

[4830-01-U]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106031-98]

RIN 1545-AW13

Trading Safe Harbors.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed rules for the treatment of foreign taxpayers trading in derivative financial instruments for their own account. These proposed rules provide that foreign taxpayers who effect transactions in derivative financial instruments for their own accounts are not thereby engaged in a trade or business in the United States if they are not dealers in stocks, securities, commodities or derivatives. These proposed rules affect foreign persons that conduct such trading for their own account either directly through U.S. offices or indirectly through partnerships or other agents. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by September 10, 1998. Outlines of oral comments to be discussed at the public hearing

scheduled for September 9, 1998, must be received by August 19, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-106031-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-106031-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Milton Cahn of the Office of Associate Chief Counsel (International), (202) 622-3870; concerning submissions and the hearing, LaNita Van Dyke, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 864(b) of the Code provides that the phrase "trade or business within the United States" generally includes the performance of personal services within the United States at any time during the taxable year but, under certain circumstances,

does not include trading in stocks, securities, or commodities through an independent agent or for a taxpayer's own account (the "trading safe harbors").

Regulations regarding certain aspects of the trading safe harbors were promulgated in 1972. Since the promulgation of these regulations, the use of derivative financial instruments has increased significantly. This is due in large measure to the overall expansion and growing sophistication of global capital markets. Although guidance concerning the tax treatment of derivatives and notional principal contracts has been issued under other provisions of the Code (see, e.g., §§1.446-3, 1.863-7(b)), the section 864(b) regulations have not been modernized to take into account the manner in which taxpayers customarily use derivative transactions.

Explanation of Provisions

1. In General

These proposed regulations provide that foreign taxpayers who are not dealers with respect to any derivative transactions, who are not otherwise dealers in stocks, securities, or commodities, and who enter into derivative transactions for their own accounts are not engaged in trade or business within the United States solely by reason of those transactions. The term "derivative" is defined as an interest rate, currency, equity or commodity notional principal contract or an evidence of an

interest in, or derivative financial instrument in, any commodity, currency, or any of the items described in Code section 475(c)(2)(A)-(D).

For purposes of these proposed regulations, the term "currency" is limited to those currencies that are of a kind customarily dealt in on an organized commodity exchange. No inference is intended, however, as to whether currencies that are not traded on an organized commodity exchange are "of a kind" customarily dealt in on an organized commodity exchange. Comments are solicited on this issue.

Under the statutory safe harbors, taxpayers who are dealers in stocks and securities but not commodities may avail themselves of the commodities trading safe harbor of section 864(b)(2)(B)(ii), and likewise, dealers in commodities but not stocks and securities may avail themselves of the stocks and securities trading safe harbor of section 864(b)(2)(A)(ii). The proposed regulations, however, do not specify into which statutory safe harbor any particular derivative transaction falls. Accordingly, dealers in stocks, securities, commodities, or derivatives may not avail themselves of the benefits of these proposed regulations.

Treasury and the IRS are considering the appropriate application of both the stocks and securities safe harbor of section 864(b)(2)(A)(ii) and the commodities safe harbor of

section 864(b)(2)(B)(ii) with respect to a dealer in a derivative which arguably might be classified as both a security and a commodity. Treasury and the IRS are also considering the appropriate application of the section 864(b)(2)(A)(ii) and (B)(ii) safe harbors to dealers in either stocks and securities or commodities who enter into a derivative transaction which arguably might be classified within both sections. Comments are solicited on these points including the classification of specific derivatives for purposes of the safe harbors.

Comments are also solicited regarding whether the final regulations should include derivative transactions in either the stocks and securities, or commodities trading safe harbors under sections 864(b)(2)(A)(i) and (B)(i). In particular, the IRS solicits comments as to whether certain dealers could inappropriately avoid the limitations of section 864(b)(2)(C) with respect to derivative transactions effected through independent agents in the United States.

2. Eligible Nondealer

Until Treasury and the IRS determine whether particular derivative transactions should be classified under the stocks and securities or commodities safe harbors, the proposed regulations provide that derivative transactions (including hedging transactions) do not constitute a U.S. trade or business if the

taxpayer meets the newly proposed definition of an "eligible nondealer."

An eligible nondealer is defined as a foreign resident taxpayer who is not a dealer in stocks, securities, commodities or derivatives at any time during the taxable year. Dealer status is determined on a worldwide basis and disqualifies a taxpayer from the safe harbor of the proposed regulations even if no dealing activities are conducted in the United States. For example, if a taxpayer is a dealer in commodities through its home country office and conducts no dealing activities through its U.S. office, but enters into derivative transactions for its own account through the U.S. office, the taxpayer fails to be an eligible nondealer.

Under the proposed regulations, the definition of dealer in stocks or securities refers to §1.864-2(c)(2)(iv) and the definition of dealer in commodities refers to the use of that term in §1.864-2(d). The definition of eligible nondealer contains language based on the definition of dealer in securities in 475(c)(1)(B), including regularly holding oneself out, in the ordinary course of one's trade or business, as being willing and able to enter into either side of a derivative transaction. See §1.475(c)-1(a)(2).

Treasury and the IRS are considering issuing additional guidance with respect to the definition of a dealer for purposes

of applying the trading safe harbors generally. Comments are solicited regarding the definition of a dealer, including the adequacy of the present rules in §1.864-2(c)(2)(iv) and §1.864-2(d), possible rules for identifying derivative transactions entered into with customers in the "ordinary course," and the appropriateness of adopting a definition similar to that provided in section 475(c)(1).

3. Swaps on U.S. Equities

Treasury and the IRS are aware that in order to avoid the tax imposed on U.S. source dividends under sections 871 and 881 and Chapter 3 of the Code, some foreign investors use notional principal contract transactions based on U.S. equities ("U.S. based equity swaps"). Accordingly, Treasury and the IRS are considering whether rules should be developed to preserve the withholding tax with respect to such transactions. Specifically, Treasury and the IRS are evaluating whether conduit (e.g., section 7701(l)) or other principles should be invoked in regulations, to characterize payments made with respect to U.S. based equity swaps as subject to U.S. withholding tax.

Treasury and the IRS are considering whether or not finalization of the proposed regulations as they relate to U.S. based equity swaps should await guidance concerning the application of the withholding rules to such transactions. Broadening the section 864(b)(2)(A)(ii) and (B)(ii) safe harbors

to include derivatives could impair the ability of the United States to tax U.S. source dividend payments.

Congress enacted the stocks and securities trading safe harbor in 1936 to provide certainty that foreign persons who merely trade stocks and securities would not be subject to the net income tax regime. Section 211(b), Revenue Act of 1936, Pub. L. 74-740, 49 Stat. 1648, 1714-15 (1936); S. Rep. No. 2156, 74th Cong., 2d Sess. 21 (1936). Congress' decision to include the safe harbor was premised on the fundamental assumption that ordinary income from U.S. stocks and securities would be appropriately subject to U.S. taxation through the withholding tax on fixed and determinable or annual and periodic income ("FDAP"), and that activities beyond the scope of the safe harbor would remain subject to net tax if the taxpayer was engaged in a trade or business or had an office in the United States. *Id.* The Foreign Investors Tax Act of 1966, which expanded the trading safe harbors to include trading activities conducted by or on behalf of a non-U.S. resident taxpayer through a U.S. office for the foreign taxpayer's own account, built upon the same principles reflected in the Revenue Act of 1936. See Section 102(d), Foreign Investors Tax Act of 1966, Pub. L. 89-809, 80 Stat. 1539, 1544 (1966); S. Rep. No. 1701, 99th Cong., 2d Sess. 16-17, 22-23, 32-33 (1966).

Treasury and the IRS request comments regarding the U.S. taxation of non-U.S. persons investing in derivatives generally in addition to the treatment of derivatives under the trading safe harbors. Comments are also solicited concerning the appropriate source of payments made pursuant to U.S. based equity swaps and whether conduit or other principles should be invoked for purposes of sections 871, 881 and Chapter 3 of the Code, including the circumstances under which such payments between non-U.S. resident counterparties (i.e., foreign-to-foreign payments) may be included in such regulations. In addition, comments are also solicited concerning the appropriate treatment of swaps or other derivative transactions on property (other than stocks and securities) that produce FDAP income, e.g., rents and royalties.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory impact analysis 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, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis under the Regulatory

Flexibility Act (5 U.S.C. Chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their 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 that are submitted timely to the IRS (a signed original and eight (8) copies). All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 9, 1998, at 10:00 A.M., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments by September 10, 1998, and submit an outline of the topics to be discussed and the time to be devoted to each topic by August 19, 1998.

A period of 10 minutes will be allotted to each person for making comments.

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

Proposed Effective Date

These regulations are proposed to be effective for taxable years beginning 30 days after the date final regulations are published in the **Federal Register**. Taxpayers may elect to apply the provisions of the final regulations to taxable years beginning before the date which is 30 days after these regulations are published as final in the **Federal Register**. No inference is intended regarding the treatment of derivative transactions under sections 864(b)(2)(A)(ii) and (B)(ii) and the current regulations. For periods prior to the effective date, taxpayers engaged in derivative transactions may take any reasonable position with regard to the section 864(b)(2)(A)(ii) and (B)(ii) safe harbors. Positions consistent with these proposed regulations will be considered reasonable.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1--INCOME TAXES

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

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

Par. 2. Section 1.864(b)-1 is added to read as follows:

§1.864(b)-1 Trading in derivatives.

(a) Trading for taxpayer's own account. As used in part I (section 861 and following) and part II (section 871 and following), subchapter N, chapter 1 of the Internal Revenue Code (Code), and chapter 3 (section 1441 and following) of the Code, and the regulations thereunder, if a taxpayer is an eligible nondealer, the term engaged in trade or business within the United States does not include effecting transactions in derivatives for the taxpayer's own account, including hedging transactions within the meaning of §1.1221-2.

(b) Definitions--(1) Eligible nondealer. For purposes of this section, an eligible nondealer is a person that is not a resident of the United States and is not, at any place (domestic or foreign), nor at any time during that person's taxable year, any of the following--

(i) A dealer in stocks or securities as defined in §1.864-2(c)(2)(iv)(a);

(ii) A dealer in commodities as that term is used in §1.864-2(d); or

(iii) A person that regularly offers to enter into, assume, offset, assign or otherwise terminate positions in derivatives with customers in the ordinary course of a trade or business, including regularly holding oneself out, in the ordinary course of one's trade or business, as being willing and able to enter into either side of a derivative transaction.

(2) Derivative. For purposes of this section, the term derivative includes--

(i) An interest rate, currency (as defined in paragraph (b)(3) of this section), equity, or commodity (as the term is used in section 864(b)(2)(B) and §1.864-2(d)) notional principal contract (as the term is used in section 475(c)(2)); or

(ii) An evidence of an interest, or a derivative financial instrument (including any option, forward contract, short position and any similar financial instrument), in any--

(A) Commodity (as the term is used in section 864(b)(2)(B) and §1.864-2(d));

(B) Currency (as defined in paragraph (b)(3) of this section);

(C) Share of stock (as the term is used in §1.864-2(c)(2));

(D) Partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust;

(E) Note, bond, debenture, or other evidence of indebtedness; or

(F) Notional principal contract described in paragraph (b)(2)(i) of this section.

(3) Limitation. For purposes of this section, the term currency is limited to currencies of a kind customarily dealt in on an organized commodity exchange.

/s/ Michael P. Dolan
Deputy Commissioner of Internal Revenue