for audit and examination purposes. The likely respondents are businesses and other for-profit institutions.

Estimated total annual reporting burden is 240,000 hours.

Estimated average annual burden per respondent is 8 hours.

Estimated average burden per response is 4 minutes.

Estimated number of respondents is 30,000.

Estimated total annual frequency of responses is 4,000,000.

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

Books or records relating to a collection of information must be retained as long as their contents may

become material in the administration of any internal revenue law. 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 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) of the Internal Revenue Code (Code). The 2012 section 871(m) regulations related 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, which are available at [www.regulations.gov](http://www.regulations.gov). A public hearing was held on April 27, 2012.

This document withdraws the 2012 proposed regulations and provides new proposed regulations (2013 proposed regulations). Based on comments received on the 2012 proposed regulations, the Treasury Department and the IRS believe that the 2013 proposed regulations better identify (1) when a notional principal contract (NPC) "is of a type which does not have the potential for tax avoidance" and (2) other payments that are dividend equivalents because they are substantially similar to specified NPC payments and substitute dividend payments.

This preamble discusses section 871(m), describes the 2012 section 871(m) regulations, summarizes the comments received on the 2012 section 871(m) regulations, and explains the 2013 proposed regulations.

**1. Section 871(m)**

Congress enacted section 871(m) (originally designated as section 871(l)) on March 18, 2010, in section 541 of the Hiring Incentives to Restore Employment Act (HIRE Act), Public Law 111-147 (124 Stat. 71). Section 871(m) treats a dividend equivalent as a

dividend from sources within the United States for purposes of sections 871(a), 881, and 4948(a), and chapters 3 and 4 of subtitle A of the Code. Section 871(m) applies to any dividend equivalent paid on or after September 14, 2010. Section 871(m)(5) provides that the term payment includes any gross amount that is used in computing any net payment that is transferred to or from the taxpayer.

Section 871(m)(2) defines a dividend equivalent as (1) any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) 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 (directly or indirectly) is contingent upon or determined by reference to the payment of a dividend from sources within the United States, or (3) any other payment that the Secretary determines is “substantially similar” to a specified NPC payment or substitute dividend payment.

Section 871(m)(3) defines the term specified NPC. For payments made on or after September 14, 2010, and on or before March 18, 2012, section 871(m)(3)(A) defines a specified NPC as any NPC if (1) the long party transferred the underlying security to the short party in connection with entering into the NPC, (2) the short party transferred the underlying security to the long party in connection with the termination of the NPC, (3) the underlying security is not readily tradable on an established securities market, (4) the short party posted the underlying security as collateral with the long party, or (5) the NPC is identified by the Secretary as a specified NPC. For payments made after March 18, 2012, section 871(m)(3)(B) provides that any NPC is a specified NPC unless the Secretary determines that the NPC is of a type that does not have the potential for tax avoidance.

## 2. 2012 Section 871(m) Regulations

The 2012 section 871(m) regulations provided guidance regarding dividend equivalents under section 871(m). Generally, the 2012 section 871(m) regulations defined the terms specified NPC and substantially similar payment, addressed certain issues regarding withholding of tax with respect to the payment of a dividend equivalent, and provided other rules relating to dividend equivalents.

Section 1.871–15(c) of the 2012 proposed regulations provided that a dividend equivalent included any gross amount used to compute any net amount transferred to or from the

taxpayer, even if the taxpayer made a net payment or no payment was made because the net amount was zero. A dividend equivalent, however, did not include any amount determined by reference to an estimate of an expected (but not yet announced) dividend. This exception did not apply if the estimate adjusted to reflect the amount of the actual dividend.

Section 1.871–16 of the 2012 section 871(m) regulations defined the term specified NPC with respect to payments made after March 18, 2012. For payments made prior to January 1, 2014, the 2012 temporary regulations (as amended by the correcting amendment published at 77 FR 53141) defined a specified NPC using substantially the same definition as provided in section 871(m)(3)(A). For payments made on or after January 1, 2014, the 2012 proposed regulations defined a specified NPC as an NPC that meets one or more of the following factors: (1) The long party is “in the market” on the same day that the parties priced or terminated the NPC; (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 actual term of the NPC is 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; or (7) the NPC is entered into on or after the announcement of a special dividend and prior to the ex-dividend date.

Section 1.871–15(d) of the 2012 proposed regulations described payments that are substantially similar to substitute dividends made pursuant to securities lending and sale-repurchase transactions and to payments made pursuant to specified NPCs. A substantially similar payment was any (1) gross-up amount paid by a short party in satisfaction of the long party’s tax liability with respect to a dividend equivalent, or (2) payment made pursuant to an equity-linked instrument (ELI) that was calculated by reference to a dividend from sources within the United States if the ELI satisfied one or more of the specified NPC factors.

The 2012 proposed regulations provided that certain indices referenced by an NPC or ELI would not be underlying securities, and therefore, would not be subject to section 871(m). Section 1.871–16(f)(1) of the 2012 proposed regulations provided that each

component security of a customized index would be treated as an underlying security in a separate NPC. Section 1.871–16(f)(3) of the 2012 proposed regulations defined a customized index as (1) a “narrow-based index,” which was generally defined based on the Securities Exchange Act of 1934, section 3(a)(5)(B); or (2) any other index unless futures contracts or options contracts referencing the index trade on a qualified board or exchange.

The 2012 section 871(m) regulations provided rules under section 1441 to require a withholding agent to withhold tax owed with respect to a dividend equivalent. Many of these amendments and proposals simply coordinated the rules in § 1.871–16T of the 2012 temporary regulations and §§ 1.871–15 and 1.871–16 of the 2012 proposed regulations with the withholding rules in chapter 3 of the Code. Section 1.1441–3(h)(2) of the 2012 proposed regulations explained the procedures for withholding when an NPC became a specified NPC after the date that the parties entered into the NPC. The proposed regulations provided that the term dividend equivalent included any payment that was made prior to the date the NPC became a specified NPC and that was (directly or indirectly) contingent upon or determined by reference to the payment of a dividend from sources within the United States.

## 3. Summary of Comments on the 2012 Section 871(m) Regulations

The Treasury Department and the IRS received numerous comments regarding the 2012 section 871(m) regulations. The major concerns raised in the comments related to (1) the definition of a specified NPC, (2) the definition of an ELI, (3) withholding issues that arise regarding the payment of a dividend equivalent, (4) the potential for over-withholding in a chain of transactions, (5) the treatment of indices, and (6) the effective date of the 2012 proposed regulations.

### A. Definition of Specified NPC

Several comments on the 2012 proposed regulations stated that the seven-factor approach to defining a specified NPC would not accurately identify tax avoidance transactions. These comments asserted that the factors could treat a contract as a specified NPC even when the contract was not entered into primarily to avoid withholding. Similarly, comments noted that some tax-motivated transactions would not be subject to tax under section 871(m) because the transaction would not meet any of the seven factors. These comments generally

recommended substantial modification to the factors used in the 2012 proposed regulations.

Comments stated that the term of a contract does not indicate the potential for tax avoidance. Comments noted that the term rule could result in retroactive withholding obligations and that it would be difficult for withholding agents to design systems to monitor withholding obligations that may arise after a payment has been made. Other comments asserted that 90 days was not the appropriate threshold for a minimum term and suggested eliminating the 90-day term factor or reducing the minimum term. Another comment acknowledged that the length of the term may indicate that a contract has a tax avoidance motive; however, this comment recommended adding an exception for termination events that are beyond the control of the parties to the transaction.

Comments asserted that withholding agents and taxpayers would have difficulty applying the “in the market” factor. Those comments recommended that a long party should be treated as being “in the market” only when the long party sold or purchased the underlying security “in connection with” entering into or terminating an NPC. In addition, several comments indicated that withholding agents would have difficulty determining whether a long party was “in the market” and would have to rely on representations from the long party to the withholding agent.

#### B. Definition of ELI

Comments stated that the definition of specified ELI in the 2012 proposed regulations was overly broad because numerous types of ELIs do not give rise to the policy concerns underlying section 871(m). The comments requested that the final regulations limit the scope of the term ELI to contracts that provide delta-one or near-delta-one exposure to the underlying equity. One comment explained that the delta of an instrument reflects the change in the value of the instrument relative to a change in the value of the underlying security. These comments asserted that non-delta-one derivatives do not provide investors with a substitute for physical ownership of the underlying security. One comment, however, disagreed that a delta-based standard is the appropriate criteria for ELIs. This comment stated that a delta-based standard would provide non-delta-one financial instruments with a competitive advantage over delta-one products because non-delta-one

financial instruments would be subject to more favorable tax treatment.

Another comment suggested that the term ELI should not include single stock futures contracts (SSFs) unless the SSF is an “exchange future for physical” (EFP). That comment described an EFP as a transaction in which an investor (1) sold stock and purchased an SSF for future delivery of the same stock or (2) purchased stock and sold an SSF to deliver the same stock in the future. The comment maintained that an SSF, other than an EFP, should not be treated as an ELI because SSFs trade on a regulated exchange, unlike bilateral over-the-counter contracts. The comment also asserted that an adjustment to the settlement price of an SSF is not a payment upon which withholding may be applied.

Similarly, several comments recommended that the final regulations provide an exception to the term ELI for exchange-traded options because many of these options do not provide close economic substitutes for owning stock. These comments explained that two of the seven specified NPC factors will apply to many standard exchange-traded options. First, the majority of exchange-traded options have an initial term of less than 90 days. Second, when an investor exercises an exchange-traded call option, the investor acquires the underlying securities because the terms of the transaction require physical settlement. If exchange-traded options continue to be treated as ELIs, these comments recommended that the final regulations account for the differences between over-the-counter and exchange-traded options.

#### C. Withholding Issues

Comments requested clarification on how the 2012 proposed regulations would interact with the withholding rules of chapter 3. Comments asserted that the 2012 proposed regulations did not clearly address whether intermediaries, custodians, clearing organizations, and members of clearing organizations are withholding agents. Due to the large volume of transactions cleared by exchanges on a daily basis, one comment noted that it would be impractical to treat an exchange as a withholding agent. Other comments stated that the 2012 proposed regulations would impose an undue burden on broker-dealers with non-U.S. customers because the broker-dealers would have to develop complicated systems to determine whether an instrument is an ELI and the amount of any dividend equivalent.

Other comments suggested limiting a withholding agent’s liability for

withholding tax with respect to dividend equivalents. Comments stated that a withholding agent should not be liable for U.S. tax when the withholding agent lacks the information necessary to determine whether a transaction constitutes a specified NPC. For instance, comments noted that a withholding agent may not know whether a long party is selling or purchasing underlying securities on the same day that a specified NPC or ELI is entered into or terminated. A comment asserted that withholding for U.S. tax would be complicated and impractical if the final regulations do not limit a withholding agent’s knowledge to the information available to the withholding agent at the trading unit level.

Comments also questioned the rule in § 1.1441–3(h)(2) of the 2012 proposed regulations treating all payments as dividend equivalents if a contract became a specified NPC only as a result of the long party acquiring physical shares upon termination (“crossing out”). Comments stated that the 2012 proposed regulations unfairly would have required a withholding agent to withhold for U.S. tax on all payments made pursuant to a contract that would be treated as dividend equivalents when the contract only became a specified NPC because of a “cross out” at the end of the contract. Other comments recommended that this rule prescribing retroactive treatment of a payment as a dividend equivalent should apply only to NPCs that are specified NPCs because they meet the “in the market” or the 90-day factor.

#### D. Chain of Transactions

Several comments stated that a chain of equity derivatives could result in the collection of cascading U.S. tax, for example, when each transaction in a chain of back-to-back equity derivatives referencing the same underlying security is subject to U.S. withholding tax. Some comments recommended that the final regulations incorporate specified NPCs into the qualified securities lender and credit forward regimes described in Notice 2010–46, 2010–24 I.R.B. 757, which outlines a framework for limiting the amount of U.S. tax withheld in a chain of securities lending or sale-repurchase transactions. See § 601.601(d)(2)(ii)(b). Other comments recommended that certain transactions be exempt from section 871(m), such as transactions entered into by a non-U.S. dealer as a long party in the ordinary course of business with customers. Comments explained that these transactions should be exempt from section 871(m) because the non-U.S. dealer does not enter into

the transaction to avoid U.S. tax and U.S. tax would be paid on any dividend equivalent paid to the customers of the non-U.S. dealer.

#### E. Indices

Comments recommended several changes to the definition of the terms narrow-based index and customized index. One comment questioned the definition of narrow-based index and suggested that the final regulations incorporate the exceptions to that term provided in section 3(a)(55) of the Securities Exchange Act of 1934.

Several comments suggested changes that would narrow the scope of the term customized index. For example, comments suggested that the term customized index be revised to apply only to a narrow-based index or any index offered by a publisher that is not a "recognized independent index publisher." Another comment recommended that the definition of a customized index exclude an index if an exchange-traded fund, exchanged-traded note, or other exchange-traded derivative tracked that index. One comment suggested that the final regulations provide that a customized index does not include any index with respect to which U.S. equity securities comprise less than 20 percent of the notional value.

Other comments suggested that the final regulations broaden the definition of customized index because the definition in the 2012 proposed regulation may have permitted certain transactions designed to avoid U.S. tax. For example, one comment suggested that a customized index should include any index that uses dividend yield as the primary criteria for inclusion in the index. Another comment noted that a partnership may function in the same manner as a customized index if the partnership was formed to hold a small basket of U.S. securities.

#### F. Effective Dates

The 2012 proposed regulations provided that the rules would apply to payments made on or after the date of publication of the Treasury decision adopting those rules as final regulations. Comments expressed concern about the potentially retroactive effect of the regulations. With respect to ELIs, comments recommended that the final regulations should apply only to those transactions entered into after the effective date (rather than payments made after the effective date) because taxpayers and withholding agents did not foresee that these contracts would be subject to U.S. tax. Comments also recommended that the effective date of

the final regulations be delayed because market participants will be required to make systems modifications and operational adjustments to comply with the final regulations.

#### 4. Explanation of Provisions

After consideration of the comments, the Treasury Department and the IRS agree that the proposed seven-factor approach to identify a specified NPC does not provide the best framework for evaluating whether an NPC "is of a type which does not have the potential for tax avoidance" and that the seven-factor approach would be difficult to administer, both for the IRS and withholding agents. Accordingly, the Treasury Department and the IRS are withdrawing the 2012 proposed regulations and proposing new regulations based on the objective measurement of a derivative's delta to determine whether a contract is subject to tax under section 871(m). The delta of an NPC or ELI is the ratio of the change in the fair market value of the contract to the change in the fair market value of the property referenced by the contract. This approach is consistent with comments suggesting that the delta of an option be used to determine whether the option is a specified ELI.

The Treasury Department and the IRS believe that this delta-based standard will prevent taxpayers from avoiding withholding tax by electing derivative exposure to U.S. equities rather than physical ownership.

A transaction has the "potential for tax avoidance" if it approximates the economics of owning an underlying security without incurring the tax liability associated with owning that security. In many cases, a long party is indifferent as to whether to invest in a derivative or a physical position because the derivative and the physical position provide comparable economic returns. Furthermore, the short party will often hedge an NPC or ELI by acquiring physical securities in proportion to the delta of the derivative to which it is exposed. When dividends paid on physical securities are subject to tax while dividend equivalents with respect to economically comparable derivatives are not, those derivatives have a potential for tax avoidance regardless of whether a long party is using the derivative in a particular case to avoid tax. Accordingly, the Treasury Department and the IRS favor a delta approach that objectively identifies transactions in which the long party is able to sufficiently approximate the economic returns associated with an underlying security.

In addition, the Treasury Department and the IRS believe that the delta-based standard of the 2013 proposed regulations provides a simpler and more administrable framework than the seven-factor test of the 2012 proposed regulations. Using the delta of an NPC or ELI to determine the application of section 871(m) employs a single standard for NPCs and ELIs, although the regulations have different applicability dates for specified NPCs and specified ELIs. Therefore, for both equity swaps and other equity derivatives, the determination of whether a transaction may give rise to a dividend equivalent will generally depend only on the determination of a single objective measurement at the time the transaction is acquired.

This notice of proposed rulemaking should not be construed as providing guidance with respect to any other section of the Code. For example, this notice should not be used as a basis for applying the delta standard to interpret other Code sections.

#### A. In General

Section 1.871-15(b) of the 2013 proposed regulations treats a dividend equivalent 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. Section 1.871-15(c) provides that a dividend equivalent is (1) any payment of a substitute dividend made pursuant to a securities lending or sale-repurchase transaction that references a U.S. source dividend payment, (2) any payment made pursuant to a specified NPC that references a U.S. source dividend payment, (3) any payment made pursuant to a specified ELI that references a U.S. source dividend payment, or (4) any other substantially similar payment. A payment references a U.S. source dividend payment if the payment is directly or indirectly contingent upon or determined by reference to the payment of a dividend from sources within the United States.

Certain transactions typically provide for dividend equivalents to be paid at the time a dividend is paid, and in an amount equal to that dividend payment, on a referenced stock. Stock loans, equity sale-repurchase transactions, and total return swaps referencing stock are the most common types of equity-linked transactions that provide the long party with either a dividend or a dividend equivalent equal to the dividend paid on the referenced stock.

Other transactions that are linked to U.S. equities may also provide for dividend equivalents. The Treasury

Department and the IRS believe that an ELI that has economic terms that are substantially similar to a payment made pursuant to a securities lending or sale-repurchase transaction, or a specified NPC, creates the same potential for avoidance of U.S. withholding tax as those transactions. Section 1.871–15(a)(4) of the 2013 proposed regulations defines an ELI 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. The term ELI includes instruments such as forward contracts, futures contracts, options, debt instruments convertible into underlying securities, and debt instruments with payments linked to underlying securities. The long party with respect to an ELI is the counterparty that holds a long position with respect to an underlying security, such as the purchaser of a call option or the writer of a put option.

Section 1.871–15(f) of the 2013 proposed regulations provides that another substantially similar payment is a gross-up amount paid by a short party in satisfaction of the long party's tax liability with respect to a dividend equivalent. The Treasury Department and the IRS request comments regarding whether other payments should be treated as substantially similar payments, such as a payment made by a seller of stock to the purchaser of the stock pursuant to an agreement to deliver a pending U.S. source dividend after the record date (for example, a due bill).

The definition of an underlying security has also been revised. The 2013 proposed regulations define an underlying security as any interest in an entity taxable as a corporation for Federal tax purposes if a payment with respect to that interest may give rise to a U.S. source dividend. If a transaction references more than one such entity (including a reference to an index that is not a qualified index), each interest is treated as a separate underlying security. If a transaction references a qualified index, the qualified index is treated as a single security that is not an underlying security.

The 2013 proposed regulations also revise the rules pertaining to indices. In general, 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 for a

high dividend yield; and (6) is referenced by futures or option contracts that trade on a national securities exchange or a domestic board of trade.

#### B. Section 871(m) Transactions and Delta

The 2013 proposed regulations define a section 871(m) transaction as any securities lending or sale-repurchase transaction, specified NPC, or specified ELI. Section 1.871–15(a)(10) of the 2013 proposed regulations defines a securities lending transaction and sale-repurchase transaction by reference to § 1.861–3(a)(6) and includes substantially similar transactions.

As noted above, to determine whether a transaction is a specified NPC or specified ELI, the 2013 proposed regulations replace the seven-factor test in the 2012 proposed regulations with a single-factor test. Section 1.871–15(d)(2) provides that, with respect to payments made on or after January 1, 2016, a specified NPC is any NPC that has a delta of 0.70 or greater when the long party acquires the transaction. Similarly, § 1.871–15(e) provides that a specified ELI is any ELI that has a delta of 0.70 or greater when the long party acquires the transaction. If a transaction references more than one underlying security, the taxpayer must determine whether the transaction is a section 871(m) transaction with respect to each underlying security. A transaction, therefore, may be a section 871(m) transaction with respect to one or more underlying securities referenced in the transaction, but may not be treated as a section 871(m) transaction with respect to other underlying securities referenced by that same transaction.

Section 1.871–15(g)(1) of the 2013 proposed regulations provides that the delta of an NPC or an ELI is the ratio of the change in the fair market value of the NPC or ELI to the change in the fair market value of the property referenced by the NPC or ELI. For purposes of the 2013 proposed regulations, the delta of a transaction must be determined in a commercially reasonable manner. If a taxpayer calculates delta for non-tax business purposes, that delta ordinarily is treated as the delta for purposes of this section. For example, to determine whether an option is a specified ELI, a dealer may use the delta that it calculates to determine the number of shares needed to balance its position on the option (even though that number of shares may not correspond to the dealer's actual hedge). 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. If

an NPC or an ELI references more than one underlying security or other property or liability, a separate delta must be determined with respect to each underlying security without taking into account any other underlying security or other property or liability referenced in the transaction. Section 1.871–15(g)(2) provides that if the delta of an NPC or ELI is not reasonably expected to vary during the term of the transaction, the NPC or ELI has a constant delta and the delta is treated as 1.0. If a transaction would not have a delta of 1.0 but for the rule in § 1.871–15(g)(2), the number of shares of the underlying security is adjusted to reflect the constant delta of 1.0. This rule is intended to prevent taxpayers from avoiding the application of the 2013 proposed regulations by using transactions that reduce delta while retaining the economics of owning a set amount of shares. For example, a transaction that provides 50 percent of the appreciation, dividends, and depreciation on 200 shares of stock X throughout the term of the transaction (and therefore has a delta of 0.5) will be treated as a contract that provides 100 percent of the same exposure on 100 shares of stock X (and therefore has a delta of 1.0). The Treasury Department and the IRS request comments regarding whether taxpayers could avoid the constant delta rule by structuring transactions with the potential for de minimis delta variability and whether such transactions should be deemed to have a constant delta.

The Treasury Department and the IRS understand that a long party may enter into multiple transactions referencing the same underlying security to substantially replicate the economics of owning the underlying security. For example, a taxpayer may purchase a call option and sell a put option referencing the same underlying security that individually have a delta below 0.70 but together have a delta that exceeds 0.70. If section 871(m) were to apply to each transaction separately, neither transaction would be a section 871(m) transaction even though the economics of the positions when considered together are the same as another transaction that would be a section 871(m) transaction. Therefore, § 1.871–15(l) of the 2013 proposed regulations treats multiple transactions as a single transaction for purposes of determining if the transactions are a section 871(m) transaction with respect to an underlying security 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. These rules apply only to combine transactions in which the taxpayer is the long party. Section 1.871-15(l) does 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. Transactions that are combined for purposes of determining whether there is a section 871(m) transaction are treated as separate transactions for all other purposes of this section, including for purposes of determining the amount of a dividend equivalent with respect to each transaction. A withholding agent, however, is not required to withhold on a dividend equivalent paid pursuant to a transaction that has been combined with one or more other transactions unless the withholding agent knows 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 request comments regarding whether (and, if applicable, how) the rules for combining separate transactions to determine whether the transactions are section 871(m) transactions should apply in other situations, such as when a taxpayer holds both long and short positions with respect to the same underlying security. Comments also are requested regarding whether (and, if applicable, 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.

### C. Amount of Dividend Equivalent

Section 1.871-15(h) of the 2013 proposed regulations provides rules for identifying a payment of a dividend equivalent. 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 long party even if the long party makes a net payment to the short party or the net payment is zero. For purposes of section 871(m), a payment is treated as made on the date the amount of the dividend equivalent is fixed even if it is paid or otherwise taken into account on a later date.

The 2012 proposed regulations provided that estimates of expected dividends were not dividend equivalents unless the estimate was adjusted to reflect actual dividend payments. The 2013 proposed regulations eliminate this exception and

explicitly treat estimated dividend payments as dividend equivalents because the economic benefit of a dividend is present in contracts that use estimated dividends in much the same way as a contract that adjusts for actual dividends. Moreover, the Treasury Department and the IRS are concerned that taxpayers may inappropriately avoid section 871(m) if estimated dividends are not treated as dividend equivalents.

In the 2013 proposed regulations, a dividend equivalent includes any amount that references the payment of a U.S. source dividend. In addition to an actual payment of dividends and an estimated payment of dividends, a dividend equivalent includes any other contractual term of a potential 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 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.

The 2013 proposed regulations also provide rules for calculating the amount of a dividend equivalent. For a securities lending or sale-repurchase transaction, § 1.871-15(i) provides that the amount of a dividend equivalent for each underlying security equals the actual per share dividend amount paid on the underlying security multiplied by the number of shares of the underlying security transferred pursuant to the transaction. For a specified NPC or specified ELI, the amount of a dividend equivalent 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 that the amount of the dividend equivalent is determined.

If a transaction provides for a payment based on an estimated dividend (including an implicit estimated dividend), § 1.871-15(h)(2)(i) and (iii) of the 2013 proposed regulations require that the actual

amount of the dividend payment 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. Prop. Treas. Reg. § 1.871-15(h)(2)(i) and (iii). If a transaction that provides for 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 amount of the estimated dividend and the amount of the actual dividend paid.

The delta used to determine whether a potential section 871(m) transaction is a section 871(m) transaction may differ from the delta used to determine the amount of the dividend equivalent of a section 871(m) transaction. Whereas the delta of a transaction at the time the long party acquires a potential section 871(m) transaction is used to determine whether the transaction is a section 871(m) transaction, the delta of the section 871(m) transaction at the time that the amount of the dividend equivalent is determined is used to calculate the amount of the dividend equivalent. Because the delta of a transaction may vary over time, the delta of the transaction at the time of acquisition may differ from the delta of the transaction at the time the amount of the dividend equivalent is determined. Under § 1.871-15(i)(1)(ii)(C)(1) of the 2013 proposed regulations, the delta used to calculate the amount of a dividend equivalent is not used to re-test whether a transaction is a section 871(m) transaction; a long party's section 871(m) transaction continues to be subject to tax even if the delta of the section 871(m) transaction is below 0.70 at the time the amount of the dividend equivalent is determined. Similarly, a long party that acquires a potential section 871(m) transaction that has a delta below 0.70 at the time of acquisition will not have a section 871(m) transaction even if the delta increases to be above 0.70 during the time the long party holds the transaction.

Under the 2013 proposed regulations, the amount of the dividend equivalent generally is determined on the earlier of the ex-dividend date or the record date for the dividend. However, if a section 871(m) transaction has a term of one year or less, the amount of the dividend equivalent is determined when the long party disposes of the transaction. Therefore, a long party that acquires an option with a term of one year or less that is a specified ELI will not incur a withholding tax if the option lapses.

#### D. Other Rules

In response to comments, § 1.871–15(j) of the 2013 proposed regulations provides exceptions to the definition of a section 871(m) transaction for two types of potential section 871(m) transactions that have little potential for tax avoidance. The first exception applies when a qualified dealer enters into a transaction as the long party in its capacity as a dealer. A qualified dealer is any dealer in securities within the meaning of section 475 that is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized. In addition, the dealer must certify to the short party that it is a qualified dealer acting in its capacity as a dealer in securities and that it will withhold and deposit any tax imposed by section 871(m) with respect to a section 871(m) transaction that it enters into as a short party in its capacity as a dealer. The second exception applies 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 50 percent or more of the entity issuing the underlying securities.

A comment to the 2012 proposed regulations stated that an NPC may reference a partnership interest and that the partnership could be formed to hold a small basket of U.S. equity securities. Noting that a partnership may function like a customized index, the comment recommended that regulations treat an NPC that references a partnership interest as a separate NPC with respect to each underlying security held by the partnership. To address the concern noted in the comment, § 1.871–15(m) of the 2013 proposed regulations treats 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 underlying securities and potential section 871(m) transactions 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.

Section 1.871–15(n) of the 2013 proposed regulations provides that the Commissioner may treat any payment made with respect to a transaction as a dividend equivalent if the taxpayer acquires a transaction with a principal purpose of avoiding the application of

these rules. The Treasury Department and the IRS will continue to closely scrutinize other transactions that are not covered by section 871(m) and that may be used to avoid U.S. taxation and U.S. withholding. 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 the equity referenced in the contract.

The 2013 proposed regulations also make a number of conforming changes to reporting and withholding requirements. Most equity-linked transactions involve a financial institution acting as a broker, dealer, or intermediary. A financial institution is usually in the best position to undertake the responsibility 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 a broker or dealer is not a party to the transaction or both parties are brokers or dealers, the short party must 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 the other person knows or has reason to know that the information is incorrect; the determinations are not binding on the IRS. In addition, certain persons described in § 1.871–15(o)(3)(ii) of the 2013 proposed regulations are permitted to request information from certain parties to a potential section 871(m) transaction who are described in § 1.871–15(o)(1) when the information is necessary to satisfy their withholding or information reporting obligations, or to determine their tax liability. If a withholding agent reasonably relies on information received, it will not be liable for underwithholding; however, the party to the transaction who failed to properly determine the amount will

be liable for the underwithholding. The Treasury Department and the IRS solicit comments with respect to these reporting rules, including comments regarding the parties that should be required to report and the extent of information that is appropriate.

The 2013 proposed regulations include amendments to chapter 3 specifically addressing dividend equivalents. The 2013 proposed regulations describe how the exception to withholding where no money or property is paid applies to a dividend equivalent. 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) The time that the amount of the dividend equivalent is determined and (2) the time at which any of the following to has occurred: (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 of the long party at any time on or after the amount of the dividend equivalent is determined, or (c) there is an upfront payment or a prepayment of the purchase price. Although § 1.1441–2(d)(5) of the 2013 proposed regulations relieves a withholding agent of liability to withhold when the withholding agent does not have control of money or other property of the long party, the long party remains liable for U.S. tax on the dividend equivalent pursuant to section 871(m) and Prop. Treas. Reg. § 1.871–15.

#### E. Certain Contingent Interest

Generally, section 871(h)(4) 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). Certain contingent interest payments, however, are excluded from the definition of portfolio interest. Section 871(h)(4)(A)(ii) grants the Secretary authority to impose tax on contingent interest when necessary to prevent the avoidance of Federal income tax. Most contingent debt instruments are either referenced to a qualified index, have an embedded option with a delta below 0.7, or both. A debt obligation that is a specified ELI and provides for a contingent interest payment determined by reference to a U.S. source dividend payment has the potential to be used by a nonresident alien individual or foreign corporation to avoid section 871(m). Therefore, § 1.871–14(h) of the 2013 proposed regulations provide that any contingent interest will not qualify for the portfolio interest exemption to the extent that the



contingent interest payment is a dividend equivalent.

#### F. Effective/Applicability Date

The 2013 proposed regulations generally will apply to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulations. Certain provisions in the 2013 proposed regulations, however, apply at different dates. For example, the definition of a specified NPC in the 2013 proposed regulations will apply to payments made pursuant to a specified NPC on or after January 1, 2016. For payments made before January 1, 2016, the definition of a specified NPC is provided in section 871(m)(3)(A), § 1.871-16T(b) of the 2012 temporary regulations, and § 1.871-15(d)(1) of the final regulations in the Rules and Regulations section of this issue of the **Federal Register**. For specified ELIs, the rules of the 2013 proposed regulations will apply to payments made on or after January 1, 2016, but only with respect to an ELI that was acquired by the long party on or after March 5, 2014.

#### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to 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 these regulations will primarily affect multinational financial institutions, which tend to be larger businesses, and foreign entities. Moreover the number of taxpayers affected and the average burden are minimal. 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.

#### 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 Treasury Department and the IRS

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 11, 2013, beginning at 10 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 § 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by March 5, 2014 and an outline of the topics to be discussed and the time to be devoted to each topic by March 5, 2014. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule 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 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.

#### Withdrawal of Proposed Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-120282-10) that was published in the **Federal Register** on Monday, January 23, 2012, (77 FR 3202) is withdrawn.

#### 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 \* \* \*

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

§ 1.871-15 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)(3).

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(i). 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) \* \* \*

(3) *Effective/applicability date.* The rules of paragraph (h) 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. 3.** Section 1.871-15 is added to 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) *Acquire.* To *acquire* means to enter into, purchase, accept by transfer, by exchange, or by conversion, or otherwise acquire a potential section 871(m) transaction.

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

(3) *Dividend.* A *dividend* means 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) *Notional principal contract*. A *notional principal contract (NPC)* is a notional principal contract as defined in § 1.446-3(c).

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

(7) *Parties to a transaction*—(i) *Long party*. A *long party* is the party to a potential section 871(m) transaction with respect to an underlying security that is entitled to a dividend equivalent 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 is liable for a dividend equivalent described in paragraph (c) of this section.

(iii) *Party to a transaction*. A *party to a transaction* is any person that is a long party or a short party to a potential section 871(m) transaction.

(iv) *Party to a 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 potential section 871(m) transaction entitles the party to receive a payment that references a dividend payment on an underlying security and obligates the same party to make a payment that references a dividend payment on another underlying security.

(B) *Example*. The following example illustrates the definitions in paragraph (a)(7) of this section:

*Example*. (i) Stock X and stock Y are underlying securities within the meaning of paragraph (a)(11) of this section. Corporations A and B enter into an NPC. The NPC 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 dividend equivalents it receives based on Stock X. A is the short party with respect to dividend equivalents it makes based on Stock Y. B is the long party with respect to dividend equivalents it receives based on Stock Y. B is the short party with respect to dividend equivalents it makes based on Stock X.

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

(9) *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.

(10) *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. *Securities lending transaction and sale-repurchase transaction* have the same meaning as provided in § 1.861-3(a)(6).

(11) *Underlying security*. An *underlying security* is any interest in an entity taxable as a C corporation (within the meaning of section 1361(a)(2)) if a payment with respect to that interest could give rise to a U.S. source dividend pursuant to § 1.861-3. If a potential section 871(m) transaction references an interest in more than one entity described in the preceding sentence (including a reference to an index that is not a qualified index described in paragraph (k) of this section) 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 Code.

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

(i) Any payment (as described in paragraph (h) of this section) pursuant to a securities lending or sale-repurchase transaction that references

the payment of a dividend from an underlying security;

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

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

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

(2) *Exceptions*—(i) *Not a dividend*. A payment pursuant to a section 871(m) transaction 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 sections 871 or 881, or withholding under chapters 3 or 4, if the long party owned the underlying security referenced by the section 871(m) transaction. For example, if a specified NPC references stock in a regulated investment company that pays a capital gains dividend described in section 852(b)(3)(C) that would not be subject to withholding tax if paid directly to the long party, then an NPC payment determined by reference to the capital gains dividend is not a dividend equivalent.

(ii) *Section 305 coordination*. A payment pursuant to a section 871(m) transaction is not a dividend equivalent to the extent that the payment is treated as a distribution taxable as a dividend pursuant to section 305.

(d) *Specified NPCs*—(1) [Reserved]

(2) *Specified NPC on or after January 1, 2016*. With respect to payments made on or after January 1, 2016, a specified NPC is any NPC that has a delta of 0.70 or greater with respect to an underlying security at the time that the long party acquires the NPC. If an NPC references more than one underlying security, the NPC is a specified NPC only with respect to underlying securities for which the NPC has a delta of 0.70 or greater at the time that the long party acquires the NPC. For example, if an NPC references underlying security A and underlying security B, and it has a delta of 1.0 with respect to A and 1.0 with respect to B, the NPC is a specified NPC with respect to A and B.

(e) *Specified ELIs*. With respect to payments made on or after January 1, 2016, a specified ELI is any ELI acquired by the long party on or after March 5, 2014 that has a delta of 0.70 or greater

with respect to an underlying security at the time that the long party acquires the ELI. If an ELI references more than one underlying security, the ELI is a specified ELI only with respect to underlying securities for which the ELI has a delta of 0.70 or greater at the time that the long party acquires the ELI. For example, if an ELI references underlying security A and underlying security B, and it has a delta of 0.90 with respect to A and 0.30 with respect to B, the ELI is a specified ELI with respect to A and is not a specified ELI with respect to B.

(f) *Other substantially similar payments.* For purposes of this section, the following payments are substantially similar payments:

(1) *Payment of a tax liability.* Any payment (as described in paragraph (h) of this section) in satisfaction of a tax liability with respect to a dividend equivalent made by a withholding agent is a dividend equivalent received by the long party in an amount determined under the gross-up formula provided in § 1.1441-3(f)(1); and

(2) *Due bill.* [Reserved].

(g) *Delta—(1) Determination of delta.* Delta is the ratio of the change in the fair market value of an NPC or ELI to the change in the fair market value of the property 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, a separate delta must be determined with respect to each underlying security without taking into account any other underlying security or other property or liability. For purposes of this section, the delta of an NPC or ELI 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) *Constant delta.* An NPC or ELI is treated as having a delta of one (1.0) with respect to an underlying security when it has a constant delta with respect to the underlying security at the time it is acquired by the long party. An NPC or ELI has a constant delta with respect to an underlying security if the NPC or ELI has a delta that is not reasonably expected to vary during the term of the transaction with respect to that underlying security. If a transaction would not have a delta of one with respect to an underlying security without this paragraph, the number of shares of the underlying security of an NPC or ELI that has a constant delta is

adjusted as described in paragraph (i)(1)(ii)(B)(2) of this section.

(3) *Examples.* The following examples illustrate the rules of paragraph (g) of this section. 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.* 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. The NPC therefore has a delta of 1.0 ( $\$1.00/(\$0.01 \times 100)$ ).

*Example 2.* LP acquires a call option that references 100 shares of Stock X. 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 X. The call option has a delta of 0.3 ( $\$0.30/(\$0.01 \times 100)$ ) when LP acquired it.

*Example 3.* (i) LP acquires an NPC that entitles LP to receive 50 percent of the appreciation and dividends on 100 shares of Stock X in return for the obligation to pay the short party 50 percent of the depreciation on 100 shares of Stock X and an interest based return. The value of the NPC is expected to change by \$0.50 for each \$0.01 change in the price of a share of Stock X. The delta is expected to remain constant during the term of the transaction.

(ii) Pursuant to the terms of the NPC and the amount of referenced underlying securities, the NPC has a delta of 0.5 ( $\$0.50/(\$0.01 \times 100)$ ) on the date that LP acquired the transaction. The delta of the NPC, however, is not expected to vary during the term of the transaction. Therefore, the NPC has a constant delta and is treated as having a delta equal to 1.0 on 50 shares of Stock X after the adjustments described in § 1.871-15(i)(1)(ii)(B)(2).

(h) *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 payment is made 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 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 inception of the transaction. For this purpose, a reasonable estimated dividend amount stated in an offering document or the documents governing the terms of the transaction will establish the estimated dividend amount in writing at the inception of the transaction. 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 a stock is not expected to pay a dividend, a reasonable estimate of the dividend amount may be zero.

(iv) *Limitation on estimated payments.* When a section 871(m) transaction provides for one or more payments based on estimated dividends supported by documentation described in paragraph (h)(2)(iii) of this section, the per share dividend amount used to calculate the amount of the dividend equivalent is the lesser of the estimated dividend amount and the actual dividend amount paid on the stock while the long party was a party to the section 871(m) transaction. If a section 871(m) transaction provides for any payment determined by reference to a dividend in addition to the estimated dividends (for example, a special dividend), the actual dividend amount paid on the stock is used for the additional dividend payment.

(3) *Deferred payments.* A payment occurs when the amount of a dividend equivalent is fixed pursuant to the terms of the transaction, even if paid or otherwise taken into account on a later date. For example, if a specified NPC provides for a payment at settlement that takes into account an earlier dividend payment, the dividend equivalent is treated as paid on the date that the amount of the dividend

equivalent is fixed pursuant to the terms of the contract.

(4) *Examples.* The following examples illustrate the rules of paragraph (h) of this section. 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 the 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 future 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 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  $\times$  \$50 per share  $\times$  1.04  $-$  (\$1  $\times$  100)).

(ii) Subject to paragraph (h)(2)(iv), the estimated dividend amount is the per share dividend amount because the estimate is reasonable and specified in accordance with paragraph (h)(2)(iii) of this section. Those estimated per share 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 does not explicitly entitle Foreign Investor to payments based on dividends paid on Stock X during the term of the contract and the swap contract does not contain any reference to an estimated dividend amount. The LIBOR rate on 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 amount is not specified, Foreign Investor is treated as receiving the actual dividend amount in accordance with paragraph (h)(2) of this section. Those actual per share dividend amounts are dividend equivalents for purposes of this section.

(i) *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 transferred pursuant to the securities lending or sale-repurchase transaction.

(ii) *Specified NPCs and specified ELIs—(A) In general.* For a specified NPC or a specified ELI, the amount of the dividend equivalent for each underlying security equals:

(1) The amount of the per share dividend (as determined under paragraph (h) of this section) with respect to the underlying security multiplied by;

(2) The number of shares of the underlying security as calculated pursuant to paragraph (i)(1)(ii)(B) of this section multiplied by;

(3) The delta of the section 871(m) transaction with respect to the underlying security at the time that the amount of the dividend equivalent is determined.

(B) *Calculation of the number of shares—(1) In general.* Except as provided in paragraph (i)(1)(ii)(B)(2) of this section, the number of shares of an underlying security for purposes of this section is the number of shares of the underlying security referenced in the section 871(m) transaction.

(2) *Adjustments.* When a section 871(m) transaction multiplies the number of shares of an underlying security by a factor or fraction, or otherwise alters the amount of a payment, the number of shares of a section 871(m) transaction is adjusted to take into account the factor, fraction, or other alteration provided by the section 871(m) transaction. For example, if a total return swap entitles a long party to receive a payment based on the appreciation and dividend amount on 100 shares of an underlying security multiplied by a factor of 1.50, the number of shares of the underlying security is 150 shares.

(C) *Delta at the time the amount of the dividend equivalent is determined—(1) In general.* The delta of a section 871(m) transaction at the time that the amount of the dividend equivalent is determined is the delta of the section 871(m) transaction determined at the time specified in paragraph (i)(2) of this section. This delta is used solely for purposes of determining the amount of the dividend equivalent at that time, and the transaction is not retested to determine if it is a section 871(m) transaction. For example, if a transaction had a delta of 0.80 when acquired by the long party and was a section 871(m) transaction, the transaction remains a section 871(m) transaction even if the delta is below

0.70 at the time the amount of the dividend equivalent is determined.

(2) *Delta of an option at lapse.* The delta of an option when it lapses is treated as zero.

(3) *Delta of an option at exercise.* The delta of an option when it is exercised is treated as one (1.0).

(iii) *Other substantially similar payments.* In addition to any amount determined pursuant to paragraph (i)(1)(i) or (ii), 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—(i) In general.* Except as provided in paragraph (i)(2)(ii) of this section, the amount of a dividend equivalent is determined on the earlier of the date that the underlying security becomes ex-dividend with respect to the dividend and the record date of 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 a dividend equivalent is determined on the earlier of the ex-dividend date or the record date for that dividend.

(ii) *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 by the long party, the amount of a dividend equivalent is determined when the long party disposes of the section 871(m) transaction. For purposes of this paragraph, to *dispose of* means to sell, exercise, terminate, allow to lapse or expire, transfer, settle (whether in cash or otherwise), cancel, exchange, convert, surrender, forfeit, or otherwise dispose of or allow to expire.

(iii) *Term.* For purposes of this section, if a transaction does not specify a term, the transaction is treated as having a term of more than one year. If a transaction permits extensions, the term of the transaction is the maximum term permitted by the transaction.

(j) *Limitation on the treatment of certain transactions as section 871(m) transactions—(1) Dealers—(i) In general.* A potential section 871(m) transaction is not a section 871(m) transaction if the potential section 871(m) transaction is entered into by a qualified dealer in its capacity as a dealer in securities and the dealer is the long party with respect to the underlying security. This paragraph does not apply with respect to any proprietary position held by a dealer in securities.

(ii) *Qualified dealer.* A qualified dealer is any dealer that:

(A) Is subject to regulatory supervision by a governmental authority in the jurisdiction in which it was created or organized; and

(B) furnishes a written certification to the short party confirming that the dealer is a qualified dealer acting in its capacity as a dealer in securities and that the dealer will withhold and deposit any tax imposed by section 871(m) with respect to any section 871(m) transactions that the dealer enters into as a short party in its capacity as a dealer in securities.

(2) *Corporate acquisitions.* 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. To qualify for the exception provided in this paragraph, the long party must furnish a written certification, provided under penalties of perjury, to the short party that it satisfies the requirements of this paragraph (j)(2).

(k) *Rules relating to indices—(1) 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 is a qualified index is made at the time that a long party acquires a potential section 871(m) transaction and is determinative only with respect to that transaction. Therefore, an index can be a qualified index with respect to a transaction entered into on one day and not be a qualified index with respect to a transaction entered into on another day.

(2) *Qualified index.* A qualified index means an index that:

(i) References 25 or more component underlying securities;

(ii) References only long positions in component underlying securities;

(iii) Contains no component underlying security that represents more than 10 percent of the weighting of the underlying securities in the index;

(iv) Is modified or rebalanced only according to predefined objective rules at set dates or intervals;

(v) Does not provide a dividend yield from component underlying securities that is greater than 1.5 times the current dividend yield of the S&P 500 Index as reported for the month immediately preceding the date the long party acquires the potential section 871(m) transaction; and

(vi) Futures contracts or option contracts on the index (whether the contracts provide price only or total return exposure to the index) trade on 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.

(3) *Safe harbor for indices that primarily reference assets other than underlying securities.* Notwithstanding paragraph (k)(2) of this section, an index is a qualified index if the index is comprised solely of long positions in assets and the referenced component underlying securities in the aggregate comprise 10 percent or less of the index's weighting.

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

(5) *Indices with components other than underlying securities.* Any component of an index that is not an underlying security is not taken into account for purposes of determining whether an index is a qualified index, except for purposes of paragraph (k)(3) of this section.

(6) *Transactions that reference a qualified index and one or more underlying securities or indices.* If a potential section 871(m) transaction references a qualified index and one or more underlying securities or indices, the qualified index will remain a qualified index only if the potential section 871(m) transaction does not reference a short position in any referenced component underlying security of the qualified index, other than a short position with respect to the entire qualified index (for example, a cap or floor). 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 707(b)) enters into one or more transactions that reduce exposure to any referenced component underlying 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.

(l) *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 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; and

(iii) 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) *Time and delta for testing.* Combined transactions are tested each time the long party (or a related person) acquires a potential section 871(m) transaction to which paragraph (l)(1) of this section applies. The deltas used to determine whether the combined transactions are section 871(m) transactions pursuant to paragraph (l)(1) of this section are the deltas of each of the combined transactions at that time. For example, if a taxpayer buys a call option on day 1 and sells a put option on day 10 on the same underlying security and the two transactions are entered into in connection with each other, the call option is tested on day 1 to determine whether it is a section 871(m) transaction, and the combined single transaction is tested on day 10 based on the deltas of the call option and put option at that time.

(3) *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, it does not cease to be a section 871(m) transaction as a result of applying paragraph (l) of this section.

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

(5) *Separate transactions for all other purposes.* Potential section 871(m) transactions that are combined for purposes of determining whether there is a section 871(m) transaction with respect to an underlying security are treated as separate transactions for all other purposes of this section, including separately determining the amount of a dividend equivalent with respect to each transaction. For withholding obligations with respect to combined transactions, see § 1.1441-1(b)(4)(xxiii).

(6) *Example.* The following examples illustrate the rules of paragraph (l) of this section. For purposes of this paragraph (l)(6), Foreign Investor (FI) is a nonresident alien individual and

Stock X is common stock of Corporation X, a domestic corporation.

*Example 1.* (i) FI purchases a call option with a term of six months that references 100 shares of Stock X, and simultaneously sells a six month put option on 100 shares of Stock X. The delta of the call option is 0.45 and the delta of the put option is 0.40 at the time FI acquired each option.

(ii) Because the purchased call option and the sold put option are entered into simultaneously by FI and reference the same underlying security, the facts and circumstances indicate that the call option and the put option are entered into in connection with each other and are treated as a combined transaction under paragraph (l)(1) of this section. Accordingly, the call option and the put option are treated as a combined transaction to compute delta for purposes of paragraph (e) of this section. The delta of the combined purchased call option and written put option is 0.85 (0.45 + 0.40). The combined transaction is therefore a specified ELI.

*Example 2.* (i) FI purchases a call option with a term of six months that references 100 shares of Stock X. At the time, the delta of the call option is 0.45. Three months later, FI re-evaluates FI's position in Stock X and writes a three month put option on 100 shares of Stock X. At the time FI writes the put option, the delta of the call option is 0.65 and the delta of the put is 0.25.

(ii) FI's purchased call option and sold put option reference the same underlying security. Because FI wrote the put option referencing Stock X to adjust FI's economic position associated with the call option referencing Stock X, these options are entered into in connection with each other and treated as a combined transaction under paragraph (l)(1) of this section. Because the delta of the combined transaction is tested on the date that FI entered into the additional transaction, the delta of the combined purchased call option and sold put option is 0.90 (0.65 + 0.25). The combined transaction is a specified ELI.

*Example 3.* (i) FI purchases a call option with a term of one month that references 100 shares of Stock X. At the time, the delta of the call option is 0.75. Two weeks later, FI re-evaluates FI's position in Stock X and writes a two week put option on 100 shares of Stock X. At the time FI writes the put option, the delta of the call option is 0.35 and the delta of the put is 0.25.

(ii) FI's purchased call option has an initial delta of .75 and therefore is a specified ELI and a section 871(m) transaction. FI's purchased call option and sold put option reference the same underlying security. Because FI sold the put option referencing Stock X to adjust FI's economic position associated with the call option referencing Stock X, these options are entered into in connection with each other and treated as a combined transaction under paragraph (l)(1) of this section. Because the delta of the combined transaction is tested on the date that FI entered into the additional transaction, the delta of the combined purchased call option and sold put option is 0.6 (0.35 + 0.25). The combined transaction

is not a specified ELI; however, the purchased call option remains a specified ELI.

(m) *Rules relating to interests in entities that are not taxable as corporations*—(1) *In general.* Except as provided in paragraph (m)(2) of this section, if a transaction references an interest in an entity that is not a C corporation (within the meaning of section 1361(a)(2)), the transaction references the allocable portion of any underlying security or potential section 871(m) transaction held, directly or indirectly (including through one or more other entities that are not C corporations), by the referenced entity. When a transaction references any underlying security as a result of the application of this paragraph, the transaction also references the payment of any dividends from those underlying securities and has a dividend equivalent equal to the allocable portion of any dividend or dividend equivalent received, directly or indirectly (including through one or more other entities that are not C corporations), by the referenced entity.

(2) *Exception.* A transaction is not treated as referencing underlying securities as a result of applying paragraph (m)(1) of this section if the underlying securities held directly or indirectly by the referenced entity and the underlying securities referenced by any potential section 871(m) transaction held directly or indirectly by the referenced entity represent, in the aggregate, 10 percent or less of the value of the referenced interest in the entity at the time the long party acquires the transaction and there is no plan or intention for acquisitions or dispositions (within the meaning of paragraph (i)(2)(ii) of this section) that would cause underlying securities to represent more than 10 percent of the value of the referenced interest. For example, if actively-traded Partnership A owns a pro rata interest in Partnership B that represents 10 percent of the value of an interest in Partnership A, and Partnership B owns an interest in Underlying Security X that represents 20 percent of the value of an interest in Partnership B, then Underlying Security X represents two percent of the value of a pro rata interest in Partnership A. Accordingly, a pro rata interest in Partnership A qualifies for the exception in paragraph (m)(2) of this section and Underlying Security X is not treated as referenced by a transaction that references a pro rata interest in Partnership A pursuant to paragraph (m)(1) of this section.

(n) *Anti-abuse rule.* If a taxpayer (directly or through the use of a related

person) acquires 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 (h) of this section) made with respect to any transaction 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 adjust the delta of a transaction, change the number of shares, adjust an estimated dividend amount, adjust the timing of payments, 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.

(o) *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 the potential section 871(m) transaction are brokers or dealers, or neither party to the 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 (h) and (i) 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, 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 (o)(2) and (o)(3) of this section. The determinations required by paragraph (o) 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 has actual knowledge or reason to know that the

information received is incorrect, but are not binding on the IRS.

(2) *Reporting requirements.* For rules regarding reporting requirements 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 on potential section 871(m) transactions—*  
(i) *In general.* Upon request by any person described in paragraph (o)(3)(ii) of this section, the party required to provide information pursuant to paragraph (o)(1) 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 (h)(2)(iii), and any other information necessary to apply the rules of this section. With respect to the delta, the party must provide the delta when the transaction is acquired, at the time the amount of each dividend equivalent is determined, and at any other time delta information is necessary to apply the rules of this section. The information requested must be provided within a reasonable time, not to exceed 14 calendar 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.* The following persons may request the information specified in paragraph (o) of this section with respect to a potential section 871(m) transaction from the party required by paragraph (o)(3)(i) of this section to provide the information—

(A) A broker who holds the potential section 871(m) transaction as an agent or nominee to any party to the transaction as described in paragraph (a)(7) of this section;

(B) A person who is required to make an information return under § 1.1461–1(c) and paragraph (o)(2) of this section and who acts as an agent or nominee to any party to the transaction as described in paragraph (a)(7) of this section; or

(C) Any party to the transaction as described in paragraph (a)(7) of this section.

(iii) *Reliance on information received.* A person described in paragraph (o)(1) or (o)(3)(ii) of this section that receives

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

(4) *Recordkeeping rules.* For rules regarding recordkeeping requirements sufficient to establish the amount of gross income treated as a dividend equivalent, see § 1.6001–1.

(p) *Effective/applicability date.* This section applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, except for paragraph (d)(1) of this section, which applies to payments made on or after January 23, 2012.

■ **Par. 4.** Section 1.1441–1 is amended by:

■ 1. Adding paragraphs (b)(4)(xxii) and (xxiii).

■ 2. Adding paragraph (f)(3).

The additions read as follows:

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

\* \* \* \* \*

(b) \* \* \*

(4) \* \* \*

(xxii) Amounts paid with respect to a notional principal contract described in § 1.871–15(a)(5), 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)(10) 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)(9) or is subject to an exception described in § 1.871–15(j). 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 to provide documentation establishing that a notional principal contract or equity-linked instrument has a delta that is less than 0.70 at the time it was acquired by the long party. For purposes of the withholding exemption for qualified dealers described in this paragraph, § 1.871–15(j)(1) applies only

if the long party furnishes to the withholding agent the documentation described in § 1.871–15(j)(1). For purposes of the withholding exemption regarding corporate acquisitions described in this paragraph, the exemption only applies if the long party furnishes to the withholding agent the documentation described in § 1.871–15(j)(2).

(xxiii) If a potential section 871(m) transaction is only a section 871(m) transaction as a result of applying § 1.871–15(l) (combined transactions) and the withholding agent did not know that the long party (or a related person) entered into the potential section 871(m) transaction in connection with any other potential section 871(m) transactions, the potential section 871(m) transaction is exempt from withholding under section 1441(a).

\* \* \* \* \*

(f) \* \* \*

(3) *Effective/applicability date.* Paragraphs (b)(xxii) and (xxiii) 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.** Section 1.1441–2 is amended by adding paragraph (d)(5) and adding a sentence to the end of paragraph (f) to read as follows:

**§ 1.1441–2 Amounts subject to withholding.**

\* \* \* \* \*

(d) \* \* \*

(5) *Payments of dividend equivalents.* A withholding agent is not obligated to withhold until the later of—

(i) The time that the amount of a dividend equivalent is determined as provided in § 1.871–15(i)(2), and

(ii) The time that the withholding agent is deemed to have control over money or other property of the long party because—

(A) Money or other property is paid to or from the long party,

(B) The withholding agent has custody or control over money or other property of the long party at any time on or after the amount of a dividend equivalent is determined as provided in § 1.871–15(i)(2), or

(C) The section 871(m) transaction provides for an upfront payment or prepayment of the purchase price even though an actual payment has not been made at the time the amount of a dividend equivalent is determined as provided in § 1.871–15(i)(2).

\* \* \* \* \*

(f) *Effective/applicability date.* \* \* \* Paragraph (d)(5) of this section applies 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. 6.** 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 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(i).

(2) *Reliance by withholding agent on reasonable determinations.* For purposes of determining whether a payment is a dividend equivalent and the amount of a dividend equivalent described in § 1.871-15, a withholding agent may rely on the information received from the party to the transaction that is required to determine whether a transaction is a section 871(m) transaction as provided in § 1.871-15(o), unless the withholding agent has actual knowledge or reason to know that the information received is incorrect. When a withholding agent fails to withhold the required amount because the party described in § 1.871-15(o) fails to reasonably determine or timely provide whether a transaction is a section 871(m) transaction, the amount of any dividend equivalent, or any other information required to be provided pursuant to § 1.871-15(o) and the withholding agent reasonably relied on that party's determination, then the failure to withhold is imputed to the party required to make the determinations described in § 1.871-15(o). In that case, the IRS may collect any underwithheld amount from the party to the transaction that is required to make the determinations described in § 1.871-15(o) and subject that party to applicable interest and penalties as a withholding agent.

(3) *Effective/applicability date.* Except for the first sentence of paragraph (h)(1), this paragraph (h) applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. The first sentence of paragraph (h)(1) applies to payments made on or after January 23, 2012.

\* \* \* \* \*  
■ **Par. 7.** Section 1.1441-7 is amended by:

- 1. Adding entry for *Example 7* in 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 U.S. CB is a broker organized in Foreign Country X 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. 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) *Effective/applicability date.*

*Example 7* of paragraph (a)(3) of this section applies to payments made on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

\* \* \* \* \*

**John Dalrymple,**

*Deputy Commissioner for Services and Enforcement.*

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**DEPARTMENT OF EDUCATION**

**34 CFR Chapter VI**

**Negotiated Rulemaking Committee, Notice of Additional Committee Meeting—Title IV Federal Student Aid Programs, Gainful Employment in a Recognized Occupation**

**AGENCY:** Office of Postsecondary Education, Department of Education.

**ACTION:** Notice of intent to establish negotiated rulemaking committee.

**SUMMARY:** On June 12, 2013, we announced our intention to establish a negotiated rulemaking committee to prepare proposed regulations to establish standards for programs that prepare students for gainful

employment in a recognized occupation. We also announced the schedule for two sessions of committee meetings. We now announce the addition of a third session consisting of a one-day committee meeting.

**DATES:** The date, times, and location of the third committee meeting are set out in the *Schedule for Negotiations* section under **SUPPLEMENTARY INFORMATION**, below.

**FOR FURTHER INFORMATION CONTACT:** For information about the content of this notice, including information about the negotiated rulemaking process, contact: Wendy Macias, U.S. Department of Education, 1990 K Street NW., Room 8017, Washington, DC 20006. Telephone: (202) 502-7526 or by email: [wendy.macias@ed.gov](mailto:wendy.macias@ed.gov).

For general information about the negotiated rulemaking process, see *The Negotiated Rulemaking Process for Title IV Regulations, Frequently Asked Questions* at <http://www2.ed.gov/policy/highered/reg/hearulemaking/hea08/neg-reg-faq.html>.

If you use a telecommunications device for the deaf or text telephone, call the Federal Relay Service, toll free, at 1-800-877-8339.

Individuals with disabilities can obtain this document in an accessible format (e.g., braille, large print, audiotape, or compact disc) on request to the program contact person listed under **FOR FURTHER INFORMATION CONTACT**.

**SUPPLEMENTARY INFORMATION:** On June 12, 2013, we published a notice in the **Federal Register** (78 FR 35179) announcing our intention to establish a negotiated rulemaking committee to prepare proposed regulations for the Federal Student Aid programs authorized under title IV of the Higher Education Act of 1965, as amended (HEA) (title IV Federal Student Aid programs) that would establish standards for programs that prepare students for gainful employment in a recognized occupation. In that notice, we set a schedule for two sessions of committee meetings and requested nominations for individual negotiators who represent key stakeholder constituencies for the issues to be negotiated to serve on the committee.

Because of the shutdown of the Federal Government due to the lapse in appropriations for fiscal year 2014, on November 7, 2013, we announced in the **Federal Register** (78 FR 66865) that we were rescheduling the second session of committee meetings from October 21-23, 2013, to November 18-20, 2013, with the meeting on the final day running from 9:00 a.m. to 5:00 p.m.